

## Chapter 6: Small Business Issues

Issue 1: Wind Energy Tax Issues.....	191	Issue 5: Work Opportunity Tax Credit .....	214
Issue 2: Embezzlement Tax Issues .....	198	Issue 6: Domestic Production	
Issue 3: Vehicle Expenses.....	200	Activities Deduction .....	234
Issue 4: Schedule C, <i>Profit or Loss</i>			
from <i>Business</i> , Special Topics .....	207		

Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

### ISSUE 1: WIND ENERGY TAX ISSUES

#### BACKGROUND INFORMATION

The top eight states in wind power generating capacity as of December 31, 2008, are listed below.<sup>1</sup>

State	Capacity Measured in Megawatts
Texas	7,118
Iowa	2,791
California	2,517
Minnesota	1,754
Washington	1,447
Colorado	1,068
Oregon	1,067
Illinois	915

Two states — Minnesota and Iowa — already generate over 7% of their electricity needs from wind.<sup>2</sup> Based on several estimates, wind energy accounts for 1 to 1.5% of the U.S. electricity supply as of December 31, 2008. Although this percentage is extremely small, it is expected to rise rapidly in the future.

<sup>1</sup>. American Wind Energy Association Annual Wind Industry Report, Year Ending 2008. Apr. 13, 2009. American Wind Energy Association. [www.awea.org/publications/reports/AWEA-Annual-Wind-Report-2009.pdf] p. 9. Accessed on May 27, 2009.

<sup>2</sup>. Ibid.

The U.S. Department of Energy (DOE) released its “20% Wind Energy by 2030” report in May 2008.<sup>3</sup> The DOE’s long-term goal is for wind energy to constitute 20% of the U.S. electricity supply by 2030. The report explores one scenario for reaching the goal and contrasts the scenario to one in which no new U.S. wind-power capacity is installed. This report makes four primary assumptions:<sup>4</sup>

1. U.S. electricity consumption grows 39% from 2005 to 2030.
2. Wind turbine energy production increases about 15% by 2030.
3. Wind turbine costs decrease about 10% by 2030.
4. No major breakthroughs are made in wind technology.

If the 20% scenario is achieved, wind-turbine energy would have the following effects in 2030:<sup>5</sup>

- Reduce projected carbon dioxide emissions from electricity generation by 25%
- Reduce total natural gas use by 11%
- Avoid 4 trillion gallons of water consumption associated with electricity production from 2008 through 2030, cumulatively
- Increase annual revenues to local communities to more than \$1.5 billion by 2030
- Support roughly 500,000 jobs in the United States, with over 150,000 workers directly employed by the wind industry

## RECENT WIND ENERGY DEVELOPMENTS

Most industry analysts predict that, due to various factors, the maximum percentage of electricity produced by wind will peak at about 20% nationally.<sup>6</sup> Because natural-gas powered electric plants can be started and shut down fairly quickly without creating logistical problems, the recent trend of pairing a small natural-gas power plant with a large wind power source is likely to continue. With this strategy, wind energy can be used when there is adequate wind, and natural gas can be used on calm days.

Local governmental units, especially counties, welcome the expansion of wind energy as a source of new property tax revenue. For example, McLean County in Illinois expects to receive \$288,000 in 2010 real estate taxes from wind energy companies that own turbines located there.<sup>7</sup>

The most important factors spurring a dramatic increase in wind energy projects nationwide are:<sup>8</sup>

- Generous federal tax credits, and
- State mandates requiring targeted percentages of electrical power be produced by renewable sources such as wind or the sun.

---

<sup>3</sup> 20% Wind Energy by 2030: Increasing Wind Energy’s Contribution to U.S. Electricity Supply. DOE/GO-102008-2567. May 2008. U.S. Department of Energy. [www.20percentwind.org/20percent\_wind\_energy\_report\_05-11-08\_wk.pdf] Accessed on May 27, 2009.

<sup>4</sup> 20% Wind Energy by 2030 (summary presentation). U.S. Department of Energy. [www.20percentwind.org/20percent\_Summary\_Presentation.pdf] Accessed on June 13, 2009.

<sup>5</sup> U.S. Wind Energy Installations Top 20,000 MW. American Wind Energy Association. [www.awea.org/pubs/factsheets/20GW.pdf] Accessed on June 13, 2009.

<sup>6</sup> Tucker, William. (2008, Aug. 18). Tilting We Will Go? *National Review*, Vol. LX, No. 15.

<sup>7</sup> Mercer, D., Associated Press reporter. (June 11, 2009). “Slowing Growth,” *The Bloomington Daily Pantagraph*, Sect. C, p. 1.

<sup>8</sup> Ibid.

Twenty-eight states, including Illinois, currently have enacted such mandates. However, due to the economic meltdown which began in September 2008, investment money for new wind farm developments has slowed. For example, the estimate of the total investment in wind energy for 2008 was \$5.5 billion. For 2009, it is anticipated that new investment will shrink to about \$4 billion.<sup>9</sup>

## WIND ENERGY PROVISIONS OF ARRA OF 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) included the following wind energy provisions:

1. The production tax credit (PTC) has been extended three years. As a result, the PTC will continue to be available for the 2010, 2011, and 2012 tax years.<sup>10</sup> The credit is presently 2.1¢ per kilowatt hour of electricity produced from wind energy facilities.<sup>11</sup>

**Note.** The PTC is adjusted annually for inflation.<sup>12</sup> It applies to each kilowatt hour of electricity produced from wind that is sold to unrelated parties during the first 10 years after a wind energy facility is placed in service.<sup>13</sup> It is claimed on Form 8835, *Renewable Electricity, Refined Coal, and Indian Coal Production Credit*.

2. The 30% business energy credit was extended to qualified wind facilities placed in service in the years 2009 through 2012. In addition, the limitation of the credit to only qualified small wind energy property was eliminated. As a result, all qualified wind facilities, regardless of size, are eligible for the 30% investment credit.<sup>14</sup>

**Note.** The 30% business energy credit may be claimed in lieu of the production tax credit. This means both credits may not be claimed simultaneously for a wind energy **facility**.<sup>15</sup> This was a provision of the ARRA.

3. **Wind energy companies** may receive a cash grant from the DOE in lieu of claiming the production tax credit or the 30% business energy credit.<sup>16</sup> The up-front cash grant is generally 30% of the cost of the project. Because the grant is up-front, it may be more beneficial to developers than the two credits explained in 1 and 2 above. The DOE grants are available for qualified facilities whose construction begins in 2009 and 2010.<sup>17</sup>

---

<sup>9</sup>. Ibid.

<sup>10</sup>. IRC §45(d) .

<sup>11</sup>. IRS Notice 2009-40, 2009-19 IRB 931.

<sup>12</sup>. IRC §45(b)(2).

<sup>13</sup>. IRC §45(a)(2).

<sup>14</sup>. IRC §48(a)(5)(C).

<sup>15</sup>. IRS Notice 2009-52, 2009-25 IRB.

<sup>16</sup>. IRC §48(d)(1).

<sup>17</sup>. American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, Subtitle G, Section 1603.

## TAX CONSEQUENCES FOR LANDOWNERS WHO GRANT EASEMENTS TO WIND ENERGY COMPANIES

Many landowners have already signed easement contracts with wind energy companies and many more will in the future. The following example explains how the various easement proceeds are reported.

**Example 1.** Matt bought an 80-acre tract of land in 2000 for \$320,000 (\$4,000/acre). He allocated \$15,000 of the purchase price to the drainage tile located underneath the 80 acres. In **2008**, he granted two **temporary (nonexclusive) easements** to ABC Wind Farm, LLC:

1. The **collection and distribution line easement** for the erection, installation, and maintenance of certain facilities for the transmission of electric power over and across a specified portion of the 80 acres.
2. The **construction easement** granted during the initial construction and installation of the collection and distribution line facilities.

The payments for the two **temporary easements** were received in 2008 and reported as rental income on Schedule E, *Supplemental Income and Loss*. Legal fees paid to his attorney for help negotiating the contracts were deducted on Schedule E.

In addition to the two temporary easements shown above, in **2009** Matt grants ABC an **exclusive perpetual easement**, referred to as the **transmission easement**. This easement is for the same purposes as the collection and distribution line easement shown in number 1 above. He receives a total of **\$207,000** for granting this perpetual easement. He pays a total of **\$7,000** to his attorney and accountant for their advice prior to signing the perpetual easement.

**Note.** The perpetual easement contract states the specific area covered by the easement. The contract language states the easement applies to a strip of land 150 feet wide by 653.5 feet long (98,025 square feet). This strip of land is equivalent to **2.25 acres** (98,025 sq. ft. ÷ 43,560 sq. ft./acre).

Matt also receives \$10,000 in 2009 for crop damages to the 80 acres. No wind turbines are erected on the 80-acre tract in 2009, and Matt expects that none will be erected in the future. ABC's use of the property is limited to electrical transmission facilities installed in the easement area.

**Tax Results for Example 1.** Matt reports the \$10,000 **crop damage payment** as crop proceeds on his Schedule F, *Profit or Loss from Farming*.

The \$207,000 **perpetual easement proceeds** are reported in Part I of Form 4797, *Sales of Business Property*. His gain on the sale is calculated below.

Cost of the 80 acres he bought in 2000	\$320,000
Less: amount allocated to tile cost	(15,000)
Balance allocable to the bare land	\$305,000
Divided by 80 acres	÷ 80
Remaining cost per acre	\$ 3,813
Multiplied by 2.25 acres	× 2.25
<b>Cost basis in easement</b>	<b>\$ 8,579</b>
Selling costs (legal and tax advice fees)	7,000
<b>Basis and other costs</b>	<b>\$ 15,579</b>

Matt's \$1231 gain is \$191,421 (207,000 sales price – 15,579 basis).

## For Example 1

Form <b>4797</b> Department of the Treasury Internal Revenue Service (99)	<b>Sales of Business Property</b> (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0184 <b>2009</b> Attachment Sequence No. 27					
Name(s) shown on return <b>Matt</b>		Identifying number <b>123-45-6789</b>					
1 Enter the gross proceeds from sales or exchanges reported to you for 2009 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)		<b>1</b> <b>207,000</b>					
<b>Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year</b> (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	Perpetual easement proceeds for						
	2.25 acres	02/11/2000	03/26/2009	207,000		15,579	191,421
3	Gain, if any, from Form 4684, line 43						<b>3</b>
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						<b>4</b>
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						<b>5</b>
6	Gain, if any, from line 32, from other than casualty or theft.						<b>6</b>
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						<b>7</b> <b>191,421</b>
<b>Partnerships (except electing large partnerships) and S corporations.</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.							
<b>Individuals, partners, S corporation shareholders, and all others.</b> If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							
8	Nonrecaptured net section 1231 losses from prior years (see instructions)						<b>8</b>
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)						<b>9</b>
<b>Ordinary Gains and Losses</b> (see instructions)							

### Observations for Matt's Form 4797

1. The \$191,421 of §1231 gain is taxed at either the 15%, the 0% rate, or a combination of both.
2. The large gain might result in an AMT liability for Matt.
3. Matt's adjusted basis in the remaining bare 77.75 acres is now \$296,421 as shown below:

Purchase price of the 80 acres	\$320,000
Less: amount allocated to tile	(15,000)
Less: amount allocated to 2.25 acre easement	(8,579)
<b>Adjusted basis in remaining bare 77.75 acres</b>	<b>\$296,421</b>

### TAXATION OF PERPETUAL EASEMENT PROCEEDS

**Granting of a Perpetual Easement.** The general rule is described in Treas. Reg. §1.61-6(a) as follows:

*When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts. The realized gain or sustained loss on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction, and gain or loss shall be computed separately on each part. Therefore, gain or loss shall be determined at the time of sale of each part and shall not be deferred.*

When a perpetual easement is granted, there are two issues involved in determining basis:

1. **Property affected.** Basis must be allocated to the portion of the property that is subject to the easement (as opposed to the basis of the rest of the property).
2. **Rights affected.** Basis must be further allocated between the rights that are sold by granting the easement and the other rights retained by the property owner.

**Question 1A.** In **Example 1**, could Matt possibly take the position that he should be allowed to use the \$207,000 easement proceeds to reduce his entire remaining \$305,000 basis in the 80-acre tract of land? If so, Matt would not be required to report any IRC §1231 gain on his 2009 tax return.

**Answer 1A.** The answer is **no**. The authority for this answer is:

- Rev. Rul. 59-121,<sup>18</sup> clarified by Rev. Rul. 68-291,<sup>19</sup> which states:

*Where a taxpayer grants an easement that affects only a specific portion of an entire tract of land, only the basis properly allocable to the **affected portion** is reduced by the consideration received in determining the amount of the gain realized, if any.*

- *Iske v. Comm'r*<sup>20</sup> (involving easements for electrical transmission lines)
- *Fasken v. Comm'r*<sup>21</sup> (involving pipeline easements)

**Note.** In **Example 1**, no wind turbines were installed on Matt's 80-acre tract. Matt granted ABC Wind Farm, LLC, three easements, two temporary and one perpetual. The perpetual easement allowed ABC Wind Farm, LLC, to install electrical transmission facilities on 2.25 acres of the 80-acre tract. His rights in the remaining 77.75 acres were completely undisturbed and unlimited.

**Question 1B.** Assume that in 2012, Matt grants a perpetual easement to ABC Wind Farm, LLC, to construct a narrow access gravel path on the 80-acre tract to a location where a wind turbine will be erected. He receives \$30,000 of easement proceeds in 2012.

The specific easement area as clearly described in the easement contract is equivalent to two acres. His cost basis in the two acres covered by the easement is \$7,626 ( $\$3,813 \times 2$ ). The easement contract which Matt signs contains the following "Covenants by Lessor" clause (standard contractual language used by ABC Wind Farm, LLC, for all such easements):

**No Interference.** *Neither Lessor nor anyone obtaining rights from or acting with the permission of Lessor shall:*

1. *Interfere with or impair the free, unobstructed and natural availability, flow, speed or direction of air or wind over or across the property (whether by planting trees or constructing structures), or*
2. *Engage in any activity on the property that might cause a decrease in the output, efficiency or longevity of the wind power facilities.*

Does this standard covenant clause in the easement contract allow Matt to merely reduce his adjusted basis in the remaining 77.75 acres by the \$30,000 proceeds **instead** of reporting a gain on the sale of the easement on Form 4797?

<sup>18</sup> Rev. Rul. 59-121, 1959-1 CB 212.

<sup>19</sup> Rev. Rul. 68-291, 1968-1 CB 351.

<sup>20</sup> *Iske v. Comm'r*, TC Memo 1980-61 (Mar. 5, 1980) *aff'd* 8th Cir. Ct. of Appeals (unpublished opinion) (Nov. 18, 1980).

<sup>21</sup> *Fasken v. Comm'r*, 71 TC 650 (Jan. 25, 1979).



**Answer 1B.** The tax issue raised in this question is based on the IRS ruling that states:

*... when it is impractical or impossible to determine the cost or other basis of the portion of the property sold, the amount realized on such sale should be applied to reduce the basis of the entire property and only the excess over the basis of the entire property is recognized as gain.<sup>22</sup>*

**Theoretically, because Matt's right to plant trees or construct buildings on the entire 80 acres is apparently restricted by the no-interference clause, he may reduce his basis in the entire property instead of reporting a Form 4797 gain.** However, realistically, Matt is not likely to plant any trees or construct any buildings that will interfere with wind turbines that are 400 feet tall. Therefore, although the standard no-interference clause theoretically restricts his use of the property, it does not restrict the way he ordinarily uses the remaining acres.

Two court cases<sup>23</sup> used by the proponents of the reduction-in-basis interpretation of tax law do not deal specifically with the no-interference standard covenant clause found in many wind energy easement contracts. Therefore, **until the courts actually rule on this issue, this tax treatment is aggressive.**

**Note.** If the reduction-in-basis interpretation is used, a disclosure should be made on Form 8275, *Disclosure Statement*, if the "reasonable basis" or "substantial authority" standards can be met. No substantial authority currently exists to support the reduction-in-basis interpretation for the majority of wind energy easement contracts containing the standard no-interference clause. See pages 383–384 and 536–538 in the 2008 *University of Illinois Federal Tax Workbook* (included on the accompanying CD) for more details on this controversial issue.

**Question 1C.** Matt is paid \$6,000 in 2013 by ABC Wind Farm, LLC, for the first year's lease payment for the wind turbine erected on his 80 acres. Where should he report this lease income on his 2013 tax return?

**Answer 1C.** On Schedule E as rental income.<sup>24</sup> Any related expenses are deducted on Schedule E to arrive at net rental income.

<sup>22</sup> Rev. Rul. 77-414, 1977-2 CB 299.

<sup>23</sup> *Bledsoe v. U.S.*, 67-2 USTC §9,581 (N.D. Okla. 1967) and *Inja Land Com., Ltd. v. Comm'r*, 9 TC 727 (1947).

<sup>24</sup> IRC §1402(a)(1).

## ISSUE 2: EMBEZZLEMENT TAX ISSUES

### BACKGROUND INFORMATION

#### Definition of Embezzlement

Embezzlement is the fraudulent appropriation of property by a person to whom it has been entrusted.

Frequent news reports of embezzlement indicate the problem is fairly common for businesses and local governments. Moreover, in many instances, the crime does not make the news. A trusted employee embezzles a relatively small amount of money; the owner becomes aware of it; the employee is dismissed; and only the owner, the owner's accountant, and the dismissed employee know the details.

A complete chapter could be devoted to ways business owners can prevent embezzlement. The following are a few suggestions:

1. Tight, rigidly-enforced internal controls are the most effective safeguard to prevent employee embezzlement. However, even the best internal controls cannot assure that it will not occur.
2. Unannounced independent audits discourage potentially unscrupulous employees from embezzling.
3. Bond employees who handle customer billings, customer payments, purchasing, and accounts payable. Bonding, also called fidelity coverage, provides insurance reimbursement for embezzlement losses.

**Note.** Practitioners may want to provide their business clients with information on ways to prevent embezzlement. A concise and practical 6-page article entitled "Preventing Embezzlement" can be found at [www.bizmove.com/general/m6t1.htm](http://www.bizmove.com/general/m6t1.htm).

### BUSINESS EMBEZZLEMENT LOSSES

IRC §165(a) establishes the general rule relating to a deduction for losses:

*There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.*

**Example 2.** Sam Stickyfingers, a long-time employee of Trust and Fidelity Bank, began to embezzle from the bank in 2006. The federal bank examiner and an FBI agent established that the amount of the embezzlement totaled \$140,000. The bank was able to recover \$40,000 of the stolen funds from Sam prior to his guilty plea on federal embezzlement charges in 2009.

The bank submitted a \$100,000 net claim to its bonding company in 2009. The bank's deductible amount on its bonding contract was \$5,000. The bank's embezzlement loss for tax purposes is \$5,000.

#### Observations for Example 2

1. Establishing the actual amount of an embezzlement loss is often a time-consuming and expensive task. In **Example 2**, the federal government bore the costs of establishing the amount of Sam's extended embezzlement scheme.
2. In many cases, a special certified audit is required as the starting point for a claim to the victim's bonding company. An extensive and detailed audit report is a necessary first step in the claim process.



## TAX CONSEQUENCES FOR THE EMBEZZLER

Embezzled funds are includable in gross income in the year of embezzlement.<sup>25</sup> This is true even though the embezzler makes restitution in a later year.

**Example 3.** Use the facts from **Example 2**. Sam filed his 2006, 2007, and 2008 tax returns timely without extensions. However, he did not report the embezzled funds as income on the returns.

The federal government's investigation of Sam Stickyfingers showed that he embezzled the following amounts:

Year of Embezzlement	Amount Embezzled
2006	\$ 50,000
2007	60,000
2008	30,000
<b>Total</b>	<b>\$140,000</b>

**Tax Result for Example 3.** Since Sam pled guilty to the embezzlement charges, an IRS exam is probable. The IRS examiner will probably propose the following in her examination report:

- An increase in gross income for 2006, 2007, and 2008 by the unreported embezzled amounts
- The 20% accuracy-related penalty<sup>26</sup>

**Note.** Even if the 2006 tax return is closed by the normal 3-year statute date of April 15, 2010, the normal statute date is extended for three additional years **if the \$50,000 omission is more than 25% of reported gross income.**<sup>27</sup> If this test is met, the IRS has until April 15, 2013, to assess additional tax on the unreported 2006 embezzlement funds. The IRS often uses this extended statute date exception in its examinations of embezzlers.

<sup>25</sup> Rev. Rul. 61-185, 1961-2 CB 9. See also *Eugene C. James v. U.S.*, 366 US 213 (1961).

<sup>26</sup> IRC §6662(a).

<sup>27</sup> IRC §6501(e)(1)(A).

**Example 4.** Use the same facts as **Example 3**. Prior to his guilty plea, Sam repaid \$40,000 to the bank in January 2009. It was his only restitution payment because his gambling losses consumed the other \$100,000 of embezzled funds. Can Sam deduct the \$40,000 restitution on his 2009 tax return?

**Tax Result for Example 4. Probably.** IRS rulings and Treasury regulations provide mixed messages.<sup>28</sup> The courts have ruled that the determination is based on the facts in each case.

If the restitution is **in lieu** of harsher punishment, the deduction may be **prohibited** under the Code section that bans deductions of fines and penalties.<sup>29</sup> Consequently, if the restitution is part of Sam's plea bargain and he receives a lighter sentence in consideration of the payment, the deduction will probably be denied.

Normally, restitution does not substitute for other legal remedies.<sup>30</sup> In this case, the restitution payment is deductible as a nonbusiness loss.<sup>31</sup> Because a restitution payment is treated as a nonbusiness expense, it cannot generate a net operating loss available for carryback or carryforward to other tax years.<sup>32</sup> If Sam voluntarily makes the restitution payment, he may deduct the \$40,000 restitution payment as a miscellaneous itemized deduction on line 23 on his 2009 Schedule A, subject to the 2% of AGI limitation.<sup>33</sup>

## ISSUE 3: VEHICLE EXPENSES

Almost every business incurs some expenses related to vehicles. Many taxpayers believe that the cost of operating their vehicles should be 100% deductible and try to convince their tax preparers that their vehicles are used 100% for business. Much to the dismay of most taxpayers, commuting to and from work is considered inherently personal.

Many self-employed taxpayers want to aggressively deduct their vehicle expenses. Congress has attempted to limit these deductions by:

- Limiting the amount of depreciation that is deductible,
- Imposing strict recordkeeping requirements,
- Requiring a lease expense adjustment, and
- Requiring employers to include the value of an employee's personal use of a company vehicle as wages on the employee's Form W-2.

There are opportunities for taxpayers to maximize their vehicle deductions. For example, the highest depreciation deductions only apply to vehicles with a gross vehicle weight of 6,000 pounds or more.<sup>34</sup> Another opportunity exists for taxpayers who qualify for a bona-fide home office deduction. If a taxpayer's home office qualifies as her principal place of business for purposes of the home office deduction, all local business transportation expenses are deductible as ordinary and necessary business expenses.<sup>35</sup>

**Note.** Depreciation of vehicles, including bonus depreciation, is covered extensively in the 2008 *University of Illinois Federal Tax Workbook*, pp. 265–273. Office in the home requirements are covered on pp. 361–371. This is included on the accompanying CD.

<sup>28</sup> Rev. Rul. 65-254, 1965-2 CB 50 specifically allows a deduction under §162(c)(2) for repayment of embezzled funds. However, Treas. Reg. §1.212-1(p) specifically disallows personal deductions for payments that would be considered fines or penalties under IRC §162(f).

<sup>29</sup> IRC §162(f). See also Treas. Reg. §1.212-1(p), *Allied-Signal, Inc. v. Comm'r*, 54 F.3d 767 (3rd Cir. 1995), and *Harvey Waldman v. Comm'r*, 88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).

<sup>30</sup> *Russell W. and Marit Spitz v. U.S.*, 432 F. Supp. 148 (E.D.Wis. 1977); See also *Jon T. and Susanne Stephens v. Comm'r*, 905 F.2d 667 (2nd Cir. 1990).

<sup>31</sup> Rev. Rul. 65-254, 1965-2 CB 50 and IRC §165(c)(2).

<sup>32</sup> IRC §172(d)(4).

<sup>33</sup> IRC §§67(a) and (b).

<sup>34</sup> IRC §280F(d)(5).

<sup>35</sup> Rev. Rul. 99-7, 1999-1 CB 361.

## 2009 VEHICLE DEPRECIATION LIMITS<sup>36</sup>

For vehicles with weights of 6,000 pounds or less, the maximum depreciation deduction is limited each year. For passenger automobiles, the weight test is for the **unloaded gross vehicle weight**. For trucks as defined by the Department of Transportation, the weight test is for the **fully-loaded gross vehicle weight**.

The maximum depreciation limits are adjusted annually for inflation.<sup>37</sup> In addition, the limits are adjusted for bonus depreciation. The **ARRA extended bonus depreciation to include new assets placed in service in 2009**.<sup>38</sup>

The limits shown in the table below are reduced by the percentage of personal use applicable each year.

**Maximum Depreciation for Vehicles  
Placed in Service during Calendar Year 2009**

<b>Tax Year</b>	<b>Passenger Automobiles</b>	<b>Trucks</b>
1st tax year (2009)	\$ 2,960	\$ 3,060
1st tax year with bonus depreciation (2009)	10,960	11,060
2nd tax year (2010)	4,800	4,900
3rd tax year (2011)	2,850	2,950
All succeeding years	1,775	1,775

**Note.** If a vehicle qualifies for bonus depreciation in 2009, the §280F limitations begin to apply when the cost exceeds \$18,266 for passenger automobiles and \$18,433 for trucks and vans. For a nonqualifying vehicle, the limitations begin to apply when the cost exceeds \$14,800 for passenger automobiles and \$15,300 for trucks and vans.<sup>39</sup>

For most vehicles with gross a vehicle weight of more than 6,000 pounds but not more than 14,000 pounds, there are no limits on the amount of depreciation that may be claimed each year. However, the §179 deduction is limited to \$25,000.<sup>40</sup>

## VEHICLE EXPENSES AND RECORDKEEPING REQUIREMENTS

Vehicle expenses include the costs of fuel, oil, tires, repairs, insurance, licenses, registration fees, taxes, and depreciation (for owned vehicles) or lease payments (for leased vehicles). All expenses must be reduced by the percentage of any personal use. If the actual expense method is used, the taxpayer must keep receipts documenting the expenses.

In lieu of tracking the actual costs of operating a vehicle, most taxpayers may use the standard mileage rate (SMR).<sup>41</sup> The 2009 SMR for business use is \$0.55 per mile. The SMR may be used to calculate costs for both leased and purchased vehicles. The election to use the SMR for leased vehicles is irrevocable.

<sup>36</sup> Rev. Proc. 2009-24, 2009-17 IRB 855.

<sup>37</sup> IRC §280F(d)(7).

<sup>38</sup> IRC §168(k).

<sup>39</sup> Calculation of cost limits: **1.** Passenger automobiles not eligible for bonus depreciation: Max depreciation = \$2,960 and MACRS depreciation rate = 20%.  $\$2,960 \div 20\% = \$14,800$ . **2.** Passenger automobiles eligible for bonus depreciation: Unlimited depreciation for a qualified vehicle would equal the following formula, where p = price:  $50\%p + 20\% \times (50\%p)$ . This formula can be restated as  $60\% \times p$ .  $\$10,960 \div 60\% = \$18,266$ . **3.** Repeat these formulas using the maximum depreciation for trucks et al. instead of the maximum depreciation for passenger autos.

<sup>40</sup> IRC §179(b)(6).

<sup>41</sup> Rev. Proc. 2008-72, 2008-50 IRB 1286.

# 2009 Workbook

The following do not qualify for the SMR:

- Vehicles used for hire, such as taxicabs
- Vehicles that are part of a fleet of five or more vehicles used **simultaneously**
- Leased vehicles, if the costs of the vehicle were previously deducted using the actual method
- Vehicles which have been depreciated under a method other than straight-line, which have been used for the §179 deduction, or which have been depreciated using bonus depreciation
- Vehicles used by C corporations

The portion of vehicle interest expense that is allocable to the business is deductible by **businesses** under both methods. For example, a self-employed taxpayer who uses her vehicle 60% for business can add 60% of the interest paid on her car to the vehicle expenses calculated using the SMR.

**Note.** The portion of interest allocable to unreimbursed **employee** expenses is not deductible.<sup>42</sup> However, if the employee uses her home as collateral against the loan used to purchase the vehicle, the interest may be deductible as home mortgage interest on Schedule A. See IRS Pub. 936, *Home Mortgage Interest Deduction*, for details on this tax strategy.

**Both the actual and SMR method require documentation of business miles.** The records for business miles must include the time and place of travel and the business purpose of the trips.<sup>43</sup>

**Note.** An exception applies to **farmers**, who are permitted to claim 75% of the use of a vehicle as business use without substantiation if the vehicle is used during most of the normal business day directly in connection with the business of farming.<sup>44</sup> This 75% safe harbor must be elected on the first return filed after the vehicle is placed in service and is interpreted by the IRS as being permitted for one vehicle only. This rule is normally used by a farmer for his primary pickup truck.

## LEASED VEHICLE ADJUSTMENTS<sup>45</sup>

Taxpayers deducting the actual cost of leased vehicles may be required to add a lease inclusion amount into income. The purpose of this adjustment is to equalize the treatment of purchased and leased vehicles with respect to the depreciation component of the lease.

For leased vehicles placed in service in 2009, the lease inclusion begins to apply to vehicles with a fair market value over \$18,500.<sup>46</sup> The lease inclusion amount is different for passenger automobiles versus trucks, vans, and SUVs.

---

<sup>42</sup> IRC §163(h)(2)(A).

<sup>43</sup> IRC §274(d)(4).

<sup>44</sup> Temp. Treas. Reg. §1.274-6T(b).

<sup>45</sup> IRC §280F(c).

<sup>46</sup> Rev. Proc. 2009-24, 2009-17 IRB 517.

# 2009 Workbook

There are four steps used to calculate the lease inclusion amount.<sup>47</sup>

- Step 1.** Find the inclusion table for the year that the leased vehicle was placed in service and the type of vehicle (passenger auto or truck/van/SUV). The tables are included in IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.
- Step 2.** Find the inclusion amount in the table based on the fair market value of the leased vehicle at the time the vehicle is placed in service and the number of tax years that the leased vehicle has been in service by the taxpayer.
- Step 3.** Prorate the lease inclusion amount for the number of days of the lease term included in the tax year.
- Step 4.** Multiply the prorated inclusion amount by the percentage of business use during the tax year.

**Example 5.** On April 16, 2009, Josephine leases a 2009 GMC Yukon XL 2500 for use in her sole-proprietor accounting practice. The fair market value of the vehicle is \$48,200 according to Kelley Blue Book ([www.kbb.com](http://www.kbb.com)). She uses the vehicle 95% for business purposes.

- Step 1.** The proper inclusion table is the one for trucks and vans first leased in 2009.
- Step 2.** The inclusion amount for the first year of a 2009 lease with a truck valued at \$48,200 is **\$75**. See excerpt of table below.
- Step 3.** The number of days of the lease term in 2009 is 270. The proration equals  $\$75 \times (270 \div 365) = \$55$ .
- Step 4.** The inclusion equals the \$55 from Step 3 times her 95% business use, or \$52.

REV. PROC. 2009-24 TABLE 6 DOLLAR AMOUNTS FOR TRUCKS AND VANS WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2009						
Fair Market Value of Electric Automobile		Tax Year During Lease				
Over	Not Over	1st	2nd	3rd	4th	5th and Later
\$18,500	\$19,000	8	17	25	30	35
19,000	19,500	9	19	29	35	40
<hr/>						
47,000	48,000	73	159	237	283	327
48,000	49,000	<b>75</b>	164	244	292	338
49,000	50,000	77	169	251	301	348

**Note.** The \$52 is reported on the *Other income* line of Schedule C, *Profit or Loss from Business*.

Assuming she continues to lease the Yukon and use it 95% for business, she adds the following amounts to income in future years:

Tax Year	Table Amount	Business Use	Inclusion Amount
2010	\$164	95%	\$156
2011	244	95%	232
2012	292	95%	277
2013 and beyond	338	95%	321

**Note.** Although the GMC has a gross vehicle weight (GVW) of 7,400 pounds, weight is not a factor in determining the lease inclusion amount.

<sup>47</sup> Treas. Reg. §1.280F-7.

## PERSONAL USE OF COMPANY-OWNED VEHICLES BY EMPLOYEES<sup>48</sup>

When a vehicle is provided to an employee by an employer, the employee's personal portion of the cost of the vehicle is generally taxable to the employee as wages. This additional income is subject to FICA, Medicare, and FUTA taxes.

**Exceptions** to the taxable income rule apply to certain qualified nonpersonal-use vehicles, such as vehicles designed to carry cargo with a loaded GVW of over 14,000 pounds. See IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*, for a complete list of nonpersonal-use vehicles.

**Note.** For companies with a fleet of 20 or more vehicles, see Treas. Reg. §1.61-21.

There is a **special accounting rule** that allows the employer to defer the inclusion of the value of the vehicle provided during the last two months of the calendar year to the next calendar year. The cut-off date can be any time between November 1 and December 31.

**Example 6.** Management-level employees of Hoostus Cupcakes are provided company-owned vehicles for business and commuting purposes. All such employees are required to report their personal-use miles and total mileage for the period of December 1, 2008 through November 30, 2009 before December 15, 2009. The imputed value of the employees' personal use is added to their gross wages on their final paychecks in December, and the applicable taxes are withheld from their checks.

To calculate the amount includable in wages for the personal use of a company-owned vehicle, the two most commonly used options are the **annual lease value rule (ALV)** and the **cents-per-mile rule (CPM)**. Generally, once a method is selected, it must be used for the remaining life of the vehicle unless a change in use causes it to be ineligible for the method previously used.

### Annual Lease Value (ALV) Rule

Under the ALV rule, the value of a vehicle provided to an employee for personal use is determined by multiplying the lease value times the proportionate share of personal use. The lease value is determined by cross referencing the fair market value (FMV) of the vehicle to the lease value found in **Table 3-1** in IRS Pub. 15-B.

The FMV is determined as of the first date the vehicle is available for personal use by the employee. The employer may be able to use a **safe-harbor value** as the FMV. If the vehicle is purchased at arm's length, the safe-harbor value is the cost of the purchase. If the vehicle is leased, there are several safe-harbor values:

- The manufacturer's invoice price, plus 4%,
- The manufacturer's suggested retail price, minus 8%, or
- The retail value of the vehicle reported by a nationally-recognized pricing source.

The ALV does **not** include the value of fuel provided by the company. The fuel is valued at cost if the employer reimburses the employee for fuel or if the employee charges the cost of fuel to the employer, such as via a fuel card. If the employer purchases the fuel and provides it to the employee, the fuel may be valued at cost or at 5.5¢ per mile.

The lease value table assumes a 4-year lease. After four years of continuous use by one employee, the ALV is recalculated based on the FMV of the vehicle on January 1 of the next year.

The ALV is also recalculated when the vehicle is transferred to a different employee. The FMV used in this case is the value on January 1 of the year of transfer.

If the company uses the special accounting rule, the date is the first day of the year used under that rule. In **Example 6**, the valuation date would be December 1.

<sup>48</sup> IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

Practitioners may find the following worksheet helpful when calculating the taxable value of an employee's personal use of a company-provided vehicle.

## Worksheet For Determining Value of Personal Use of Employer-Provided Vehicles

1. Vehicle make, model and year \_\_\_\_\_

2. Date the vehicle was first available to the employee \_\_\_\_\_

3. FMV of the vehicle as of the date specified in #2

Fair Market Value \_\_\_\_\_

4. Use the FMV determined in #3 to find the corresponding amount in the Annual Lease Value Table

Annual Value of Use \_\_\_\_\_

5. Compute the fraction of the year available to the employee

$$\frac{\# \text{ Days Available}}{365 \text{ Days}} = \text{Fraction of Year Available}$$

6. Compute the prorated annual value of use

$$\text{Annual Value of Use} \times \text{Fraction of Year} = \text{Prorated Annual Value of Use}$$

Prorated Annual Value of Use \_\_\_\_\_

7. Compute personal use percentage

$$\frac{\# \text{ Personal Miles}}{\# \text{ Total Miles}} = \text{Personal Use Percentage}$$

Personal Use Percentage \_\_\_\_\_

8. Compute value of personal use

$$\text{Prorated Annual Value of Use} \times \text{Personal Use Percentage} = \text{Value of Personal Use}$$

Value of Personal Use \_\_\_\_\_

9. Compute value of employer-provided fuel

Actual Cost OR

$$\text{Personal Miles} \times \$0.055 = \text{Value of Employer-Provided Fuel}$$

Value of Employer-Provided Fuel \_\_\_\_\_

10. Compute total value of personal use of vehicle

$$\text{Value of Personal Use} + \text{Value of Employer-Provided Fuel}$$

Total Value of Personal Use of Vehicle \_\_\_\_\_



## Cents-per-Mile (CPM) Rule

Under the CPM rule, the value of a vehicle provided to an employee for personal use is determined by multiplying the SMR by the total miles the employee drives for personal purposes. This rule can be used if **either** of the following requirements is met:

- The vehicle is used regularly for business purposes throughout the calendar year, **or**
- The vehicle is driven at least 10,000 miles during the year, and it is used primarily by employees. If the vehicle is owned for only part of the year, the mileage requirement is reduced proportionately.

Restrictions on use of the CPM rule:

1. It **cannot** be used for vehicles whose values exceed certain limits when first used by employees for personal use. For 2009, the maximum values are \$15,000 for passenger automobiles and \$15,200 for trucks and vans.<sup>49</sup>
2. The rule must be used on the first day the vehicle is available to **any** employee for personal use.
3. It must be used for all later years unless the vehicle ceases to qualify for use of the rule.

If the employer does **not** provide fuel for the vehicle, the CPM taxed to the employee may be reduced by up to **5.5¢ per mile**.

## Adding the Personal-Use Value to Wages

The value of personal use of a company-owned vehicle is a fringe benefit subject to payroll taxes, including income, FICA, Medicare, and FUTA. Generally, income tax withholding on the value of the benefit is the flat 25% rate that applies to supplemental wages. However, the employer may **elect not to withhold income taxes** on this benefit.<sup>50</sup>

The employee's portion of FICA and Medicare taxes on the benefit are still the responsibility of the employee. Therefore, the employer must **either withhold** these taxes from the employee's wages **or pay** the employee's portion of these taxes on behalf of the employee.

If the employer pays the taxes on behalf of the employee, the amount paid is includable in gross wages subject to all payroll taxes. This creates a circular calculation. The IRS provides the basic formula for this situation in IRS Pub. 15-A, *Employer's Supplemental Tax Guide*. The basic formula must be modified if the employee's wages subject to FICA taxes exceed the wage base.

- Step 1.** Determine the factor to be used in the formula. The factor equals one less the combined employee portion of FICA and Medicare tax rates for the year. For 2009, the tax rates are 0.062 and 0.0145 for a combined total of 0.0765. **The factor equals .9235 (1 – 0.0765).**
- Step 2.** Divide the taxable value of the vehicle by the factor.
- Step 3.** Add the result from Step 2 to the wages in boxes 1, 3, and 5 of Form W-2. If the benefit is also taxable for state or local purposes, increase the wages in boxes 16 and/or 18, as appropriate.
- Step 4.** Multiply the result from Step 2 by the applicable FICA and Medicare rates.
- Step 5.** Using the results from Step 4, increase the amount of FICA and Medicare taxes reported as withheld, shown in boxes 4 and 6.

---

<sup>49</sup> Rev. Proc. 2009-12, 2009-3 IRB 321.

<sup>50</sup> IRC §3402(s).

**Example 7.** In 2009, MaPa Company purchased a vehicle for Tracy, the chief operating officer, to use while overseeing various work sites. Tracy also uses the vehicle for her commute. MaPa's accountant, Mike, is told about the auto purchase in January of 2010. Mike immediately contacts Tracy and requires her to give him an accounting of her 2009 personal miles. Mike calculates the value of Tracy's personal use of the auto in 2009 as \$1,000.

Since Tracy has already received her last paycheck for 2009, MaPa pays both the employee and employer portion of the social security taxes. To prepare the fourth-quarter payroll reports and Tracy's W-2, Mike must first calculate the total increase in wages.

- Step 1.** The factor to be used for 2009 is .9235 (see **Step 1** above this example).
- Step 2.** The taxable value of the vehicle is \$1,000. Divided by .9235, the result is \$1,082.84.
- Step 3.** \$1,082.84 is added to taxable wages on the quarterly reports and Tracy's W-2 in boxes 1, 3, and 5.
- Step 4.** \$1,082.84 is multiplied by 6.2% and 1.45% to yield \$67.14 and \$15.70, respectively.
- Step 5.** On Tracy's W-2, \$67.14 is added to FICA taxes paid and \$15.70 is added to Medicare taxes paid in boxes 4 and 6, respectively.

## ISSUE 4: SCHEDULE C, PROFIT OR LOSS FROM BUSINESS, SPECIAL TOPICS

6

### ORDINARY AND NECESSARY BUSINESS EXPENSES

Taxpayers are allowed to deduct **ordinary and necessary** business expenses incurred in operating a trade or business. Occasionally, taxpayers stretch the definitions of these terms beyond recognition.

The tax code does not define these terms, so the courts have been forced to provide the framework for evaluating whether or not expenses meet these requirements. The courts have determined that deductions are "a matter of legislative grace,"<sup>51</sup> and, therefore, the burden of proof is on the taxpayers to establish the legitimacy of their deductions.

There are **three key factors** in determining if an expense is ordinary and necessary:<sup>52</sup>

1. Is there a bona-fide business purpose for the expense?
2. Is the expense appropriate and helpful to the business?
3. Is this type of expense commonly incurred in operating this type of business?

Recent court cases have found that the following expenses were **not** ordinary and necessary business expenses:

- Personal living expenses disguised as home office expenses (*Chaney*,<sup>53</sup> *Fadeley*,<sup>54</sup> *Rodriguez*<sup>55</sup>)
- Pet care (*Chaney*)
- Clothes for a business meeting (*Chaney*)
- Personal birthday and wedding gifts (*Chaney*)
- Farm expenses for a farm with no income (*Fadeley*)

<sup>51.</sup> *Stephen G. and Suzanne Q. Chaney v. Comm'r*, TC Memo 2009-55 (Mar. 12, 2009).

<sup>52.</sup> *Ibid.*

<sup>53.</sup> *Ibid.*

<sup>54.</sup> *Edward Norman Fadeley v. Comm'r*, 96 TCM 257, TC Memo 2008-235 (Oct. 22, 2008).

<sup>55.</sup> *John M. Rodriguez v. Comm'r*, TC Memo 2009-22 (Jan. 29, 2009).

# 2009 Workbook

- Reimbursable employee expenses deducted on Schedule C (*Fadeley*)
- Expenses without sufficient records to substantiate the expenses (*Basalyk*,<sup>56</sup> *Ioane*,<sup>57</sup> *Garrison*,<sup>58</sup> *Rodriguez*, *Cartier*<sup>59</sup>)
- Expenses incurred prior to actively carrying on a trade or business (*Woody*<sup>60</sup>)
- Expenses incurred without sufficient profit motive (*Rowden*<sup>61</sup>)

Once an expense has passed the “smell test,” it may still be subject to capitalization instead of being allowed as a current year deduction. The expense can be capitalized as part of inventory<sup>62</sup> or capitalized as an asset.<sup>63</sup>

Expenses must generally be capitalized when they either:

1. Create or enhance a separate and distinct asset, or
2. Generate significant benefits for the taxpayer beyond the end of the taxable year.<sup>64</sup>

The rules regarding capitalization of inventory costs, such as freight, do not apply to small **resellers**. Small resellers are those whose average annual gross receipts for the past three tax years do not exceed \$10 million.<sup>65</sup>

However, taxpayers who **produce** tangible personal property or real property are required to capitalize all direct and indirect costs of producing the property. Direct costs include such expenses as materials and labor, which can be associated with the inventory produced.

**Indirect costs include such expenses as:**<sup>66</sup>

- Bidding;
- Depreciation, amortization, and other cost recovery allowances of facilities and equipment;
- Employee benefits;
- Engineering and design;
- Handling;
- Indirect labor;
- Indirect materials;
- Insurance;
- Interest;
- Licensing and franchise;

---

<sup>56</sup> *Peter I. and Daria A. Basalyk v. Comm’r*, TC Memo 2009-100 (May 14, 2009).

<sup>57</sup> *Michael Scott Ioane and Shelly Jean Olson-Ioane v. Comm’r*, TC Memo 2009-68 (Mar. 26, 2009).

<sup>58</sup> *Edward T. and Jennifer B. Garrison v. Comm’r*, TC Memo 2009-32 (Feb. 10, 2009).

<sup>59</sup> *Delminda M. Cartier aka Delminda M. Costa v. Comm’r*, TC Memo 2009-10 (Jan. 14, 2009).

<sup>60</sup> *Thomas J. Woody v. Comm’r*, TC Memo 2009-93 (Apr. 30, 2009).

<sup>61</sup> *Robert L. Rowden v. Comm’r*, TC Memo 2009-41 (Feb. 19, 2009).

<sup>62</sup> IRC §263A.

<sup>63</sup> IRC §263(a)(1).

<sup>64</sup> *Santa Fe Pacific Gold Company and Subsidiaries v. Comm’r*, 132 TC 12 (Apr. 27, 2009).

<sup>65</sup> Treas. Reg. §1.263A-3(b).

<sup>66</sup> Treas. Reg. §1.263A-1.

- Officer compensation;
- Pensions and related costs;
- Purchasing;
- Quality control;
- Rent;
- Repairs and maintenance;
- Spoilage;
- Storage;
- Taxes;
- Tools and equipment; and
- Utilities.

**Indirect costs that are not required to be capitalized include:<sup>67</sup>**

- Depreciation and other adjustments on temporarily idle equipment and facilities;
- Income taxes;
- IRC §179 deductions;
- IRC §165 losses;
- On-site storage;
- Research and experimental;
- Selling and distribution;
- Service costs for marketing, selling, advertising, and distribution;
- Strike expenses;
- Unsuccessful bidding; and
- Warranty and product liability.

Capitalization of assets that are not part of a business's inventory is generally required for real property, equipment purchases, and expenses that increase the value of the property.<sup>68</sup> The Code contains a number of specific exceptions to the general rule. For example, taxpayers may currently elect to deduct expenditures for the removal of architectural barriers to the handicapped.<sup>69</sup>

There are also specific exceptions listed in the Treasury Regulations. For example, farmers may deduct the cost of ordinary tools with short lives and small costs.<sup>70</sup> Professionals may deduct books and special equipment with short lives.<sup>71</sup>

---

<sup>67</sup> Ibid.

<sup>68</sup> IRC §280(a)(1).

<sup>69</sup> IRC §280(a)(1)(E).

<sup>70</sup> Treas. Reg. §1.162-12.

<sup>71</sup> Treas. Reg. §1.162-6.

## PROPOSED REGULATIONS ON CAPITALIZATION

In May 2008, the IRS published a set of proposed changes to the regulations under IRC §§162 and 263. The Notice of Proposed Rulemaking<sup>72</sup> includes:

- Explanations of the recommended changes,
- The reasoning behind the changes, and
- The technical language of the proposed amendments.

The proposed regulations include provisions for de minimis purchases, under which items costing less than \$100 each are automatically considered materials and supplies and are, therefore, currently deductible.

One of the most hotly contested areas is whether an expense is an **improvement** to be capitalized or a **repair** to be expensed. The proposed regulations attempt to reduce controversy and clarify which expenditures qualify as improvements and which are currently deductible. Under these regulations, taxpayers **must capitalize** expenditures that:

1. Result in a betterment to a unit of property,
2. Restore a unit of property, or
3. Adapt a unit of property to a new or different use.

The proposed regulations also create a **safe harbor** for routine maintenance:

*Under this safe harbor, routine maintenance activities include recurring activities that a taxpayer expects to perform more than once over the class life of the unit of property as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Amounts paid for betterments do not keep the unit of property in an ordinarily efficient operating condition; however, the replacement of minor parts with improved but comparable parts generally does not result in a betterment. Thus, for example, the safe harbor includes amounts paid for replacement parts that the taxpayer expects to replace more than once during the class life of the unit of property, even if the replacement part is an improved but comparable part. As part of the safe harbor provisions, these new proposed regulations provide a list of relevant considerations to be taken into account in determining whether an amount is paid for routine maintenance. These considerations include the recurring nature of the activity, industry practice, manufacturer recommendations, taxpayer experience and the treatment of the activity on the taxpayer's AFS.<sup>73</sup>*

**Example 8.** Adam bought a new rental duplex in 1993 for \$300,000. He allocated \$240,000 to the cost of the building and did not utilize cost segregation for computing the allowable MACRS deductions. After a windstorm, the roof began to leak in several places in 2009. Following the advice of a roofing contractor, Adam replaced the original asphalt shingles with comparable shingles at a cost of \$10,000 in May 2009.

**Question 8A.** Is Adam permitted to expense the \$10,000 as a repair on his Schedule E?

**Answer 8A. Yes.**<sup>74</sup> The replacement of the original shingles did not result in an improvement to his rental duplex.

---

<sup>72</sup> IRS Notice 2008-18, IRB pp. 871–901. The notice can be found online at: [www.irs.gov/irb/2008-18\_IRB/ar20.html#d0e2504] Accessed on June 6, 2009.

<sup>73</sup> Ibid, p. 877. AFS means applicable financial statements.

<sup>74</sup> Prop. Treas. Reg. §1.263(a)-3(f)(3), Example 9.

**Example 9.** Use the same facts as **Example 8**. Adam replaces the original shingles with a metal roof covering that has a 50-year warranty and a Class A fire rating. The cost of the metal roof is \$25,000.

**Question 9A.** Is Adam permitted to expense the \$25,000 as a repair on his Schedule E?

**Answer 9A. No.**<sup>75</sup> The metal roof is an improvement over the original shingles. Thus, the \$25,000 cost must be capitalized and depreciated over 27.5 years starting in May 2009.

## DISCLOSURES<sup>76</sup>

In 2008, the IRS issued updated procedures defining adequate disclosure for purposes of avoiding **substantial understatement penalties** and **preparer penalties** imposed on understatements due to unreasonable positions. These procedures apply specifically to 2007 returns, but they have not been updated yet; we assume that future revenue procedures regarding 2008 and 2009 returns will be similar.

**Note.** Meeting the disclosure requirements discussed here will not protect the preparer against penalties if the issue involves a tax shelter. Tax shelters are defined as plans or arrangements whose principal purpose is to avoid or evade income tax.<sup>77</sup>

In order to avoid substantial underpayment penalties, the taxpayer must furnish all required information in accordance with the applicable forms and instructions. In addition, the money amounts entered on the forms must be verifiable.

For the deductions listed on the following page, additional disclosures are not required when the following conditions apply. This exception only applies when the forms and attachments are completed in a clear manner and in accordance with their instructions:

1. **Verifiable money amounts.** A number is verifiable if the taxpayer can demonstrate the origin of the number and the taxpayer can show good faith in using that amount.
2. **Clear descriptions.** When an amount is shown on a line that does not have a preprinted description identifying that item, the taxpayer must clearly identify the item by including an accurate description of the item. If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.
3. **Reasonable basis.** This standard is significantly higher than “not frivolous” and “not patently improper.” The return position must be reasonable based on one or more proper authorities.<sup>78</sup> See Chapter 13, Rulings and Cases, Explanation of Contents, for a list of authorities and methods for evaluating the weight of those authorities.
4. **Proper substantiation.** The taxpayer must keep adequate books and records pertaining to the item or position.

---

<sup>75</sup> Ibid, Example 11.

<sup>76</sup> Rev. Proc. 2008-14, 2008-7 IRB 435.

<sup>77</sup> Treas. Reg. §1.6662-4(g).

<sup>78</sup> Treas. Reg. §1.6662-3(b)(3).

Assuming the above conditions are met, the following deductions do not require additional disclosure if the amount claimed is clearly stated:

1. Casualty and theft losses when each affected item or article is listed on Form 4684
2. Legal expenses
3. Specific bad-debt charge-off
4. Repair expenses
5. Taxes

**Example 10.** Alright Construction reports income on its Schedule C using the percentage-of-completion method. In 2008, the company reported income from jobs in progress in excess of the amount it collected during the year. In 2009, its primary customer went bankrupt with a balance due to the company of \$110,000. The company's accountant is afraid that a bad debt that large will raise an audit flag, so instead of reporting the loss on Schedule C, line 2, *Returns and allowances*, he accounts for the loss by reducing income on line 1, *Gross receipts or sales*.

Upon audit, the IRS determines that the company was not entitled to a bad-debt deduction in 2009 because the company had a reasonable expectation of recovering most of the balance due via the bankruptcy proceedings.<sup>79</sup> The IRS imposes substantial understatement penalties on the taxpayer and preparer penalties against the preparer for failure to make the necessary disclosures pertaining to the bad debt expense deduction.

The preparer has no relief under Rev. Proc. 2008-14 because the bad-debt expense was not clearly disclosed on the return.

If an entry involves a legal issue or controversy because of a related-party transaction, then that transaction and the relationship must be disclosed on Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*.

## HUSBAND AND WIFE JOINT VENTURES<sup>80, 81</sup>

A husband and wife operating a business together may be in a joint venture, a partnership, or an employer/employee situation. The proper classification depends on all of the facts of the arrangement.

An employer/employee relationship exists when one spouse substantially controls and manages the business and the other spouse is under the direction and control of the first spouse. In this case, the second spouse is an employee subject to income, social security, and Medicare tax withholding. The first spouse should report the activity on a Schedule C under his name, and the second spouse should receive a Form W-2 from the business.

A partnership or joint venture exists when both spouses:

- Have an equal say in the affairs of the business,
- Provide substantially equal services to the business, and
- Contribute capital to the business.

The primary difference between a partnership and a joint venture for husband-wife undertakings is the existence of formal partnership documents. Prior to January 1, 2007, an unincorporated business owned jointly by a husband-wife team was automatically considered a partnership by the IRS. However, for tax years beginning after December 31, 2006, a **qualified joint venture** operated by spouses can elect **not** to be treated as a partnership. Instead, both spouses report their share of the activity of the venture on separate Schedules C or F.

---

<sup>79</sup> Treas. Reg. §1.166-2(c)(2).

<sup>80</sup> *Husband and Wife Business*. Nov. 5, 2008. Internal Revenue Service. [www.irs.gov/businesses/small/article/0,,id=97732,00.html] Accessed on June 2, 2009.

<sup>81</sup> *Election for Husband and Wife Unincorporated Businesses*. Apr. 3, 2009. Internal Revenue Service. [www.irs.gov/businesses/small/article/0,,id=177376,00.html] Accessed on June 2, 2009.



## Definition of a Qualified Joint Venture

To be a qualified joint venture the business must meet these requirements:

1. The only members are a husband and wife who file a joint return.
2. Both spouses materially participate in the trade/business. Material participation has the same meaning as it has under the passive activity loss rules.<sup>82</sup>
3. Both spouses elect not to be treated as a partnership.
4. The business must be owned and operated by the spouses as co-owners and **not** in the name of a state law entity, such as a limited liability company, general partnership, or limited partnership.<sup>83</sup>
5. The spouses must share the items of income, gain, loss, deduction, and credit in accordance with each spouse's interest in the business.

## Reasons for Making the Election

1. With this election, the business is released from all of the requirements related to partnerships under **the entire tax code**. Therefore, not only is the business **not** required to file a Form 1065, *U.S. Return of Partnership Income*, the partners are not subject to the same at-risk rules, etc. Under this election, both partners are treated as sole proprietors for their portions of the business activity.
2. Previously, many bona-fide joint ventures reported the entire net profit under one spouse's social security number. This practice allocated all of the social security and Medicare taxes to one spouse, when, in fact, both spouses should have been receiving credit for those taxes. For many taxpayers, the tax is the same on the joint return under this method. However, if one spouse's income exceeded the limit for taxable social security income, this treatment produced an incorrect amount of total taxes.

## Making the Election

Spouses make the election by filing a joint return that includes the joint venture reported on two separate business schedules that show each spouse's proportional share of the venture's income and expenses. For example, a husband and wife with a joint farming operation file two separate forms: one Schedule F, *Profit or Loss From Farming*, for **each** spouse. In addition, if the operation is profitable, **each spouse** files a separate Schedule SE, *Self-Employment Tax*, showing the separate spouse's share of the net profit.

If the joint venture was previously reported on Form 1065, the partnership terminates at the end of the prior year. The federal employer identification number (FEIN) of the partnership cannot be used for the joint venture. If the joint venture needs an FEIN for employment, excise, alcohol, tobacco, or firearm returns, one spouse should apply for an FEIN as a sole proprietor. The spouse will file these returns under the new number. If the business has already filed payroll tax returns or paid taxes for part of the year under the partnership's FEIN, the spouse with the new FEIN will be considered a "successor employer" for determining wage base limits. See IRS Pub. 15, (*Circular E*) *Employer's Tax Guide*, for more information on the successor-employer rules.

Once the election is made, it cannot be revoked without permission of the IRS. If the spouses do not continue to meet the requirements for filing as a qualifying joint venture, a partnership return must then be filed. A new election will be necessary for any future year in which the spouses meet the requirements and wish to file as a qualified joint venture.

**Note.** For additional information on qualified husband and wife joint ventures, see pp. 509–515 of the Agricultural Issues and Rural Investments chapter in the 2008 *University of Illinois Federal Tax Workbook*. This can be found on the accompanying CD.

<sup>82</sup> See IRC §469(h), Temp. Treas. Reg. §1.469-5T, and IRS Pub. 925, *Passive Activity and At-Risk Rules*.

<sup>83</sup> See Rev. Proc. 2002-69, 2002-2 CB 831 for special rules applicable to community property states.

## ISSUE 5: WORK OPPORTUNITY TAX CREDIT

The work opportunity tax credit (WOTC) provides an incentive for employers to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. **The credit can be as high as \$9,000 per employee.** The WOTC applies against both regular tax and AMT.<sup>84</sup>

The credit is nonrefundable.<sup>85</sup> Any unused credit is first carried back one year and then forward for up to 20 years until completely used.<sup>86</sup> If there is any remaining credit after the taxpayer dies, the taxpayer ceases business, or the 20-year carryforward expires, the amount of the unused credit is deductible by the taxpayer.<sup>87</sup>

The amount of the credit depends on which WOTC target group the new hire is in and the number of hours that person works for the company during the year. The qualifying wages used for the credit are capped at various levels depending on the target group. Generally, only the wages paid for work performed during the **1-year period** beginning on the date the individual begins to work for the company qualify for the credit. However, wages paid during the second year of hire to certified long-term family assistance recipients also qualify.

**Caution.** The logistical problem for employers is that the certification paperwork must be completed **prior to hiring the employee.** The certification is issued by the state employment security agency of the employee's state of residence.

Under current law, the credit sunsets for individuals who begin work after August 31, 2011.<sup>88</sup>

### APPLYING FOR THE WOTC CERTIFICATION<sup>89</sup>

There are **three** steps to applying for WOTC certification. The employer:

1. Prescreens potential employees by completing Form 8850, *Pre-Screening Notice & Certification Request for Work Opportunity Credit*. If the employee is not precertified, this form is required to be completed **on or before** the day the individual is offered employment.<sup>90</sup>
2. Asks the employee to complete the U.S. Department of Labor's **ETA<sup>91</sup> Form 9061**, *Individual Characteristics Form*. The most current release of this form may be found at [www.doleta.gov/Business/Incentives/opptax/PDF/ETA\\_Form\\_9061.pdf](http://www.doleta.gov/Business/Incentives/opptax/PDF/ETA_Form_9061.pdf).
3. Mails the original signed forms to the WOTC unit of the state employment security agency no later than 29 calendar days after the new hire's start date.

**Note.** The state employment security agency of the employee's state of residence may have specific requirements for the request for certification. Practitioners and employers are advised to refer to that state's agency for its instructions.

<sup>84</sup>. IRC §38(c)(4).

<sup>85</sup>. IRC §38(c)(1).

<sup>86</sup>. IRC §39(a)(1).

<sup>87</sup>. IRC §196.

<sup>88</sup>. IRC §51(c)(4).

<sup>89</sup>. *Employment Security*. 2009. Illinois Department of Employment Security. [[www.ides.state.il.us/employer/uitax/credits.asp](http://www.ides.state.il.us/employer/uitax/credits.asp)] Accessed on May 24, 2009.

<sup>90</sup>. IRC §51(d)(13).

<sup>91</sup>. ETA is the acronym for the Employment and Training Administration department of the U.S. Department of Labor.

## TARGETED GROUPS<sup>92</sup>

**Note.** Since employers must usually receive certification of the employee's membership in a targeted group, practitioners are not responsible for knowing all of the details of eligibility for each group. However, being familiar with the requirements may help practitioners give advice to clients concerning the WOTC.

### Long-Term Family Assistance (LFA) Recipients

This group includes members of families receiving assistance under Temporary Assistance for Needy Families (TANF) for at least **18 months**. In general, the 18-month participation requirement must be met in the period ending on the hire date. There are two types of 2-year look-back periods for certain families; however, they are not discussed in this material.

### Temporary Assistance for Needy Families (TANF) Recipients

This group includes members of families receiving assistance from the TANF program. To qualify, the family must have received benefits for at least **nine months** during the 18-month period ending on the hire date.

### Veterans

The qualified veterans group includes three sub-types:

1. Veterans who begin employment during 2009 and 2010 and who received unemployment benefits for at least four weeks during the 1-year period prior to the hire date. These veterans must have been discharged or released from active duty by the U.S. Armed Forces during the 5-year period ending on the hire date.<sup>93</sup>
2. Veterans whose families receive food stamps for at least a 3-month period ending during the 12-month period prior to the hire date.
3. Veterans entitled to compensation for service-connected disabilities who are:
  - Hired not more than one year after having been discharged or released from active duty, **or**
  - Unemployed or occasionally employed for at least six months during the 1-year period prior to hire.<sup>94</sup>

**Note.** The State of Illinois also offers a tax credit for certain veterans.<sup>95</sup> For more information, contact the Illinois Department of Employment Security.

### Ex-Felons

This group includes individuals convicted of a felony who are hired within one year after their release from prison.

**Note.** The State of Illinois also offers a tax credit for ex-offenders who were incarcerated by Illinois.<sup>96</sup> For more information, contact the Illinois Department of Employment Security.

<sup>92</sup> IRC §51(d)(2).

<sup>93</sup> IRC §51(d)(14)(B)(i) — added by the ARRA.

<sup>94</sup> Notice 2009-69. Clarification to IRC §51. Released August 12, 2009.

<sup>95</sup> *Employment Security*. 2009. Illinois Department of Employment Security. [www.ides.state.il.us/employer/uitax/credits.asp] Accessed on May 24, 2009.

<sup>96</sup> Ibid.

## Vocational Rehabilitation Referrals

This group includes physically or mentally disabled persons who are referred to the employer by certain rehabilitation programs.

## Designated Community Residents

This group includes individuals who are at least 18 and not yet 40 on the hire date. To qualify, they must live within one of the following:

- Empowerment zone
- Enterprise community
- Renewal community
- Rural renewal county

Only wages paid while the employee is a resident of a designated community qualify for the credit.

**Note.** The number of potential employees living in designated communities is immense. Businesses near these areas may be losing a significant amount of money by ignoring the WOTC. Practitioners should encourage their clients to certify qualified employees prior to hiring them.

**Caution. Only Rural Renewal Counties** include the entire county. (See page 4 of the instructions for Form 8850.) For the other designated areas, additional information is required in order to determine whether the employee lives in a qualifying area. Thus, all residents of Clark County in Missouri are members of the targeted-group inhabitants of Rural Renewal Counties. However, to determine whether a resident of St. Louis, MO, lives in an Empowerment Zone, an employer must contact HUD.

## Summer Youth Employees

This group includes members who are at least 16 but not yet 18 on the hire date. To qualify, they must also live within one of the following:

- Empowerment zone
- Enterprise community
- Renewal community

Only the wages paid between May 1 and September 15 qualify for the credit. In addition, only wages paid while the individual lives in a designated community qualify.

**Note.** The communities qualifying residents for the **Designated Community** and **Summer Youth** classifications change based on economic conditions and population fluctuations of the areas. For a current list of qualifying areas, see the instructions for Form 8850.

## Food Stamp Recipients

This group generally includes recipients who are at least 18 but not yet 40 on the hire date. To qualify, the recipients must be members of a family receiving food stamps for **at least** a 3-month period ending during the 6-month period prior to the hire date.

## SSI Recipients

This group includes people who received supplemental social security benefits for any month ending within the 60-day period prior to the hire date.

## Hurricane Katrina Residents

This group includes persons hired **before** August 28, 2009, to work in the Gulf Opportunity (GO) Zone who had a main home in the GO Zone on August 28, **2005**. Members of this group are not required to be certified by an outside agency. The employer is required to have reasonable evidence provided by the employee that the employee qualifies.

## Disconnected Youth<sup>97</sup>

This group was added to the list of targeted groups by the ARRA. Wages paid to members of this group only qualify for individuals who start work in 2009 or 2010. Members of this group include individuals who:

- Are at least 16 but not yet 25 on the hire date,
- Are not readily employable due to a lack of basic skills,
- Average under 10 hours per week of school during the six months before the hire date,<sup>98</sup> and
- Average gross earnings of less than 30 hours per week at applicable minimum wage during the six months before the hire date.<sup>99</sup>

A low level of formal education satisfies the requirement that an individual is not readily employable by reason of lacking a sufficient number of skills. An individual who does not have a high school diploma and does not have a GED meets this requirement. An individual may also meet this requirement if he received his diploma or GED no more than six months prior to the hire date and has not held a job (other than occasionally)<sup>100</sup> or been admitted to a technical/post-secondary school since receiving the diploma/GED.<sup>101</sup>

The IRS also requires that the employee state in writing that he does not have a high school diploma or GED, or that he meets the six-month exception.<sup>102</sup>

---

<sup>97</sup>. IRC §51(d)(14)(B)(ii) — added by the ARRA.

<sup>98</sup>. IRS Notice 2009-28, 2009-24 IRB 1082 (June 15, 2009).

<sup>99</sup>. Ibid.

<sup>100</sup>. IRS Notice 2009-69, IRB 2009-35 (Aug. 31, 2009).

<sup>101</sup>. IRS Notice 2009-28, 2009-24 IRB 1082 (June 15, 2009).

<sup>102</sup>. IRS Notice 2009-69, IRB 2009-35 (Aug. 31, 2009).

## INELIGIBLE INDIVIDUALS<sup>103</sup>

Wages paid to certain employees do not qualify for the credit even if the employee is a member of one of the targeted groups. **Ineligible** individuals include the following:

1. **Persons related to the employer.** For this purpose, relatives include all the relationships qualifying under the dependency exemption except for unrelated people who only qualify by living with the taxpayer for the entire tax year.<sup>104</sup> If the employer is a corporation or other entity, the employee must not be related to anyone with more than 50% ownership or control of the employer.
2. **Dependents of the owner of the business.** This expands on the first exception by including unrelated people who live with the taxpayer-employer for the entire year and who meet the other qualifications to be claimed as a dependent.
3. **Prior employees.** Any past employment of the individual by the employer disqualifies that person from this credit.
4. **Individuals working fewer than 120 hours in the first year of employment.**<sup>105</sup>
5. **Individuals hired as replacement workers during a strike or walkout.**
6. **Individuals performing services for a person other than the employer, who are paid by the employer for that service, if the employer does not expect to receive compensation from the person in excess of the wages paid to the employee.**<sup>106</sup> This provision attempts to limit abuse of the credit by employers who might “hire” an individual in collusion with the person receiving the services.

The August 2009 version of Form 8850 and its instructions are shown next. This form was revised due to the changes made by the ARRA.

Following the IRS form is the most recent ETA Form 9061 available when this book was printed.

---

<sup>103</sup>. IRC §51(i).

<sup>104</sup>. See IRC §§152(d)(2)(A) thru (G).

<sup>105</sup>. The language of IRC §51 is “hours of service for the employer.” The committee report for ARRA specifies that these hours must occur in the first year of employment. Presumably for this purpose, the first year of employment is defined in the same manner as first year wages. House Report 111-016, *Conference Report to Accompany H.R. 1*, Feb. 12, 2009. COM-RPT, ARRA09 ¶10,260, Act Sec. 1221. *Modification of work opportunity tax credit.*

<sup>106</sup>. IRC §51(k)(2).



Form **8850**  
(Rev. August 2009)  
Department of the Treasury  
Internal Revenue Service

## Pre-Screening Notice and Certification Request for the Work Opportunity Credit

OMB No. 1545-1500

► See separate instructions.

**Job applicant: Fill in the lines below and check any boxes that apply. Complete only this side.**

Your name \_\_\_\_\_ Social security number ► \_\_\_\_\_

Street address where you live \_\_\_\_\_

City or town, state, and ZIP code \_\_\_\_\_

County \_\_\_\_\_ Telephone number (\_\_\_\_) \_\_\_\_\_ - \_\_\_\_\_

If you are under age 40, enter your date of birth (month, day, year) \_\_\_\_ / \_\_\_\_ / \_\_\_\_

- 1 ☐ Check here if you are completing this form **before** August 28, 2009, and you lived in the area impacted by Hurricane Katrina on August 28, 2005. If so, please enter the address, including county or parish and state where you lived at that time.
- 2 ☐ Check here if you received a conditional certification from the state workforce agency (SWA) or a participating local agency for the work opportunity credit.
- 3 ☐ Check here if **any** of the following statements apply to you.
  - I am a member of a family that has received assistance from Temporary Assistance for Needy Families (TANF) for any 9 months during the past 18 months.
  - I am a veteran and a member of a family that received Supplemental Nutrition Assistance Program (SNAP) benefits (food stamps) for at least a 3-month period during the past 15 months.
  - I was referred here by a rehabilitation agency approved by the state, an employment network under the Ticket to Work program, or the Department of Veterans Affairs.
  - I am at least age 18 but **not** age 40 or older and I am a member of a family that:
    - a Received SNAP benefits (food stamps) for the past 6 months, **or**
    - b Received SNAP benefits (food stamps) for at least 3 of the past 5 months, **but** is no longer eligible to receive them.
  - During the past year, I was convicted of a felony or released from prison for a felony.
  - I received supplemental security income (SSI) benefits for any month ending during the past 60 days.
  - I am a veteran and I was discharged or released from active duty in the U.S. Armed Forces during the past 5 years **and**, for at least 4 weeks during the past year, I received unemployment compensation.
  - I am at least age 16 but **not** age 25 or older, **and**:
    - a During the past 6 months, I have not attended a secondary, technical, or post-secondary school for more than an average of 10 hours per week, not counting periods during which the school was closed for scheduled vacations, **and**
    - b During the past 6 months, if I was employed, during each consecutive 3-month period within the past 6 months, I earned less than I would have earned if I had worked for the applicable minimum wage 30 hours every week during the 3-month period, **and**
    - c I do not have a certificate of graduation from a secondary school or a General Education Development (GED) certificate **or** I have a certificate that was awarded at least 6 months ago and I have not held a job (other than occasionally) or been admitted to a technical or post-secondary school since I received the certificate.
- 4 ☐ Check here if you are a veteran entitled to compensation for a service-connected disability **and**, during the past year, you were:
  - Discharged or released from active duty in the U.S. Armed Forces, **or**
  - Unemployed for a period or periods totaling at least 6 months.
- 5 ☐ Check here if you are a member of a family that:
  - Received TANF payments for at least the past 18 months, **or**
  - Received TANF payments for any 18 months beginning after August 5, 1997, **and** the earliest 18-month period beginning after August 5, 1997, ended during the past 2 years, **or**
  - Stopped being eligible for TANF payments during the past 2 years because federal or state law limited the maximum time those payments could be made.

### Signature—All Applicants Must Sign

Under penalties of perjury, I declare that I gave the above information to the employer on or before the day I was offered a job, and it is, to the best of my knowledge, true, correct, and complete.

Job applicant's signature ► \_\_\_\_\_

Date \_\_\_\_ / \_\_\_\_ / \_\_\_\_

For Privacy Act and Paperwork Reduction Act Notice, see page 2.

Cat. No. 22851L

Form **8850** (Rev. 8-2009)



# 2009 Workbook

Form 8850 (Rev. 8-2009)

Page **2**

## For Employer's Use Only

Employer's name \_\_\_\_\_ Telephone no. ( ) - EIN ▶ \_\_\_\_\_

Street address \_\_\_\_\_

City or town, state, and ZIP code \_\_\_\_\_

Person to contact, if different from above \_\_\_\_\_ Telephone no. ( ) - \_\_\_\_\_

Street address \_\_\_\_\_

City or town, state, and ZIP code \_\_\_\_\_

If, based on the individual's age and home address, he or she is a member of group 4 or 6 (as described under Members of Targeted Groups in the separate instructions), enter that group number (4 or 6) . . . . . ▶ \_\_\_\_\_

Date applicant:

Gave information \_\_\_\_/\_\_\_\_/\_\_\_\_ Was offered job \_\_\_\_/\_\_\_\_/\_\_\_\_ Was hired \_\_\_\_/\_\_\_\_/\_\_\_\_ Started job \_\_\_\_/\_\_\_\_/\_\_\_\_

### Complete Only If Box 1 on Page 1 is Checked

State and county or parish of job \_\_\_\_\_

☐ Check if the individual was not your employee on August 28, 2005, and this is the first time the employee has been hired by you since August 28, 2005.

Under penalties of perjury, I declare that the applicant provided the information on this form on or before the day a job was offered to the applicant and that the information I have furnished is, to the best of my knowledge, true, correct, and complete. Based on the information the job applicant furnished on page 1, I believe the individual is a member of a targeted group. I hereby request a certification that the individual is a member of a targeted group.

Employer's signature ▶ \_\_\_\_\_

Title \_\_\_\_\_

Date \_\_\_\_/\_\_\_\_/\_\_\_\_

### Privacy Act and Paperwork Reduction Act Notice

*Section references are to the Internal Revenue Code.*

Section 51(d)(13) permits a prospective employer to request the applicant to complete this form and give it to the prospective employer. The information will be used by the employer to complete the employer's federal tax return. Completion of this form is voluntary and may assist members of targeted groups in securing employment. Routine uses of this form include giving it to the state workforce agency (SWA), which will contact appropriate sources to confirm that the applicant is a member of a targeted group. This form may also be given to the Internal Revenue Service for administration of the Internal Revenue laws, to the Department of Justice for civil and

criminal litigation, to the Department of Labor for oversight of the certifications performed by the SWA, and to cities, states, and the District of Columbia for use in administering their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

**Recordkeeping** . . . . .3 hrs., 16 min.

**Learning about the law or the form** . . . . .46 min.

**Preparing and sending this form to the SWA** . . . . .42 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224.

Do not send this form to this address. Instead, see *When and Where To File* in the separate instructions.

Form **8850** (Rev. 8-2009)

## Instructions for Form 8850

(Rev. August 2009)



Department of the Treasury  
Internal Revenue Service

### Pre-Screening Notice and Certification Request for the Work Opportunity Credit

## General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

### What's New

- The targeted group for Hurricane Katrina employees has been extended to cover certain employees hired after August 27, 2007, and before August 28, 2009.
- For certain veterans who begin work after 2008 and before 2011, a new targeted group has been added for certain unemployed veterans who were discharged or released from active duty in the U.S. Armed Forces during the 5-year period ending on the hiring date and received unemployment compensation for at least 4 weeks during the 1-year period ending on the hiring date. For details, see page 2.
- For individuals who begin work after 2008 and before 2011, a new targeted group has been added for disconnected youth. For details, see page 2.
- For unemployed veterans and disconnected youth (discussed above) hired before September 17, 2009, employers are required to file Form 8850 with the SWA no later than October 17, 2009.
- The food stamp program has been renamed the Supplemental Nutrition Assistance Program (SNAP).
- Parts of Washington, DC will continue to be treated as an empowerment zone until the end of 2009. See page 3.

### Purpose of Form

Employers use Form 8850 to pre-screen and to make a written request to their state workforce agency (SWA) (unless the employee checks only the Hurricane Katrina employee box) to certify an individual as a member of a targeted group for purposes of qualifying for the work opportunity credit.

Submitting Form 8850 to the SWA (unless the employee checks only the Hurricane Katrina employee box) is but one step in the process of qualifying for the work opportunity credit. The state work opportunity tax credit (WOTC) coordinator for the SWA must certify the job applicant is a member of a targeted group. After starting work, the employee must meet the minimum number-of-hours-worked requirement for the work opportunity credit. The employer elects to take the credit by filing Form 5884, Work Opportunity Credit.



*The certification requirements described above do not apply to Hurricane Katrina employees. For an employer of a Hurricane Katrina employee, this form is used to accept reasonable evidence that the worker is a Hurricane Katrina employee. It is the employer's responsibility to ascertain that the place where the employee lived on August 28, 2005, (the address on line 1 of the form) is in fact in the Gulf Opportunity Zone (core disaster area) (see page 3 for a list of these areas). The employer is not required to ask employees to furnish any documentary evidence.*

## Who Should Complete and Sign the Form

The job applicant gives information to the employer on or before the day a job offer is made. This information is entered on Form 8850. Based on the applicant's information, the employer determines whether or not he or she believes the applicant is a member of a targeted group (as defined under Members of Targeted Groups). If the employer believes the applicant is a member of a targeted group, the employer completes the rest of the form no later than the day the job offer is made. Both the job applicant and the employer must sign Form 8850 no later than the date for submitting the form to the SWA.

## Instructions for Employer

### When and Where to File

Do not file Form 8850 with the Internal Revenue Service. Instead, if required, file it with your SWA no later than the 28th day after the job applicant begins work for you (by October 17, 2009, for unemployed veterans or disconnected youth hired after 2008 and before September 17, 2009). Although electronic filing of Form 8850 is permitted, at the time these instructions were published, Alabama and Colorado were the only states equipped to receive Form 8850 electronically. See Announcement 2002-44 for details. You can find Announcement 2002-44 on page 809 of Internal Revenue Bulletin 2002-17 at [www.irs.gov/pub/irs-irbs/irb02-17.pdf](http://www.irs.gov/pub/irs-irbs/irb02-17.pdf).

To get the name, address, phone and fax numbers, and email address of the WOTC coordinator for your state, visit the Department of Labor Employment and Training Administration (ETA) website at [www.doleta.gov/business/Incentives/opptax](http://www.doleta.gov/business/Incentives/opptax).



*Never attach Form 8850 to a tax return or otherwise send it to the IRS, regardless of the employee's targeted group. Form 8850 should be filed with the SWA unless the employee checks only the Hurricane Katrina employee box, in which case the employer should keep the Form 8850 for its records.*

## Additional Requirements for Certification

In addition to filing Form 8850, you must complete and send to your state WOTC coordinator either:

- ETA Form 9062, Conditional Certification Form, if the job applicant received this form from a participating agency (e.g., the Jobs Corps), or
- ETA Form 9061, Individual Characteristics Form, if the job applicant did not receive a conditional certification.

You can get ETA Form 9061 from your local public employment service office or you can download it from the ETA website at [www.doleta.gov/business/Incentives/opptax](http://www.doleta.gov/business/Incentives/opptax).

Cat. No. 24833J



## Recordkeeping

Keep copies of Forms 8850, any transmittal letters that you submit to your state WOTC coordinator, and certification letters you receive from your WOTC coordinator as long as they may be needed for the administration of the provisions relating to the work opportunity credit. Records that support the credit usually must be kept for 3 years from the date any income tax return claiming the credit is due or filed, whichever is later.

## Members of Targeted Groups

A job applicant may be certified as a member of a targeted group if he or she is described in one of the following groups.

1. **Qualified IV-A recipient.** An individual who is a member of a family receiving assistance under a state plan approved under part A of title IV of the Social Security Act relating to Temporary Assistance for Needy Families (TANF). The assistance must be received for any 9 months during the 18-month period ending on the hiring date.

2. **Qualified veteran.** A veteran who is any of the following.

- A member of a family receiving assistance under the Supplemental Nutrition Assistance Program (SNAP) (food stamps) for at least a 3-month period during the 15-month period ending on the hiring date.
- Entitled to compensation for a service-connected disability and is hired not more than 1 year after being discharged or released from active duty in the U.S. Armed Forces.
- Entitled to compensation for a service-connected disability and was unemployed for a period or periods totaling at least 6 months (whether or not consecutive) in the 1-year period ending on the hiring date.

**Note.** Requesting the information in box 4 of Form 8850 is an exception to the Americans with Disabilities Act's prohibition on pre-offer disability-related inquiries. The purpose of this request is to support the hiring of certain disabled veterans, which will entitle the employer to a larger work opportunity credit than the hiring of other targeted group members.

To be considered a veteran, the applicant must:

- Have served on active duty (not including training) in the Armed Forces of the United States for more than 180 days or have been discharged or released from active duty for a service-connected disability, and
  - Not have a period of active duty (not including training) of more than 90 days that ended during the 60-day period ending on the hiring date.
3. **Qualified ex-felon.** An ex-felon who has been convicted of a felony under any federal or state law, and is hired not more than 1 year after the conviction or release from prison for that felony.

4. **Designated community resident.** An individual who is at least age 18 but not yet age 40 on the hiring date and lives within an empowerment zone, renewal community, or rural renewal county (defined later).

5. **Vocational rehabilitation referral.** An individual who has a physical or mental disability resulting in a substantial handicap to employment and who was referred to the employer upon completion of (or while receiving) rehabilitation services by a rehabilitation agency approved by the state, an employment network under the Ticket to Work program, or the Department of Veterans Affairs.

6. **Summer youth employee.** An individual who:

- Performs services for the employer between May 1 and September 15,
- Is at least age 16 but not yet age 18 on the hiring date (or if later, on May 1),

- Has never worked for the employer before, and
- Lives within an empowerment zone or renewal community.

7. **Recipient of SNAP benefits (food stamps).** An individual who:

- Is at least age 18 but not yet age 40 on the hiring date, and
- Is a member of a family that:
  - a. Has received SNAP benefits for the 6-month period ending on the hiring date, or
  - b. Is no longer eligible for such assistance under section 6(o) of the Food Stamp Act of 1977, but the family received SNAP benefits for at least 3 months of the 5-month period ending on the hiring date.

8. **SSI recipient.** An individual who is receiving supplemental security income benefits under title XVI of the Social Security Act (including benefits of the type described in section 1616 of the Social Security Act or section 212 of Public Law 93-66) for any month ending during the 60-day period ending on the hiring date.

9. **Long-term family assistance recipient.** An individual who is a member of a family that:

- Has received TANF payments for at least 18 consecutive months ending on the hiring date, or
- Receives TANF payments for any 18 months (whether or not consecutive) beginning after August 5, 1997, and the earliest 18-month period beginning after August 5, 1997, ended during the past 2 years, or
- Stopped being eligible for TANF payments because federal or state law limits the maximum period such assistance is payable and the individual is hired not more than 2 years after such eligibility ended.

10. **Hurricane Katrina employee.** A Hurricane Katrina employee is a person who, on August 28, 2005, had a main home in the Gulf Opportunity (GO) Zone (core disaster area) and, during a 4-year period beginning on this date, is hired to perform services principally in the GO Zone. Certification does not apply to this group.

11. **Unemployed veteran.** A veteran hired after 2008 and before 2011 who:

- Has been discharged or released from active duty in the U.S. Armed Forces at any time during the 5-year period ending on the hiring date, and
- Received unemployment compensation under state or federal law for at least 4 weeks during the 1-year period ending on the hiring date.

To be considered a veteran, the applicant must have served on active duty (not including training) in the Armed Forces of the United States for more than 180 days or have been discharged or released from active duty for a service-connected disability.

12. **Disconnected youth.** An individual hired after 2008 and before 2011 who:

- Is at least age 16 but not yet age 25 on the hiring date;
- During the past 6 months, has not attended or has not regularly attended any secondary, technical, or post-secondary school for more than an average of 10 hours per week, not counting periods during which the school was closed for scheduled vacation;
- During each consecutive 3-month period within the past 6 months, was not employed or was employed and earned an amount less than he or she would have earned working for the applicable minimum wage 30 hours every week during the 3-month period; and
- Does not have a certificate of graduation from a secondary school or a General Education Development (GED) certificate or has a certificate that was awarded at least 6 months ago and he or she has not held a job (other than occasionally) or been admitted to a technical or post-secondary school since receiving the certificate.

"Minimum wage" means the higher of the federal minimum wage (as defined in 29 U.S.C. 206(a)(1)) or the generally applicable state minimum wage (if any).

"Secondary school" means an institutional day or residential school, including a public secondary charter school, that provides secondary education, as determined under state law, except that the term does not include any education beyond grade 12. A General Education Development (GED) program is not a secondary school for this purpose.

The terms "technical school" and "post-secondary school" mean institutions of higher education as defined in 20 U.S.C. 1001; 1002(a)(1), (b), and (c); and 1059c(b)(3).

## Member of a Family

With respect to the qualified IV-A recipient, qualified veteran, recipient of SNAP benefits (food stamps), and long-term family assistance recipient, an individual whose family receives assistance for the requisite period meets the family assistance requirement of the applicable group if the individual is included on the grant (and thus receives assistance) for some portion of the specified period.

## Gulf Opportunity (GO) Zone (Core Disaster Area)

The GO Zone (also called the core disaster area) covers the portion of the Hurricane Katrina disaster area determined by the Federal Emergency Management Agency (FEMA) to be eligible for either individual only or both individual and public assistance from the Federal Government. The GO Zone covers the following areas in three states.

**Alabama.** The counties of Baldwin, Choctaw, Clarke, Greene, Hale, Marengo, Mobile, Pickens, Sumter, Tuscaloosa, and Washington.

**Louisiana.** The parishes of Acadia, Ascension, Assumption, Calcasieu, Cameron, East Baton Rouge, East Feliciana, Iberia, Iberville, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Orleans, Plaquemines, Pointe Coupee, St. Bernard, St. Charles, St. Helena, St. James, St. John the Baptist, St. Martin, St. Mary, St. Tammany, Tangipahoa, Terrebonne, Vermilion, Washington, West Baton Rouge, and West Feliciana.

**Mississippi.** The counties of Adams, Amite, Attala, Choctaw, Claiborne, Clarke, Copiah, Covington, Forrest, Franklin, George, Greene, Hancock, Harrison, Hinds, Holmes, Humphreys, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Lincoln, Lowndes, Madison, Marion, Neshoba, Newton, Noxubee, Oktibbeha, Pearl River, Perry, Pike, Rankin, Scott, Simpson, Smith, Stone, Walthall, Warren, Wayne, Wilkinson, Winston, and Yazoo.

## Empowerment Zones

The following paragraphs describe current designations of empowerment zones. The designations will generally remain in effect until the end of 2009.

**Urban areas.** [Parts] of the following urban areas are empowerment zones. You can find out if your business or an employee's residence is located within an urban empowerment zone by using the RC/EZ/EC Address Locator at [www.hud.gov/crlocator](http://www.hud.gov/crlocator) or by calling 1-800-998-9999.

- Pulaski County, AR
- Tucson, AZ
- Fresno, CA
- Los Angeles, CA (city and county)
- Santa Ana, CA
- New Haven, CT

- Jacksonville, FL
- Miami/Dade County, FL
- Chicago, IL
- Gary/Hammond/East Chicago, IN
- Boston, MA
- Baltimore, MD
- Detroit, MI
- Minneapolis, MN
- St. Louis, MO/East St. Louis, IL
- Cumberland County, NJ
- New York, NY
- Syracuse, NY
- Yonkers, NY
- Cincinnati, OH
- Cleveland, OH
- Columbus, OH
- Oklahoma City, OK
- Philadelphia, PA/Camden, NJ
- Columbia/Sumter, SC
- Knoxville, TN
- El Paso, TX
- San Antonio, TX
- Norfolk/Portsmouth, VA
- Huntington, WV/Ironton, OH

**Washington, DC.** Under section 1400, parts of Washington, DC, are treated as an empowerment zone. This treatment will generally remain in effect until the end of 2009. For details, use the RC/EZ/EC Address Locator at [www.hud.gov/crlocator](http://www.hud.gov/crlocator) or see Notice 98-57 on page 9 of Internal Revenue Bulletin 1998-47 at [www.irs.gov/pub/irs-irbs/irb98-47.pdf](http://www.irs.gov/pub/irs-irbs/irb98-47.pdf).

**Rural areas.** [Parts] of the following rural areas are empowerment zones. You can find out if your business or an employee's residence is located within a rural empowerment zone by using the RC/EZ/EC Address Locator at [www.hud.gov/crlocator](http://www.hud.gov/crlocator) or by calling 1-800-998-9999.

- Desert Communities, CA (part of Riverside County)
- Southwest Georgia United, GA (part of Crisp County and all of Dooly County)
- Southernmost Illinois Delta, IL (parts of Alexander and Johnson Counties and all of Pulaski County)
- Kentucky Highlands, KY (part of Wayne County and all of Clinton and Jackson Counties)
- Aroostook County, ME (part of Aroostook County)
- Mid-Delta, MS (parts of Bolivar, Holmes, Humphreys, Leflore, Sunflower, and Washington Counties)
- Griggs-Steele, ND (part of Griggs County and all of Steele County)
- Oglala Sioux Tribe, SD (parts of Jackson and Bennett Counties and all of Shannon County)
- Middle Rio Grande FUTURO Communities, TX (parts of Dimmit, Maverick, Uvalde, and Zavala Counties)
- Rio Grande Valley, TX (parts of Cameron, Hidalgo, Starr, and Willacy Counties)

## Renewal Communities

[Parts] of the following areas are designated as renewal communities. The designations will generally remain in effect until the end of 2009. You can find out if your business or an employee's residence is located within a renewal community by using the RC/EZ/EC Address Locator at [www.hud.gov/crlocator](http://www.hud.gov/crlocator) or by calling 1-800-998-9999.

- Greene-Sumter County, AL
- Mobile County, AL
- Southern Alabama
- Los Angeles, CA
- Orange Grove, CA
- Parlier, CA
- San Diego, CA
- San Francisco, CA

-3-



- Atlanta, GA
- Chicago, IL
- Eastern KY
- Central Louisiana
- New Orleans, LA
- Northern Louisiana
- Ouachita Parish, LA
- Lawrence, MA
- Lowell, MA
- Detroit, MI
- Flint, MI
- West Central Mississippi
- Turtle Mountain Band of Chippewa, ND
- Camden, NJ
- Newark, NJ
- Buffalo-Lackawanna, NY
- Jamestown, NY
- Niagara Falls, NY
- Rochester, NY
- Schenectady, NY
- Hamilton, OH
- Youngstown, OH
- Philadelphia, PA
- Charleston, SC
- Chattanooga, TN
- Memphis, TN
- Corpus Christi, TX
- El Paso County, TX
- Burlington, VT
- Tacoma, WA
- Yakima, WA
- Milwaukee, WI

## Rural Renewal Counties

A rural renewal county is a county in a rural area that lost population during the 5-year periods 1990 through 1994 and 1995 through 1999. Rural renewal counties are listed below.

**Alabama.** The counties of Butler, Dallas, Macon, Perry, Sumter, and Wilcox.

**Alaska.** The census areas of Aleutians West, Wrangell-Petersburg, and Yukon-Koyukuk.

**Arkansas.** The counties of Arkansas, Chicot, Clay, Desha, Jackson, Lafayette, Lee, Little River, Monroe, Nevada, Ouachita, Phillips, Union, and Woodruff.

**Colorado.** The counties of Cheyenne, Kiowa, and San Juan.

**Georgia.** The counties of Randolph and Stewart.

**Illinois.** The counties of Alexander, Edwards, Franklin, Gallatin, Greene, Hancock, Hardin, Jasper, Knox, McDonough, Montgomery, Pulaski, Randolph, Richland, Scott, Warren, Wayne, and White.

**Indiana.** Perry County.

**Iowa.** The counties of Adair, Adams, Appanoose, Audubon, Butler, Calhoun, Cass, Cherokee, Clay, Clayton, Emmet, Floyd, Franklin, Fremont, Hancock, Humboldt, Ida, Keokuk, Kossuth, Montgomery, Osceola, Palo Alto, Pocahontas, Poweshiek, Sac, Taylor, Union, Wayne, Winnebago, and Worth.

**Kansas.** The counties of Atchison, Barber, Barton, Brown, Clay, Cloud, Comanche, Decatur, Edwards, Elk, Ellsworth, Gove, Graham, Greeley, Greenwood, Harper, Hodgeman, Jewell, Kiowa, Labette, Lane, Lincoln, Marshall, Mitchell, Montgomery, Ness, Osborne, Phillips, Rawlins, Republic, Rooks, Rush, Russell, Scott, Sheridan, Sherman, Smith, Stafford, Trego, Wallace, Washington, Wichita, and Woodson.

**Kentucky.** The counties of Bell, Caldwell, Floyd, Harlan, Hickman, Leslie, Letcher, Pike, and Union.

**Louisiana.** The parishes of Bienville, Claiborne, Franklin, Jackson, Morehouse, St. Mary, Tensas, Vernon, and Webster.

**Maine.** The counties of Aroostook and Piscataquis.

**Michigan.** The counties of Gogebic, Marquette, and Ontonagon.

**Minnesota.** The counties of Big Stone, Chippewa, Cottonwood, Faribault, Jackson, Kittson, Koochiching, Lac Qui Parle, Lincoln, Marshall, Martin, Murray, Norman, Pipestone, Red Lake, Redwood, Renville, Stevens, Traverse, Wilkin, and Yellow Medicine.

**Mississippi.** The counties of Adams, Coahoma, Humphreys, Montgomery, Quitman, Sharkey, Tallahatchie, and Washington.

**Missouri.** The counties of Atchison, Carroll, Chariton, Clark, Holt, Knox, Mississippi, New Madrid, Pemiscot, and Worth.

**Montana.** The counties of Carter, Daniels, Dawson, Deer Lodge, Fallon, Garfield, Hill, Liberty, McCone, Petroleum, Phillips, Powder River, Prairie, Richland, Roosevelt, Rosebud, Sheridan, Valley, and Wibaux.

**Nebraska.** The counties of Antelope, Banner, Boone, Box Butte, Boyd, Burt, Cedar, Chase, Deuel, Dundy, Fillmore, Franklin, Garden, Garfield, Greeley, Hayes, Hitchcock, Holt, Jefferson, Johnson, Logan, Nance, Nemaha, Nuckolls, Pawnee, Perkins, Red Willow, Richardson, Rock, Sheridan, Sherman, Thayer, Thomas, Valley, Webster, and Wheeler.

**Nevada.** The counties of Esmeralda, Lander, and Mineral.

**New Hampshire.** Coos County.

**New Mexico.** The counties of Harding and Quay.

**New York.** The counties of Clinton and Montgomery.

**North Dakota.** The counties of Adams, Barnes, Benson, Billings, Bottineau, Burke, Cavalier, Dickey, Divide, Dunn, Eddy, Emmons, Foster, Golden Valley, Grant, Griggs, Hettinger, Kidder, LaMoure, Logan, McHenry, McIntosh, McKenzie, McLean, Mercer, Mountrail, Nelson, Oliver, Pembina, Pierce, Ramsey, Ransom, Renville, Sargent, Sheridan, Slope, Stark, Steele, Stutsman, Towner, Traill, Walsh, Wells, and Williams.

**Ohio.** The counties of Crawford, Monroe, Paulding, Seneca, and Van Wert.

**Oklahoma.** The counties of Alfalfa, Beaver, Cimarron, Custer, Dewey, Ellis, Grant, Greer, Harmon, Harper, Kiowa, Major, Roger Mills, Seminole, Tillman, and Woodward.

**Pennsylvania.** The counties of Venango and Warren.

**South Carolina.** Marlboro County.

**South Dakota.** The counties of Aurora, Campbell, Clark, Day, Deuel, Douglas, Faulk, Grant, Gregory, Haakon, Hand, Harding, Hutchinson, Jones, Kingsbury, Marshall, McPherson, Miner, Perkins, Potter, Sanborn, Spink, Tripp, and Walworth.

**Texas.** The counties of Andrews, Bailey, Baylor, Borden, Briscoe, Brooks, Castro, Cochran, Coleman, Collingsworth, Cottle, Crane, Culberson, Deaf Smith, Dimmit, Eastland, Fisher, Floyd, Foard, Gray, Hall, Hardeman, Haskell, Hemphill, Hockley, Hutchinson, Kenedy, Kent, Knox, Lamb, Martin, McCulloch, Morris, Nolan, Oldham, Reagan, Reeves, Refugio, Roberts, Scurry, Stonewall, Terrell, Terry, Upton, Ward, Wheeler, Wilbarger, Winkler, Yoakum, and Zavala.

**Virginia.** The counties of Buchanan, Dickenson, Highland, and Lee and the independent cities of Clifton Forge, Covington, Norton, and Staunton.

**West Virginia.** The counties of Calhoun, Gilmer, Logan, McDowell, Mercer, Mingo, Summers, Tucker, Webster, Wetzel, and Wyoming.

**Wyoming.** The counties of Carbon and Niobrara.

# 2009 Workbook

## Individual Characteristics Form (ICF) Work Opportunity Tax Credit

U.S. Department of Labor  
Employment and Training Administration

1. Control No. (For Agency use only)	<b>APPLICANT INFORMATION</b> (See instructions on reverse)		OMB No. 1205-0371 Expiration Date: November 30, 2011 2. Date Received (For Agency Use only)
<b>EMPLOYER INFORMATION</b>			
3. Employer Name	4. Employer Address and Telephone	5. Employer Federal ID Number (EIN)	
<b>APPLICANT INFORMATION</b>			
6. Applicant Name (Last, First, MI)	7. Social Security Number.	8. Have you worked for this employer before? Yes ____ No ____  If YES, enter last date of employment: _____	
<b>APPLICANT CHARACTERISTICS FOR WOTC TARGET GROUP CERTIFICATION</b>			
9. Employment Start Date	10. Starting Wage	11. Position	
12. Are you at least age 16, but under age 40? If YES, enter your <i>date of birth</i> _____			Yes ____ No ____
13. Are you a Veteran of the U.S. Armed Forces? If NO, go to Box 14. If YES, are you a member of a family that received Food Stamps for at least 3 months during the 15 months before you were hired? If YES, enter name of <i>primary recipient</i> _____ and <i>city and state</i> where benefits were received _____. OR, are you a veteran entitled to compensation for a service-connected disability? If YES, were you discharged or released from active duty within a year before you were hired? OR, were you unemployed for a combined period of at least 6 months during the year before you were hired?			Yes ____ No ____  Yes ____ No ____  Yes ____ No ____  Yes ____ No ____
14. Are you a member of a family that received Food Stamps for the 6 months before you were hired? OR, received Food Stamps for at least a 3-month period within the last 5 months But you are no longer receiving them? If YES to either question, enter name of <i>primary recipient</i> _____ and <i>city and state</i> where benefits were received _____.			Yes ____ No ____  Yes ____ No ____

# 2009 Workbook

15. Were you referred to an employer by a Vocational Rehabilitation Agency approved by a State? <b>OR</b> , by an Employment Network under the Ticket to Work Program? <b>OR</b> , by the Department of Veterans Affairs?	Yes ___ No ___ Yes ___ No ___ Yes ___ No ___
16. Are you a member of a family that received TANF assistance for at least the last 18 months before you were hired? <b>OR</b> , are you a member of a family that received TANF benefits for <b>any</b> 18 months beginning after August 5, 1997, and the earliest 18-month period beginning after August 5, 1997, ended within 2 years before you were hired? <b>OR</b> , did your family stop being eligible for TANF assistance within 2 years before you were hired because a Federal or state law limited the maximum time those payments could be made? <b>If NO</b> , are you a member of a family that received TANF assistance for any 9 months during the 18 month period before you were hired? <b>If YES, to any question</b> , enter name of <i>primary recipient</i> _____ and the <i>city and state</i> where benefits were received _____.	Yes ___ No ___  Yes ___ No ___ Yes ___ No ___ Yes ___ No ___
17. Were you convicted of a felony or released from prison after a felony conviction during the year before you were hired? <b>If YES</b> , enter <i>date of conviction</i> _____ and <i>date of release</i> _____. <b>Was</b> this a Federal _____ or a State conviction _____? (Check one)	Yes ___ No ___   
18. Do you live in an Empowerment Zone or Renewal Community? <b>OR</b> , in a Rural Renewal County (RRC)? <b>If YES</b> , enter <i>name of the RRC</i> : _____	Yes ___ No ___ Yes ___ No ___
19. Did you receive Supplemental Security Income (SSI) benefits for any month ending within 60 days before you were hired?	Yes ___ No ___
20. Sources used to document eligibility: ( <b>Employers/Consultants:</b> List all documentation provided or forthcoming. <b>SWAs:</b> List all documentation used in determining target group eligibility and enter your initials and date when determination was made.)	
<p><b>I certify that this information is true and correct to the best of my knowledge. I understand that the information above may be subject to verification.</b></p>	
21(a). Signature: (See instructions for Box 21 for who signs this signature block)	21. (b) Indicate with a ✓ who signed the form: <input type="checkbox"/> Employer, <input type="checkbox"/> Consultant, <input type="checkbox"/> SWA, <input type="checkbox"/> Participating Agency, <input type="checkbox"/> Applicant, or <input type="checkbox"/> Parent/Guardian (if applicant is a minor)  22. Date:



**INSTRUCTIONS FOR COMPLETING THE INDIVIDUAL CHARACTERISTICS FORM (ICF), ETA 9061.** This form is used together with IRS Form 8850 to help state workforce agencies (SWAs) determine eligibility for the Work Opportunity Tax Credit (WOTC) Program. The form may be completed, on behalf of the applicant, by: 1) the employer or employer representative, the SWA, a participating agency, or by 2) the applicant directly (if a minor, the parent or guardian must sign the form) and signed by the individual completing the form. This form is required to be used, without modification, by all employers (or their representatives) seeking WOTC certification.

Boxes 1 and 2. **SWA.** For agency use only.

Boxes 3-5. **Employer Information.** Enter the name, address including ZIP code, telephone number, and employer Federal ID number (EIN) of the employer requesting the certification for the WOTC. Do not enter information pertaining to the employer's representative, if any.

Boxes 6-11. **Applicant Information.** Enter the applicant's name and social security number as they appear on the applicant's social security card. In Box 8, indicate whether the applicant previously worked for the employer, and if Yes, enter the last date or approximate last date of employment. This information will help the "48-hour" reviewer to, early in the verification process, eliminate requests for former employees and to issue denials to these type of requests, or certifications in the case of "qualifying rehires" during valid "breaks in employment" (see pages III-12 and III-13, Nov. 2002, Third Ed., ETA Handbook 408) during the first year of employment.

Boxes 12-19. **Applicant Characteristics.** Read each question carefully, answer each question, and provide additional information where requested.

Box 20. **Sources to Document Eligibility.** The applicant or employer is requested to provide documentary evidence to substantiate the **YES** answers on page 1. List or describe the documentary evidence that is attached to the ICF or that will be provided to the SWA. Indicate in parentheses next to each document listed whether it is attached (A) or forthcoming (F). Some examples of acceptable documentary evidence are provided below. A letter from the agency that administers a relevant program may be furnished specifically addressing the question to which the applicant answered YES. For example, if an applicant answers YES to either question in Box 14 and enters the name of the primary recipient and the city and state in which the benefits were received, the applicant could provide a letter from the appropriate Food Stamp agency stating to whom Food Stamp benefits were paid, the months for which they were paid, and the names of the individuals included on the grant for each month. SWAs will use this box to document the sources used when verifying target group eligibility, followed by their initials and the date the determination was completed.

**Examples of Documentary Evidence and Collateral Contacts. Employers/Consultants:** You may check with your SWA to find out what other sources you can use to prove target group eligibility. (You are encouraged to provide copies of documentation or names of collateral contacts for each question for which you answered **YES**.)

## QUESTION 12

- Birth Certificate
- Driver's License
- School I.D. Card\*
- Work Permit\*
- Federal/State/Local Gov't I.D.\*
- Copy of Hospital Record of Birth

## QUESTION 13

- SSI Record or Authorization
- DD-214
- Reserve Unit Contacts
- Discharge Papers

## QUESTIONS 14 & 16

- TANF/Food Stamp Benefit History
- Signed Statement from Authorized Individual with Specific Description of the Months Benefits Were Received
- Case Number Identifier

## QUESTION 15

- Vocational Rehabilitation Agency Contact
- Veterans Administration
- Signed Statement from Authorized Individual With Specific Description of Months Benefits Received
- **For SWAs:** To determine *Ticket Holder* (TH) eligibility, Fax page 1 of Form 8850 to MAXIMUS to 703-683-1051 to verify if applicant:
  - 1) is a TH, and 2) has an Individual Work Plan from and Employment Network.

## QUESTION 17

- Parole Officer's Name or Statement
- Correction Institution Records
- Court Records Extracts

## QUESTION 18

- Driver's License
- Work Permit
- Utility Bills
- W-4
- Lease Papers
- Library Card\*\*
- Voter Registration Card
- Food Stamp Award Letter
- Selective Service Registration Card
- To determine if a Designated Community Resident lives in a RRC, visit the site: [www.usps.com](http://www.usps.com). **Click on Find Zip Code; Enter & Submit Address/Zip Code; Click on Mailing Industry Information; Download and Print the Information,** then compare the county of the address to the list in the June 2007 Instructions to IRS 8850.

## QUESTION 19

- SSI Record or Authorization
- SSI Contact
- Evidence of SSI Benefits

**Notes.** 1. Where a Federal/State/Local Gov't., School I.D. Card, or Work Permit does not contain age or birth date, another valid document must be obtained to verify an individual's age.

2. Where a Library Card does not contain the holder's address another document, issued in the jurisdiction where the EZ/RC or RR County is located, must be obtained showing the holder's address.

3. ESPL No. 05-98, dated 3/18/98, officially rescinded the authority to use Form I-9 as proof of age and residence. **Therefore, the I-9 is no longer a valid piece of documentary evidence.**

# 2009 Workbook

Box 21: **Signature.** The person who completes the form signs the signature block. Options: (a) Employer or Authorized Representative, (b) SWA staff, (c) Participating Agency staff, or (d) Applicant (If applicant is a minor, the parent or guardian must sign).

Box 22: **Date.** Enter the month, day and year when the form was completed.

---

Persons are not required to respond to this collection of information unless it displays a currently valid OMB Control Number. Respondent's obligation to reply to these questions is required to obtain and retain benefits per law 104-188. Public reporting burden for this collection of information is estimated to average 20 minutes per response including the time for reading instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing burden to the U.S. Department of Labor, Employment and Training Administration, Division of Adult Services, Room S-4209, Washington, D.C. 20210 (Paperwork Reduction Project Control No. 1205-0371).

---

..... ✂ .....  
(Cut along dotted line and keep in your files)

**TO: THE JOB APPLICANT OR EMPLOYEE,**

THE INFORMATION AND THE SUPPORTING DOCUMENTATION YOU HAVE PROVIDED IN COMPLETING THIS FORM —OR IN SOME CASES OTHER INFORMATION THAT COULD VERIFY THE RESPONSES YOU HAVE GIVEN TO THE ITEMS/QUESTIONS IN THIS FORM— WILL BE DISCLOSED BY YOUR EMPLOYER TO THE STATE WORKFORCE AGENCY (SWA). ENTER THE SWA's NAME BELOW:

\_\_\_\_\_  
\_\_\_\_\_  
  
IN ORDER TO QUALIFY FOR A FEDERAL EMPLOYER TAX CREDIT, PROVISION OF THIS INFORMATION IS VOLUNTARY. HOWEVER, THE INFORMATION IS REQUIRED FOR YOUR EMPLOYER TO RECEIVE THE FEDERAL TAX CREDIT. IF THE INFORMATION YOU PROVIDE IS ABOUT A MEMBER OF YOUR FAMILY, YOU SHOULD PROVIDE HIM/HER A COPY OF THIS NOTICE.

## CALCULATING THE CREDIT

The tax preparer must know how many hours each person worked, the employee's hire date, wages paid during the year to each employee, and in which group the employee was certified before completing Form 5884, *Work Opportunity Credit*.

Wages for purposes of the credit include all compensation included as wages for federal unemployment tax (FUTA) purposes. For those agricultural workers whose wages are not subject to federal unemployment tax, the definition of wages under FUTA is used even if the employment is exempt.<sup>107</sup>

The wages must be reduced by any federally-funded on-the-job training and work support payments. An employee's wages only qualify for the credit if more than 50% of that person's wages is for services performed in a trade or business of the employer. Therefore, earnings of primarily household employees do not qualify.<sup>108</sup>

Generally, the credit is **40%** of the applicable wages. However, if the employee has worked less than 400 hours for the employer,<sup>109</sup> the credit is limited to **25%** of the applicable wages. If the employee is a member of the LFA group, the second year wages qualify for a **50%** credit. For all other target groups, only the wages paid for work performed during the **1-year period beginning on the date the individual begins to work for the company** qualify for the credit.

The maximum amount of wages that can be included for each individual in each group is shown below:

Summer youth	\$ 3,000 <sup>110</sup>
Disabled veterans	12,000 <sup>111</sup>
LFA 1st year wages	10,000 <sup>112</sup>
LFA 2nd year wages	10,000 <sup>113</sup>
All others	6,000 <sup>114</sup>

After calculating the amount of the credit, the deduction for wages paid must be reduced by the amount of the credit.<sup>115</sup>

<sup>107</sup>. IRC §51(h)(1)(A).

<sup>108</sup>. IRC §51(f)(1).

<sup>109</sup>. House Report 111-016, see full cite above.

<sup>110</sup>. IRC §51(d)(7)(B)(2).

<sup>111</sup>. IRC §51(b)(3).

<sup>112</sup>. IRC §51(e)(1)(B).

<sup>113</sup>. Ibid.

<sup>114</sup>. IRC §51(b)(3).

<sup>115</sup>. IRC §280C(a).

# 2009 Workbook

**Example 11.** Michael Milking owns a consulting company, EF Advisors, Inc. As an ex-felon, he is dedicated to hiring people who need a second chance. He gives his accountant the following information about his 2009 employees.

Name	Certified Group	Hire Date	2009 Wages Paid	Hours Worked	Additional Information
Opie Taylor	Summer youth	5/2/2009	\$ 4,000	300	No wages paid after 09/01/09
Hawk Pearse	Unemployed veteran	8/1/2009	15,000	680	
Bob Doel	Disabled veteran	6/30/2008	20,000	1,000	2008 wages used for credit: \$5,000 2009 wages paid for services through 6/29: \$4,000
James Deen	Disconnected youth	8/25/2009	800	100	No longer employed
Jack Abramout	Ex-felon	12/15/2009	10,000	80	Still employed, has completed 400 hours of service as of March 1, 2010
Britnia Speres	Long-term family assistance	7/1/2009	15,000	1,000	2008 wages used for credit: \$8,000 2009 wages paid for services through 6/30: \$6,000 2009 wages paid for services after 6/30: \$9,000

EF Advisors' tax preparer uses the information above to determine the amounts of qualified wages paid for the WOTC credit.

**Step 1.** The preparer first looks for employees who do not qualify for the credit. She determines that James Deen's wages do not qualify because he worked less than 120 hours for the company. However, she finds that Jack Abramout's wages are **not disqualified** because he worked more than 120 hours during his first year of employment, even though only 80 hours were in 2009.

**Step 2.** She looks for employees who qualify for less than the full credit because they worked less than 400 hours. She determines that Opie Taylor falls in this category. She also notices that Opie is also a summer youth employee, so the maximum amount of wages that can be used for the credit is \$3,000. Since Opie is the only employee in the under 400 hours category, she enters \$3,000 before line 1a on Form 5884.

She determines that Jack Abramout does not fall into this category because he has worked for the company more than 400 hours during his first year of employment. This is true even though only 80 of the hours were in 2009.

**Step 3.** She divides the remaining employees into first year and second year categories, and then she calculates the amount of qualifying wages for each employee as shown in the following table. She enters the corresponding totals before Lines 1b and 1c on Form 5884.

## First Year Wages

Employee	Total Wages	Qualifying Wages	Reason
Hawk Pearse	\$15,000	\$ 6,000	Maximum qualifying wages for non-disabled veterans
Bob Doel	20,000	4,000	There was \$7,000 of the \$12,000 cap remaining for disabled veterans after \$5,000 was used in 2008. However, only wages paid during the first year of service qualify for the credit.
Jack Abramout	10,000	6,000	Maximum qualifying wages for ex-felons
Britnia Speres	15,000	2,000	Maximum first year qualifying wages for LFA recipients is \$10,000. Of this, \$8,000 was used in 2008. The \$2,000 remaining is less than the \$6,000 paid during the first year of service.
<b>Total before Line 1b</b>		<b>\$18,000</b>	

## Second Year Wages

Employee	Total Wages	Qualifying Wages	Reason
Britnia Speres	\$15,000	\$9,000	Maximum second year wages for LFA recipients is \$10,000. However, she only received \$9,000 during the period which includes her 2nd year. Note that for 2010, \$1,000 of her wages earned prior to July will qualify as second year wages.
<b>Total before Line 1c</b>		<b>\$9,000</b>	

**Step 4.** The preparer's computer software calculates the credit based on her entries. The completed Form 5884 is shown next. The \$12,450 credit is entered on Form 3800, *General Business Credit*.

**Step 5.** The preparer reduces the amount of deductible wages by the \$12,450 credit.

# 2009 Workbook

Form **5884**

Department of the Treasury  
Internal Revenue Service

## Work Opportunity Credit

► Attach to your tax return.

OMB No. 1545-0219

**2009**

Attachment  
Sequence No. **77**

Name(s) shown on return

**EF Advisors, Inc.**

Identifying number

**01-9999999**

**1** Enter on the applicable line below the total qualified first- or second-year wages paid or incurred during the tax year, and multiply by the percentage shown, for services of employees who are certified (if required) as members of a targeted group.

**a** Qualified first-year wages of employees who worked for you at least 120 hours but fewer than 400 hours . . . . . \$ **3,000** × 25% (.25) **1a** **750**

**b** Qualified first-year wages of employees who worked for you at least 400 hours . . . . . \$ **18,000** × 40% (.40) **1b** **7,200**

**c** Qualified second-year wages of employees certified as long-term family assistance recipients . . . . . \$ **9,000** × 50% (.50) **1c** **4,500**

**2** Add lines 1a, 1b, and 1c. See instructions for the adjustment you must make to salaries and wages **2** **12,450**

**3** Work opportunity credit from partnerships, S corporations, cooperatives, estates, and trusts **3**

**4** Add lines 2 and 3. Partnerships and S corporations, report this amount on Schedule K; all others, go to line 5 **4** **12,450**

**5** Work opportunity credit included on line 4 from passive activities (see instructions) **5**

**6** Subtract line 5 from line 4 **6** **12,450**

**7** Work opportunity credit allowed for 2009 from a passive activity (see instructions) **7**

**8** Carryforward of any work opportunity credit that originated in a tax year that began after 2006 and carryforward from 2008 of the New York Liberty Zone business employee credit **8**

**9** Carryback of the work opportunity credit from 2010 (see instructions) **9**

**10** Add lines 6 through 9. Cooperatives, estates, and trusts, continue on to line 11. All others, report this amount on Form 3800, line 29b **10** **12,450**



## ELECTION TO NOT CLAIM THE CREDIT<sup>116</sup>

Taking the credit is not mandatory. The employer has three years from the due date of the return, including extensions, to elect the credit or revoke a previous election. However, situations in which the credit is less advantageous than the deduction are rare.

**Example 12.** Recession Proof Alliance is a calendar-year C corporation. In 2007, it had a very profitable year and incurred a significant tax liability. In 2008, it incurred a small net operating loss, which was carried back to 2006. In 2009, it also has a small net operating loss, which is carried back to 2007.

In 2009, the company realizes it is in the middle of a designated community. For every new hire, the HR department obtains the appropriate certification. The tax preparer dutifully calculates the WOTC and files Form 5884 with the tax return. Since the company has a loss in 2009, there is no income tax to apply the credit against. There was also no 2008 tax, so the entire WOTC credit is carried forward to 2010.

In 2012, the accountant realizes that the company is amassing a significant amount of WOTC credit carryforward. He estimates that the company will never again pay federal income taxes.

Based on this assumption, he amends the 2009 return to revoke the credit. After revoking the credit, the deductible wages are increased, which increases the amount of the NOL carried back to 2007.

## TREATMENT OF SUCCESSOR EMPLOYERS<sup>117</sup>

In the case of an employer determined to be a successor employer for federal unemployment tax purposes,<sup>118</sup> the successor employer may continue to claim the credit for employees who were certified by the predecessor employer without recertification.

## CONTROLLED GROUPS<sup>119</sup>

Employees of corporations that are members of the same controlled group are treated as being employed by a single employer. The WOTC for each corporation is based on its proportionate share of the wages giving rise to the credit. A controlled group for this purpose is defined under IRC §1563(a) except “more than 50%” is substituted for “at least 80%” each place it appears in §1563(a)(1) and subsections (a)(4) and (e)(3)(C) are disregarded.

**Note.** For more information about controlled groups, see Chapter 8, Related Parties.

Employees of partnerships, proprietorships, etc., which are under common control, are treated as being employed by a single employer. Each business’s portion of the WOTC credit is based on its proportionate share of the wages giving rise to the credit. See Treas. Reg. §1.52-1 for more information on common control of noncorporate businesses.

<sup>116</sup>. IRC §51(j).

<sup>117</sup>. IRC §51(k)(1).

<sup>118</sup>. See IRC §3306(b)(1).

<sup>119</sup>. IRC §52.



## ISSUE 6: DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

**Note.** The 2005 and 2006 *University of Illinois Federal Tax Workbooks* each contain an entire chapter on the IRC §199 deduction. These can be found on the CD that accompanies this workbook.

The domestic production activities deduction (DPAD) is also known as the manufacturer's deduction. However, manufacturing is a misnomer because many industries, which are not generally thought of as manufacturing, also qualify for the deduction.

For 2009, the deduction is equal to **6%** of the qualified income. However, it is limited to **50% of the W-2 wages** paid by the activity. For 2010, the deduction will be equal to **9%** of the qualified income. The potential tax savings for businesses is significant.

**Note.** In March 2009, President Obama created a tax-code review task force aimed at closing loopholes, streamlining the Code, and raising revenues.<sup>120</sup> One of the anticipated recommendations is the complete elimination of DPAD.<sup>121</sup> The deadline for the committee's report is December 2009.

The DPAD for oil and gas production is already limited to a lower percentage deduction than other industries. According to an internal IRS memo dated December 6, 2006, *Industry Director Directive on Domestic Production Deduction (DPD)*, DPAD was expected to cost the U.S. Treasury \$76 billion over the first 10 years of its life.<sup>122</sup>

For businesses with a single line of products or services, the computation of the deduction is simple. The 2009 deduction is the smallest of:

- 6% of the net profit from qualified activities,
- 6% of taxable income for C corporations or AGI for individuals, or
- 50% of W-2 wages related to qualified activities.

Pass-through entities, such as partnerships and S corporations, do not take the deduction directly. The components of the deduction are passed through to the owners who may qualify for the deduction based on the totality of their returns.

<sup>120</sup>. *Obama Asks Volcker to Lead Panel on Tax-Code Overhaul (Update4)*. Runningen, Roger, and Donmoyer, Ryan J. Mar. 25, 2009. Bloomberg L.P. [www.bloomberg.com/apps/news?sid=a8yCQsJfpb24&pid=20601087] Accessed on June 15, 2009.

<sup>121</sup>. "Obama will push for tax reform next year." (2009, Apr. 17). *Kiplinger Tax Letter*, Vol. 84, No. 8, p. 1.

<sup>122</sup>. *Industry Director Directive on Domestic Production Deduction (DPD)*. Henry V. Singleton, Industry Director, Heavy Manufacturing and Transportation. December 6, 2006, last updated Oct. 17, 2008. Internal Revenue Service. [www.irs.gov/businesses/article/0,,id=164979,00.html] Accessed on May 26, 2009.

## IRC §199(C)

The language which defines the activities qualifying for the deduction is shown below (emphasis added):

*(4) Domestic production gross receipts. —*

**(A) In general.** — *The term "domestic production gross receipts" means the gross receipts of the taxpayer which are derived from —*

**(i) any lease, rental, license, sale, exchange, or other disposition of —**

**(I) qualifying production property which was *manufactured, produced, grown, or extracted* by the taxpayer in whole or in significant part *within the United States*,**

**(II) any qualified *film* produced by the taxpayer, or**

**(III) *electricity, natural gas, or potable water produced* by the taxpayer in the United States,**

**(ii) *construction* performed in the United States, or**

**(iii) *engineering or architectural* services performed in the United States for construction projects in the United States.**

**(B) Exceptions.** — *Such term shall not include gross receipts of the taxpayer which are derived from —*

**(i) the sale of food and beverages prepared by the taxpayer at a retail establishment, and**

**(ii) the transmission or distribution of electricity, natural gas, or potable water.**

**(5) Qualifying production property.** — *The term "qualifying production property" means —*

**(A) tangible personal property,**

**(B) any computer software, and**

**(C) any property described in section 168(f)(4). (sound recordings)**

## ACTIVITIES THAT MAY QUALIFY FOR THE DPAD

Not all of the activities of a business have to qualify for the deduction. However, the deduction must be calculated only on the aspects of the business that do qualify. The following list is meant to show how many different types of business activities can qualify for the deduction. The list is not exhaustive.

- Traditional manufacturing
  - ♦ Processing
  - ♦ Manipulating
  - ♦ Refining
  - ♦ Installing
  - ♦ Developing
  - ♦ Creating
  - ♦ Combining
  - ♦ Assembling
- Farming
  - ♦ Cultivating soil
  - ♦ Raising livestock
  - ♦ Growing produce
  - ♦ Fishing
  - ♦ Storing, handling, and processing agricultural products
- Mining or extracting
- Software developing
  - ♦ Off-the-shelf software
  - ♦ Downloadable software

- Construction
  - ♦ Residential
  - ♦ Commercial
  - ♦ Swimming pools
  - ♦ Parking lots
  - ♦ Wells
  - ♦ Platforms
  - ♦ Pipelines
  - ♦ Roads
- Sewers
- Sidewalks
- Power lines
- General contracting
- ♦ **Exclusions** — repairs & maintenance
  - Construction-related architectural services
  - Construction-related engineering
  - Music recording
  - Film production

## ACTIVITIES THAT GENERALLY DO NOT QUALIFY FOR THE DPAD

In general, the following business pursuits are **not** considered qualifying activities:

- Accounting and law services
- Restaurants and bars
- Retail outlets
- Transportation of goods
- Transmission of utilities
- Most services
- Advertising and product placement
- Activities involving related parties
- Activities involving the lease, sale, etc. of land
- Packaging, repackaging, labeling, or minor assembly

## GROSS RECEIPTS FROM QUALIFYING ACTIVITIES

The first step in determining gross receipts for purposes of the DPAD is to separate the business's receipts into qualifying and nonqualifying activities. Many businesses with qualifying activities also have receipts from other activities.

**Example 13.** American Heating & Air installs HVAC units in newly constructed buildings. The company also replaces HVAC in existing homes and performs routine maintenance and repairs. The units placed in newly constructed buildings qualify under the construction category, but the repair work on existing units does not.

Once the qualifying and nonqualifying revenues have been separated, the related cost of goods sold (COGS) and other expenses must also be allocated between the two categories. There are several **safe harbor** methods of allocating expenses.

## SAFE HARBOR METHODS OF ALLOCATING EXPENSES

### Small Business Simplified Overall Method (SBSOM)<sup>123</sup>

This method is available to small businesses with 3-year average annual gross receipts of \$5 million or less that are eligible to use the cash basis of accounting.

Under this method, the taxpayer's expenses are allocated to the activities based on the proportion of qualifying income to nonqualifying income.

---

<sup>123</sup>. Treas. Reg. §1.199-4(f).

**Example 14.** Bryan owns a small farm in the country and a rental house in town. All of his farm income is from qualifying production activities. By definition, all of his rental income is nonqualifying. The farm grossed \$90,000 and the rental \$10,000. His total gross receipts are \$100,000. The farm receipts are 90% of his gross receipts.

Using SBSOM, 90% of his total farm and rental expenses are allocated to the farm income to determine his net income from qualifying activities.

## Simplified Deduction Method (SDM)<sup>124</sup>

This method is available to taxpayers who meet **either** of the following tests:

1. Average annual gross receipts from the last three years of \$100 million or less
2. Total business assets at the end of the tax year of \$10 million or less

Under this method, COGS is directly allocated to the related activity, but all other expenses are allocated to the activities based on the proportion of qualifying income to nonqualifying income.

**Example 15.** Filips Factory, a C corporation, manufactures machine tools. The company also provides repair services.

In 2009, the company had the following income and expenses.

	Tools	Repairs	Total
Sales	\$80,000 (80%)	\$20,000 (20%)	\$100,000
COGS	(40,000)	(15,000)	(55,000)
Gross income	\$40,000	\$ 5,000	\$ 45,000
Other expenses			\$30,000

The accountant allocates 80% of the other expenses to the tools activity to determine the company's net income from qualifying activities.

	Tools	Repairs	Total
Gross income	\$40,000	\$5,000	\$45,000
Other expenses	(24,000) (80% of \$30k)	(6,000) (20% of \$30k)	(30,000)
Net income	\$16,000	(\$1,000)	\$15,000

**Note.** If Filips used SBSOM instead of SDM, \$68,000 of the total expenses (\$55,000 COGS + \$30,000 other = \$85,000 × 80%) would be allocated to the tools activity. The net income from the manufacturing activity would only be \$12,000 (\$80,000 – \$68,000) instead of \$16,000.

<sup>124</sup>. Treas. Reg. §1.199-4(e).

## CALCULATING THE DEDUCTION

The cost accounting necessary to properly allocate transactions can be time consuming and complicated for taxpayers with both qualifying and nonqualifying activities. However, the computation of the deduction is rather simple. The deduction is calculated on Form 8903, *Domestic Activities Deduction*.

As stated previously, the 2009 deduction is the **smallest** of:

- 6% of the net profit from qualified activities,
- 6% of taxable income for C corporations or AGI for individuals, or
- 50% of W-2 wages related to qualified activities.

**Example 16.** Use the same facts as **Example 15**. For 2009, Filips's W-2 wages related to tool manufacturing are \$50,000.

The DPAD is the smallest of:

6% of net tool profit	$\$16,000 \times 6\% = \$$	960
6% of taxable income	$15,000 \times 6\% =$	900
50% of W-2 wages	$50,000 \times 50\% =$	25,000

**Tax Result for Example 16.** Filips's 2009 DPAD is \$900.

**Note.** The regulations governing the DPAD are complex. If the taxpayer's business is multifaceted, practitioners are advised to consult the final regulations, Treas. Regs. §§1.199-0 through -8, and the instructions for Form 8903, *Domestic Production Activities Deduction*. If the deduction is significant, practitioners may also want to review the Industry Director Directives, which give guidance to IRS auditors. The directives are published on the IRS website at [www.irs.gov/businesses/corporations/article/0,,id=200593,00.html](http://www.irs.gov/businesses/corporations/article/0,,id=200593,00.html).

Additional information on the IRC §199 deduction can be found in Chapter 12, Agricultural and Rural Investment Issues.