Chapter 8: Special Taxpayers

8

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

BANKRUPT TAXPAYERS

It is necessary for tax professionals to understand the tax implications and tax treatments of various complex issues. This can include understanding the rules associated with bankruptcy and discharge of indebtedness.

While it is difficult to keep up with changes in the law and the complexities surrounding bankruptcy, the more a tax professional knows, the more he can assist his clients in understanding the resulting tax consequences. This section begins with an overview of bankruptcy and a discussion of the 2005 bankruptcy act, followed by a review of tax issues surrounding debt discharge.

The number of bankruptcy filings increased in the last quarter of 2005, preceding the harsher filing climate enacted under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) on October 17, 2005.

Caution. As always, it is important for tax professionals to stop short of "practicing law" while advising clients on financial issues.

OVERVIEW OF BANKRUPTCY

This section addresses three main areas of concern relating bankruptcy to income tax issues. It is not intended to be a thorough guide to the bankruptcy process or the legal issues involving bankruptcy.

The three areas in which bankruptcy affects tax preparation are:

1. The preparation of income tax returns for the tax year bankruptcy is filed
2. The impact on future tax years as a result of the bankruptcy filing
3. The consequences of a bankruptcy filing on past unpaid tax debts

Bankruptcy Chapter Definitions

Black's Law Dictionary defines bankruptcy as: "A statutory procedure by which a (usually insolvent) debtor obtains financial relief and undergoes a judicially supervised reorganization or liquidation of the debtor's assets for the benefit of creditors." [1]

Bankruptcy laws fall under Title 11 of the United States Code, whereas income tax laws fall under Title 26. There are four main chapters of bankruptcy filings under Title 11: Chapters 7, 11, 12, and 13. Each of these chapters offers unique debt relief to qualified debtors, as described below.

Chapter 7. Chapter 7, the most common type of bankruptcy filed, is often termed **straight bankruptcy** or **liquidation bankruptcy.** An individual debtor who undergoes this type of liquidation usually gets a fresh financial start by receiving a discharge of all debts. Bankruptcy trustees are allowed to collect and liquidate the debtor's nonexempt property, either voluntarily or by court order, to satisfy creditors in a Chapter 7 bankruptcy.

Chapter 7 liquidation involves three main steps:

1. Selling the debtor's property
2. Distributing the sales proceeds among the creditors
3. Determining whether the debtor is discharged from further liability to the creditors

Chapter 11. Although individual nonbusiness debtors may file Chapter 11 bankruptcies, the vast majority of Chapter 11 cases involve business debtors. Chapter 11 allows a business that is insolvent, or on the brink of insolvency, to reorganize its capital structure under court supervision while continuing its normal operations. The reorganization is subject to creditor approval.

Chapter 12. Chapter 12 provides a method for farmers with a regular income to establish a debt-payment relief plan. This court-approved plan authorizes a trustee to collect the farmer's net income and pay the proceeds to creditors.

Chapter 13. Chapter 13, similar to Chapter 12, allows a trustee to collect a debtor's earnings for payment to creditors by means of a court-approved debt-repayment plan. The debtor must have a regular income to be eligible to file Chapter 13, which is sometimes called a **wage-earner's plan** or an **income-based plan.**

Chapter 13 allows a debtor to propose a **plan of rehabilitation** to extend or reduce the balance of any obligations and to receive a discharge from unsecured debts upon completion of the payments under the plan. A plan made in good faith will be confirmed if the creditors receive what they would have received under Chapter 7, and if the plan pledges all of the debtor's disposable income for three years.

In order to file a Chapter 13 bankruptcy, a petitioner must have sufficient regular income to pay living expenses, and funds to pay debts according to the bankruptcy plan. A petitioner also may not have excessive debt. Chapter 13 is only available for debtors who owe $922,975 or less in secured debt, such as home mortgages and vehicle loans, and $307,675 or less in unsecured debt, such as credit card debt.

A Chapter 13 plan can sometimes be amended after it is filed. Even after the plan is completed and the debtor receives a discharge in Chapter 13, it may be possible for the taxpayer to file a new Chapter 13 plan if unexpected circumstances arise that make it impossible for the debtor to deal with new bills.

Filing a Bankruptcy Petition

Bankruptcy petitions are filed on an individual basis. A husband and wife are not required to jointly file a bankruptcy petition, although they may do so. If a married taxpayer files a bankruptcy petition and has debts discharged, the spouse may be held fully responsible for those debts to the extent the spouse has guaranteed the debts or has co-signed for the debts.

---

1. *Black's Law Dictionary,* 8th Edition

Filing a joint bankruptcy petition can be beneficial at times. However, if a spouse solely liable for debts files a bankruptcy petition, the family unit can be better off financially. Whether to file a joint petition or an individual petition is something to be decided after discussing the issue with a bankruptcy attorney.

A bankruptcy petition often provides an automatic stay of collection for many debts. Consequently, creditors are generally barred from collecting on debts that exist on the filing date of the bankruptcy petition. This stay has a few exceptions pertaining to IRS matters. The key exceptions are that the IRS can still issue notices of deficiency, pursue criminal proceedings, and examine tax returns.

A creditor can ask the court to lift an automatic stay if the creditor can show that the lifting will not harm the bankruptcy estate. This could happen when a creditor's debt is fully secured by property and there is no equity left in the property for any other creditor to receive.

Creation of Bankruptcy Estate

A **Chapter 7** bankruptcy petition creates a separate bankruptcy estate. This estate reports the income and expenses related to the estate's assets. The bankruptcy estate files its own income tax return apart from the petitioner's return. Normally, a taxpayer is no longer involved with the estate's assets and debts in a Chapter 7 filing.

A **Chapter 11** individual bankruptcy petition also creates a separate bankruptcy estate. This estate, if for an individual, reports the income and expenses related to the estate's assets on the estate's income tax return, separate from the petitioner's return.

Normally, the taxpayer remains involved in the operation of the business under a Chapter 11 filing, but as an employee instead of an owner. This involvement is often important since the taxpayer has the knowledge or skills necessary to keep the business operations viable until a buyer can be found.

A **Chapter 12** or a **Chapter 13** bankruptcy petition does not create a separate bankruptcy estate. All of the income and expenses pertaining to the taxpayer's assets are still reported on the taxpayer's personal income tax return.

A corporation or a partnership that files any of these bankruptcy petitions continues to report all income and expenses on the entity's tax return. A **separate bankruptcy estate is not created** for tax purposes.[2]

Tax Debts and Discharge

Bankruptcy debts are divided into various categories. Initially, they are divided into **secured** and **unsecured** debts. The unsecured debts are then divided into **priority** and **other unsecured** debts. As a rule, priority debts are not discharged. Debts in the "other unsecured debts" category are the last paid from the bankruptcy estate and are discharged if they cannot be paid.

Secured debts are those debts that are secured by specific assets. This means the collateral can be taken to satisfy the related debt. If the property value exceeds the amount of attached debt, the excess value is available to be used to pay other debts. If the secured debt exceeds the property's value, the rest of the debt is changed to an unsecured debt. Secured debts are paid before other debts.

Unsecured debts fall into either "priority" or "other unsecured" positions. Those in the priority position are not dischargeable, while those in the other unsecured position are dischargeable. In a Chapter 7 plan, payments must be applied to the priority claims before any available funds can be used to pay other unsecured claims. In a Chapter 11 plan, priority claims must be paid in full.

Priority position debts are divided into several sub-priorities. Payments on these debts are made based on their respective priority level. If there are insufficient assets to pay these debts, the debts are not discharged, but return to the taxpayer.

2. IRC §1399

First priority claims include the administration-related expenses of the bankruptcy estate. These expenses include trustee fees, accounting fees, legal fees, taxes relating to the income/expenses of the estate, payroll taxes for any employees, and any other administration expenses. First priority claims are paid before second priority claims, and so on.

Observation. First priority claims include accounting fees, meaning the accountant is one of the first to get paid for any work performed for the bankruptcy estate. However, unpaid fees for services performed prior to the bankruptcy filing are not a priority claim. The accountant becomes an unsecured creditor for these fees.

Trust Fund Taxes. Trust fund taxes are those a bankruptcy petitioner withheld from employees' paychecks and were "entrusted" to remit to the government. These include federal income tax, social security, and Medicare withholdings. These **do not include** the employer's taxes, such as unemployment taxes and FICA matching.

Certain Income Taxes and Sales Taxes. In order for an income or sales tax debt to be considered a priority claim, a petitioner's tax return must meet one of the following three conditions:

1. The due date of the tax return, including valid extensions, must fall within the 3-year period immediately preceding the filing date of the bankruptcy petition;
2. The tax return must have been filed within the 2-year period immediately before the filing date of the bankruptcy petition; **or**
3. The tax must have been assessed within a 240-day period before the filing date of the bankruptcy petition.

Taxes falling outside of these three conditions are grouped into the category of "other unsecured debts," which are dischargeable.

This category also includes any taxes that are still assessable, such as a balance due determined as a result of an examination. If a taxpayer signed a Form 872-A, *Special Consent to Extend the Time to Assess Tax*, which waves the statute of limitations, the IRS can make an assessment at any time. Therefore, the tax year remains open and any balance due is not dischargeable.

Alternatively, a taxpayer could terminate a waiver by filing Form 872-T, *Notice of Termination of Special Consent to Extend the Time to Assess Tax*, wait for the assessment, and then file bankruptcy at least 240 days after the assessment date.

Example 1. Mr. and Mrs. Klet filed two extensions for each of their 1992–1995 tax returns and filed the returns according to the following table:

Year	Due Date	Extended Date	Filed Date
1992	April 15, 1993	October 15, 1993	December 18, 1993
1993	April 15, 1994	October 15, 1994	September 5, 1995
1994	April 15, 1995	October 15, 1995	October 10, 1995
1995	April 15, 1996	October 15, 1996	August 16, 1997

The Klets filed a bankruptcy petition under Chapter 13 on September 30, 1996. It was changed to a Chapter 7 petition on November 1, 1996, with the final discharge on March 14, 1997. On February 11, 2003, the IRS filed a lien against Mr. and Mrs. Klet's property for the taxes due from their 1993–1995 returns.

The Klets argued that the bankruptcy proceedings discharged these tax debts. The IRS disagreed and the Tax Court ruled in favor of the IRS. The 1992–1995 returns did not have due dates (including extensions) more than three years before the bankruptcy petition filing date. In fact, the 1995 return was not even due (due to an extension being filed) until after the bankruptcy petition filing date. Therefore these debts were not dischargeable.

The 1993–1995 returns also were not filed more than two years before the petition filing date. Although the 1993 and 1994 taxes were probably assessed more than 240 days before the petition filing date, the Klets' 1995 income tax liability had not been determined until almost a year after the petition date.

If Mr. and Mrs. Klet had filed their bankruptcy petition 16 days later, on October 16, 1996, the 1992 return's tax would have been dischargeable as "other unsecured debt." The 1992 tax return's due date would have been more than three years before the petition; the return was filed more then two years before the petition; and the assessment was more than 240 days before the petition.

Employer's Payroll Taxes. The employer's share of payroll taxes due on wages paid within three years before a bankruptcy petition is filed is considered a priority debt. Any remaining payroll tax debt, not paid from the assets of the bankruptcy estate, is the responsibility of the taxpayer.

Other Unsecured Debt. Taxes included in the **"other unsecured debt"** position include those:

- Shown on a return that is more than three years past its due date,
- Imposed on returns filed more than two years prior to the bankruptcy petition date, **and**
- Assessed more than 240 days prior to the petition date.

Post-Petition Taxes. Post-petition taxes are taxes incurred for periods after the bankruptcy estate is created. These taxes are the responsibility of the taxpayer/debtor.

Interest and Penalties. Interest and penalties are tied into the discharge of the underlying taxes. If a tax is discharged, the related interest and penalties are also discharged. Interest and penalties on nondischargeable taxes remain the liability of the debtor until repaid.

8

If a married taxpayer files for bankruptcy, the IRS retains the right to collect any tax owed by the petitioning spouse from the other spouse, to the extent of the nonpetitioning spouse's tax liability. Filing a joint tax return generally makes each spouse separately liable for the **entire** tax shown on the return. Therefore, the IRS can collect the entire amount of delinquent tax from the nonpetitioning spouse.

Tax Consequences of Bankruptcy

Transfers between Debtor and Bankruptcy Estate. The transfer of the taxpayer's assets and debts to a bankruptcy estate is a nontaxable event that does not trigger any recognizable income or loss.

If a collateral asset has insufficient equity to pay a corresponding debt, a trustee can "kick" the asset out of the bankruptcy estate, and back into the hands of the taxpayer. The taxpayer then regains ownership of the property and all applicable debt. Neither income nor loss results from this transfer, but the taxpayer either has to pay the debt or relinquish the property. The resulting sale or debt forgiveness income could result in a recognized gain or loss.

Any assets remaining after the bankruptcy estate is completed are transferred back to the taxpayer. There is neither income nor loss to report as a result of this transfer.

Tax Attributes. A taxpayer who specifically files bankruptcy under **Chapters 7 or 11** surrenders his tax attributes to the bankruptcy estate. These attributes are the same type of attributes that may be given up when debts are forgiven. In bankruptcy, unlike debt forgiveness, the attributes are given over to the bankruptcy estate prior to the forgiveness.

These attributes include all of the following:

- Capital losses
- Net operating losses
- Passive losses
- Foreign tax credits
- General business tax credits
- Minimum tax credits
- Passive activity loss carryovers
- Passive activity credits

The attribute amounts transferred to the bankruptcy estate equal the amounts remaining after the taxpayer files his last income tax return for the tax year ending immediately prior to the bankruptcy petition date.

Example 2. Thomas filed a Chapter 11 bankruptcy petition June 3, 2006. Thomas has $120,000 of capital losses carried over from his 2005 calendar year income tax return. Thomas files his 2006 income tax return on the calendar year basis. The entire $120,000 of capital losses are transferred to the bankruptcy estate.[3]

Any attributes remaining after the bankruptcy estate files its final return are transferred back to the taxpayer. If any attribute, such as an NOL, has a limitation on the number of years to which it can be carried, each tax year of the bankruptcy estate counts as one year. Filing the bankruptcy petition sets up a type of "wall." The taxpayer cannot carry any losses from years ending after the bankruptcy petition filing to any year ending prior to the petition's filing.[4]

The bankruptcy estate can utilize the taxpayer's tax returns for any open years prior to the date of the bankruptcy petition filing. If the estate has an NOL in its operations, the loss can be carried back to the taxpayer's prior years' returns and a refund obtained for the benefit of the estate. The taxpayer's adjusted basis and prior depreciation for assets the estate receives is transferred to the estate. The depreciation deductions for the bankruptcy filing year are allocated on a monthly basis between the taxpayer and the bankruptcy estate. The taxpayer receives the depreciation for the month of the transfer.

Example 3. Samantha filed a Chapter 11 bankruptcy petition on June 3, 2006. There is $12,000 of depreciation available for the 2006 calendar year. Since the bankruptcy estate was created in June, Samantha receives $6,000 [($12,000 ÷ 12 months) × 6 months] of depreciation and the bankruptcy estate receives the remaining $6,000.

3. See *Mourad v. Commr.*, No. 03-2367 (1st Cir.), October 20, 2004; and *Williams*, 123 TC No. 8, July 22, 2004

4. IRC §1398(j)(2)(B)

Year End Options

12-Month Year. Normally an individual taxpayer files a full 12-month tax return on a calendar year basis. In the year a bankruptcy petition is filed, a taxpayer has two options:

1. A normal 12-month year, or
2. A short year.

> **Note.** Normally, the 12-month year option is chosen. This is not necessarily the best choice for the taxpayer. However, the taxpayer frequently does not talk with a tax professional early enough to even become aware of the short-year option.

When the normal 12-month year is chosen, the taxpayer's tax return includes all income and expenses from the first day of the tax year up to the date prior to the bankruptcy petition filing date, plus all income and expenses from the petition date until the end of the year. The amounts to report are based on the taxpayer's normal method of accounting: cash, accrual, or hybrid.

Example 4. Donald is a single taxpayer without any dependents. His income consists only of wages. He claims the standard deduction. He charged large amounts on his credit cards and filed bankruptcy to escape the burdening debt.

Since his debts were forgiven in bankruptcy, Donald does not have debt forgiveness income at the individual level. He chooses the normal 12-month year, and files a Form 1040 for the year, along with a Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness and Section 1082 Basis Adjustment*.

Example 5. Peter filed a bankruptcy petition on June 3, 2006. Prior to the bankruptcy filing, he ran a small restaurant as a sole proprietorship that operated at a **loss of $10,000**. As a result of the bankruptcy filing, the restaurant was transferred to the bankruptcy estate.

Peter took a job as a teacher at the local university and had W-2 income of $12,000. Peter chooses a normal 12-month year. His 2006 calendar-year income tax return shows a Schedule C with the income and expenses of the restaurant from January 1 through June 2, 2005 and W-2 wages for the rest of the year.

By choosing a 12-month year, a taxpayer can utilize the loss from the Schedule C. The taxpayer loses the tax attributes existing after the last day of the taxpayer's last tax return (ending before the bankruptcy petition date), because they are transferred to the bankruptcy estate. Since the last day of a calendar year taxpayer's tax year is December 31, the attributes that are carried forward from that return are transferred to the estate.

Short Years

In the year the bankruptcy petition is filed, an individual taxpayer can elect to file two short-year individual returns.[5] The first short year is the period from the beginning of the normal year (January 1 for calendar year filers) running through the day before the bankruptcy petition filing. The second short year is the period starting with the bankruptcy petition's filing date, running through the end of the taxpayer's tax year, which is normally December 31.

Opting for short-year filing is beneficial if a taxpayer has positive income for the first short year. This is the case because any **tax liability** becomes a debt of the estate and could be paid with estate assets.

5. IRC §1398(d)

8

Example 6. Use the same facts as **Example 5**, except Peter's restaurant is **profitable to the extent of $10,000** during the first six months of the year and he files two short-year returns.

Peter is only responsible for tax on the $12,000 of W-2 income and has effectively shifted the **tax** on the sole proprietorship to the bankruptcy estate.

Note. If his estimated tax payments for the first six months are more than his tax liability for the first six months, he may wish to file a normal 12-month year.

A taxpayer with a loss during the first short year may want to file a 12-month return. This is the case because the loss could be used to offset income for the remainder of the year. Since tax attributes are transferred to the estate after the last return for the year ending before the filing of the bankruptcy petition, a taxpayer filing two short years could use these attributes on the first short year's return before any excess is transferred to the bankruptcy estate.

The tax for each short year must be calculated using the annualized method found in IRC §443. The taxpayer must compute his income and deductions for each short year, annualize the income, compute the tax, and then prorate the tax back to the short year. This causes the income to be taxed at tax rates that would have applied if the taxpayer's income level was steady for the entire 12-month year. This annualization is calculated on a monthly basis, not a daily basis. The standard deduction cannot be claimed for a short-year period. The taxpayer must itemize his deductions.[6]

Attribute Carryforwards

Taxpayers with significant tax attribute carryforwards (such as NOLs) require analysis to decide the timing of filing and whether to choose a 12-month year, or elect two short years:

Example 7. Use the same facts as **Example 5**, except Peter has a net operating loss carryforward of $2,500 from the previous year. Peter chooses the full year method and reports $2,000 of income. The net operating loss attribute goes to the bankruptcy estate (possibly to return to Peter, at the end of the proceedings).

Example 8. Use the same facts as **Example 6.** Peter still has an NOL carryforward of $2,500 from the previous year. Peter elects the two short year method. In the first short year, the NOL attribute of $2,500 reduces the $10,000 sole proprietor income. The tax on the $7,500 is a priority claim in the bankruptcy estate. The second short year reports the $12,000 of wage income, and the tax liability is Peter's responsibility.

Note. Significant consideration should be given to:

1. Timing the bankruptcy filing to avoid the loss of the carryforward attributes to the bankruptcy estate.
2. Choosing the filing method of greatest advantage; either the 12-month year or electing the two short year method.

6. IRC §63(c)(6)(C)

Example 9. Mike has a short year from January 1 through April 18, 2006. During this short year, he has wage income of $12,000 and deductions consisting of $2,000 of real estate taxes, $1,000 of mortgage interest, and $500 of charitable contributions. He lives in a state without state income tax. He is single and can only claim himself. His annualized income and short-year income tax are computed as follows:

Wages (for short year)	$12,000
Itemized deductions (for short year)	(3,500)
Short-period income	$ 8,500
Divided by months in short year	÷ 4
	$ 2,125
Times months in full year (12)	× 12
Annualized income	$25,500
Exemptions	(3,200)
Annualized taxable income	$22,300
Tax on annualized taxable income	$ 3,015
Divided by months in full year	÷ 12
	$ 251
Times months in short year	× 4
Prorated short-year income tax	$ 1,004

Mike's tax for his second short-year return is calculated the same way, except eight months are in his second short year instead of four.

Short-Year Election. The election to file two short years must be made by the normal unextended due date of the first short year. The election must be made by the 15th day of the 4th month following the day before the filing of the bankruptcy petition. This is also the unextended due date for the first short-year return. "§1398 Election" is printed at the top of the first page of each short-year Form 1040.

A taxpayer who cannot complete the first short-year return by this date should file an extension showing the fiscal year for the short year. This constitutes a valid election. Once made, the election is irrevocable.

As mentioned earlier, by filing two short years, a taxpayer can use any existing tax attributes on the first short year's return. If new forms are not available, the most current income tax forms are used. The inappropriate year is crossed out, and the correct year is written beside it. Fiscal year dates are entered in their appropriate place at the top of the first page of each return.

Filing Status in Bankruptcy Filing Year

The taxpayer's filing status is based on the taxpayer's marital status on the last day of the short year. If the taxpayer is married on the last day of the short year, then the taxpayer files MFS or MFJ. Since bankruptcy is an individual filing, a married taxpayer normally uses MFS. The spouse of a taxpayer who filed a bankruptcy petition can elect to end his tax year on the same date as the taxpayer who filed for bankruptcy.

Bankruptcy Estate's Income Tax Return

The bankruptcy estate's income tax return includes the income and expenses from the date of the bankruptcy petition filing through the year end. An annual return is required until the date the bankruptcy proceeding terminates. The bankruptcy estate tax return is the responsibility of the bankruptcy trustee who has been assigned the case. It is not the responsibility of the taxpayer who filed the bankruptcy petition.

The annual return for an individual's bankruptcy estate is filed on Form 1041, *U.S. Income Tax Return for Estates and Trusts.* The trustee does not report the bankruptcy estate's income or expenses on Form 1041, although the tax is shown on this form. The trustee prepares a Form 1040 to report the estate's income and expenses. This Form 1040 is prepared using the MFS filing status, regardless of the taxpayer's normal filing status or marital status.

As mentioned earlier, a separate bankruptcy estate is not created for tax purposes for an individual filing a Chapter 13 bankruptcy, or for a corporation or partnership filing for bankruptcy. These taxpayers file normal returns for the year, and include all activity taking place in the bankruptcy proceeding.

Observation. Often a bankruptcy estate's trustee fails to have the estate's income tax returns prepared. Since the cost of tax preparation is an administration expense, preparing returns leaves fewer assets available to distribute to creditors.

It appears the IRS has been lax in pursuing trustees for their failure to file bankruptcy estate income tax returns. Since bankruptcy estates often generate sales of assets and debt forgiveness, the IRS has the potential to collect additional tax. A side consequence of failing to prepare a bankruptcy estate's income tax return is the loss of any remaining tax attributes being transferred back to the taxpayer.

BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 (BAPCPA)

New bankruptcy provisions took effect October 17, 2005 under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).[7] This act is the most extensive revamping of the bankruptcy code since its enactment in 1978.

Bankruptcy can no longer to be looked at as a quick fix. BAPCPA includes provisions that favor Chapter 13 credit rehabilitation over Chapter 7 debt relief. The new law seeks to return bankruptcy to its former position as an option of last resort by emphasizing the debtor's personal responsibility for his financial actions.

Expanded Duties and Responsibilities of Debtors

Credit Counseling.[8] BAPCPA expands the duties of the debtor upon filing a bankruptcy petition. Chief among these expanded duties is the requirement for petitioners to be certified by an approved nonprofit credit counseling agency within 180 days of filing a bankruptcy petition. Petitioners who fail to receive certification are ineligible for debt relief under any chapter of the bankruptcy code.

Petitioners must file this certificate with the court, disclosing the kind of service provided by the agency and a copy of a proposed debt repayment plan. This certification requirement does not apply to incapacitated or disabled petitioners, or petitioners who are serving on active duty in a military zone. Petitioners approved for bankruptcy relief must participate in financial management training.

Credit counseling agencies must meet certain standards and be approved by a U.S. trustee or the administrator of a bankruptcy estate to be qualified to issue certification. One standard requires agencies to provide services without a fee if a debtor is unable to pay. Services do not have to be provided in person. They may be provided over the phone or the Internet. The agency must provide assistance with budget analysis and offer opportunities for credit counseling.

7. BAPCPA (Senate Bill 256) was enacted on April 20, 2005, but most provisions became effective on October 17, 2005.

8. 11 USC §109(h)

> **Note.** The requirement of debtors to obtain credit counseling from approved nonprofit counseling agencies may be complicated by the fact that the number of available agencies is dwindling. Over the past two years, the IRS has undertaken a review of tax-exempt organizations that provide credit counseling services. Of the 41 audits completed as of May 15, 2006, 100% resulted in revocation, proposed revocation, or other termination of the agencies' tax-exempt statuses.[9] The IRS has tightened the application process as well. In 2005, only three of over 100 agencies were approved as tax-exempt.

Record Production. BAPCPA requires petitioners to produce additional documentation to verify their financial status when filing for bankruptcy.[10] This documentation includes pay stubs, itemized monthly income and expense records, postpetition projections of increases to income or spending, and copies of tax returns.

Chapters 7 and 11 petitioners must provide a copy of their most recently filed tax return to any creditor who timely requests it. If the return is not provided at least seven days prior to the meeting of creditors, the petition is dismissed.

Chapters 7, 11, and 13 debtors also must file a copy of their tax returns with the court, on the request of either the judge or an interested party. This requirement extends to any tax return required for periods ending while the bankruptcy case is pending and all tax returns for tax years ending during the three-year period prior to the filing date. Chapters 7 and 11 petitioners must produce all requested information within 45 days after filing. If a petitioner fails to produce records, his case is dismissed.

Chapter 13 debtors must file all required tax returns for the four-year period prior to the petition filing date. The trustee or court may grant debtors more time to comply with this requirement if a petitioner can show that failure to file was due to unusual circumstances. If a debtor fails to comply, the court may convert the Chapter 13 petition to a Chapter 7 petition. Chapter 7 permits a trustee to collect and liquidate the debtor's nonexempt assets by court order.

> **Observation.** This requirement may cause some taxpayers to request a quick turnaround time from preparers.

To protect the privacy of petitioners, the Director of the Administrative Office of the United States Courts is charged with establishing procedures for safeguarding "the confidentiality of any tax information" required to be provided under this section. This includes restrictions on creditor access to tax information.

Abuse Prevention

The driving force behind bankruptcy reform was to prevent abusive filings. Reform supporters felt the old bankruptcy law was too lenient, granting relief to some debtors who could afford to repay their debts, while allowing them to keep their homes, vehicles, boats, and so on.

The new law seeks to address these abuses by requiring stringent "means" testing, lengthening the limitation period for repeat filings, and limiting the household goods exemption. BAPCPA also places additional responsibilities on debtor's attorneys to discourage abusive filings.

Automatic Stay. Bankruptcy petitioners are granted an "automatic stay" that halts debt collections, utility shut-offs, repossessions, foreclosures, evictions, garnishments, and attachments. BAPCPA altered some of the provisions of the automatic stay. Landlords now, under certain conditions, may proceed with residential evictions. Regarding tax debts, the automatic stay is limited to taxes owed by the petitioner prior to filing for bankruptcy. The stay does not apply to any taxes incurred after filing.

---

9. *IRS Takes New Steps to Curb Abuses by Credit Counseling* Agencies, IR-2006-80, May 16, 2006

10. 11 USC §521

Elimination of "Superdischarge." BAPCPA eliminated the practice known as "superdischarge," where some courts dismissed the tax obligations of Chapter 13 debtors who failed to file tax returns. Now, taxes resulting from failure to file, untimely filing, or fraudulent filing cannot be discharged under Chapter 13. Chapter 7 filers are prohibited from discharging tax obligations arising from failure to file or untimely filing of tax returns.

Tests for Abuse. BAPCPA raises the qualifying bar for Chapter 7 debt relief by eliminating the presumption that a petitioner is entitled to relief unless there is a finding of substantial abuse. The new standard replaces the requirement for a finding of substantial abuse to that of just simple abuse. However, abuse can be determined by facts and circumstances even if a petitioner satisfies this new standard.

A Chapter 7 petition failing the test for simple abuse faces dismissal. Alternatively, a Chapter 7 petition for debt relief could be converted to a Chapter 13 petition upon consent of the debtor. Chapter 13 requires the debtor to repay some of his debts.

The test to determine whether simple abuse exists involves two steps:

1. **Median Income Test.** This step determines if a debtor's current monthly income exceeds the state median income for a family of the same size.
2. **Means Test.** This step determines the amount of a debtor's current monthly income in excess of allowable expenses for a family of that size.

> **Note.** The standards used in this test are IRS National Standards. These are the same standards used by the IRS to determine eligibility for an offer in compromise.

A petitioner's **current monthly income** is his average monthly income over a 6-month period. If a petitioner has current monthly income below the state median level, no presumption of abuse exists. Petitioners whose net current monthly income exceeds the state median income are subject to the means test of Step 2.

The **means test** projects a debtor's current monthly income less specified expenses over a 5-year period.[11] IRS National Standards establish allowances for food, clothing, personal care, and entertainment based on the debtor's family size. If reasonable and necessary, debtors are allowed to increase their food and clothing allowance by up to 5%. Local standards establish transportation and housing allowances. An additional category of "other necessary expenses" is recognized, but there is no standard allowance for this type of expense.

11. 11 USC S707(b)(2)

The following chart is taken from the IRS National Standards for a 4-person household.[12]

Four Persons National Standards
Based on Gross Monthly Income

Item	less than $833	$833 to $1,249	$1,250 to $1,666	$1,667 to $2,499	$2,500 to $3,333	$3,334 to $4,166	$4,167 to $5,833	$5,834 and over
Food	433	463	501	502	558	574	685	868
Housekeeping supplies	42	43	44	46	52	53	66	94
Apparel & services	144	145	151	152	190	191	201	302
Personal care products & services	44	46	47	48	49	52	58	89
Miscellaneous	193	193	193	193	193	193	193	193
Total	**$856**	**$890**	**$936**	**$941**	**$1,042**	**$1,063**	**$1,203**	**$1,546**
Bankruptcy Allowable Living Expenses – National Standards (See 11 U.S.C. § 707(b)(2)(A)(ii)(I))								
Food & Clothing (Apparel & services)*	577	608	652	654	748	765	886	1170
5% of Food & Clothing	**29**	**30**	**33**	**33**	**37**	**38**	**44**	**59**

Presumption of Abuse. BAPCPA initiates a "bright line" rule for determining whether a rebuttable presumption of abuse exists.[13] This rule renders a petitioner ineligible for debt relief under Chapter 7 if:

- The debtor has $166.67 or more in current monthly income ($10,000 over a 5-year period) after allowable expenses are deducted, regardless of the amount of the debtor's unsecured debt; or
- The debtor has at least $100 of current monthly income ($6,000 over a 5-year period) that is sufficient to pay at least 25% of the debtor's nonpriority, unsecured debt over five years.

Example 10. Tim's net monthly income exceeds the Illinois median income. After deducting allowed expenses, his net monthly income is $125. Tim owes $33,000 in nonpriority, unsecured debt.

Since Tim's excess monthly income is more than the Illinois median but less than $166.67, he may be eligible for Chapter 7 debt relief. However, he must also have sufficient funds to pay at least 25% of his nonpriority, unsecured debt over a 5-year period. This means Tim must have projected excess income of at least $8,250 ($33,000 × 25%) over the five-year (60-month) period.

However, Tim's 5-year projected excess income is only $7,500 ($125 × 60 months). Since Tim cannot pay at least 25% of his nonpriority, unsecured debt over five years with his excess income, no abuse is presumed.

Example 11. Use the same facts as in **Example 10,** except Tim owes $30,000 in nonpriority, unsecured debt. Since, over five years, Tim could pay at least 25% of this debt ($30,000 × 25% = $7,500), abuse would be presumed. Tim's Chapter 7 case would either be dismissed or he could convert his case to a Chapter 13 bankruptcy.

---

12. www.usdoj.gov/ust/eo/bapcpa/bci_data/national_expense_standards.htm

13. 11 USC 707(b)(2)(A)(i)

Rebutting a Presumption of Abuse. A debtor can rebut the presumption of abuse if special circumstances require an allowance for additional expenses or adjustments to monthly income. The debtor must fully support any rebuttal with detailed documentation.

Attorney Compliance. Attorneys and agencies that advertise services in the debt management field must disclose the services they provide and must openly state that bankruptcy may be one of the options they employ. They must also provide debtors with notices regarding alternatives to bankruptcy.

Within five business days after the first date on which a debtor's attorney provides any bankruptcy assistance services, and prior to filing a petition, the attorney must execute and provide a copy of a written contract with the prospective bankruptcy filer. This contract must explain the services that will be provided, fees and charges, and the terms of payment.

BAPCPA effectively requires attorneys to ensure that debtors comply with Chapter 7 means testing by imposing civil penalties on attorneys who file nonqualified Chapter 7 petitions. The act also permits the court to award costs and fees to a trustee who successfully brings suit against an attorney who violates the rules.[14]

Future Bankruptcy Filings. BAPCPA expands the time between subsequent Chapter 7 debt discharges from six to eight years.[15] It also requires those granted Chapter 13 relief to wait two years before refiling, or three years if the debtor received a discharge under Chapters 7, 11, or 12.

If a debtor has a history of repeated filings, it may give rise to a rebuttable presumption of abuse.

Protection of Consumer Assets

In addition to abuse prevention, BAPCPA also instituted some consumer protection provisions. The act provides protection for certain retirement funds and also protects certain education savings accounts from being turned over to the bankruptcy estate. The debtor's residence is also protected, although this homestead exemption may be limited in certain circumstances.

Qualified Pension Plan Exemption. BAPCPA allows debtors to exempt the following pension plans entirely from their bankruptcy estates: Plans qualified under IRC §§401, 403, 414, 457, or 501(a), SEPs, and SIMPLEs.

IRA Exclusion. BAPCPA imposes a cap of $1 million on the protection of assets in a debtor's traditional and/or Roth IRA accounts. This amount is subject to inflation indexing. The limitation applies only to contributions, growth, and nonexempt rollovers. It does not apply to funds that were rolled over from qualified pension plans.

> **Note.** Practitioners should advise their clients to keep records regarding any amounts rolled from qualified plans into IRAs. These records should include the source, date, and the amount of the rollover. Records pertaining to the source account should also be retained.

Education Accounts.[16] BAPCPA generally exempts funds held in certain IRC §§529 and 530 educational accounts established at least 720 days before a bankruptcy is filed. The account beneficiary must be a child, including an adopted or foster child, stepchild, grandchild, or stepgrandchild of the petitioner. The act imposes a $5,000 exemption limit on contributions made between 720 and 365 days before a petition is filed.

Contributions made to education accounts within one year of filing a bankruptcy petition, or made in connection with an extension of credit, are included in the petitioner's bankruptcy estate. Contributions in excess of the annual $2,000 cap per child will also be included in the estate.

14. A trustee may pursue action under a 11 USC §707(b) motion for violation of Rule 9011 in filing a Chapter 7 bankruptcy.

15. 11 USC §727(a)(8)

16. 11 USC 541(b)(5)

Homestead Exemption. A debtor is allowed an exemption for his personal residence. However, this is not a blanket exemption. The timing of the sale in relation to the bankruptcy filing affects the exemption amount. Dollar limitations also apply in certain cases:

1. If a debtor sells nonexempt property and reinvests the proceeds into his home in an attempt to hinder, delay, or defraud a creditor within 10 years prior to filing bankruptcy, the homestead exemption is effectively reduced by the amount attributable to this transaction.
2. If any interest in a homestead is acquired within 1,215 days of filing (roughly three years and four months), the amount of the acquisition available to be excluded is limited to $125,000.

> **Note.** This limitation does not apply to family farms or to amounts "rolled over" from the sale of a previous residence in the same state. It also does not apply to the extent that any value in excess of $125,000 is reasonably necessary for the support of the debtor or his dependents.

3. The homestead exemption also is limited to $125,000 under each of the following circumstances:
   - **a.** The debtor is convicted of a felony, which circumstantially demonstrates that the filing was an abuse of the bankruptcy laws, or
   - **b.** The debtor owes debt arising from:
     - Violations of the Securities Exchange Act or similar laws;
     - RICO civil penalties; or
     - Criminal acts, intentional tort, or reckless misconduct causing serious physical injury or death to another individual in the preceding five years.

> **Note.** The court does not have to find "intent" to impose this limit.

Example 12. P. J. Stimpson lost a civil suit in February 1997. In March of that year, he sold several paintings for $500,000 and used that money to build a room addition onto his new Florida home. In December of 2005, he filed for bankruptcy. His Florida home was worth $1.3 million at the time he filed.

Under the new law, if the court finds that the sale and investment were transacted with the intent to protect assets from creditors, the court can limit the value of his homestead exemption to $800,000 ($1,300,000 – $500,000).

Example 13. Kendra purchases her first home for $200,000 in January of 2003. The home was purchased with money Kendra inherited. In January of 2006, she files for bankruptcy. The value of her homestead exemption is limited to $125,000 because her home was purchased within 1,215 days of filing.

Nondischargeable Debts Expanded

BAPCPA expanded the categories of debts that do not qualify for discharge under bankruptcy. The following list includes some of these expansions:

- Money or credit obtained through fraud or false written statements
- Debts incurred for luxury items
- Debts of over $500 owed to a single creditor and incurred within 60 days of filing
- Cash advances exceeding $750 that were made within 70 days of filing
- Domestic support obligations and nonsupport obligations incurred in divorce or separation

- Debt incurred to pay state or local taxes
- Student loans obtained from for-profit and nongovernmental agencies

DISCHARGE OF INDEBTEDNESS (DOI)

> **Note.** The income tax consequences of debt resolution, including the handling of discharge of indebtedness income is discussed in Chapter 12, "Agricultural Issues and Rural Investments."

Form 1099-C

Debt relief is reported on Form 1099-C, *Cancellation of Debt*. This form, if required, is issued for certain debts of $600 or more that are canceled during the year.[17] Total forgiven debt is shown in box 2, while any interest included in the debt is identified in box 3 of the form.

> **Note.** See the *Earnshaw* case in the "Gross Income" section of Chapter 15, "Rulings and Cases."

Where to Report. An individual taxpayer reports nonbusiness debt forgiveness on Form 1040 as other income (line 21 of the 2005 Form 1040). If debt forgiveness is business related, it is reported on the appropriate business form, such as Schedule C, *Profit or Loss from Business (Sole Proprietorship)*, or Schedule F, *Profit or Loss from Farming*. It is subject to self-employment tax. Debt forgiveness related to rental activities is reported on Schedule E, *Supplemental Income and Loss*.

C corporations report debt forgiveness income as other income on Form 1120, *U.S. Corporation Income Tax Return*. Special rules apply to S corporations.[18] DOI is passed through to shareholders, but it does not increase a shareholder's basis for purposes of deducting losses. This applies to losses occurring after October 11, 2001, as a result of the *Gitlitz* Supreme Court decision.[19] A partnership passes debt forgiveness income through to its partners. Any available exclusion for pass-through debt forgiveness is determined individually at the partner's level.

Requirements to Issue Form 1099-C. Since 2000, lending institutions, including credit card companies, are required to issue Form 1099-C when debt is cancelled. The following entities are required to file this form:

1. Financial institutions described in IRC §581 or IRC §591(a), such as domestic banks, trust companies, building and loans, or savings and loan associations
2. Credit unions
3. Federal government offices, including the following:
   - Departments
   - Agencies
   - Court or court administrative offices
   - Instrumentalities in the executive, judicial, or legislative branches of the government, including government corporations

---

17. IRC §6050P
18. IRC §108(d)(7)
19. *D.A. Gitlitz v. Commr.*, S Ct. 2001-1 USTC ¶50,147, 121 Sct. 701, January 9, 2001

4. Any of the following, or a successor or subunit of the following:
   - Federal Deposit Insurance Corporation (FDIC)
   - Resolution Trust Corporation
   - National Credit Union Administration
   - Any military department
   - U.S. Postal Service
   - Postal Rate Commission
5. A corporation that is a direct or indirect subsidiary of a financial institution or credit union, but only if, because of the affiliation, it is subject to supervision and examination by a federal or state regulatory agency
6. Any organization engaged in the significant trade or business of lending money, such as a finance company or credit card company, whether or not affiliated with a financial institution. The lending of money is a significant trade or business if money is lent on a regular and continuing basis.

Timing of Issuance. A Form 1099-C is required to be issued in the year a debt is forgiven. Regulations stipulate eight identifiable events that can trigger the issuance of Form 1099-C.[20] These events are as follows:

1. A discharge of indebtedness under Title 11 of the United States Code (bankruptcy).
2. A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in receivership, foreclosure, or similar proceeding in federal or state court, as described in IRC §3686(e)(3)(A)(ii) (other than bankruptcy).
3. A cancellation or extinguishment of indebtedness upon the expiration of the statue of limitations for the collection of indebtedness.
4. A cancellation or extinguishment of indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collections.
5. A cancellation or extinguishment of indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding.
6. A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge the debt at less than full consideration.
7. A discharge of indebtedness pursuant to a decision by the creditor to discontinue collection activity and discharge debt.
8. The expiration of the nonpayment testing period. This period expires during the calendar year if the creditor has not received a payment on the debt at any time during the testing period ending at the close of the year. The testing period is a 36-month period increased by the number of months during all or part of which the creditor was precluded from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law.
   - This identifiable event may be rebutted by the creditor if the creditor has engaged in significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year, or if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged.
   - Significant, bona fide collection does not include merely nominal collection action, such as automated mailings. Facts and circumstances showing the debt has not been discharged include the existence of a lien relating to the debt, or the sale or packaging for sale of the indebtedness by the creditor.

8

20. Treas. Reg. §1.6050P-1(b)(2)

Form Not Required. A Form 1099-C is not required to be issued for the following types of debt:

1. Debt discharged in bankruptcy, unless the creditor knows that the debt was incurred for business or investment purposes
2. Interest related to the debt, since interest forgiven on business, investment, or mortgage loans may not result in taxable income
3. Nonprincipal amounts, such as penalties and administrative costs
4. Debts canceled by a person related to the debtor

An individual or business who is not required to file a Form 1099-C for a forgiven debt can voluntarily file one if the taxpayer so chooses. In this case, a Form 1099-C should be issued in the same manner as those required to be filed. However, filing a false or fraudulent 1099-C can result in the imposition of penalties against the filer.[21]

Filing a Form 1099-C does not preclude a lender from collecting from a guarantor of a loan.[22] In *Leonard,* a bank made a loan to a corporation and had the shareholder personally guarantee the loan. After the corporation defaulted on the loan, it filed for bankruptcy. The corporation's bankruptcy case was dismissed and no discharge was granted. The bank then issued a Form 1099-C for the uncollected balance of the loan. Next, the bank demanded payment from the shareholder who filed suit saying the filing of the 1099-C was evidence the note was cancelled. The court did not agree with the shareholder.

Recourse versus Nonrecourse Liabilities

A recourse liability is a liability for which a taxpayer will be held responsible, regardless of the value of the property relinquished. When property subject to a recourse debt is transferred due to foreclosure, the sales price is deemed to be the lower of the fair market value (FMV) of the property or the debt outstanding. Debt relief to the extent of FMV is considered part of the sales price and is used to compute gain or loss on the sale, which can be capital or ordinary, depending on the property transferred.

However, if the outstanding debt exceeds the FMV, the debtor is still liable for the difference. If and when a debtor is relieved from a recourse liability, the amount of debt forgiveness is shown on Form 1099-C, *Cancellation of Debt.* If a taxpayer receives a Form 1099-A, it indicates that debt forgiveness may be associated with the transfer of property, though it may not occur at that same time. This debt forgiveness income is treated as ordinary income.

> **Example 14.** Sandy borrowed $100,000 from the bank to purchase land on which she intends to build a vacation home for personal use. She remits the proceeds of the loan to the seller. When she is unable to make her loan payments, Sandy negotiates with the bank to reduce the loan to $80,000. Sandy has debt forgiveness income of $20,000 ($100,000 – $80,000).

Debt relief on the transfer of property subject to a nonrecourse liability does not automatically result in debt discharge income. The amount of the debt relieved will be included in the amount realized on the sale or exchange of the property.

A recourse debt that a creditor cancels with outstanding debt remaining immediately after abandonment or foreclosure can result in a creditor issuing either:

1. A Form 1099-A **and** a Form 1099-C, or
2. A Form 1099-C only, with boxes 5 and 7 completed in addition to boxes 2 and 3.

21. Service Center Advice Memorandum 1998-020, June 17, 1998

22. *Leonard v. Old National Bank Corporation*, 837 N.E. 2d 543 (Ind.), November 21, 2005

Renegotiation of Debt

A third-party lender's renegotiation of a loan can result in DOI income. This applies to both recourse and nonrecourse liabilities. A debt reduction due to a renegotiation with the original seller is not DOI income but is an adjustment to the purchase price.

> **Example 15.** Jim purchases land for $100,000 financed by the seller. He is unable to make his payments so he negotiates with the seller to reduce the loan to $80,000. Jim does not have debt forgiveness income. Instead, Jim reduces the basis of the land to $80,000. The seller now reports a sales price of $80,000 instead of $100,000.

Debt Released by Gift

If debt discharge is intended as a gift, there is no reportable DOI income. The discharged amount is treated as a payment to the creditor and a like amount is deemed given to the debtor as a gift. The IRS considers the donative intent of forgiveness in determining whether debt forgiveness is taxable or treated as a gift.

Unless the presumption is refuted, a familial relationship implies gratuitous gifting. To be considered a gift, the transaction must not be one in which the creditor is simply attempting to dispose of the claim for the "best price available." A gift tax return may be required if the forgiven amount is more than the annual exemption amount.

> **Example 16.** A grandson purchases land on contract from his grandfather for $100,000. The grandson is unable to make his payments so his grandfather reduces the loan to $80,000. The grandson does not have debt forgiveness income because his grandfather is considered to have gifted the $20,000 to him.
>
> The grandson is considered to have made the $20,000 payment to his grandfather. Since this gift exceeds the gift tax threshold of $12,000, the grandfather is required to file a gift tax return. Unlike **Example 15,** the grandfather must still report a sales price of $100,000.

8

Exceptions under IRC §108

IRC §108(a)(1) provides four situations when debt forgiveness does not result in income to the taxpayer at the time the debt is forgiven. These exceptions are applied in the following order:

1. Title 11 bankruptcy;
2. Insolvency;
3. Qualified farm indebtedness; and
4. Qualified real property business indebtedness for taxpayers other than C corporations.

Title 11 Bankruptcy Exception. To qualify for the bankruptcy exception, a discharge must be granted within a plan approved by the court under Chapters 7, 11, or 13 of the bankruptcy code.[23]

Debt forgiveness may take place in the same year as a bankruptcy. To determine whether DOI income is reported on the return of the debtor or of the bankruptcy estate, it is important to know whether a debt was forgiven before a bankruptcy, as part of a bankruptcy, or after the filing of a bankruptcy petition.

A Form 1099-C should be addressed to the bankruptcy estate for a Chapter 7 bankruptcy. However, the form is often issued to the taxpayer and institutions often do not reissue it. Taxpayers must account for this form on their individual tax returns to avoid IRS notification of a mismatch. The bankruptcy box should be checked on the form.

---

23. Title 11 of the U.S. Code

Insolvency Exception. To qualify for an exclusion based on insolvency, a taxpayer must have liabilities in excess of the FMV of his assets immediately before the debt is forgiven. This exclusion is limited to the lesser of the debt or the insolvency.

> **Example 17.** Joel and Maria had total assets of $62,500 and debts of $75,000. Therefore, they are insolvent by $12,500.

To determine the amount of insolvency, a taxpayer must show the FMV of all assets. Some property may be included in the determination of insolvency even though state law exempts these assets from the claims of creditors. The Tax Court denied a married couple an exclusion for debt forgiveness income because they failed to consider their home and a portion of the value of their personal property assets when determining the extent of their insolvency.[24]

Qualified Farm Indebtedness Exception. The farm indebtedness exclusion is available for debts directly related to the running of a farm business. To qualify, 50% or more of a taxpayer's gross receipts for the prior three years must be from farming. The sale of inventory, livestock, and farm machinery count toward this percentage. However, farm rental income, in which the owner does not participate in the farming activity, and credits received under the Wisconsin Farmland Preservation Act are not considered proceeds from farming.[25]

Qualified Real Property Business Indebtedness Exception (Noncorporate). A debt must be incurred or assumed by a taxpayer in connection with real property used in a trade or business, including a rental activity. It must be secured by that property to qualify for this exception. The debt must either have been incurred prior to January 1, 1993, or be qualified acquisition indebtedness, which is debt incurred specifically to purchase a property. A taxpayer can exclude up to the amount of the outstanding principal of the debt minus the FMV of the property securing it. Real estate must continue to be held by the taxpayer after the debt forgiveness.

Limitations on §108 Exclusions

IRC §108 exclusions apply only to debt discharge that is not treated as a portion of the sale of property. When two or more exclusions are applicable, §108 provides the order in which they should be applied.

> **Example 18.** Lenny is both insolvent and has qualified farm indebtedness. He first applies the insolvency exception. If there is remaining debt forgiveness after this exception, the qualified farm indebtedness exception is then applied.

Tax Consequences of Excluding Discharged Debt

While §108 provides for the exclusion of certain debt forgiveness income from taxable income, this exclusion is not without cost. A taxpayer must reduce certain tax attributes to the extent of any exclusion. Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, is used to report any applicable reductions.

Order of Reduction of Tax Attributes

Tax attributes to the extent of the excludable debt are reduced in the following order:

1. NOLs and carryovers, with the NOL occurring in the year of discharge considered first and the remaining amount carried into such year considered next
2. General business credits available as of the beginning of the year
3. The minimum tax credit available as of the beginning of the year
4. Capital loss carryovers from the current year first, then prior years
5. Basis of the taxpayer's property

---

24. *E.D. Johns*, TC Summary Opinion 2001-67, May 9, 2001

25. *M.A. Lawinge v. Commr.*, 103 TC 428, September 1, 1994

6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers

> **Note.** The minimum tax credit, general business credits, passive activity credits, and foreign tax credit carryovers are reduced at the rate of 33¢ for every excludable dollar. Other attributes are reduced on a dollar-for-dollar basis.

In the case of bankruptcy and insolvency, the amount of nontaxable debt forgiveness is not tied to the amount of available tax attributes.

Example 19. Pam's Form 1099-C reflects $5,000 of credit card debt forgiveness. Pam's assets include personal effects of $700. She also has student loans of $20,000. Her liabilities immediately before the cancellation of debt exceed her assets by $24,300 [($5,000 + $20,000) – $700]. Pam reduces the basis of her personal effects to $0, but she still excludes the entire $5,000 even though her tax attributes are only $700.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code **Credit Services** **10 This Place** **Whosville, MI 50000**			OMB No. 1545-1424 **2006** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S federal identification number **111-11-1111**	DEBTOR'S identification number **123-45-6789**	1 Date canceled **07/10/2005**	2 Amount of debt canceled $ **5000.00**	**Copy B** **For Debtor** 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 taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name **Pam**		3 Interest if included in box 2 $	4	
Street address (including apt. no.) **10 Somewhere St.** City, state, and ZIP code **Anywhere, IL 60000**		5 Debt description **Credit card**		
Account number (see instructions) **1**		6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

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

The reduction in basis due to cancelled debt in bankruptcy or insolvency cannot be more than the total basis of property held immediately after the debt cancellation, minus the total liabilities immediately after the cancellation. This limitation does not apply if an election is made to reduce basis before reducing other attributes. This election is discussed later.

Example 20. Lynda has assets with a basis of $94,000 and debts of $105,000. Her debt is reduced by $20,000 to $85,000. Therefore the basis in her assets can only be reduced by $9,000 ($94,000 – $85,000).

In the case of a qualified farm indebtedness or real property indebtedness exception, the amount of nontaxable debt discharged cannot exceed the amount of tax attributes available. Property qualifying for these two exceptions includes only that which is used in a trade or business, or for investment.

Example 21. John has qualified farm debt. The bank issues him a Form 1099-C related to the purchase of farm equipment in the amount of $120,000. John's only tax attributes include NOL carryovers of $50,000. John sold his farm property in the prior year but has a personal residence worth $150,000.

John is not insolvent but the residence is not taken into consideration when calculating the qualified farm indebtedness exclusion. Therefore, John excludes $50,000 of debt forgiveness income and pays taxes on the remaining $70,000.

Election to Reduce Basis

A taxpayer may make a special election to reduce the basis of the taxpayer's property before applying other tax attribute reductions. This election applies only to the aggregate adjusted basis of **depreciable** property held by the taxpayer on the first day of the year following the election. Assets sold during the current year are not subject to basis reduction. IRC §1017 provides ordering rules when there are multiple properties subject to basis reduction.

This election must be made on the taxpayer's timely filed return for the taxable year in which the discharge occurs. An election after the due date of the return may only be made with the consent of the IRS. To request this consent, the taxpayer must:

1. File a statement making the election and a completed Form 982 with an amended return or claim for credit or refund; and
2. Establish reasonable cause for failing to make the election on the original return.

The election is revocable only with the consent of the Secretary.

> **Note.** A special automatic extension of six months from the due date (including extensions) may apply to any election whose due date is the taxpayer's timely filed return. The automatic extension is exercised by providing the following statement atop the document: "Filed Pursuant to §301.9001-2." A late election made under this provision should be sent to the same address a timely election would have been sent.

Example 22. Sherry received a Form 1099-C in the amount of $40,000 of qualified farm indebtedness. Her tax attributes include her home, which is worth $150,000, farm equipment worth $25,000, and an NOL of $50,000. Since Sherry is not insolvent, she is excluding the debt forgiveness income under the qualified farm indebtedness exception. Her personal residence is not taken into consideration for this purpose.

Sherry wishes to preserve her NOL for future use, so she elects to reduce the basis of her farm equipment first. This election is shown on the completed Form 982 which is shown below.

> **Note.** A taxpayer may have good reason to make the election relating to depreciable property. It may be to preserve the NOL for use in the future against the sale of the property whose basis has been reduced or in anticipation of future income.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code **Farmer Credit Inc.** **20 This Place** **Whosville, MI 50000**			OMB No. 1545-1424 **2006** Form **1099-C**	**Cancellation of Debt**
CREDITOR'S federal identification number **222-22-2222**	DEBTOR'S identification number **987-65-4321**	1 Date canceled **07/12/2005**	2 Amount of debt canceled $ **40000.00**	**Copy B** **For Debtor**
DEBTOR'S name **Sherry**		3 Interest if included in box 2 $	4	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 taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.) **50 Somewhere St.** City, state, and ZIP code **Anywhere, IL 60000**		5 Debt description		
Account number (see instructions) **3**		6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

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

For Example 22

Form **982** (Rev. January 2006) Department of the Treasury Internal Revenue Service	**Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)** ▶ Attach this form to your income tax return.	OMB No. 1545-0046 Attachment Sequence No. **94**

Name shown on return	Identifying number
Sherry	987-65-4321

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☐
c	Discharge of qualified farm indebtedness		☑
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of certain indebtedness of a qualified individual by reason of Hurricane Katrina		☐
2	Total amount of discharged indebtedness excluded from gross income	2	40,000
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☑ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations sections 1.1017-1 and 1.1017-1T for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

	Enter amount excluded from gross income:		
4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	25,000
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	15,000
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	9	
10	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10	
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	11a	
b	Land used or held for use in a trade or business of farming	11b	
c	Other property used or held for use in a trade or business, or for the production of income	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III **Consent of Corporation to Adjustment of Basis of its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ .... from its gross income for the tax year beginning .... , and ending .... Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ....
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 3 of this form. Cat. No. 17066E Form **982** (Rev. 1-2006)

8

Limitation on Basis Reduction. Under the §108 exclusions for bankruptcy or insolvency, a reduction in basis of the taxpayer's assets is limited to the total bases of the taxpayer's property, including money, immediately after the discharge minus the taxpayer's total liabilities immediately after the discharge.[26]

By making an election to reduce bases before other attributes, a taxpayer reduces only the bases of depreciable property. However, this bases reduction applies only if the reductions will reduce the amount of depreciation or amortization allowed in future years, including the year immediately following the year of discharge.

Once this election is made, the reduction in bases is limited to the total bases of the taxpayer's depreciable property, ignoring any liabilities. Making this election could result in a larger basis reduction than without the election, depending on the amount of post-discharge liabilities.

> **Example 23.** Tom has $70,000 of debt forgiveness excludable under the insolvency exception. His depreciable assets have a basis of $100,000 with debts remaining after discharge of $150,000. Tom also has a $40,000 NOL.
>
> Without the election, Tom reduces his NOL to zero and has no asset basis reduction since his debts exceed his asset basis. Thus, Tom's depreciable asset basis remains at $100,000 and his tax attributes decreased by $40,000.
>
> However, by making an election, Tom can reduce the basis of his assets by the $70,000 exclusion from $100,000 to $30,000, but keep his NOL.

Inventory Election. A taxpayer can make an election to treat certain real property inventory described in IRC §1221(1) as if it were "depreciable property" by checking the box on Form 982, line 3. Making this election allows a taxpayer to have or increase the amount of depreciable property on which to make an election to reduce the basis of depreciable property, thus preserving other tax attributes for later use.

Ordering Rules for Basis Reduction

There are specific ordering rules for bases reductions. The reductions are proportioned among all items in a particular group. Reductions should be applied in the following order:

1. Real property used in a trade or business or held for investment that secured the debt immediately before its discharge, other than real property inventory
2. Personal property used in a trade or business or held for investment that secured the debt immediately before its discharge, other than inventory, accounts receivable, and notes receivable
3. Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, or real property inventory
4. Inventory, accounts receivable, notes receivable, and real property inventory
5. Property not used in a trade or business nor held for investment

Basis reductions affect property a taxpayer holds at the beginning of the year immediately following the year the debt is discharged. These reductions are treated as depreciation when the property is eventually sold. Property, such as land, that does not fall under IRC §1250 is treated as IRC §1245 property when it is sold.

These reductions lower the amount of depreciation the taxpayer may claim in future years. A taxpayer using MACRS calculates depreciation by dividing each remaining year's depreciation rate by the total of the remaining years' rates.[27]

---

26. IRC §1017

27. Treas. Reg. §1.168-2(d)(3)

Example 24. During Year 1, Sam paid $20,000 for a computer that he depreciated under MACRS as five-year property with a half-year convention. Sam claimed 20% and 32%, respectively, as his MACRS deductions for the first two years.

During Year 3, Sam has $2,000 of basis reduction for this asset as a result of debt discharge. His depreciation calculations for the remaining life of this computer follow:

Original cost		$20,000
Prior depreciation		
Year 1 ($20,000 × 20%)	$ 4,000	
Year 2 ($20,000 × 32%)	6,400	
Total acumulated depreciation	$10,400	($10,400)
Adjusted basis		$ 9,600
Less debt discharge from basis reduction		(2,000)
Remaining adjusted basis		$ 7,600

Sam's depreciation on this asset for future years is calculated using the reduced basis and an adjusted rate of depreciation. The adjusted rate is the applicable depreciation rate for the year divided by the total of the remaining depreciation rates.

The total depreciation rates for the remaining depreciable life of Sam's computer are as follows:

Year 3	19.20%
Year 4	11.52%
Year 5	11.52%
Year 6	5.76%
Total	**48.00%**

Sam divides the applicable unadjusted depreciation rates by the total percentage of depreciation remaining to arrive at his debt discharge adjusted depreciation rates for his computer:

Year 3	19.20%	÷	48.00%	=	40.00%
Year 4	11.52%	÷	48.00%	=	24.00%
Year 5	11.52%	÷	48.00%	=	24.00%
Year 6	5.76%	÷	48.00%	=	12.00%
Total					100.00%

Sam applies these adjusted depreciation rates to the reduced adjusted basis of the computer for the remaining years:

Year 3	40.00%	×	$7,600	=	$3,040
Year 4	24.00%	×	$7,600	=	$1,824
Year 5	24.00%	×	$7,600	=	$1,824
Year 6	12.00%	×	$7,600	=	$ 912
Total					$7,600

The $2,000 debt forgiveness basis reduction is treated as accumulated depreciation. If Sam holds his computer until it is completely depreciated, the depreciation claimed plus the basis reduction equals his original basis of $20,000 [($10,400 + $7,600) + $2,000 = $20,000].

Student Loans

IRC§108(f) provides special rules for the exclusion of income resulting from the forgiveness of student loans. Students engaged in public-service oriented occupations, such as education or medicine, may qualify for this exclusion. The loans must have been provided by the U.S. government or one of its agencies, a state government or political subdivision, a public benefit corporation exempt under IRC §501(c)(3), or an educational institution that has an arrangement with one of these to provide loans for education in certain areas of need.

This debt forgiveness exception does not apply if the student or former student performs these public services for the benefit of the educational institution that lent the money. Forgiveness in these cases is treated as compensation to the student. Performance of services for businesses that agree to pay or loan money to fund education and forgive the loan after completion of a certain time period generally results in compensation to the employee.

Miscellaneous

Amended Returns. A taxpayer that repays a discharged debt previously included in income is permitted to file an amended return for the year the discharged income was taxed, providing the statute of limitations has not expired for that year.[28] The special repayment rules that require taxpayers to claim a credit or deduction on the return for the year of repayment, such as for repayment of disability income, do not apply to debt discharge situations.

Timing of Debt Forgiveness. The timing of debt forgiveness was addressed in the case of *Walter Sims Jr.*[29] Mr. Sims obtained a Discover credit card in 1986. He quit making payments in 1993. Various collection attempts were made, but discontinued in 1996. In 1998, Mr. Sims was issued a Form 1099-C for the $3,104 balance of his account. However, he had moved and never received the form. Subsequently, he did not report this income on his 1998 return.

The Tax Court examined the credit card company's records from September 2001 and found Mr. Sims' debt on its books. The record did not show how the company determined that the debt had been discharged in 1998, or even if it ever made such a determination. The Tax Court found the only identifying item fixing the time of the loss in 1996 was when the company stopped collection activities.

Since the company could not show any activity occurring between 1996 and 1998 that triggered the debt forgiveness, and since the debt still existed on the company's books, the actual timing of any forgiveness was in doubt. Since the IRS relied solely on the issuance of the Form 1099-C to determine the timing of the debt forgiveness and since the timing of the form's issuance was in question, the Tax Court denied the IRS's position, ruling that the income was not taxable in 1998.

Taxability of Credit Card Insurance Proceeds. The Tax Court addressed the issue of whether the proceeds of credit card insurance policies are taxable in the case of *Khen Thi Huynh*.[30] Mr. Huynh was unemployed for nearly two years during 1996 and 1997. Previous to this time, he had purchased an insurance policy to cover his credit card payments in the event of his unemployment, disability or death. This policy paid about $20,000 of payments on his credit cards during his period of unemployment.

Mr. Huynh argued these payments were not taxable, comparing the proceeds to payments for an auto insurance claim. He then argued the payments were about the same as the credit card companies' interest charged for the year. He finally argued that the credit card companies benefited by the payments, not him.

The Tax Court discounted Mr. Huynh's comparison of the insurance proceeds he received for credit card payments to those for an auto insurance claim since auto claims are contingent on damages to property. Payments for damage claims are nontaxable if they restore a taxpayer's investment in damaged property. If recovery for a damage claim exceeds the basis in damaged property, taxable income may result.

---

28. Significant Service Advice Memorandum 200235030, September 13, 2002

29. *Walter Sims Jr.*, TC Summary 2002-76, June 26, 2002

30. *Khen Thi and Hong Van Huynh v. Commr.*, TC Summary Opinion 2001-131, August 30, 2001

The court determined Mr. Huynh's payments were taxable since he received an economic benefit when the insurance company made the payments owed on his credit cards. Although the IRS counsel conceded he could offset this taxable amount by any premiums paid for the unemployment portion of his policy, Mr. Huynh was unable to substantiate his premium payments and failed to receive this reduction.

The court addressed a similar issue in 2005 with Gerald Bunker, who argued his insurance policy proceeds were similar to property insurance payments and therefore nontaxable.[31] The Tax Court cited two cases in which realized accessions to wealth are presumed taxable income, unless a taxpayer can demonstrate that an acquisition is specifically exempted from taxation.[32] Since the insurance payments did not compensate Mr. Bunker for capital destroyed or damaged, his proceeds were taxable.

INVESTOR ISSUES FOR SPECIFIC INDUSTRIES

GAS AND OIL

Ownership of a gas or oil operation may take the form of a partnership or a **working interest**. Passive activity rules apply to oil and gas investments in which the taxpayer does not materially participate. A common form of passive participation is through a limited partnership that invests in oil and gas. A working interest ownership, however, provides a means to avoid the passive implications without direct involvement.

Operational Expenses

Investors who take active roles in the operation of gas or oil businesses are entitled to claim deductions in the same manner as any other business owner. Operational expenses may include the cost of drilling wells and the operation of the wells itself. These operational costs may be expensed or capitalized and recovered through depreciation or depletion.

Tangible drilling costs may include labor, fuel, repairs, hauling, and supplies. These may be charged to the capital account if they are associated with drilling, shooting, and cleaning of wells, clearing ground, draining, road making, surveying, and construction of derricks, tanks, pipelines, and other physical structures. Depreciable items include structures in the wells or on the property, as well as physical property such as drilling tools, pipe, casing, tubing, tanks, engines, boilers, and machines.

The costs associated with the production or creation of these assets are capitalized into the basis and not available as a current deduction or an IRC §59(e)(1) cost. Assets used in the drilling of offshore oil and gas wells are in asset class 13.0, which has a class life of 7.5 years, a MACRS life of five years, and an ADS life of 7.5 years. Onshore drilling has a separate class 13.1 with a class life of six years, a MACRS life of five years, and an ADS life of six years.

Independent producers may claim a deduction for percentage depletion at the rate of 15% of gross income, less rents and royalties paid in respect to the property. The deduction may not exceed the taxable income of the property. The calculation must be made on each separate property. An independent producer is **one who produces no more than 75,000 barrels per day**. This rate increased from 50,000 barrels effective August 8, 2005.

8

31. *Gerald Bunker*, TC Summary 2005-35, March 30, 2005

32. *Glenshaw Glass Co.*, 348 U.S. 426, March 28, 1955; and *Roemer*, 716 F2d 693, September 22, 1983

Example 25. Joe Slick owns two oil wells. His depletion is calculated as follows:

	A	B
Gross income	$1,000	$2,000
Operating expenses	(900)	(1,500)
Net profit before depletion	$ 100	$ 500
Percentage depletion (15%)	150	300
Allowable depletion	100	300

A depletion deduction can also be calculated on the basis of cost. The method resulting in the largest deduction should be used. Cost depletion is calculated on each property or well separately. Three steps are required in determining cost depletion:

1. Estimate the number of units (barrels of oil) that make up the deposit.
2. Determine the cost per barrel by dividing the cost or basis of property allocable to the depletable reserves and divide it by the number of units (barrels) from Step 1.
3. Multiply the cost per barrel by the number of barrels extracted and sold during the year.

Example 26. The cost associated with the ABC Oil Well is $1,000,000. The well is expected to yield 100,000 barrels of oil. In 2006 the well produces 20,000 barrels.

The cost depletion for 2006 is $200,000 ($1,000,000 cost ÷ 100,000 barrels) or $10 per barrel times the 20,000 barrels produced in 2006.

IRC §59(e) Elections

Intangible drilling costs (IDC) include all operator expenditures incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil, gas, or geothermal energy. These expenses may be recovered currently or they may be capitalized and recovered through depletion or depreciation, as applicable. Capitalized IDC associated with nonproductive wells (dry holes) may be deducted currently, even if located outside the United States.

An election may be made under IRC §59(e)(1) to amortize expenses ratably over a 60-month period, beginning with the month the expense is paid or incurred. This election must be made by the due date of the return, plus extensions, for the year the deduction will be claimed. The election is made by attaching a statement to the tax return, which must include the taxpayer's name, address, and tax identification number. It must also include the type and amount of the qualified IDC cost that the taxpayer elects to amortize.

A taxpayer may elect to amortize all or a portion of the costs incurred or paid in a taxable year. The election can be revoked only with the consent of the Commissioner in rare and unusual circumstances. If granted, a revocation applies retroactively to the year the amortization was first claimed, unless the year is closed. In that case, the revocation applies to the first open year. If a taxpayer incurs IDC in a partnership or S corporation, the election is made by the individual, rather than at the entity level.

AMT Implications

Percentage depletion may result in an AMT adjustment if the deduction claimed for the year is more than the adjusted basis of the property at the end of the year, without regard to the current year's depletion deduction. This adjustment is the difference between the depletion claimed and the basis of the property.[33] Independent oil and gas producers and royalty owners are not subject to this preference item.

33. IRC §57(a)(1)

Intangible drilling costs also may result in an AMT adjustment. If the expenses are deducted currently a preference may exist. If a §59(e)(1) election is made, no preference will exist. If the election is not made, a formula is provided in the instructions to Form 6251, *Alternative Minimum Tax — Individuals*, for determining the amount of the preference. The preference has been repealed for independent producers, unless the reduction in AMT tax would be more than 30%. To determine this, a calculation of the preference is still required.

Working Interest

A working interest in an oil and gas well is an "operating mineral interest" in which the taxpayer is burdened with the cost of development and operation of an oil or gas property, including the responsibility to share the expenses of drilling, completing, or operating the property. This form of ownership entitles a taxpayer to deductions that would otherwise be limited by the passive activity rules.[34]

Under the working interest exception, a taxpayer need not meet the normal material participation rules to avoid passive activity limitations. A working interest is distinguishable from other interests because the liability of the taxpayer may not be limited either personally or through a pass-through entity. Royalty interests, production payment interests, or net profit interests do not qualify as working interests.

> **Note.** Taxpayers with working interests should receive a statement of the expenses incurred during the year. This statement includes ordinary expenses, capital improvements, and any other information necessary to complete the tax return. This income may be reported on Form 1099-MISC.
>
> Working interest income and expenses are reportable on Schedule C and are subject to self-employment tax. A partnership K-1 may also reflect a working interest if the taxpayer is a general partner. Limited partnership interests and ownership of stock in a corporation dealing in oil and gas will not be considered a working interest.

WIND TURBINES (WINDMILLS)

Electricity produced by wind at a qualifying facility is eligible for a credit under IRC §45(a). Form 8835, *Renewable Electricity, Refined Coal, and Indian Coal Production Credit*, is used to calculate this credit. The 2005 credit was equal to 1.9¢ per kilowatt hour of electricity produced.

To qualify for the credit, the power generated must not be sold to a related party. The credit may be used for a 10-year period for a wind facility placed in service after December 31, 2005, and before January 1, 2008. This credit was extended for two years by the Energy Tax Incentives Act of 2005.

Wind energy facilities are also one of the resources qualifying for the clean renewable energy bond (CREB) credit during 2006 and 2007. More information on CREBs, and other provisions of the recent energy bills, may be found in Chapter 14, "New Legislation."

Wind Energy Property

In general, wind energy property consists of windmills, wind-driven generators, storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. The depreciable life of wind energy property is five years.[35]

An item used by both auxiliary equipment and wind energy equipment is wind energy equipment only if its use of energy other than wind energy does not exceed 25% of its total energy input. This input is determined by an annual measuring period and only to the extent of its basis or cost allocation to its use of wind energy during an annual measuring period.

---

34. IRC 469(c)(3)

35. IRC §168(e)(3)(B)

Further Credit Incentives

The credit under §45(a) was expanded by the Energy Tax Incentives Act of 2005. The credit now is available not only to facilities using wind to produce electricity, but also to other electricity-producing facilities, such as the following:

- Closed loop biomass facilities that produce electricity using organic matter from plants
- Open-loop biomass facilities that use manure, litter, or nonhazardous waste materials
- Geothermal energy sources consisting of natural heat stored in rocks
- Solar energy facilities
- Small irrigation power facilities generating power without the use of dams
- Municipal solid waste facilities using garbage, refuse, or sludge
- Hydropower facilities

These credits may be 5 or 10 years in duration depending on the type of facility. The credit is part of the general business credit. The credit is generally 1.5¢ per unit of energy produced, indexed for inflation, but may be reduced by one-half in the case of open-loop facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities.

FIX-AND-FLIP DEVELOPERS

Fix-and-flip developers are taxpayers who are interested in making a quick profit by purchasing, renovating, and reselling property. These activities may be construed as either investment or business related. Taxpayers receive several tax advantages when profits are treated as investment income, such as lower capital gains tax rates and relief from self-employment taxation.

The IRS's perception of the activities of fix-and-flip developers dictates the type of tax treatment that applies to profits from these ventures. Since the code and case law do not directly address the treatment of fix-and-flip developers, the tax treatment often depends on the unique facts and circumstances of each situation.

In the *Gartrell* case,[36] the court set forth eight factors for determining whether real estate purchased and later sold is held for sale or investment. These factors also could be applied to fix-and-flip activities. In *Gartrell*, the court determined the individuals were not in the trade or business of selling real estate. The *Gartrell* factors include:

1. The purpose for which the property was acquired;
2. The purpose for which the property was held;
3. The type and extent of improvements made to the property by the taxpayer;
4. The frequency, number and continuity of sales made by the taxpayer;
5. The nature and substance of each real estate transaction, including the volume of income generated from real estate sales compared to the taxpayer's other resources;
6. The nature and extent of the taxpayer's trade or business (e.g., a taxpayer employed in the real estate industry might have a more difficult time proving investment status than a factory worker);
7. The extent of (or lack of) advertising to promote sales; and
8. The direct use of a broker to list the property for sale.

---

36. *Francis E Gartrell and Mabel L. Gartrell*, 619 F2d 1150, April 2, 1980

The courts have held that the frequency of sales and the manner in which a seller holds himself to the public will influence the determination of whether a taxpayer is considered to be an investor or a business owner. In the case of *M.W. Enslin*,[37] the court disallowed capital gain treatment on a land sale. The taxpayer purchased land in 1966 with the intention of developing it and selling the lots and homes, but an economic downturn forced him to leave the construction industry, selling most of his property.

In the early 1970s, after attempting several other business activities, Enslin began building homes. He also resurrected his plans for the parcel purchased in 1966. In completing his income tax return, Enslin treated the land sale as a capital asset, rather than a business asset. The court disallowed this capital gain treatment, asserting the land and the homes were held for sale as a business activity.

However, the court determined land sold by an accountant qualified as an investment-related activity in *R.L. Hamilton*.[38] Hamilton, an accountant, sold a 10-acre parcel of land adjacent to his personal residence that he had acquired some years earlier to protect his access road to lake frontage. Even though the property was sold for development, the court ruled that Hamilton's occupation and the lack of frequency of these types of transactions allowed the sale to qualify for capital gain treatment.

Business

A business is defined as a regular and continuous activity carried on for the purpose of producing a profit. However, the definition of "regular and continuous" is not black and white. It could mean flipping five properties in a year or it could mean selling one property each year for a series of years.

An individual that purchases properties to renovate and resell as a business must treat properties held for sale as inventory. Sales of such property would generate ordinary income, regardless of the length of time the property was held. Costs associated with these renovations would be capitalized. The profits from these activities are subject to self-employment tax.

In determining whether an activity is considered a business or investment, the frequency of activity is often assessed. In *M.L. Rockwell*,[39] the court determined that extensive real estate activity over a long period of time, together with a lack of other income-producing activities, signaled that profits from real estate sales were business-related and subject to self-employment tax.

> **Note.** The court often leans toward business treatment if a taxpayer has any link to the real estate industry, whether in construction or sales.

Investment

A property held for investment is one in which the return is made from the appreciation of the asset. A fix-and-flip developer ideally would like to classify the transaction as an investment rather than a business, taking advantage of the capital gain rates and saving self-employment tax.

Perhaps the best way to defend investment activity would be to spend a minimal amount of time and money on the renovation of property. With minimal additional investment and a sale at an appreciated value, the investment factor would be more credible.

Another alternative to the business side might be to commit to renting the renovated property for a period of time. This would make the sale easier to justify as capital gain, particularly if there are a number of properties involved.

---

37. *M.W. Enslin*, TC Memo 1982-430, July 28, 1982

38. *R.L. Hamilton*, TC Memo 1973-93, April 23, 1973

39. *M.L. Rockwell*, TC Memo 1972-133, June 22, 1972

Land Developers

The land development area of real estate taxation has more code and case law to allow an educated judgment of the business versus investment outcome. IRC §1237 includes conditions when the sale of a tract of real estate as lots would not automatically be considered to be a business subject to self-employment tax. The conditions are as follows:

1. An individual is not currently in the business of selling lots.
2. No substantial improvements have been made to the lots. An improvement is considered substantial if a taxpayer has owned the property for 10 years and the improvements involve the building of roads, or the installation of sewer and water facilities.[40]
3. The improvements are necessary for the sale of the property.
4. The cost of the improvements is not included in the basis.
5. The lots or parcel have been held by the taxpayer for five years, except in the case of inheritance or devise.

A nonbusiness activity is presumed if the above conditions are met and not more than five lots are sold. If more than five lots are sold, a portion of the gain from the sale or exchange may be treated as ordinary income.

In the year a sixth lot is sold, that lot and any other lots sold during the year are subject to a special tax calculation, where the gain equivalent to 5% of the selling price, reduced by selling expenses, is treated as ordinary gain in the course of a trade or business. If a period of five years passes between the sales of these lots, the tract are treated as a new tract with the five-lot exception starting over.

Example 27. In 2005, Andy sold five of six lots he had developed that qualified for §1237 treatment. In 2006, Andy sells the sixth lot in the parcel for $125,000. Andys basis in this lot is $99,250, with selling expenses of $750. His net profit is $25,000.

Andy's ordinary income from the transaction is $5,500 [($125,000 × 5%) – $750]. The remaining gain of $19,500 receives capital gain treatment.

If ongoing maintenance and improvements are made, such as the addition of roads, and an election is chosen to treat the improvements as insubstantial, no adjustment is made for improvements. Maintenance is treated as a miscellaneous investment expense on Schedule A, subject to 2%.

The IRS determined that §1237 could not be used to apply capital gain treatment to the conversion of rental units in an apartment building into condominiums for sale to the general public.[41] IRC §1237 applies only to a tract of unimproved land. The IRS did not address whether the sale was considered a business or investment activity.

TAX-EXEMPT ORGANIZATIONS

Note. Detailed information about tax-exempt organizations can be found in several IRS publications: Pub. 4220, *Applying for 501(c)(3) Tax Exempt Organizations,* Pub. 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations,* and Pub. 557, *Tax-Exempt Status for Your Organization.*

Accountants often are asked to serve on the boards of nonprofit organizations or churches due to their expertise in financial and tax matters and their organizational skills. The tax rules governing nonprofits are numerous and complex and violations of these rules may endanger the tax-exempt status of an organization. Therefore, it is important to understand the basic rules for nonprofit entities. The following section discusses major issues and filing requirements for nonprofit organizations. In-depth research may be required for specific situations.

40. IRC §1237(b)(3)

41. Rev. Rul. 80-216

CRITERIA FOR TAX-EXEMPT STATUS

The American Bar Association defines a tax-exempt or nonprofit organization as a corporation "no part of the income or profit of which is distributed to its members, directors or officers."[42] A nonprofit organization is not precluded from making a profit from its own operations, as long as it is used to further the exempt purpose and maintain or improve the organization. Many of these organizations generate substantial profits and may pay reasonable compensation to officers and directors for services rendered.

There are two types of tax-exempt corporations:

1. Donative nonprofits, which are public benefit corporations
2. Commercial nonprofits, which are mutual benefit corporations

Donative types are generally charitable organizations providing service to the general public whereas commercial nonprofits sell a product or service to a limited membership.

The absence of equity shares is a clear distinction between a business corporation and a not-for-profit organization. There are also three main **characteristics** common to all nonprofit corporations:

1. The entities are specifically designated as nonprofit corporations when organized and registered with the Secretary of State or other designated state filing offices;[43]
2. No portion of the profits or assets of the organizations are distributed to corporate officers, directors or members; and
3. The corporations pursue only activities or purposes that are permitted by their respective state statutes.

8

> **Note.** Some states make a distinction between nonprofit and not-for-profit. However, this discussion uses both terms interchangeably.

Public officials examine the reasonableness of corporate activities when evaluating whether a corporation has a profit or nonprofit motive. Following are some examples of the types of activities examined:

- Payments for salaries, fees, transfers, or gifts to any person who controls or is controlled, either directly or indirectly, by the organization
- Loans, liens, or guaranties
- Sales, purchases, or management of property
- Vendor payments for supplies and services

Example 28. Carol is the unpaid treasurer for the Boys and Girls Club, a nonprofit organization. She and her husband own and operate a janitorial service. If their business provides any goods or services to the club, their charges cannot be any higher than comparably charged goods and services. If their charges exceed reasonable and customary charges, both Carol and the club could be liable for sanctions imposed by state government officials.

---

42. American Law Institute, *Model Nonprofit Corporation Act of 1964*

43. Labor unions, cooperative organizations, and organizations subject to any insurance laws of a state may not be organized as a nonprofit under the above act which serves as the model act for most states.

PRIVILEGES OF NONPROFIT ORGANIZATIONS

Nonprofit organizations are granted special privileges that allow them to maximize available funding to promote their tax-exempt purposes. Examples of these privileges are itemized below:

- Exemption from federal income tax
- Authorization to solicit tax-deductible donations and contributions
- Reduced postal rates
- Exemption from state sales tax on purchases
- Exemption from real estate taxes
- Relief from certain payroll taxes, such as the following:
  - Federal unemployment tax
  - Certain state unemployment taxes, as authorized by each individual state
  - Social security tax for exempt employees (e.g., ministers)

In addition to the nonprofit corporations described earlier, other entities eligible for exempt status include trusts (testamentary or *inter vivos*), unincorporated associations with at least two members, and limited liability companies.

TAX-EXEMPT STATUS

Different rules apply to organizations based on the organization's IRS classification. The following table shows the applicable code section for each type of nonprofit organization.

Code Section	Tax-Exempt Organization
501(c)(1)	Corporations organized under an act of Congress
501(c)(2)	Title-holding corporations for exempt organizations
501(c)(3)	Charitable, religious, educational, scientific, and certain other organizations
501(c)(4)	Civic leagues, social welfare organizations, and local associations of employees
501(c)(5)	Labor, agricultural, and horticultural organizations
501(c)(6)	Business leagues, chambers of commerce, real estate boards, etc.
501(c)(7)	Social and recreation clubs
501(c)(8) & (10)	Fraternal beneficiary (8) and domestic fraternal (10) societies and associations
501(c)(9)	Voluntary employees' beneficiary associations
501(c)(11)	Teachers' retirement fund associations
501(c)(12)	Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, etc.
501(c)(13)	Cemetery companies
501(c)(14)	State chartered credit unions, mutual reserve funds
501(c)(15)	Insurance companies or associations other than life insurance
501(c)(16)	Cooperative organizations to finance crop operations
501(c)(17)	Supplemental unemployment benefit trusts
501(c)(18)	Employee-funded pension trusts (created before June 25, 1959)
501(c)(19) & (23)	Post or organization of past or present members of the armed forces
501(c)(21)	Black lung benefit trusts
501(c)(22)	Withdrawal liability payment funds
501(c)(25)	Title-holding corporations or trusts with multiple parents
501(c)(26)	State-sponsored organizations providing health coverage for high-risk individuals
501(c)(27)	State-sponsored workmen's compensation and insurance and reinsurance organizations
501(d)	Religious and apostolic associations
501(e)	Cooperative hospital service organizations
501(f)	Cooperative service organizations of operating educational organizations
501(k)	Child care organizations
501(n)	Charitable risk pools
527	Political organizations

Requirements to Qualify for IRC §501(c)(3) Status

Many organizations strive to achieve an IRC §501(c)(3) status. Although organizations listed in §§501(c), (d), (e), (f), (k), and (n) are generally exempt from federal tax, §501(c)(3) organizations have a distinct fund-raising advantage since donors may deduct donations made to organizations qualifying under this code section.

There are five main requirements an organization must satisfy in order to qualify for tax-exempt status under §501(c)(3):

1. The organization must be organized and operated exclusively for religious, charitable, scientific, educational, literary, or other listed purposes;
2. The organization's net earnings or assets must not be used for the advantage of any private individual or shareholder;
3. No substantial part of the organization's activity may attempt to influence legislation;
4. The organization must not intervene in political campaigns; and
5. The organization's purposes and activities must be legal and may not violate any fundamental public policies.

Exempt Purposes under §501(c)(3)

The first requirement shown above is the most important in determining an organization's tax status. An organization's purpose should be clearly stated in its articles of incorporation, bylaws, or other organizing documents.[44] The qualifying purpose may be religious, charitable, scientific, educational, or "other," as further defined below.

Religious. Treas. Reg. §1.511-2(a)(3)(ii) provides the following guidance for determining whether an organization's purpose may be construed as religious:

What constitutes conduct of religious worship or the ministration of sacerdotal functions depends on the interests and practices of a particular religious body constituting a church.

To avoid charges of discrimination, the government is very careful not to limit the definition of a "religious" purpose. The following are examples of characteristics commonly attributed to churches:

- Recognized creed and form of worship
- Definite and distinct ecclesiastical government
- Code of doctrine and discipline
- Distinct religious history
- Ordained ministers complete prescribed courses of study
- Regular religious services led by ordained ministers

Charitable. Since this area may cover a broad spectrum of purposes, the code does not limit this category by providing specific definitions. Charitable purposes may include activities undertaken for the building and maintenance of public buildings and monuments, assistance to the poor, underprivileged, or distressed, or other similarly typed activities.

Scientific. To qualify under this category an organization must have a scientific purpose benefiting the general public, as opposed to private interests. Organizations in this category include nonprofit hospitals, cooperative hospital service organizations, and medical research organizations. Research for commercial activities does not qualify. However, commercial research activities that are made available to the public on a nondiscriminatory basis, such as cancer research, may qualify.

Educational. The regulations provide a broad definition of education. Obvious entities such as colleges, universities, and professional schools qualify, but museums, zoos, and planetariums may also qualify.

Factors used to determine whether an organization's purpose qualifies as educational include the following:

- Is the primary function of the organization to provide formal instruction?
- Does the organization maintain a regularly scheduled curriculum?
- Does the organization have a regular faculty of qualified teachers?
- Is there a regularly enrolled student body?
- Is there a fixed location where educational activities are carried on regularly?

It is important to note that the government does not grant tax-exempt status to any school that employs discrimination, regardless of whether the school may otherwise be considered to have an educational purpose.

---

44. An organization's purposes, at a minimum, must be included in the articles of organization. Stating the purpose solely in the bylaws is insufficient.

Other Purposes. Other qualified organizational purposes may include providing low-income housing for the elderly or handicapped, or providing scholarships, fellowships, educational loans, or other educational grants to students or researchers.

Examples of §501(c)(3) Organizations

The following list itemizes examples of organizations that may qualify for §501(c)(3) status:

- Nonprofit old-age homes
- Parent–teacher associations
- Charitable hospitals
- Alumni associations
- Schools
- Red Cross or Salvation Army chapters
- Boys or Girls Clubs
- Churches

An organization cannot be considered exempt simply based on its activities, nor can it be considered exempt based on the use of tax-exempt type wording in its title.

Example 29. In 1970, famed atheist Madalyn Murray O'Hair[45] and her husband Richard organized "The Poor Richard's…Church." [46] The purpose of this organization was tax evasion. Of course, this purpose did not qualify under §501(c)(3) and the "church" was not granted tax-exempt status.

8

Classification of §501(c)(3) Organizations

An organization qualifying under §501(c)(3) may be classified as either a public charity or a private foundation. The distinction lies in the source of financial support. A public charity has a broad base of support, whereas a private foundation receives support from a small number of donors. Donations to a private foundation are limited more than a public charity. A private foundation may also be subject to excise taxes.

IRS statistics record the following information regarding the total number of §501(c)(3) organizations (by subsection) in the United States in 2004, as well as the number of returns filed by each type of entity, the gross receipts, and total assets held by each subtype.

45. Yes, that's really how her name is spelled.

46. *Nonprofit Corporations Organizations & Associations*, 6th Edition, Howard L. Oleck, Prentice Hall Trade, May 1994

Number of Non-501(c)(3) Exempt Organizations in the United States, 2004

IRS Subsection	Number	Number Filing with IRS	Gross Receipts	Total Assets
01- Corporations originated under act of Congress, including Federal Credit Unions	97	7	13,035,657	292,841,376
02- Title-holding corporation for a tax-exempt organization	5,899	3,507	3,026,661,683	13,984,888,455
04- Civic leagues, social welfare organizations, and local associations of employees	119,515	30,625	63,610,625,155	68,150,434,929
05- Labor, agricultural, horticultural organizations. These are educational or instructional groups. . . .	58,362	23,850	27,818,627,238	24,743,271,933
06- Business leagues, chambers of commerce, real estate boards, etc. formed to improve conditions. . . .	71,470	35,486	49,465,182,709	48,968,589,749
07- Social and recreational clubs which provide pleasure, recreation, and social activities	56,494	19,756	12,399,255,278	19,518,493,882
08- Fraternal beneficiary societies and associations, with lodges providing for payment of life. . . .	66,998	8,917	43,272,342,488	78,007,159,645
09- Voluntary employees' beneficiary associations (including fed. employees' voluntary beneficiary. . . .	10,731	7,879	229,098,421,623	114,524,267,884
10- Domestic fraternal societies and associations — lodges devoting their net earnings to charitable. . . .	20,835	3,930	1,221,968,150	2,549,575,575
11- Teachers retirement fund associations	13	8	701,954,408	1,247,750,418
12- Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or coop. . . .	5,918	3,861	34,910,483,847	76,737,658,653
13- Cemetery companies, providing burial and incidental activities for members	9,660	2,792	2,877,364,629	7,637,388,111
14- State-chartered credit unions, mutual reserve funds, offering loans to members. . . .	3,855	1,448	25,688,574,600	320,761,268,004
15- Mutual insurance companies or associations, providing insurance to members substantially at cost. . . .	1,181	720	1,886,255,827	4,560,912,663
16- Cooperative organizations to finance crop operations, in conjunction with activities. . .	17	12	21,553,579	384,511,834
17- Supplemental unemployment benefit trusts, providing payments of supplemental unemployment comp. . . .	315	156	425,109,264	287,185,535
18- Employee funded pension trusts, providing benefits under a pension plan funded by employees. . . .	1	1	1,803,608,897	1,527,870,206
19- Post or organization of war veterans	35,097	8,808	2,360,695,496	269,528,882,121
20- Trusts for prepaid group legal services, as part of a qualifying group legal service plan or plans	10	8	5,816,031	5,217,232
21- Black lung trusts, satisfying claims for compensation under Black Lung Acts	28	0	0	0
23- Veterans association formed prior to 1880	2	2	294,655,177	2,478,242,295
24- Trust described in Section 4049 of ERISA	1	0	0	0
25- Title-holding company for pensions, etc.	1,213	1,050	5,680,244,086	26,570,194,754
26- State-sponsored high risk health insurance organizations	9	8	260,358,026	113,724,681
27- State-sponsored workers compensation reinsurance	9	4	4,077,092,965	5,086,141,429
40- Apostolic and religious orgs. - 501(d)	142	0	0	0
50- Cooperative hospital service organization - 501(e)	18	13	893,191,343	624,786,836
60- Cooperative service org. of operating educ. org.- 501(f)	1	0	0	0
90- 4947(a)(2) Split interest trust	482	437	846,012,737	26,969,710,364
92- 4947(a)(1) Private foundations	3,187	2,953	1,254,146,725	3,845,269,645
	471,560	**156,238**	**513,913,237,618**	**1,119,106,238,209**

Source: IRS Business Master File 12/2004 (with modifications by the National Center for Charitable Statistics at the Urban Institute)

> **Note.** Possible explanations for the large discrepancy between the number of approved 501(c)(3) organizations and the number of organizations that file returns:
>
> 1. The entities ceased operating but failed to inform the IRS.
> 2. The entities are failing to comply with IRS reporting requirements.
> 3. They are otherwise exempt.

Application Process for §501(c)(3)

Before applying for §501(c)(3) status, an organization must obtain an employee identification number. Qualifying organizations then must receive approval from the IRS. Applications for approval are filed on Form 1023, *Application for Recognition under Section 501(c)(3) of the Internal Revenue Code*.

Form 1023. Form 1023 is a 12-page application consisting of detailed questions regarding an organization's structure, history, activities, purpose, compensation arrangements, and financial data. Form 1023, Schedules A through H, also must be submitted as required.

User Fee. A nonrefundable user fee is charged for processing an application. If an organization's annual gross receipts are expected to be $10,000 or less, the fee is $150. If receipts are expected to be more than $10,000, the fee is $500.

Attachments. A copy of an organization's articles of organization, including amendments, bylaws, and bylaw amendments, must be submitted with the application.

8

Filing Deadline. Applicants should file Form 1023 within 15 months of the month in which the organization is legally formed. However, an automatic 12-month extension is available to organizations that miss this original 15-month deadline. To obtain an automatic extension, the following statement should be shown at the top of the applicant's Form 1023: "Filed pursuant to §301.9100-2."

Completed applications should be submitted, along with the user fee and all attachments, to the following address:

Internal Revenue Service
P.O. Box 192
Covington, KY 41012-0192

> **Note.** Applicants using express mail or a delivery service should consult the checklist found in the Form 1023 instructions for an alternate address.

Effective Date. The effective date of exemption is the organization's legal date of formation.

Application Checklist. The IRS provides a useful checklist (shown below) to prevent the submission of an incomplete Form 1023. All form questions should be answered or, when appropriate, "not applicable" should be indicated. Missing information may result in the application being returned as incomplete.

Form 1023 Checklist

(Revised June 2006)

Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code

Note. *Retain a copy of the completed Form 1023 in your permanent records. Refer to the* General Instructions *regarding Public Inspection of approved applications.*

Check each box to finish your application (Form 1023). Send this completed Checklist with your filled-in application. If you have not answered all the items below, your application may be returned to you as incomplete.

☐ Assemble the application and materials in this order:
- Form 1023 Checklist
- Form 2848, *Power of Attorney and Declaration of Representative* (if filing)
- Form 8821, *Tax Information Authorization* (if filing)
- Expedite request (if requesting)
- Application (Form 1023 and Schedules A through H, as required)
- Articles of organization
- Amendments to articles of organization in chronological order
- Bylaws or other rules of operation and amendments
- Documentation of nondiscriminatory policy for schools, as required by Schedule B
- Form 5768, Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation (if filing)
- All other attachments, including explanations, financial data, and printed materials or publications. Label each page with name and EIN.

☐ User fee payment placed in envelope on top of checklist. DO NOT STAPLE or otherwise attach your check or money order to your application. Instead, just place it in the envelope.

☐ Employer Identification Number (EIN)

☐ Completed Parts I through XI of the application, including any requested information and any required Schedules A through H.
- You must provide specific details about your past, present, and planned activities.
- Generalizations or failure to answer questions in the Form 1023 application will prevent us from recognizing you as tax exempt.
- Describe your purposes and proposed activities in specific easily understood terms.
- Financial information should correspond with proposed activities.

☐ Schedules. Submit only those schedules that apply to you and check either "Yes" or "No" below.

Schedule A	Yes ___	No ___	Schedule E	Yes ___	No ___
Schedule B	Yes ___	No ___	Schedule F	Yes ___	No ___
Schedule C	Yes ___	No ___	Schedule G	Yes ___	No ___
Schedule D	Yes ___	No ___	Schedule H	Yes ___	No ___

☐ An exact copy of your complete articles of organization (creating document). Absence of the proper purpose and dissolution clauses is the number one reason for delays in the issuance of determination letters.

- Location of Purpose Clause from Part III, line 1 (Page, Article and Paragraph Number) ________________
- Location of Dissolution Clause from Part III, line 2b or 2c (Page, Article and Paragraph Number) or by operation of state law ________________

☐ Signature of an officer, director, trustee, or other official who is authorized to sign the application.

- Signature at Part XI of Form 1023.

☐ Your name on the application must be the same as your legal name as it appears in your articles of organization.

Send completed Form 1023, user fee payment, and all other required information, to:

Internal Revenue Service
P.O. Box 192
Covington, KY 41012-0192

If you are using express mail or a delivery service, send Form 1023, user fee payment, and attachments to:

Internal Revenue Service
201 West Rivercenter Blvd.
Attn: Extracting Stop 312
Covington, KY 41011

Exemption from Requirement to File Form 1023. The following organizations are considered tax-exempt regardless of whether they file a Form 1023. However, these organizations still may wish to file a form to receive a determination letter recognizing their exempt status and specifying the tax deductibility of any contributions donated to them.

- Churches, synagogues, temples, and mosques
- Integrated auxiliaries of churches and conventions or associations of churches
- Public charities with gross annual receipts of $5,000, or less

Note. IRS Pub. 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986,* lists organizations eligible to receive tax-deductible contributions. This publication is available on the IRS website. However, it is not a complete listing of all eligible organizations since it does not include organizations that are exempt from filing Form 1023.

Non-§501(c)(3) Tax Exemption

Civil leagues, social clubs, cemetery companies, voluntary employees' beneficiary associations, fraternal societies, and agricultural organizations seeking tax-exempt status outside §501(c)(3), file Form 1024, *Application for Recognition of Exemption under Section 501(a).*

Farmers' cooperative associations file Form 1028, *Application for Recognition of Exemption under Section 521.* User fees apply to these forms. When no specific application form is prescribed, applicants should submit a written request for exemption to the IRS.

Requirements for Maintaining §501(c)(3) Status

Organizations qualifying as §501(c)(3) entities must adhere to specific rules and avoid engaging in prohibited transactions. The following activities can result in the assessment of an excise tax or the loss of an organization's tax-exempt status:

1. **Using an organization's net earnings for the advantage of any private shareholder or individual or to provide a substantial benefit to a nonqualifying private interest.** Advantages to insiders may include, but are not limited to, the payment of unreasonable compensation or the transfer of property for less than fair market value. This prohibition is absolute and failure to comply can result in the loss of an organization's tax-exempt status and subject the insider and organization's managers to an excise tax.

   The provision of a private benefit to persons who are not insiders must be for a charitable, educational, religious, or other exempt purpose. Examples of qualifying outside private beneficiaries are the poor or distressed, or the community at large. Violations of the private benefit rule must be substantial before an organization's tax-exempt status is jeopardized.

2. **Devoting a substantial part of an organization's activities to attempting to influence legislation (lobbying).** Attempting to influence legislation includes contacting or urging the public to contact members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or advocating the adoption or rejection of legislation.

   The penalty for excessive lobbying activities may include the revocation of an organization's exempt status, resulting in all income becoming taxable. A 5% excise tax may be imposed on the lobbying expenditures of the organization. A separate 5% excise tax may be imposed against organizational managers who knowingly authorize such expenditures.

   The excise taxes and penalties which can be imposed on exempt organizations and their employees were increased in the Pension Protection Act of 2006. These provisions are discussed in Chapter 14, "New Legislation."

> **Observation.** The IRS is currently warning exempt organizations that they are inspecting possible lobbying activities.

3. **Participating in, or intervening in, any political campaign on behalf of, or in opposition to, any candidate for public office.** Contributions to political campaign funds or public position statements are a clear violation of this rule. Voter education activities, public forums, and get-out-to-vote drives conducted in a nonpartisan manner are acceptable activities. Candidates may be invited to speak at organizational functions as long as opposing candidates have an equal opportunity to speak and no political fundraising occurs.

   This prohibition does not restrict individuals from expressing their personal opinions, as long as it is clearly indicated that the opinion is the individual's and not that of the organization. To avoid potential problems, all political comments should be made outside of organizational activities, meetings, and publications.

   Violations of this rule may result in the revocation of an organization's exempt status and/or the assessment of excise taxes. The excise tax imposed on charitable organizations is 10% of the political expenditures. An excise tax of 2.5% also may be imposed on the organization's managers, up to $5,000 per expenditure.

   The law provides a period of time to correct expenditures to the extent possible. If left uncorrected, an additional tax of 100% may be imposed against the organization and 50% on the managers, not to exceed $10,000. The IRS is very serious in these matters and organizations need to be properly advised of the consequences of engaging in these activities.

Example 30. The Christian United Methodist Church, an autonomous congregation, is a staunch advocate for Governor Rob Smith in his 2006 reelection campaign. In a series of sermons, Pastor Jim strongly advocated that all church members vote for Governor Rob. The church spent $5,000 to print a color brochure extolling Governor Rob's virtuous character.

Given the above facts, the IRS might impose the following excise taxes for prohibited involvement in a political campaign:

Church	$500 ($5,000 × 10%)
Pastor Jim	$125 ($5,000 × 2.5%)

The IRS could also seek to revoke the congregation's §501(c)(3) tax exemption.

4. **Engaging in illegal activities or violating fundamental public policies**. This rule speaks for itself. The penalty is revocation of the organization's tax-exempt status.

TAX RETURN FILING REQUIREMENTS FOR NONPROFITS

Nonprofit organizations may be required to file one or more income tax returns in the 990 series. Requirements for filing Form 990, *Return of Organization Exempt From Income Tax;* Form 990EZ, *Short Form Return of Organization Exempt From Income Tax*; and Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation*, vary for different organizations.

Tax-exempt organizations may be liable for tax on unrelated business income. If so, Form 990-T, *Exempt Organization Business Income Tax Return* , must be filed in addition to the organization's Form 990 annual information return.

8

Form 990 or 990EZ, *Return of Organization Exempt From Income Tax*

Unless an organization meets an exception, it must annually file either Form 990 or Form 990-EZ. There are 15 specific exclusions listed under General Instruction B of the instructions for Form 990/Form 990-EZ. These exemptions include churches, schools, private foundations, governmental units, and certain political organizations.

Form 990-EZ. Organizations meeting the following criteria may file Form 990EZ:

- Annual gross receipts more than $25,000 and less than $100,000, and
- Total assets at year end less than $250,000.

Organizations exceeding these limits must file Form 990. An organization qualifying to file Form 990-EZ may choose to file the longer Form 990.

For purposes of these rules, gross receipts include all amounts received from all sources during the accounting year without subtracting any costs or expenses. In determining the $25,000 gross receipts threshold, an organization is presumed to be under $25,000 if:

- It has been in existence for one year or less and received donations, or pledged to give, $37,500 or less during its first tax year.
- It has been in existence between one and three years and averaged $30,000 or less in gross receipts during each of its first two tax years.
- It has been in existence three or more years and averaged $25,000 or less in gross receipts for the immediately preceding three tax years, including the year for which the return would be filed.

An organization with a pending application for exemption should check the "application pending" box and complete the return as otherwise required. An organization that was required to file a return in a previous year but is no longer required to file, should notify the IRS to update its filing status. This will prevent future notices regarding nonfiling. Failure to file can jeopardize the deductibility of donor contributions.

SCHEDULES A AND B

IRC §501(c)(3) organizations and §4947(a)(1) nonexempt charitable trusts not treated as private foundations must attach a completed Form 990/990-EZ, **Schedule A**, *Organization Exempt Under Section 501(c)(3)*, to their returns.

This schedule provides additional information regarding highly-paid employees, independent contractors, statements about activities, reason for nonprivate foundation status, a support schedule, and information specific to other entities. Failure to attach this schedule constitutes an incomplete return. If it is not submitted, it can result in late filing penalties.

Form 990/990-EZ, **Schedule B,** *Schedule of Contributors*, must be filed by organizations unless they meet one of the special exceptions. Schedule B lists contributors who directly or indirectly donated money, securities, or any other type of property aggregating $5,000 or more to the organization during the year. The box on the front of Forms 990 or 990EZ must be checked to indicate if Schedule B is not required or a return is considered incomplete.

DUE DATES

Forms 990 and 990EZ are due by the 15th day of the 5th month after the end of an organization's accounting year. Form 8868, *Application for Extension of Time To File an Exempt Organization Return*, may be used to request an automatic three-month extension or longer.

A late-filing penalty of $20 per day, not to exceed the smaller of $10,000 or 5% of the organization's gross receipts for the year, is imposed on tardy returns, unless an organization can show the late filing was due to reasonable cause.

> **Note.** The IRS seems to be somewhat lenient in abating proposed penalties for first offenses. Optimally, any request for abatement should be submitted by the organization and not the accountant. A request may begin with the statement "We respectfully request…," followed by a reason for the tardiness (e.g., illness of a financial officer, death, etc.). If applicable, a statement should be included indicating that any penalty would impose a financial hardship on the organization.

FORM 990-T, *EXEMPT ORGANIZATION BUSINESS INCOME TAX RETURN*

Form 990-T, *Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))*, is used to report an organization's unrelated business income and to compute any unrelated business income tax liability. It is also used to report proxy tax liability and claim a refund of income tax paid by a regulated investment company, or a real estate investment trust on undistributed long-term capital gain. Any domestic or foreign organization exempt under §§501(a) or 529(a) must file Form 990-T if it has gross income from unrelated trade or business of $1,000 or more.

Organizations filing Form 990-T must make **estimated tax payments** if the expected tax for the year is $500 or more. These deposits must be made using Form 8109, *Federal Tax Deposit Coupon*, or using the Electronic Federal Tax Payment System (EFTPS). Payments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

Forms filed for employees' trusts, IRAs, Roth IRAs, Coverdell ESAs, and Archer MSAs are **due** on the 15th day of the fourth month. All other entities must file by the 15th day of the fifth month after the tax year-end. The **penalty for late filing** is 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25%. The minimum penalty for a return more than 60 days late is the smaller of the tax due or $100. The penalty for late payment of tax is one-half of 1% of the unpaid tax for each month or part of a month, not to exceed 25% of the unpaid tax.

FORM 990-PF, *RETURN OF PRIVATE FOUNDATION*

Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, is used to calculate tax based on investment income and to report charitable distributions and activities. It must be filed by the following organizations:

- Exempt private foundations
- Taxable private foundations
- Organizations that agree to private foundation status while their application is pending
- Organizations making a §41(e)(6) election
- Organizations making a §507 termination
- IRC §4947(a)(1) nonexempt charitable trusts that are treated as private foundations

Form 990-PF is due by the 15th day of the fifth month following the close of a foundation's tax year. Failure to file a timely return bears the same penalties as the Form 990 and 990EZ. However, large organizations are subject to a $100-per-day fine rather than $20 per day.

The filing address for all forms in the 990 series is:

Internal Revenue Service
Ogden, Utah 84201-0027

UNRELATED BUSINESS TAXABLE INCOME (UBTI)

Not-for-profit organizations are afforded exemption from income tax on activities that are related to their exempt purpose. If they choose to engage in a trade or business unrelated to their exempt purpose, they must use Form 990-T to report and pay tax. This helps prevent a nontaxable entity from competing against tax-paying businesses.[47] An organization subject to the unrelated business tax is taxed at the corporate tax rates or trust rates, depending on the nature of the organization.

Unrelated business taxable income (UBTI) is defined as the gross income derived from any trade or business that is regularly carried on, and not substantially related to the organization's exempt purpose or function aside from the need for income or funds or the use it makes of the profits. A trade or business is any activity carried on for the production of income from selling goods or performing services.

The "not substantially related to" requirement means the activity producing the income does not contribute importantly to the organization's exempt purpose. This must be determined on a case-by-case basis. The following are some examples of unrelated activities as determined by the IRS:

- The sale of membership lists to business firms
- A miniature golf course open to the public, operated by a youth welfare organization
- Rental income from the lease of an exempt university's football stadium to a professional football team
- A public university's sale of computer time to the public

Additional examples may be found in IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations.*

---

47. In Ltr. Rul. 20062052, the IRS revoked a lakeside club's tax-exempt status because more than 15% of the club's gross revenue came from sales to nonmembers.

Income Excluded from UBTI. Specific types of income may be excluded when computing UBTI. These exclusions, listed below, are subject to special rules.

1. Dividends, interest, annuities, and other investment income
2. Insurance activity income of a controlled foreign corporation
3. Income from lending securities
4. Royalties
5. Rents
6. Income from research
7. Gains and losses from disposition of property (there are exceptions)
8. Lapse or termination of options
9. Gain or loss on disposition of certain brownfield property[48]
10. Income from services provided under federal license
11. Member income of mutual or cooperative electric companies

Activities Excluded from UBTI. Income from the following activities is also specifically excluded from UBTI:

1. An activity in which substantially all the work is preformed for the organization by volunteers working without compensation, such as a charity golf tournament.
2. Activities carried on by a §501(c)(3) organization primarily for the convenience of its members, students, patients, officers, or employees
3. Soliciting and receiving qualified sponsorship payments
4. The sale of merchandise received as gifts or contributions (e.g., a thrift shop)
5. An association selling work-related clothes and equipment and items normally sold through vending machines to members at their usual place of employment
6. Bingo games meeting specific criteria
7. A qualified pole rental by a mutual or cooperative telephone or electric company described in section §501(c)(12)
8. Qualified convention or trade show activities
9. A qualified public entertainment activity
10. Exchange or rental of member lists between §501 organizations
11. Hospital services described in §501(e)(1)(A) to other exempt hospitals subject to §513(e)

48. "Brownfield property" refers to any real property, which is certified by an appropriate State agency, before the taxpayer incurs any eligible remediation expenditures.

DEDUCTIONS

UBTI deductions include expenses, depreciation, and similar items that qualify as deductions allowed by §§162, 167, or other applicable code sections. These deductions **must be directly connected** to the operation of the unrelated trade or business activity. To be directly connected, there must be a proximate and primary relationship to the business.

Dual use of facilities or personnel must be allocated on a reasonable basis. For example, if 10% of an organization's building is used for an unrelated business purpose, 10% of the expenses of that building, e.g., utilities, insurance, and depreciation, must be allocated. Expenses are not deductible if the unrelated business use exploits the exempt activity. However, there is an exception if all of these three criteria apply:

1. The unrelated business exploits the exempt activity.
2. The unrelated business is a type normally carried on for profit by taxable organizations.
3. The exempt activity is a type normally conducted by taxable organizations in carrying on that type of business.

Special rules apply to the sale of advertising in a periodical. Additional research is required to determine the taxability of income associated with this activity.

Example 31. The Fraternal Organization of Merrymakers qualifies as a tax-exempt organization. The Merrymakers is a membership organization which owns a banquet hall where they hold weekly dinners and dances for their members. They also rent the hall to members and occasionally to a nonmember. Profits from these functions are donated back to organizations in their community.

In 2005, they rented the banquet hall to nonmembers for two wedding receptions. Therefore, they have some unrelated business taxable income and must file Form 990-T along with their Form 990.

The information regarding the rental of the banquet hall is as follows:

	Amount	Percentage
Income		
Rental to members	$ 8,499	75%
Rental to nonmembers	2,851	25%
	$11,350	100%
	Direct Expense	**25%**
Rental Expense		
Insurance	$ 459	$ 115
Utilities	3,073	768
Repairs	850	213
Real estate tax	610	153
Depreciation	400	100
Refunds	1,400	0 (none are unrelated)
Total rental expense	$ 6,792	$1,348

The organization will file the Form 990-T shown on the following pages.

8

For Example 31

Form **990-T**

Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return
(and proxy tax under section 6033(e))

For calendar year 2005 or other tax year beginning ...., 2005, and ending ...., 20 .....
▶ See separate instructions.

OMB No. 1545-0687

2005

A ☐ Check box if address changed

B Exempt under section
☒ 501( ) ( )
☐ 408(e) ☐ 220(e)
☐ 408A ☐ 530(a)
☐ 529(a)

C Book value of all assets at end of year 144,597

Print or Type

Name of organization (☐ Check box if name changed and see instructions.)
Fraternal Organization of Merrymakers

Number, street, and room or suite no. (If a P.O. box, see page 7 of instructions.)

City or town, state, and ZIP code

D Employer identification number (Employees' trust, see instructions for Block D on page 7.)

E New unrelated bus. activity codes (See instructions for Block E on page 7.) 11

F Group exemption number (See instructions for Block F on page 7.) ▶

G Check organization type ▶ ☒ 501(c) corporation ☐ 501(c) trust ☐ 401(a) trust ☐ Other trust

H Describe the organization's primary unrelated business activity. ▶

I During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? ▶ ☐ Yes ☒ No
If "Yes," enter the name and identifying number of the parent corporation. ▶

J The books are in care of ▶ Telephone number ▶ ( )

Part I Unrelated Trade or Business Income

		Line	(A) Income	(B) Expenses	(C) Net
1a	Gross receipts or sales				
b	Less returns and allowances c Balance ▶	1c			
2	Cost of goods sold (Schedule A, line 7)	2			
3	Gross profit. Subtract line 2 from line 1c	3			
4a	Capital gain net income (attach Schedule D)	4a			
b	Net gain (loss) (Form 4797, Part II, line 17) (attach Form 4797)	4b			
c	Capital loss deduction for trusts	4c			
5	Income (loss) from partnerships and S corporations (attach statement)	5			
6	Rent income (Schedule C)	6	2,851	1,349	1,502
7	Unrelated debt-financed income (Schedule E)	7			
8	Interest, annuities, royalties, and rents from controlled organizations (Schedule F)	8			
9	Investment income of a section 501(c)(7), (9), or (17) organization (Schedule G)	9			
10	Exploited exempt activity income (Schedule I)	10			
11	Advertising income (Schedule J)	11			
12	Other income (See page 9 of the instructions—attach schedule.)	12			
13	**Total.** Combine lines 3 through 12	13	2,851	1,349	1,502

Part II Deductions Not Taken Elsewhere (See page 9 of the instructions for limitations on deductions.) (Except for contributions, deductions must be directly connected with the unrelated business income.)

				Line	Amount
14	Compensation of officers, directors, and trustees (Schedule K)			14	
15	Salaries and wages			15	
16	Repairs and maintenance			16	
17	Bad debts			17	
18	Interest (attach schedule)			18	
19	Taxes and licenses			19	
20	Charitable contributions (See page 11 of the instructions for limitation rules.)			20	
21	Depreciation (attach Form 4562)	21	100		
22	Less depreciation claimed on Schedule A and elsewhere on return	22a	100	22b	0
23	Depletion			23	
24	Contributions to deferred compensation plans			24	
25	Employee benefit programs			25	
26	Excess exempt expenses (Schedule I)			26	
27	Excess readership costs (Schedule J)			27	
28	Other deductions (attach schedule)			28	
29	**Total deductions.** Add lines 14 through 28			29	
30	Unrelated business taxable income before net operating loss deduction. Subtract line 29 from line 13			30	1,502
31	Net operating loss deduction (limited to the amount on line 30)			31	
32	Unrelated business taxable income before specific deduction. Subtract line 31 from line 30			32	1,502
33	Specific deduction (Generally $1,000, but see line 33 instructions for exceptions.)			33	1,000
34	**Unrelated business taxable income.** Subtract line 33 from line 32. If line 33 is greater than line 32, enter the smaller of zero or line 32.			34	502

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 11291J Form **990-T** (2005)

For Example 31

Form 990-T (2005) Page **2**

Part III Tax Computation

35	**Organizations Taxable as Corporations.** See instructions for tax computation on page 13. Controlled group members (sections 1561 and 1563)—check here ☐. **See instructions** and:		
a	Enter your share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order): **(1)** $ **(2)** $ **(3)** $		
b	Enter organization's share of: **(1)** Additional 5% tax (not more than $11,750) $ **(2)** Additional 3% tax (not more than $100,000) $		
c	Income tax on the amount on line 34 ▶	35c	75
36	**Trusts Taxable at Trust Rates.** See instructions for tax computation on page 14. Income tax on the amount on line 34 from: ☐ Tax rate schedule or ☐ Schedule D (Form 1041) ▶	36	
37	**Proxy tax.** See page 14 of the instructions ▶	37	
38	Alternative minimum tax	38	
39	**Total.** Add lines 37 and 38 to line 35c or 36, whichever applies	39	75

Part IV Tax and Payments

40a	Foreign tax credit (corporations attach Form 1118; trusts attach Form 1116)	40a			
b	Other credits (See page 14 of the instructions.)	40b			
c	General business credit—Check here and indicate which forms are attached: ☐ Form 3800 ☐ Form(s) (specify) ▶	40c			
d	Credit for prior year minimum tax (attach Form 8801 or 8827)	40d			
e	**Total credits.** Add lines 40a through 40d			40e	
41	Subtract line 40e from line 39			41	75
42	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Other (attach schedule)			42	
43	**Total tax.** Add lines 41 and 42			43	75
44a	Payments: A 2004 overpayment credited to 2005	44a			
b	2005 estimated tax payments	44b			
c	Tax deposited with Form 8868	44c			
d	Foreign organizations—Tax paid or withheld at source (see instructions)	44d			
e	Backup withholding (see instructions)	44e			
f	Other credits and payments: ☐ Form 2439 ☐ Form 4136 ☐ Other Total ▶	44f			
45	**Total payments.** Add lines 44a through 44f			45	
46	Estimated tax penalty (See page 4 of the instructions.) Check ▶ ☐ if Form 2220 is attached			46	
47	**Tax due.** If line 45 is less than the total of lines 43 and 46, enter amount owed ▶			47	75
48	**Overpayment.** If line 45 is larger than the total of lines 43 and 46, enter amount overpaid ▶			48	
49	Enter the amount of line 48 you want: **Credited to 2006 estimated tax** ▶ **Refunded** ▶			49	

Part V Statements Regarding Certain Activities and Other Information (See instructions on page 16.)

		Yes	No
1	At any time during the 2005 calendar year, did the organization have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the organization may have to file Form TD F 90-22.1. If "Yes," enter the name of the foreign country here ▶		X
2	During the tax year, did the organization receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," see page 5 of the instructions for other forms the organization may have to file.		X
3	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $		

Schedule A—Cost of Goods Sold. Enter method of inventory valuation ▶

1	Inventory at beginning of year	1		6	Inventory at end of year	6
2	Purchases	2		7	**Cost of goods sold.** Subtract line 6 from line 5. Enter here and in Part I, line 2	7
3	Cost of labor	3				
4a	Additional section 263A costs (attach schedule)	4a		8	Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the organization?	Yes / No
b	Other costs (attach schedule)	4b				
5	**Total.** Add lines 1 through 4b	5				

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

▶ Signature of officer — Date — ▶ Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ☐ Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ EIN Phone no. ( )

Form **990-T** (2005)

8

For Example 31

Form 990-T (2005) Page **3**

Schedule C—Rent Income (From Real Property and Personal Property Leased With Real Property) (See instructions on page 17.)

1 Description of property

(1)	Rental
(2)	
(3)	
(4)	

	2 Rent received or accrued		
	(a) From personal property (if the percentage of rent for personal property is more than 10% but not more than 50%)	**(b)** From real and personal property (if the percentage of rent for personal property exceeds 50% or if the rent is based on profit or income)	**3** Deductions directly connected with the income in columns 2(a) and 2(b) (attach schedule) See Statement 1
(1)		2,851	1,349
(2)			
(3)			
(4)			
Total		Total 2,851	**Total deductions.** Enter here and on page 1, Part I, line 6, column (B) . . ▶ 1,349
Total income. Add totals of columns 2(a) and 2(b). Enter here and on page 1, Part I, line 6, column (A) . . . ▶		2,851	

Schedule E—Unrelated Debt-Financed Income (See instructions on page 17.)

1 Description of debt-financed property	**2** Gross income from or allocable to debt-financed property	**3** Deductions directly connected with or allocable to debt-financed property: **(a)** Straight line depreciation (attach schedule)	**(b)** Other deductions (attach schedule)
(1) N/A			
(2)			
(3)			
(4)			

	4 Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)	**5** Average adjusted basis of or allocable to debt-financed property (attach schedule)	**6** Column 4 divided by column 5	**7** Gross income reportable (column 2 × column 6)	**8** Allocable deductions (column 6 × total of columns 3(a) and 3(b))
(1)			%		
(2)			%		
(3)			%		
(4)			%		
Totals . . . ▶				Enter here and on page 1, Part I, line 7, column (A).	Enter here and on page 1, Part I, line 7, column (B).
Total dividends-received deductions included in column 8 . . . ▶					

Schedule F—Interest, Annuities, Royalties, and Rents From Controlled Organizations (See instructions on page 18.)

1 Name of Controlled Organization	**2** Employer Identification Number	Exempt Controlled Organizations: **3** Net unrelated income (loss) (see instructions)	**4** Total of specified payments made	**5** Part of column (4) that is included in the controlling organization's gross income	**6** Deductions directly connected with income in column (5)
(1) N/A					
(2)					
(3)					
(4)					

Nonexempt Controlled Organizations

7 Taxable Income	**8** Net unrelated income (loss) (see instructions)	**9** Total of specified payments made	**10** Part of column (9) that is included in the controlling organization's gross income	**11** Deductions directly connected with income in column (10)
(1)				
(2)				
(3)				
(4)				
Totals . . . ▶			Add columns 5 and 10. Enter here and on page 1, Part I, line 8, column (A).	Add columns 6 and 11. Enter here and on page 1, Part I, line 8, column (B).

Form **990-T** (2005)

SPECIAL ORGANIZATIONS

The following four organizations must calculate UBTI without excluding investment income such as dividends, interest, rent, and so on:

1. Social clubs described in section §501(c)(7)
2. Voluntary employees' beneficiary associations described in §501(c)(9)
3. Supplemental unemployment compensation benefit trusts described in §501(c)(17)
4. Group legal services organizations described in §501(c)(20)

There are other special rules for veterans' organizations and foreign organizations.[49]

INCOME FROM DEBT-FINANCED PROPERTY

Debt-financed property is any property held to produce income, including gain from disposition, for which there is acquisition indebtedness at any time during the tax year. It includes rental real estate, tangible personal property, and corporate stock. Income that would otherwise be excluded from UBTI is taxed to the extent it is derived from debt-financed property.

For example, if a church owns a commercial building debt-free, the rental income from the building is specifically excluded. If there is acquisition indebtedness on the building, the church is subject to the unrelated business income tax.

This is another area in which there are many special rules and exceptions. Research is necessary to determine any tax liability attributable to this type of income.

TAX DEFERRED RETIREMENT PLANS

Although most practitioners do not consider a retirement plan to be a charitable organization, a growing phenomenon in the real estate industry is the purchase of properties with tax-deferred retirement plan funds. If purchased outright (i.e., without financing), then UBTI is not an issue. However, if some or all of the purchase price is financed, then UBTI must be calculated on both the rental income and the gain when the property is sold.

Note. This is a very complicated area of tax law, and caution is advised.

49. IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations*

CHURCHES

The code specifically provides a tax exemption for churches, conventions and associations of churches, and the integrated auxiliaries of churches. This exemption is not extended to include nondenominational ministries, interdenominational and ecumenical organizations, and other entities whose principal purpose is the study or advancement of religion.

One major advantage to qualifying as a "church" is the exemption from filing Form 990 provided under IRC§6033. However, an exempt church still is required to file employment tax returns, and Forms 1099 and 990-T if applicable.

The IRS evaluates the following items when determining whether an organization qualifies as a church (other factors also may be taken into consideration):

- The organization must be a corporation or a distinct legal entity.
- The entity must be organized exclusively for exempt purposes.
- The organization must be operated exclusively for exempt purposes.
- None of the organization's net earnings may benefit any private individual.
- The organization must have a recognized creed and form of worship.
- The organization must have a definite and distinct ecclesiastical government.
- The organization may not engage in substantial efforts to influence legislation.
- The organization must not intervene or participate in political campaigns.
- The organization must advocate a formal code of doctrine and discipline.
- There must be an established place of worship, regular congregations, and regular religious services.

The unrelated business income tax applies to churches as well. Areas which can produce this tax include advertising, rental income on debt-financed property, bookstores, gift shops, concerts, and rental of parking lots and storage units. These activities and others may create UBTI liability, depending on the facts of each case.

The income of a church is not automatically exempt from taxation. The following examples demonstrate the subtleties involved in determining whether income a church generates from concert ticket sales is taxable.

1. Income from the sale of tickets for a gospel concert was ruled to be exempt from UBTI.[50]
2. Income from the sale of tickets to a fund-raising concert was determined to be subject to UBTI since the concert did not further the charity's exempt purpose.[51]

This distinction emphasizes the importance of gathering all the details of an activity before making a determination as to tax liability.

50. Ltr. Rul. 9325062, April 2, 1993
51. Ltr. Rul. 9712001, October 17, 1996

Audits

The IRS may initiate a "tax inquiry" on a church only on a limited basis as provided under IRC§7611. Provisions in this code section require that the Director of Exempt Organizations, Examination, must reasonably believe that an organization does not qualify for exemption or that the organization should be paying taxes on UBTI.

These beliefs must be supported by a written statement of the facts and circumstances. These restrictions do not apply to inquiries regarding employment tax, criminal investigations, or to the investigation of any person connected with the church.

If the reasonable belief requirement is met, the audit commences as follows:

1. The IRS issues a written notice explaining its concerns.
2. The church is allowed a reasonable amount of time to respond.
3. If the church fails to respond, or its response is inadequate, the IRS may issue a second notice informing the church of the need to examine the books and records.
4. The church then may request a conference with an IRS official.
5. If the examination proceeds, generally it must be completed within two years from the date of the second notice.
6. If at any time during the inquiry, adequate information is provided to answer the original concerns, the matter is closed.

IRC §7611 also protects churches from subsequent examinations for a period of five years unless the previous inquiry resulted in a revocation, notice of deficiency of assessment, or a request for a significant change in church operations, including a significant change in accounting practices.

The loss of exemption for a church is a very serious matter. It is prudent for the governing board of a church to annually review the church's operations and activities to ascertain continued compliance.