Chapter 10: Small Business Issues

Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

ISSUE 1: HOBBY INCOME VERSUS BUSINESS INCOME

Each year the tax courts deal with many situations in which taxpayers claim business losses for activities that are related to hobbies. Most tax preparers are familiar with the factors to consider and can often tell at a glance which unprofitable activities do not qualify as a business.

However, **profitable** activities are seldom examined to determine if the activities should be considered hobbies. Classifying an activity as a hobby, rather than a business, eliminates self-employment tax liability on that activity. Unfortunately, deductions for the related expenses are limited.

The facts and circumstances of an activity should be reviewed periodically to determine if the activity is classified correctly. Has the business become a hobby? Has the hobby become a business? Which classification is most beneficial to the taxpayer?

WHEN IS AN ACTIVITY CONSIDERED SELF-EMPLOYMENT?

Net earnings from self-employment is defined by the Internal Revenue Code (Code) as gross income derived from any trade or business carried on by an individual less any allowable deductions.[1] "Trade or business" is not defined by the Code other than for limited circumstances.[2] The courts concluded that the facts of each case determine whether an activity is a business.[3] In the remainder of this section, "business" means "trade or business."

In 1987, the U.S. Supreme Court identified a two-prong test to determine whether an activity is engaged in as a business. To meet this test, the taxpayer must:

- Be involved in the activity with continuity and regularity, and
- Intend to generate a profit.

A sporadic activity, hobby, or amusement diversion does not qualify as a business.[4]

Note. The IRS also uses this test to determine that income is not from a business, and therefore, is not considered in calculation of the earned income credit.

1. IRC §1402(a)
2. *Commr. v. Robert P. Groetzinger,* 480 U.S. 23, 87-1 USTC ¶9191, February 24, 1987
3. *Eugene Higgins v. Commr.,* 312 U.S. 212, 41-1 USTC ¶9233, February 3, 1941
4. *Commr. v. Robert P. Groetzinger,* 480 U.S. 23, 87-1 USTC ¶9191, February 24, 1987

WHEN IS AN ACTIVITY CONSIDERED A HOBBY?

The term "hobby" is not actually used in the Code or defined in the regulations. It is commonly used to mean any activity that is not primarily engaged in for profit (i.e., sports and recreational pastimes), but it can also be used to mean any activity that is not a business.

In *Batok v. Commissioner,*[5] Batok had been paid as an independent contractor for installing windows for approximately one month. The Tax Court ruled that the taxpayer's activity, although engaged in for profit, did not rise to the level of a business. This interpretation is supported by IRC §183, which defines "activities not engaged in for profit." The purpose of this code section is to limit the deductions related to such activities. It also includes the **safe harbor test** that allows a taxpayer to be presumed to have a profit motive if the activity has a **net profit in three out of the last five years.**[6] For activities involving horses, the time frame is two out of seven years. If this test is met, the burden of proof shifts and the IRS must prove the activity is a hobby.

> **Caution.** A legitimate business can have losses for more than two years, and the losses are still deductible. Failing the safe harbor test simply puts the burden on the taxpayer to prove that sufficient profit motive exists to classify the activity as a business venture.

Meeting the test does not require the activity to be treated as a business; it merely gives the taxpayer a stronger argument to treat the activity as a business. Nothing in this section requires that all activities engaged in for profit be considered businesses. If profit motive were enough, anyone purchasing a lottery ticket would be in the business of buying lottery tickets.

> **Caution.** The IRS usually prefers to see profitable activities treated as businesses subject to self-employment tax. If the taxpayer and tax preparer conclude that the activity does not rise to the level of a business, they should be prepared to defend that conclusion.

DETERMINING PROFIT MOTIVE

To determine whether the taxpayer has a profit motive, the IRS issued **a list of nine factors** to consider in addition to any other factors relevant to each situation:[7]

1. Is the activity conducted in a businesslike manner?
2. Does the taxpayer or her advisors have the necessary expertise to create a profit?
3. How much time and effort are devoted to the activity?
4. Are the assets used in the activity expected to appreciate?
5. Has the taxpayer been successful in a related endeavor?
6. What is the history of income and losses for the activity?
7. Is the investment in the venture reasonable compared to potential profits?
8. Does the taxpayer have substantial income from other sources?
9. Is the activity pleasurable or fun?

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5. *John A. and Mary L. Batok v. Commr.,* TC Memo 1992-727, 64 TCM 1605, December 28, 1992
6. IRC §184(d)
7. Treas. Reg. §1.183-2(b)

Note. These factors are also discussed in the Rulings and Cases Chapter and in the *2003 University of Illinois Federal Tax Workbook,* pages 430-434.

Therefore, although a lack of profit motive limits the deductions that are available, neither profit nor motive creates a business.

Example 1. From February to August of 2004, Samantha watched her sister's child while her sister worked. She was paid $4,000 by the state and issued a Form 1099-MISC at the end of the year showing the income as nonemployee compensation. Samantha does not have a babysitting license and does not watch any other children. She has no out-of-pocket costs since the mother provides all of the child's food, toys, and other needs.

Samantha was 19 and living at home during the time she was babysitting. She had no other income. In August, she left home to go to college. Her parents provided over half of her support.

The following compares the tax consequences of classifying this activity as a business versus a hobby:

	Business	Hobby
Net self-employment income	$4,000	
Deduction for ½ SE tax	(283)	
Other income		$4,000
Standard deduction	(3,967)	(800)
Taxable income	$ (250)	$3,200
Income tax (from tax table)	0	323
Self-employment tax	565	0
Total tax liability	$ 565	$ 323

Question A. Does Samantha meet the conditions of being in business?

Answer A. A period of six months may or may not be considered continuous and regular enough to conclusively determine that an activity constituted a business. Samantha claims that although she appreciated being paid, her motive was to help her sister, not to make money.

Question B. How does her situation compare to the nine factors used to determine profit motive?

Answer B.

1. **Business-like manner:** Samantha does not describe herself as being in the babysitting business. She does not keep separate records, advertise, or attempt to obtain additional customers.
2. **Special expertise:** Samantha has no childcare training or licensing.
3. **Time and effort:** Six months was spent in the activity, but no efforts were made to build an ongoing business.
4. **Appreciating assets:** None
5. **Previous profitable businesses:** None
6. **History:** None
7. **Profit versus investment:** Since she had nothing invested in the activity, the rate of return was excellent.
8. **Financial status:** Samantha had no other sources of income and was supported by her parents.
9. **Elements of personal pleasure:** Samantha loved spending time with her niece (most days).

Conclusion. Samantha's tax preparer believes that she has a defendable position for treating this activity as a hobby.

Example 2. Use the same facts as **Example 1** except, Samantha is **not claimed as a dependent** by her parents since they did not provide over half of her support in 2004. Samantha lived with a boyfriend from April through December 2004. He cannot claim her as a dependent since she did not live with him for the whole year. The following information compares the tax consequences of her characterizing the babysitting as a business versus hobby.

	Business	Hobby
Net self-employment income	$4,000	
Deduction for ½ SE tax	(283)	
Other income		$4,000
Standard deduction	(4,850)	(4,850)
Personal exemption	(3,100)	(3,100)
Taxable income	($4,233)	($3,950)
Income tax	0	0
Self-employment tax	565	0
Total tax liability	$ 565	$ 0

Conclusion. Treating this activity as a hobby lowers Samantha's tax liability in the current year. However, the activity treated as a business offers benefits such as social security coverage, improved creditworthiness, and so on. She should discuss all possibilities with her tax preparer. By treating the activity as a hobby, Samantha may receive a notice from the IRS assessing SE tax.

REPORTING THE INCOME AND EXPENSES OF A HOBBY

How income is reported depends on the product or service sold. Gross hobby income, other than net gains from capital assets and collectibles, is reported on Form 1040, line 21 (Other Income). Net gains from capital assets and collectibles are reported on Form 1040, Schedule D. Net gains should be reported correctly as short-term or long-term. The maximum rate on most long-term collectibles is 28%. **Net losses from sales of hobby merchandise and collectibles are not deductible.**

Note. Inventory for sale to customers in the ordinary course of business is not a capital asset.[8] However, since there is no business, the products for sale are classified as capital assets.

Example 3. Henry is a full-time astrophysicist. He sells Home Exterior products on the side. Henry admits that his only motive for being a product rep. is to get the dealer discount and supply his family with merchandise. After considering all of the factors, Henry's CPA determines that he is not in the business of selling Home Exterior products. The CPA prepares his taxes using the following information:

Wages	$80,000
Product sales	6,000
Cost of products	4,000
Selling expenses	500

8. IRC §1221

The net gain from the sales of the product $2,000 ($6,000 – $4,000) is reported as a short-term gain on Schedule D. Since Henry does not itemize, he cannot deduct his selling expenses.

Henry's tax liability from the hobby is $560 ($2000 × 28%). If he were in "business," the related taxes would be $602 ($212 SE tax + $390 income tax on the $1,500 net business profit).

Hobby expenses, other than the costs of products used to determine net gain, are reported on Form 1040, Schedule A. Treasury Regulations[9] specify the order in which deductions may be taken for these expenses by categorizing them into three tiers:

- **Tier 1** expenses are **those related to the hobby** and also qualify as deductible under other provisions of the Code. This includes home mortgage interest, taxes, and casualty losses. These are normally Schedule A deductions. These deductions are not limited to the income from the hobby. However, if first tier expenses exceed the hobby income, no further deductions for hobby expenses are allowed.
- **Tier 2** expenses are **those that do not result in an adjustment to the basis of property.** Examples include advertising, supplies, and travel. Deductions for Tier 2 expenses cannot exceed gross income minus Tier 1 expenses.
- **Tier 3** expenses are **those that reduce the basis of property such as depreciation.** Deductions for Tier 3 expenses cannot exceed gross income minus the previous tiers.

The expenses in Tiers 2 and 3 are subject to the 2% AGI limitation. Expenses in excess of income do not carry forward. However, disallowed Tier 3 expenses do not reduce the asset's basis.

Example 4. Paige sells homemade Thingies instead of name-brand merchandise. She purchased a $10,000 machine to make the Thingies. Despite her large investment, she is still doing this for fun instead of profit. She borrowed against her home equity line-of-credit to buy the machine. Paige has the following deductions on Schedule A.

Mortgage interest (1st mortgage)	$3,000
Mortgage interest (home equity loan)	1,000
Real estate tax	800
Charitable contribution to church	900
Unreimbursed employee expenses (unrelated to hobby)	1,500

Paige had a net gain of $2,000 from Thingies. Following is the calculation for her allowable deductions related to the hobby income.

		Where Reported
Net gain from products	$2,000	Schedule D, short-term
Home equity interest	(1,000)	Schedule A
Remaining profit for Tier 2 & 3 expenses	$1,000	
Selling expense (Tier 2)	(500)	Schedule A, line 22
Remaining profit for Tier 3 expenses	500	
Depreciation allowable on machine (Tier 3)*	(500)	Schedule A, line 22
	0	

*Not to exceed remaining profit for Tier 3 expenses. Any excess depreciation is not deductible.

Paige's Schedule A is shown on the following page.

9. Treas. Reg. §1.183-1

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For Example 4

SCHEDULES A&B (Form 1040) — Department of the Treasury, Internal Revenue Service

Schedule A— Itemized Deductions

(Schedule B is on back)

► Attach to Form 1040. ► See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074 — 2004 — Attachment Sequence No. 07

Name(s) shown on Form 1040: Paige — Your social security number: 111 22 3333

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see page A-2)		
	2	Enter amount from Form 1040, line 37		
	3	Multiply line 2 by 7.5% (.075)		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		
Taxes You Paid (See page A-2.)	5	State and local income taxes		
	6	Real estate taxes (see page A-2)	800 00	
	7	Personal property taxes		
	8	Other taxes. List type and amount ►		
	9	Add lines 5 through 8		800 00
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	4,000 00	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ►		
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules		
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)		
	14	Add lines 10 through 13		4,000 00
Gifts to Charity (If you made a gift and got a benefit for it, see page A-4.)	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	900 00	
	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500		
	17	Carryover from prior year		
	18	Add lines 15 through 17		900 00
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)		
Job Expenses and Most Other Miscellaneous Deductions (See page A-5.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-5.) ►	1,500 00	
	21	Tax preparation fees		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ► Hobby expense (Tier 2 & 3)	1,000 00	
	23	Add lines 20 through 22	2,500 00	
	24	Enter amount from Form 1040, line 37 — 82,000 00		
	25	Multiply line 24 by 2% (.02)	1,640 00	
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-		860 00
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ►		
Total Itemized Deductions	28	Is Form 1040, line 37, over $142,700 (over $71,350 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 39. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ►		6,560 00

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2004**

Paige's tax liability from the hobby is $70. If she was characterized as in "business," a net business loss of up to $9,500 could be deducted, saving over $2,400 in taxes.

TRANSITIONING

Just as there is **no definitive rule** to determine if an activity is a business or a hobby, **no criteria exist which determines when a business changes into a hobby or vice versa.** Consider the following situations and the classification of each:

Example 5. The Auto Mechanic. John owned a profitable automobile repair shop five years ago. When he got out of the business, he sold the building where the shop was located. He now repairs cars in his garage at home to supplement his social security and investment income. For the last three years he has reported a loss on the activity, but he says he can't quit because he needs the money.

Possible taxpayer argument: John believes that he devotes sufficient time and effort to his work to classify it as a business. He intends to and does make a profit. John demonstrates that the loss he reports is created by taking advantage of the home office deductions for mortgage interest and real estate taxes. He indicates these expenses would continue even if he closed the business. He contends that a review of the facts in relation to the nine tests for profit motive shows that he has the expertise and track record sufficient to prove a profit motive.

Possible IRS argument: John's sporadic work repairing cars does not rise to the level of a legitimate business activity. Since he has not met the safe harbor test of profits in three out of the last five years, John must prove that his profit motive is sufficient to classify this activity as a business. The IRS contends that a review of the facts in relation to the nine tests for profit motive leads them to conclude that:

- He is not conducting the activity in a businesslike manner,
- He does not devote enough time to the business to be trying to make a profit,
- There is no expectation of asset appreciation, and
- His income from other sources is such that he doesn't need this to be profitable to support himself.

Example 6. The Home Enthusiast. Dick is a retired teacher with a flair for home decorating. He holds a real estate license. Periodically, he purchases run-down homes and fixes them up in his spare time. After the homes are refurbished, he sells them at a profit. He usually doesn't sell more than one home per year. He doesn't need the income and he spends a great deal of his time each year traveling for pleasure.

Possible taxpayer argument: Dick argues that the homes are investments, subject to capital gain treatment. He says that he does not sell enough homes nor devote enough of his time to the investments to be considered to be in business.

Possible IRS argument: Dick has a clear profit motive related to the real estate activities. He has a real estate license. Although his sales are not frequent, they do generate a substantial level of gross income. Furthermore, the fact that Dick has been participating in this activity for several years indicates that it is an ongoing business venture.

Example 7. The Crafter. Geoff is a stay-at-home dad. His wife has an executive position with a local corporation. Geoff makes decorative doodads and sells them at the annual citywide craft fair. For the past two years, he reported his income as hobby income. This year, he stepped up the pace of production, began selling at other craft fairs, and placed his products on consignment with a local craft store. He traveled quite a bit during the summer and purchased a lot of supplies for setting up his craft booths. He even applied for a sales tax number and purchased a laptop for keeping track of his business records. He hopes that the venture will become profitable in the next few years.

Possible taxpayer argument: Geoff contends that he is now in the business of making doodads. He is devoting a substantial amount of time and effort to the activity and intends to make money as soon as his doodads become popular. The fact that he has registered with the state and is keeping business records proves that he is serious about this business.

Possible IRS argument: Geoff has not proved that he has a profit motive in the activity. Although the activity is currently conducted in a business-like manner as compared to the past, the taxpayer still does not meet most of the other tests for profit motive, such as expertise, time, past success, and so on.

Example 8. The Artist. Jane paints artwork. For the past ten years, she has been selling her work in art galleries and craft shows, as well as painting commissioned pieces. Historically, she made enough to support herself and appropriately reported her profits as business income. Last year she got tired of subsistence living and got a full-time job with CPA Geeks, Inc. She hasn't painted anything new since she started with the CPA firm, but she still sells pieces from her collection.

Possible taxpayer argument: Jane insists that she is no longer in business. She believes that reporting her sales as long-term capital gains is correct since she spends essentially no time on her painting activities.

Possible IRS argument: Jane's sales are as a result of her previous self-employed activities. According to Treasury Regulations, income derived from an individual's trade or business may be subject to self-employment tax even when the income is from services rendered in a prior taxable year.

Caution. There are a number of factors in addition to tax liability that should be considered in determining proper tax treatment. Factors to consider: hobby income does not qualify for consideration in the EITC, social security, bank loans, and so on.

ISSUE 2: RECORDKEEPING

One of the most common questions asked of professional tax preparers is "How **long** should I keep my tax returns/ business records?" The reason for this question's popularity is because taxpayers don't want to store endless amounts of paper. However, taxpayers seldom ask "What **type** of records should I keep?"

As trusted advisors, it is important for tax preparers to inform clients of the specific records to retain as required by law and/or the IRS. The following is intended as an introduction to recordkeeping for small businesses. A taxpayer starting a new business should use the following IRS publications for detailed information about rules and regulations affecting businesses:

- IRS Pub. 15, *Circular E, Employer's Tax Guide*
- IRS Pub. 334, *Tax Guide for Small Business (For individuals who use Schedule C or C-EZ)*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 538, *Accounting Periods and Methods*
- IRS Pub. 583, *Starting a Business and Keeping Records*

BASIC RECORDKEEPING REQUIREMENTS

For most small businesses, income and expenses are summarized from information recorded in the checkbook. However, before anything is written in the checkbook, there is usually a piece of paper that triggers an entry. For example, a check is written because a bill is received. The bill usually shows the date of the transaction and what was purchased; it is called a "supporting document."

Supporting Documents to Keep

General. Supporting documents that are generally used by small businesses are:

- Check register,
- Bank statements,
- Depreciation schedules, and
- Year-end inventory calculations.

These documents may be kept either on paper or electronically.

Income Related. Supporting documents related to income are typically:

- Invoices given to customers,
- Bank deposit slips,
- Receipt books,
- Cash register tapes,
- Credit card sales slips, and
- Forms 1099-MISC and 1099-INT received by the business.

Expense Related. Supporting documents typically related to outgoing transactions or expenses are:

- Invoices from vendors,
- Cancelled checks,
- Cash register receipts,
- Account statements,
- Credit card charge slips,
- Real estate closing statements, and
- Forms 1099-MISC and 1099-INT issued by the business.

Caution. Proof of payment of an amount, by itself, does not establish deductibility. Documents that show why the cost was incurred must also be kept. For example, a credit card statement may show a $500 charge at the office supply store. However, the statement does not show whether what was purchased was a Personal Digital Assistant for business use or an MP3 player for a child's birthday.

SPECIFIC RECORDKEEPING REQUIREMENTS

Specific recordkeeping rules apply to expenses related to travel, transportation, entertainment, and gifts. IRS Pub. 463, *Travel, Entertainment, Gifts, and Car Expenses,* provides useful information about these expenses. Evidence is usually considered adequate if it shows the amount, date, place, and business purpose of the expense.

The chart at the end of this section summarizes the special requirements for these expenses.

Sampling

If an adequate record is kept for part of the tax year, that record can be used to prove the amount of business or investment use for the entire year.[10] Other evidence must demonstrate that the periods for which the record is kept are representative of the use throughout the tax year.

> **Example 9.** Sandy uses her car to visit the offices of clients, meet with suppliers, and pick up and deliver items to clients. She and her family also use the car for personal purposes. She keeps adequate records during the first week of each month that show that 75% of the use of the car is for business. Invoices and bills show that her business use continues at the same rate during the later weeks of each month. Her weekly records are representative of the use of the car each month and are sufficient evidence to support the percentage of business use for the year.

The IRS released guidance on establishing the amount of meal and entertainment expenses when the expenses are not subject to the 50% limitation.

> **Note.** Statistical sampling is addressed in Rev. Proc. 2004-29 which is covered in Chapter 13, Rulings and Cases, Business Expenses.

Car Expenses

Several uses of a car can be considered part of a single use, such as a round trip or uninterrupted business use, and documented with a single record. Minimal personal use, such as a stop for lunch on the way between two business stops, is not an interruption of business use.

> **Example 10.** Howard makes deliveries at several different locations on a route that begins and ends at his office. He can account for these using a single record of miles driven. This is true even if he also stops to pick up his dry cleaning between two of the deliveries.

10. Temp. Treas. Reg. §1.274-5T(c)(3)(ii)

HOW LONG TO KEEP BUSINESS RECORDS

Taxpayers must keep records "as long as they may be needed for the administration of any provision of the Internal Revenue Code."[11] Some books and records of a business may be "material" for tax purposes as long as the business remains in existence. In addition, there may be nontax reasons to retain certain records for an indefinite period of time. The IRS recommends that copies of filed returns be kept indefinitely. The general time requirement can be separated into two categories:

1. **Records of Property.** Records of property, required to determine a basis to compute gain or loss upon disposition, depreciation, or amortization, must be kept until a taxable disposition is made. After the disposition, the time requirements listed below apply.

Example 11. In 1995, Phil bought a backhoe. Before it was fully depreciated, he traded it for another backhoe in 2000. Phil sold this backhoe in 2004. He must take both backhoes into account when calculating the realized gain/loss. Therefore, even though the 1995 backhoe is now fully depreciated, the supporting documents for both backhoes might be required if the 2004 return is audited.

2. **Records of Income, Deductions and Credits.** At a minimum, records of income, deductions, and credits appearing on a tax return should be kept until the statute of limitations expires on the tax return. Generally, tax must be assessed within three years of the date the return is filed or two years after payment, whichever is later.[12] A claim for refund or credit must be filed within three years after the date the return is filed or two years after payment was made, whichever is later.[13]

If the taxpayer...	Then the period is...
1. Owes additional tax and 2, 3, and 4 do not apply	3 years
2. Does not report income that he should and it is more than 25% of the gross income shown on the return	6 years
3. Files a fraudulent return	No limit
4. Does not file a return	No limit
5. Files a claim for credit or refund after filing the return	Later of 3 years or 2 years after tax was paid
6. Files a claim for a loss from worthless securities	7 years
7. Has employment records	4 years after the tax becomes due or is paid.

Note. Returns filed before the due date are treated as filed on the due date.

There are specific recordkeeping requirements if accounting records are kept using an automatic data processing system.[14] These requirements generally apply to multi-million dollar businesses and are not covered in this section.

11. 26 CFR 1.6001-1

12. 26 CFR 301.6501(a)-1

13. 26 CFR 301.6511(a)-1

14. Rev. Proc. 98-25

Fraud. While fraud carries an unlimited time period for an IRS audit, the IRS often has a difficult time proving fraud. The determination of whether fraud exists is a difficult problem for the courts. It is best explained in a court case which lists several indications of fraud or "badges of fraud."[15] They include:

1. Understatement of income,
2. Inadequate books and records,
3. Failure to file tax returns,
4. Implausible or inconsistent explanations of behavior,
5. Concealment of assets,
6. Failure to cooperate with tax authorities,
7. Filing false Forms W-4,
8. Failure to make estimated tax payments,
9. Dealing in cash,
10. Engaging in illegal activity, and
11. Attempting to conceal illegal activity.

Employment Taxes. If a business has employees, employment tax records must be kept for at least four years after the date the tax becomes due or is paid, whichever is later. For more information about recordkeeping for employment taxes, see IRS Pub. 15, *Circular E, Employer's Tax Guide*.

DOCUMENTATION TO PROVE EXPENSES

Expenses should be listed in an account ledger or log, this can include reports kept on the computer. In addition, documentation showing the date, place, amount, and the "essential character" of the expense should be kept to support the ledger entries. Receipts, bills, and cancelled checks usually contain the required information for most types of expenses. For the expenses listed in the following table, additional support is required.

15. *Gold Bar, Inc. DBA All American Trucking Co v. Commr.,* TC Memo 2000-211, 80 TCM 33, July 10, 2000

SPECIFIC RECORDS AND INFORMATION REQUIRED TO SUPPORT CERTAIN EXPENSES

Type of Expense	Figuring the Amount	Time	Place or Description	Business Purpose and Business Relationship
TRANSPORTATION				
Vehicle	Use the standard mileage rate (published by the IRS annually) multiplied by the business miles, or actual expenses multiplied by the percent of business use. With either method, a record should be kept of the date the vehicle was first used for business, the mileage for each business use, and the total miles for the year. To use actual expenses, keep track of the costs of the vehicle, operating expenses and improvements.	Date of the expense. For car expenses, the date of the use of the car.	The business destination	**Purpose:** Business purpose for the expense **Relationship:** N/A
Other transportation	Cost of each separate expense	Date	Destination	**Purpose:** Business purpose of the expense
TRAVEL	Cost of each separate expense for travel, lodging, and meals Incidental expenses may be totaled in reasonable categories such as taxis, daily meals, telephone, etc. Special rules apply on cruise ships.	Dates of departure and return for each trip and number of days spent on business	Destination or area of travel (name of city, town, or other designation)	**Purpose:** Business purpose for the expense or the business benefit gained or expected to be gained **Relationship:** N/A
ENTERTAINMENT	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc. may be totaled on a daily basis. Only 50% of entertainment expenses are deductible.	Date of entertainment	Name and address or location of place of entertainment Type of entertainment if not otherwise apparent	**Purpose:** Business purpose for the expense or the business benefit gained or expected to be gained For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion, the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.

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SPECIFIC RECORDS AND INFORMATION REQUIRED TO SUPPORT CERTAIN EXPENSES (continued)

Type of Expense	Figuring the Amount	Time	Place or Description	Business Purpose and Business Relationship
GIFTS	Cost of the gift The maximum amount of deductible gifts is generally $25 per person per year.	Date of the gift	Description of the gift	**Relationship:** Occupations or other information, such as names, titles, or other designations about the recipients that shows their business relationship to the business
MEALS	The cost of the meal if it was for entertainment purposes	Date		See **Entertainment** above. In addition, records must show that an employee or owner was present during the entertaining meal.
	If the meal expense was incurred while traveling out of town, use either the actual cost of the meals or figure the costs using the published meal and incidental rates by city multiplied by the number of days at each location. The rates can be found on the Internet at www.policyworks.gov/perdiem or in IRS Pub. 1542, *Per Diem Rates (For travel within the continental United States).*	Dates of travel		See **Travel** above.
LISTED PROPERTY Cell phones Computers and peripherals Cameras Other property generally used for entertainment, recreation, or amusement	A log must be kept which shows the amount of business use and personal use. Expenses related to the property must be prorated based on the percentage of business use. A log is not required if the property is exclusively used on the business premises or as part of the business purpose.	Dates used		Business purpose for the expense

ISSUE 3: CASUALTY LOSSES FOR A BUSINESS OR RENTAL PROPERTY

Taxpayers who experience a casualty loss may be able to deduct the loss for tax purposes. For a casualty loss related to a business or rental property, the method of deducting the loss is different than for other losses.

DEFINITION OF A CASUALTY LOSS

Numerous actions can create a casualty loss. Generally, the loss must be caused by an event resulting from some unusual, unexpected, or sudden event. Situations giving rise to a casualty loss include:

- Storms,
- Shipwrecks,
- Fires,
- Earthquakes,
- Hurricanes,
- Floods,
- Blasting,
- Car collisions,
- Freezing,
- Theft, and
- Drought.

Since the event causing the loss must be unforeseen, losses from the following are **not** considered casualty losses:

- Disease and insect damage to plants
- Moth damage to a fur coat
- Termite damage
- Rusting
- Contamination to a well
- Drying up of a well from a drought
- Normal deterioration of property

An individual's loss of a deposit from the insolvency of a financial institution may be considered a casualty loss. However, this loss might also qualify as a short-term capital loss under the bad debt provisions.

LIMITATIONS ON THE DEDUCTIBLE LOSS

The loss amount is calculated as the difference between the fair market value (FMV) of the property before and after the casualty.[16]

16. Treas. Reg. §1.165-7(a)(2)(i)

Example 12. Jane owns rental real estate that was damaged by a tornado. Before the loss, the property was worth $70,000. After the loss, and before any repair work was done, the property was worth $40,000. Jane has a loss of $30,000.

If the property is insured, the loss deduction is reduced by any insurance proceeds. The loss is also limited to the adjusted basis in the property.[17]

Example 13. Use the same facts as **Example 12.** Jane received $19,000 in insurance proceeds related to her $30,000 loss. Since she was reimbursed for a portion of the loss, only $11,000 is deductible as a casualty loss.

Example 14. Use the same facts as **Example 12.** Jane's adjusted basis in the property is $3,000. Her deduction is limited to the $3,000 basis.

Note. Jane also has a reportable gain. This is discussed later in this section.

CALCULATING THE LOSS

In order to claim the loss, the taxpayer must be able to substantiate the amount of the casualty loss. The best approach is to have a professional appraisal of the property after the casualty. The appraisal should also include an estimate of the property's value before the casualty. Unfortunately, many taxpayers do not have a post-casualty appraisal done until the damaged property has been repaired.

If the taxpayer does not have an appraisal to substantiate the loss, the IRS allows the taxpayer to use the cost-of-repairs method to determine the loss. This method results in an estimate of the loss based on the cost of the repairs required to return the property to its precasualty condition.[18] To use the cost-of-repairs method, the following conditions must be met:

- The repairs were actually made.
- The repairs were necessary to bring the property back to its precasualty condition.
- The amount spent for repairs is not excessive.
- The repairs take care of the damage only.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Example 15. Jane, from **Example 12,** did not think to get a real estate appraisal of the damaged property before she had the property repaired. She spent $27,000 to repair the house and landscape. This amount can be used to determine the amount of loss, if the repairs meet the above conditions.

Example 16. Use the same facts as **Example 15** except, Jane spent $36,000 on the house and landscape after the tornado. In addition to making the repairs, she had a room addition built. The expenses for the room addition totaled $10,000. Consequently, only $26,000 can be used to estimate the loss of value in the property.

17. IRC §§165(a) and (b)

18. Treas. Reg. §1.165-7(a)(2)(ii)

FORM 4684

Form 4684, *Casualties and Thefts,* is used to report casualty losses. **Section A is used to report personal property losses. Section B is used for reporting business or rental property losses.**

Example 17. Georgie purchased rental property on April 1, 2001 for $40,000. His property was damaged by a tornado on May 10, 2004. His adjusted basis before the tornado struck was $35,739 ($40,000 basis – $4,261 depreciation). According to the county tax assessor, prior to the damage, the property was worth $60,000. Georgie conducted research on sales of comparable undamaged property in the area and determined the assessed value of his property was accurate.

In all the confusion following the tornado, Georgie didn't remember to get an appraisal of the property before repairs were made. The repairs cost $25,000 which covered the building and the landscape. The repairs were necessary, not excessive, applied to the tornado damage only and merely restored the property to its previous condition. Therefore, the assumed FMV after the casualty is $35,000 ($60,000 – $25,000). The property was insured and the insurance proceeds were $20,000 for the loss.

Georgie has a net loss of $5,000 which carries to Georgie's Form 4797, line 14 and Form 1040, line 14. Georgie's Form 4684, page 2, Section B is completed as follows:

For Example 17

Form 4684 (2003) Attachment Sequence No. **26** Page **2**

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.
Georgie

Identifying number **111-22-3333**

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** Residential Rental Real Estate, Smalltown, USA, 04-01-2001
Property **B**
Property **C**
Property **D**

	Line	Properties A	B	C	D
20 Cost or adjusted basis of each property	20	35,739			
21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3	21	20,000			
Note: *If line 20 is* ***more*** *than line 21, skip line 22.*					
22 Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	22				
23 Fair market value **before** casualty or theft	23	60,000			
24 Fair market value **after** casualty or theft	24	35,000			
25 Subtract line 24 from line 23	25	25,000			
26 Enter the **smaller** of line 20 or line 25	26	25,000			
Note: *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.*					
27 Subtract line 21 from line 26. If zero or less, enter -0-	27	5,000			

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions) **28** 5,000

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft		(b) Losses from casualties or thefts: (i) Trade, business, rental or royalty property	(ii) Income-producing and employee property	(c) Gains from casualties or thefts includible in income
Casualty or Theft of Property Held One Year or Less				
29		( )	( )	
		( )	( )	
30 Totals. Add the amounts on line 29	30	( )	( )	
31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	31			
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, partnerships, and S corporations, see instructions	32			
Casualty or Theft of Property Held More Than One Year				
33 Casualty or theft gains from Form 4797, line 32	33			
34 Tornado 05-10-2004		(5,000)	( )	
		( )	( )	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii)	35	(5,000)	( )	
36 Total gains. Add lines 33 and 34, column (c)	36			
37 Add amounts on line 35, columns (b)(i) and (b)(ii)	37			(5,000)
38 If the loss on line 37 is **more** than the gain on line 36:				
a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	38a			(5,000)
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11	38b			
39 If the loss on line 37 is **less** than or **equal** to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3, column (g) and the net post-May 5 gain or (loss), if applicable, in column (h)	39			

Note: *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.*

Form **4684** (2003)

ADJUSTING BASIS AND DEPRECIATION

The basis of the property **must be reduced by the amount of insurance proceeds and the amount of loss claimed from the casualty.**[19] The new basis must be used for calculating depreciation for the remainder of the property's useful life.

Example 18. Use the same facts as **Example 17.** Georgie calculates the property's new basis by subtracting the insurance proceeds and loss claimed from his adjusted basis at the time the tornado struck. His new basis is $10,739 ($35,739 adjusted basis – $20,000 insurance – $5,000 loss).

Residential rental real estate is depreciated over 27½ years (or 330 months). As of May 10, 2004, Georgie claimed 37 of the 330 months of depreciation. The property's remaining life is 293 months.

The new basis of $10,739 is depreciated over 293 months starting May 10, 2004.

DEDUCTING THE REPAIR EXPENSE

Although repair costs can be used to calculate the amount of loss, the taxpayer may still deduct the actual costs of the repairs. The casualty loss deduction only relates to the loss in FMV of the property, not the cash expenditures for repairs.[20] Repairs can be deducted if they return the property to its condition prior to the casualty without making the property more valuable, more useful, or longer-lived.

If repairs materially improve the value, use, life expectancy, strength, or capacity of the property they should be capitalized. Although the IRS often disallows repair deductions for large expenditures, the courts have recognized that even large expenditures may qualify as repairs.[21]

Example 19. Use the same facts as **Example 17.** Based on the repairs made, Georgie determines they neither improve his property nor significantly extended its useful life. He is prepared to defend his position in court and has supporting documentation. Georgie claims the $25,000 in repair expenses on his Schedule E in addition to depreciation, real estate taxes, mortgage interest, and other expenses of owning the rental property.

Rental real estate is subject to the passive activity loss limitations, and the casualty loss must be included in the total loss from this activity.

Example 20. Use the same facts as **Example 19.** After deducting repair costs and other expenses, Georgie has a net loss of $29,800 on his Schedule E. With his casualty loss of $5,000, his total loss is $34,800. Georgie's income is $90,000 and he actively participates in the management of the property. He is allowed a maximum of $25,000 rental loss deduction from his passive activities. The allowed loss is prorated between the casualty and the rental loss and the remaining unallowed losses of $9,800 ($34,800 – $25,000) are carried forward to next year.

> **Note.** Insurance proceeds are taken into consideration when computing the new basis. They do not reduce the repair expense.

19. IRC §1016(a)(1)

20. Letter Ruling 199903030

21. *Nevia Campbell v. Commr.,* TC Summary Opinion 2002-117, September 6, 2002; and *Thomas J. Northen v. Commr,* TC Summary Opinion 2003-113, August 13, 2003

SPECIAL PROVISIONS FOR DISASTER AREAS

Losses that occur in an area declared eligible for federal assistance under the Disaster Relief and Emergency Assistance Act have special rules. When a loss occurs in one of these areas, the taxpayer may choose to deduct the loss either on:

- The current year's return (when the disaster occurred), or
- A return for the immediately preceding tax year.

To deduct the loss on the previous year's return (or amended return), the loss is treated as if it happened in the previous year. A statement should be attached to the return indicating the:

- Taxpayer is making an election to deduct the loss on the previous year's return,
- Date of the disaster, and
- City or town, county, and state where the damaged or destroyed property was located at the time of the disaster.

The choice to take the casualty loss in the preceding year generally must be made by the due date, **without** extensions, for filing the income tax return for the tax year in which the disaster actually occurred.

Example 21. Daria is a calendar-year taxpayer. She has until April 15, 2005, to amend her 2003 tax return to claim a casualty loss that occurred during 2004.

To revoke the choice, the refund/credit created by the election must be returned to the IRS within 90 days after filing the return with a statement indicating the choice is being revoked. If the revocation is made before the refund is received, the refund must be returned within 30 days after receiving it in order for the revocation to be effective.

Note. A list of the Presidentially Declared Disaster Areas is available at the Federal Emergency Management Agency (FEMA) web site (www.fema.gov).

CASUALTIES THAT RESULT IN GAINS

When insurance proceeds are greater than the adjusted basis of the asset, a gain results.

Real Estate

If the insurance payment is more than the adjusted basis of the damaged property, the taxpayer has a gain from the casualty. The gain is equal to the amount received minus the adjusted basis in the property at the time of the casualty.

Example 22. Helen owns rental real estate with an adjusted basis of $24,000. The property was destroyed in a flood on July 25, 2004. Her insurance company reimbursed her $34,000 for the loss. Helen has a gain of $10,000 due to the casualty ($34,000 – $24,000).

Reporting the gain from a casualty can be **postponed** if the reimbursement is used to restore or replace the damaged property. The replacement period **begins** on the date the property was damaged. The replacement period **ends** two years after the close of the first tax year in which any part of the gain is realized.

To postpone reporting all of the gain, the cost of the replacement property must be at least as much as the reimbursement received. If the ultimate cost of the replacement property is less than the reimbursement, the gain is included in income up to the amount of the unspent reimbursement.

Example 23. Use the same facts as **Example 22.** The land on which Helen's property was located is completely submerged. Therefore, her property is considered totally worthless. Consequently, Helen decides to buy a replacement rental house located farther away from the river. She purchases the replacement property on March 16, 2005 for $8,000. Helen plans to make extensive improvements to the property during the summer of 2005. Helen attaches the following election to her 2004 tax return.

Director
Internal Revenue Service Center
Kansas City, MO 64999

Notice of Replacement of Involuntarily Converted Property

Helen Lane
200 River Road
Riverview, IL 55555

Identification Number: 111-22-3333

Tax Year End: 12/31/04

Helen Lane hereby notifies the IRS of the following information in regard to certain involuntarily converted property:

Will the involuntarily converted property be replaced? Yes
Converted Property Information:
Description of Converted Property: Residential rental real estate: 245 S. 1st St., Town and State
Date of Conversion: 07/25/04
Type of Conversion: Flood destroyed house and rendered land useless.
Replacement Property Information:
Description of Replacement Property: Residential rental real estate: 400 S. 8th St., Town and State
Date of Acquisition: 03/16/2005
Cost of Replacement Property: $8,000
Expiration Date of Replacement Period: 12/31/06

Computation of Any Gain Realized:

Acquisition cost	$30,000
Less: Accumulated Depreciation	(6,000)
Adjusted basis at conversion date	$24,000
Proceeds from involuntary conversion	34,000
Less: Adjusted basis (above)	24,000
Realized gain	$10,000

$8,000 of the gain was reinvested on March 15, 2005. The remaining $2,000 will be reinvested prior to December 31, 2006.

____ Date: ____________________
Helen Lane

Inventory

There are two ways to report casualty losses of inventory and related insurance reimbursements.

1. Deduct the loss through the increase in the cost of goods sold by reporting opening and closing inventories based on the actual quantities on hand. This loss may not be claimed again as a casualty loss. If the loss is taken through the increase in the cost of goods sold, any insurance reimbursements are included in gross income.
2. Deduct the loss separately. If it is deducted separately, the affected inventory items are eliminated from the cost of goods sold by making a downward adjustment to opening inventory or purchases. The loss is reduced by the reimbursement received. The reimbursement is not included in gross income.

If the reimbursement is not received by the end of the year, no loss can be claimed to the extent there is reasonable prospect of recovery.

Business Personal Property

Generally, if a single casualty or theft involves more than one item of property, the loss on each item must be calculated separately. To calculate the loss:

Determine which is the least:

- Decrease in the FMV, or
- Remaining basis of the property

Subtract any insurance reimbursements from that lesser amount.

The combined losses for all items determine the total loss from that casualty or theft.

> **Note.** Often there is no remaining basis because the asset was fully depreciated or expensed at the time of purchase. In addition, the FMV of the asset prior to the casualty should not be confused with the replacement cost, since most of the assets are replaced with newer and more valuable items.

Crops and Cattle

Losses of livestock, plants, produce, and crops raised for sale are generally not deductible if the taxpayer uses the cash method. The cost of raising these items was previously deducted as farm expenses.

Often farmers raise crops in one year and sell them the next. In the event of a casualty, insurance proceeds might be received in the year of the disaster for commodities that ordinarily would have been sold the following year. This causes the farmer's gross income to be unusually high one year and unusually low the next year. The tax code provides relief for this problem by allowing a farmer to elect to defer reporting the income to the next year.[22]

Similar relief is also provided to farmers who are forced to sell livestock solely because of drought, flood, or other weather-related conditions.[23]

The taxpayer may elect to defer reporting sales of livestock until the next year. However, if the livestock is replaced within the replacement period, the farmer may elect to postpone the gain until the replacements are sold. The replacement period generally ends two years after the close of the first tax year in which any part of the gain from the involuntary conversion is realized.

22. IRC §451(d)
23. IRC §451(e)

ADDITIONAL INFORMATION

The following IRS Publications may provide additional information for the preparation of a return involving a casualty loss:

- IRS Pub. 547, *Casualties, Disasters, and Thefts*
- IRS Pub. 584, *Casualty, Disaster, and Theft Loss Workbook*
- IRS Pub. 584B, *Business Casualty, Disaster, and Theft Loss Workbook*

ISSUE 4: RENTALS

When an individual taxpayer brings in information regarding a rental activity, the tax preparer typically thinks about filing a Schedule E, since profits reported on Schedule E are exempt from self-employment (SE) tax. Any losses incurred are subject to the passive activity loss rules.[24] Depending on the situation, Schedule E may not be the correct form. One test used by the IRS to establish if rental income is subject to SE tax is whether the rental activity has risen to a level considered a trade or business.

One often cited court case in this area is the *Stevenson* case.[25] Mr. Stevenson owned and operated a one-man business. He rented portable advertising signs, as well as selling and repairing them. Based on testimony, Mr. Stevenson purchased portable signs and assembled them for either rental or resale. In addition, he sold used signs that he previously rented. He advertised his business in the Yellow Pages, in newspapers and on portable signs. In the eyes of the Tax Court, this was sufficient to make Mr. Stevenson's activity qualify as a trade or business.

The following section discusses various types of rentals and how they are reported.

NONFARM RENTAL REAL ESTATE PROPERTY

Nonfarm rental real estate property is normally a very straightforward transaction. The property owner reports all rents received and all expenses incurred, including depreciation, on Schedule E. An individual that individually owns real property and rents it to his own corporation is able to avoid SE tax on the rental profit. However, there is an exception if this is farm real estate and the owner also materially participates in the farming corporation.[26]

Because of the SE savings, a sole proprietor may be tempted to pay rent from his Schedule C business to himself as the owner of the real estate. The IRS does not recognize this as a rental transaction and will assess the SE tax.[27]

10

Real Estate Owned by Both Husband and Wife

Whether rents from real estate owned by both a husband and wife can be deducted has been litigated in the Tax Courts. The courts have not allowed any rental deduction for the portion of the property belonging to the business owner. However, they have allowed the rent paid to the business owner's spouse to be deducted.

In the *Cox* case,[28] Mr. and Mrs. Cox purchased a building in 1980 and held title to the building as tenants by the entirety. In 1987, Mr. Cox's law practice occupied space in the building. The law practice paid $18,000 rent for use of the space. The money was paid by Mr. Cox to his wife and himself.

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24. IRC §469

25. *Carl and Floy M. Stevenson v. Commr.,* TC Memo 1989-357, 57 TCM 1032, July 24, 1989

26. IRC §1402(a)(1)

27. IRC §162(a)(3)

28. *D. Sherman and Maxine M. Cox v. Commr.,* (CA-8), U.S. Court of Appeals, 8th Circuit, 96-2896, 97-2 USTC ¶50,582, August 5, 1997

The IRS refused to allow the rent as a deduction and assessed a tax deficiency. The court allowed that half of the rental deduction, the part paid to Mrs. Cox, and the half to Mr. Cox was disallowed under IRC §162(a)(3). The court noted the fact that Mr. Cox was a sole practitioner and operated the law practice as a sole proprietorship.

> **Note.** The result would have been different if Mr. Cox operated the business as a corporation because all rent payments could have been expensed.

In 1974, the IRS addressed a similar issue. A couple owned Wisconsin real estate as joint tenants. The taxpayer only sought a deduction for the rent for the half of the property owned by his wife. The IRS allowed the deduction and based their opinion on Wisconsin law. In Wisconsin, if a joint tenancy is present, each of the joint tenants is entitled to half of the rental income. In fact, the IRS ruling stated that under Wisconsin law, the taxpayer has a definite obligation to pay his wife half of the fair rental value of the real estate.[29]

> **Note.** The result may be different in other states.

Space

Whether the rental of space is considered to be self-employment income is another litigated question. One argument is that space is a part of real estate and should be exempt from SE tax. However, the exemption is very much a facts and circumstances issue. The Code provides that the term "net earnings from self-employment" means the gross income less deductions from any trade or business.[30] In computing net earnings from self-employment, rentals from real estate less any attributable deductions are excluded, unless the rentals are received in the course of a trade or business as a real estate dealer under IRC §1402(a)(1).[31]

Payments for the use of rooms or other space where services are also rendered to the occupant are not rentals from real estate.[32] Examples include hotel rooms, tourist homes and camps, space in parking lots, and storage units. Generally services are considered rendered to the occupant if they are for the occupant's convenience and are other than those ordinarily rendered with the rental of rooms or other space for occupancy. Furnishing maid service is such a service, while furnishing heat and lights are not considered services rendered to the occupant.

In the *Bobo* court case,[33] the taxpayers rented space in a trailer park. The court ruled these rents were rents from real estate and were exempt from SE tax. The taxpayer furnished sewerage, vacant mobile home maintenance (for the trailers owned by the park and used as rentals), trash collection, grounds maintenance, and a laundry facility with equipment owned by a concessionaire. The court looked to determine if the services were provided for the convenience of the tenant or if they were required to maintain the space in a condition for occupancy. The court agreed that all of the services, except the laundry facility, were provided to keep the premises in a condition for occupancy. They ruled the laundry service was an insignificant part of the rental and did not raise the level of the activity to a trade or business.

In a Letter Ruling,[34] which cited the *Bobo* case, the IRS ruled against a taxpayer who rented out space in an antique mall. This taxpayer rented space to house her antique mall. She then subleased the floor space to up to 60 antique dealers. The rent was based on location and square footage used. In addition, dealers were required to pay the taxpayer 10% of the sale price of merchandise sold from the space.

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29. Rev. Rul. 74-209
30. IRC §1402(a)
31. Treas. Reg. §1.1402(a)-4(a)
32. Treas. Reg. §1.1402(a)-4(c)(2)
33. *Fabian and Florence Bobo v. Commr.,* 70 TC 706, August 17, 1978
34. Letter Ruling 9421001

The mall owner was at the antique mall most of the hours it was open. If she was not there, she hired a person to be present. She answered buyer's questions, wrote up sales receipts and collected the money and sales tax from the sale. She also advertised the mall. The dealers visited their space to restock, organize their antiques, and some met with customers. The IRS ruled the taxpayer was liable for SE tax for both the floor space charge and the 10% commission.

FARM PROPERTY

There are situations where the rental of farm real estate differs from nonfarm real estate. One of the basic differences deals with material participation.

Cash Rent Farm Real Estate with No Participation

The IRS has not challenged situations where farm real estate is rented to an entity where there is no material participation by the landowner. Therefore, these rents are free of SE tax and are reported on Schedule E.

Paying rent to a nonparticipating spouse can have a totally different result, however. In one IRS Letter Ruling, the IRS opinion was that a farmer was not entitled to deduct rents paid to his wife. Consequently, his farming income was higher and his SE tax liability increased. The facts of the case were not in favor of the taxpayers.

The couple did not consistently treat the wife's interest in the farmland as separate rental property. The husband had deducted the full amount of mortgage interest and property taxes as expenses on his Schedule F. However, the rental payments were treated as though the wife had separately owned the farmland.

The IRS commented that in order for the rental arrangement to be recognized for tax purposes, the couple needed to share the economic burden of ownership and claim separate expenses for the property. Because they failed to maintain consistency in the tax reporting, it did not appear there was a bona fide landlord–tenant relationship.[35]

Cash Rent Farm Real Estate with Participation

Normally, a cash lease for farmland is exempt form SE tax and is reported on Schedule E. However, it is possible for a landlord to provide enough participation to trigger the SE tax. This is most likely to occur when the land is cash rented to an entity in which the landowner is actively participating. This is often referred to as the Mizell Problem.

Renting Land to a Family Entity — the Mizell Problem. The *Mizell*[36] case involved an Arkansas farmer who rented 731 acres of farmland to a family partnership operated with his three sons. The father owned a 25% interest in the partnership and the partnership agreement specified that each partner had an equal vote in the management of the partnership operation and in the conduct of the farming business. Each partner was required to work full-time in the operation, and the father was active in the partnership in the years in question and reported the distributive share of partnership income as net earnings from self-employment. The lease was on a 25% crop-share basis with the partnership paying all of the crop expense.

The father treated the lease as a nonmaterial participation lease and did not reflect the rental amounts as self-employment income. The Tax Court focused on the language in IRC §1402(a)(1) providing an exception to the general rule that rentals from real estate are excluded from net earning from self-employment if there is an "arrangement" with material participation by the owner in the "production or the management of the production" of agricultural commodities. The court noted that the father was materially participating in the partnership operations and the statutory language referring to "an arrangement" necessarily included the father's involvement in the partnership as well as under the lease. Thus, the rental income under the lease was subject to SE tax. The type of lease, the court reasoned, was immaterial where the lessor was materially participating in the lessee entity.

35. IRS Letter Ruling 9206008

36. *Lee and Pearlene Mizell v. Commr.,* TC Memo 1995-571, 70 TCM 1469, November 29, 1995

Subsequent Cases and Rulings. A 1996 technical advice memorandum[37] reached the same conclusion with a cash rent lease to a corporation. Three Field Service Advice rulings in 1998 were in accord.[38]

In three cases decided in 1999, the Tax Court applied *Mizell* and imposed SE tax on rents from land rented to a family farming operation.[39] On appeal, the three Tax Court cases were consolidated and were reversed in late 2000.[40] The Eighth Circuit held that the lessor–lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were "consistent with market rates for agricultural land" the rents were not "derived under an arrangement" and, therefore, SE tax was not due. The court pointed out that "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received" into self-employment income. The court pointed out that rents consistent with market rates "very strongly suggest" that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production. The court remanded the cases to the Tax Court to provide an opportunity for the IRS to show a connection between rents and the "arrangement."

On July 10, 2002, the Tax Court rendered its remand opinion holding that the rental arrangements reflected FMV and that no SE tax should be imposed.

Two additional cases were published in 2004. In the first, the taxpayer rented hog barns to his corporation at a higher than fair market value. The court ruled the rent was self-employment income.[41] In the second case, the Tax Court found the cash rents paid were at fair market value and the lease was at arm's length. They ruled no SE tax was due.[42] Both cases are eligible for appeal in the Eighth Circuit.

Note. These cases are covered in Chapter 13, Rulings and Cases, and Chapter 12, Agricultural Issues.

Note. Based on the Eighth Circuit's opinion in *McNamara*, it is imperative that taxpayers potentially subject to challenge set the rental rates at FMV for comparable land. In addition, it is important that evidence of rental rates be preserved for use in any later audit.

Practice Pointers. For taxpayers occupying a dual status as lessor and lessee, it is important for the lease to be in writing with standard terms and conditions calling for a reasonable rental. Also, it is important for the status as partner, employee, or LLC member to be formally established and maintained.

The *Mizell* case involved a partnership. A more general solution to the problem may be to convey the land to another type of entity (such as an LLC or LLP), since the regulations on handling self-employment income for such pass-through entities are still in limbo.

The key, outside the Eighth Circuit, is to make sure that the taxpayer is not on "both sides of the equation" as both lessor and lessee. In the IRS view, supported by the Tax Court opinion in *Mizell*, the question is whether the taxpayer's combination of involvement as lessor and lessee rises to the level of material participation. In the Eighth Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota) the key is to make sure the rental rate is representative of a fair market rental for comparable land.

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37. TAM 9637004, May 1, 1996

38. FSA Ltr. Rul. 9917008, December 10, 1998; FSA Ltr. Rul. 9917005, December 10, 1998; FSA Ltr. Rul. 9917006, December. 10, 1998

39. *Vincent E. and Judy Bot v. Commr.,* TC Memo 1999-256; *John P. and Teresa Hennen v. Commr.,* TC Memo 1999-306; *Michael and Nancy McNamara v. Commr.,* TC Memo 1999-333

40. *Michael and Nancy McNamara v. Commr.,* US-CT-APP-8, 2001-1 USTC ¶50,188, December 29, 2000

41. *Jere J. Solvie,* TC Memo 2004-55, March 9, 2004

42. *Gerald E. Johnson,* TC Memo 2004-56, March 9, 2004

Another approach may be to transfer the land to a nonparticipating spouse and have the spouse lease the land to the farming business under a passive lease.

Observation. The IRS continues to litigate *Mizell*-type situations. A case involving an upstate New York apple tree and produce farm was pending in the Tax Court and could have been appealed to the Second Circuit; however, the case was settled without releasing any details.[43] Another case appealable to the Eighth Circuit[44] involved the cash leasing of land by a family partnership to a corporation controlled by the same individuals. The IRS argued that the partnership rental income was subject to SE tax. On January 28, 2003, a stipulated decision was entered. The IRS entirely dropped the assessment of SE tax. This case was within the same jurisdiction as *McNamara* and the taxpayer obtained independent verification each year that rental amounts were similar to other rents in the area.

Note. In early 2003, the U.S. Senate considered legislation that would constrain the IRS to examining only the lease agreement to determine if sufficient material participation under the lease is present.[45] However, the provision was not included in the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Cash Rent Farm Real Estate and Equipment

For retired clients renting both machinery and real estate, including both in the same lease may strengthen the argument that the amounts received are not subject to SE tax. The statutory language of IRC §1402 should be strong enough to specifically exclude the rental income from self-employment tax if the taxpayer is not materially participating.

In this situation, the rental income is reported on Schedule E.

Crop Share Farm Real Estate with Participation

Any time there is participation in an activity, SE tax becomes an issue. If the taxpayer is performing services in connection with the rental, the IRS usually rules that SE tax should be paid. In this case, the income would be reported on Schedule F.

In some cases, the courts have allowed minor participation without assessing SE tax.[46] Unfortunately, "minor" has not been defined.

Example 24. Wanda owns 500 acres that she crop shares with a neighbor. The only decision Wanda makes regarding the farm is whether to participate in the government program. Her involvement is likely considered "minor" participation and not subject to SE tax. Wanda reports her income and expense on Form 4835.

Example 25. Use the same facts as **Example 24** except, Wanda decides which fields are planted in corn and soybeans. She specifies when the crop is to be harvested so her grandson has the best hunting conditions, regardless of whether this is the best farming practice. She specifies which seed varieties to use and markets her share of the crop. The IRS will likely rule her participation is more than minor and that she should report her income and expenses on Schedule F.

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43. *Fowler Farms v. Commr.,* TC Docket No. 013920-01, December 11, 2001

44. *Milton v. Commr.,* TC Docket No. 13594-01, December 4, 2001

45. S. 665

46. *M.A. Felber v. Commr.,* 64 TCM 261, TC Memo 1992-418, aff'd, CA-8, July 2, 1993

Crop Share Farm Real Estate with No Participation

If the tenant is making all decisions relating to field selection, seed varieties, fertility, and general farming practices, the IRS will not likely challenge the amount of participation. Income and expenses are reported on Form 4835. However, losses may be limited due to the passive activity rules.

EQUIPMENT

A note on Form 1040, Schedule E, Part 1 states, "If you are in the business of renting personal property, use Schedule C or C-EZ." This raises concerns about the proper reporting of a retired businessperson's rentals from personal property such as construction machinery rented to children or others. Several high profile audits, in which examining agents have taken a relatively aggressive stance on the issue, have added to the concerns.

> **Note.** IRC §1402 imposes SE tax on **net earnings from self-employment derived by an individual during the taxable year.** Excluded from this definition are "rentals from real estate and from personal property leased with real estate." The statutory language does not provide exclusion for the rental of personal property apart from the real estate. **The statute requires an individual to be engaged in a trade or business in order for income to be self-employment income.** For a taxpayer to be engaged in a trade or business, he must be engaged in an activity for the primary purpose of producing income or profit and must be involved in the activity with continuity and regularity.

When a business person retires, he may decide to rent his machinery and equipment for a period of time rather than sell it and face depreciation recapture in the year of sale. If he is retired and the equipment is not leased with his business, the IRS may question whether he is in the trade or business of renting equipment. If the IRS determines he is in the trade or business, the rental income is subject to SE tax. He must report the income and any related expenses on Schedule C.

If he is not in the trade or business, the rent is not subject to SE tax and the rent is reported on Form 1040, line 21 (Other Income) and identified as personal property rental income. Deductible expenses related to income on line 21 from rental of personal property engaged in for profit should be reported on Form 1040, line 32, and identified as "PPR."

Example 26. Clem, a retired contractor, rented his backhoe to a neighbor for $150 per day. The neighbor used the backhoe for two days to install a sewer. Clem reports the $300 received for rent of his backhoe on Form 1040, line 21. Clem is not engaged in the trade or business of renting machinery or equipment. If Clem rents the backhoe to his neighbor every year or to a number of neighbors, the IRS may argue that Clem is in the trade or business of renting backhoes.

Practice Pointers

For clients who rent machinery to another, **the key is whether the client, as lessor, is carrying on a trade or business**. If the client is carrying on a trade or business, rentals are included in the client's self-employment income and are reported on Schedules C or F. If the client is not carrying on a trade or business, the rentals involved are not included in self-employment income.

For clients who rent personal property but do not want self-employment income, the lease should be drafted to **place responsibility on the lessee for maintenance and repair of the rental property.** The client, as lessor, should avoid involvement in management or decision making relative to the property under the lease. Even in this case, the IRS may argue that the rental is a trade or business.

VACATION PROPERTY

There are special rules dealing with the rental of vacation properties. Depending on the situation, the taxpayer may report expense deductions on Schedule E, Schedule A, or prorate the deductions and report on both. For many taxpayers, renting the vacation property for a portion of the year is the only way they can afford the property.

Personal Use

The basic determination is whether the property is a residence or not a residence. The IRS uses a 14 day or 10% rule to make this determination.

Property Is Considered a Residence if It Is:	Tax Treatment
Used greater than 14 days for personal use or more than 10% of total days rented	No deductions in excess of rental income
Rented for less than 15 days	Income is tax-free; no deduction for rental expenses

Example 27. Hank and Sandy own a condo in Orlando, FL. They use the property for their winter vacation for four weeks in March each year. The remainder of the time, they allow the condo association to rent it on a monthly basis. Hank and Sandy receive the rental income minus a 25% handling fee the condo association charges for managing the rental and getting the condo ready for the new tenant. In 2003, the association rented the condo for a total of 250 days. The rental income, net of the condo fee was $25,000 ($33,333 gross rental income minus $8,333 gross rental income).

Since the owners used the property for **over 14 days, they must look to the 10% rule** to determine if their deductions are limited.

250 days × 10% = 25 days

Hank and Sandy used the property for 27 days. Consequently, they are limited in their Schedule E deductions.

The following illustrates the allocations to Schedule E and Schedule A.

Rental portion	250 days ÷ 365 days = 68.49%
Residential portion*	115 days ÷ 365 days = 31.51%

*Any day that the property is available for rent, but not actually rented is **not** a day of rental use.

Item	Total	Rental Portion	Residential Portion
Rental income	$33,333	$33,333	$ 0
Expenses			
Utilities	4,000	2,740	1,260
Condo fees	2,000	1,370	630
Rental fee	8,333	8,333	0
Real estate tax	5,000	3,424	1,576
Mortgage interest	18,000	12,328	5,672
Depreciation	9,000	6,164	2,836
Total expenses	$46,333	$34,359	$11,974
Net rental	($13,000)	($ 1,026)	($11,974)

The $1,026 rental loss is not deductible. This loss can be carried forward to future years. Only the mortgage interest and real estate taxes are allowable itemized deductions. Therefore, the total itemized deduction produced by the vacation home is $7,248 or ($1,576 + $5,672). Hank and Sandy effectively sheltered their rental income.

Example 28. Use the same facts as in **Example 27** except, the condo association guarantees Hank and Sandy $25,000 of rental income each year. The condo association collects more than $25,000 in rent and it retains the excess. Hank and Sandy can deduct their rental expenses against the rental income since the condo association rented the property for all but the 27 days the property was used by the owners.[47]

The Ninth and Tenth Circuits do not agree with the IRS on the calculation of the allocations. These two circuits ruled that for mortgage interest and real estate taxes a full 365 days is used in the denominator to calculate the percentage of rental use rather than the number of days rented.

A personal-use day is considered to be the 24-hour period for which a normal rental is calculated. Therefore, if the owner occupies the property on Friday and Saturday night, it is considered two days even if they arrive at noon on Friday and leave on noon Sunday.[48] Personal-use days do not include owner "work days" on the condo.

Use by Family Members

Use by a family member is considered to be personal use, even if they pay a fair rental value. Family members include spouses, brothers, sisters, ancestors, lineal descendants, and spouses of lineal descendants.[49] If the family member **pays a fair rental value** and uses the property **as their principal residence,** the time rented is not counted as personal use.[50]

Any rental under a reciprocal arrangement, whether or not a fair rental is charged, is considered personal use.

Example 29. Terri and Randy own a vacation home in Canada which they typically rent for $700 per week. They agree to trade their friends Chris and Kay, who own a property in St. Thomas, a week at the St. Thomas property for a week at the Canada property. The St. Thomas property rents for $2,000 per week, so Terri and Randy pay Chris and Kay $1,300. This is considered to be a week's personal use by both couples.

Any use of the vacation property is considered to be personal use if less than a fair rental amount is charged.

Donation of Use of Vacation Property

A taxpayer may donate the right to use his vacation property to a charity fund-raising auction. Even though the week's use is sold at or above the fair rental value, the use by the successful bidder is considered to be a week's personal use. **A charitable deduction is not available to the property owner** because the gift of a right to use property is not a deductible contribution.

RENTAL OF PROPERTY WITH SERVICES

An arrangement where the landlord agrees to furnish services in conjunction with the rental of property can result in SE tax.

Example 30. Wanda owned Water Tite Storage Units and reported her income and expenses on Schedule C each year. Wanda has no employees and manages the property herself. She collects the rents, keeps the outside premises clean, and does whatever is needed to run the business. Wanda only has a 55% occupancy rate and is having trouble meeting her mortgage payments. She discussed her financial problems at a bridge game with her friend Patsy. Patsy, a marketing expert, believes the occupancy rate could be increased to 95% with the proper promotion.

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47. *M. Razavi v. Commr.,* CA-6, 96-1 USTC ¶50,060, 74 F3d 125, January 29, 1996

48. *Dorrance D. and Helen A. Bolton v. Commr.,* U.S. Court of Appeals, 9th Circuit, 82-2 USTC ¶9699, December 2, 1982, and *Edith G. McKinney v. Commr.,* U.S. Court of Appeals, 10th Circuit, 83-2 USTC ¶9655, October 3, 1983

49. IRC §267(c)(4)

50. IRC §280A(e)(1)

Patsy offers to rent the entire unit for $30,000 per year if Wanda continues to manage and operate the business. Wanda does not receive any additional money for her services. Wanda accepts the offer since it will provide her with enough cash flow to meet her payments, and she doesn't think Patsy can increase occupancy. If occupancy increases, Wanda need not extend the lease at the end of the year.

Wanda must continue to report the $30,000 of income and any deductions on Schedule C. The net income is reported on Schedule SE.

Note. Wanda could avoid SE tax if she had two separate agreements, one for the rental and one for her services.

Similar situations exist in farming. It is not uncommon for a farmer to rent his unused hog facilities to a large hog producer. In such an agreement, the producer pays all expenses while the building owner furnishes the buildings and all the labor. The landlord is paid either a flat fee or a fixed fee for each pig that goes through the facility. In this situation the landlord reports the income on Schedule F.

Note. This information is also covered in Chapter 1, Individual Taxpayer Problems, Passive Activities.

ISSUE 5: CHANGE IN DEPRECIATION METHOD USING FORM 3115

INTRODUCTION

Form 3115, *Application for Change in Accounting Method,* is one of the most complicated forms issued by the IRS. It is designed to cover hundreds of different situations that result in a change in accounting method. Anyone using the form should pay careful attention to the detailed instructions provided by the IRS and should review the Revenue Procedures applicable to the requested change.

Changes in depreciation are generally covered under the automatic change procedures. This allows the application to be filed with the return and without an application fee. Applying for a change in accounting method to claim previously unclaimed depreciation allows the taxpayer to deduct, in the **current year,** the entire amount of depreciation not previously deducted.[51]

This is significant because depreciation errors may have affected tax returns that are no longer open for amendment. In addition, when an asset is sold, the "allowed or allowable" rules **require the taxpayer to reduce the asset's basis by depreciation that:**

- **Was claimed,** and
- **Could have been claimed.**[52]

Without the Form 3115 adjustment, the taxpayer would pay taxes on the allowable depreciation in the year the asset is sold, even though the taxpayer never received the tax benefit of the depreciation deduction.

51. Rev. Proc. 2002-19 (Section 2.02(1))

52. Treas. Reg. §1.1016-3(b)(2)

WHEN AND HOW TO FILE

Two copies of Form 3115 are filed when requesting an automatic change:

1. The original Form 3115 must be attached to the taxpayer's timely filed (including extensions) federal income tax return for the year of the change.
2. A copy of Form 3115 must be filed with the IRS National Office no earlier than the first day of the year of change and no later than when the original is filed with the tax return.

The address for the IRS National Office is in the Form 3115 instructions. Special procedures and limitations apply to late filed applications.

For an application related to post-disposition depreciation, the original must be filed with a timely filed amended return for the year of the disposition. The copy of Form 3115 must be filed with the IRS National Office no later than the when the original is filed.

LIMITATIONS ON WHO CAN FILE AUTOMATIC CHANGE REQUESTS

Even if the type of change is allowed under the automatic change procedures, the following applicants are generally not allowed to use the automatic change procedures:

- Applicants under examination by the IRS
- Applicants who are a member of a consolidated group that is under examination, or before Appeals, or before a Federal Court for the tax year(s) the applicants was a member of the group
- Applicants who are a partnership or S corporation and the accounting method change requested is an issue under consideration in an examination, before Appeals, or before a Federal Court with respect to a partner, member, or shareholder of the applicants
- Applicants who have made or applied to make the same change within the last five tax years, including the year of change
- Corporate applicants who have acquired assets from another corporation (as described under IRC §381(a)) during the tax year of the change
- Applicants who are in the final tax year of the trade or business

Of course, there are exceptions to these limitations. Rev. Proc. 2002-9 covers these limitations and exceptions in depth.

Note. If an applicant is not allowed to use the automatic change procedure, the Advance Consent Procedures may be utilized.

DEPRECIATION CHANGES ALLOWED AS AUTOMATIC CHANGES

There are 76 accounting method changes that can be requested under the automatic change procedures. These are included in the instructions for Form 3115. Seven of these changes specifically deal with depreciation. They include changing:

1. From an impermissible method of depreciation to a permissible method,
2. In the year of disposition from an impermissible method to a permissible method,
3. From one permissible method to another permissible method,
4. To the original tire capitalization method,
5. The asset class of gas pump canopies,
6. The asset class of assets owned by a utility company, and
7. The asset class of cable TV fiber optics.

Example 31. Morgaine forgot to tell her accountant about the $20,000 she spent in 1999 on office furniture. She still owns and uses the furniture. The 1999 return was timely filed, and therefore cannot be amended for a refund. Morgaine's accountant wants to file Form 3115 to change the depreciation method from an impermissible method (none) to a permissible method.

Example 32. Use the same facts as in **Example 31** except, Morgaine sold the furniture in 2003. In 2004, her accountant wants to file Form 3115 with an amended return to change the depreciation method **in the year of disposition** from an impermissible method to a permissible one.

Example 33. John's former accountant set up all of his assets using the straight-line depreciation method. His new accountant suggests that he change to the sum-of-the-years-digit method for qualifying assets. John wants to change from one permissible method to another permissible method.

Caution. Changes from one permissible method to another permissible method are not discussed further in this section. However, the list of allowable changes is very specific. Temp. Treas. Reg. §1.446-1T and Rev. Proc. 2004-11 should be studied before attempting to apply for this type of change.

Changing from Impermissible to Permissible Method

Rev. Proc. 2004-11 revised the provisions for using the automatic change procedures to apply for a change from an impermissible method to a permissible method of accounting for depreciation or amortization. Section 1 in the appendix of this Rev. Proc. replaces the corresponding section of Rev Proc. 2002-9 for this type of change. The following special rules are found in Rev. Proc. 2004-11 and are specific to this type of change.

Exceptions to Ineligibility Guidelines. Some applicants who otherwise would not qualify for the automatic change procedures can still use these procedures for changing from an impermissible method to a permissible method. These are applicants who would not otherwise qualify because they:

- Are in the final year of business, or
- Were involved in an IRC §381 transaction during the year.[53]

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53. Rev. Proc. 2004-11, Appendix Section 1.01(1)(c) specifies that the scope limitations in Rev. Proc. 2002-9 §§4.02(7) and (8) are not applicable for this change

Nonqualifying Changes in Methods of Accounting. There are 15 specific changes which do not qualify under these provisions:[54]

1. Changes related to property held by tax-exempt organizations
2. Changes related to depreciation of capitalized inventory costs under IRC §263A if the costs are not being capitalized as required
3. Changes in the pooling methods used for assets
4. Changes related to property depreciated under the income forecast method
5. Reclassification of IRC §1250 property to an asset class that doesn't specifically include IRC §1250 property (for example, asset class 57.0, Distributive Trades and Services)
6. Revocations or late elections relating to amortizable IRC §197 intangibles
7. Changes in the useful life of property, if the useful life is not specifically assigned by the Code, Treas. Regs., IRS, and so on
8. Changes in computing depreciation in the taxable year in which the use of an asset changes in the hands of the same taxpayer
9. Changes related to property depreciated under the ADR system
10. Changes from expensing to capitalizing costs
11. Changes from one permissible method to another permissible method
12. Changes involving both reclassifying items from nondepreciable to depreciable and adopting a method of depreciation that requires an election to use that method
13. Changes not related to depreciation
14. Changes from MACRS to ACRS for property subject to the transition rules for making such a change
15. Changes to the placed-in-service date of property

The Two-Year Rule Waived. A taxpayer adopts an impermissible method of depreciation when he treats the property the same improper way in two or more consecutively filed federal tax returns. Previously, an asset had to be depreciated improperly for at least two years to apply for an automatic change to correct the depreciation. However, Rev. Proc. 2004-11 waived the two-year rule requirement, so that the depreciation for all improperly depreciated assets can be corrected using Form 3115. In order to take advantage of this waiver for one-year assets, all other impermissible depreciation must be corrected as well.

Example 34. Lola prepared and timely filed her own taxes for 1999 through 2003. She purchased residential rental real estate in 1999 and also in 2003. During both years, she started depreciating the properties over 40 years rather than 27½ years. She used an impermissible method for five years for the property purchased in 1999 but only for one year for the 2003 property. The only way to claim the correct depreciation for the 1999 property is to file Form 3115. Under the old rules, she would have to file Form 3115 to correct the depreciation for the 1999 asset and file an amended return to correct the depreciation for the 2003 asset. Under the new rules, she also has the option to correct the depreciation for both assets on a single Form 3115. However, she cannot file Form 3115 to correct the depreciation for only the 2003 asset. She must include the 1999 asset.

54. Rev. Proc. 2004-11 Appendix Section 1.01(1)(d)

Note. Some argue that reclassifying the life of an asset is just a correction of a clerical error and not a change in accounting method. Taxpayers have been successful with that argument in recent court cases.[55] However, Form 3115 filed under the automatic change procedures is less likely to be challenged by the IRS than using clerical corrections to change the asset class.

Required Statements.[56] The taxpayer must attach the following information to the application unless the information is already provided elsewhere on the form:

- A detailed description of the former and new methods of accounting
- A description of the business or income-producing activity related to the property
- The facts and law supporting the new method of accounting, classification, and asset class
- The year the asset was placed in service
- If the ACRS depreciation method is used, the asset class that applies under the former and new methods of accounting
- If the property is public-utility property, a statement agreeing to specified terms and conditions
- If the property classification is being changed from real estate (IRC §1250) property to a "retail motor fuels outlet," a representation regarding the property's qualifications for the change (the required wording is provided in Rev. Proc. 2004-11)
- If the property classification is being changed from real estate (IRC §1250) to personal property (IRC §1245), a representation regarding the authority for the classification (the required wording is provided in Rev. Proc. 2004-11)

Example 35. Thea owns a retail clothing store. While preparing her 2004 return, her accountant realized that she forgot to depreciate a computer purchased in 1998 for $1,350. The computer is still in use in her store. The accountant prepared the following Form 3115.

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55. *Commr. v. Brookshire Brothers Holding, Inc.,* U.S. Court of Appeals, 5th Circuit, 2003-1 USTC ¶50,214, January 29, 2003, and *Roger O'Shaughnessy v. Commr.,* U.S. Court of Appeals, 8th Circuit, 2003-1 USTC ¶50,522, June 13, 2003

56. Rev. Proc. 2004-11 Appendix Section 1.01(2)

For Example 35

Form **3115** (Rev. December 2003) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

OMB No. 1545-0152

Name of filer (name of parent corporation if a consolidated group) (see instructions) **Thea**	**Identification number (see instructions)** **333-22-1111** Principal business activity code number (see instructions) **448190**
Number, street, and room or suite no. If a P.O. box, see the instructions. **20 Street Ave.**	Tax year of change begins (MM/DD/YYYY) **01/01/04** Tax year of change ends (MM/DD/YYYY) **12/31/04**
City or town, state, and ZIP code **Small Town, USA 99999**	Name of contact person (see instructions) **Embarrassed TaxPreparer, EA**
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)	Contact person's telephone number (**555**) **555-1212**

If the applicant is a member of a consolidated group, check this box ▶ ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached, check this box ▶ ☑

Check the box to indicate the applicant.

- ☑ Individual
- ☐ Corporation
- ☐ Controlled foreign corporation (Sec. 957)
- ☐ 10/50 corporation (Sec. 904(d)(2)(E))
- ☐ Qualified personal service corporation (Sec. 448(d)(2))
- ☐ Exempt organization. Enter Code section ▶
- ☐ Cooperative (Sec. 1381)
- ☐ Partnership
- ☐ S corporation
- ☐ Insurance co. (Sec. 816(a))
- ☐ Insurance co. (Sec. 831)
- ☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. (see instructions)

- ☑ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☐ Other (specify) ▶

Caution: *The applicant must provide the requested information to be eligible for approval of the requested accounting method change. The applicant may be required to provide information specific to the accounting method change such as an attached statement. The applicant must provide all information relevant to the requested accounting method change, even if not specifically requested by the Form 3115.*

Part I Information For Automatic Change Request	Yes	No
1 Enter the requested designated accounting method change number from the **List of Automatic Accounting Method Changes** (see instructions). Enter only one method change number, except as provided for in the instructions. If the requested change is not included in that list, check "Other," and provide a description. ▶ (a) Change No. **7** (b) Other ☐ Description ▶		
2 Is the accounting method change being requested one for which the scope limitations of section 4.02 of Rev. Proc. 2002-9 (or its successor) **do not** apply?	✓	
If "Yes," go to Part II.		
3 Is the tax year of change the final tax year of a trade or business for which the taxpayer would be required to take the entire amount of the section 481(a) adjustment into account in computing taxable income?		✓
If "Yes," the applicant is not eligible to make the change under automatic change request procedures.		

Note: *Complete Part II below and then Part IV, and also Schedules A through E of this form (if applicable).*

Part II Information For All Requests	Yes	No
4a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) under examination (see instructions)?		✓
If you answered "No," go to line 5.		
b Is the method of accounting the applicant is requesting to change an issue (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) either (i) under consideration or (ii) placed in suspense (see instructions)?		

Signature *(see instructions)*

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Filer	**Preparer (other than filer/applicant)**
Signature and date	Signature of individual preparing the application and date
Thea, Taxpayer Name and title (print or type)	**Embarrassed Taxpreparer, EA** Name of individual preparing the application (print or type)
	TaxPrep Is Us, Inc. Name of firm preparing the application

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 19280E Form **3115** (Rev. 12-2003)

For Example 35

Form 3115 (Rev. 12-2003) Page 2

Part II Information For All Requests (continued)	Yes	No
4c Is the method of accounting the applicant is requesting to change an issue pending (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) for any tax year under examination (see instructions)?		
d Is the request to change the method of accounting being filed under the procedures requiring that the operating division director consent to the filing of the request (see instructions)?		
If "Yes," attach the consent statement from the director.		
e Is the request to change the method of accounting being filed under the 90-day or 120-day window period?		
If "Yes," check the box for the applicable window period and attach the required statement (see instructions). ☐ 90 day ☐ 120 day		
f If you answered "Yes" to line 4a, enter the name and telephone number of the examining agent and the tax year(s) under examination. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
g Has a copy of this Form 3115 been provided to the examining agent identified on line 4f?		
5a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) before Appeals and/or a Federal court?		✓
If "Yes," enter the name of the (check the box) ☐ Appeals officer and/or ☐ counsel for the government, and the tax year(s) before Appeals and/or a Federal court. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
b Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 5a? N/A		
c Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a Federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member)? N/A		
If "Yes," attach an explanation.		
6 If the applicant answered "Yes" to line 4a and/or 5a with respect to any present or former consolidated group, provide each parent corporation's **(a)** name, **(b)** identification number, **(c)** address, and **(d)** tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a Federal court. N/A		
7 If the applicant is an entity (including a limited liability company) treated as a partnership or S corporation for Federal income tax purposes, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a Federal court, with respect to a Federal income tax return of a partner, member, or shareholder of that entity? N/A		
If "Yes," the applicant is **not** eligible to make the change.		
8 Is the applicant making a change to which audit protection does not apply (see instructions)?		✓
9a Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in accounting method within the past 5 years (including the year of the requested change)?		✓
b If "Yes," attach a description of each change and the year of change for each separate trade or business and whether consent was obtained.		
c If any application was withdrawn, not perfected, or denied, or if a Consent Agreement was sent to the taxpayer but was not signed and returned to the IRS, or if the change was not made or not made in the requested year of change, include an explanation.		
10a Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in accounting method, or technical advice?		✓
b If "Yes," for each request attach a statement providing the name(s) of the taxpayer, identification number(s), the type of request (private letter ruling, change in accounting method, or technical advice), and the specific issue(s) in the request(s).		
11 Is the applicant requesting to change its **overall** method of accounting?		✓
If "Yes," check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also, complete Schedule A on page 4 of the form.		
Present method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)		
Proposed method: ☐ Cash ☐ Accrual ☐ Hybrid (attach description)		
12 If the applicant is **not** changing its overall method of accounting, attach a detailed and complete description for each of the following:		
a The item(s) being changed.		
b The applicant's present method for the item(s) being changed.		
c The applicant's proposed method for the item(s) being changed.		
d The applicant's present overall method of accounting (cash, accrual, or hybrid).		

Form **3115** (Rev. 12-2003)

10

For Example 35

Form 3115 (Rev. 12-2003) Page **3**

Part II **Information For All Requests** (continued)	Yes	No
13 Attach a detailed and complete description of the applicant's trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application.		
14 Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions . . . . If "No," attach an explanation.		✓
15a Has the applicant engaged, or will it engage, in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed tax year of change determined without regard to any potential closing of the year under section 381(b)(1)?		✓
b If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application. N/A		
16 Does the applicant request a **conference of right** with the IRS National Office if the IRS proposes an adverse response?.	✓	
17 If the applicant is changing to or from the cash method or changing its method of accounting under sections 263A, 448, 460, or 471, enter the gross receipts of the 3 tax years preceding the year of change. N/A		

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.
$	$	$

Part III **Information For Advance Consent Request**	Yes	No
18 Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request? . . . . If "Yes," attach an explanation describing why the applicant is submitting its request under advance consent request procedures.		
19 Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. The applicant should include a discussion of any authorities that may be contrary to its use of the proposed method.		
20 Attach a copy of all documents related to the proposed change (see instructions).		
21 Attach a statement of the applicant's reasons for the proposed change.		
22 If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? . . . . If "No," attach an explanation.		
23a Enter the amount of **user fee** attached to this application (see instructions). ▶ $ ______		
b If the applicant qualifies for a reduced user fee, attach the necessary information or certification required by Rev. Proc. 2003-1 (or its successor) (see instructions).		

Part IV **Section 481(a) Adjustment**	Yes	No
24 Do the procedures for the accounting method change being requested require the use of the cut-off method? If "Yes," do not complete lines 25, 26, and 27 below.		✓
25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ **-1,350** Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.		
26 If the section 481(a) adjustment is an increase to income of less than $25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change? . . . . N/A		
27 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? . . . . If "Yes," attach an explanation.		✓

Form **3115** (Rev. 12-2003)

For Example 35

11 Other costs (Attach a list of these costs.) . . . .

Schedule E—Change in Depreciation or Amortization (see instructions)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants must provide this information for each item or class of property for which a change is requested.

Note: *See the **List of Automatic Accounting Method Changes** in the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400I, 1400L, or former section 168. Do not file Form 3115 with respect to certain late elections and election revocations (see instructions).*

1 Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? . . . . ☐ **Yes** ☑ **No**
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? . . . . ☐ **Yes** ☑ **No**
If "Yes," enter the applicable section ▶ ....

3 Has a depreciation or amortization election been made for the property (e.g., the election under section 168(f)(1))? . . . . ☐ **Yes** ☑ **No**
If "Yes," state the election made ▶ ....

4a To the extent not already provided, attach a statement describing the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? N/A ☐ **Yes** ☐ **No**

c Is the property public utility property? . . . . ☐ **Yes** ☑ **No**

5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, provide the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods:

a The Code section under which the property is or will be depreciated or amortized (e.g., section 168(g)).

b The applicable asset class from Rev. Proc. 87-56, 1987-2 C.B. 674, for each asset depreciated under section 168 (MACRS) or under section 1400L; the applicable asset class from Rev. Proc. 83-35, 1983-1 C.B. 745, for each asset depreciated under former section 168 (ACRS); an explanation why no asset class is identified for each asset for which an asset class has not been identified by the applicant.

c The facts to support the asset class for the proposed method.

d The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)).

e The useful life, recovery period, or amortization period of the property.

f The applicable convention of the property.

Form **3115** (Rev. 12-2003)

For Example 35

THEA SS#333-22-1111

FORM 3115 ATTACHMENT

		Also answers Schedule E Questions:
PART II		
Q 12		
	A. Computer equipment for Retail Store omitted from depreciation, purchased April of 1998.	4a
	B. No depreciation has been taken under the present method. It should have been depreciated under IRC §§167(a)(1) and 1245.	5 7a
	C. We propose calculating the allowable depreciation from April of 1998 to current.	6
	D. Cash	

Q 13

The applicant operates a Retail Clothing Store (activity code # 448190.) The primary source of income for the business is the selling of uniforms to the healthcare industry. The income for the business is reported on Schedule C using the Cash Basis (with inventory treated in the same manner as materials and supplies that are not incidental under Treas. Reg. §1.162-3.)

PART IV

Q25 — 7b,c,d,e,f

A computer is 5-yr class property and should have been depreciated over 6 years using MACRS, 200DB, [IRC §168(b)(1)] half-year convention beginning April 1998. An Asset Life History showing the allowable depreciation is attached.

Asset Life History — 2003

Yearly Allowable Depreciation

Name(s) Shown on Return: THEA — Social Security Number: 333-22-1111

Description: 98 EQUIPMENT — Depreciation type: MACRS — Asset class: 5

Cost/Basis: 1,350. — Depreciable Basis: 1,350. — Method: 200DB — Life: 5.00

AMT Cost/Basis: 1,350. — AMT Depreciable Basis: 1,350. — AMT Method: 150DB — AMT Life: 5.00

	Tax Year	Prior Depreciation	Deduction for the Year	AMT Prior Depreciation	AMT Deduction for the Year
1	1998	0.	270.	0.	203.
2	1999	270.	432.	203.	344.
3	2000	702.	259.	547.	241.
4	2001	961.	156.	788.	225.
5	2002	1,117.	155.	1,013.	225.
6	2003	1,272.	78.	1,238.	112.
7					
8					
9	PREPARED USING ProSeries				

Note the following entries on **Form 3115:**

- The principal business activity code is the same as shown on Thea's Schedule C.
- The preparer should have the taxpayer sign a Form 2848, *Power of Attorney and Declaration of Representative*, and should attach a copy of the POA to the application.
- **Part I, Q1(a).** The change numbers are listed in the instructions. Code 7 is for changes from an impermissible method of depreciation to a permissible method.
- **Part I, Q2.** "Scope limitations" means the list of taxpayers who cannot use the automatic change request procedures. If the limitations do not apply, then the answer to this question is "Yes." (As in, "Yes, I can use the automatic procedures.")
- **Part I, Q3.** The first part of this question is "Is this the final year of a trade or business?" Since Thea is still in business, the answer is "No" and the second part of the question is ignored.
- **Part II, Q4a.** Since Thea does not have any returns under examination, lines 4b-4g are skipped.
- **Part II, Questions 5b-7** are not applicable to Thea.
- **Part II, Q8.** The instructions list the revenue procedures that should be reviewed to determine if the applicant will not receive audit protection in connection with the change being requested. There is no such limitation for the change that Thea is requesting.
- **Part III** does not have to be completed since Thea qualifies under the Automatic Change Procedures.
- **Part IV, Q24.** The Revenue Rulings require the cut-off method for certain accounting method changes. When the cut-off method is used, only transactions occurring after the change in accounting method is made are treated under the new method. Thea is not required to use the cut-off method.
- **Part IV, Q25.** A "section 481(a) adjustment" is a change due to items being duplicated or omitted on the original return. The amount of the adjustment is the difference between the improper method and the allowed method. Thea claimed no depreciation under the original method. Under the proper method, depreciation of $1,350 would have been taken from 1998 through 2003. She has a negative adjustment to net income of $1,350.
- Pages 4 though 7 of Form 3115 contain Schedules A through D, which are used for changes not related to depreciation. These pages are omitted from this example.

Notes for **Page 8, Schedule E:**

- **Q1.** Treas. Reg. §1.167(a)-11 relates to ACRS depreciation. Since Thea's computer was purchased after 1986, the MACRS depreciation rules are applicable, not the ACRS rules.
- **Q2.** IRC §263A relates to the Uniform Capitalization Rules for inventory type property. Since the computer is not part of the production of inventory, these rules do not apply.
- **Q3.** No elections were made previously with respect to depreciation of this asset.
- The remaining questions on Schedule E are answered as part of the Statement attached to the form. To avoid repetition, the preparer first answers the questions from Part II and IV that require attachments, and then notes in the margin which questions for Schedule E are addressed by each previous answer.

Changing in Year of Disposition on an Amended Return

Prior to Rev. Proc. 2004-11, there were no provisions to use the automatic change procedures to apply for a change from an impermissible method to a permissible method of accounting for depreciation or amortization of disposed property. Section 3 of this Rev. Proc. contains rules for making this change and Section 4 in the appendix of this Rev. Proc. adds a corresponding section to Rev. Proc. 2002-9. The following special rules are found in Rev. Proc. 2004-11 and are specific to this type of change.

These procedures only apply to properties for which less than the allowable depreciation was claimed.

Exceptions to Ineligibility Guidelines. Applicants who otherwise would not qualify for the automatic change procedures can still use the automatic change procedures for changing from an impermissible depreciation method to a permissible depreciation method for property that has been disposed of in the year of change. None of the limitations shown on page 330 apply to this type of change.

However, if the taxpayer is involved in any examination, appeals, or legal proceedings, an additional copy of the application must be provided to the appropriate IRS representative, and the application must contain the contact information of the IRS representative.

Nonqualifying Changes in Methods of Accounting. There are four specific changes or property types that are excluded from these provisions.[57]

1. Property held by tax-exempt organizations,
2. Revocations of timely valid depreciation elections or attempts to make late elections,
3. Property for which the taxpayer deducted the cost/basis as an expense, and
4. Property disposed of by the taxpayer in a transaction to which a non-recognition section of the IRC applies. However, this restriction does not apply in certain circumstances.[58]

Example 36. LaVon sold a residential rental property in April of 2003. Her accountant relied on the depreciation schedule from her previous tax returns and reported the sale as follows:

Sales price		$50,000	
Cost	$10,000		
Sales expenses	1,000		
Depreciation	(8,000)		
Adjusted basis		3,000	
Total gain		$47,000	
Tax on unrecaptured §1250 gain ($8,000 × 25%)			$2,000
Tax on remaining gain ($39,000 × 20%)			7,800
Total tax due on sale of property			$9,800

After the return is filed, LaVon's son called the accountant to complain about the amount of tax his mom had to pay. He informed the accountant that the house was used for a personal residence from 1968 to 1986. The $10,000 cost shown on the depreciation schedule is the original cost. During the 18 years prior to becoming a rental property, the taxpayer put $20,000 of improvements on the house. These improvements were neither depreciated nor expensed since the costs were incurred before it was a rental property.

57. Rev. Proc. 2004-11 Appendix Section 3.02

58. Rev. Proc. 2004-11 §3.01(2)(d)

LaVon's accountant recalculated the return based on this new information.

Sales price		$50,000	
Cost	$10,000		
Improvements	20,000		
Sales expenses	1,000		
Depreciation allowed	(8,000)		
Depreciation allowable on improvements	(18,500)		
Adjusted basis		4,500	
Total gain		$45,500	
Tax on unrecaptured §1250 gain ($26,500 × 25%)			$ 6,625
Tax on remaining gain ($19,000 × 20%)			3,800
Total tax due on sale of property			$10,425

The accountant is dismayed to discover that the new information results in a higher tax liability than previously reported. Then she remembers a similar situation being discussed at a seminar. She realizes that she can prepare Form 3115 to claim the previously unclaimed depreciation and file it with an amended return.

She amends the 2003 return and deducts the additional $18,500 in previously unclaimed depreciation on Schedule E under other expenses as "Form 3115 adjustment." LaVon's total passive losses do not exceed $25,000 and her AGI is under $100,000. The adjustment reduces the amount of her income in the 25% bracket, resulting in a tax savings of $4,625.

The accountant also corrects the capital gain reported on the original return to reflect the new calculation as shown above. LaVon has a $4,000 refund receivable from the amended return.

Corrected tax due to sale of property (from above calculation)	$10,425
Savings from Form 3115 adjustment	4,625
Taxes related to sale reported on **amended** return	$ 5,800
Taxes reported on sale reported on **original** return	9,800
Net refund receivable	$ 4,000

Her Form 3115 is very similar to the one shown in **Example 35.** Only the entries that are different are shown:

must provide all information relevant to the requested accounting method change, even if not specifically requested by the Form 3115.

Part I Information For Automatic Change Request	Yes	No
1 Enter the requested designated accounting method change number from the **List of Automatic Accounting Method Changes** (see instructions). Enter only one method change number, except as provided for in the instructions. If the requested change is not included in that list, check "Other," and provide a description. ▶ (a) Change No. 9 (b) Other ☐ Description ▶		

Proc. 2003-1 (or its successor) (see instructions).

Part IV Section 481(a) Adjustment	Yes	No
24 Do the procedures for the accounting method change being requested require the use of the cut-off method? If "Yes," do not complete lines 25, 26, and 27 below.		✔
25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ -18,500 Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.		

10

The following is attached to LaVon's application:

LAVON 111-11-1112

FORM 3115 ATTACHMENT

			SCH E
PART II			
Q 12			
	a	Improvements to residential rental real estate omitted from depreciation.	4a
		The real estate was used as primary residence from 1968 to November 1985.	6
		When the home was converted to rental use, only the original purchase price	7c
		was used for depreciation purposes. Lavon determined that $20,000 of	
		improvements were made from 1968-1985.	
	b	No depreciation has been taken under the present method.	5
		It should be depreciated under IRC §167(a)(2) and 1250.	7a
	c	We propose calculating the allowable depreciation from November 1985	
		to the date the property was sold in April of 2003 and deducting that	
		depreciation on Schedule E.	
	d	Cash	
Q 13		The applicant does not have a trade or business. This is income producing property.	
PART IV			
Q25		Lavon omitted improvements = $20,000.	
		These should have been depreciated as 19-Year Real Property	7b, 7e
		using the Accelerated Cost Recovery System Tables under former §168	7d
		using the mid-month convention beginning November 1985.	7f
		An Asset Life History showing the allowable depreciation of $18,500	
		is attached.	

Application Procedures. Usually the same procedures are followed to submit an application for this change as for the other automatic change requests, except this change can be requested with a timely filed amended tax return. In addition, the amended return must also include any related adjustments to taxable income and the tax liability resulting from the change. The other changes must be submitted with the original tax return for the year of change.

Example 37. Use the same facts as in **Example 36**. LaVon cannot file Form 3115 to take the extra depreciation without also adjusting the cost basis and depreciation amounts that are reported for the sale.

ISSUE 6: FRINGE BENEFITS

Compensation for performance of services generally means paying wages and salaries. In addition to bonuses, commissions, tips, and other items, fringe benefits are an additional way that employers reward workers for performance of services. By definition, these **fringe benefits generally are marginal, additional, or secondary in nature and are noncash items.** Employees are not the sole recipients of fringe benefits. Independent contractors, partners, or members of the board of directors of an organization may qualify to receive fringe benefits as long as services are performed and the person is not otherwise excluded by tax laws. There may even be a lag in incurring fringe benefits relative to performance of services. For example, individuals who have an agreement not to compete may be deemed to perform services for fringe benefits purposes. IRS Pub.15-B, *Employers Tax Guide to Fringe Benefits,* is an excellent source of information about fringe benefits.

Five questions should be addressed when reviewing potential fringe benefits for tax purposes:

1. **Is it a fringe benefit?** While fringe benefits are defined and specifically identified in the Internal Revenue Code, comprehensive listings of common fringe benefits are also available.

> **Note.** See the *2003 University of Illinois Tax School Workbook,* pages 343–346, also *2001 University of Illinois Farm Income Tax Workbook,* pages 268–270 for more information.

2. **Who is the provider of the fringe benefit?** An employer is the provider of a fringe benefit if the services are provided for him even if the benefit is provided by someone else. If a client or customer provides a fringe benefit to the employee, the employer is still the provider if the services were performed for the employer.

3. **Who is the recipient of the fringe benefit?** The individual performing the services is the recipient of any fringe benefit provided for those services. If family members of the employee receive the fringe benefit, the employee remains the recipient.

4. **Is the fringe benefit taxable?** Fringe benefits are taxable unless excluded by a specific IRS code section. Included in the recipient's pay is the amount by which the value of the fringe benefit that is greater than the sum of:

   - Any amount excluded by law, plus
   - Any amount the recipient paid for the benefit.

   If the recipient is not an employee of the business, the benefit is not subject to employment taxes.

Employers report taxable **employee** fringe benefits on Form W-2, box 14.

a Control number	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at **www.irs.gov**.
b Employer identification number		1 Wages, tips, other compensation	2 Federal income tax withheld
c Employer's name, address, and ZIP code		3 Social security wages	4 Social security tax withheld
		5 Medicare wages and tips	6 Medicare tax withheld
		7 Social security tips	8 Allocated tips
d Employee's social security number		9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial	Last name	11 Nonqualified plans	12a See instructions for box 12 (Code)
		13 Statutory employee / Retirement plan / Third-party sick pay	12b (Code)
		14 Other	12c (Code)
			12d (Code)
f Employee's address and ZIP code			

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** **Wage and Tax Statement** 2004 Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

For **nonemployees,** taxable fringe benefits are reported on Form 1099-MISC, box 7.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Rents $	OMB No. 1545-0115 2004 Form **1099-MISC**	**Miscellaneous Income**
		2 Royalties $		
		3 Other income $	**4 Federal income tax withheld** $	**Copy B For Recipient**
PAYER'S Federal identification number	RECIPIENT'S identification number	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name		7 Nonemployee compensation $	8 Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	10 Crop insurance proceeds $	
City, state, and ZIP code		11	12	
Account number (optional)		13 Excess golden parachute payments $	14 Gross proceeds paid to an attorney $	
15		16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form **1099-MISC** (keep for your records) Department of the Treasury - Internal Revenue Service

Fringe benefits paid to **partners** are reported on Form 1065, box 13.

6511

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **2004**

Department of the Treasury
Internal Revenue Service

Tax year beginning ______, 2004
and ending ______, 20__

Partner's Share of Income, Deductions, Credits, etc.

► **See back of form and separate instructions.**

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS Center where partnership filed return

D ☐ Check if this is a publicly traded partnership (PTP)

E ☐ Tax shelter registration number, if any ______

F ☐ Check if Form 8271 is attached

Part II Information About the Partner

G Partner's identifying number

H Partner's name, address, city, state, and ZIP code

I ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

J ☐ Domestic partner ☐ Foreign partner

K What type of entity is this partner? ______

L Partner's share of profit, loss, and capital:

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

M Partner's share of liabilities at year end:

Nonrecourse . . . . $______
Qualified nonrecourse financing . . $______
Recourse . . . . $______

N Partner's capital account analysis:

Beginning capital account . . . . $______
Capital contributed during the year . $______
Current year increase (decrease) . . $______
Withdrawals & distributions . . . $( )
Ending capital account . . . . . $______

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss)
2 Net rental real estate income (loss)
3 Other net rental income (loss)
4 Guaranteed payments
5 Interest income
6a Ordinary dividends
6b Qualified dividends
7 Royalties
8 Net short-term capital gain (loss)
9a Net long-term capital gain (loss)
9b Collectibles (28%) gain (loss)
9c Unrecaptured section 1250 gain
10 Net section 1231 gain (loss)
11 Other income (loss)
12 Section 179 deduction
13 Other deductions
14 Self-employment earnings (loss)
15 Credits & credit recapture
16 Foreign transactions
17 Alternative minimum tax (AMT) items
18 Tax-exempt income and nondeductible expenses
19 Distributions
20 Other information

*See attached statement for additional information.

For IRS Use Only

For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1065. Cat. No. 11394R Schedule K-1 (Form 1065) 2004

Fringe benefits paid to **S corporation shareholders** are reported on Form 1120S, box 12.

6711

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) **2004**
Department of the Treasury
Internal Revenue Service

Tax year beginning ____________, 2004
and ending ____________, 20__

Shareholder's Share of Income, Deductions, Credits, etc. ▶ **See back of form and separate instructions.**

Part I Information About the Corporation

A Corporation's employer identification number:

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return:

D ☐ Tax shelter registration number, if any ____________
E ☐ Check if Form 8271 is attached

Part II Information About the Shareholder

F Shareholder's identifying number:

G Shareholder's name, address, city, state and ZIP code

H Shareholder's percentage of stock ownership for tax year . . . . ____ %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss)	13 Credits & credit recapture
2 Net rental real estate income (loss)	
3 Other net rental income (loss)	
4 Interest income	
5a Ordinary dividends	
5b Qualified dividends	14 Foreign transactions
6 Royalties	
7 Net short-term capital gain (loss)	
8a Net long-term capital gain (loss)	
8b Collectibles (28%) gain (loss)	
8c Unrecaptured section 1250 gain	
9 Net section 1231 gain (loss)	
10 Other income (loss)	15 Alternative minimum tax (AMT) items
11 Section 179 deduction	16 Items affecting shareholder basis
12 Other deductions	
	17 Other information

* See attached statement for additional information.

For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1120S. Cat. No. 11520D **Schedule K-1 (Form 1120S) 2004**

> **Note.** Shareholder-employees of a C corporation have more nontaxable fringe benefits available to them than shareholder-employees of pass-through entities, such as partnerships and S corporations. Therefore, when tax planners are advising clients as to the potential tax consequences of fringe benefits, the type of entity must be taken into consideration.

5. **What is the value of the fringe benefit?** Generally, the value of the benefit is its fair market value (FMV). This is the amount an individual would pay for the benefit in an arm's-length transaction, considering all facts and circumstances. Special valuation rules are identified in the Treasury Regulations. They are applicable for certain fringe benefits such as employer-provided vehicles, airline flights, and meals.[59]

> **Note.** There is some overlap of fringe benefits and accountable-plan reimbursements. These are treated the same for tax purposes, but fringe benefits are subject to fewer requirements.

FRINGE BENEFITS EXCLUDABLE FROM TAXABLE INCOME

Many fringe benefits may be excluded from income, resulting in no federal income tax or employment tax on the benefits. These fringe benefits include:

- Qualified tuition reductions,
- Meals or lodging furnished at the convenience of the employer,
- Dependent care assistance,
- No-additional-cost services,
- Qualified employee discounts,
- Working condition fringe benefits, and
- De minimis fringes.

However, excludability may depend on fulfilling a number of requirements involving substantiation or documentation before they avoid Federal income tax and employment tax withholding. Determining excludability, valuation, and reporting present several challenges and may require considerable review.

EMPLOYER-SPONSORED FISHING TRIP

Occasionally, it is necessary for the courts to determine if a fringe benefit is taxable. The following cases illustrate some of the issues that must be examined before determining a benefit is tax-free.

Facts. This case involved an employer-provided fishing trip. Initially, the IRS determined this trip was a taxable event and the court agreed. However, the case was overturned by the Appellate Court.

After a two-day sales meeting, the employer sponsored a fishing trip for his employees. The trip was not mandatory, but he encouraged employees to attend and many did. Family members were not invited and did not attend. The event was held at a Canadian resort. During the trip, management and employees engaged in business discussions, whether at the resort or while on the boats. Costs of the trip were not treated as taxable wages to the employees since the employer viewed the trip as a working condition fringe benefit. The employer assigned employees to certain boats in order to encourage interaction.

59. Treas. Reg. §1.61-21(b)(2)

Law. Working-condition fringe benefits are defined as any property or services provided to an employee to the extent the employee would have been allowed a trade or business expense or depreciation deduction had he paid for the property or services.[60] IRC §162(a) allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade or business including travel expenses while away from home in pursuit of a trade or business. Additionally, expenses that are ordinary and necessary must meet substantiation requirements when they are considered to constitute entertainment, amusement, or recreation.[61] To be deductible, they must be directly related to a substantial and bona fide business discussion including business meetings at a convention, provided they are associated with the active conduct of trade or business.

Finding. Believing the trip to be an excludable fringe benefit, the employer did not include the cost of the fishing trips on Form W-2s for the employees. The IRS did not agree. The IRS determined the costs of the fishing trips were wages, and assessed deficiencies against the company for payroll taxes. The employer filed for a refund, after paying some of the deficiency. A District court in Iowa held for the IRS and indicated it was not a working-condition fringe benefit because:

- There was a lax attendance policy,
- It was held after a formal sales meeting, and
- The business was not conducted in an organized manner.[62]

However, the Eighth Circuit Court of Appeals reversed the District court's ruling, indicating the employees clearly viewed the trip as part of the course of business. They found clear evidence of business discussions, a history of these meetings, and that no family members attended. Therefore, the cost of the fishing trip was excludable as a working-condition fringe benefit.[63]

> **Note.** See the *2003 University of Illinois Federal Tax Workbook* page 590 for a summary of the *Townsend* case.

> **Note.** If the employer formally required employees to attend, had an agenda for designated business discussions, and documented the business benefits, the IRS might not have challenged the deduction.

NONPERSONAL USE OF A COMPANY VEHICLE

Facts. A department within a state agency responsible for highway construction, maintenance, and safety, requires an employee to take home a half-ton truck. The employee is required to respond to emergencies during off-duty hours. This truck is painted either white or orange and has clearly identifiable state decals on the sides. The vehicle carries equipment, tools, and materials and has flashing lights and devices for highway emergencies. Some of the trucks have toolboxes. The department's policy states that personal use during work hours or after work is prohibited.

Law. The personal use of a qualified nonpersonal use vehicle is a working condition fringe benefit. A qualified nonpersonal use vehicle is any vehicle the employee is not likely to use more than minimally for personal purposes because of its design. As stated in IRS Pub. 15-B, qualified nonpersonal use vehicles include:

- Clearly marked police and fire vehicles,
- Unmarked vehicles for law enforcement officers if authorized for use,

60. IRC §132(d)

61. IRC §274(a)

62. *Townsend Industries, Inc., v. United States,* 2002-2 USTC ¶50,518, August 21, 2002

63. *Townsend Industries, Inc., v. United States,* U.S. Court of Appeals, 8th Circuit; 2003-2 USTC ¶50,666, September 15, 2003

- An ambulance or hearse used for its purpose,
- Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds,
- Delivery trucks with seating for the driver only, or additionally a folding jump seat,
- A passenger bus with a capacity of at least 20 passengers used for its specific purpose,
- School buses,
- Tractors and other special purpose farm vehicles, and
- Pickup trucks and vans with a loaded gross vehicle weight of 14,000 pounds or less if it has been specially modified so it is not likely to be used more than minimally for personal purposes.

The IRS has noted that a pickup truck qualifies if the vehicle is clearly marked with permanently affixed decals or with special painting or other advertising associated with the employer's trade, business, or function.[64] It must also be equipped with at least one of the following:

- Hydraulic lift gate
- Permanently installed tanks or drums
- Permanently installed side boards or panels materially raising the level of the sides of the bed of the pickup truck
- Other heavy equipment, such as an electric generator, welder, boom, or crane used to tow automobiles and other vehicles

Additionally, the vehicle might be used primarily for transporting a particular type of load other than over the public highway in connection with a construction, manufacturing, processing, farming, mining, drilling, timbering, or other similar operation, and has been specifically designed or modified to a significant degree for such use.

Finding. The highway department excluded the use value of the pickup truck determining it to be a qualified nonpersonal use vehicle. Available information seems to support this conclusion. However, in a letter ruling, the IRS concluded the vehicle is not a qualified nonpersonal use vehicle for purposes of the regulations. Therefore, the value of use of the vehicle should be included in gross income. Although clearly marked as the employer's vehicle, the vehicle was not sufficiently modified when compared to the listed examples. Thus, the value of the personal use portion of the vehicle is a taxable fringe to the employee.[65]

Note. A detailed explanation of employer-provided vehicles can be found on pages 144–147 of the *2002 Illinois Farm Income Tax Workbook.*

Reporting

The employer can determine on what date fringe benefits are reported for payroll tax purposes. He may treat fringe benefits as paid on a normal pay period, quarterly, semiannual, annual, or other basis. It is not necessary to choose the same period for all employees. It is also possible to treat the value of a single fringe benefit as paid on one or more dates in the same calendar year, even if the benefit is received at one time. When property is transferred, the actual date of transfer counts for purposes of withholding tax. He must include the value of the benefit for employment tax and withholding purposes at least annually. The value of the fringe benefit may be added to regular wages for a payroll period to determine withholding. Alternately, the flat 25% rate, used for supplemental wages, may be withheld on the value of the fringe benefit. Tax deposit rules follow the conventional rules for wages. There is a **special accounting**

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64. Rev. Rul. 86-97

65. Letter Ruling 200236022

rule for benefits actually provided in the last two or fewer months of the calendar year. The value provided in the last two (or fewer) months may be included in the following year along with the first ten months of the following year. This rule may be applied to some benefits, but not to others. However, the rule must be applied for all recipients of the same benefit. No notification to the IRS is necessary if choosing to use this rule. This special accounting cannot be used for property transferred as a fringe benefit.

Example 38. Jay, a state worker, drives the State's pickup truck home daily throughout the year in order to respond to emergencies. He does not take the vehicle home during his two-week vacation. He earns $50,000 in wages. He also received a $2,000 qualified achievement award during the year. The safety award is a qualified achievement award of which $1,600 is excludable from income. The state agency decides to use the commuting rule to value the vehicle for inclusion on Form W-2 as follows:

5 days × 50 weeks × $3 per round-trip = $750

For withholding purposes, he is single and claims zero exemptions. His Form W-2 contains entries of $51,150 in boxes 1, 3, and 5. The $51,150 is comprised of the following:

- Wages of $50,000
- Includible portion of qualified achievement award of $400
- Personal use vehicle value of $750

The completed Form W-2 follows:

a Control number	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at www.irs.gov.
b Employer identification number 09-1234567		1 Wages, tips, other compensation 51150.00	2 Federal income tax withheld 8957.50
c Employer's name, address, and ZIP code STATE AGENCY 100 STATE AVENUE STATEVILLE, VA 12345		3 Social security wages 51150.00	4 Social security tax withheld 3171.30
		5 Medicare wages and tips 51150.00	6 Medicare tax withheld 741.68
		7 Social security tips	8 Allocated tips
d Employee's social security number 123-45-6789		9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial JAY — Last name		11 Nonqualified plans	12a See instructions for box 12 Code
1111 ALL GATE ROAD FARMVILLE, VA 16678		13 Statutory employee / Retirement plan / Third-party sick pay	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement **2004** Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

The value of the fringe benefit is included in box 1 and if applicable, in boxes 3 and 5. The total value of the fringe benefit provided may be shown optionally in box 14.

Gross income does not include "qualified transportation fringes" as defined by IRC §132. These fringes include qualified parking, which is parking provided to an employee on or near the business premises and parking which is not on or near property used by the employee for residential purposes. For 2004, the amount excludable may not exceed $195. To qualify as an excludable fringe benefit, IRS regulations require employees to elect to participate in a salary reduction arrangement. They must make a written request and are subject to a number of conditions.

Example 39. An employer has the right to use a parking lot adjoining the office space she leases. The employer has a plan that permits employees to park in the lot. Each employee is charged $150 per month for the parking and wages are reduced by a like amount. Employees who choose to participate in the arrangement and park in the lot make a written election to receive parking valued at $150 in lieu of an additional $150 in compensation per month. The election is subject to several requirements and is irrevocable during its one-month term. The employer does not include the $150 compensation per month in the wages of the employee.

The IRS indicated in a letter ruling that such a parking benefit is qualified parking and the arrangement meets the requirements. The $150 is excludable from gross income and not subject to income tax withholding, FICA, or FUTA by the employer.[66]

Employers may exclude from wages fringe benefits that qualify as "de minimis." De minimis is defined as any property or service that is so small in value that accounting for it is unreasonable or administratively impracticable.[67] The Treasury Regulations include as de minimis items such as:[68]

- Occasional typing of letters by a company secretary,
- Occasional personal use of an employer's copy machine,
- Occasional cocktail parties, group meals, or picnics for employees and their guests,
- Traditional birthday or holiday gifts of property (noncash) with a low market value,
- Occasional theater or sporting event tickets,
- Coffee, doughnuts, and soft drinks,
- Local telephone calls, and
- Flowers, fruit, books, or other similar items given to employees for special occasions or under special circumstances such as illness, performance, or family crisis.

Key considerations in determining de minimis include low value, infrequency of use, and impracticability of monitoring. Unfortunately, low value is not defined and frequency is only partially defined. Items similar in nature to the above listing that do not qualify as de minimis include:

- Season tickets to sporting or theatrical events,
- Employer-provided vehicle used more than once a month to commute to work,
- Membership in a private country club or athletic facility, and
- Use of employer-owned or -leased facilities such as an apartment or boat, for a weekend.

66. Letter Ruling 200347003

67. IRC §132(e)

68. Treas. Reg. §1.132-6 (e)

IRS Pub. 15-B states that "cash, no matter how little, is never excludable as a de minimis benefit, except for occasional meal money or transportation fare." The regulations clarify that cash includes a cash equivalent such as a gift certificate, or credit card which could be converted to cash.[69] Therefore, even though the employer intended to simply provide all employees with a similar de minimis fringe benefit, the employer should include the value of the cash equivalent with wages.

Example 40. The employer hosts a picnic for all employees in the summer as appreciation for the accomplishments of the organization. Of the 100 employees that are employed, 10 cannot attend. Nonetheless, the employer decides to provide them with the opportunity to participate in the recognition. Each of the 10 employees is provided with a $30 American Express gift certificate (can be converted to cash) to use at a restaurant. The employer excludes the cost of the picnic, but must include the value of the gift certificates in the wages of the employees who received them.

Note. Distributing certificates that are for specific events and are not redeemable for cash, like a gift certificate to attend a movie, may provide the employer an alternative solution.

ISSUE 7: DEPRECIATION

INTRODUCTION

Many changes in deprecation have occurred over the past two years. Congress enacted several changes, and consequently, the IRS updated related regulations and revenue procedures. Meanwhile, the courts are hearing depreciation-related cases. This section reviews the most significant depreciation-related developments.

BONUS DEPRECIATION

In 2002, Job Creation and Workers Assistance Act (JCWAA) created IRC §168(k). This allows taxpayers a 30% bonus depreciation in the asset's first year of original use. In 2003, Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), increased the bonus to 50% for purchases after May 5, 2003. The definition of qualifying property for the 50% bonus depreciation mirrors the 30% bonus depreciation definition.

On March 1, 2004, the IRS amended Temp. Treas. Reg. §1.168(k)-1T. This regulation covers the requirements and qualifications for bonus depreciation. The following discussion includes a description of some of the provisions contained in this regulation.

Note. See pages 42–51 in the *2002 University of Illinois Farm Income Tax Workbook* for information on JCWAA and depreciation. See pages 455–496 (for information on depreciation) and 647–651 (for information on JGTRRA and depreciation) in the *2003 University of Illinois Federal Tax Workbook.*

Electing Out of Bonus Depreciation[70]

The 50% bonus depreciation is not an election. It is **mandatory** unless a taxpayer **elects out**. Without an election out, a taxpayer is required to use the 50% bonus depreciation for eligible assets.

The election must be filed by the due date, plus extensions, for filing the tax return that includes the qualifying assets. This election can be made by the sixth month after the unextended due date, even if made on an amended return.[71] Therefore, an individual calendar-year taxpayer, who failed to attach a statement to his 2003 Form 4562, *Depreciation and Amortization,* can file an amended return with the election by October 15, 2004.

69. Treas, Reg.§1.132-6 (c)
70. Temp. Treas. Reg. §1.168(k)-1T(e)
71. Treas. Reg. §301.9100-2

A taxpayer who does not attach the proper election to his applicable income tax return is required to use the bonus depreciation on eligible assets. A taxpayer that files an income tax return after the maximum extended due date is also required to use the bonus depreciation on eligible assets.

The election is made by asset class. For example, a taxpayer can elect out of the bonus depreciation for 5-year assets, while claiming the bonus depreciation on the 7-year assets. In this case, the bonus depreciation applies for the 7-year assets.

There are two ways to elect out. A taxpayer can elect out of the

1. 50% bonus depreciation in favor of the 30% bonus depreciation, or
2. 50% bonus depreciation **and** the 30% bonus depreciation, leaving the taxpayer with normal depreciation.

Example 41. Jerry purchases a super computer (a 5-year asset) for $40,000 on March 30, 2004. Jerry manages the depreciation in one of three ways.

- He **does not elect out of the 50% bonus depreciation** for 5-year assets. The result is $20,000 of bonus depreciation, plus the regular depreciation on the remaining $20,000 of basis.
- He **elects out of the 50% bonus depreciation** for 5-year assets, but **does not elect out of the 30% bonus depreciation.** The result is $12,000 of bonus depreciation, plus the regular depreciation on the remaining $28,000.
- He elects out of both the 50% and the 30% bonus depreciation. He takes regular depreciation on the $40,000.

Original Use Defined[72]

To be eligible for bonus depreciation, the asset must be an "original" or "first" use asset. The following circumstances are considered original use. New qualifying property is eligible for the bonus depreciation if:

1. Purchased after September 10, 2001 and before January 1, 2005. The property must be placed in service during this time frame. It is not necessary that "purchased" and "placed-in-service" happen at the same time; however, they both must occur in the window from September 11, 2001 to December 31, 2004.

Example 42. Charlene purchased a new laptop computer for personal use on August 5, 2003. On April 3, 2004, she put the computer into use in her business. Since the purchase date and the placed-in-service dates are both within the time frame, the property is qualifying property for the bonus depreciation in 2004; the year it was placed in service.

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Caution. To qualify for the 50% bonus depreciation, both the purchase and the placed in service date must occur after May 5, 2003 and before January 1, 2005.

2. Sold by a lessor within three months after the date it was originally placed in service **and** the user of the property doesn't change during this three-month period. There can be multiple purchasers of the property. However, the purchaser of the property in the last sale within this three-month period is considered the original user.
3. Acquired by a taxpayer in a sale-leaseback transaction **and** it is acquired within three months of the placed in service date.
4. At least 80% of the cost of reconditioned or rebuilt property is for new parts. New parts purchased to recondition existing property also qualify.

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72. Treas. Reg. §1.168(k)-1T(b)(2)(B)(3)

5. A merchant, in the ordinary course of business, sells fractional interests in property to unrelated third-parties. Each fractional owner is considered the original user of its proportionate share of the property. Once a share has been used by the owner, that share will not qualify for subsequent purchasers.

INCREASED IRC §179 DEDUCTION

The 2003 act increased the maximum amount of the IRC §179 deduction from $25,000 to $100,000. The maximum amount of qualified purchases before the phase-out begins increased from $200,000 to $400,000. These maximums are increased in 2004 to $102,000 and $410,000, respectively. These two provisions permit more taxpayers to elect the deduction and allow those taxpayers to elect a higher amount than before.

Requirements

As a direct result of these increases, sport utility vehicle (SUV) dealers began advertising that the entire cost of their vehicles qualify for income tax deductions. The advertisements neglect to inform potential purchasers of the requirements:

1. The asset must be used more than 50% in a trade or business (rental properties do not meet the trade or business definition),
2. Only the cash portion, not the trade-in portion, of the purchase price qualifies,
3. Only vehicles having gross vehicle weights over 6,000 pounds qualify for unlimited IRC §179 deduction,
4. Records must be kept to substantiate the business use and vehicle expenses (gas, oil, repairs, etc.),
5. Actual expenses rather than standard mileage rate must be used, and
6. The other limitations for IRC §179, such as the business income limitation must be considered.

Note. Using the maximum $102,000 IRC §179 deduction gives the taxpayer a large deduction in the year of purchase, but takes the depreciation deductions away from the future. If the taxpayer is in the same tax bracket for all years involved, taking the deduction currently saves the time value of the money. If the taxpayer's income tax bracket fluctuates or will fluctuate as a result of this deduction, claiming the IRC §179 deduction may not be in the taxpayer's best interest. The amount of self-employment tax paid can also vary depending on when the deduction is taken.

Example 43. Josephine is a single taxpayer with taxable self-employment income of $200,000, which places her in the 33% tax bracket. As such, she is saving 33% on all business expenses until she hits the floor of the bracket which is $146,750 for 2004. After her income goes below this floor, she is only saving 28% on additional expenses. Below the next floor of $70,350 (for 2004), she is only saving at 25%.

If Josephine claims $100,000 of IRC §179 expense, she will save 33% on the first $53,250 and only 28% on the remaining $46,750. The tax professional has to help Josephine decide if it is worth the $2,338 in lost tax savings ((33% – 28%) × $46,750) to claim the full $100,000 in the current year.

State Adjustments

Most states have changed their tax laws to **NOT** accept the federal provisions for bonus depreciation and/or the higher limit under IRC §179. Depending on the state's laws, this causes several problems:

1. Two depreciation schedules must be maintained; one for federal and one for state tax purposes.
2. Different amounts of depreciation are allowed when assets are sold. This may affect the type of gain that results when the sale takes place.
3. Differences in income may result in different amounts allowed for those items that are tied directly to the amount of self-employment income, such as SEP contributions for the owner, IRA contributions, self-employed health insurance deductions, and the IRC §179 deduction.
4. Differences in adjusted gross income (AGI) as computed under state law could result in different amounts for taxable social security income, IRA contribution deductions, allowed passive losses, itemized deductions, etc.
5. Taxpayers may pay increased fees to tax professionals for keeping the second set of depreciation records and doing the necessary annual adjustments.

CHANGING DEPRECIATION

Rev. Proc. 2004-11 provides an automatic consent procedure for taxpayers that want to change their method of depreciation in certain situations.

Note. Filing procedures under Rev. Proc. 2004-11 start on page 331 of this chapter.

CHANGE IN ASSET'S USE

On June 17, 2004, the IRS issued a new regulation that applies to tax years ending on or after that date.[73] For tax years ending before then, the IRS will allow any method that is reasonable and consistently used. The following information is from the new regulation.

Property converted from business or income-producing use to personal use during a taxable year is treated as if it was disposed of for depreciation purposes. Depreciation is allowed up to the date of the change in use.

The depreciable life or method for a piece of property can change when its use changes. If use changes **in the same year** the property is first placed in service, the depreciation is based on the primary use for that year. If use changes **after the first year,** the change is considered to have happened on the first day of the taxable year. The depreciation for new use is calculated differently depending on whether the new life and/or method changes.

Caution. The new depreciable basis does not qualify for bonus depreciation nor the IRC §179 election.

73. Treas. Reg. §1.168(i)-4

Shorter Recovery Period and/or More Accelerated Method

The taxpayer has two choices when the new use has a shorter life or faster recovery method. The taxpayer can treat the asset as if no change occurred and continue to depreciate it under the old method. The taxpayer could also treat the asset as if it was purchased in the current tax year. If the taxpayer chooses to use the optional depreciation tables from Rev. Proc. 87-57, the taxpayer will use the new life and recovery method, and the old convention. If the taxpayer does not use the tables, the depreciation is calculated **without applying the applicable convention.**

Example 44. In 1999, the Able Corporation purchased a piece of equipment for $119,000. The maximum IRC §179 deduction was taken and the remaining balance was depreciated over seven years using the 200% declining balance method and the half-year convention. The use of the equipment changed in 2004. As a result, the classification of the equipment changed to five years, but the method did not change. On January 1, 2004, the adjusted basis of the equipment was $22,311.

Able can choose to:

1. Let the remaining basis depreciate over the two and one-half years left without making any changes to the life or method, or
2. Treat the asset as if it was purchased in 2004.

Able's option are:

- Use the optional tables. The 2004 depreciation is $4,462 and the 2005 depreciation is $7,140. From Table 1 in Rev. Proc. 87-57, the applicable rates for 2004 and 2005 are 20% and 32%. These are multiplied times the adjusted basis of $22,311 to calculate the annual depreciation.
- Not use the tables. The 2004 depreciation is $8,924. ($22,311 × 40%). The 2005 depreciation is $5,355 [($22,311 – 8,924) × 40%].

Longer Recovery Period and/or Slower Method

There are two ways of calculating the depreciation if the new use results in a longer life or less accelerated method. The calculation used depends on whether or not the taxpayer chooses to use the optional depreciation tables of Rev. Proc. 87-57. In either case, the depreciation is determined as if the property had originally been subject to the longer life/slower method using the original depreciation convention.

If the tables are not used, the adjusted basis, as of the beginning of the year, is multiplied by the applicable rate. The rate is determined using the appropriate method and recovery period. The recovery period used in the calculation depends on whether the new method is straight line or one of the declining balance methods. For straight line, the applicable recovery period is the number of years **remaining** in the new longer life. For a declining balance method, the applicable recovery period is the new longer life.

If the tables are used, the first step is to choose the table that corresponds to the system, method, recovery period, and convention that would have applied had the original use of the property been the same as the new use. The next step is to determine what year of the table applies to the current year. Finally, the following formula is used:

1. Total the remaining depreciation rates from the IRS tables for the new method and/or life,
2. Divide each year's rate from the IRS table by this total,
3. Multiply the result times the adjusted basis of the property as of the beginning of the year of change.

Example 45. On July 7, 1994, Kurt placed into service residential rental property costing $100,000, with a recovery period of 27.5-years. As of December 2003, he had claimed a total of $34,391 in depreciation representing the first 9½ years of useful life. As of January 1, 2004, the property's adjusted basis was $65,609. In August 2004, Kurt changed the use of the building to commercial, which is 39-year recovery property.

Kurt has two options. He can:

- Not use the optional tables. The remaining balance of $65,609 is divided by 29.5 years (39 years minus 9½ years elapsed). This is the life that remains if the property had always been rented for commercial use. His 2004 depreciation for the property is $2,224.

MACRS Nonresidential Real Property (39 Years)
For property placed in service after May 12, 1993, Straight-line, Mid-month Convention

	Month Placed in Service											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2-39	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%	2.564%
40	0.107%	0.321%	0.535%	0.749%	0.963%	1.177%	1.391%	1.605%	1.819%	2.033%	2.247%	2.461%

- Use the above table, and calculate his depreciation as follows:

Years 11-39	(2.564% × 29 years)	74.356%
Year 40		1.177%
Total		75.533%

The rate for 2004 of 2.564% divided by 75.533% = 3.394%

The modified rate of 3.394% times the adjusted basis of $65,609 = $2,227

Note. Because the straight line method was used in **Example 45,** using the table did not result in much difference in the 2004 depreciation. However, if one of the declining balance methods had been required, using the table might have resulted in a larger difference.

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EXCHANGES AND INVOLUNTARY CONVERSIONS[74]

Introduction

The IRS adopted new regulations for determining the basis and calculating the depreciation of exchanged property on March 1, 2004. The provisions are effective for exchanges in which both the disposition and replacement occur after February 27, 2004. If either the disposition or the replacement occurred on or before that date, the taxpayer may elect to use these provisions, or may rely on prior IRS guidance.

If a taxpayer wishes to use these provisions for an exchange which was included in a return filed on or before February 27, 2004, she must file Form 3115, *Application for Change in Accounting Method.*

A taxpayer may elect not to use these provisions. Instead the exchange basis and excess basis are combined into one basis. This new basis is treated as an asset placed in service on the date the replacement property is placed in service. This election is made by printing at the top of Form 4562, "ELECTION MADE UNDER SECTION 1.168(i)-6T(i)." Once made, the election may be revoked only with the consent of the Commissioner.[75]

74. Temp. Treas. Reg. §1.168(i)-6T

75. Temp. Treas. Reg. §1.168(i)-6T(j)

Definitions

Exchange. As used in this section, "exchange" includes both a like-kind exchange under IRC §1031 and an involuntary conversion under IRC §1033.

Replacement Property. The new property received as a result of the exchange.

Relinquished Property. The old property given up as a result of the exchange.

Exchanged Basis. The adjusted basis of the relinquished property at the time of its disposition. This is determined after the current year's depreciation allowed, if any, on the relinquished property.

Excess Basis. The amount of money exchanged in addition to the relinquished property for the replacement property. This is commonly called "boot."

Depreciable and Nondepreciable Properties

If land or other nondepreciable property is acquired in an exchange for depreciable property, the land is not depreciated. If both nondepreciable property and depreciable property are acquired in an exchange of depreciable property, only the basis allocated to the depreciable property received is eligible for depreciation.

Depreciation is not allowed for any MACRS property that is placed in service and exchanged in the same year. If the replacement property received in this exchange is disposed of in the same year, no depreciation deduction is permitted for either property.[76]

Depreciation for the Year of the Exchange

Same Recovery Period and Depreciation Method. If the recovery period and depreciation method for the replacement property are the same as the recovery period and method for the relinquished property, the replacement property is depreciated as if it is a continuation of the relinquished property as of the **beginning of the year** of the exchange.

> **Example 46.** In February 2003, David acquired a digital color copier for $50,000. David elected out of the bonus depreciation and depreciated the asset using straight-line MACRS, a 5-year recovery period, and the half-year convention. His 2003 depreciation was $5,000 for the copier. If he had kept the copier, the depreciation deduction for 2004 would have been $10,000 (20% × $50,000). However, David traded the copier for a new model copier on December 5, 2004. David did not pay or receive any boot. The depreciation for copier for 2004 is $0 since the exchange is treated as if it occurred at the beginning of the year. Because the depreciable life, method, and convention for the new copier are the same as the copier, the depreciation for the new copier is $10,000 for 2004.

Different Recovery Periods, Straight Line Method. If the recovery period is different for the properties, the depreciation for each asset is prorated for the year. The depreciation on the relinquished property for the year is equal to the normal depreciation allowance for the year divided by 12 months in the year, multiplied by the number of months the property was deemed to be used during the year, taking into account the convention (half-year, mid-quarter, etc.). If the tax year is a short taxable year, the number of months in the taxable year is used instead of the "12" in this equation.

> **Example 47.** In February, 2001, Hose Mfg., Inc. a calendar-year taxpayer and manufacturer of rubber products, acquired and placed into service a stirrer (a special tool) for $60,000. It depreciated the stirrer using the straight-line method election under IRC §168(b)(5) and the mid-quarter convention over its three-year recovery period. In June 2004, Hose exchanged the stirrer for a tractor (not a special tool) in a like-kind exchange. Hose elected not to deduct the additional first-year depreciation for seven-year property placed in service in 2004. Since the recovery period prescribed under §168 for the tractor (seven years) is longer than that of the stirrer (three years), the tractor is depreciated as if it had originally been placed in service in February 2001 using a seven-year recovery period.

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76. Temp. Treas. Reg. §1.168(i)-6T(c)(5)

If the recovery period for the **replacement property** is **longer** than the recovery period for the relinquished property, the depreciation for the exchange basis is calculated using the longer recovery period that would be remaining if the replacement property had been placed in service at the time the relinquished property was placed into service. For example, if a 5-year asset has been depreciated for 1.5 years and is replaced by a 7-year asset, the 7-year asset is deemed to have 5.5 years left.

Example 48. Use the same facts as **Example 47.** Since the depreciation method prescribed under §168 for the tractor (200% declining balance method) is more accelerated than that of the stirrer (straight line method) at the time of disposition, the depreciation allowance is computed using the straight-line method. The tractor is depreciated over its remaining recovery period of 3.75 years using the straight-line method of depreciation and the mid-quarter convention.

If the recovery period for the **replacement property** is **shorter** than the recovery period for the relinquished property, the depreciation for the exchange basis is calculated using the same recovery period that existed for the relinquished property.

When the assets have different recovery periods, the longer of the recovery periods is used.

Note. This will cause questions in the future when a new tax professional looks at the depreciation records. For example, a taxpayer who exchanged a commercial nonresidential building for a residential rental will have a 39-year life on the depreciation schedules when normally a residential rental will have a 27.5-year life.

Different Depreciation Methods and Accelerated Depreciation. If the depreciation method for one of the properties is slower than the other, the slower of the two methods is used.

When the depreciation method changes or when the longer life **and** an accelerated depreciation is used, manual calculations may be necessary. When the taxpayer elects to use the optional tables of Rev. Proc. 87-57, the depreciation for a year can be calculated as follows:

1. Total the remaining depreciation rates from the IRS tables for the new method and/or life,
2. Divide each year's rate from the IRS table by this total,
3. Multiply the resulting factor by the adjusted basis of the relinquished property as of the date of the exchange.

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Example 49. During 2003, Marv placed into service a red trailer (a 5-year asset), at a cost of $10,000. He elected out of the bonus depreciation and chose to use straight-line MACRS and the half-year convention. The depreciation for 2003 was $1,000, leaving a $9,000 adjusted basis. On April 3, 2004, Marv exchanged the red trailer for a blue trailer. He did not pay or receive any boot. Marv wants to use regular MACRS for the blue trailer. Since the straight-line method used on the red trailer is slower than the regular MACRS, Marv must use the straight-line method for the blue trailer. The depreciation calculations for the blue trailer are the same as they would have been for the red trailer.

Example 50. Use the same information as in **Example 49** except, Marv elected to use regular MACRS for the red trailer. Marv wants to use straight-line MACRS for the blue trailer. Since the straight-line method is slower than the regular MACRS, he can use the straight-line method for the blue trailer.

The depreciation and exchanged basis for the red trailer is calculated as follows:

MACRS Depreciation		
2003	$ 2,000	(20% × $10,000)
2004	1,600	(32% × $10,000) ÷ 2 [half year]
Total Depreciation	$ 3,600	
Cost	$10,000	
Less Accum. Depr.	(3,600)	
Exchanged Basis	$6,400	

The depreciation for the blue trailer is calculated as follows:

Using the straight line method over five years, the remaining factors are:

Year	Straight-line
2004	20%
2005	20%
2006	20%
2007	20%
2008	10%
Total	90%

2004's rate of 20% divided by the total of 90% results in an adjusted depreciation rate of 22.22%

Exchange Basis	$6,400
Adjusted Depr. Rate	× 22%
Half-Year Convention	× 50%
2004 Depreciation	$ 704

If the taxpayer does not use the optional tables contained in Rev. Proc. 87-57, the tax preparer should consult Temp. Treas. Reg. §1.168(i)-6T(c)(4) for the appropriate calculations.

Excess Basis (Boot). Any excess basis in the replacement property is treated as a new asset and is subject to the normal recovery period, depreciation method, and convention rules in effect at the time the replacement property is placed in service.

Deferred Transactions. When the old property is given up before the new property is acquired, depreciation is not allowed during the period between the disposition date and the acquisition date. The recovery period of the replacement property is considered suspended during this time.

Replacement Property Acquired Prior to Disposition of Relinquished Property. Special rules apply when replacement property is acquired prior to the disposition of relinquished property in an involuntary conversion. Depreciation on **replacement** property is calculated as a new asset using the method, recovery period, and convention applicable on the replacement's placed-in-service date. At the time of the disposition of the **relinquished** property, the exchanged basis and excess basis are calculated and future depreciation is determined as discussed earlier.

The amount of the **replacement** property's depreciation for the period prior to the disposition of the **relinquished** property that is greater than the amount attributable to boot, is excess depreciation. When the **relinquished** property is disposed of, this excess depreciation is reported as income.

Mid-Quarter Convention. When an exchange or involuntary conversion takes place, mid-quarter testing still must be performed to determine which convention applies to the property. The exchange basis is normally not used for this testing. Only **excess basis** is taken into account for testing. The excess basis is considered paid in the quarter in which the replacement property is placed in service.

The exchange basis is required to be used in mid-quarter testing if the relinquished property is placed in service and disposed of in the same year. The in-service date of the exchange basis depends on whether the **replacement** property is acquired in the same year or a later year. If the **replacement property** is placed in service in the:

- **Same** year, the exchange basis is considered placed in service on the date the **relinquished** property is placed in service.
- **Following** year, the exchange basis is considered placed in service on the date the **replacement** property is placed in service.

The exchange basis is also used in mid-quarter testing when depreciable property is received in exchange for nondepreciable property.

AUTOMOBILES SUBJECT TO LISTED PROPERTY LIMITS

The listed property limits of IRC §280F have existed for many years. However, the dollar amounts have changed as limits are indexed for inflation. Prior to 2003, the listed property limits were identical for automobiles, light-duty trucks, and vans. Starting with vehicles placed in service in 2003, the IRS has a separate table for light-duty trucks and vans. This change was due to higher inflation on the purchase price of these vehicles. The term "trucks and vans" for this purpose include any passenger automobile that is built on a truck chassis, including minivans and SUVs.[77]

The following vehicles are not subject to the limitations for listed property:[78]

- Cars with an unloaded gross vehicle weight in excess of 6000 pounds,
- Trucks with a gross vehicle weight in excess of 6000 pounds,
- Ambulances, hearses, or combination ambulance-hearses used directly in a trade or business,
- Vehicles used directly in the business of transporting persons or property for hire, and
- Trucks and vans that are **qualified** nonpersonal use vehicles placed in service after July 6, 2003.

The listed property limits for vehicles first placed in service in 2004 are found in Rev. Proc. 2004-20. This revenue procedure does not list a separate limit if a taxpayer elects out of the 50% bonus depreciation in favor of the 30% bonus depreciation. If the taxpayer elects to use the 30% bonus in 2004, he still increases his depreciation limit by $7,650.[79]

77. Rev. Proc. 2004-20, Section 2.01

78. IRS Pub. 946, *How To Depreciate Property*

79. Rev. Proc. 2003-75

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PROPERTY LIMITS FOR VEHICLES FIRST PLACED IN SERVICE IN 2004

Automobiles (other than trucks, vans, and electric automobiles)

Tax Year	Amount
First tax year	$2,960*
Second tax year	4,800
Third tax year	2,850
Each succeeding tax year	1,675

*If bonus depreciation is claimed, the "first tax year" amount is increased to $10,610.

Trucks and Vans

Tax Year	Amount
First tax year	$3,260*
Second tax year	5,300
Third tax year	3,150
Each succeeding tax year	1,875

*If bonus depreciation is claimed, the "first tax year" amount is increased to $10,910.

Electric Automobiles

Tax Year	Amount
First tax year	$ 8,880*
Second tax year	14,300
Third tax year	8,550
Each succeeding tax year	5,125

*If bonus depreciation is claimed, the "first tax year" amount is increased to $31,830.

LISTED PROPERTY LIMITS WHEN TRADING CARS

Most vehicles are subject to listed property limits. When a trade-in takes place, the default rules for depreciation require continuation of the old basis and treatment of the boot as a new asset. Formerly, the regulations stated depreciation on the old vehicle was not permitted in the year of the exchange and depreciation of the new vehicle was subject to limitations. This left some confusion regarding which year of the listed property limits applied to the two depreciable items (old basis and boot).

The new regulations[80] address this issue and provide specific ordering rules to follow:

1. Depreciate the old vehicle as if it had been disposed, limiting the deduction to the amount that would have been allowed under the **old** vehicle's limit. The half-year or mid-quarter convention applies for the year of a disposition.
2. For the **replacement automobile,** the first year limit applies. The 50% bonus depreciation is applied to the adjusted basis of the old vehicle, after taking into account the depreciation from Step 1. The **new** vehicle's limit is applied, less the amount used in Step 1.
3. Depreciate the recalculated adjusted basis of the old vehicle after taking into account the depreciation deductions from Steps 1 and 2. The **old** vehicle's limit is applied, less the amounts used in Steps 1 and 2.
4. Claim any IRC §179 on the excess basis (boot) applying the **new** vehicle's limit, less the amounts used in Steps 1–3.
5. Apply the 50% bonus depreciation on the remaining excess basis (after any §179 claimed). The **new** vehicle's limit is applied, less the amounts used in Steps 1–4.
6. Depreciate the remaining excess basis (after the deductions in Steps 4 and 5). The **new** vehicle's limit is applied, less the amounts used in Steps 1–5.

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80. Temp. Treas. Reg. §1.168(i)-6T(d)(3)

Example 51. In January 2000, Margaret started using a $30,000 vehicle (OLD) for business (100% business use). As of the end of 2003, her adjusted basis in the vehicle was $17,315. In April 2004, Margaret traded OLD for a new vehicle (NEW) paying $15,000 in boot. She wants to use the 50% bonus depreciation on NEW. The depreciation limit for OLD for 2004 is $1,775. The depreciation limit for NEW for 2004 is $10,610.

Step	OLD §280F Limit	NEW §280F Limit
A) Enter IRC §280F limits	$1,775	$10,610
1. Depreciation on old vehicle (Cannot exceed Line A, Column OLD)	**(1,775)**	(1,775)
B) Balance of remaining limit	$ 0	$ 8,835
2. Bonus depreciation on basis of old vehicle [($17,315 − 1,775)/2] (Cannot exceed Line B, Column NEW)	0	**(7,770)**
C) Balance of remaining limit	$ 0	$ 1,065
3. Depreciation on exchange basis (Cannot exceed Line C, Column OLD)	0	0
D) Balance of remaining limit	$ 0	$ 1,065
4. IRC §179 on boot ($15,000) (Cannot exceed Line D, Column NEW)		**n/a**
E) Balance of remaining limit		$ 1,065
5. Bonus depreciation on remaining boot (Cannot exceed Line E, Column NEW)		(1,065)
F) Balance of remaining limit		$ 0
6. Depreciation on remaining excess basis (Cannot exceed Line F, Column NEW)		0

Amounts used go in both limit columns.
The calculations on the numbered lines cannot exceed the "Balance of remaining limit" immediately above the applicable line.

Amounts used are entered in both columns OLD and NEW. The calculations on the numbered lines cannot exceed the "Balance of limit left" immediately above the applicable line.

Margaret's depreciation deduction for 2004 is $1,775 allocated to OLD and $8,835 allocated to NEW for a total of $10,610.

COURT CASES AND REVENUE RULINGS ON DEPRECIABLE LIVES

Most court cases can be cited and used as a precedent for taking a particular position on a tax return or appealing a case. One exception to this includes cases that fall under the Tax Court's Small Case Procedures. The findings in these cases are released as **Tax Court Summary Opinions**. Cases decided under the Small Case Procedures cannot be appealed by either the taxpayer or the IRS. Without the appeals process, incorrect legal interpretations by the Tax Court cannot be challenged. Therefore, the Tax Court's decision is only binding on that particular case. However, reviewing the cases can still be useful since they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

Roof Repairs

***Nevia Campbell v. Commissioner,* TC Summary Opinion 2002-117, September 6, 2002**

Ms. Campbell owned a residential rental house. She hired a contractor to fix the leaky roof. The contractors removed the existing top layers of the roof and recovered it with fiberglass sheets and hot asphalt. They made no structural changes to the roof. Ms. Campbell claimed the $8,000 cost of removing and replacing the roof-covering material as a repair. The examiner argued the costs should be capitalized and depreciated over 27½ years.

***Thomas J. Northen, Jr., et ux. v. Commissioner,* TC Summary Opinion 2003-113, August 13, 2003**

Ms. Cox owned a commercial rental building. She hired a roofing firm to stop the leaks and install a foam roofing system. The acting roof superintendent examined the roof and found it basically intact except for one location "where water was coming through, almost like a river." The firm installed 28 sheets of plywood replacing those damaged due to dry rot. The superintendent explained it was not necessary to remove the tar and gravel from the roof, but the firm's policy was remove them down to the plywood roof, spray on a primer, and top it off with a spray foam coating. Since the leaks were located under the rooftop air conditioning unit, the air conditioner had to be moved and reinstalled, which involved disconnecting and reconnecting gas and electrical lines. Ms. Cox deducted the $52,880 cost as a repair. The examiner argued the costs should be capitalized and depreciated over 39 years.

In both *Campbell and Northen,* the Tax Court ruled in favor of the taxpayer, permitting the deduction of the costs.

The Court refers to IRC §162(a) which allows the deduction for ordinary and necessary business expenses. It also refers to Treas. Reg. §1.162-4, which discusses repairs by stating *"repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, must generally be capitalized and depreciated…"* The Court cited *Oberman,*[81] where the cost of removing and replacing roof-covering material, as well as the cost of inserting an expansion joint in the roof, was held to be a deductible expense. The Court stated *"it is necessary to take into consideration the purpose for which an expenditure is made in order to determine whether such expenditure is capital in nature or constitutes a current expense."* In *Oberman*, the Court determined the taxpayer's only purposes in having the work done was to stop the leaking and to keep the property in an operable condition over its probable useful life. The taxpayer's purpose was not to prolong the property's life, increase its value, or make it adaptable to another use.

> **Note.** Even though *Northen* and *Campbell* cannot be cited when taking a position, the cases introduce the reader to the *Oberman* case, which is a regular Tax Court decision and therefore can be cited.

Engine Shop Visits for Aircraft

***FedEx Corporation,* US District Court, West District of Tennessee 01-2200, August 27, 2003**

FedEx spends large amounts of money for scheduled engine shop visits (ESVs). The ESVs are required by the FAA, not because the engine is necessarily in need of repair, but to avoid accidents. After the ESV, the engine has to be recertified before it can be put back into an aircraft. During these visits, the engine is removed from the aircraft and a replacement engine is installed so the aircraft can continue to operate.

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In 1993 and 1994, the maintenance on these engines was performed by an outside vendor and included: disassembly, cleaning, inspection, repair, replacement, reassembly, and testing. Replacements for parts that were beyond repair were either taken from FedEx stockpiles or were purchased from the vendor. The average cost of an ESV typically ranged from 0.2% to 8.1% of the value of the aircraft. FedEx argued these expenses were deductible as repairs and maintenance since they did not greatly affect the life of the aircraft as a whole and the costs were small in comparison to the aircraft's value. The IRS argued that the engines were a unit by themselves, the ESV's increased their life, and the costs were large compared to the engine's values.

The District Court ruled the engines were so closely linked to the aircraft that they were part of a "single unit of property" (the aircraft). Therefore the entire cost, value, and life of the aircraft have to be considered. As such the ESVs were deductible as a repair and maintenance and were not required to be depreciated.

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81. *Oberman Manufacturing Co v. Commr.,* 47 TC 471, February 8, 1967

Above Ground Gas Tanks

***PDV America, Inc and Subsidiaries v. Commr.*, TC Memo 2004-118, May 12, 2004**

PDV America, Inc. spent several million dollars to construct gas tanks on top of concrete ringwall foundations filled with sand. The taxpayer and the IRS disagreed on the life of the tanks. The Tax Court determined the gas tanks belong in asset class 57.0 of the class life table and therefore are 5-year recovery period property. The decision was based on various factors. The main factor leading to the decision was the ability of the tanks to be moved to a new location, even though it was highly unlikely they would ever be moved.

Gas Pump Canopies & Footings

Rev. Rul. 2003-54, May 8, 2003

Stand-alone gasoline pump canopies are assigned to asset class 57.0, Distributive Trades and Services, which has a 5-year Recovery Period for GDS and a 9-year ADS life. The supporting concrete footings are assigned to asset class 57.1, Distributive Trades and Services – Petroleum Marketing Land Improvements, which has a 15-year Recovery Period for GDS and a 20-year ADS life.

Any taxpayer that is treating the canopies as a class 57.1 asset may continue to do so. Any taxpayer that wishes to change the lives on these assets to match the lives in this revenue ruling can file Form 3115, *Change of Accounting Method.* This is considered an automatic change, thereby not requiring a user fee. The statement "Automatic Change Filed Under Rev. Rul. 2003-54" should be printed on the appropriate line of Form 3115.

ISSUE 8: VALUATION

The valuation of property is very important in today's economy. Many times a client comes to her accountant and requests that he provide an estimate of the value of her property. While the accountant may have considerable experience and knowledge regarding the value of the particular property, he should be aware of the risks if his estimated value is wrong. Many preparers avoid this risk by recommending the services of a professional appraiser. People are concerned with the value of property, both real and personal, for a number of reasons.

PURCHASE OR SALE OF A BUSINESS OR ASSET

Assets normally sell at their fair market value (FMV). This is defined as what a willing buyer pays a willing seller, neither of which is obligated to buy or sell and both have knowledge of all of the relevant facts. In a situation where a business is sold, the parties may arrive at a price for the entire business. However, there may be disagreement when it comes to placing values on the individual pieces of the business. Depending on the asset, the tax consequences vary greatly. In addition, what is most beneficial to the buyer is normally least beneficial to the seller.

When a business is sold, the purchase/sale price must be distributed between seven classes of property:[82]

Class	Description
I	Cash and demand deposits
II	CDs and government and marketable securities
III	Accounts receivable incurred in the ordinary course of business
IV	Inventory
V	All assets not included in other classes
VI	Intangible assets, other than goodwill and going-concern value
VII	Goodwill and going-concern value

82. Temp. Treas. Reg. §1.338-6T(b)(2)

The IRS requires the use of a residual method of allocation. The taxpayer begins with the total business purchase price and then subtracts the value of each class of property. For example, if value is depleted before arriving at class VI, no value is assigned to either Class VI or VII.

However, the taxpayer must first arrive at a value for the entire business, and then determine the value of each asset.

IMPORTANCE OF CORRECT APPRAISAL

Substantiating the Value of Donations

Chapter 6 of this book addresses the deductibility of charitable gifts. The chapter discusses IRS forms that are used to document the value of a gift. It also describes the penalties imposed on the taxpayer and the appraiser if the gift is not accurately valued.

The IRS assesses accuracy related penalties for inaccurate appraisals. In a 2003 case, the IRS assessed an accuracy related penalty on a Florida couple.[83] This couple donated a boat to the Salvation Army. The boat was a 1982 21-foot Angler motor boat with a 115-horsepower outboard motor and a boat trailer. The taxpayer had experienced medical problems, tried to sell the boat and finally donated it after he was unable to find a buyer. He did not have an appraisal done for the boat. The taxpayer testified in court that when the boat was donated, it was in "mint" condition and ready for use. The donee's receipt recorded the boat as in good condition.

After receiving the donation, the Salvation Army had the boat delivered to a local boat repair shop for an appraisal. The appraiser determined the boat had been sunk. He indicated, among other things, that it had a rotten transom, rusty cables and a locked-up motor. He appraised the boat at $500 with most of the value attributable to the trailer.

The court ruled that the value of the boat was $500 and that the negligence penalty was properly assessed.

Valuation of Estate Assets

The estate of a decedent can be as high as $1.5 million dollars in 2004 without incurring federal estate taxes. Assets in excess of this value are taxed at a progressive rate beginning at 45%. Taxpayers again face the situation of what is good for one party is detrimental to the other. If the estate is over-valued, excess estate taxes are paid. However, the heir of the assets received will receive a stepped-up basis which will reduce the amount of tax owed if the asset is sold. Therefore, the heir wants a high value assigned to the asset.

If the estate contains fractional interests of property, for example a 40% partnership interest, the value of the interest is not 40% of the FMV of the partnership assets. The value can be legitimately reduced because of marketability and minority discounts. A marketability discount occurs because there is no ready market for the asset. This may occur because the interest is a minority interest. In the example of a 40% partnership interest, a buyer could always be out-voted by the majority partners resulting in the investor having no control.

The courts have often upheld discounts of 35% and higher in these situations.

Insurance Claims

This is another situation where it is not in the best interest of both the insured and the insurer to use the same FMV. In case of a disagreement on the value of a claim, whoever can best substantiate his value is most likely to win.

Casualty Loss

This is a similar situation to an insurance claim. In this case, the amount of the loss may exceed the amount of insurance coverage and the taxpayer is looking for a tax deduction to help recoup his loss.

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83. *Gabe W. Stewart v. Commr.,* TC Summary Opinion 2003-101, July 24, 2003

APPRAISAL METHODS

Obviously, the best estimate of FMV is the actual selling price of the asset. In many of the above situations, the person requesting the appraisal is not interested in selling the asset so it is not an option to put the asset on the market and wait for a buyer. Professional appraisers place an FMV on an asset in one of three ways.

1. Market Approach

The market approach compares the asset to a similar asset and looks at its selling price. Adjustments are made based on differences in quality and the amount of time between the sale date and the current date. The appraisal of a business also begins with comparable sales, but includes additional factors such as:

- Size
- Methods of operation
- Markets and customers served
- Accounting methods employed
- Projected growth in sales and earnings

The appraiser looks at comparable sales. He takes the sales, net income and book value of the comparable company and uses them to estimate the FMV of the business.

2. Income Approach

The income approach is very applicable to valuing a business. The appraiser determines the income the business generates as a factor in arriving at his final appraisal. For rental property, the appraiser may use the direct capitalization method. He analyzes the current leases to estimate the potential rental income. From this he deducts operating expenses, allowing him to arrive at net operating income. By dividing this amount by a rate of return he can arrive at the value of the property.

For a business, the appraiser may use the discounted cash flow method (DCF) to arrive at the value. This method works well for a business where future earnings are projected to be materially different from past performance.

DCF requires explicit identification of the future cash flow streams that anticipated business plans will generate. For this reason, the DCF approach is also useful when valuing companies that operate in niches which are uninhabited by comparable companies. It is also useful for valuing businesses which face unique circumstances or operating environments.

> **Example 52.** Allen is interested in purchasing a tax and accounting business. He hires an appraiser to estimate the value of the business. The business grosses $50,000 per year, and the owner prepares over 1,000 tax returns annually. Allen believes he can increase the average tax preparation fee by $50. The appraiser places a higher value on the business than the $50,000 of actual revenue.

3. Asset Approach

The asset approach is sometimes referred to as the replacement cost approach. This is often used with tangible property such as buildings, machinery and vehicles. This is the most common appraisal method used by insurance companies. Arriving at the value is as simple as looking at current selling prices for identical assets or having a builder arrive at the cost of building a replacement.

UNIQUE ASSETS

Some assets are more difficult to appraise than others. Paintings and other one-of-a-kind collectibles present special challenges to appraisers. They must take into consideration such factors as:

- Artist
- Age of the artwork
- Condition
- Recorded sale of other pieces by same artist
- Cost of restoration

Even taking these factors into consideration, the appraisers are sometimes surprised when the artwork sells at auction. Depending on the number of interested buyers, the selling price may differ substantially from the appraisal.

Intangibles

One aspect of appraising intangibles is to attempt to measure its economic life. Factors which contribute to the economic life include:

- Technological changes
- Product life cycles
- Contractual terms
- Legal issues
- Buyer/seller expectations
- Possibly mortality studies

Computer Software

To arrive at the value of computer software, the appraiser should consider some of the following factors:

- Number of programs
- Number of lines of code
- Number of person days required to reproduce
- Cost of a person day of programming
- Estimated amount of obsolecence

If the software is marketable, the appraiser should consider additional factors. These include:

- Number of potential customers
- Competitive products
- Pricing volatility
- Manufacturing costs

Depending on the asset being appraised, factors that affect the value are very different. It is the responsibility of the appraiser to know what these factors are before accepting an engagement.

QUALIFIED APPRAISAL

For charitable contributions the Treasury Regulations define the term "qualified appraisal"[84] as an appraisal document that:

1. Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the property, or later than the date the tax return claiming the donation is filed.
2. Is prepared, signed and dated by a qualified appraiser.
3. Includes all required information.
    a. A detailed description of the property that allows a person unfamiliar with the subject property to ascertain that the appraisal is of the subject property.
    b. The physical condition of the property, if it is tangible property.
    c. The date of the contribution to the donee.
    d. The terms of any agreement related to the use, sale or disposition of the contributed property.
    e. The name, address and identification number of the appraiser.
    f. The qualifications of the appraiser including his background, experience, education and membership in any professional associations.
    g. A statement that the appraisal was prepared for income tax purposes.
    h. The date the property was appraised.
    i. The appraised FMV.
    j. The method of valuation used to determine the FMV.
    k. The specific basis for the valuation, such as comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.
4. Does not involve a prohibited appraisal fee.

84. Treas. Reg. §1.170A-14(c)(3)

QUALIFIED APPRAISER[85]

The term *qualified appraiser* means an individual who includes on the appraisal summary a declaration that:

1. The individual either holds himself out to the public as an appraiser or performs appraisals on a regular basis,
2. The appraiser is qualified to make appraisals of the type of property valued,
3. The appraiser is not excluded because:
   a. He is the donor, or the taxpayer claiming a deduction for the appraised property.
   b. He is a party to the transaction.
   c. He is the donee of the property.
   d. He is employed by any of the above persons. For example, the art dealer who sells a painting to the donor cannot be the appraiser of the painting.
   e. He is related to any of the above persons.
   f. He is an appraiser who is regularly used by any of the people listed in (a), (b) or (c), or a person who does not perform a majority of his appraisals during the year for other persons.
4. The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property may subject him to a civil penalty for aiding and abetting an understatement of tax liability.

There are numerous organizations for professional appraisers. These associations have professional standards and codes of ethics to which their members must abide. In addition, they offer continuing educations for their members. Three of these organizations are National Association of Independent Fee Appraisers, Appraisers Association of America, Inc. and the American Society of Appraisers. Taxpayers wishing to find a professional appraiser can find numerous listings by searching the Internet.

Effect of Signature of the Qualified Appraiser[86]

Any appraiser who falsely or fraudulently overstates the value of the contributed property referred to in a qualified appraisal or appraisal summary that the appraiser has signed may be subject to a civil penalty for aiding and abetting an understatement of tax liability. The amount of the penalty is $1,000 unless it affects the tax liability of a corporation where the penalty is increased to $10,000.

Validity of Appraisal

No two appraisers arrive at the same value of a given piece of property. They may use different comparable properties. They may project rents or costs differently if using the income approach to arrive at value. This is quite evident in a 1980 court case.[87]

Interco donated City Block 526 in St. Louis, MO to Washington University. The improvements on the property consisted of a 10-story warehouse building containing 617,950 square feet of space plus a 40,923 square foot paved parking lot. Interco valued the property at $1,690,000 and claimed a charitable donation on its tax return. Upon audit, IRS determined the correct value to be $518,000.

85. Treas. Reg. §1.170A-13(c)(5)

86. Treas. Reg. §1.170A-13(c)(3)(iii)

87. *Interco Incorporated v. United States;* 80-1 USTC ¶9346, April 9, 1980

Interco tried to sell the building privately prior to the donation, but received no acceptable offers. While the city had an assessed value on the property $2,900,000 for property taxes, Interco was appealing the assessment and informed the city the building was for sale with an asking price of $1,000,000. This caused the city to revalue the building and their new appraisal came to $1,542,400.

In September 1970, Interco had a professional appraisal of the building by Mr. Talbot. He valued the property at $1,425,000. Because of the negotiations with Washington University, Interco's asked their appraiser to review his prior appraisal in September 1971. Mr. Talbot updated his appraisal and arrived at a new value of $1,525,000.

Because of the large discrepancy in values between the taxpayer and the IRS, Interco decided to let the court decide the correct value. The IRS hired an appraiser. He was a well respected appraiser, author and broker in St. Louis. After looking at comparables, he arrived at a value of $600,000.

The first day of trial was spent with the court touring the property and the adjoining neighborhood. From the tour, they decided there were no comparable properties. In addition, they found the IRS appraisal was based on comparable properties that were much smaller than the donated property. The court's final determination was that using the income approach was the best way to value the property. When this approach was used, the court decided the correct value was $1,134,052.

While the court's value was lower than the value Interco used, it was much higher then the value the IRS wished to place on the property.

APPRAISAL FEES

Generally, appraisal fees cannot be based on a percentage of the appraised value. If a fee arrangement for an appraisal is based in whole or part on the amount of the appraised value of the property, it is treated as if it is based on a percentage. For example, if the appraiser's fee is subject to a reduction if the appraised value is reduced by the IRS, it is treated as a fee based on a percentage of the appraised value.