Chapter 9: Small Business Issues

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

ISSUE 1: FRINGE BENEFITS

Employers may provide employees with certain fringe benefits that allow a deduction at the employer level and are nontaxable to the employee. A fringe benefit is a form of pay for the performance of services by an employee. The regulations provide that the definition of "employee" includes an individual who is self-employed within the meaning of IRC §401(c)(1). This section provides that a self-employed individual is one who has earned income within the meaning of IRC §1402(a), which specifically also includes income from a partnership.

Fringe benefits are taxable wages for the employee unless specifically excluded by a section of the code. Some code sections that specifically **exclude fringe benefits from taxation** are:

- **§79.** Group-term life insurance (up to $50,000)
- **§105.** Medical reimbursement plans
- **§106.** Health insurance premiums
- **§117(d).** Qualified tuition reductions
- **§119.** Meals or lodging for the employer's convenience
- **§125.** Cafeteria plans
- **§127.** Educational assistance programs
- **§129.** Dependent care assistance programs
- **§132.** Certain fringe benefits

If fringe benefits are fully nontaxable, they are not reported to the IRS.

MEDICAL REIMBURSEMENT PLANS

A self-insured medical reimbursement plan is one that reimburses employees for medical expenses not reimbursed under another insurance policy.[1]

1. Treas. Reg. §1.105-11(b)(2)

These types of plans may not discriminate in favor of highly compensated employees, defined as:

- One of the five highest paid officers,
- A shareholder who owns more than 10% in value of the employer's stock (attribution rules under §318 apply), or
- Among the highest paid 25% of all employees.

These types of plans must also meet a percentage test or classification test to qualify:

- **Percentage Test.** Seventy percent or more of all employees must participate, or 80% or more of all the employees who are eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan.
- **Classification Test.** Employees may qualify under a classification test established by the employer which is found by the IRS not to be discriminatory in favor of highly compensated employees. This determination is made based upon the facts and circumstances of each case by applying the same standards as used in IRC §410(b)(1)(B).

Employers may exclude certain employees as follows:

1. Employees who have not completed three years of service prior to the beginning of the plan year
2. Employees who have not reached age 25 prior to the beginning of the plan year
3. Part-time employees whose customary weekly employment is less than 25 hours
4. Seasonal employees whose customary annual employment is less than seven months
5. Employees who are nonresident aliens and who receive no earned income under IRC §911(b)

Self-employed medical reimbursement plans have become popular with self-employed farmers and small businesses that do not have any nonfamily employees. The plan allows them to employ spouses and furnish them with a medical reimbursement plan and health insurance. The provided plan typically covers all members of the employee's family. Therefore, the employer is also covered as the spouse of the employee. In addition, the employer provides health insurance for the employee and his family.

> **Example 1.** Travis owns and operates a small convenience store. His only employee is Margo, who is his wife. Travis pays $10,800 for a health insurance policy which covers Margo and her family. He also has a written medical reimbursement plan which reimburses Margo and her family for the first $8,000 of annual medical expenses. These are the expenses which are not covered under health insurance and includes such services as dental, mental health, and vision, as well as amounts not covered under the insurance policy deductible. The expenses for both the health insurance and medical reimbursements are deductible on Travis's Schedule C. Therefore, he not only receives an income tax deduction without having to itemize his personal deductions, but he also saves self employment taxes.

Health Reimbursement Arrangements (HRA)[2]

An HRA is an arrangement that is paid for solely by the employer which reimburses the employee for medical care expenses incurred by the employee, or the employee's spouse and dependents. This type of arrangement provides reimbursements up to a maximum dollar amount for a coverage period and any **unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent periods.**

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2. IRS Notice 2002-45, June 26, 2002

Health Savings Accounts (HSA)

Employers may contribute to HSAs for eligible employees.

The Tax Relief and Health Care Act of 2006 (TRHCA), enacted December 20, 2006, allows for certain amounts in a health FSA or HRA to be rolled over into an HSA. The following conditions must be satisfied in order to receive tax-deferred treatment:

1. The transaction must be completed by the plan year-end.
2. The plan must be amended.
3. The employee must elect the rollover.
4. The year-end balance must be frozen.
5. The funds must be transferred by the employer within 2½ months after the end of the plan year and result in a zero balance in the FSA or HRA.

The distribution (rollover to an HSA) must not exceed the lesser of the balance in the FSA or HRA on September 21, 2006, or as of the date of the distribution. The distribution must be contributed directly to the HSA trustee by the employer. These distributions are not taken into account in applying the annual limit for HSA contributions.

The employee must remain HSA eligible during the testing period following the distribution. The testing period is defined as the period beginning with the month in which the qualified HSA distribution is contributed to the HSA and ending on the last day of the 12th month following that month. **If the employee does not remain HSA eligible, then the distribution is taxable, and the 10% penalty is applied.**[2]

HEALTH INSURANCE

Contributions by an employer to an accident and health plan are not included in the income of the employee. **Reimbursements** by an employer to his employees for premiums for hospital and medical insurance may be considered as contributions by the employer to accident and health plans, and are not "wages" subject to withholding. This is true whether the employer pays accident and health insurance premiums directly to the insurer of the employees or reimburses the employee for premiums paid. However, unless the employee is required to prove he is making premium payments, the reimbursement must be included in employee income.[4]

To be excluded from compensation, the employee must be the one making the premium payments. If the employer reduces the employee's compensation, pays the insurance premium, and then reimburses the employee, the reimbursement is considered compensation.[5]

A qualified long-term care insurance policy is treated as an accident and health insurance policy. This allows employers to provide qualified long-term care coverage for their employees as a tax-free fringe benefit.

Insured plans (as opposed to self-insured plans) are not subject to the nondiscrimination rules under §105. Insured plans include medical expense reimbursements provided under an individual or group policy of accident or health insurance issued by a licensed insurance company or a prepaid health care plan, such as an HMO, that is regulated in a manner similar to the regulation of insurance companies.

3. Notice 2007-22 (February 15, 2007)
4. Rev. Rul. 75-241, 1975-1 CB 316
5. Rev. Rul. 2002-3, 2002-1 CB 316

QUALIFIED TUITION REDUCTIONS

The term "qualified tuition reduction" means any amount of reduction in tuition provided to an employee of an educational institution at the elementary, secondary, or undergraduate levels.[6] The employee's spouse and dependent children under the age of 25 also qualify as employees.[7] The education need not be obtained at the institution where the employee works, and there is no monetary limitation for the education assistance programs.[8]

> **Example 2.** Jennifer is a professor at State University. The school has a qualified tuition reduction program available for employees with a certain number of years of service. Under the program, Jennifer, her spouse, or her dependent children under age 25 are provided tuition at any qualified educational institution.

In the case of a graduate student engaged in teaching or research activities at the educational institution, any qualified tuition reduction is excluded from income.[9]

> **Example 3.** Farley is a PhD candidate at State University. He receives a tuition reduction of $10,000 for teaching two classes while working on his degree. The tuition reduction is not taxable.

MEALS AND LODGING FOR CONVENIENCE OF EMPLOYER

Meals and lodging furnished to an employee may be excludable from compensation.

Meals

The fair market value of meals furnished to an employee by an employer are excludable from employee wages and 100% deductible by the employer[10] if the following two tests are met:

1. The meals must be furnished on the employer's premises, and
2. The meals must be furnished for the convenience of the employer.[11]

The meals must be furnished for noncompensatory reasons. The meals will meet this requirement if they are furnished during working hours to allow employees to remain on the premises for emergency reasons. It must be shown that emergencies can and do occur during the meal period. An example is meals furnished to fire personnel at the firehouse while on duty.

Meals are also regarded as furnished for noncompensatory reasons if the employee is restricted to a short meal period, such as 30 to 40 minutes, and the employee could not be expected to eat somewhere else and return within the time allotted. However, if the reason for the short meal period is to allow the employee to leave work earlier, the meals must be included in compensation.[12] The value of the meals is also excludable if the employment is in a location where suitable eating facilities are not available.

Meals furnished to restaurant employees and food service workers are excludable for each meal period in which the employee works. The meals may be furnished during, immediately before, or immediately after the employee's working hours.

Meals furnished for the purpose of promoting goodwill or morale, or to attract new employees are includable in employee compensation, and are treated as wages for income and employment tax purposes.[13]

The meals must be furnished in-kind. This means the employee receives a meal, not just a meal reimbursement.

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6. IRC §117(d)
7. IRC §132(h)
8. Rev. Rul. 86-69, 1986-1 CB 78
9. IRC §117(d)(5)
10. Announcement 99-77 (August 9, 1999)
11. Treas. Reg. §1.119-1(a)(1)
12. Treas. Reg. §1.119-1(a)(2)(ii)(b)
13. Rev. Rul. 81-222, 1981-2 CB 205

Example 4. Freddy's Fishlures has its factory in the north woods of Minnesota. In order to test each lure produced, the factory must be near a good walleye lake out in the middle of nowhere. Consequently, the factory has a kitchen facility, and Freddy serves a daily lunch to each employee. In order to reduce costs, Freddy serves freshly caught fish five days per week. Employee Rod has a fish allergy, so brings his lunch to work. In order to be fair to all employees, Freddy reimburses Rod $3 per day for providing his own lunch. Because the meal is not provided in-kind, the employer must include the reimbursement in Rod's W-2.

Lodging

Three tests must be met to exclude the value of employer-provided lodging from an employee's compensation:[14]

1. The lodging must be furnished on the business premises of the employer,
2. The lodging must be furnished for the convenience of the employer, and
3. The employee must be required to accept the lodging as a condition of employment.

Being a condition of employment means the employee must accept the lodging to enable him to properly perform his duties of employment.

Example 5. Alaskan pipeline workers may spend weeks working in the wilderness. Due to the remote location and unstable weather conditions, employees are unable to travel away from the worksite. The employer provides meals and lodging and deducts $40 per week from each employee's pay to offset these costs. The $40 is pretax and any cost incurred by the employer above the $40 is not compensation to the employee.[15]

Example 6. J. Bunion works for the Washington Forestry Service. While the service prefers Bunion live in a provided cabin, he is permitted to commute from a nearby town. Although Bunion decides to live in the provided cabin, the value of the lodging is included in his compensation because he was **not required** to live on premises as a condition of employment.

On Business Premises

Business premise refers to the place where the employee performs a significant portion of his duties.[16] This must be within the perimeter of the business — not "near" the premises. This definition may include temporary work sites, such as rented hotel conference rooms; however, public restaurants do not qualify as business premises.

The following cases illustrate how the courts look at "on the premises":

- An apartment furnished to a motel manager located "just two short blocks" from the motel did not qualify for the income exclusion.[17]
- A house furnished to the hotel manager, but located across the street, was considered to be on the business premises.[18] The court distinguished this situation from the Anderson case.
- A farm corporation furnished a home and utilities to the farm manager/shareholder. The lodging met all three conditions and the court allowed its value to be excluded from the manager's compensation.[19]

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14. Treas. Reg. §1.119-1(b)
15. Treas. Reg. §1.119-1(f), Example 7
16. Treas. Reg. §1.119-1(c)
17. *Comm'r v. C.N. Anderson;* 371 F.2d 59 (1966) *cert. denied*
18. *J.B. Lindeman v. Comm'r;* 60 TC 609 (1973)
19. *J. Grant Farms, Inc. v. Comm'r;* TC Memo 1985-174, April 8, 1985

Example 7. Fanny Farmer owns a Wisconsin dairy farm. She lives in the farm house and employs a full-time herdsman. She does not have any additional living facilities on the farm and rents a small home for the herdsman one mile from the farmstead. Fanny must include the value of the rental house in the herdsman's compensation because it is not located on the premises.

Meal Allowances/Reimbursements

Reimbursements or allowances must meet the accountable plan rules in order to be excluded from compensation. An accountable plan requires employees to submit receipts for expenses and to repay advances in excess of substantiated expenses. An accountable plan is a written plan that specifically:[20]

1. Limits expense reimbursement to the expenses to be paid or incurred in connection with the employee's job;
2. Limits expenses to those which qualify as deductible employee business expenses;
3. Requires the employee to substantiate his expenses within a reasonable amount of time; and
4. Requires employees to return any unused portion in excess of substantiated expenses.

In order to exclude meal reimbursements from compensation, the employee must be away from his tax home overnight while on the employer's business, or attending meetings or entertaining clients. To be considered away from the tax home overnight, the taxpayer must be gone substantially longer than an ordinary day's work, and the employee needs to obtain substantial sleep or rest to meet the demands of the work while away from home.

Entertainment meal reimbursements may be excluded from compensation if the expense is ordinary and necessary and meets one of the following tests:

1. **Directly Related Test**[21]
   - The main purpose of the combined business and meal is the active conduct of business,
   - Business is actually conducted during the meal period, and
   - There is more than a general expectation of deriving income or some other specific business benefit at some future time.

Example 8. Brett is an independent life insurance salesman. He has been telephoning Sean in hopes of selling him a life insurance policy. In an attempt to close the deal, Brett takes Sean to the Urbana Gourmet Grill for lunch. Sean knows Brett is bringing a copy of the policy and financial projections. Prior to dinner, Brett explains the policy in detail. Sean agrees to consider the policy, but does not make the purchase at that time. The cost of the meal qualifies as a deductible entertainment meal.

Example 9. Kyle and Kurt are best friends. Kurt sells real estate and Kyle is a realtor. They get together with their wives for dinner at least once a month. One month Kurt picks up the tab and the next month Kyle pays the bill. While business is discussed, this is primarily a social visit. Therefore, this does not qualify as a deductible entertainment meal.

2. **Associated Test**
   - The meal is associated with the active conduct of the employer's business, and
   - Takes place either directly before or after a substantial business discussion.

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20. Temp. Treas. Reg. §1.62-1T(e)
21. Treas. Reg. §1.274-2(c)(2)

Example 10. Mahomet Sales, Inc., brings all of their sales representatives to town each year for an annual meeting. The representatives and their spouses are invited to the home of the CEO the evening preceding the meeting. While no business is conducted at the dinner, the expense is a deductible entertainment meal expense because it is considered to immediately precede a business meeting.

Employer Deduction. An employer can fully deduct the following:

1. The cost of all meals furnished on the business premises to employees if more than one-half of the employees were furnished meals for the employer's convenience;[22]
2. The cost of meals and entertainment that are treated as compensation to an employee on the taxpayer's return and as wages to the employee for purposes of withholding;[23]
3. The cost of meals expenses paid or reimbursed to an employee who is moving, if the expenses are included in the employee's income under §82;[24]
4. The cost of meals paid to employees on certain vessels and oil and gas platforms and drilling rigs and their support camps;[25] and
5. Expenses for certain traditional social or recreational activities that are primarily for the benefit of employees.[26]

CAFETERIA PLANS

A cafeteria plan is a separate **written** benefit plan maintained by an employer for the benefit of its employees, under which **all** participants are employees and each participant has the opportunity to select the particular benefits that he desires.[27] A cafeteria plan may offer participants the opportunity to select among various taxable benefits and nontaxable benefits, but a plan **must** offer at least one taxable benefit and at least one nontaxable benefit. For example, if participants are given the opportunity to elect only among two or more nontaxable benefits, the plan is not a cafeteria plan.

Example 11. Savoy Builders offers a cafeteria plan to its employees. The employees have the choice of selecting two of the following three benefits:

1. $50,000 of group term life insurance,
2. $400 of group legal assistance, or
3. $400 of dependent care.

This plan does not qualify as a cafeteria plan since the participants do not have the opportunity to select a taxable benefit.

Example 12. Use the same facts as **Example 11,** except that Savoy Builders modifies its cafeteria plan to allow employees to select cash in place of these benefits. The plan now qualifies because it contains both taxable and nontaxable benefits.

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22. IRC §§132(e)(2) and 274(n)(2)(B)
23. IRC §§274(e)(2) and 274(n)(2)(A)
24. IRC §274(n)(2)(D)
25. IRC §274(n)(2)(E)
26. IRC §§274(e)(4) and 274(n)(2)(A))
27. IRC §125

The participant in a nondiscriminatory cafeteria plan is not treated as receiving taxable benefits solely because he has the opportunity, prior to the benefit becoming available, to chose between taxable and nontaxable benefits.[28] Taxable benefits include cash, property, and other benefits attributable to employer contributions that are currently taxable under the code. Nontaxable benefits are those attributable to employer contributions which are not currently taxable.

Benefits that may be included in a §125 plan and are generally excluded from gross income include the following:

- Accident or health insurance (IRC §105)
- Medical costs (IRC §106)
- Up to $50,000 in group-term life insurance (IRC §79)
- Elective contributions under a qualified cash or deferred arrangement (IRC §401(k))
- Dependent care assistance (IRC §129)
- Adoption assistance (IRC §137)
- Elective paid vacation days (as a taxable benefit)

Nontaxable benefits that are attributable to after-tax employee contributions may also be included in the cafeteria plan. This might include the payment for a disability benefit.

Employer contributions may be subject to a salary reduction agreement. This allows employees to reduce their compensation, or to forego salary increases and have these amounts contributed by the employer to the plan. With the exception of elective contributions to a 401(k) plan, the cafeteria plan may not offer a benefit which allows the employee to defer compensation.

Even though the employee has the opportunity to select a benefit or cash prior to the benefit or cash becoming available, the constructive receipt doctrine does not come into play.

The cafeteria plan may not discriminate in favor of the highly compensated employee. The highly compensated individual is defined as an officer, or a shareholder owning more than 5% of the voting power or value of all classes of stock of the employer, or someone who is highly compensated. The classification of highly compensated is made on each case's facts and circumstances.

Employers who have §125 plans are not required to file Form 5500, Schedule F for years after June 30, 1992.

Educational Assistance Programs

Nondiscriminatory educational assistance plan benefits are nontaxable to the employee up to $5,250 per year.[29] The plan must be written and meet certain requirements.

1. The plan may not discriminate in favor of highly compensated employees or their dependents.
2. No more than 5% of the plan benefits can be paid to principal shareholders or owners of the business. Principal shareholders, or owners, are those individuals who own more than 5% of the stock or capital of the business.
3. The plan may not offer employees the choice between educational benefits or cash.
4. There are no funding requirements for the plan.
5. All eligible employees must receive notice of the availability and terms of the program.

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28. Treas. Reg. §1.125-1

29. IRC §127

Example 13. Jamie and Marcy own and are the sole employees of Fancy Dos, Inc. Both have teenage children. They decide to provide an education assistance plan for their employees. In 2007, Marcy's son receives a $5,000 tuition grant from Fancy Dos. This is considered taxable compensation to Marcy because more than 5% of the plan benefits are going to someone who owns more than 5% of the business.

The plan may pay for tuition, fees, books, supplies, equipment and other educational expenses. However, plan benefits paying for tools or supplies which are retained by the student at the completion of the course or for meals and lodging are taxable. Plan benefits for any course or other type of education involving sports, games, or hobbies are includible in compensation.

A plan is not disqualified because a certain course must be taken or a certain grade attained. A student may not claim any educational benefit or credit for the expenses paid by the educational assistance benefits.

DEPENDENT CARE ASSISTANCE PROGRAMS

Dependent care assistance payments are those payments eligible for the child care credit under IRC §21(b)(2). They include expenses incurred for household services for care of a child or other dependent to enable the employee to work. Dependent care assistance can be a part of a cafeteria plan. The benefit is not included in taxable employee compensation as long as it does not exceed $5,000 ($2,500 if married filing separately).[30] Any amounts excluded from income are not eligible for any other type of deduction or credit.

> **Note.** If the employee's spouse has a lower earned income, then a portion and perhaps the entire employer-provided dependent care assistance would be taxable to the employee.

The expenses are treated as incurred when the care is provided, not when the employee is billed or pays for the care. Plan requirements include the following:

1. The plan must be written.
2. The plan must be nondiscriminatory.
3. The employee must be notified of the existence and terms of the plan.

If a plan does not meet these requirements, highly compensated employees must include the benefits in income.[31]

The dependent care assistance program is required to give a written statement to any employee receiving dependent care benefits. The statement must include the amounts paid or expenses incurred in providing the benefit. The employer is also required to furnish a statement to the employee. Both of these requirements are met by including the dependent care information on the Form W-2.

The dependent care benefit amount is shown on Form W-2, box 10. This includes the FMV of in-kind care provided at the employer's on-site care facility, as well as cash expended for the employee. If the in-kind care is part of a salary reduction program under a cafeteria plan, the employee's elective contribution is reported in box 10 only if the amount of the FMV of the assistance provided is greater than the employee's after-tax contribution. Otherwise, the box 10 amount is the FMV of the assistance.

30. IRC §129(a)(1)
31. IRC §129(d)(1)

Example 14. Ramona Paymaster is an employee of the Ajax Manufacturing Company. Ajax has a dependent care assistance program which is available to all employees. Ajax runs an on-site care center. Ramona takes her son to the care center each work day. Ajax determines the FMV of the care to be $2,400 for the year.

Ramona's 2007 Form W-2 is shown below.

	a Employee's social security number 123-45-6789	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at www.irs.gov/efile.
b Employer identification number (EIN) 98-7654321		1 Wages, tips, other compensation 25000.00	2 Federal income tax withheld 2500.00
c Employer's name, address, and ZIP code Ajax Manufacturing Company Rt 1 Someplace, IA 55555		3 Social security wages 25000.00	4 Social security tax withheld 1550.00
		5 Medicare wages and tips 25000.00	6 Medicare tax withheld 363.00
		7 Social security tips	8 Allocated tips
d Control number		9 Advance EIC payment	10 Dependent care benefits 2400.00
e Employee's first name and initial Last name Suff. Ramona Paymaster 1 Main Avenue Someplace, IA 55555		11 Nonqualified plans	12a See instructions for box 12
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b
		14 Other	12c
			12d
f Employee's address and ZIP code			

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

Form **W-2** Wage and Tax Statement 2007 Department of the Treasury—Internal Revenue Service

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

WORKING CONDITION FRINGE BENEFITS

A working condition fringe benefit is any property or service provided to an employee to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under IRC §§162 or 167.[32] Therefore, if the cost of any item is deductible by an employee as a business expense, it may be excluded from the employee's wages if provided by the employer.

A service or property offered by an employer in connection with a flexible spending account is not excludable from gross income as a working condition fringe benefit.

Cash payments made to an employee do not qualify as a working condition fringe, unless the employer requires the employee to:

1. Use the payment for expenses in connection with a specific or prearranged activity which would be deductible under §§162 or 167,
2. Verify that the payment is actually used for those purposes, and
3. Return any part of the payment which is not used.

32. Treas. Reg. §1.132-5(a)(1)

Vehicle Allocation Rules

The **availability** of a company-provided vehicle can be a working condition fringe benefit.[33] The excludable amount is what would be deductible to the employee under §§162 or 167.

> **Example 15.** Christina is provided with a company-owned vehicle. If Christina paid to use a vehicle similar to the one available to her, the cost would be $2,000. Assuming no personal use, this cost would be deductible to her. However, Christina drove the vehicle 6,000 miles for her employer's business and 2,000 mile for personal use. The value of the working condition fringe is calculated by dividing the business miles by the total miles driven. This is multiplied by the availability value: ((6,000 ÷ 8,000) × $2,000) = $1,500. Therefore, the value of the working condition fringe benefit is $1,500. The amount includible in Christina's gross income because of the availability is $500 ($2,000 – $1,500).

Moving Expenses

Reimbursements of job-related moving expenses are normally includable in employee income, unless they qualify as a fringe benefit. A moving expense reimbursement received directly or indirectly from an employer is excludable to the employee if specific tests of IRC §217 are met.

Timing Requirement. The expense must be both incurred by the employee and be in connection with his commencement of work at the new job site.[34] To qualify as being in connection with commencement of work, the move must bear a reasonable proximity, both in time and place, to beginning work at the new location. Normally, expenses incurred within one year from the commencement of work at the new location are considered a reasonable proximity in time. Expenses incurred after the 1-year period can qualify if it is shown that circumstances existed which prevented the employee from incurring the moving expenses at an earlier time.

> **Example 16.** Aaron is transferred by his employer from the Boston, Massachusetts, office to the Washington, D.C., office. Aaron moves his residence to Washington and commences work February 1, 2006. Aaron's wife and two children remain in Boston until June 2007 to allow the children to complete their grade school education. Aaron sells the Boston residence, and his wife and children move to Washington, D.C. The selling and moving expenses incurred in June 2007 are allowable as a deduction, although incurred 16 months after Aaron began work in Washington, D.C. They are deductible because Aaron established a new residence in Washington, D.C., and incurred part of the total expenses of the move prior to the expiration of the 1-year period.

> **Example 17.** Keith was transferred by his employer from Washington, D.C., to Baltimore, Maryland. He begins work in Baltimore on January 1, 2006. He commutes from his Washington, D.C., residence to Baltimore for a period of 18 months. On July 1, 2007, he decides to sell his Washington, D.C., residence and establish a new residence in Baltimore. None of the moving expenses may be deducted because the expenses are incurred outside the 1-year time period, and Keith can show no circumstances which prevented him from moving within the 1-year window.

Minimum Employment Period. The moving expense deduction is **not** allowed unless the taxpayer is an employee during the 12-month period immediately following his arrival in the general location of the new principal place of work. He must be a full-time employee in that location during the last 39 weeks.[35]

33. Treas. Reg. §1.132-5(b)(1)(i)
34. Treas. Reg. §1.217-2(a)(1)
35. Treas. Reg. §1.217-2(c)(4)(i)(a)

Minimum Distance. The employee must meet certain minimum distance requirements to deduct moving expenses. These requirements differ depending upon whether the employee is a first-time employee without any prior principal work location or an individual who is presently in the work force and currently has a principal place of employment.

If the employee **has no former place of employment**, the distance between the former residence and the new principal place of work must be at least 50 miles. If the employee **had a former principal place of employment**, the distance between the former residence and the new principal place of employment must **exceed** by at least 50 miles the distance between the former residence and the former principal place of employment.

The following types of expenses are deductible moving expense:

1. Moving other household members
2. Airfare
3. Travel by car ($0.18 per mile for 2007, or actual gas and oil)
4. Lodging while traveling
5. Parking fees
6. Tolls
7. Packing, crating and transporting household goods/personal effects
8. Connecting/disconnecting utilities
9. Shipping a car or pet
10. Storage and insurance of household goods for 30 consecutive days after goods are moved from the former home and before they are delivered to the new home.

Moving expense reimbursements are not considered wages, and are consequently not subject to payroll taxes or withholding. However, the expense, if paid personally, must be deductible by the employee to escape taxation. Any excess reimbursements are subject to withholding and payroll taxes.

Example 18. Roadrunner Engineering provides all new employees who relocate more than 150 miles a payment of $1,000. Jared accepts employment with Roadrunner and moves 300 miles to his new home. He receives a check for $1,000. Jared is able to convince friends and family to move him and incurs no out-of-pocket expense. Therefore, the entire $1,000 is taxable to Jared.

Observation. It should be kept in mind that both househunting trips and temporary living expenses are no longer qualified moving expenses. Therefore, if a new employer pays for a weekend househunting trip made by a new employee (who was moving from a distant city to start the new job), the costs of this trip must be included in the new employee's first paycheck as additional wages.

Qualified Transportation Fringe Benefits[36]

Qualified transportation fringe benefits consist of:

- Transportation in a commuter highway vehicle,
- Transit passes, and
- Qualified parking.

An employer may simultaneously provide any one or more of these three benefits to an employee. A qualified transportation fringe benefit plan need not be in writing.

36. Treas. Reg. §1.132-9

Commuter Highway Vehicle. A commuter highway vehicle is a vehicle provided by an employer to an employee in connection with travel between the employee's residence and place of employment. A commuter highway vehicle has a seating capacity of at least six adults (excluding the driver). At least 80% of the vehicle's mileage for a year is reasonably expected to be:

1. For transporting employees in connection with travel between their residences and their place of employment, and
2. On trips, during which the number of commuting employees transported is at least one-half of the vehicle's adult seating capacity (excluding the driver).

Only the first $110 of employer reimbursement for transportation expenses are excludable from the employee's income.

Transit Passes. This includes any pass, token, fare card, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation. The transportation can be either on mass transit facilities, or provided by any person in the business of transporting persons for compensation or hire in a highway vehicle with a seating capacity of at least six adults (excluding the driver).

The exclusion from income for transit passes is limited to $110 per month.

> **Example 19.** Springer Law Center provides employees with Metro passes. Each employee receives a $125 fare card at the beginning of the month. The employer must include $180 in the employee's wages for income and employment tax purposes. This is the amount in excess of the $110 monthly limitation (($125 – $110) × 12).

Transportation pass benefits may be provided to an employee through the issuance of a smart card. This is a card purchased from the transportation company that has an imbedded memory chip. The smart card does qualify for the income exclusion as long as the card cannot be used for anything but transportation.[37]

Qualified Parking. This refers to parking provided to an employee on or near the employer's business premises, or at a location from which the employee commutes to work (including commuting by carpool, commuter highway vehicle, mass transit facilities, or transportation provided by any person in the business of transporting persons for compensation or hire).

However, qualified parking does not include the value of parking provided to an employee that is excludable from gross income under IRC §132(a)(3) (as a working condition fringe). Also, it does not include reimbursements paid to an employee for parking costs that are excludable from gross income as an amount treated as paid under an accountable plan. However, parking on or near property used by the employee for residential purposes is not qualified parking.

Parking is provided by an employer if:

1. The parking is on the employer's owned or leased property,
2. The employer pays for the parking, or
3. The employer reimburses the employee for parking expenses.

An employee may exclude up to $215 per month of employer parking reimbursements.

> **Example 20.** Downtown Consulting Services pays consultant Tom a parking reimbursement of $215 per month. Tom receives the July reimbursement on June 30, 2007, and resigns from the firm effective July 1, 2007. Because Tom did not work for the firm after he received the July reimbursement, the $215 is included in his wages for income and employment tax purposes.

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37. Rev. Rul. 2006-57, 2006-47 IRB 911

Example 21. Speedy Taxsavers implemented a new employee parking plan. They allow employees to park in the employer-owned parking lot. For this privilege, they reduce the employee's gross wage by $215 per month. Next, they reimburse the employee $215 per month as a parking reimbursement. The net effect is that the employee's net cash does not change, but their taxable wages are reduced by $215.[38]

This plan does not meet the requirements of a qualified transportation fringe benefit. Because the employees do not actually incur any reimbursable expenses, the "reimbursement payments" must be included in gross income.[39]

Qualified transportation fringe benefits are not available to sole proprietors, partners, or 2% S corporation owners. However, other exclusions for working condition and de minimis fringe benefits may be available. While parking is not a working condition fringe benefit, it can fall under the de minimis rules.

BENEFIT SUMMARY

The following summarizes the deductibility of various fringe benefits grouped by entity type.

Sole Proprietors

Health Insurance. Health insurance premiums on a sole proprietor are fully deductible (subject to net income of the entity) as an adjustment to income on the front page of Form 1040. The deduction is not allowed on Schedule C or F. Health insurance premiums paid for the employees or dependents of employees are allowed as a deduction on the Schedule C or F.

Medical Reimbursement Plans. Sole proprietors are not allowed to participate in a medical reimbursement plan. Employees may participate whether or not they are related to the employer. The deduction for these types of expenses is deductible on the Schedule C or F.

Health Savings Accounts. Sole proprietors may participate in HSAs. The deduction is taken as an adjustment to income on the front page of Form 1040. Any contribution by the employer for employees is deducted on Schedule C or F.

Company Vehicles. Sole proprietors may deduct expenses for the business use of vehicles using the mileage rate if they have fewer than five vehicles being used simultaneously. Or, they may deduct actual operating expenses and depreciate the vehicle within the limits allowed under IRC §168. These deductions are taken on Schedule C or F.

Dependent Care Assistance. Sole proprietors may participate in a dependent care assistance program. However, in addition to requiring that the plan be written, it may **not** be discriminatory. To meet the nondiscriminatory test, the plan must not allow more than 25% of the benefits paid or incurred to be for the benefit of owners (or their spouses and dependents) who have more than a 5% capital or profits interest. In addition, the average dependent care assistance benefit provided to the employees who are not 5% or greater owners must be at least 55% of the average benefits provided to the owners.

Partnerships

Health Insurance. Health insurance premiums for a partner in a partnership are fully deductible as an adjustment to income on the individual partner's tax return subject to net income of the entity. The deduction may not be taken on the Form 1065. The premiums for the employees of the partnership, whether or not they are related to a partner, are deductible as a fringe benefit on the Form 1065.

Medical Reimbursement Plans. Partners in a partnership may not participate in a medical reimbursement plan. Employees may participate in the medical reimbursement plan whether or not they are related to a partner. The deduction for these types of plans is deducted on Form 1065 as an employee benefit.

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38. Rev. Rul. 2004-98, 2004-2 CB 664

39. Ibid.

Health Savings Accounts. Partners may participate in HSAs. If the partnership contributes to the plan, it is treated as a distribution to the partner and the partner deducts it as an adjustment on the front page of his Form 1040. If the partner makes the contribution himself, he deducts it as an adjustment to income on the front page of the Form 1040 as well. Contributions made for employees (whether or not related to a partner) are deducted on Form 1065 as an employee benefit.

Company Vehicles. Partnerships may either deduct vehicle expenses using the cents per mile method if they are using fewer than five vehicles simultaneously, or deduct actual expenses including depreciation. In addition, the partnership may reimburse partners for the business use of the partner's personal vehicle. If the partner uses his personal vehicle for partnership business and does not get reimbursed, the partner may deduct the business percentage costs on Schedule E, page 2. This deduction is also used to lower any self-employment tax liability.

Dependent Care Assistance. Partners may participate in dependent care assistance programs using the same guidelines as found under Sole Proprietorships.

S Corporations

Health Insurance. The premiums paid by an S corporation on behalf of an employee who is not a 2% or greater shareholder are deductible on the S corporate return, and are also excluded from the employee's income. Premiums paid for a 2% or greater shareholder are deductible as an employee benefit on Form 1120S, but they must also be added to the W-2 income of the shareholder.

> **Note.** Rev. Rul. 91-26 exempts this income from FICA.

These premiums may then be deducted as an income adjustment on the front page of the shareholder's Form 1040.

> **Note.** The rules of attribution under IRC §318(a) apply to 2% or greater shareholders of S corporations; therefore, anyone related to this shareholder is also considered a 2% or greater shareholder.

Medical Reimbursement Plans. Shareholders who own 2% or more of the outstanding stock of an S corporation may participate in a medical reimbursement plan but the reimbursement is a taxable fringe benefit. Employees that do **not** own 2% or more stock may participate, and the entity deducts the expense as an employee benefit on Form 1120S, and the employee excludes the benefit from income.

The same rules of attribution under IRC §318(a) apply for this benefit as well.

> **Note.** The reimbursement may or may not be subject to social security taxes. The IRS has not issued guidance on this and experts disagree.

Health Savings Accounts. Taxpayers that are 2% or greater shareholders in an S corporation may participate in HSAs. If the corporation makes the contribution, it is deducted as an employee benefit on the Form 1120S, but it must be added to the employee/shareholder's W-2. The taxpayer then deducts it as an adjustment to income on the front page of his Form 1040. For employees who are not 2% or greater shareholders, the corporation deducts the contribution as an employee benefit on Form 1120S, and the employee does not have to report it as income.

Company Vehicles. The corporation may deduct 100% of a company-owned vehicle. The employee who uses the vehicle for personal and business use must report the personal use portion of the vehicle as taxable income.

The personal use portion may be determined under three different methods:

1. Lease valuation method,
2. Standard mileage rate, or
3. Commuting use method

The amount computed under one of the above three methods is added to the employee's W-2, and is subject to federal, state, and FICA taxes.

> **Tax Planning Note.** The employee may reimburse the company for the personal use portion. Any amount reimbursed by the employee to the employer reduces the amount of additional income determined by the employer to be taxable. The employee may use one of the special valuation methods (cents-per-mile, commuting, or annual lease value method) to determine the amount of reimbursement only if the employer uses the same method.[40] The corporation reports this reimbursement as miscellaneous income, or as a reduction of auto expenses.

Dependent Care Assistance. Individuals that are 2% or greater shareholders may participate in a dependent care assistance program. The same rules that apply to sole proprietorships and partners in a partnership also apply for 2% or greater shareholder/employees in an S corporation.

C Corporations

Health Insurance. The premiums paid for all employees of C corporations are deductible as fringe benefits on the Form 1120, and may be excluded from the employee's income.

Medical Reimbursement Plans. All employees of a C corporation may participate in a medical reimbursement plan subject to the requirements under IRC §105, requiring 70% or more of all eligible employees be covered. The plan may not discriminate in favor of highly compensated employees. The corporation deducts the expense as an employee benefit on Form 1120, and the fringe benefit is excluded from the employee's income.

Health Savings Accounts. All employees of a C corporation may participate in an HSA. The contributions are deducted on Form 1120 as an employee benefit, and are **excluded** from the participating employee's income.

Company Vehicles. The same rules apply as for S corporations.

Dependent Care Assistance. All employees of a C corporation may participate in a dependent care assistance program; however, the same rules apply as for a sole proprietorship.

ISSUE 2: DEPRECIATE OR DEDUCT REPAIR EXPENSES

On January 20, 2004, the IRS and Treasury Department published Notice 2004-6 announcing an intention to propose regulations providing guidance in the area of repair expense treatment. The proposed regulations issued August 21, 2006, apply to amounts paid to acquire, produce, or improve tangible property.[41] These proposed regulations clarify and expand the standards in the current regulations under IRC §263(a) including "bright-line" tests for determining when to capitalize and when to deduct.

These regulations, **if** they become final, will replace current regulations.[42] These proposed regulations do not address amounts paid to acquire or create intangible interests in land, such as easements, life estates, mineral interests, timber rights, and zoning variances. These regulations also do not address the treatment of software development costs. These proposed regulations clarify and expand the standards in the current IRC §263(a) regulations, and provide "several safe harbors and simplifying assumptions."

40. Treas. Reg. §1.61-21(c)(2)(i)
41. IRB 2006-39 (September 25, 2006)
42. Treas. Regs. §§1.2631(a)-1 to -3

AMOUNTS PAID TO ACQUIRE OR PRODUCE TANGIBLE PROPERTY

The proposed regulations require capitalization of amounts paid for property having a useful life substantially beyond the taxable year, including:

- Land and land improvements,
- Buildings,
- Machinery and equipment,
- Furniture and fixtures, and
- Units of property.

In addition, the proposed regulations require capitalization of amounts paid for certain property that is intended to be used as a **component in the repair or improvement of a unit** of property. These uses are discussed in detail later in the chapter.

These regulations do **not** require that the cost of property with an economic useful life of 12 months or less to be capitalized. However, capitalization of costs may be required under other regulations. For example, under §263A, all indirect costs that directly benefit a taxpayer's manufacturing activities must be capitalized to the property produced for sale.

These regulations do **not** change the treatment of incidental materials and supplies, which are deductible when purchased.[43] They also do **not** change the treatment by certain qualifying small business taxpayers of nonincidental materials and supplies, which are generally deductible when purchased or used, whichever is later.[44]

There is no de minimis rule for acquisition costs. However, the following proviso is included in the "Supplementary Information" provided with the proposed regulations:[45]

> *The IRS and Treasury Department recognize that taxpayers often reach an agreement with IRS examining agents that, as an administrative matter, based on risk analysis and/or materiality, the IRS examining agents do not select certain items for review such as the acquisition of tangible assets with a small cost. This often is referred to by taxpayers and IRS examining agents as a de minimis rule. The absence of a de minimis rule in the proposed regulations is not intended to change this practice.*

AMOUNTS PAID TO IMPROVE TANGIBLE PROPERTY

The **unit of property rules** in the proposed regulations are intended to provide guidance in determining whether an amount paid improves the unit of property. The unit of property rules apply to all real and personal property. These regulations provide specific rules for four categories of property:

1. Property owned by taxpayers in a regulated industry
2. Buildings and structural components
3. Other personal property
4. Other real property

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43. Treas. Reg. §1.162-3
44. Rev. Proc. 2002-28, 2002-1 CB 815
45. IRB 2006-39 (September 25, 2006)

Property Owned by Taxpayers in a Regulated Industry

If the taxpayer is in an industry for which a federal regulator has a uniform system of accounts (USOA) identifying a particular unit of property, the taxpayer must use the same unit of property for federal income tax purposes. This is the case regardless of whether the taxpayer is subject to the regulatory accounting rules of the federal regulator, and regardless of whether the property is particular to that industry. This rule ties into the regulatory accounting element of the *FedEx* factor,[46] as well as the general concept of industry practice. The IRS and Treasury Department are aware of three federal regulators that provide a USOA:

1. The Federal Energy Regulatory Commission (FERC)
2. The Federal Communications Commission (FCC)
3. The Surface Transportation Board (STB)

Therefore, this unit of property category applies to taxpayers such as power companies, telecommunications companies, and railroads.

Building and Structural Components

A building and its structural components must be treated as one unit of property. Property located inside a building that is not a structural component must be analyzed under one of the other three units of property categories.

> **Observation.** "Component depreciation" was specifically overturned with the passage of the 1981 Tax Act (e.g., in which various "components" such as the roofing, plumbing, and wiring of a building were broken out and depreciated as separate assets). This compares to cost segregation studies which seek to identify and break out distinct assets such fixtures and equipment which are their own assets under the MACRS system of depreciation.

Other Personal Property

The unit of property determination for this category is based upon a facts and circumstances test, based on four exclusive factors, none of which weigh more heavily than the others:

1. **Marketplace Treatment Factor.** Is the component marketed separately to the taxpayer, subject to a warranty contract, subject to a separate maintenance manual, appraised separately, or sold separately by the taxpayer to another party?
2. **Industry Practice and Financial Accounting Factor.** Is the component treated as a separate unit of property in industry practice, or by the taxpayer in its books and records?
3. **Rotable Part Factor.** Does the taxpayer treat the component as a rotable part? A rotable part is defined as a part that is removable from property, repaired or improved, and either immediately reinstalled on other property or stored for later installation.
4. **Function Factor.** Does the property, of which the component is a part, generally function for its intended use without the component?

> **Observation.** Although a state sales and use tax division might look to how a taxpayer treated an item for purposes of determining whether sales tax might be due (e.g., on tangible personal property broken out as separate assets in a cost segregation study), the IRS normally disregards such status when it reviews a taxpayer's position on such assets.

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46. *FedEx Corporation v. U.S.*, 291 F.Supp.2d 699 (W.D.Tenn. 2003)

Other Real Property

The unit of property determination for other real property is also based on a facts and circumstances test. There are no specific factors, because land and land improvements are such unique assets that specific factors cannot uniformly provide results.

Additional Rule for Unit of Property

After determining the category for the initial unit of property, the additional rule must be applied.[47] If a taxpayer properly treats a component as a separate unit of property for any federal income tax purpose, the taxpayer must treat the component as a separate unit of property for purposes of Prop. Treas. Reg. §1.263(a)-3. The purpose of this rule is to prevent taxpayers from taking inconsistent positions by stating that a component of property is a unit of property for one tax purpose, and that it is not a separate unit for capitalization purposes. For example, if a taxpayer does a cost segregation on a building, and properly identifies separate IRC §1245 property, the taxpayer must treat that separate property as the unit of property for capitalization purposes.

Improvements

Currently, Treas. Reg. §1.263(a)-1(b) provides that an amount must be capitalized if it materially adds to the value, substantially prolongs the useful life of property, or adapts the property to a new or different use. This proposed legislation attempts to clarify and expand the standards by setting rules to determine whether there was restoration of the property. In general, a taxpayer must capitalize the aggregate of related amounts paid that improve a unit of property, whether the taxpayer or a third party makes the improvements. Under this proposed regulation, amounts paid that keep property in ordinarily efficient operating conditions are not necessarily deductible repair costs, particularly if the useful life is extended.

Also, the fact that a federal, state, or local regulator requires that a taxpayer perform certain repairs or maintenance is not relevant in determining whether the amount paid improves the unit of property.

Value

Taxpayers must capitalize amounts paid that materially increase the value of a unit of property. The proposed regulations provide an exclusive list of five tests for determining whether an amount paid materially increases the value of the property. If the amount paid meets **any** of the five tests, it must be capitalized:

1. Does the amount paid ameliorate a condition or defect that either existed prior to the taxpayer's acquisition or arose during the production of the unit of property? This rule is consistent with the concept that amounts paid to put property into ordinarily efficient operating condition must be capitalized.

> **Note.** To "put" the property into operating condition is distinct from "keeping" the property in ordinary operating condition.

2. Was the work performed prior to the date the property was placed in service by the taxpayer? This rule restates the concept that amounts paid to **put** property into ordinarily efficient operating condition must be capitalized. For example, work performed prior to receiving the certificate of occupancy is normally capitalized.
3. Do the amounts paid adapt the property to a new or different use? This test remains unchanged.
4. Does the amount paid result in a betterment or material addition to the unit of property? A betterment is considered an improvement that does more than restore property to a former good condition. Unlike repairs, these types of improvements make the property better and more valuable, such as using upgraded materials when materials comparable to the original were available and would have sufficed.
5. Does the amount paid result in a material increase in capacity, productivity, efficiency, or quality of output of the unit of property? This test is also unchanged from the current regulations.

47. Prop. Treas. Reg. §1.263(a)-3(d)(2)(vii)

Restoration

A taxpayer must capitalize amounts paid to restore property. This comes from the current regulations that require capitalization if the amounts paid substantially prolong the useful life of the property.

There are four rules for determining when an amount paid substantially prolongs the economic useful life. If **one** of these rules is met, the amount paid must be capitalized:

1. The amount paid extends the property's useful life for the period it was reasonably expected to be **useful,** beyond the end of the taxable year immediately succeeding the taxable year in which the economic useful life of the property was originally expected to cease. Useful life is distinct from the recovery period assigned by MACRS tables.

2. A major component or substantial structural part of the unit of property is replaced. The replacement of a relatively minor portion of the physical structure of the unit of property or a relatively minor portion of any of its major parts does not constitute the replacement of a major component or substantial structural part of the unit of property. This rule is not intended to require capitalization if a major component is replaced with a similar, used component that was not rebuilt. For example, replacing a car engine with a used engine with similar mileage obtained from a junkyard. This is also not intended to require capitalization of tires.

3. Amounts paid to restore a unit of property to a **like-new** condition which substantially prolongs the useful life. The IRS and Treasury Department intend that this test be applied to situations in which the property undergoes the equivalent of being rebuilt.

> **Note.** This proposed regulation directly opposes a 6th Circuit Court of Appeals decision which allowed FedEx to expense the cost of rebuilding jet engines. See page 474 in the 2005 *University of Illinois Federal Tax Workbook* for an analysis of this case.
>
> If this regulation is finalized, the regulation will have greater weight than the court case. See "Explanation of Contents" in the "Rulings and Cases" chapter for an explanation of weighing various sources of substantial authority.

4. Amounts paid when restoring a unit of property after the taxpayer has properly deducted a casualty loss under IRC §165. Any amounts paid to repair property after a casualty loss must be capitalized.

NEW REPAIR ALLOWANCE METHOD

When a client makes a major expenditure to rehabilitate an asset, especially real property, the desire is to deduct the cost immediately as a "repair," or at least be able to cost segregate it as tangible personal property with a MACRS recovery period of five or seven years. There has been a dramatic shift from capitalization to expensing such costs as repairs because of a series of court decisions.[48] These cases serve to remind tax practitioners of the 3-prong test, which should be employed each time they consider this issue. At times, IRS agents and the Tax Court conduct a "percentage comparison" of the amount of the expenditures to the cost of the property. In addition, if the percentage is very high, they attempt to deny the deduction as being a repair. For instance, expenditures that were almost twice the cost of an uninhabitable building were found to be capital improvements.[49] Even so, maintenance costs in this same case were allowed as current deductions, even though incurred during a general plan of renovation. In fact, the Tax Court allowed deductible repair expenditures that equaled 35% of the building's total cost.[50]

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48. *Campbell v. Comm'r,* 504 F.2d 1158 (1974); *Thomas Northen and Shirley Cox,* TC Summ. Op. 2003-113; *FedEx Corp. v. U.S.,* 03-6514 (6th Cir. Feb. 16, 2005); *Cinergy Corp. v. U.S.,* 55 Fed. Cl. 489 (2003)

49. *Stoeltizing v. Comm'r,* 266 F.2d 374 (3rd Cir., 1959)

50. *Buckland v. Comm'r,* 66 F. Supp. 681, (D. Conn., 1946)

Just because the cost involved with the repair is substantial does **not** automatically result in the item(s) having to be capitalized. The following current repair or maintenance deductions were allowed in court:

- Over $46,000 spent to arrest and prevent further damage to the building's foundation piles caused by an unexpected lowering of the water level[51]
- Costs of $108,000 spent for second-hand engines to replace broken-down engines on a cargo vessel[52]
- Expenditures of over $1 million made to repair and prevent cave-ins at a plant that had been erected on a geological fault[53]
- Costs of $12,000 to add layers of insulating material over the roof of a newly-constructed factory building. The court found that the new roof only put the building "back to its former efficient operating condition.[54]
- Costs of $21,000 to repair a leaking roof when the only reason for the repair was to prevent leaks. The property was originally leak-free and the repair "merely restored it to that condition.[55]
- Costs of $50,000 to enlarge a reservoir by one-fourth acre to one-half acre in order to prevent the dam from leaking, and thus, "keep it in ordinary operating condition." The reservoir was drained and soil excavated from the dam and then replaced with 10,000 cubic yards of clay to seal the dam. Despite being "extensive," the court found that the expenditures "merely restored the capability of retaining water."[56]
- Costs of $270,000 incurred to repaint and repaper a hotel as part of normal, ongoing maintenance. The hotel did this in order to retain its 5-star rating. Furthermore, the court agreed with the taxpayer's deduction of these costs even though they were "substantial in amount and done in conjunction with major remodeling."[57]
- Costs of $8,000 to remove and replace the roof-covering material on a rental house.[58]

51. *Illinois Merchants Trust Co.*, 4 BTA 103 (1926)
52. *Shore v. Comm'r*, TC Memo 1959-166, August 27, 1959
53. *American Benberg Corp. v. Comm'r*, 10 TC 361 (1948)
54. *Munroe Land Co. v. Comm'r*, TC Memo 1966-2, January 4, 1966
55. *Oberman Mfg. v. Comm'r*, 47 TC 471 (1967)
56. *Evans v. Comm'r*, 557 F.2d 1095 (5th Cir., 1977)
57. *Moss v. Comm'r*, 831 F.2d 833, (9th Cir., 1987)
58. *Campbell v. Comm'r*, TC Summ. Op. 2002-117, (September 6, 2002)

The proposed regulations contain a new, elective repair allowance method (RAM) that taxpayers are permitted to use for most repairs, maintenance, and improvement expenses. Instead of determining whether an expense is currently deductible or must be capitalized, the proposed regulations allow a taxpayer to elect to treat most amounts paid for repairing, maintaining, or improving tangible property as:

1. Currently deductible under §162 to the extent they do **not** exceed the repair allowance for that particular MACRS class of the property, or
2. Amounts that are required to be capitalized under §263 to the extent of any such excess.[59]

Comment. This new optional RAM is fashioned after the asset depreciation range (ADR) class life repair allowance method found in Treas. Reg. §1.167(a)-11(d)(2) for property placed in service after 1970 and before 1981. It allowed the IRS, by way of regulations, to provide that a taxpayer could make an election under which amounts comprising **either** repair expenses or specified repair, rehabilitation, or improvement expenditures for any class of depreciable property:

1. Were allowable as a deduction under §162(a) or §212 (whichever is appropriate) to the extent of the repair allowance for that class; and
2. Were chargeable to the capital account to the extent such amounts exceeded the repair allowance for the tax year.

Observation. It is surprising and somewhat interesting that the IRS is reviving a depreciation method that Congress specifically repealed in the 1981 Economic Recovery Tax Act.

PROPERTY ELIGIBLE FOR RAM

Only the following types of property are treated as repair allowance property and are eligible for the new RAM:

1. IRC §1231 real or personal property subject to the depreciation rules of §168 and used in the taxpayer's trade or business, or §212 investment property held for production of income
2. Tangible depreciable property **not** otherwise subject to MACRS. However, the taxpayer must classify the property as MACRS property solely for purposes of the RAM, and the taxpayer must have placed the property into service prior to IRC §168 or elected out of §168 with regard to the property.[60]

Comment. For these purposes, "property **not** otherwise subject to MACRS" includes property that the taxpayer elected under §168(f)(1) to depreciate using either the units-of-production method or another depreciation method **not** expressed in a term of years (other than the retirement-replacement-betterment method or similar method). Under this definition, the regulations make it clear that the RAM is **not** available for repairs, maintenance, or improvements that a lessee makes to leased property, since these costs are technically **not** eligible for recovery under §168. The preamble to the proposed regulations states that the IRS is soliciting comments on how the RAM might be applied to leased property. Finally, property is ineligible for the RAM if the taxpayer used the prior law's ADR repair allowance method, or it is certain railroad property or any other property designated by the IRS.[61]

59. Prop. Treas. Reg. §1.63-3(g)
60. Prop. Reg. §1.63-3(g)(6)
61. Prop. Treas. Reg. §1.63-3(g)(6)(iii)

COSTS INELIGIBLE FOR RAM

Taxpayers are **not** permitted to use the RAM for amounts paid:

1. To acquire or produce a specific unit of property
2. For work that ameliorates a condition or defect that either existed before the taxpayer acquired the unit of property, or arose during the production of the unit of property. This applies whether or not the taxpayer was aware of the condition or defect at its acquisition or production.
3. For work done **before** the date the unit of property is placed in service by the taxpayer without regard to any applicable placed-in-service convention under §168(d)
4. To adapt the unit of property to a **new or different use**
5. To increase the cubic or square space of a building[62]

COST LIMITATIONS ON USE OF RAM

Under the RAM, for assets other than buildings, a taxpayer treats all eligible amounts paid for materials and labor to repair, maintain, or improve all repair allowance property in a particular MACRS class as deductible expenses under §162 for the tax year, up to the "repair allowance amount" for that MACRS class. The repair allowance is measured by the taxpayer's average unadjusted basis for the MACRS property class multiplied by the repair allowance percentage for the MACRS class. The repair allowance percentages are:

MACRS Recovery Period (Years)	Allowance Percentage
3	16.50%
5	10.00%
7	7.14%
10	5.00%
15	3.33%
20	2.50%
25	2.00%
27.5	1.82%
39	1.28%
50	1.00%

The average unadjusted basis equals the unadjusted basis of all repair allowance property in the MACRS class at the beginning of the tax year, plus the unadjusted basis of all repair allowance property in the MACRS class at the end of the tax year divided by two. Meanwhile, a particular property's unadjusted basis generally equals the taxpayer's cost basis:

- Unreduced for any amounts that the taxpayer elects to expense under §179,
- Reduced for any credits taken for the property, and
- Adjusted for any personal use of the asset such as the personal use percentage of a business auto.[63]

62. Prop. Treas. Reg. §1.63-3(g)(7)

63. Prop. Treas. Regs. §§1.63-3(g)(3) and §1.63-3(g)(4)

Example 22. South Corp. is a calendar-year taxpayer that elects to use the RAM. The total unadjusted basis of all of its MACRS 10-year property as of January 1, 2008, is $10 million. The total unadjusted basis of all its MACRS 10-year property as of December 31, 2008, is $15 million. For 2008, its repair allowance amount for 10-year property is $625,000 ((($10,000,000 + $15,000,000) ÷ 2) × .05). As a result, for 2008, South may elect under the RAM to currently deduct up to $625,000 of its cost of repairing, maintaining, or improving 10-year MACRS property and not have this deduction questioned by the IRS.[64]

RAM FOR BUILDINGS AND STRUCTURAL COMPONENTS

For buildings and structural components that are repair allowance property, the RAM is applied separately for each unit of property.[65]

CAPITALIZATION REQUIRED FOR COSTS IN EXCESS OF RAM LIMIT

Under the RAM, the portion of costs of repairing, maintaining, or improving repair allowance property in each MACRS class that exceeds the repair allowance amount must be capitalized.

Example 23. Use the same facts as in **Example 22,** except that in 2008, South Corp. spends $1 million to repair, maintain, or improve its 10-year MACRS property. South Corp. is allowed to currently deduct $625,000 (i.e., the repair allowance amount), but it must capitalize the remaining $375,000 balance.[66]

RECOVERY OF COSTS REQUIRED TO BE CAPITALIZED UNDER RAM

To the extent that certain costs must be capitalized under the RAM, they can be recovered in one of two possible methods:

1. They can be treated as a single asset and depreciated as a §168(i)(6) improvement, placed in service on the last day of the first half of the year in which the amount is paid unless the mid-quarter convention otherwise applies. Under §168(i)(6), capitalized additions to property which **cannot** otherwise be currently deducted as repairs are depreciated over the **same** MACRS recovery period that would apply to the underlying property if placed in service at the same time as the addition. The recovery period begins on the later of the date the property or the addition is placed in service. Moreover, except for a sale of assets constituting a trade or business, no gain or loss is recognized on the disposition of the capitalized amount. The taxpayer continues to depreciate that amount over the remaining recovery period.[67]
2. They can be allocated to all repair allowance property in the particular MACRS class in proportion to the unadjusted basis of the property in that class as of the beginning of the tax year. The capitalized amount is then treated as a §168(i)(6) improvement to the underlying repair allowance property, placed in service on the last day of the first half of the tax year in which the amount is paid, before application of any averaging convention under §168(d).[68]

64. Prop. Treas. Reg. §1.63-3(g)(11), Example 1
65. Prop. Treas. Reg. §1.63-3(g)(4)(iv)
66. Prop. Treas. Reg. §1.63-3(g)(11), Example 1
67. Prop. Treas. Reg. §1.63-3(g)(5)(ii)
68. Prop. Treas. Reg. §1.63-3(g)(5)(iii)

GUIDANCE NEEDED ON MAKING THE RAM ELECTION

At this point, the proposed regulations fail to explain how a taxpayer elects the RAM. However, they are clear that once made, the election **cannot** be revoked without the IRS's consent. Following a revocation, a taxpayer generally is **not** permitted to use the RAM for at least five years.[69]

> **Comment.** The regulations's preamble states that the respective RAM percentages are fashioned on the principle that taxpayers spend approximately 50% of a property's unadjusted basis on repairs over its recovery period. If a taxpayer's experience shows its costs for repairs, maintenance and improvements during the recovery period typically do **not** exceed this percentage, the RAM election results in increased current deductions. It also serves to avoid the complex classification system of costs in the proposed regulations. However, if repairs tend to exceed these prescribed percentages, the RAM election results in the additional complexity of establishing and maintaining new systems for depreciating costs that exceed the repair allowance while still abiding by the RAM for assets already placed in service. Although the RAM system might be recommended for certain types of tangible personal property, it probably is not beneficial to use it in a real estate context where only 50% of the S/L rate (1/27 years or 1/39 years; .0182 or .0128) could be taken under this safe-harbor method.

EFFECTIVE DATE

The new rules will be effective for tax years beginning on or after the date that the regulations are finalized.

ISSUE 3: MEAL AND INCIDENTAL EXPENSES

MEALS

Taxpayers may deduct the cost of meals if either of the following situations applies:

- It is necessary to stop for substantial sleep or rest to properly perform duties while traveling away from home on business.
- The meal is business-related entertainment.

Meals that are lavish or extravagant cannot be deducted. Facts and circumstances determine whether an expense is considered reasonable. Expenses are not disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

Meal deductions are computed based on either actual cost or the standard meal and incidental expenses (M&IE) allowance. Generally, the taxpayer is allowed to deduct 50% of the unreimbursed cost of the meal. If the taxpayer is reimbursed, the 50% limit is applied based upon whether the employer's plan was accountable or unaccountable. Taxpayers subject to the Department of Transportation (DOT) hours of service requirements may deduct 75% of their unreimbursed meal costs for the 2007 tax year. This rate remains unchanged from 2006 and will increase to 80% for tax years 2008 and thereafter.[70]

Actual Cost Method

If the taxpayer chooses to use the actual cost method, he must keep records of actual costs incurred.

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69. Prop. Treas. Reg. §1.63-3(g)(10)
70. IRC §274(n)(3)(b)

Standard Meal and Incidental Expenses (M&IE) Allowance

The taxpayer may use the standard M&IE allowance published in IRS Pub. 1542, *Per Diem Rates*, as an alternative to the actual cost method. This allows the taxpayer to deduct a standard amount for daily meals and incidental expenses instead of keeping records of actual costs. The taxpayer must still keep records to prove the time, place, and business purpose of his travel.

For travel in 2007, the rate for most small localities in the United States is $39 a day. For specific localities, see IRS Pub. 1542, *Per Diem Rates for Travel Within the Continental United States*. Per diem rates generally are updated October 1 each year.

The standard meal allowance may be used to calculate meal expenses when a taxpayer travels in connection with business, investment, or other income-producing activity. Taxpayers may also use the allowance when traveling for qualified educational purposes. Taxpayers may not use the meal allowance when traveling for medical or charitable purposes.

Travel Days for Departure and Return

Taxpayers must prorate the standard meal allowance for the day they depart and the day they return. This is accomplished using one of the following two methods:

- **Method 1.** Claim 75% of the standard meal allowance
- **Method 2.** Prorate the standard meal allowance using any method that the taxpayer uses consistently and that is in accordance with reasonable business practice.

Example 24. Mary is employed in New Orleans as a convention planner. In March, her employer sent her on a 3-day trip to Washington, D.C., to attend a planning seminar. She left her home in New Orleans at 10 a.m. on Wednesday and arrived in Washington, D.C. at 5:30 p.m. After spending two nights there, she flew back to New Orleans and arrived back home Friday at 8:00 p.m. Mary's employer gave her a flat amount to cover her expenses and included it in her wages.

Under Method 1, Mary can claim 2 1/2 days of the standard meal allowance for Washington, D.C., 75% of the daily rate for Wednesday and Friday, and the full daily rate for Thursday.

Under Method 2, Mary could use any method that she applies consistently and that is in accordance with reasonable business practice. For example, she could claim three days of the standard meal allowance even though a federal employee would have to use Method 1 and be limited to only 2 1/2 days.

INCIDENTAL EXPENSES

Incidental expenses include the following:

- Fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries
- Transportation between places of lodging or business and places where meals are taken, if suitable meals cannot be obtained at the temporary duty site
- Mailing costs associated with filing travel vouchers and payment of employer-sponsored charge card billings

Incidental expenses do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls.

The taxpayer may use an optional method for deducting incidental expenses only. The amount of the deduction is $3 per day for incidental expenses paid for travel away from home in 2007. The taxpayer may only use this method if she did not pay or incur any meal expenses. This optional method is **not** available on any day that the taxpayer uses the standard M&IE allowance. This optional method is also subject to the proration rules for partial days.

ISSUE 4: FIX AND FLIP — INVESTMENT OR BUSINESS

A lot of real estate investors buy and hold properties for long-term investment. They expect their total return to come from rental income and long-term appreciation. However, some investors would rather not manage properties over time. Their goal is to purchase at the best price they can obtain, renovate or rehabilitate the property (fix), and then resell (flip) it for immediate gain. These kinds of properties may not qualify as traditional "investment" properties. They may be treated as dealer properties or developer properties.

DEALER PROPERTIES

Investors who buy property to resell in the ordinary course of their trade or business are considered dealers, not investors. These types of taxpayers must treat the real estate as inventory, not capital assets. Therefore, gains are taxed as ordinary income, not capital gains. These taxpayers may not depreciate the property for the time they hold it. In addition, §1031 (like-kind exchange) is not available for inventory. The income from such activities is also subject to self-employment tax.

There is no definitive rule for determining who qualifies as a dealer. The key elements to consider are as follows:

- Why are they buying the property? Taxpayers who buy property specifically intending to resell it qualify as a dealer for that property, even if they buy other properties for investment.
- How long do they hold the property? Shorter holding periods, such as two years or less, generally indicate dealer intent.
- How much property do they sell? A buyer who buys a dozen houses in a year, then sells 10 of them, is more likely to be treated as a dealer than if he just sells two.
- How much of the taxpayer's income comes from selling? A buyer who lucks into a single deal for a quick $25,000 gain is less likely to be treated as a dealer than one who makes her living flipping properties.
- How actively do they work selling property? Buying and selling full-time, keeping a sales office, advertising regularly, and managing a sales staff indicate dealer intent.

Example 25. Ted and Gary, who are high-school teachers, routinely buy one older single family residence each spring. They fix up the property during their summer vacation and sell it for a profit before the end of the year.

Question 25A. What is the property tax treatment of their gain on the sale of the refurbished residence?

Answer 25A. Because Ted and Gary have engaged in this activity continuously and regularly for several years, the IRS may consider this a **business** activity as opposed to an **investment** activity. If this interpretation is correct, they should report the gain as trade or business partnership income subject to self-employment tax. In addition, the gain does not qualify for the like-kind exchange rules of IRC §1031.

DEVELOPER PROPERTIES

Investors who buy property with the intent to develop it face special rules requiring them to capitalize costs associated with developing the property. This also means they must capitalize, rather than deduct, the indirect costs associated with developing the property once the development phase commences. These types of expenses include mortgage interest, taxes, administrative and managerial costs, and similar costs that would otherwise be deductible had the building been placed in service immediately.

Example 26. In September, Joe buys a 100-year-old building to renovate into offices. He invites his friends Steve, Ted, Gary, and Chris to join him in refurbishing the building and occupying it at completion. From September through November, he pays $5,000 in mortgage interest, $2,500 in management and administrative costs, $15,000 in maintenance and repairs, and $130,000 in general renovations. On December 1, the partners host a grand opening for their new offices. While the mortgage interest, management and administrative costs, and maintenance and repairs might otherwise be deductible, Joe and his partners must capitalize all of those costs and add them to the basis of their new offices.

ISSUE 5: DEPRECIATION NOT TAKEN IN PRIOR YEARS

To change an adopted method of accounting for depreciation or amortization, a taxpayer must file Form 3115, *Application for Change in Accounting Method*, and follow the automatic consent procedures of Rev. Proc. 2002-9 (if applicable), or the advance consent procedures of Rev. Proc. 97-27.

Examples of amortization and depreciation changes that are considered a change in accounting method are as follows:

1. Changing the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable[71]
2. A correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets[72]
3. A change in the depreciation method, recovery period, or convention of a depreciable or amortizable asset[73]
4. A change in the salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by statute or other guidance[74]

Note. Form 3115 may be used to "catch up" depreciation that was previously omitted in error.

Examples of depreciation and amortization changes that are **not** considered a change in accounting methods are as follows:

1. Correction of mathematical or posting errors[75]
2. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under IRC §167[76]
3. A change in computing depreciation allowances in the tax year in which the use of the property changes in the hands of the same taxpayer[77]
4. The making of a late depreciation election or the revocation of a timely valid depreciation election[78]
5. A change in salvage value, unless a salvage value of zero is expressly required, as in the case of ACRS, MACRS, and §197 intangibles[79]
6. Any change in the placed-in service date of a depreciable, or amortizable asset unless provided otherwise in the code, regulations, or other IRS guidance[80]
7. The required change for MACRS assets from a declining balance method to the straight-line method in the year that the straight-line method produces a larger deduction[81]

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71. Treas. Reg. §1.446-1(e)(2)(iii)
72. Treas. Reg. §1.446-1(e)(2)(ii)(d)(2)
73. Treas. Reg. §1.446-1(e)(2)(ii)(d)(2)(i)
74. Treas. Reg. §1.446-1(e)(2)(ii)(d)(2)(v)
75. Treas. Reg. §1.446-a(e)(2)(ii)(b)
76. Treas. Reg. §1.446-1(e)(2)(iii)
77. Treas. Reg. §1.446-1(e)(2)(ii)(d)(3)(ii)
78. Treas. Reg. §1.446-1(e)(2)(ii)(d)(3)(iii)
79. Treas. Reg. §1.446-1(e)(2)(ii)(d)(3)(iv)
80. Treas. Reg. §1.446-1(e)(2)(ii)(d)(3)(v)
81. Treas. Reg. §1.446-1(e)(2)(ii)(d)(5)(i)

Taxpayers who adopted a method of accounting for depreciation and claimed less or more depreciation or amortization than they are entitled to may usually obtain automatic consent to change from an impermissible method to a permissible method of accounting. This is done by filing Form 3115 and reporting the correct amount of depreciation or amortization as a IRC §481(a) adjustment.

Prior to January 22, 2007, the taxpayer must have used the impermissible method for two years before qualifying for a §481(a) adjustment. Rev. Proc. 2007-16 eliminated the 2-year rule in Rev. Proc. 90-38. A taxpayer may now utilize Form 3115 and take the §481(a) adjustment even if the impermissible method was only used for one year.

Excess or inadequate depreciation from open and closed years prior to the year of change is taken into account as a §481(a) adjustment in computing taxable income over a 4-year period for a net **positive** adjustment, and in 1-year period if a net **negative** adjustment. A taxpayer may elect a 1-year adjustment period for positive adjustments if the net adjustment is less than $25,000.

Example 27. Gary places in service a commercial office building in July 2002. The depreciation is computed on the purchase price of $500,000, including land. Depreciation was computed as follows:

2002	$ 5,885	5.5 month MM convention
2003	12,820	
2004	12,820	
2005	12,820	
2006	12,820	
Total	$57,165	

In 2007, Gary completes a cost segregation study, and certain building elements are reclassified as **5-year** property. An allocation is also made for the land that was purchased in 2002. The building now has a value of $300,000, plus $100,000 for land and $100,000 for the **reclassified** 5-year property. Correct depreciation for prior years should have been:

	Building	Land	Equipment		
2002	$ 3,531	$0	$20,000		
2003	7,692	0	32,000		
2004	7,692	0	29,200		
2005	7,692	0	11,520		
2006	7,692	0	11,520		
Total	$34,299	+	$94,240	=	$128,539

Therefore, Gary has an IRC §481(a) adjustment for 2007 of $71,374 ($128,539 – $57,165). The net is a negative adjustment; therefore, he is allowed the full deduction in one tax year.[82]

82. Rev. Proc. 2002-19, 2002-1 CB 696

For Example 27

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

Application for Change in Accounting Method

OMB No. 1545-0152

Name of filer (name of parent corporation if a consolidated group) (see instructions)
Gary Illinois

Number, street, and room or suite no. If a P.O. box, see the instructions.

City or town, state, and ZIP code

Identification number (see instructions) 123-45-6777

Principal business activity code number (see instructions)

Tax year of change begins (MM/DD/YYYY) 1/01/2006
Tax year of change ends (MM/DD/YYYY) 12/31/2006

Name of contact person (see instructions)
Gary Illinois

Name of applicant(s) (if different than filer) and identification number(s) (see instructions)
Gary Illinois 123-45-6777

Contact person's telephone number ( )

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

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

Check the box to indicate the applicant.

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

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

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

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

Part I Information For Automatic Change Request	Yes	No
1 Enter the requested designated accounting method change number from the **List of Automatic Accounting Method Changes** (see instructions). Enter only one method change number, except as provided for in the instructions. If the requested change is not included in that list, check "Other," and provide a description. ▶ (a) Change No. 8 (b) Other ☑ Description ▶ Depr. from a permissible method to a permissible method		
2 Is the accounting method change being requested one for which the scope limitations of section 4.02 of Rev. Proc. 2002-9 (or its successor) **do not** apply? If "Yes," go to Part II.		✓
3 Is the tax year of change the final tax year of a trade or business for which the taxpayer would be required to take the entire amount of the section 481(a) adjustment into account in computing taxable income? If "Yes," the applicant is not eligible to make the change under automatic change request procedures.	✓	

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

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

Signature *(see instructions)*

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

Filer

Signature and date

Gary Illinois
Name and title (print or type)

Preparer (other than filer/applicant)

Signature of individual preparing the application and date

Name of individual preparing the application (print or type)

Name of firm preparing the application

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

For Example 27

Form 3115 (Rev. 12-2003) **Gary Illinois** **123-45-6777** Page **2**

Part II **Information For All Requests** (continued)

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

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

For Example 27

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

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

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

Part IV Section 481(a) Adjustment	Yes	No
24 Do the procedures for the accounting method change being requested require the use of the cut-off method? If "Yes," do not complete lines 25, 26, and 27 below.		✓
25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ **-71,374** Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.		
26 If the section 481(a) adjustment is an increase to income of less than $25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change?	✓	
27 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? . . . . . If "Yes," attach an explanation.		✓

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

For Example 27

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Part III **Method of Cost Allocation** (see instructions) (continued)

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

		Present method	Proposed method
1	Marketing, selling, advertising, and distribution expenses	N/A	N/A
2	Research and experimental expenses not included on line 26 above	N/A	N/A
3	Bidding expenses not included on line 22 above	N/A	N/A
4	General and administrative costs not included in Section B above	N/A	N/A
5	Income taxes	N/A	N/A
6	Cost of strikes	N/A	N/A
7	Warranty and product liability costs	N/A	N/A
8	Section 179 costs	N/A	N/A
9	On-site storage	N/A	N/A
10	Depreciation, amortization, and cost recovery allowance not included on line 11 above	N/A	N/A
11	Other costs (Attach a list of these costs.)	N/A	N/A

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

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

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

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

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

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

4a To the extent not already provided, attach a statement describing the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity. **See statement 3**

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

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

5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.). **See statement 4**

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

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods: **See statement 5**

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

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

c The facts to support the asset class for the proposed method. **See statement 6**

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

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

f The applicable convention of the property.

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

9

For Example 27

123456777 ILLINOIS, GARY
123-45-6777

7/24/2007 2:43 PM

Federal Statements

DEPRECIATION

Statement 1 - Form 3115, Page 3, Part II, Line 13 - Description of Trade(s) or Business(es)

Description
RENTAL OF COMMERCIAL BUILDING

DEPRECIATION

Statement 2 - Form 3115, Pg 3, Pt II, Line 25 - Computation & Explanation for Sec. 481(a) Adj.

Description
DEPRCIATION ON BUILDING AND LAND ORIGINALLY - $57,165 DEPRECIATION ON RECLASSIFIED 5-YEAR BUILDING EQUIPMENT ORIGINALLY - $-0- COST SEGREGATION STUDY DETERMINED BUILDING HAS A BASIS OF $300,000 LAND HAS A BASIS OF $100,000 RECLASSIFIED 5-YEAR BUILDING EQUIPMENT HAS A BASIS OF $100,000 DEPRECIATION COMPUTED USING CORRECT BASIS - $128,539 THEREFORE, TAXPAYER HAS A NEGATIVE ADJUSTMENT OF $71,374

1-2

For Example 27

123456777 ILLINOIS, GARY
123-45-6777

7/24/2007 2:43 PM

Federal Statements

BUILDING

Statement 3 - Form 3115, Pg 8, Pt III, Sch E, Line 4a - Description of Property Being Changed

Type of Property	Year Property Placed in Service	Trade/Business Use
COMMERICAL BUILDING	2002	RENTAL
RECLASSIFIED 5-YEAR BUILDING EQUIPMENT	2002	RENTAL
LAND	2002	RENTAL

BUILDING

Statement 4 - Form 3115, Pg 8, Pt III, Sch E, Ln 5- Treatment of Property Under Present Method

Description
PROPERTY WAS BEING DEPRECIATIOD ON 39 YEAR STRIAGHT LINE DEPRECIATION WITH NO ALLOCATION TO LAND OR RECLASSIFIED 5-YEAR BLDG. EQUIP. COST SEGREGATION STUDY PROVIDED INFORMATION NECESSARY TO MAKE THE ALLOCATION

BUILDING

Statement 5 - Form 3115, Pg 8, Pt III, Sch E, Ln 7 - Information Under Present/Propsed Method

Description	Present Method	Proposed Method
Code section property is depreciated/amortized	168	168
Asset class under Section 168	39	5
Depreciation/amortization method	MACRS	MACRS
Applicable convention of property	MM	HY

BUILDING

Statement 6 - Form 3115, Page 8, Part III, Schedule E, Line 7c - Facts to Support Asset Class

Description
COST SEGREGATION STUDY PROVIDED BY A LICENSED APPRAISER

3-6

ISSUE 6: TAXPAYERS OF SE-EXEMPT RELIGIOUS SECTS

Sometimes members of certain religious sects are granted special tax treatments, which can have either positive or negative consequences on their returns. A number of common religions fall into this category, such as the Amish, Mennonite, and Quaker faiths.

To be eligible for special tax treatment, a recognized religious sect must have certain established tenets and teachings. For instance, a religious sect that opposes public and private insurance must have provisions for caring for its dependent members for a substantial period of time, with a living standard deemed adequate by the commissioner of Social Security. The sect also must have been in existence since 1950.

ELECTING OUT OF SOCIAL SECURITY TAXATION

IRC §1402(g) grants an exception from social security taxation to individuals who are conscientiously opposed to accepting benefits from **any** private or public insurance policy in the event of death, disability, old age, retirement, or for medical care. This includes any benefits established by the Social Security Act.

It is important to note that although it is possible to obtain an exemption from paying social security tax, **there is no comparable exemption from filing or paying federal income tax**. The courts have supported this position in numerous cases.[83] In *Packard v. U.S.*,[84] a member of the Religious Society of Friends (Quakers) filed income tax returns each year for 16 years, but failed to remit the associated tax.

Ms. Packard objected to paying income taxes on the basis of her deeply held religious convictions that opposed the financing of war or national defense. When the court denied her argument, she conceded she was obliged to pay income taxes but fought to have the penalties removed on the basis of undue hardship in exercising her religion. The court also denied this request.

Form 4029

To be covered under §1402(g), an individual must apply and be granted an exemption from social security and Medicare taxation from the IRS. Applications are submitted on Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits*.

The application is granted only to applicants who demonstrate evidence of membership in, and adherence to the tenets and teachings of a recognized sect opposed to insurance. Applicants also must waive all spousal or dependent benefits and any other payments under Titles II and XVIII of the Social Security Act that may result from the wages of other covered persons.

This election affects benefits based on wages earned before and during the period of exemption. The exemption applies to the first taxable year the individual meets the application requirements and continues until the individual no longer qualifies. An individual is required to notify the IRS within 60 days of any status change, at which point the exemption becomes invalid.

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83. *Robinson v. U.S.*, 84-0149-Mc, (D. Mass., Dec. 17, 1985); and *Nelson v. U.S.*, 796 F2d 164 (6th Cir. 1986)

84. *Packard v. U.S.*, 7 F. Supp. 2d 143 (D. Conn. 1998) *aff'd* 198 F.3d 234, Cert. denies

Such a change can occur when a member is excommunicated from an order. The Tax Court ruled a former member of the Old Order of Amish religion was no longer exempt from self-employment taxation under §1402(g) after being excommunicated from his sect.[85]

> **Note.** Not all religious sects can qualify for this exception. In *U.S. v. Indianapolis Baptist Temple*, a Baptist church asserted that paying social security and income taxes violated the free exercise of religion guaranteed by the First Amendment's Establishment Clause.[86] The court disagreed, ruling that the good of many outweighed the good of only a few.

Comparison to Non–Form 4029 Clergy

An individual conscientious objector election under §1402(g) should not be confused with an election out of social security coverage made by members of clergy under §1402(e)(1). Clergy under this election are declaring they are consciously opposed to **public** insurance. They are not opposed to **all** insurance, as is the case for the religious sect exemption.

Only clergy who are ordained, licensed, or called ministers may take advantage of this election. Any other religious person who has the same objection is obliged to pay into the system. Clergy must make the decision to elect out during the first two years of receiving $400 or more from ministerial service. Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*, is used for the application.

Clergy have had the opportunity to revoke this election three times in history, occurring in 1978, 1987, and 2001.[87] The revocation could be made by filing Form 2031, *Revocation of Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders, and Christian Science Practitioners*, during the allowed period. Once a revocation is filed, an individual may no longer reapply for exempt status.

Form 4029 Filing Information

Form 4029 is filed by the individual but must be certified by a representative of the religious sect qualifying for the exemption. The application must be submitted in triplicate on the current version of the form, which was last revised in April 2006. An individual signing the form certifies that he is in good standing with the religious sect named on the first line of the form. The sect should be specifically identified by district or congregation, with the address indicated on the second line.

In addition, the form is signed internally by the Social Security Administration (SSA) and the IRS. Upon acceptance of the application, the IRS returns one of the three copies submitted, stamped "Approved." This approval gives the applicant the right to exclude self-employment income from self-employment tax. Exempt taxpayers should write "Form 4029" on the self-employment tax line of their returns.

> **Caution.** The approved form should be kept with the taxpayer's permanent records. In the event of an IRS audit, the revenue agent would want to see the form.

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85. *E.E. Borntrager v. Comm'r*, TC Memo 1990-32, January 17, 1990

86. *U.S. v. Indianapolis Baptist Temple*, 61 F. Supp. 2d 831 (D. Ind. 1999), *aff'd* 244 F.3d 627, Cert. denied.

87. Temp. Treas. Reg. §301.9100-7T

EMPLOYER ISSUES

Qualifying Religious Sect Employer

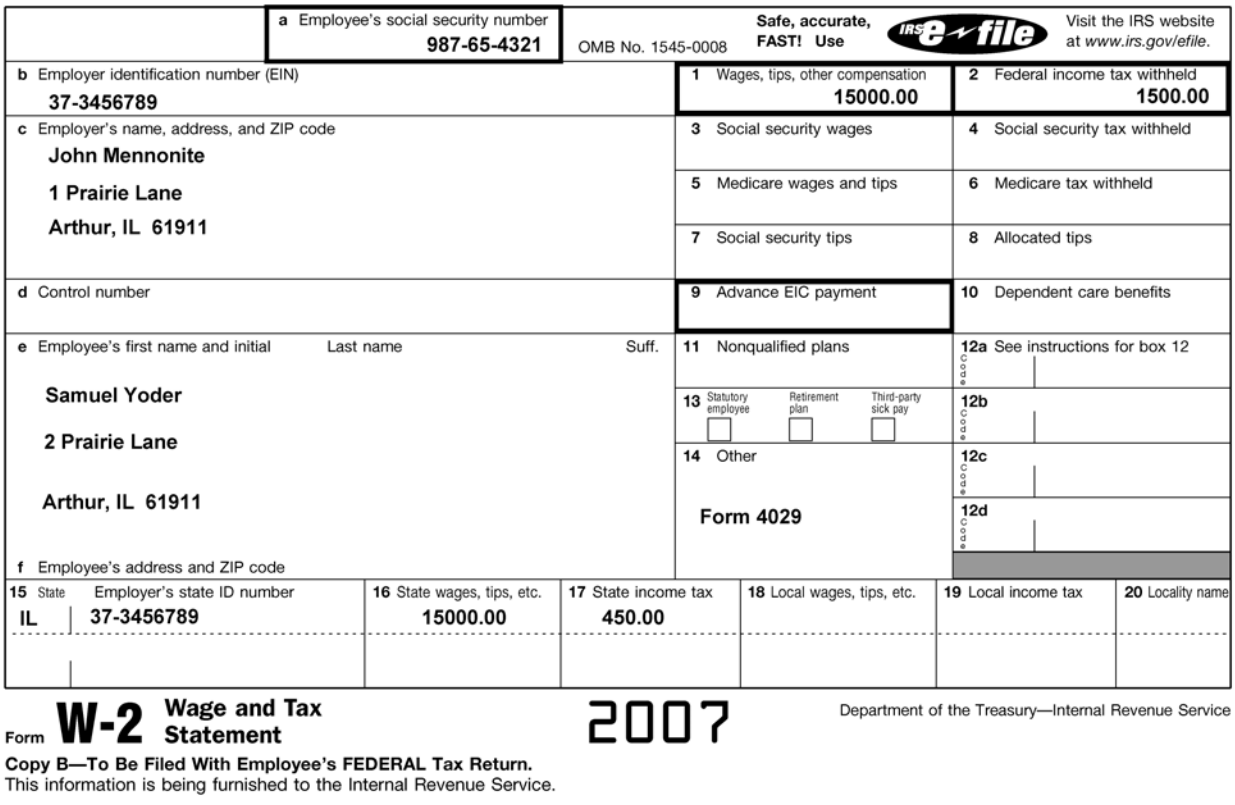
IRC §3127 provides an exemption from certain payroll taxes for employers who are members of recognized religious sects opposed to public or private insurance. An employer must be either self-employed or a member of a partnership in which all partners adhere to the beliefs and practices of the religious sect that is the basis for the objection.

This code section grants employers the opportunity to avoid withholding and matching social security and Medicare taxes that are normally the responsibility of the employer. For this provision to apply, the employee, as well as the employer, must be practicing members in good standing with the religious sect for which an approved Form 4029 exemption applies. **An exempt employer who employs nonexempt workers has the same payroll obligations as any nonexempt employer.**

Exempt employers who employ exempt employees are not required to report the employees' wages when filing Forms 941, 943, or 944. Employers should check the box on the appropriate forms and write "Form 4029" in the empty space below each checked box. Employers are still required to issue Form W-2, *Wage and Tax Statement*, to exempt employees. Form W-2, box 1 should include the employee's income from wages, but boxes 3 and 5 should be left blank. Box 14 should include "Form 4029."

Example 28. John is a Mennonite who has a valid exemption from paying social security tax. He employs Samuel, who also has a valid exemption. Samuel's W-2 shows his wages of $15,000 in box 1, but boxes 3 and 5 are empty. Box 14 contains the words "Form 4029" to indicate to the IRS the reason for the absence of social security and Medicare withholding.

John still needs to file Form 941. Samuel's wages are included on line 2 and income tax withholding is indicated on line 3. Lines 5 including a, b, and c are left blank. "Form 4029" appears to the right of line 5.



a Employee's social security number: 987-65-4321
OMB No. 1545-0008
Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at www.irs.gov/efile.

b Employer identification number (EIN): 37-3456789
c Employer's name, address, and ZIP code: John Mennonite, 1 Prairie Lane, Arthur, IL 61911
d Control number
e Employee's first name and initial: Samuel Yoder; Last name; Suff.
2 Prairie Lane
Arthur, IL 61911
f Employee's address and ZIP code

1 Wages, tips, other compensation: 15000.00
2 Federal income tax withheld: 1500.00
3 Social security wages
4 Social security tax withheld
5 Medicare wages and tips
6 Medicare tax withheld
7 Social security tips
8 Allocated tips
9 Advance EIC payment
10 Dependent care benefits
11 Nonqualified plans
12a See instructions for box 12
13 Statutory employee / Retirement plan / Third-party sick pay
12b
14 Other: Form 4029
12c
12d

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL	37-3456789	15000.00	450.00			

Form W-2 Wage and Tax Statement 2007 Department of the Treasury—Internal Revenue Service

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

For Example 28

Form **941 for 2007: Employer's QUARTERLY Federal Tax Return** 990107

(Rev. January 2007) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

(EIN) Employer identification number: 1 2 – 3 4 5 6 7 8 9

Name *(not your trade name)*: John Mennonite

Trade name *(if any)*: Amish Kennels

Address: 1 Prairie Lane (Number Street) (Suite or room number)

Arthur (City) IL (State) 61911 (ZIP code)

Report for this Quarter of 2007 (Check one.)

- ☐ 1: January, February, March
- ☐ 2: April, May, June
- ☐ 3: July, August, September
- ☐ 4: October, November, December

Read the separate instructions before you fill out this form. Please type or print within the boxes.

Part 1: Answer these questions for this quarter.

1 Number of employees who received wages, tips, or other compensation for the pay period including: *Mar. 12* (Quarter 1), *June 12* (Quarter 2), *Sept. 12* (Quarter 3), *Dec. 12* (Quarter 4)	1	1
2 Wages, tips, and other compensation	2	15000 . 00
3 Total income tax withheld from wages, tips, and other compensation	3	1500 . 00
4 If no wages, tips, and other compensation are subject to social security or Medicare tax		☑ Check and go to line 6.

5 Taxable social security and Medicare wages and tips:

	Column 1		Column 2
5a Taxable social security wages	.	× .124 =	.
5b Taxable social security tips	.	× .124 =	.
5c Taxable Medicare wages & tips	.	× .029 =	.

Form 4029

5d Total social security and Medicare taxes (*Column 2*, lines 5a + 5b + 5c = line 5d)	5d	.
6 Total taxes before adjustments (lines 3 + 5d = line 6)	6	1500 . 00

7 TAX ADJUSTMENTS (Read the instructions for line 7 before completing lines 7a through 7h.):

Note. Because the wages are exempt from FICA withholding, they do not qualify as wages for purposes of the IRC §199 deduction.

For Example 28

Form **4029** (Rev. April 2006)
Department of the Treasury
Internal Revenue Service

Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits

► Before you file this form, see the instructions under **Who may apply** on page 2.
► Do not use prior versions of this form.

OMB No. 1545-0064

File Three Copies

Caution: *Approval of Form 4029 exempts you from social security and Medicare taxes only. The exemption does* ***not*** *apply to federal income tax. Ministers, members of religious orders, and Christian Science practitioners, see* ***Form 4361,*** *Application for Exemption From Self-Employment Tax for use by Ministers, Members of Religious Orders, and Christian Science Practitioners.*

Part I **To Be Completed by Applicant** (Print or type)

Print or type

1 Name of taxpayer	2 Social security number
Samuel Yoder	987 65 4321
Address (number, street, or P.O. box)	3 Date of birth
2 Prairie Lane	10/11/80
City or town, state, and ZIP code	4 Contact phone number
Arthur, IL 61911	(217) 555-5555

5 ☐ Do not send me my Social Security Statement.

I certify that I am and continuously have been a member of **Old Order Amish Church**
(Name of religious group)

The Arthur (Illinois) Old Order Amish Mennonite Church, Arthur, IL 61911
(Religious district or congregation, and county and/or city, state, and ZIP code)

since **10** (Month) **11** (Day) **1998** (Year), and as a follower of the established teachings of that group, I am conscientiously opposed to accepting benefits of any private or public insurance that makes payments in the event of death, disability, old age, or retirement; or makes payments for the cost of medical care; or provides services for medical care. Public insurance includes any insurance system established by the Social Security Act.

I request that I be exempted from paying social security and Medicare taxes on my earnings from self-employment under Internal Revenue Code section 1401 and from the employer's share of social security and Medicare taxes under Internal Revenue Code section 3111.

I further request exemption from the employee's share of social security and Medicare taxes under Internal Revenue Code section 3101, for my services as an employee whenever I am employed by an employer who has an identical exemption from social security and Medicare taxes.

I waive all rights to any social security payment or benefit under Titles II and XVIII of the Social Security Act. I understand and agree that no benefits or other payments of any kind under Titles II and XVIII of the Social Security Act will be paid based on my wages and self-employment income to any other person. I certify that I have never received benefits or payments under the above titles, nor has anyone else received these benefits based on my earnings.

I agree to **notify** the Internal Revenue Service within 60 days of any occurrence that results in my **no longer** being a member of the religious group described above, or **no longer** following the established teachings of this group. See *Where to file* on page 2.

Furthermore, I understand that if the tax exemption for myself or for my employer under sections 1402(g)(1) or 3127 of the Internal Revenue Code is no longer effective, this waiver will also no longer be effective for:

- Myself, with respect to all my wages and self-employment income; and
- My employees with respect to wages I may pay to them; and that if my employer's exemption is no longer in effect, my exemption will end with respect to wages paid to me by my employer. However, the waiver will no longer be effective only to the extent that benefits and other payments under Titles II and XVIII of the Social Security Act can be payable on the basis of:
- My self-employment income for and after the first tax year in which the exemption ends; and
- My wages for and after the calendar year following the calendar year in which the exemption no longer meets the requirements of section 1402(g)(1) or 3127 on which the end of the exemption is based.

Under penalties of perjury, I declare that I have examined this application and waiver, and to the best of my knowledge and belief, it is true and correct.

Signature of Applicant ► _____ Date ► _____

Part II **To Be Completed by Authorized Representative of Religious Group** (Print or type)

I certify that **Samuel Yoder** (Name of taxpayer) is a member of **Old Order Amish Church** (Name of religious group/district/congregation).

Name of Authorized Representative **Daniel Miller** (Please print or type) **3 Prairie Lane, Arthur, IL 61911** (Address)

Signature of Authorized Representative ► _____ Title ► **Bishop** Date ► _____

Social Security Administration Use Only

☐ This religious group **is** recognized as being in existence continuously since December 31, 1950, as providing a reasonable level of living for its dependent members, and as being conscientiously opposed to public or private insurance.

☐ This religious group **is not** recognized as being in existence continuously since December 31, 1950, as providing a reasonable level of living for its dependent members, and/or as being conscientiously opposed to public or private insurance.

Signature of Authorized SSA Representative ► _____ Date ► _____

Internal Revenue Service Use Only

☐ Approved for exemption from social security and Medicare taxes. (See **Caution** in Part I above.)
☐ Disapproved for exemption from social security and Medicare taxes.

Signature and Title of Authorized IRS Representative ► _____ Date ► _____

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 41277T Form **4029** (Rev. 4-2006)

Nonqualifying Employer

The Supreme Court ruled that members of a religious sect cannot avoid social security taxation when they voluntarily enter into a working relationship with nonexempt employers. **An exempt individual who is employed by a nonexempt employer thus forfeits his exemption and payroll obligations apply as with any nonexempt employee.**

In *U.S. v. Lee*,[88] the court acknowledged that compulsory participation in the social security system does infringe on the free exercise rights of members of the Amish faith. Nevertheless, the court upheld this limitation on religious liberty under strict scrutiny. The court reasoned that mandatory participation in the social security system is essential in accomplishing the overriding governmental interest of providing the public with a comprehensive insurance system.

Dependency Exemption

Members of religious sects exempt from social security taxation are still entitled to claim an exemption for any dependent who satisfies the dependency tests of IRC §152. Under the current rules, a dependent must be a qualifying child or a qualifying relative. A qualifying child is one whose principal residence is with the taxpayer for more than six months, is under the age of 19 or under age 24 and a full-time student, and who is a citizen or resident of the United States or a resident of a country contiguous with the United States.

A qualifying relative must be a member of the household for the entire year, have income less than the exemption amount, does not file a joint return (unless a married separate return would not have resulted in a tax), and meets the citizenship test.

> **Note.** See Chapter 2, Problem 1, of the 2006 *University of Illinois Federal Tax Workbook*, for a detailed explanation of the qualifying child and qualifying relative dependency tests.

Earned Income Credit

Other tax consequences result when a taxpayer is granted an exemption from paying social security taxes. The earned income credit (EIC), in part, is awarded to compensate low-income taxpayers for wages reduced by social security tax withholding.

The EIC is based on earned income, including both wages and earnings from self-employment. The performance of service by a member of a religious sect that has elected to be exempt does not qualify as "trade or business income."[89] Thus, individuals who have been granted an exception under §1402(g) have no earnings subject to self-employment or FICA taxes and are not eligible for EIC benefits.[90] However, if they have wages upon which FICA taxes are required to be withheld, that income is considered earned income and may be used in computation of the credit.

> **Example 29.** Joe Troyer, a self-employed carpenter, has a valid exemption from FICA taxes under §1402(g). He files MFJ and has two children. He earned $12,000 from his carpentry business in 2007. He is also employed by a local farmer, who is not a member of a qualified religious sect. Joe earned $3,000 from the local farmer. These wages were subject to social security and Medicare tax withholding.
>
> Joe will have $3,000 of earned income in 2007 on which to base his EIC. However, Joe's entire income of $15,000 will be considered for AGI purposes. Joe's 2007 EIC is $1,210, as calculated on the following forms.

88. *U.S. v. Lee*, 102 S. Ct. 1051 (1982)

89. Treas. Reg. §1.1402(c)-7

90. Rev. Rul. 79-78, 1979-2 CB 9, states that the earned income tax credit is not available when a member of a qualifying religious sect elects out of social security.

For Example 29

SCHEDULE C (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)
► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
► Attach to Form 1040, 1040NR, or 1041. ► See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
2007
Attachment Sequence No. 09

Name of proprietor: JOE TROYER
Social security number (SSN): 121 21 2121

A Principal business or profession, including product or service (see page C-2 of the instructions): CARPENTRY
B Enter code from pages C-8, 9, & 10: ► 2 3 8 1 9 0
C Business name. If no separate business name, leave blank.
D Employer ID number (EIN), if any

E Business address (including suite or room no.) ► AMISH LANE
City, town or post office, state, and ZIP code GREEN BAY WI 54313

F Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►
G Did you "materially participate" in the operation of this business during 2007? If "No," see page C-3 for limit on losses ☑ Yes ☐ No
H If you started or acquired this business during 2007, check here ► ☐

Part I Income

1	Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ► ☐	1	20,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	20,000
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	20,000
6	Other income, including federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	**Gross income.** Add lines 5 and 6 ►	7	20,000

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense	18	
9	Car and truck expenses (see page C-4)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see page C-5):		
11	Contract labor (see page C-4)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	8,000
15	Insurance (other than health)	15		23	Taxes and licenses	23	
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see page C-6)	24b	
17	Legal and professional services	17		25	Utilities	25	
				26	Wages (less employment credits)	26	
				27	Other expenses (from line 48 on page 2)	27	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ►	28	8,000
29	Tentative profit (loss). Subtract line 28 from line 7	29	12,000
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go to line 32.	31	12,000
32	If you have a loss, check the box that describes your investment in this activity (see page C-6). • If you checked 32a, enter the loss on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see page C-8 of the instructions. Cat. No. 11334P Schedule C (Form 1040) 2007

For Example 29

Worksheet B—Earned Income Credit (EIC)—Lines 66a and 66b

Keep for Your Records

Use this worksheet if you answered "Yes" to Step 5, question 3, on page 48.

✓ Complete the parts below (Parts 1 through 3) that apply to you. Then, continue to Part 4.

✓ If you are married filing a joint return, include your spouse's amounts, if any, with yours to figure the amounts to enter in Parts 1 through 3.

Part 1 — Self-Employed, Members of the Clergy, and People With Church Employee Income Filing Schedule SE

1a.	Enter the amount from Schedule SE, Section A, line 3, or Section B, line 3, whichever applies.		1a
b.	Enter any amount from Schedule SE, Section B, line 4b, and line 5a.	+	1b
c.	Combine lines 1a and 1b.	=	1c
d.	Enter the amount from Schedule SE, Section A, line 6, or Section B, line 13, whichever applies.	−	1d
e.	Subtract line 1d from 1c.	=	1e

Part 2 — Self-Employed NOT Required To File Schedule SE

For example, your net earnings from self-employment were less than $400.

2. Do not include on these lines any statutory employee income, any net profit from services performed as a notary public, or any amount exempt from self-employment tax as the result of the filing and approval of Form 4029 or Form 4361.

a.	Enter any net farm profit or (loss) from Schedule F, line 36, and from farm partnerships, Schedule K-1 (Form 1065), box 14, code A*.		2a
b.	Enter any net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1*.	+	2b
c.	Combine lines 2a and 2b.	=	2c

*Reduce any Schedule K-1 amounts by any partnership section 179 expense deduction claimed, unreimbursed partnership expenses claimed, and depletion claimed on oil and gas properties. If you have any Schedule K-1 amounts, complete the appropriate line(s) of Schedule SE, Section A. Enter your name and social security number on Schedule SE and attach it to your return.

Part 3 — Statutory Employees Filing Schedule C or C-EZ

3. Enter the amount from Schedule C, line 1, or Schedule C-EZ, line 1, that you are filing as a statutory employee. — 3

Part 4 — All Filers Using Worksheet B

Note. If line 4b includes income on which you should have paid self-employment tax but did not, we may reduce your credit by the amount of self-employment tax not paid.

4a. Enter your earned income from Step 5 on page 48. — 4a: 3,000

b. Combine lines 1e, 2c, 3, and 4a. **This is your total earned income.** — 4b: 3,000

If line 4b is zero or less, STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

5. If you have:
- 2 or more qualifying children, is line 4b less than $36,348 ($38,348 if married filing jointly)?
- 1 qualifying child, is line 4b less than $32,001 ($34,001 if married filing jointly)?
- No qualifying children, is line 4b less than $12,120 ($14,120 if married filing jointly)?

☑ **Yes.** If you want the IRS to figure your credit, see page 48. If you want to figure the credit yourself, enter the amount from line 4b on line 6 (page 52).

☐ **No.** STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

9

For Example 29

Worksheet B—*Continued from page 51* *Keep for Your Records*

Part 5
All Filers Using Worksheet B

6. Enter your total earned income from Part 4, line 4b, on page 51. | 6 | 3,000

7. Look up the amount on line 6 above in the EIC Table on pages 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. | 7 | 1,210

If line 7 is zero, STOP You cannot take the credit. Enter "No" on the dotted line next to line 66a.

8. Enter the amount from Form 1040, line 38. | 8 | 15,000

9. Are the amounts on lines 8 and 6 the same?

☐ **Yes.** Skip line 10; enter the amount from line 7 on line 11.

☑ **No.** Go to line 10.

Part 6
Filers Who Answered "No" on Line 9

10. If you have:
- No qualifying children, is the amount on line 8 less than $6,750 ($8,750 if married filing jointly)?
- 1 or more qualifying children, is the amount on line 8 less than $14,850 ($16,850 if married filing jointly)?

☑ **Yes.** Leave line 10 blank; enter the amount from line 7 on line 11.

☐ **No.** Look up the amount on line 8 in the EIC Table on pages 53–59 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. Look at the amounts on lines 10 and 7. Then, enter the **smaller** amount on line 11. | 10 |

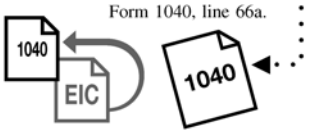
Part 7
Your Earned Income Credit

11. **This is your earned income credit.** | 11 | 1,210

Enter this amount on Form 1040, line 66a.

Reminder—

√ If you have a qualifying child, complete and attach Schedule EIC.



CAUTION *If your EIC for a year after 1996 was reduced or disallowed, see page 49 to find out if you must file Form 8862 to take the credit for 2006.*

For Example 29

SCHEDULE EIC
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit
Qualifying Child Information

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

1040A 1040 EIC

OMB No. 1545-0074

2007

Attachment Sequence No. 43

Name(s) shown on return: **Joe and Mary Troyer**

Your social security number: **121 21 2121**

Before you begin: See the instructions for Form 1040A, lines 40a and 40b, or Form 1040, lines 66a and 66b, to make sure that **(a)** you can take the EIC, and **(b)** you have a qualifying child.

CAUTION

- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information	Child 1	Child 2
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name Last name: **Jo Troyer**	First name Last name: **Riley Troyer**
2 Child's SSN The child must have an SSN as defined on page 43 of the Form 1040A instructions or page 49 of the Form 1040 instructions unless the child was born and died in 2007. If your child was born and died in 2007 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	**111 11 1111**	**222 22 2222**
3 Child's year of birth	Year **2 0 0 3** *If born after 1988, skip lines 4a and 4b; go to line 5.*	Year **2 0 0 5** *If born after 1988, skip lines 4a and 4b; go to line 5.*
4 If the child was born before 1989— **a** Was the child under age 24 at the end of 2007 and a student?	☑ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*	☑ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*
b Was the child permanently and totally disabled during any part of 2007?	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	**Daughter**	**Son**
6 Number of months child lived with you in the United States during 2007 • If the child lived with you for more than half of 2007 but less than 7 months, enter "7." • If the child was born or died in 2007 and your home was the child's home for the entire time he or she was alive during 2007, enter "12."	**12** months *Do not enter more than 12 months.*	**12** months *Do not enter more than 12 months.*

TIP

You may also be able to take the additional child tax credit if your child **(a)** was under age 17 at the end of 2007, **and (b)** is a U.S. citizen or resident alien. For more details, see the instructions for line 41 of Form 1040A or line 68 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 2007**

For Example 29

Form 1040 (2007) Page 2

Tax and Credits

	38	Amount from line 37 (adjusted gross income)		38	15,000
	39a	Check if: ☐ You were born before January 2, 1943, ☐ Blind. ☐ Spouse was born before January 2, 1943, ☐ Blind. Total boxes checked ▶ 39a			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶39b ☐			
Standard Deduction for— • People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 34. • All others: Single or Married filing separately, $5,350; Married filing jointly or Qualifying widow(er), $10,700; Head of household, $7,850	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40	10,000
	41	Subtract line 40 from line 38		41	5,000
	42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page XX		42	12,800
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	0
	44	**Tax** (see page 36). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐ Form(s) 8889		44	0
	45	**Alternative minimum tax** (see page 39). Attach Form 6251		45	
	46	Add lines 44 and 45 ▶		46	
	47	Credit for child and dependent care expenses. Attach Form 2441	47		
	48	Credit for the elderly or the disabled. Attach Schedule R	48		
	49	Education credits. Attach Form 8863	49		
	50	Residential energy credits. Attach Form 5695	50		
	51	Foreign tax credit. Attach Form 1116 if required	51		
	52	Child tax credit (see page XX). Attach Form 8901 if required	52		
	53	Retirement savings contributions credit. Attach Form 8880	53		
	54	Credits from: a ☐ Form 8396 b ☐ Form 8859 c ☐ Form 8839	54		
	55	Other credits: a ☐ Form 3800 b ☐ Form 8801 c ☐ Form	55		
	56	Add lines 47 through 55. These are your **total credits**		56	
	57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶		57	0

Other Taxes

	58	Self-employment tax. Attach Schedule SE F4029		58	
	59	Unreported social security and Medicare tax from: a ☐ Form 4137 b ☐ Form 8919		59	
	60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		60	
	61	Advance earned income credit payments from Form(s) W-2, box 9		61	
	62	Household employment taxes. Attach Schedule H		62	
	63	Add lines 57 through 62. This is your **total tax** ▶		63	0

Payments

	64	Federal income tax withheld from Forms W-2 and 1099	64		
	65	2007 estimated tax payments and amount applied from 2006 return	65		
If you have a qualifying child, attach Schedule EIC.	66a	**Earned income credit (EIC)**	66a	1,210	
	b	Nontaxable combat pay election ▶ 66b			
	67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67		
	68	Additional child tax credit. Attach Form 8812	68		
	69	Amount paid with request for extension to file (see page 60)	69		
	70	Payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	70		
	71	Refundable credit for prior year minimum tax from Form 8801, line 27	71		
	72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶		72	1,210

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**		73	1,210
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		74a	1,210
▶ b	Routing number X X X X X X X X X ▶ c Type: ☐ Checking ☐ Savings			
▶ d	Account number X X X X X X X X X X X X X X X X			
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶	75		

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 62 ▶		76	
77	Estimated tax penalty (see page 62)	77		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

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

Joint return? See page 17. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
			( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

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 **1040** (2007)

Child Tax Credit

IRC §24(a) allows a child tax credit for taxpayers who have qualifying children under the age of 17. This $1,000-per-child credit is nonrefundable and can only be applied against any tax due, including AMT. Since members of qualifying religious sects are eligible to claim dependency exemptions, they are also eligible for the **nonrefundable** portion of the child tax credit.

IRC §24(d) allows, under certain circumstances, for a refundable portion of this credit. This refundable portion is based on earned income as defined in IRC §32, the same section that defines earned income for purposes of the EIC. Since exempt individuals have no income for purposes of EIC, they also have no income for purposes of the additional child tax credit.

The nonrefundable credit under §24(a) makes no reference to earned income. However, §24(d) refers to IRC §32, IRC §1401 relating to self-employment tax, and IRC §3211 relating to FICA taxes.