# Chapter 11: Small Business Issues

Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

## ISSUE 1: NEW TAX LAWS AFFECTING SMALL BUSINESSES

Legislation passed in 2010 contained a number of provisions affecting small businesses. Although the following provisions are covered extensively in Chapter 12, **New Legislation,** they are listed below as a quick reference.

### 2010 HEALTH CARE REFORM ACTS

The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act of 2010 (HCERA) include many significant tax provisions. Some of those affecting small businesses are:

### New Tax Credits

- **A tax credit for businesses with 25 or fewer employees who provide health insurance to their employees for tax years beginning after 2009**
- An investment credit for qualifying therapeutic discovery projects for companies with 250 or fewer employees for tax years beginning **after 2008**
- Modification of cellulosic biofuel producer credit for fuels sold or used **after 2009**

### Changes to Cafeteria and FSA Plans

- An expansion of tax-free health coverage to include employees' children who are less than 27 years old beginning **in 2010**
- An increase of $1,000 in the maximum exclusion **for 2010** on the amount of employer-provided adoption assistance to $13,170 per eligible child
- A new SIMPLE **cafeteria** plan for years beginning **after 2010**
- A restriction on distributions from health accounts (HRAs, health FSAs, HSAs, and Archer MSAs) disallowing payments for nonprescription drugs and medicine **after 2010**
- A new limit of $2,500 for the amount of salary-reduction contributions that an employee may elect to make to a health FSA **after** 2012

### New Excise Taxes

- A 10% excise tax on the amount each individual pays for indoor tanning services **starting July 1, 2010**
- A 2.3% excise tax on medical device manufacturers for sales **after December 31, 2012**
- An excise tax starting **in 2014** on businesses with 50 or more full-time employees that fail to offer health insurance
- A 40% excise tax on high-cost employer-sponsored health coverage for tax years beginning **after 2017**

### Reporting Requirements

- A requirement to disclose on each employee's **2011** Form W-2 the value of the employee's health insurance coverage
- An expansion of **Form 1099 reporting requirements to include corporations** for payments made **in 2012** and later years
- A requirement to file Form 1099 for all property purchases of $600 or more made **in 2012 and later years**

**Note.** Businesses are vehemently opposed to the new Form 1099 reporting requirements. In response, Congress is seriously considering a repeal of the reporting requirements.

- A requirement to report to full-time employees and to the IRS certain information about the employees' health insurance coverage for tax years beginning **after 2013**

### Penalties and Other Provisions

- For employers with 50 or more full-time equivalent employees, a penalty for failing to provide sufficient levels of health coverage beginning **after 2013**
- A requirement that **after 2013**, employers paying for certain types of coverage must provide qualified employees who do not participate in the plan with a voucher whose value can be applied to purchase health plan coverage through a state exchange
- Additional 0.9% Medicare tax on high-income wages and SE income for tax years beginning **after 2012**

## HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT

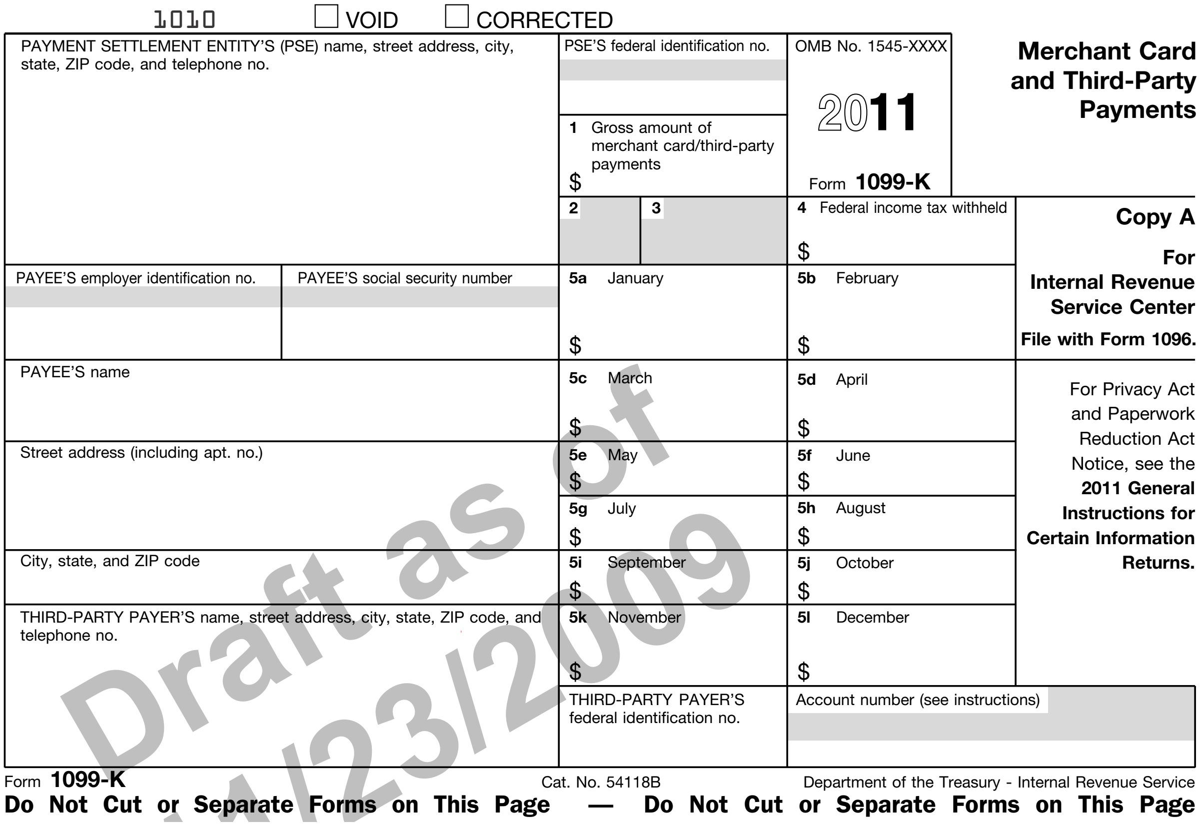
The most significant provisions of the Hiring Incentives to Restore Employment Act that affect small businesses encourage the hiring of unemployed workers and extend IRC §179 limits:

- The employer's portion of FICA payroll taxes is eliminated for wages paid to **qualifying** employees from March 19, 2010, through December 31, 2010.
- A general business tax credit of up to $1,000 is allowed for each **qualified** employee employed for at least 52 consecutive weeks who is hired after February 3, 2010, and before January 1, 2011.
- The IRC §179 deduction limit of $250,000 is extended for tax years beginning in 2010. The investment limitation of $800,000 is also extended.

## ISSUE 2: 1099 REPORTING BY CREDIT AND DEBIT CARD COMPANIES

For 2011 transactions, the Housing Assistance Tax Act of 2008 added a new information reporting requirement.[1] Companies that process credit and debit card payments must report the total amount paid to merchants to the IRS. This requirement also applies to other third-party settlement organizations, such as PayPal. In this chapter, payment processors are referred to as **payment settlement entities (PSEs).**

The IRS created a new form, Form 1099-K, *Merchant Card and Third-Party Payments*, that is used solely for reporting these transactions.[2] Note that on the following draft of Form 1099-K, **total yearly** payments must be shown in box 1 **and payments by month** in boxes 5a to 5l.



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| | | | | |
|---|---|---|---|---|
| PAYMENT SETTLEMENT ENTITY'S (PSE) name, street address, city, state, ZIP code, and telephone no. | | PSE'S federal identification no.<br>1 Gross amount of merchant card/third-party payments<br>$ | OMB No. 1545-XXXX<br>2011<br>Form **1099-K** | **Merchant Card and Third-Party Payments** |
| | | 2<br>3 | 4 Federal income tax withheld<br>$ | **Copy A**<br>**For Internal Revenue Service Center**<br>**File with Form 1096.** |
| PAYEE'S employer identification no. | PAYEE'S social security number | **5a** January<br>$ | **5b** February<br>$ | |
| PAYEE'S name | | **5c** March<br>$ | **5d** April<br>$ | For Privacy Act and Paperwork Reduction Act Notice, see the **2011 General Instructions for Certain Information Returns.** |
| Street address (including apt. no.) | | **5e** May<br>$ | **5f** June<br>$ | |
| | | **5g** July<br>$ | **5h** August<br>$ | |
| City, state, and ZIP code | | **5i** September<br>$ | **5j** October<br>$ | |
| THIRD-PARTY PAYER'S name, street address, city, state, ZIP code, and telephone no. | | **5k** November<br>$ | **5l** December<br>$ | |
| | | THIRD-PARTY PAYER'S federal identification no. | Account number (see instructions) | |

Form **1099-K** Cat. No. 54118B Department of the Treasury - Internal Revenue Service

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In December 2009, the IRS issued a proposed regulation and request for comments regarding this new reporting requirement.[3] The regulations were finalized on August 13, 2010.[4]

**It may be advisable for businesses to change their bookkeeping methods at the beginning of 2011 to prepare for these changes.** These changes affect both companies that issue Forms 1099 to their vendors and companies that accept third-party settlement payments from PSEs.

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[1] IRC §6050W.

[2] Prop. Treas. Reg-139255-08, 2009-49 IRB 747.

[3] Ibid.

[4] TD 9496.

**1.** Payments made through PSEs are reportable by the PSEs and **not** the parties that made the initial payments.

> **Example 1.** Jordan LaForge, a sole proprietor, charges Enterprise Collectibles $800 to repair its furnace. On January 31, 2011, Enterprise pays Jordan for the service using a company credit card.
>
> Previously, Enterprise would have been required to report this payment as nonemployee compensation on Form 1099-MISC, *Miscellaneous Income*. **Starting with 2011 transactions, Enterprise will not report this payment.** Jordan's PSE will report the payment on Form 1099-K.

**2.** The reportable amount includes **all** payment transactions for each recipient **without adjustments** for credits, cash equivalents, discount amounts, fees, refunded amounts, or any other amounts. There is no distinction between payments related to trade or business and personal.

> **Example 2.** Jordan, from **Example 1**, receives $776 from the PSE after it processes the $800 credit card payment from Enterprise. The PSE must include the entire $800 in box 1 on the 2011 Form 1099-K.

**3.** The reportable amounts are subject to **backup withholding** requirements.[5] PSEs must withhold 28% of the gross payments made after December 31, **2011,** if the merchant fails to provide a correct tax identification number (TIN). PSEs are allowed to verify TINs against the name/TIN combination contained in the IRS's database.

**4.** There is a **de minimis exception** to the reporting requirements. A PSE is only required to report on merchants who:

- **a.** Receive more than $20,000 from the PSE; **and**
- **b.** Process more than 200 transactions through the PSE.

**5.** A company that receives payments from a PSE on behalf of other payees and then distributes those payments to the other payees will **receive** a Form 1099-K from the PSE **and issue** Forms 1099-K to the ultimate recipients of the payments.

> **Example 3.** Merle Borman Cosmetics processes credit card payments on behalf of its independently-owned franchise stores. The bank that pays the main corporate entity issues a Form 1099-K to Merle Borman Cosmetics. Borman then issues Forms 1099-K to each of its franchise owners.

### Observations

1. To avoid duplicate reporting, the initial payers must be able to separate their disbursement records by payment method. However, some payers will not make this distinction when they prepare Forms 1099-MISC. Taxpayers should design their bookkeeping records to facilitate reconciliation.
2. Some taxpayers report only the net deposits from PSEs as gross receipts. It will be easier to reconcile Form 1099-K income if taxpayers revise their bookkeeping methods to include the gross amounts in income. Processing fees, discounts, and refunds should be tracked separately as expenses.
3. PSEs have been allowed to use the IRS's TIN matching program since July 30, 2008, to verify TINs. The IRS hopes that this will reduce the number of TIN errors and the number of required backup withholding notices before the new reporting requirements become effective in 2011.[6]

**Observation.** Some PSEs may report on all merchants rather than filter their databases for the exceptions.

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[5] IRC §3406(b)(3).

[6] IRS Ann. 2009-6, 2009-9 IRB 643.

## ISSUE 3: CREDIT CARD INCENTIVES

### BACKGROUND

The credit card industry is extremely competitive. Credit card companies may send out 50,000 solicitations to get 1,000 completed applications.[7] After the costs of evaluating applicants and processing new accounts are added, it can cost a credit card company $100 to obtain each new customer.[8]

It takes two years on average for the profit generated by a new customer to offset the costs of obtaining the client. The longer a customer stays with the company, the greater the annual profit created by that customer.[9] One analyst estimates that an increase of just 5% in the customer retention rate increases the average value of each customer by 75%.[10]

In order to obtain and retain loyal customers, many credit card companies offer incentives to users of their cards. Credit card holders may receive cash rebates or points to use for products or services. The tax implications of these programs vary based on the type of incentives offered.

### IN-KIND INCENTIVES

The official position of the IRS is that it will **not** pursue tax on **in-kind** promotional benefits attributable to the taxpayer's business.[11] In-kind benefits include the following:

- Free travel
- Upgraded seating
- Discounted travel
- Travel-related services
- Merchandise

### CASH INCENTIVES

Promotional benefits attributable to a taxpayer's business that are **converted to cash** reduce the basis of the items purchased.[12]

> **Example 4.** Quirk Frengy is a sole proprietor who deals in rare coins. He uses his Lithium Universal credit card to purchase a new impenetrable wall safe for $20,000. The credit card company pays a 5% cash back bonus on the amount charged to his account. Quirk must reduce his basis in the safe by the $1,000 (5% of $20,000) he receives.

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[7] Frederick F. Reichheld, *The Loyalty Effect*, 42 (Harvard Business School Press 1996).

[8] Ibid.

[9] Reichheld, p. 50.

[10] Reichheld, p. 56.

[11] IRS Ann. 2002-18, 2002-1 CB 621.

[12] IRS Pub. 525, *Taxable and Nontaxable Income* (2009).

## INCENTIVES RECEIVED BY EMPLOYEES

The IRS will **not** pursue tax on **in-kind** promotional benefits attributable to a taxpayer's employment.[13] However, the following **are** taxable:

- Cash benefits
- In-kind benefits given as a substitute for compensation
- Benefits used for tax avoidance

**Example 5.** Jade Daxx, the owner of a retail store, has two employees. She charges most of her business expenses to her Universal Airlines credit card, which gives her points that can be traded for airline tickets. By the end of the year, the value of her points is significant. Each December, she transfers one-third of her accumulated points to each of the employees instead of giving them bonuses. The value of these points must be included in each employee's gross wages.

**Example 6.** Detective Odoh works for a private investigation firm. As part of his duties, he incurs significant travel expenses, which the company reimburses. The detective also earns airline miles for his trips and for expenses charged to his personal credit card. He is too busy to use the travel awards, so he sells the miles to his employer for $5,000, which is the fair market value of the miles. The $5,000 is taxable income to Mr. Odoh. He reports the sale as a short-term capital gain with $0 basis.

**Observation.** The facts in **Example 6** are similar to the facts in *Charley v. Comm'r*.[14] In that case, the 9th Circuit Appeals Court agreed with the Tax Court that the payment was taxable income. In its decision, the court declared that the funds received were taxable as either compensation or as a gain from the sale of the frequent-flyer miles. However, the court did not specify the preferred treatment.

**Example 7.** Kyrie Nerrys is the sole shareholder and employee of Belgium Treats, Inc., a C corporation. The company runs an Internet retail site specializing in exotic chocolates. She charges almost all of the corporation's expenses to her personal credit card, which pays her an annual rebate based on the total amount charged. The corporation reimburses her for all of its expenses based on expense reports she submits monthly.

In 2010, Kyrie receives $1,000 from her credit card issuer. She deposits the rebate to her personal checking account. She does not report the payment as income on the corporate return or on her personal tax return. Belgium's 2010 corporate return is audited by the IRS.

The following are possible tax results:

1. The corporation is deemed to have received $1,000 of income and to have paid $1,000 in dividends. Both Kyrie and the company owe income tax on $1,000.
2. The corporation is deemed to have received $1,000 of income and to have paid $1,000 in net compensation to Kyrie. The corporation owes employment tax on the grossed-up value of the $1,000, and Kyrie owes income tax on the grossed-up value.
3. The IRS does not propose any audit adjustments related to the $1,000 rebate received by Kyrie.

**Observation.** In **Example 7,** the employee is also the sole shareholder. This increases the likelihood that the IRS will propose an audit adjustment if the value of the incentives is substantial.

In order to maximize their credit card incentive plans, many individuals use their credit cards to pay substantially all their expenses. However, when they charge business-related expenses, they do not adjust their reimbursement requests for any rebates or incentives that they receive. The IRS does not have an official position on this common practice.

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[13] IRS Ann. 2002-18, 2002-1 CB 621.

[14] *Philip J. Charley, and Katherine T. Charley, v. Comm'r*, 91 F.3d 72 (9th Cir. 1996), *aff'g and rev'g* TC Memo 1993-558.

# ISSUE 4: HOME OFFICE DEDUCTION

## BACKGROUND[15]

**Note.** See the section "Business Use of Home" in Chapter 4, Tax Aspects of Home Ownership, for further explanation of the requirements to claim the home-office deduction.

Generally, in order to claim a business deduction for a home office, the taxpayer must use part of the home **exclusively** and **regularly**:

- As the principal place of business;
- As a place to meet or deal with patients, clients, or customers in the normal course of the business; **or**
- In any connection with a trade or business where the building is a separate structure not attached to the home.

For certain storage use, rental use, or daycare-facility use, the property must be used regularly but **not** exclusively. For **employees**, the office must also be for the **convenience of the employer**. Employees are prohibited from renting a portion of their homes to their employers if that portion is used to provide services to the employer in the capacity of an employee.

**Observation.** Employee-owners of closely-held corporations, LLCs, and partnerships may realize greater tax savings if the company reimburses them for their allocable home office expenses rather than claiming a home-office deduction.

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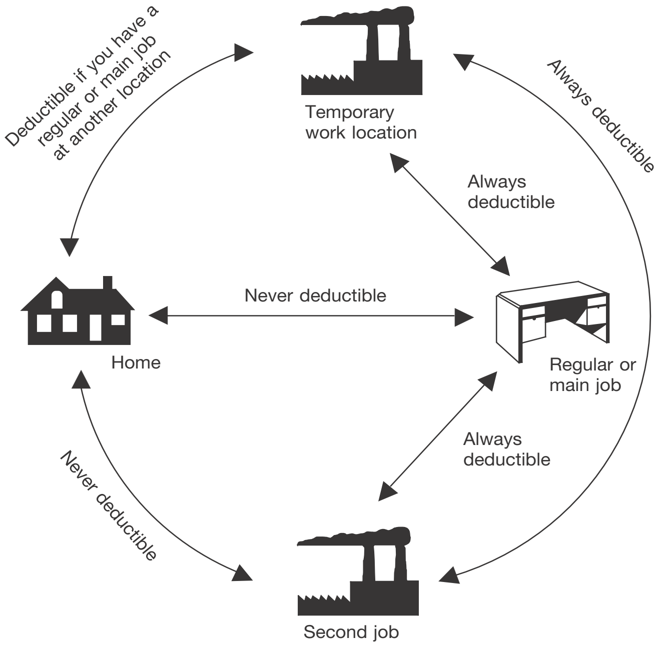
[15] IRS Pub. 587, *Business Use of Your Home* (2009).

## TRANSPORTATION EXPENSES[16]

Taxpayers whose principal places of business are their home offices may deduct transportation expenses incurred from their homes to any other business-related locations. However, taxpayers whose home offices do not meet the principal-place-of-business test cannot deduct the cost of commuting between the home office and the main work place.[17] The following chart from IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*, illustrates this rule.

Figure B. **When Are Transportation Expenses Deductible?**
Most employees and self-employed persons can use this chart.
(Do not use this chart if your home is your principal place of business.
See *Office in the home.*)



**Home:** The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

**Regular or main job:** Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

**Temporary work location:** A place where your work assignment is realistically expected to last (and does in fact last) one year or less. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary work location outside your metropolitan area.

**Second job:** If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. If you do not go directly from your first job to your second job, you can only deduct the transportation expenses of going directly from your first job to your second job. You cannot deduct your transportation expenses between your home and a second job on a day off from your main job.

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[16] IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses* (2009).

[17] Rev. Rul. 99-7, 1999-1 CB 361.

**Example 8.** Diana Troy is a clinical psychologist. Her home office is her principal place of business where she meets with clients and conducts all of the administrative functions. **She does not have any other place of business.** Once a week she travels to the local prison to conduct evaluations. Once a month she travels to the local courthouse to testify about the evaluations. The transportation costs of her round trips from her home to the prison and the courthouse are **fully deductible.**

**Example 9.** Alexander Rozingko is a martial arts trainer. He owns a studio building where he meets with students four days per week. He also conducts all of his business administrative functions in an office located in the studio building. However, once a week he hosts training sessions at his home in a room set aside for this purpose. The room at home qualifies for the home-office deduction, but the studio building is his principal place of business. Therefore, the transportation costs between his home office and the studio are **not deductible.**

## CONSEQUENCES OF DEPRECIATION WHEN THE HOME IS SOLD[18]

A depreciation deduction is allowed for the portion of the home used for a home office. The home office is nonresidential property and is depreciated using the straight-line method over 39 years. The depreciable basis is the lower of cost or FMV on the date the property is first used for business purposes.

**Note.** See Problem 5 in Chapter 5, Individual Taxpayer Problems, for a detailed discussion of depreciable basis for real estate. See **Example 26** in that chapter for guidance on how to report the sale of a residence when part of the gain is taxable and part is excludable under IRC §121.

A taxpayer may exclude up to $250,000 of gain on the sale of a home if it was owned and used as the taxpayer's principal residence in two out of the last five years ending on the date of the sale.[19] The limit is $500,000 for MFJ taxpayers. However, any depreciation deducted after May 6, 1997, is taxable up to the amount of the gain. This amount is subject to a maximum tax rate of 25%.[20]

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[18] IRS Pub. 587, *Business Use of Your Home* (2009).

[19] IRC §121.

[20] IRC §§1(h)(1)(D) and 1(h)(6)(A).

**Example 10.** Bevie Crasher is a self-employed surgeon at Starfleet Medical. Her primary place of business is the hospital, but she performs all of her business administrative tasks in her home office. She originally purchased her home in 1990 for $200,000. Her home office was used regularly and exclusively for business purposes from the first day she moved in until the day she moved out in 2010.

She sold the home for $400,000 in 2010. From 1990 to 2010, she deducted a total of $11,380 of depreciation on the home-office portion of her house. The total deduction attributable to the depreciation **after May 6, 1997,** is $7,492.

**Tax Result.**

**Step 1.** Bevie calculates her adjusted basis in the home as follows.

| | |
|---|---|
| Original purchase price | $200,000 |
| Less: depreciation allowed or allowable | (11,380) |
| **Adjusted basis** | **$188,620** |

**Step 2.** Bevie then calculates her gain on the sale of the home.

| | |
|---|---|
| Sales price | $400,000 |
| Less: adjusted basis | (188,620) |
| **Total gain** | **$211,380** |

**Step 3.** Bevie reports the lesser of the total gain or the amount of depreciation allowed after May 6, 1997.

| | |
|---|---|
| A. Total gain | $211,380 |
| B. Depreciation deducted after May 6, 1997 | 7,492 |
| **Taxable portion of gain: lesser of A or B** | **$ 7,492** |

**Note.** According to IRS Pub. 587, *Business Use of Your Home*, if the taxpayer can prove that the amount of depreciation deducted was less than the allowable amount, the taxpayer does **not** have to use the allowed or allowable rule to determine the taxable portion of the gain. However, this does not change the rule that the taxpayer must use the allowed or allowable rule to determine the adjusted basis of the property.

If the allowed or allowable rule causes the taxpayer to owe additional taxes, the taxpayer should file Form 3115, *Application for Change in Accounting Method*, to claim the previously-missed depreciation deduction. See Issue 7 in this chapter for more information about Form 3115.

**The taxpayer may also have a reportable gain if the part of the property used for business is separate from the home, such as an outbuilding used for storage.** To determine the amount of gain attributable to the separate structure, the taxpayer must allocate the basis and amount realized using the same method of allocation that the taxpayer used to determine depreciation deductions.[21]

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[21] Treas. Reg. §1.121-1(e)(3).

**Example 11.** In 2001, David Soong purchased one acre of land for $20,000 in rural Tennessee. He built a house and a separate structure to use as an art studio at a cost of $200,000. The studio is located on 1/10 of the acre lot. His artistic creations are well received and he makes a modest annual profit selling his paintings. The house is his principal residence until July 1, 2010, when he sells the entire property for $440,000.

| | Total | Allocated to Residence | Allocated to Studio |
|---|---|---|---|
| Cost of acreage | $ 20,000 | $ 18,000 | $ 2,000 |
| Cost of structures | 200,000 | 150,000 | 50,000 |
| **Total cost** | **$220,000** | **$168,000** | **$ 52,000** |
| Percentage of total cost | 100% | 76% | 24% |
| Apportioned sales price | $440,000 | $334,400 | $105,600 |
| Depreciation allowed/allowable on studio | | | (11,538) |
| **Adjusted basis (cost less depreciation)** | | **$168,000** | **$ 40,462** |

**Tax Result.** David calculates his gain separately for the residence and the studio:

| | Allocated to Residence | Allocated to Studio |
|---|---|---|
| Sale price | $334,400 | $105,600 |
| Less: adjusted basis | (168,000) | (40,462) |
| **Gain** | **$166,400** | **$ 65,138** |

David's $166,400 gain on the sale of his principal residence is fully excludable under IRC §121. The $65,138 gain on the studio is fully taxable. The portion of the sale allocable to the studio is reported in Part III of Form 4797, *Sales of Business Property*.

**Observation.** The gain on the studio would be excludable if the studio met the two-out-of-five-year ownership and use tests. If David converted the studio to personal use two years prior to the sale, his taxable gain would be limited to the depreciation deducted from 2001 to 2008.

**The gain on a building that is divided into separate units must be calculated separately for each unit.**

**Example 12.** Whinnie Guynan purchases a two-story building in downtown San Francisco. She converts the first floor to a high-class restaurant. She uses the second story as her residence. Each story has its own entrance. Each story is considered a separate structure if she sells the building.

# ISSUE 5: FRINGE BENEFITS

## BACKGROUND

Many employers offer fringe benefits as a way to reward employees, reduce the employees' income tax liability, and save money on the company's share of employment taxes. Even so, not all fringe benefits are tax-free. Only those specifically identified by law can be excluded from an employee's income. Furthermore, the tax treatment of certain benefits vary based on:

- The employee's level of wages,
- The employee's ownership level in the employer,
- The employee's relationship to the employer's owners, and/or
- The type of employing entity (sole proprietorship, partnership, S corporation, or C corporation).

In order to qualify as tax-free, many benefits must **not** be provided in such a way as to discriminate in favor of highly-compensated employees. Surprisingly, this is not true for all benefits. **Benefits that are tax-free even if the employer provides them only to highly-compensated employees include:**

- Working condition fringe,[22]
- De minimis fringe,[23]
- Qualified transportation fringe,[24]
- Qualified moving expense reimbursements,[25] and
- Access to on-premise athletic facilities.[26]

This topic explores three specific issues:

1. Health insurance benefits
2. Special rules for health insurance and owner-employees of pass-through entities
3. Fringe benefits and entities under common control

## HEALTH INSURANCE BENEFITS

### Excludable Health Insurance Premiums

Health insurance first became a popular fringe benefit during World War II when Congress froze wages but allowed companies to adopt employee insurance plans. In 1954, Congress codified the tax-free treatment of health insurance premiums paid on behalf of employees. The fact that this tax-free treatment applies to both payroll taxes and income taxes helped further the popularity of this fringe benefit.[27]

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[22] IRC §132(d).

[23] IRC §132(e).

[24] IRC §132(f).

[25] IRC §132(g).

[26] IRC §132(j)(4).

[27] *Health Insurance in the United States*. Thomasson, Melissa. Feb. 1, 2010. Economic History Association. [http://eh.net/encyclopedia/article/thomasson.insurance.health.us] Accessed on July 8, 2010.

Health insurance **premiums** paid on behalf of employees are **not** subject to top-heavy restrictions. IRC §106(a) states:

> ***General Rule*** *— Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.*

The only restriction requiring equal treatment of employees in this code section relates to contributions to health savings accounts.[28]

> **Example 13.** Hope Sayto is the sole owner of Babelfishing, Inc., a C corporation. Her company provides translation services for software developers, enabling them to provide multiple-language versions of their products. She has two employees. They work for minimum wage and perform low-tech administrative duties.
>
> In September 2010, her company is hired by a large multinational company for a huge interface translation project. Hope knows it is time to hire another technical expert. In October, she finds the perfect candidate, Max Forst. He insists on employer-provided health insurance as part of his compensation package. Babelfishing may provide tax-free individual health insurance to Max without providing it to Hope or the two other employees.

**For plan years beginning on or after September 23, 2010, group health insurance plans are not allowed to favor highly-compensated employees.**[29] These restrictions apply at the plan-sponsor level, but do not apply to self-insured plans.[30] The nondiscrimination requirements are similar to those shown in the following section.

> **Example 14.** Max, from **Example 13,** is unable to obtain an **individual** health insurance policy. After consulting with an insurance broker, Hope finds an insurance company that offers small group policies. As the plan sponsor, Babelfishing must establish a plan that does not discriminate in favor of highly-paid employees.

### Medical Reimbursement Plans: Nondiscrimination Requirements[31]

Employers may reimburse employees for medical expenses incurred by their employees and their families. **Payments under this type of arrangement are excluded from compensation only if the plan does not discriminate in favor of highly-compensated employees.**

A highly-compensated employee is anyone who meets **one** of the following conditions:

- The employee is one of the five highest paid officers.
- The employee is a shareholder who owns more than 10% of the value of the company's stock.
- The employee is among the 25% highest paid of all qualified employees.

A qualified plan **may exclude** the following employees:

- Those who have not completed three years of service prior to the beginning of the plan year
- Those who have not attained age 25 prior to the beginning of the plan year
- Those who usually work less than 25 hours per week[32]
- Those who usually work less than seven months per year[33]
- Those who are covered under a collective-bargaining agreement
- Those who are nonresident aliens who receive no earned income from the employer which constitutes income from sources within the United States

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[28] IRC §106(d)(3).

[29] IRC §9815.

[30] Sec. 2716 of Title XXVII of the Public Health Service Act (as amended by the Patient Protection and Affordable Care Act).

[31] IRC §105.

[32] Treas. Reg. §1.105-11(c)(2)(iii)(C).

[33] Ibid.

**The plan may also exclude part-time employees whose customary weekly employment is less than 35 hours,** if other employees doing similar work with the same employer work substantially more hours. In addition, it may exclude seasonal employees whose customary annual employment is less than **nine** months, if other employees doing similar work with the same employer work substantially more months.

### ERISA Nondiscrimination Requirements[34]

The nondiscrimination rules of the Employee Retirement Income Security Act (ERISA) prohibit discrimination based on **health factors**. However, plans may treat distinct groups of individuals differently. Distinctions among groups must be made on bona fide employment-based classifications consistent with the employer's usual business practice. Whether classifications are bona fide is based on relevant facts and circumstances, which might include the following:

- Full-time versus part-time employee status
- Different geographic locations
- Membership in a collective-bargaining unit
- Date of hire or length of service
- Differing occupations

In addition, plans may treat participants and beneficiaries as two separate groups. Plans may also distinguish among beneficiaries. Distinctions among groups of **beneficiaries** may be based on any factor that is not related to health.

## HEALTH INSURANCE AND PASS-THROUGH ENTITIES

Health insurance provided to owner-employees of partnerships and S corporations may be taxable to recipients. Owner-employees include any general partner and any person owning more than 2% of the stock in an S corporation.

For **partners**, the cost of health insurance premiums is treated as an addition to the guaranteed payments paid to the partners.[35] The partnership deducts the guaranteed payments, and the partners declare the guaranteed payments as income.[36] If the partners otherwise qualify, they may deduct the premiums on their individual income tax returns as self-employed health insurance.

> **Example 15.** Johnny Archer is a general partner in an engineering firm. The partnership pays $500 per month for Johnny’s health insurance premiums. The firm does not purchase health insurance for any other partners or employees. In 2010, the partnership pays $6,000 for Johnny’s health insurance.
>
> **Tax Result.** The $6,000 is added to Johnny’s guaranteed payments, which the company deducts. Johnny must report this income as part of his income subject to SE tax. However, he may deduct the $6,000 as self-employed health insurance on the front page of his Form 1040 for income tax purposes, provided he meets the other requirements.[37]

For a **2% shareholder-employee,** the cost of health insurance premiums is added to gross wages.[38] The corporation deducts the premiums and the shareholder-employee includes them in income. If the shareholder-employee otherwise qualifies, they may deduct the premiums on their individual income tax returns as self-employed health insurance.

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[34] *Health Benefits Coverage under Federal Law* [www.dol.gov/ebsa/pdf/CAG.pdf] p. 55. Accessed on July 8, 2010; 29 CFR 2590.702(d).

[35] Rev. Rul. 91-26, 1991-1 CB 184.

[36] Rev. Rul. 91-26, 1991-1 CB 184.

[37] IRC §162(l).

[38] IRC §1372.

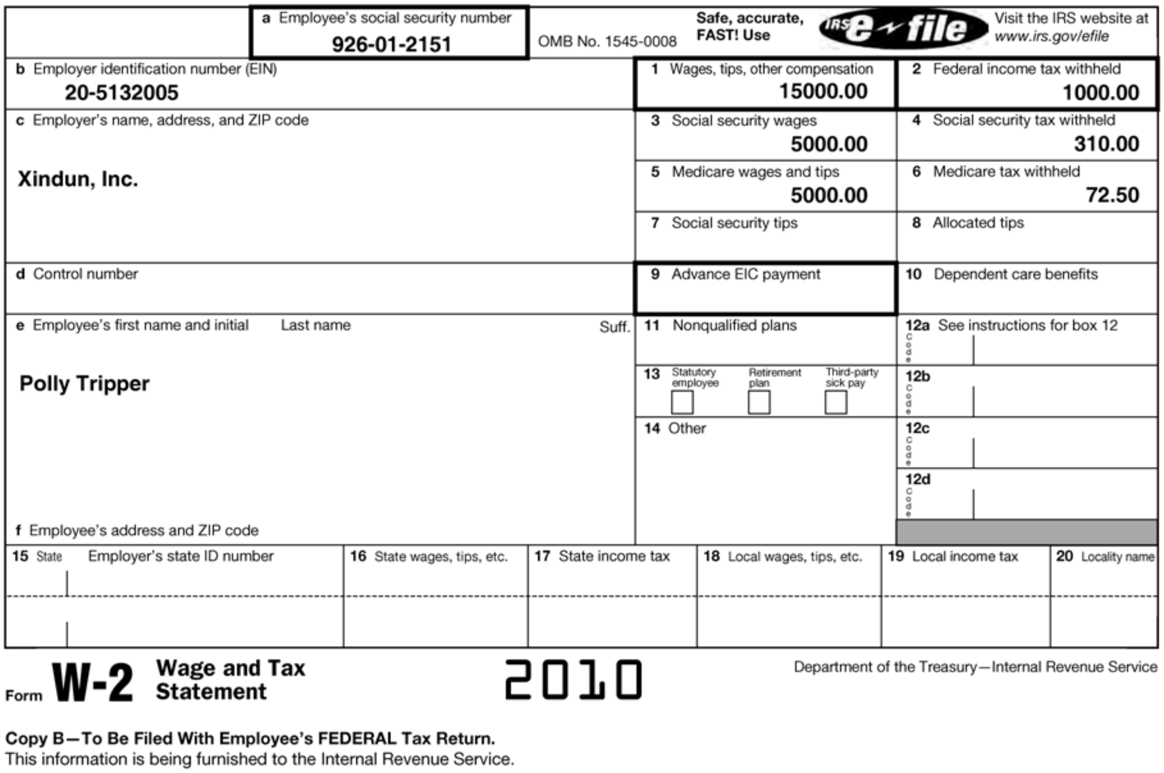
The plan providing the insurance must be established by the S corporation. This requirement is met if the S corporation pays for the insurance premium or if the shareholder-employee is reimbursed by the S corporation for the premiums paid via an accountable plan. In addition, the premiums **must** be included in the shareholder-employee's wages on the shareholder-employee's Form W-2 in box 1.[39] The shareholder-employee's deduction is limited to the amount of income subject to FICA and Medicare taxes received from the company.[40]

However, the premiums are **not** included in the shareholder-employee's wages for FICA and Medicare purposes.[41] Although 2% shareholders are generally treated as partners for fringe-benefit purposes, in this instance the S corporation has an advantage over the partnership.

Under the constructive-ownership rules, an S corporation shareholder's spouse, children, parents, and grandchildren are treated as owners of the S corporation's stock.[42]

**Example 16.** Charles Tripper is the 100% owner of an S corporation, Xindun, Inc. Xindun operates a DNA research facility. The only other employee is Charles' wife, Polly, who is also a scientist. The company pays $10,000 per year for Polly's health insurance premiums. Her policy covers her husband and their children. In addition to the health insurance coverage, Polly receives a salary of $5,000 per year.

**Tax Result.** Under the constructive-ownership rules, Polly is considered a 2% shareholder-employee of Xindun, Inc. Polly's Form W-2, which follows, reflects the $10,000 paid for the premiums plus the $5,000 salary in box 1 wages. Her deduction for self-employed health insurance is limited to income subject to FICA and Medicare taxes, which is the $5,000 salary shown in boxes 3 and 5. The net effect is taxable income of $10,000 ($15,000 – $5,000).



a Employee's social security number 926-01-2151

OMB No. 1545-0008

Safe, accurate, FAST! Use IRS e-file

Visit the IRS website at www.irs.gov/efile

b Employer identification number (EIN) 20-5132005

1 Wages, tips, other compensation 15000.00

2 Federal income tax withheld 1000.00

c Employer's name, address, and ZIP code Xindun, Inc.

3 Social security wages 5000.00

4 Social security tax withheld 310.00

5 Medicare wages and tips 5000.00

6 Medicare tax withheld 72.50

7 Social security tips

8 Allocated tips

d Control number

9 Advance EIC payment

10 Dependent care benefits

e Employee's first name and initial Last name Suff. Polly Tripper

11 Nonqualified plans

12a See instructions for box 12 Code

13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐

12b Code

14 Other

12c Code

12d Code

f Employee's address and ZIP code

15 State Employer's state ID number

16 State wages, tips, etc.

17 State income tax

18 Local wages, tips, etc.

19 Local income tax

20 Locality name

Form W-2 Wage and Tax Statement 2010

Department of the Treasury—Internal Revenue Service

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

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[39] IRS Notice 2008-1, 2008-1 CB 251.

[40] IRC §162(l)(5)(A).

[41] IRS Notice 2008-1, 2008-1 CB 251.

[42] IRC §318.

**Observation.** In **Example 16,** if Xindun, Inc. were a sole proprietorship, the tax result for the health insurance premiums would be more advantageous. As a sole proprietor, Charles could deduct the entire $10,000 paid for Polly's health insurance as an employee fringe benefit and the $10,000 would not appear on her Form W-2. This deduction would reduce **both** his income taxes and SE taxes.

## FRINGE BENEFITS AND ENTITIES UNDER COMMON CONTROL

### Fringe Benefits Subject to Common Control Provisions

To prevent taxpayers from establishing separate companies in order to provide fringe benefits to only select employees, the Code treats related companies as one employer with regards to certain benefits:[43]

- Medical reimbursement plans[44]
- Group-term life insurance policies
- Employer contributions to health savings accounts
- Qualified tuition reductions
- Qualified group legal services plans
- Cafeteria plans
- Educational-assistance programs
- Dependent-care assistance programs
- No-additional-cost services
- Qualified employee discounts
- Qualified retirement planning services
- Employer-provided eating facilities
- Adoption-assistance programs
- Employee-achievement awards
- Qualified pension, bonus, or stock-sharing plans under IRC §401
- SEP plans
- SIMPLE plans

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[43] IRC §414(t).

[44] IRC §105(h)(8).

### Entities under Common Control[45]

**Caution.** The definitions related to control can be very complex. The following lists are meant to alert the reader to situations that warrant more research.

For fringe-benefit purposes, the following groups are treated as one employer:

1. Parent-subsidiary group under common control — at least 80% of the effective control held in common[46]
2. Brother-sister group under common control — five or fewer individuals possess more than 50% of the effective control in common[47]
3. Combined groups — three or more businesses with members in the above two groups[48]
4. Employee leasing arrangements — a person with a 5% or greater ownership interest in a company is leased to the company to perform services for the company[49]
5. Affiliated service groups[50] — interrelated service businesses in which:
    - **a.** A service business with an ownership interest in a second service business performs nonemployee services for or in conjunction with the second service business;
    - **b.** 10% or more of the ownership in one service business is held by highly-compensated employees of the other service business; or
    - **c.** A company performs the management functions for primarily one customer and its affiliates.

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[45] IRC §§414(b) and (c).

[46] IRC §1563(a)(1); Treas. Reg. §1.414(c)-2(b).

[47] IRC §§1563(a)(2) and (f)(5); Treas. Reg. §1.414(c)-2(c).

[48] IRC §1563(a)(3); Treas. Reg. §1.414(c)-2(d).

[49] Prop. Treas. Reg. §1.414(o)-1.

[50] IRC §414(m).

## Attribution Rules for Corporate Stock

The Code also includes the following provisions to treat individuals as owners in corporations whose stock is held by closely-related parties.

1. Any person with an option to acquire stock is treated as owning the stock.[51]
2. Any partner having a 5% or greater interest in a partnership is treated as owning a proportionate share of any stock held by the partnership.[52]
3. Any beneficiary having a 5% or greater interest in an estate or trust is treated as owning a proportionate share of any stock held by the entity.[53]
4. A grantor of a grantor trust is treated as owning stock held by the trust.[54]
5. Any person having a 5% or greater interest in a corporation is treated as owning a proportionate share of any stock held by the corporation.[55]
6. A person is treated as owning shares held by his spouse except in certain circumstances.[56]
7. A person is treated as owning shares held by his minor children.[57]
8. A person who is under age 21 is treated as owning shares held by his parents.[58]
9. A person who directly owns more than 50% of a corporation is treated as owning any shares held by his adult children, grandchildren, parents, and grandparents.[59]

Among other goals, these provisions are intended to keep people from establishing discriminatory fringe-benefit plans through shell corporations.

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[51] IRC §1563(e)(1).

[52] IRC §1563(e)(2).

[53] IRC §1563(e)(3)(A).

[54] IRC §1563(e)(3)(B).

[55] IRC §1563(e)(4).

[56] IRC §1563(e)(5).

[57] IRC §1563(e)(6)(A).

[58] Ibid.

[59] IRC §1563(e)(6)(B).

## ISSUE 6: BASIS OF PROPERTY ACQUIRED IN A LIKE-KIND EXCHANGE

**Note.** For comprehensive coverage of like-kind exchanges, see the 2007 *University of Illinois Federal Tax Workbook*, Chapter 4, Like-Kind Exchanges. This can be found on the accompanying CD.

### OVERVIEW[60]

Generally, no gain or loss is recognized when business property is exchanged for property of the same class. If the exchange is a simple trade with no other cash or property involved, the basis of the acquired property is equal to the adjusted basis of the relinquished property.

**Example 17.** Kathlyn Jeanway purchased 20 acres of farmland in 1995 for $140,000. In 2010, she exchanged the 20 acres for a commercial building. At the time of the exchange, the FMV of both properties is $180,000. Her basis in the commercial building is $140,000.

Most exchanges also involve money. If the taxpayer pays cash in addition to surrendering the like-kind property, the cash is added to the adjusted basis of the relinquished property to determine the basis of the acquired property.

**Example 18.** Kathlyn, from **Example 17,** also pays the former owner of the commercial building $10,000 as part of the trade. Her new basis in the commercial building is:

| | |
|---|---|
| Basis of 20 acres relinquished | $140,000 |
| Plus: cash paid as part of exchange | 10,000 |
| **Basis of commercial building** | **$150,000** |

If the taxpayer receives cash in addition to the like-kind property, any gain must be recognized up to the amount of cash received. The cash received is subtracted from the basis and the gain recognized is added to the basis of the acquired property.

**Example 19.** Tommy Parish also purchased farmland for $140,000 in 1995. In 2010, he trades the farmland for an apartment building plus $10,000 cash. At the time of the exchange, the FMV of the farmland is $146,000.

**Step 1.** The gain realized and the gain recognized are calculated as follows.

| | |
|---|---|
| FMV of farmland | $146,000 |
| Less: basis of farmland | (140,000) |
| **Gain realized** | **$ 6,000** |
| Cash received | 10,000 |
| **Gain recognized: lesser of cash received or gain realized** | **6,000** |

**Step 2.** The basis of the apartment building can then be determined.

| | |
|---|---|
| Basis of farmland | $140,000 |
| Less: cash received | (10,000) |
| Plus: gain recognized | 6,000 |
| **Basis of apartment building** | **$136,000** |

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[60] IRS Pub. 544, *Sales and other Dispositions of Assets* (2009).

## DEPRECIATING PROPERTY RECEIVED IN A LIKE-KIND EXCHANGE[61]

**Caution.** Special rules apply to **vehicles** acquired in a trade-in. For information on how to calculate depreciation for a vehicle acquired in a trade-in, see Chapter 5 of IRS Pub. 946, *How to Depreciate Property* (2009).

Generally, property acquired in a like-kind exchange is depreciated over the remaining recovery period of the property exchanged. The same depreciation method and convention used for the relinquished property is used for the acquired property. This only applies to **acquired property** with **the same or shorter recovery period** and **the same or more accelerated depreciation method** than the property relinquished. Cash paid is treated as newly placed in service property.

**Example 20.** Annicka Handson owns a 700 unit mini-storage complex that she purchased in October of 1997 for $700,000. On October 15, 2010, she trades the mini-storage complex plus $9,000 for an airplane hangar complex. The recovery period of 39 years and the depreciation method (straight-line) are the same for both buildings. Therefore, the airplane hangars are depreciated over the remaining recovery period of the mini-storage complex.

The mini-storage complex is deemed disposed of on October 15, 2010. The adjusted basis is $466,664. The hangars are placed in service on October 15 using the cost basis $466,664. The hangars are depreciated using the straight-line method over the **remaining 26 years**. Therefore, the depreciation deduction does not change. The $9,000 boot is depreciated over 39 years using the straight-line method starting October 15, 2010.

**Acquired property** that has **a longer recovery period or less accelerated depreciation method** than the relinquished property is generally depreciated as if it were placed in service in the same tax year as the relinquished property. However, the longer recovery period or less accelerated depreciation method of the acquired property is used instead of those applying to the relinquished property.

**Example 21.** In 2008, Amil Kottay purchased a helicopter for business use for $150,000. A helicopter is 5-year property. On August 25, 2010, he trades the helicopter for an airplane to use to carry passengers on island tours. No boot is paid or received in the transaction. A passenger airplane is 7-year property.

**Tax Result.** Because the airplane has a **longer** recovery period than the helicopter, the longer life must be used to calculate the depreciation deduction for the airplane. The adjusted basis of the helicopter is $57,600 on August 25. If the airplane had been placed in service in 2008, there would be five years remaining in the recovery period. Therefore, the airplane is considered placed in service on August 25, 2010, with a 5-year recovery period using the cost basis of $57,600.

**Instead of using the above rules,** taxpayers may elect to treat the adjusted basis of the relinquished property as if it were disposed of at the time of the exchange. The entire basis of the acquired property is then depreciated as if placed in service on the later of the date acquired or exchanged. The election, if made, applies to both the acquired property and the exchanged property. The election is made on a timely-filed return, including extensions, for the year of replacement by indicating on the return "Election made under §1.168(i)-6(i)." Once made, the election may not be revoked without IRS consent.

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[61] IRS Pub. 946, *How to Depreciate Property* (2009).

## SELLING PROPERTY RECEIVED IN A LIKE-KIND EXCHANGE

When property that was acquired in a like-kind exchange is sold, it is important to know the amount and types of depreciation taken on the original property. The tax treatment of the gain varies based on the amount and type of depreciation previously taken. Any depreciation recapture that would have applied to the sale of the original property is deferred until the replacement property is sold.

### §1245 Property

The gain on the sale of §1245 personal property is treated as ordinary income up to the amount of depreciation used to determine its basis. For property acquired via trade, the depreciation taken on the relinquished property must also be included with the depreciation on the replacement property used to calculate the §1245 ordinary gain.[62]

**Example 22.** Elana Torres owns a small engine repair shop. In 2000, she purchased a computerized engine analyzer for $4,000. She depreciated the analyzer over seven years using MACRS. Consequently, the analyzer was fully depreciated in 2008. In January of 2010, she trades the analyzer plus $10,000 for a premier portable kit. In December 2010, she sells the kit for $11,000.

**Tax Result.** Elana is not allowed to deduct any depreciation on the kit because she purchased and sold it in the same year. Her taxable gain is $1,000. The entire $1,000 is taxed as ordinary income because it is less than the depreciation used to determine the adjusted basis.

**Step 1.** The adjusted basis of the kit is calculated as follows.

| | |
|---|---|
| Adjusted basis of analyzer given in trade | $ 0 |
| Cash paid | 10,000 |
| **Adjusted basis of kit** | **$10,000** |

**Step 2.** The potential §1245 depreciation recapture is then determined.

| | |
|---|---|
| Depreciation on analyzer | $4,000 |
| Depreciation on kit | 0 |
| **Potential depreciation recapture** | **$4,000** |

**Step 3.** Finally, the gain on the sale is calculated.

| | |
|---|---|
| Sale price | $11,000 |
| Minus: adjusted basis | (10,000) |
| **Gain** | **$ 1,000** |
| **Depreciation recapture subject to ordinary income tax rates:**<br>**lesser of gain or potential recapture** | **1,000** |

Property may be acquired through a series of trades. The potential recapture is equal to the depreciation taken on all of the properties less any gain previously recognized.[63]

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[62] IRC §1245(a)(2)(A); Treas. Reg. §1.1245-2(c)(4)(i)(b).

[63] Ibid.

**Example 23.** Henry Kimm owns a holodeck entertainment facility where patrons can purchase holodeck use by the hour. In **2008**, he was excited to buy a $20,000 Veesta holoemitter, which was advertised as being sophisticated but user friendly. On his 2008 return, he claimed $10,000 of bonus depreciation and $2,000 of MACRS depreciation using a 5-year class life and the half-year convention.

By August of **2009**, he was disgusted with Veesta's lack of compatibility with his other equipment. He traded the Veesta, with a $15,000 FMV, for an Expee holoemitter, with a $12,000 FMV, and received $3,000 cash.

**Tax Result.**

**Step 1.** Veesta's adjusted basis is calculated at the time of the exchange.

| | | |
|---|---|---|
| Cost of Veesta holoemitter | | $20,000 |
| Less: depreciation adjustments | | |
| Bonus depreciation | $10,000 | |
| 2008 depreciation | 2,000 | |
| 2009 depreciation | 1,600 | |
| Total depreciation adjustments | $13,600 | (13,600) |
| **Adjusted basis of the Veesta holoemitter** | | **$ 6,400** |

**Step 2.** The gain **realized** and the gain **recognized** is then determined.

| | |
|---|---|
| Value of Expee received | $12,000 |
| Plus: cash received | 3,000 |
| Less: adjusted basis of Veesta | (6,400) |
| **Total gain realized** | **$ 8,600** |
| **Ordinary gain recognized (depreciation recapture)** [a] | **$ 3,000** |

[a] Limited to lesser of cash received ($3,000) or depreciation recapture ($13,600).

Henry made the election under Treas. Reg. §1.168(i)-6(i) to treat the Veesta as a disposition and the Expee as newly purchased. His 2009 depreciation deduction for the Expee was $1,280.

**Example 24.** Use the same facts as **Example 23.** In February **2010**, a traveling wastrel offers Henry $25,000 for the Expee machine. Being no fool, Henry quickly accepts the offer. The following calculations are reflected on Henry's 2010 return.

**Step 1.** The adjusted basis of the Expee is calculated as follows.

| | | |
|---|---|---|
| Adjusted basis of Veesta used as Expee's basis for depreciation | | $6,400 |
| Less: depreciation adjustments | | |
| 2009 depreciation | $1,280 | |
| 2010 depreciation | 1,024 | |
| Total depreciation adjustments | $2,304 | (2,304) |
| **Adjusted basis of the Expee** | | **$4,096** |

**Step 2.** The potential §1245 depreciation recapture is then determined.

| | |
|---|---|
| Depreciation on Veesta | $13,600 |
| Depreciation on Expee | 2,304 |
| Depreciation recaptured on trade of Veesta | (3,000) |
| **Potential depreciation recapture** | **$12,904** |

**Step 3.** Next, the gain on the sale of Expee is calculated.

| | |
|---|---|
| Sale price | $25,000 |
| Less: adjusted basis | (4,096) |
| **Gain realized** | **$20,904** |

**Step 4.** Finally, income subject to capital gain tax rates is determined.

| | |
|---|---|
| Gain realized | $20,904 |
| Ordinary §1245 gain (depreciation recapture) | (12,904) |
| **Capital gain** | **$ 8,000** |

## §1250 Property

Capital gains from the sale of most forms of real estate are covered under IRC §1250. The depreciation **recapture** under this section is only applicable to depreciation **in excess of straight-line depreciation**. Typically, this is not a problem since nonresidential real property placed in service after 1986 is depreciated using the straight-line method. However, **bonus depreciation** is depreciation in excess of straight-line and **is subject to recapture** if the real estate is sold.

The depreciation that is not in excess of straight-line is called **unrecaptured** §1250 depreciation. Unrecaptured depreciation is generally taxed at ordinary tax rates. However, for individuals, the maximum tax rate is 25%.

**Example 25.** In 2008, Knealix Phillips opened a nightclub in a leased facility in Juneau, Alaska. The facility is owned by an unrelated party. Prior to opening night, he invested $60,000 in improvements to the interior of the building. On his 2008 tax return, Knealix claimed $30,000 of bonus depreciation on the leasehold improvements in addition to straight-line depreciation on the remaining half of the basis.

In 2010, the contract rights under the lease and the leasehold improvements are traded for a leasehold in Dyersburg, Tennessee, plus $50,000 cash. As a part of the exchange contract, the Tennessee leasehold improvements are valued at $20,000. Before consideration of the exchange, Knealix's 2010 taxable income is $100,000. Knealix is single with no dependents.

**Tax Result.** Knealix has a gain on the like-kind exchange of the leasehold improvement. The gain is taxed at three different rates.

**Step 1.** The adjusted basis of the Alaska leasehold improvements is calculated.

| | | |
|---|---|---|
| Cost of Alaska leasehold improvements | | $60,000 |
| Less: depreciation adjustments: | | |
| Bonus depreciation | $30,000 | |
| Straight-line depreciation 2008–2010 | 1,539 | |
| Total depreciation adjustments | $31,539 | (31,539) |
| **Adjusted basis of Alaska leasehold improvements** | | **$28,461** |

**Step 2.** Then, the gain **realized** and the gain **recognized** are determined.

| | |
|---|---|
| Value of the Tennessee leasehold improvements received | $20,000 |
| Plus: cash received | 50,000 |
| Less: adjusted basis of Alaska leasehold improvements | (28,461) |
| **Gain realized** | **$41,539** |
| **Gain recognized: lesser of cash received or gain realized** | **$41,539** |

**Step 3.** Depreciation recapture is next determined.

| | |
|---|---|
| Total depreciation deductions | $31,539 |
| Less: straight-line depreciation from 2008–2010 (if no bonus depreciation claimed) | (3,078) |
| Depreciation in excess of straight-line | $28,461 |
| **Gain subject to ordinary income tax rates (depreciation recapture): lesser of gain recognized or depreciation in excess of straight-line** | **$28,461** |

**Step 4.** Then, unrecaptured §1250 gain is calculated.

| | |
|---|---|
| Gain recognized | $41,539 |
| Less: depreciation recaptured | (28,461) |
| **A. Remaining gain after depreciation recapture** | **$13,078** |
| B. Straight-line depreciation if no bonus depreciation claimed | 3,078 |
| **Unrecaptured §1250 gain: lesser of A or B** | **$ 3,078** |

**Step 5.** Finally, the gain subject to capital gain tax rates is determined.

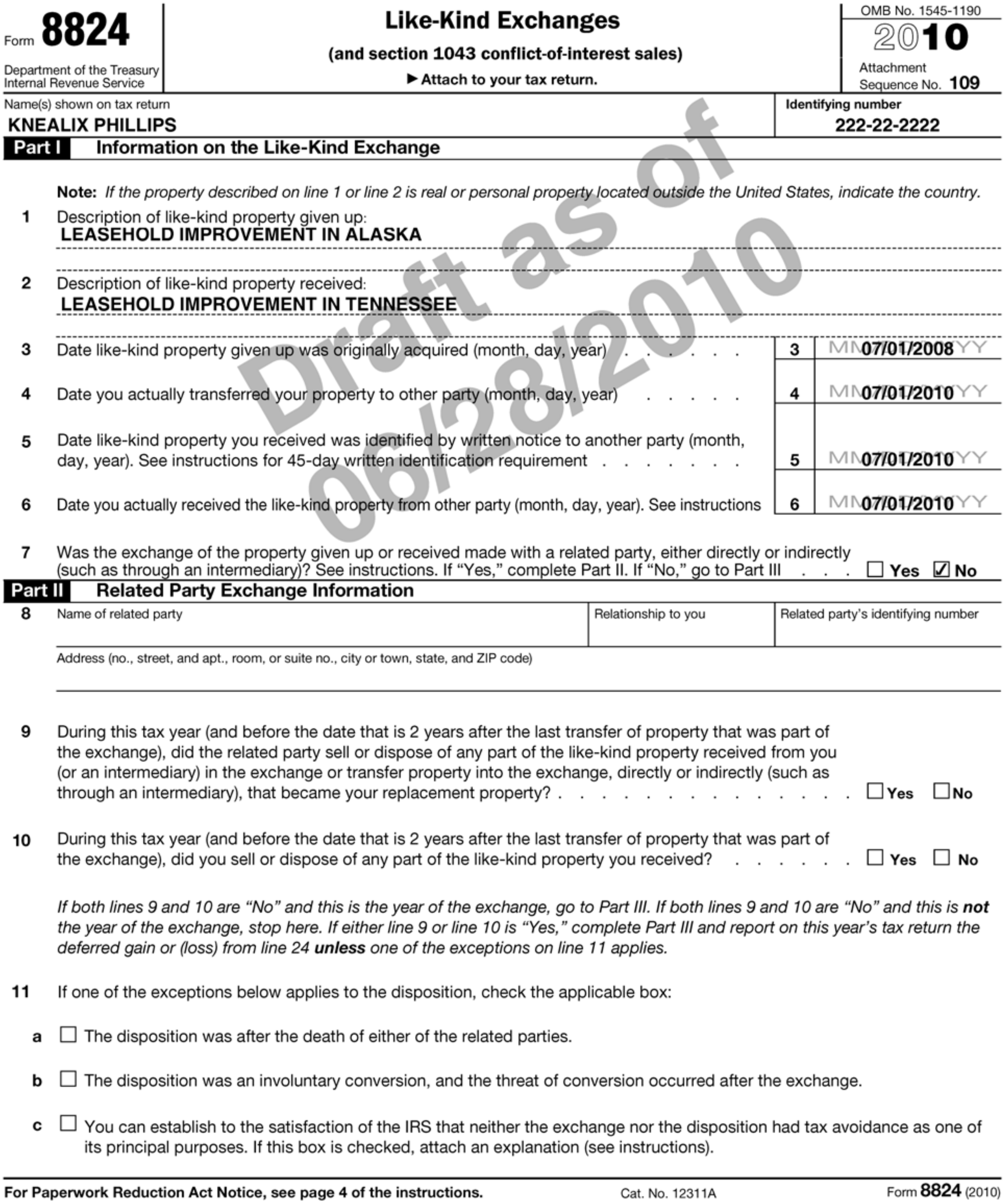
| | |
|---|---|
| Remaining gain after depreciation recapture | $13,078 |
| Less: unrecaptured §1250 gain | (3,078) |
| **Gain subject to capital gain tax rates** | **$10,000** |

**Observations.**

1. Because Knealix's taxable income is $100,000 before consideration of this exchange, his marginal tax rate for 2010 is 28%.
2. The $28,461 depreciation recapture is taxed at the 28% ordinary income tax rate **(Step 3).**
3. The $3,078 unrecaptured §1250 gain is taxed at the 25% tax rate **(Step 4).**
4. The remaining gain of $10,000 is taxed at the 15% capital gains tax rate **(Step 5).**
5. For §1250 property on which 50% bonus depreciation was used, depreciation in excess of straight-line will always equal the adjusted basis of the property.

Knealix's Form 8824, *Like-Kind Exchanges,* and Form 4797, *Sales of Business Property,* are shown on the following pages.

## For Example 25



Form **8824**

Department of the Treasury
Internal Revenue Service

## Like-Kind Exchanges

**(and section 1043 conflict-of-interest sales)**

▶ **Attach to your tax return.**

OMB No. 1545-1190

2010

Attachment
Sequence No. **109**

Name(s) shown on tax return: **KNEALIX PHILLIPS**

**Identifying number:** **222-22-2222**

**Part I** **Information on the Like-Kind Exchange**

**Note:** *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1 Description of like-kind property given up:
**LEASEHOLD IMPROVEMENT IN ALASKA**

2 Description of like-kind property received:
**LEASEHOLD IMPROVEMENT IN TENNESSEE**

3 Date like-kind property given up was originally acquired (month, day, year) . . . . . . . **3** **07/01/2008**

4 Date you actually transferred your property to other party (month, day, year) . . . . . . **4** **07/01/2010**

5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement . . . . . . . . **5** **07/01/2010**

6 Date you actually received the like-kind property from other party (month, day, year). See instructions **6** **07/01/2010**

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . . ☐ **Yes** ☑ **No**

**Part II** **Related Party Exchange Information**

8 Name of related party
Relationship to you
Related party's identifying number
Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange or transfer property into the exchange, directly or indirectly (such as through an intermediary), that became your replacement property? . . . . . . . . . . . . . . ☐ **Yes** ☐ **No**

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? . . . . . . . ☐ **Yes** ☐ **No**

*If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is* ***not*** *the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24* ***unless*** *one of the exceptions on line 11 applies.*

11 If one of the exceptions below applies to the disposition, check the applicable box:

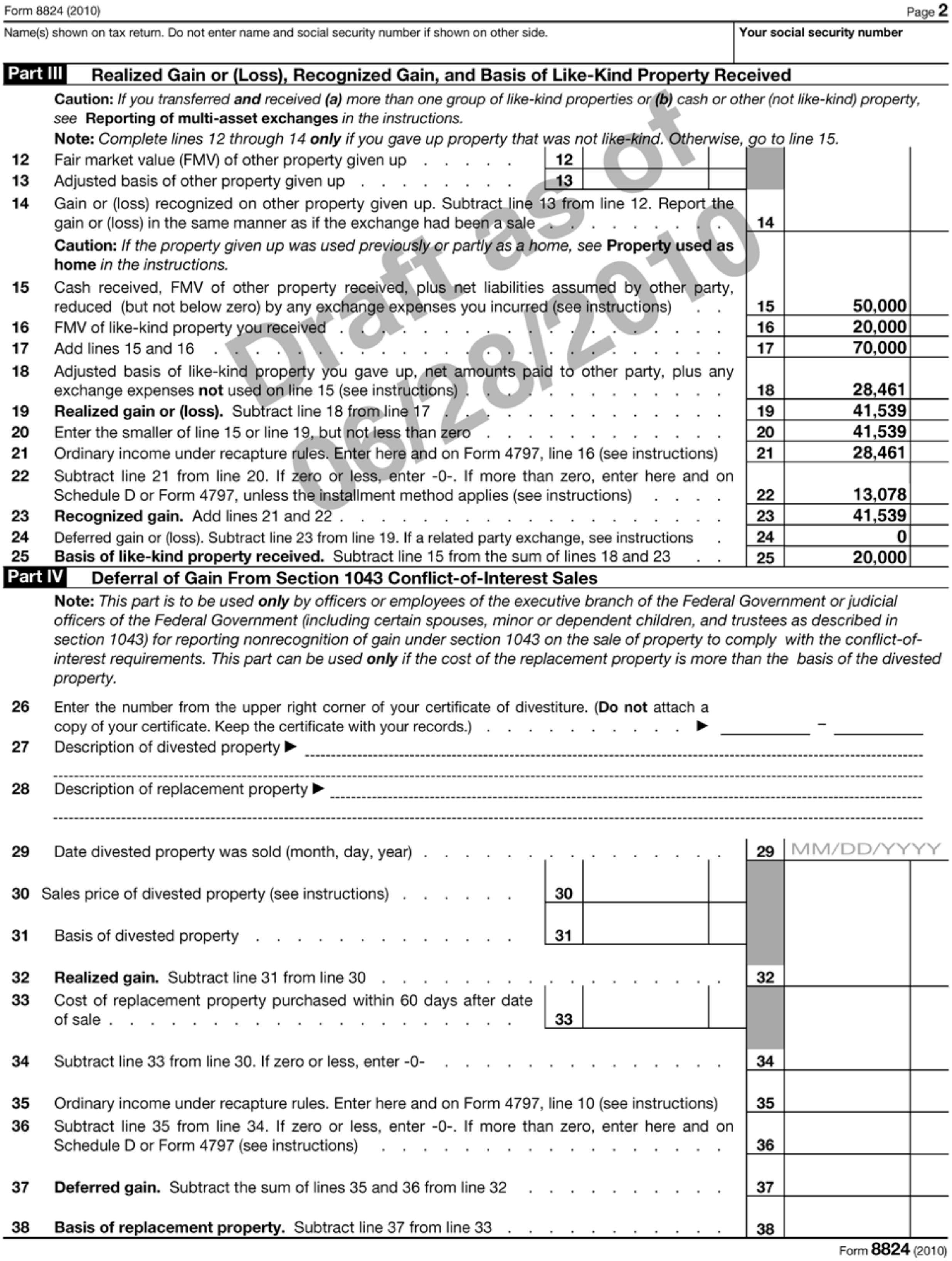
**a** ☐ The disposition was after the death of either of the related parties.

**b** ☐ The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

**c** ☐ You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation (see instructions).

**For Paperwork Reduction Act Notice, see page 4 of the instructions.** Cat. No. 12311A Form **8824** (2010)

## For Example 25



Form 8824 (2010) Page **2**

Name(s) shown on tax return. Do not enter name and social security number if shown on other side. | **Your social security number**

**Part III** **Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received**

**Caution:** *If you transferred **and** received **(a)** more than one group of like-kind properties or **(b)** cash or other (not like-kind) property, see* **Reporting of multi-asset exchanges** *in the instructions.*

**Note:** *Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.*

| | | | | | |
|---|---|---|---|---|---|
| 12 | Fair market value (FMV) of other property given up | 12 | | | |
| 13 | Adjusted basis of other property given up | 13 | | | |
| 14 | Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale | | | 14 | |
| | **Caution:** *If the property given up was used previously or partly as a home, see* **Property used as home** *in the instructions.* | | | | |
| 15 | Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions) | | | 15 | 50,000 |
| 16 | FMV of like-kind property you received | | | 16 | 20,000 |
| 17 | Add lines 15 and 16 | | | 17 | 70,000 |
| 18 | Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15 (see instructions) | | | 18 | 28,461 |
| 19 | **Realized gain or (loss).** Subtract line 18 from line 17 | | | 19 | 41,539 |
| 20 | Enter the smaller of line 15 or line 19, but not less than zero | | | 20 | 41,539 |
| 21 | Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions) | | | 21 | 28,461 |
| 22 | Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions) | | | 22 | 13,078 |
| 23 | **Recognized gain.** Add lines 21 and 22 | | | 23 | 41,539 |
| 24 | Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions | | | 24 | 0 |
| 25 | **Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23 | | | 25 | 20,000 |

**Part IV** **Deferral of Gain From Section 1043 Conflict-of-Interest Sales**

**Note:** *This part is to be used **only** by officers or employees of the executive branch of the Federal Government or judicial officers of the Federal Government (including certain spouses, minor or dependent children, and trustees as described in section 1043) for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used **only** if the cost of the replacement property is more than the basis of the divested property.*

26 Enter the number from the upper right corner of your certificate of divestiture. (**Do not** attach a copy of your certificate. Keep the certificate with your records.) ▶ ________ – ________

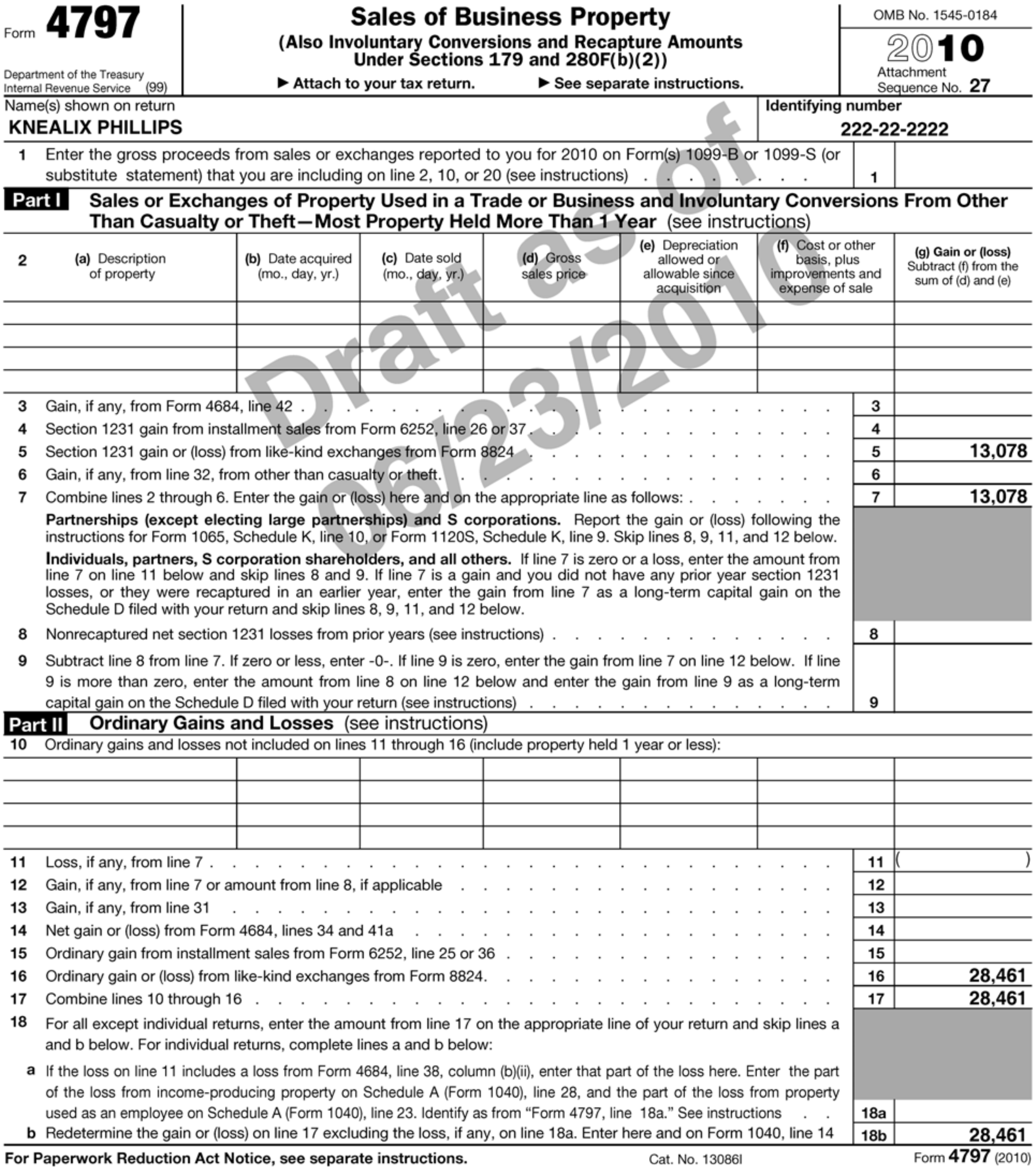
27 Description of divested property ▶ ______________________________

28 Description of replacement property ▶ ______________________________

| | | | | | |
|---|---|---|---|---|---|
| 29 | Date divested property was sold (month, day, year) | | | 29 | MM/DD/YYYY |
| 30 | Sales price of divested property (see instructions) | 30 | | | |
| 31 | Basis of divested property | 31 | | | |
| 32 | **Realized gain.** Subtract line 31 from line 30 | | | 32 | |
| 33 | Cost of replacement property purchased within 60 days after date of sale | 33 | | | |
| 34 | Subtract line 33 from line 30. If zero or less, enter -0- | | | 34 | |
| 35 | Ordinary income under recapture rules. Enter here and on Form 4797, line 10 (see instructions) | | | 35 | |
| 36 | Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797 (see instructions) | | | 36 | |
| 37 | **Deferred gain.** Subtract the sum of lines 35 and 36 from line 32 | | | 37 | |
| 38 | **Basis of replacement property.** Subtract line 37 from line 33 | | | 38 | |

Form **8824** (2010)

**For Example 25**



Form **4797**

Department of the Treasury
Internal Revenue Service (99)

## Sales of Business Property

**(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

2010

Attachment Sequence No. 27

Name(s) shown on return: **KNEALIX PHILLIPS**

Identifying number: **222-22-2222**

| | | | |
|---|---|---|---|
| 1 | Enter the gross proceeds from sales or exchanges reported to you for 2010 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) | 1 | |

**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** (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) |
|---|---|---|---|---|---|---|
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

| | | | |
|---|---|---|---|
| 3 | Gain, if any, from Form 4684, line 42 | 3 | |
| 4 | Section 1231 gain from installment sales from Form 6252, line 26 or 37 | 4 | |
| 5 | Section 1231 gain or (loss) from like-kind exchanges from Form 8824 | 5 | 13,078 |
| 6 | Gain, if any, from line 32, from other than casualty or theft | 6 | |
| 7 | Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: | 7 | 13,078 |
| | **Partnerships (except electing large partnerships) and S corporations.** 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.<br>**Individuals, partners, S corporation shareholders, and all others.** 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) | 8 | |
| 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) | 9 | |

**Part II** **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

| | | | |
|---|---|---|---|
| 11 | Loss, if any, from line 7 | 11 | ( ) |
| 12 | Gain, if any, from line 7 or amount from line 8, if applicable | 12 | |
| 13 | Gain, if any, from line 31 | 13 | |
| 14 | Net gain or (loss) from Form 4684, lines 34 and 41a | 14 | |
| 15 | Ordinary gain from installment sales from Form 6252, line 25 or 36 | 15 | |
| 16 | Ordinary gain or (loss) from like-kind exchanges from Form 8824 | 16 | 28,461 |
| 17 | Combine lines 10 through 16 | 17 | 28,461 |
| 18 | For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below: | | |
| a | If the loss on line 11 includes a loss from Form 4684, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions | 18a | |
| b | Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14 | 18b | 28,461 |

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 13086I Form **4797** (2010)

## ISSUE 7: FORM 3115 CHANGE IN ACCOUNTING METHOD

Form 3115, *Application for Change in Accounting Method,* is used to apply for a change in accounting method. A "change in accounting method," according to the regulations, is more than correcting a mathematical error.[64] A change must involve the timing of a deduction or inclusion of income.

**Example 26.** Christine has always reported her postage expense as an **office supply expense**. In 2010, she reports the expense as **postage expense.** This is not a change in accounting method and does not require a Form 3115.

Changes in method of accounting include a change from the cash receipts and disbursements method to the accrual method or vice versa. Other changes include switching the method or basis used in valuing inventories or converting from the cash or accrual method to a long-term contract method.[65]

> **Note.** Adjustments related to changes in accounting method are calculated without regard to whether the underlying transaction occurred during a closed period. For example, a depreciation adjustment includes years barred from amendment by the statute of limitations.

**Example 27.** Monty Scott is a picker. He travels the back roads of Arkansas looking for "junk" that some people think is worthless but other people may consider antiques or collectibles. Monty buys $25,000 of "junk" each year. He may hold the purchases up to five years before he finds a buyer. When he files his Schedule C, he deducts his current-year purchases as cost of goods sold. He has reported the purchases in this manner for seven years.

Monty's new tax preparer questions why there is no ending inventory on his prior returns. Monty replies, "Because the money's all spent." The preparer informs him that the unsold purchases should be included in ending inventory. Fortunately, Monty keeps a detailed log of all of his purchases which shows the dates purchased and sold as well as the cost and selling price. Together he and his preparer determine that as of December 31, 2009, he had $80,000 of unsold items in inventory.

**Tax Result.** Changing Monty's method of accounting for inventory delays the reporting of the deduction and must be reported on Form 3115. Monty's completed Form 3115 follows. Pages of the form not applicable to Monty were omitted.

Monty reports $20,000 (**one-fourth**[66] of the total $80,000 adjustment) as other income on his Schedule C for 2010 and the deferred income of $60,000 (three-fourths of the total $80,000 adjustment) is reflected on his balance sheet. The $80,000 of inventory will be reported on line 39 of Schedule C as a §481(a) adjustment.

The change Monty is making is covered under the automatic change procedures and is described in the Instructions to Form 3115:

***50.** Small taxpayer ($1 million) inventory exception (section 471) — for a qualifying applicant with average annual gross receipts of $1,000,000 or less (see Rev. Proc. 2001-10, 2001-1 C.B. 272), from the present method of accounting for inventoriable items (including, if applicable, the method of capitalizing costs under section 263A) to treating inventoriable items in the same manner as materials and supplies that are not incidental under Regulations section 1.162-3. Complete Schedule A, Part I, and Schedule D, Parts II and III, of Form 3115, as applicable. See section 21.03 in the Appendix of Rev. Proc. 2008-52.*

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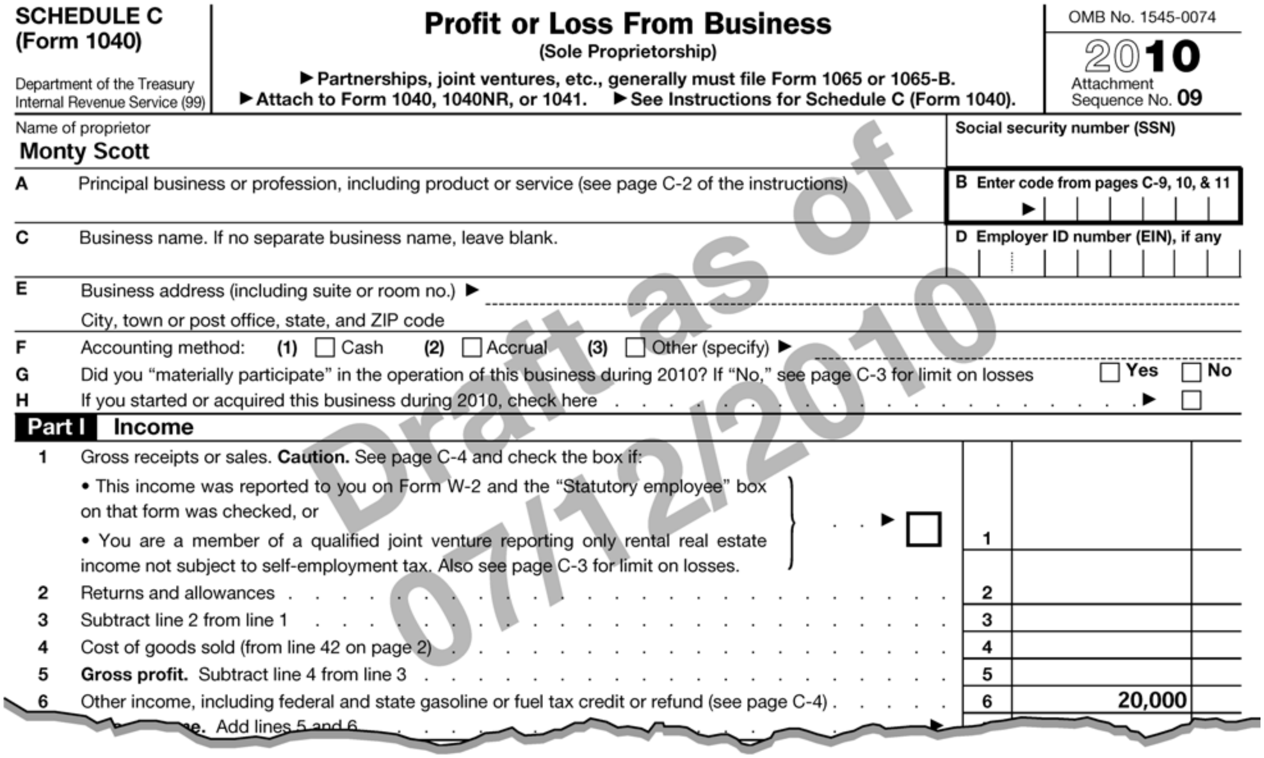
[64] Treas. Reg. §1.446-1(e)(2)(ii)(b).

[65] Treas. Reg. §1.446-1(e)(2)(ii)(a).

[66] IRC §481(a).

## For Example 27



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

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

OMB No. 1545-0074
2010
Attachment Sequence No. 09

Name of proprietor: Monty Scott

**Social security number (SSN)**

A Principal business or profession, including product or service (see page C-2 of the instructions)

**B Enter code from pages C-9, 10, & 11** ▶

C Business name. If no separate business name, leave blank.

**D Employer ID number (EIN), if any**

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

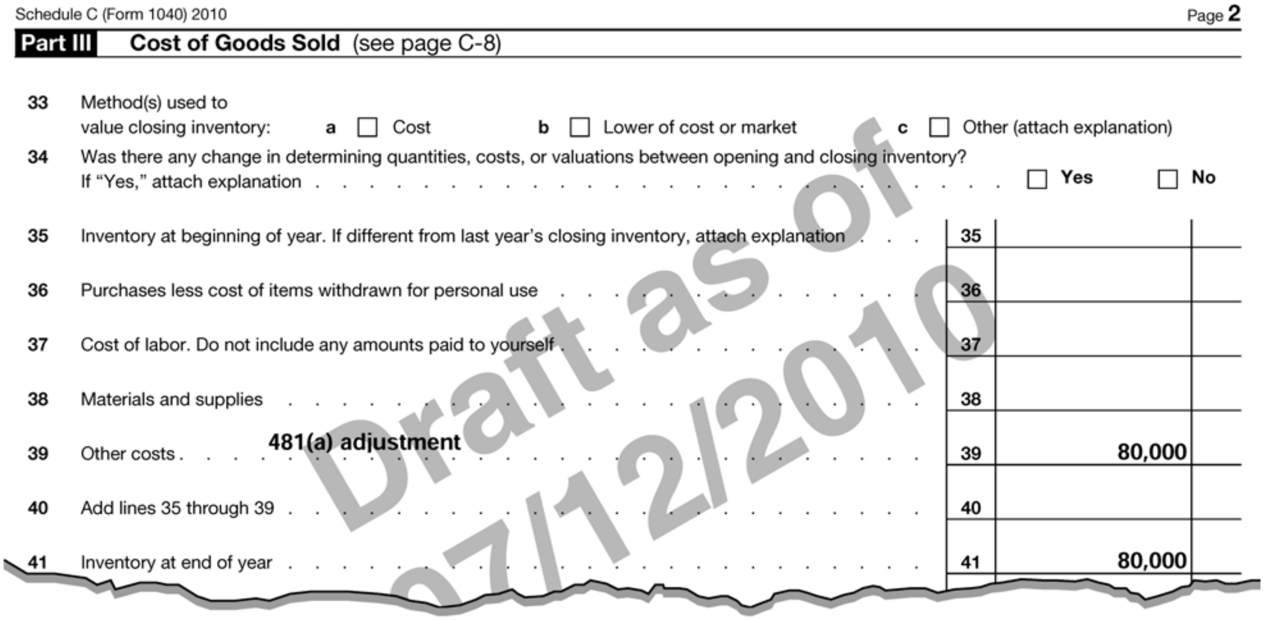
F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2010? If "No," see page C-3 for limit on losses ☐ Yes ☐ No

H If you started or acquired this business during 2010, check here ▶ ☐

**Part I Income**

| | | | |
|---|---|---|---|
| 1 | Gross receipts or sales. **Caution.** See page C-4 and check the box if:<br>• This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or<br>• You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses. ▶ ☐ | 1 | |
| 2 | Returns and allowances | 2 | |
| 3 | Subtract line 2 from line 1 | 3 | |
| 4 | Cost of goods sold (from line 42 on page 2) | 4 | |
| 5 | **Gross profit.** Subtract line 4 from line 3 | 5 | |
| 6 | Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4) | 6 | 20,000 |
| | **e.** Add lines 5 and 6 ▶ | | |



Schedule C (Form 1040) 2010 Page **2**

**Part III Cost of Goods Sold** (see page C-8)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

| | | | |
|---|---|---|---|
| 35 | Inventory at beginning of year. If different from last year's closing inventory, attach explanation | 35 | |
| 36 | Purchases less cost of items withdrawn for personal use | 36 | |
| 37 | Cost of labor. Do not include any amounts paid to yourself | 37 | |
| 38 | Materials and supplies | 38 | |
| 39 | Other costs **481(a) adjustment** | 39 | 80,000 |
| 40 | Add lines 35 through 39 | 40 | |
| 41 | Inventory at end of year | 41 | 80,000 |

**For Example 27**

Form **3115**
(Rev. December 2009)
Department of the Treasury
Internal Revenue Service

## Application for Change in Accounting Method

OMB No. 1545-0152

Name of filer (name of parent corporation if a consolidated group) (see instructions): MONTY SCOTT

**Identification number (see instructions):** 199-62-1969

Principal business activity code number (see instructions): 453310

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

Tax year of change begins (MM/DD/YYYY): 01/01/2010

Tax year of change ends (MM/DD/YYYY): 12/31/2010

City or town, state, and ZIP code

Name of contact person (see instructions): LENNY SPROCK, CPA

Name of applicant(s) (if different than filer) and identification number(s) (see instructions)

Contact person's telephone number: (217) 555-5555

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

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ▶ ☑

**Check the box to indicate the type of applicant.**

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

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

- ☐ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☑ Other (specify) ▶ SEE PART I LINE 1

**Caution.** *To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes all information requested on this Form 3115 (including its instructions), as well as any other information that is not specifically requested.*

**The taxpayer must attach all applicable supplemental statements requested throughout this form.**

### Part I Information For Automatic Change Request

| | | Yes | No |
|---|---|---|---|
| 1 | Enter the applicable designated automatic accounting method change number for the requested automatic change. Enter only one designated automatic accounting method change number, except as provided for in guidance published by the IRS. If the requested change has no designated automatic accounting method change number, check "Other," and provide both a description of the change and citation of the IRS guidance providing the automatic change. See instructions.<br>▶ (a) Change No. 50 (b) Other ☐ Description ▶ | | |
| 2 | Do any of the scope limitations described in section 4.02 of Rev. Proc. 2008-52 cause automatic consent to be unavailable for the applicant's requested change? If "Yes," attach an explanation. . . . . . . . . . . . . | | ✓ |

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

### Part II Information For All Requests

| | | Yes | No |
|---|---|---|---|
| 3 | Did or will the applicant cease to engage in the trade or business to which the requested change relates, or terminate its existence, in the tax year of change (see instructions)? . . . . . . . . . . . . . . . . . . . . . .<br>If "Yes," the applicant is not eligible to make the change under automatic change request procedures. | | ✓ |
| 4a | Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) under examination (see instructions)? . . . . . .<br>If "No," go to line 5. | | ✓ |
| b | Is the method of accounting the applicant is requesting to change an issue (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) either (i) under consideration or (ii) placed in suspense (see instructions)? . . . . . . . . . . . . . . . | | ✓ |

**Signature** *(see instructions)*

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

| Filer | Preparer (other than filer/applicant) |
|---|---|
| Signature and date | Signature of individual preparing the application and date |
| Name and title (print or type) | Name of individual preparing the application (print or type) |
| | Name of firm preparing the application |

**For Privacy Act and Paperwork Reduction Act Notice, see the instructions.** Cat. No. 19280E Form **3115** (Rev. 12-2009)

### For Example 27

Form 3115 (Rev. 12-2009) Page **2**

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

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

Form **3115** (Rev. 12-2009)

## For Example 27

Form 3115 (Rev. 12-2009) Page **3**

| | **Part II** **Information For All Requests** (continued) | **Yes** | **No** |
|---|---|---|---|
| **12** | If the applicant is either (i) **not** changing its overall method of accounting, or (ii) is changing its overall method of accounting and also changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following: | | |
| **a** | The item(s) being changed. | | |
| **b** | The applicant's present method for the item(s) being changed. | | |
| **c** | The applicant's proposed method for the item(s) being changed. | | |
| **d** | The applicant's present overall method of accounting (cash, accrual, or hybrid). | | |
| **13** | Attach a detailed and complete description of the applicant's trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application. | | |
| **14** | Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions . . . . . . . . . . . . . . . . . . . . . . . . <br>If "No," attach an explanation. | ✓ | |
| **15a** | Has the applicant engaged, or will it engage, in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed tax year of change determined without regard to any potential closing of the year under section 381(b)(1)? . . . . . . . . . . . . . . . . . . . . . | | ✓ |
| **b** | If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application. | | |
| **16** | Does the applicant request a conference with the IRS National Office if the IRS proposes an adverse response? | | ✓ |
| **17** | If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460, or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change. | | |

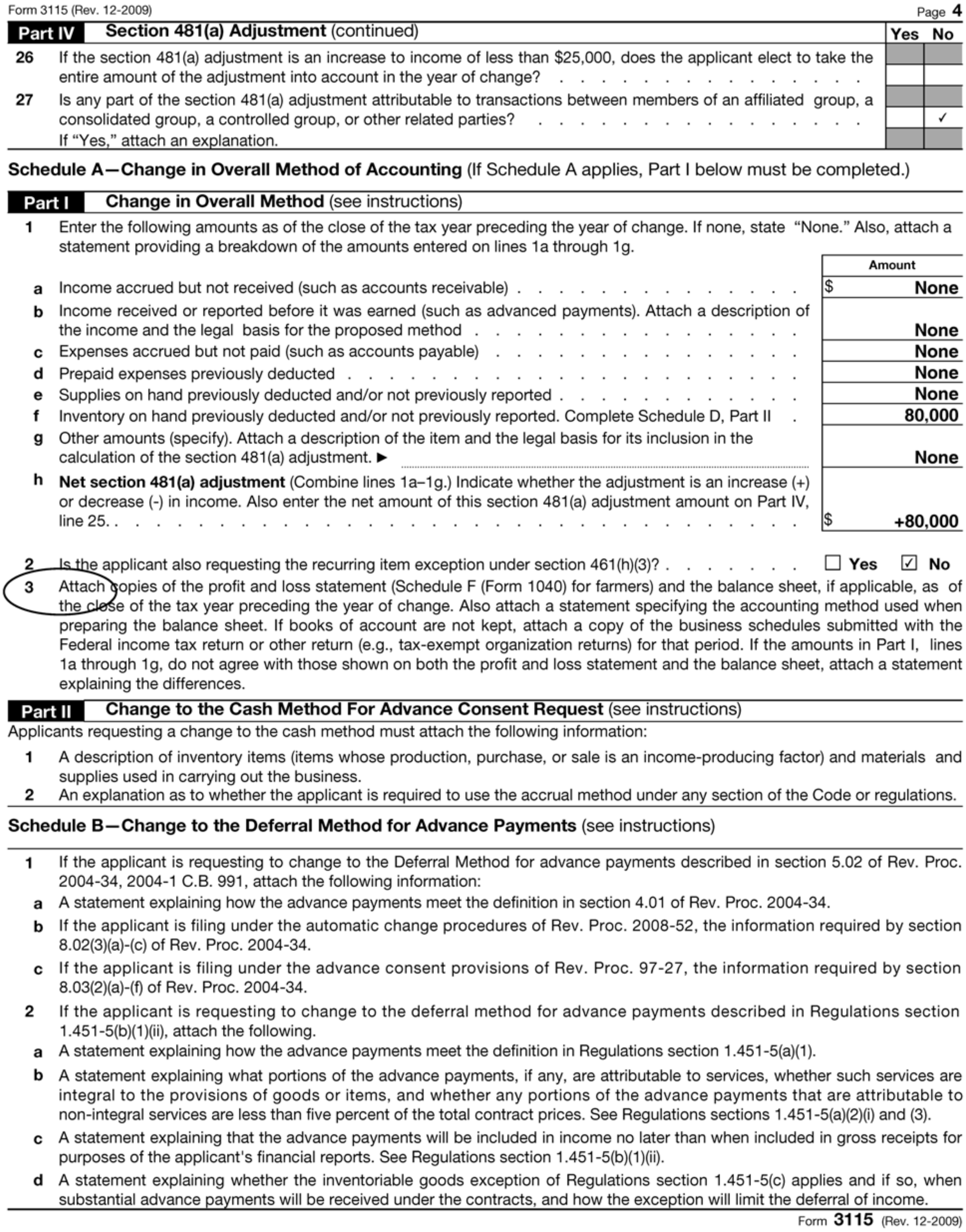
| 1st preceding year ended: mo. | yr. | 2nd preceding year ended: mo. | yr. | 3rd preceding year ended: mo. | yr. |
|---|---|---|---|---|---|
| $ 30,000 | 2007 | $ 35,000 | 2008 | $ 28,000 | 2009 |

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

| | **Part IV** **Section 481(a) Adjustment** | **Yes** | **No** |
|---|---|---|---|
| **24** | Does the applicable revenue procedure, revenue ruling, notice, regulation, or other published guidance require the applicant to implement the requested change in method of accounting on a cut-off basis rather than a section 481(a) adjustment? . . . <br>If "Yes," do not complete lines 25, 26, and 27 below. | | ✓ |
| **25** | Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ +80,000 Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant. | | |

Form **3115** (Rev. 12-2009)

## For Example 27



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**Part IV** **Section 481(a) Adjustment** (continued)

| | | Yes | No |
|---|---|---|---|
| **26** | If the section 481(a) adjustment is an increase to income of less than $25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change? | | |
| **27** | Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? If "Yes," attach an explanation. | | ✓ |

**Schedule A—Change in Overall Method of Accounting** (If Schedule A applies, Part I below must be completed.)

**Part I** **Change in Overall Method** (see instructions)

**1** Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also, attach a statement providing a breakdown of the amounts entered on lines 1a through 1g.

| | | Amount |
|---|---|---|
| **a** | Income accrued but not received (such as accounts receivable) | $ **None** |
| **b** | Income received or reported before it was earned (such as advanced payments). Attach a description of the income and the legal basis for the proposed method | **None** |
| **c** | Expenses accrued but not paid (such as accounts payable) | **None** |
| **d** | Prepaid expenses previously deducted | **None** |
| **e** | Supplies on hand previously deducted and/or not previously reported | **None** |
| **f** | Inventory on hand previously deducted and/or not previously reported. Complete Schedule D, Part II | **80,000** |
| **g** | Other amounts (specify). Attach a description of the item and the legal basis for its inclusion in the calculation of the section 481(a) adjustment. ▶ | **None** |
| **h** | **Net section 481(a) adjustment** (Combine lines 1a–1g.) Indicate whether the adjustment is an increase (+) or decrease (-) in income. Also enter the net amount of this section 481(a) adjustment amount on Part IV, line 25. | $ **+80,000** |

**2** Is the applicant also requesting the recurring item exception under section 461(h)(3)? ☐ **Yes** ☑ **No**

**3** Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. Also attach a statement specifying the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, attach a statement explaining the differences.

**Part II** **Change to the Cash Method For Advance Consent Request** (see instructions)

Applicants requesting a change to the cash method must attach the following information:

**1** A description of inventory items (items whose production, purchase, or sale is an income-producing factor) and materials and supplies used in carrying out the business.

**2** An explanation as to whether the applicant is required to use the accrual method under any section of the Code or regulations.

**Schedule B—Change to the Deferral Method for Advance Payments** (see instructions)

**1** If the applicant is requesting to change to the Deferral Method for advance payments described in section 5.02 of Rev. Proc. 2004-34, 2004-1 C.B. 991, attach the following information:

**a** A statement explaining how the advance payments meet the definition in section 4.01 of Rev. Proc. 2004-34.

**b** If the applicant is filing under the automatic change procedures of Rev. Proc. 2008-52, the information required by section 8.02(3)(a)-(c) of Rev. Proc. 2004-34.

**c** If the applicant is filing under the advance consent provisions of Rev. Proc. 97-27, the information required by section 8.03(2)(a)-(f) of Rev. Proc. 2004-34.

**2** If the applicant is requesting to change to the deferral method for advance payments described in Regulations section 1.451-5(b)(1)(ii), attach the following.

**a** A statement explaining how the advance payments meet the definition in Regulations section 1.451-5(a)(1).

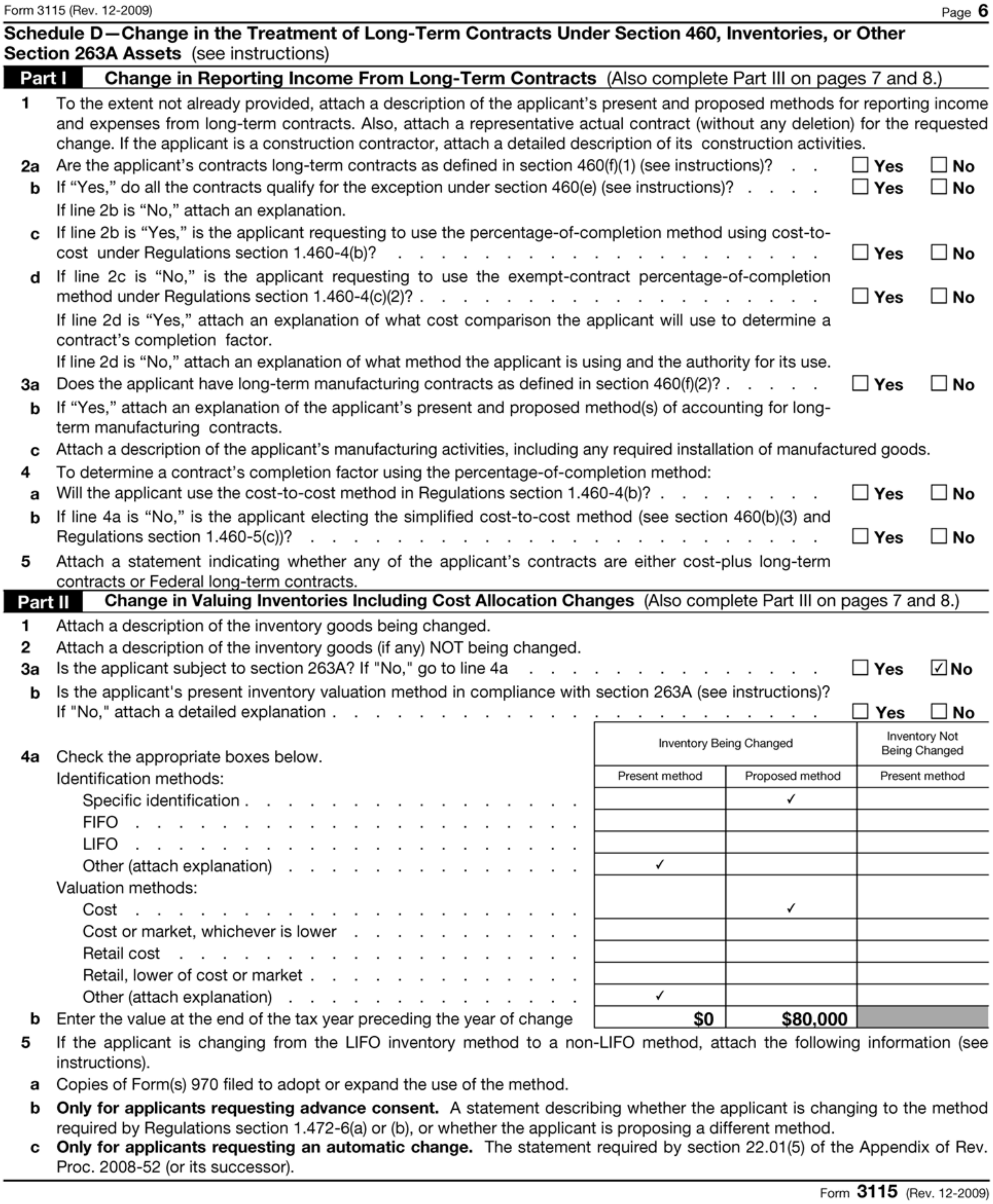
**b** A statement explaining what portions of the advance payments, if any, are attributable to services, whether such services are integral to the provisions of goods or items, and whether any portions of the advance payments that are attributable to non-integral services are less than five percent of the total contract prices. See Regulations sections 1.451-5(a)(2)(i) and (3).

**c** A statement explaining that the advance payments will be included in income no later than when included in gross receipts for purposes of the applicant's financial reports. See Regulations section 1.451-5(b)(1)(ii).

**d** A statement explaining whether the inventoriable goods exception of Regulations section 1.451-5(c) applies and if so, when substantial advance payments will be received under the contracts, and how the exception will limit the deferral of income.

Form **3115** (Rev. 12-2009)

**For Example 27**



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## Schedule D—Change in the Treatment of Long-Term Contracts Under Section 460, Inventories, or Other Section 263A Assets (see instructions)

**Part I** **Change in Reporting Income From Long-Term Contracts** (Also complete Part III on pages 7 and 8.)

**1** To the extent not already provided, attach a description of the applicant's present and proposed methods for reporting income and expenses from long-term contracts. Also, attach a representative actual contract (without any deletion) for the requested change. If the applicant is a construction contractor, attach a detailed description of its construction activities.

**2a** Are the applicant's contracts long-term contracts as defined in section 460(f)(1) (see instructions)? . . ☐ **Yes** ☐ **No**

**b** If "Yes," do all the contracts qualify for the exception under section 460(e) (see instructions)? . . . . ☐ **Yes** ☐ **No**

If line 2b is "No," attach an explanation.

**c** If line 2b is "Yes," is the applicant requesting to use the percentage-of-completion method using cost-to-cost under Regulations section 1.460-4(b)? . . . . . . . . . . . . . . . . . . . . . . . ☐ **Yes** ☐ **No**

**d** If line 2c is "No," is the applicant requesting to use the exempt-contract percentage-of-completion method under Regulations section 1.460-4(c)(2)? . . . . . . . . . . . . . . . . . . . . . . ☐ **Yes** ☐ **No**

If line 2d is "Yes," attach an explanation of what cost comparison the applicant will use to determine a contract's completion factor.

If line 2d is "No," attach an explanation of what method the applicant is using and the authority for its use.

**3a** Does the applicant have long-term manufacturing contracts as defined in section 460(f)(2)? . . . . . ☐ **Yes** ☐ **No**

**b** If "Yes," attach an explanation of the applicant's present and proposed method(s) of accounting for long-term manufacturing contracts.

**c** Attach a description of the applicant's manufacturing activities, including any required installation of manufactured goods.

**4** To determine a contract's completion factor using the percentage-of-completion method:

**a** Will the applicant use the cost-to-cost method in Regulations section 1.460-4(b)? . . . . . . . . ☐ **Yes** ☐ **No**

**b** If line 4a is "No," is the applicant electing the simplified cost-to-cost method (see section 460(b)(3) and Regulations section 1.460-5(c))? . . . . . . . . . . . . . . . . . . . . . . . . . . ☐ **Yes** ☐ **No**

**5** Attach a statement indicating whether any of the applicant's contracts are either cost-plus long-term contracts or Federal long-term contracts.

**Part II** **Change in Valuing Inventories Including Cost Allocation Changes** (Also complete Part III on pages 7 and 8.)

**1** Attach a description of the inventory goods being changed.

**2** Attach a description of the inventory goods (if any) NOT being changed.

**3a** Is the applicant subject to section 263A? If "No," go to line 4a . . . . . . . . . . . . . . . ☐ **Yes** ☑ **No**

**b** Is the applicant's present inventory valuation method in compliance with section 263A (see instructions)? If "No," attach a detailed explanation . . . . . . . . . . . . . . . . . . . . . . . . ☐ **Yes** ☐ **No**

| **4a** Check the appropriate boxes below. | Inventory Being Changed | | Inventory Not Being Changed |
|---|---|---|---|
| | Present method | Proposed method | Present method |
| Identification methods: | | | |
| Specific identification . . . . . . . . . . . . . . . . . | | ✓ | |
| FIFO . . . . . . . . . . . . . . . . . . . . . | | | |
| LIFO . . . . . . . . . . . . . . . . . . . . . | | | |
| Other (attach explanation) . . . . . . . . . . . . . . | ✓ | | |
| Valuation methods: | | | |
| Cost . . . . . . . . . . . . . . . . . . . . . | | ✓ | |
| Cost or market, whichever is lower . . . . . . . . | | | |
| Retail cost . . . . . . . . . . . . . . . . . . | | | |
| Retail, lower of cost or market . . . . . . . . . . | | | |
| Other (attach explanation) . . . . . . . . . . . . . . | ✓ | | |
| **b** Enter the value at the end of the tax year preceding the year of change | **$0** | **$80,000** | |

**5** If the applicant is changing from the LIFO inventory method to a non-LIFO method, attach the following information (see instructions).

**a** Copies of Form(s) 970 filed to adopt or expand the use of the method.

**b** **Only for applicants requesting advance consent.** A statement describing whether the applicant is changing to the method required by Regulations section 1.472-6(a) or (b), or whether the applicant is proposing a different method.

**c** **Only for applicants requesting an automatic change.** The statement required by section 22.01(5) of the Appendix of Rev. Proc. 2008-52 (or its successor).

Form **3115** (Rev. 12-2009)

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**For Example 27**

**ATTACHMENT TO FORM 3115**

MONTY SCOTT SS# 199-62-1969

**PART II Information for All Requests**

**QUESTION 12.**

- **a.** Taxpayer is changing the method of accounting for inventory.
- **b.** The present method of accounting for inventory is to exclude all items regardless of cost.
- **c.** The proposed method of accounting for inventory is to treat purchases in the same manner as material and supplies that are not incidental. The cost of these items will be deducted in the year that they are sold or the year that they are paid for, whichever is later, as described in Rev. Proc. 2002-28.
- **d.** The applicant's overall method of accounting is the cash basis.

**QUESTION 13.**

The applicant's only business is retailing used merchandise. The principal business activity code is 453310. The taxpayer procures antiques and other items of possible value from remote regions to sell to savvy investors. He maintains a storefront, a website, and a presence on online auction sites.

**PART IV Section 481(a) Adjustment**

25. §481(a) Adjustment

The applicant maintains a detailed inventory log showing the amount paid and date purchased for each item. The log also shows the selling price and date sold. His unsold inventory on December 31, 2010, that was previously deducted for tax years 2003 through 2009 cost $80,000.

**SCHEDULE A**

**PART I Line 3** — Please see copy of applicant's Schedule C from tax year ending 12/31/2009, attached. The taxpayer does not maintain a balance sheet as part of its books and records.

**SCHEDULE D**

**PART II**

- **1.** The inventory items are described above under PART II Question 13.
- **2.** The accounting for all items is being changed.
- **4.** a. The method of identification and valuation used for tax years 2003 through 2009 was None.

**PART III**

The applicant is not subject to §263A or §460.

The IRS has updated Form 3115, *Application for Change in Accounting Method*, and its instructions. Applicants must now use the **December 2009 revision** to request approval for a change in accounting method.[67] Some changes are approved automatically while others require the advance consent of the IRS.

> **Caution.** As of June 30, 2010, the December 2009 revision of Form 3115 and its instructions include all the applicable revenue procedures to date. However, the IRS usually makes multiple changes to the procedures before it revises the form and/or instructions.
>
> Therefore, the instructions for Form 3115 may not reflect all the current revenue procedures and notices. The first revenue procedure issued each year by the IRS includes an update for applications for changes in accounting methods. Practitioners should refer to this revenue procedure and subsequent current year guidance for changes that may affect the filing of Form 3115.

## AUTOMATIC CHANGE PROCEDURES[68]

Listed in the Form 3115 instructions are approximately 149 changes that can be made under the automatic change procedures by qualifying taxpayers. Taxpayers using these procedures are deemed to have automatically received the IRS's consent to make the change, provided the taxpayers meet the conditions and follow the procedures. **There is no fee for applications filed under the automatic change procedures.** The IRS does not acknowledge approval of applications filed under these procedures. However, the IRS reviews the Form 3115, and if they require more information or deny the change, they notify the taxpayer.

Of the changes allowed under the automatic change procedures, those most applicable to a small business include the following:

- **Commodity Credit Corporation Loans.** Change from including the loan amount in gross income for the tax year in which the loan is received to treating the loan amount as a loan.
- **Lawyers Handling Cases on a Contingent-Fee Basis.** Change from treating advances of money to clients for litigation costs as deductible business expenses to treating those advances as loans.
- **Bad Debts.** For an applicant other than a bank, change from accounting for bad debts using a reserve or other improper method to a specific charge-off method that complies with IRC §166.
- **State or Local Income or Franchise Tax Refunds.** For an accrual-method applicant with state or local income or franchise tax refunds, change to accruing these refunds in the tax year the applicant receives payments or notice of approval of its refund claim, whichever is earlier.
- **Timing of Incurring Real Property Taxes, Personal Property Taxes, State Income Taxes, and State Franchise Taxes.** For a qualifying applicant, either change to treating these taxes as incurred in the tax year in which the taxes are paid, or to account for these taxes under the recurring item exception to the economic performance rules, or to revoke the ratable accrual election under IRC §461(c).
- **Timing of Incurring Certain Payroll Tax Liabilities.** For FICA and FUTA taxes, state unemployment taxes, and railroad retirement taxes, change to the method under which the applicant may deduct in Year 1 its otherwise deductible payroll taxes for yearend wages properly accrued in Year 1, but paid in Year 2.

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[67] IRS Ann. 2010-32, 2010-19 IRB 681.

[68] Instructions for Form 3115, *Application for Change in Accounting Method.*

- **Impermissible to Permissible Method of Accounting for Depreciation or Amortization for Disposed Depreciable or Amortizable Property.** For property that has been disposed by the taxpayer and for which the taxpayer deducted less than the depreciation allowable, change from using an impermissible method of accounting for depreciation to using a permissible method of accounting for depreciation.
- **Improperly Capitalized Repair and Maintenance Costs.** For repair and maintenance costs improperly capitalized as improvements, change from deducting the remaining basis as a depreciation expense over the remaining life to deducting the remaining basis as a repair expense in the current year.

**Note.** For additional information about changing from an impermissible method to a permissible method of depreciation, see Chapter 7, Depreciation, of the 2008 *University of Illinois Federal Tax Workbook*, and Chapter 9, Small Business Issues, of the 2009 edition. These can be found on the accompanying CD.

## Exceptions

Generally, the following taxpayers do **not** qualify to use the automatic procedures:

1. Taxpayers being audited (For exceptions, see section 4.02(1) of Rev. Proc. 2008-52, as modified by Rev. Proc. 2009-39.)
2. Members of a consolidated group that is under examination for tax year(s) when the applicant was a member of the group[69]
3. Partnerships and S corporations when the accounting method to be changed is an issue under consideration in an examination of a partner, member, or shareholder of the applicant[70]
4. Taxpayers engaged in transactions involving carryovers in certain corporate acquisitions[71] in the proposed tax year of change[72]
5. Taxpayers in the final tax year of their trade or business[73] (This exclusion does not apply to all changes. For example, changes from impermissible to permissible methods of accounting for depreciation and amortization are allowed in the final year of business under the automatic change procedures.[74])
6. Taxpayers who have made or applied to make a change in method of accounting for the same item (or for its overall method) within the last five tax years, including the year of change[75]

Form 3115 must be filed in duplicate under the procedures for automatic change requests. The original is attached to the taxpayer's timely-filed (including extensions) federal income tax return for the year of change. A copy of Form 3115 is filed with the IRS national office no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change. A limited 6-month extension of time to file Form 3115 is sometimes available for automatic change requests.[76] An application fee is charged for an extension request.

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[69] For more information, see section 4.02(2) of Rev. Proc. 2008-52, 2008-36 IRB 587.

[70] Ibid, section 4.02(3).

[71] As described in IRC §381(a).

[72] For more information, including exceptions to this limitation, see section 4.02(4) of Rev. Proc. 2008-52, 2008-36 IRB 587, as modified by Rev. Proc. 2009-39, 2009-38 IRB 371.

[73] For more information see sections 4.02(5) and 5.04(3)(c) of Rev. Proc. 2008-52, 2008-36 IRB 587.

[74] Ibid, section 6.01(2).

[75] Ibid, sections 4.02(6) and 4.02(7).

[76] Ibid, section 6.02(3)(b); Treas. Reg. §301.9100-2.

Copies of Form 3115 may be required to be sent to additional IRS offices. For example, taxpayers under examination are required to submit an additional copy to the examining agent. Taxpayers who have issues before the appeals office or the federal court also must file additional copies as directed by the current revenue procedure.

The taxpayer and preparer must sign and date the copy of the Form 3115 that is sent to the IRS national office and any additional copy that is not attached to an income tax return. The original which is attached to the income tax return does **not** need to be signed. The copy of Form 3115 for the IRS national office is sent to one of the following addresses:

1. **Mailing address:**

   Internal Revenue Service
   Automatic Rulings Branch
   PO Box 7604
   Ben Franklin Station
   Washington, DC 20044

2. **Private delivery address:**

   Internal Revenue Service
   Automatic Rulings Branch
   Room 5336
   1111 Constitution Ave., NW
   Washington, DC 20244

## ADVANCE CONSENT REQUEST PROCEDURES

The advance consent request procedures are used by taxpayers who do not qualify for the automatic procedures and by taxpayers who are requesting a change that is not included in the automatic procedures. The fees for applications under the advance procedures are found in Rev. Proc. 2010-1. The IRS issues letter rulings for approved changes requested under these procedures.

Generally, the following taxpayers do **not** qualify to use the advance consent request procedures:

1. Taxpayers requesting a change that is required according to a published automatic change procedure[77]
2. Taxpayers under examination (For exceptions, see section 4.02(2) of Rev. Proc. 97-27, as modified by Rev. Proc. 2002-19, and Rev. Proc. 2009-39.)
3. Members of a consolidated group that is under examination, before an appeals office, or before a federal court for the tax year(s) when the applicant was a member of the group[78]
4. Partnerships and S corporations when the accounting method to be changed is an issue under consideration in an examination, by an appeals office, or before a federal court with respect to a partner, member, or shareholder of the applicant[79]

Form 3115 submitted under the advance consent request procedures must be filed during the tax year for which the change is requested. If the tax year is a short period, Form 3115 must be filed by the last day of the short tax year. The original is filed with the IRS national office. The form should be filed as early as possible to provide adequate time for the IRS to respond before the due date of the return. Late applications are allowed in limited circumstances and additional fees apply. The completed Form 3115 is sent to one of the following addresses:

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[77] As of June 30, 2010, the current published procedures are found in Rev. Proc. 2008-52, 2008-36 IRB 587, as modified by Rev. Proc. 2009-39, 2009-38 IRB 371. For more information, see section 4.02(1) of Rev. Proc. 97-27, 1997-1 CB 680.

[78] For more information, see section 4.02(5) of Rev. Proc. 97-27, 1997-1 CB 680, as modified by Rev. Proc. 2009-39, 2009-38 IRB 371.

[79] Ibid, section 4.02(6).

1. **Mailing address:**

   Internal Revenue Service
   Attn: CC:PA:LPD:DRU
   PO Box 7604
   Ben Franklin Station
   Washington, DC 20044

2. **Private delivery address:**

   Internal Revenue Service
   Attn: CC:PA:LPD:DRU
   Room 5336
   1111 Constitution Ave., NW
   Washington, DC 20244

> **Note.** After February 1, 2010, the user fee for an advance consent for nonautomatic changes on Form 3115 is $4,200.

## CATEGORIES OF ACCOUNTING METHOD CHANGES

According to the Form 3115 instructions, there are three primary categories of accounting method changes:

1. Depreciation or amortization includes:
   - **a.** Computation of depreciation or amortization (for example, the depreciation method or recovery period),
   - **b.** Treatment of salvage proceeds or costs of removal,
   - **c.** Method of accounting for retirements of depreciable property, and
   - **d.** Treatment of depreciable property from a single-asset account to a multiple-asset account (pooling), or vice versa.
2. Financial products and/or financial activities of financial institutions includes a change in the treatment of accounting for:
   - **a.** Financial products, including the following:
     - Debt instruments
     - Derivatives
     - Mark-to-market accounting
   - **b.** Financial institutions, including the following:
     - Lending institutions
     - Regulated investment companies
     - Real estate investment trusts
     - Real estate mortgage investment conduits
3. All other changes are included in the **Other** category. For advance consent requests, a short description of the change and the most specific applicable Code section(s) must be included on the front of Form 3115. For automatic change requests, the description is provided by using the change number assigned by the instructions. The instructions also provide a reference to the basic published guidance which provides more information about each automatic change.

# ISSUE 8: NONQUALIFIED DEFERRED COMPENSATION

## OVERVIEW

### Reason for Enactment

A nonqualified deferred compensation arrangement is an arrangement under which compensation is earned in one year but is paid in a later year. These plans can be subject to abuse such as:

- Locating trusts offshore outside the reach of the judiciary and other unsecured creditors, or
- Accelerating service provider payments when financial distress is imminent.

IRC §409A was enacted as part of the American Jobs Creation Act of 2004 to prevent abuse. It applies to **nonqualified deferred compensation** that a taxpayer (a **service recipient**) provides to executives, general employees, board members, and some independent contractors (termed **service providers**). It became effective on January 1, 2005, and was enacted as a Congressional response to the perceived abuse of nonqualified deferred compensation plans by executives of Enron and WorldCom.

**Note.** The provision, however, does not apply to earnings on pre-2005 deferrals, unless the plan was materially modified after October 3, 2004.

The enactment of IRC §162(m) in 1993 led to the creation of many nonqualified deferred compensation plans to preserve tax deductions for compensation over $1 million. IRC §162(m) resulted in compensation packages created to reward risk. Because option income was not covered, stock options became a popular element of compensation packages. Thus, after enactment of §162(m), executives benefitted when the stock value went up but suffered no loss when stock values declined.

While §409A might appear to apply only to formal nonqualified deferred compensation plans, it applies to any promise of compensation to employees or service providers.

### Pre-IRC §409A Rules

Before enactment of IRC §409A, deferrals were governed by several Code provisions, rulings, and court decisions. These included the constructive-receipt doctrine, the economic-benefit rule, and IRC §404(a)(5) which required matching the tax deduction of the payor (i.e., the employer) with the income realization of the payee (i.e., the employee). Also applicable were the following:

- IRC §402(b), which governed the tax consequences of nonqualified funded trusts for deferred compensation
- IRC §3121(v), which imposed FICA tax at the time services are performed or at vesting
- Rev. Proc. 92-64, 1992-2 CB 422 which governed Rabbi trusts

To avoid the deferred compensation being includible in the employee's gross income under the constructive-receipt doctrine, the employee could only have the employer's promise to pay in the future. Therefore, the employee's payment was unsecured until received, unless the funds were set aside in some type of escrow account. This benefitted the employee by delaying the receipt of the income and thereby delaying payment of tax (other than FICA tax) related to that income. Unfortunately, the employer could not get a current deduction and also had to pay tax on investment earnings on the deferred amounts.

## IRC §409A

IRC §409A(d)(1) defines a covered nonqualified deferred compensation plan as any plan that "provides for the deferral of compensation, other than a qualified employer plan (under IRC §401(a), 457(b), or similar provision), and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan." However, severance pay arrangements under §457(f) and certain equity-based compensation arrangements are within the scope of §409A.

According to the final regulations, the following equity-based arrangements are subject to §409A:

- Nonqualified stock options or stock appreciation rights that have an exercise price less than FMV at the date of the grant or that provide a deferral feature
- Restricted stock units that are not paid upon vesting
- Deferred stock units that are not paid upon vesting
- Options to acquire stock that do not constitute "service recipient stock" under §409A

However, certain types of equity-based arrangements (that relate to service recipient stock) are not subject to §409A, such as incentive-stock options, §423 employee-stock purchase plans, and others.

The final regulations also specify that if a principal purpose of a plan is to achieve a deferral of compensation that is inconsistent with the purposes of §409A, the Commissioner may treat the plan as subject to §409A.

Under §409A, deferred compensation is subject to a punitive penalty and must be included in current income if at any time the plan is not properly documented or in operational compliance. Whether a plan provides for the deferral of compensation is determined at the time the service provider obtains a legally-enforceable right to compensation under the plan. That means that subsequent events that might otherwise satisfy an exemption are ignored. Also, §409A requires that both initial and subsequent elections to defer compensation must be made at very specific times. The result is that much of the contractual freedom that executives and employers had to negotiate executive compensation has been eliminated.

IRC §409A does not repeal any Code provision that applies to nonqualified deferred compensation. It also contains a very broad definition of what constitutes nonqualified deferred compensation.

## IRS Regulations

The IRS issued regulations specifying that §409A applies whenever there is a **deferral of compensation.** This is defined as an employee's legal right to income during a tax year that either is or may be deferred to a later year. The effective date of the final regulations is January 1, 2009.

**Note.** However, nonqualified deferred compensation plans still need to be operated in compliance with §409A for deferrals made for taxable years beginning on or after January 1, 2005. For deferrals made before January 1, 2005, §409A is only applicable if the nonqualified deferred compensation plan is materially modified after October 3, 2004.[80]

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[80] Treas. Reg. §1.409A-6(a)(1)(i).

## EXCEPTIONS

There are exceptions to the deferred compensation current inclusion rule. IRC §409A does not apply to the following:

1. Deferred compensation subject to a **substantial risk of forfeiture** (A substantial risk of forfeiture means that the service provider's entitlement to compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to the purpose of the compensation, and the risk of forfeiture is substantial.)
2. Short-term deferrals in which the compensation is received by the later of the 15th day of the third month after the end of the service performer's or the service recipient's taxable year in which the amount is no longer subject to a substantial risk of forfeiture
3. A service provider who uses accrual accounting

**Note.** Service providers rarely use accrual accounting.

4. An independent contractor who performs significant services (as determined by a facts and circumstances test) for two or more unrelated entities and is not related to the service recipient
5. An independent contractor who provides services to a related service recipient as long as:
    a. The contractor provides significant services to at least two service recipients that are not related to the independent contractor or each other and satisfies either the general 70% test or a 3-year look-back safe harbor;
    b. The plan providing for the deferral is a bona fide agreement, method, program, or other arrangement with a related-service recipient that arose in the ordinary course of the independent contractor's trade or business; **and**
    c. The plan is substantially similar to another plan applicable to one or more unrelated service recipients to whom the independent contractor provides substantial services and that produce a majority of the total revenue that the independent contractor earns from the trade or business at issue during the relevant tax year.
6. Any qualified retirement plan (IRC §401(a)) or a plan that would qualify under §401(a) if it had been created or maintained in the United States, tax-exempt annuity, SEP, SIMPLE, §501(c)(18) trust, governmental excess plan (as described in §415(m), or plan described in ERISA section 1022(i)(2)
7. Bona fide vacation leave, sick leave, compensatory time, disability pay or death-benefit plan, Archer medical savings accounts, or other nontaxable health reimbursement arrangements under §§105 or 106

**Note.** The final regulations clarify that changing a plan that provides for payment of benefits on events other than death to one that only provides benefits on death remains exempt from §409A.

8. Payments made to employees in the normal course during a payroll period (as described in IRC §3401(b)) that spans tax years, or similar payments to other service providers
9. IRC §457(b) plans or, to the extent they provide nonelective deferred compensation, to persons who are not employees under §457(e)(12) (Also, length-of-service awards to volunteers under §457(e)(11)(A)(ii) are exempt from §409A.)
10. Grants of partnership interests (or options to purchase partnership interests) in exchange for the performance of services (They are treated under the same principles that govern the issuance of stock. That means their issuance is exempt to the same extent that the issuance of stock is exempt.)

11. Partnership distributions that are used to buy out a partner (except for certain retirement payments to a partner, and distributions to a partner who is not acting in the partner's capacity as a partner)
12. Separation-from-service payments
13. Indemnification rights, at least to the extent that the plan provides for the indemnification of all or part of the expenses or damages a service provider pays with respect to a bona fide claim against the service provider or recipient (This includes amounts paid to settle a bona fide claim against the service provider or recipient.)
14. Legal settlements of bona fide employment claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers' compensation statutes
15. Taxable educational benefits for the service provider
16. Rights that accrued and vested before January 1, 2005, as long as those rights were not materially modified after October 3, 2004 (The final regulations provide detailed rules for determining the extent of grandfathering in any particular situation, and also provide guidance on what does not constitute a material modification.)

**Caution.** If a plan fails to comply with the requirements of §409A as applied to an individual, the failure taints all other plans of the same type.

### Penalty Provision

If the rules are not satisfied (in both form and operation), a harsh penalty applies. The noncompliance penalty requires the following:

1. All compensation deferred under the plan must be included in gross income in the year of the failure.
2. The included amount is subject to a 20% penalty.
3. Interest is charged on the tax due on the included amount attributable to amounts deferred in previous years.[81]

**Observation.** Because the penalty requires the compensation to be included in income, the payor can deduct a like amount under IRC §404(a)(5).

**Application to Trusts.** An offshore Rabbi trust or similar security device triggers the penalty provision.[82]

**Observation.** A Rabbi trust is a type of trust that can defer taxability for the person receiving payments from the trust. Rev. Proc. 92-64 clarifies the rules for Rabbi trusts and provides a model trust document and the necessary features to avoid constructive receipt of income to the employee.

A financial health trigger in a Rabbi trust also triggers the penalty. An employer cannot use a trust to hold deferred compensation if the trust assets become protected from general claims of creditors upon a change in the employer's financial condition. Thus, the benefits of using offshore trusts for deferred compensation are substantially diminished.

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[81] IRC §409A(a)(1). The interest is charged at the underpayment rate plus an additional 1%.

[82] IRC §409A(b)(1). However, there is an exception for foreign Rabbi trusts and similar security devices when substantially all services giving rise to deferred amounts were performed in the jurisdiction in which the Rabbi trust or similar security device is located.

## TIMING RESTRICTIONS AND DISTRIBUTION RULES

As noted above, §409A has various timing restrictions and distribution rules. The timing restrictions can be categorized as follows:

- Restrictions on the timing of distributions
- Restrictions against the acceleration of benefits
- Restrictions on the timing of deferral elections

The distribution rules specify that distributions under a nonqualified deferred compensation plan can only be payable upon the occurrence of one of the following:

- The employee's separation from service[83]
- The employee becoming disabled[84]
- The death of the employee[85]
- A fixed time or schedule specified under the plan[86]
- A change in ownership of a substantial portion of the corporation's assets[87]
- The occurrence of an unforeseeable emergency[88] (The provision limits an **unforeseeable emergency** to illness, accident, or property casualty of the participant, spouse or dependent, or to "other similar extraordinary and unforeseeable circumstances. . . beyond the control of the participant."[89] The amount that can be distributed under this provision is limited to the amount that is necessary to respond to the emergency, plus tax on the amount distributed.)

Many common events are not permitted distribution events under the rules. Examples include the following:

- Any specified event with no definite time (such as the birth of a child)
- Plan termination
- A distribution on request
- An event triggering the penalty for plan failure
- A distribution based on a financial trigger (the Enron provision)
- Any event that is tied to the employer's discretion
- A distribution made because a corresponding amount under a qualified plan is being distributed

However, compensation arrangements can have multiple permissible payments. For instance, a deferred compensation arrangement may provide that payment will occur on the earlier of a specified time, disability, or death.

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[83] With respect to certain "key employees" (as defined in IRC §416(i)) of publicly-traded corporations, distributions upon separation from service must be delayed until six months after separation from service (or until death, if earlier). IRC §409A(a)(2)(B)(i).

[84] The definition of "disability" is contained in IRC §409A(a)(2)(A)(ii) and IRC §409A(a)(2)(C).

[85] IRC §409A(a)(2)(A)(iii).

[86] IRC §409A(a)(2)(A)(iv).

[87] IRC §409A(a)(2)(A)(v). The statute states that this rule applies only to corporations.

[88] IRC §409A(a)(2)(A)(vi).

[89] IRC §409A(a)(2)(B)(ii)(I).

## ELECTIONS

### General Rule

Before enactment of §409A, an employee was not deemed to have constructively received compensation until it was actually paid — even if the employee had already performed the services. Under §409A, however, an initial election to defer must be made **before** the first day of the calendar year in which the **compensation is earned.**

> **Example 28.** Sam Hill would like to defer compensation for services performed in 2010. To do so, a deferral election must have been made on or before December 31, 2009.

**Exceptions.**There are two exceptions to the general rule:

1. In a participant's first year of participation, an election to defer compensation earned during the year, but after the date of the election, may be made as late as 30 days after the participant becomes eligible.[90] In that case, the election applies to compensation earned after the date of the election for the remainder of that year.

> **Example 29.** Iona Ford is hired on June 1, 2010. As a result of her hiring, Iona can participate in a nonqualified deferred compensation plan that her employer offers. Under §409A, if Iona wants to participate for 2010, the employer must make the election on or before July 1, 2010.

2. For performance-based compensation that is based on services performed over a period of at least 12 months, the election must be made not later than six months before the end of the performance period.[91]

   **Performance-based** is defined similarly to the phrase contained in §162(m), and generally refers to compensation to which the payment or amount is contingent on the satisfaction of pre-established organizational or individual performance criteria over a performance period of at least 12 consecutive months. The performance criteria must be in writing within 90 days after the performance period begins, and must not be substantially certain to be satisfied at the time they are established. Subjective performance criteria are allowed as long as the service provider or any related party has no role in determining whether the subjective criteria have been satisfied.

> **Example 30.** Olive Branch is eligible to receive a bonus from her employer. The bonus is 5% of the employer's profits for the 2010 calendar year. To satisfy the exception, the employer must make the election to defer on or before June 30, 2010.

**Observation.** This exception provides little practical help for most discretionary bonus programs. Uncertainty as to the payment and the amount of the bonus make it impractical to make an election six months in advance.

### Making Changes to Deferral Elections

The §409A rules prevent an election from being made to accelerate a distribution before its previously-scheduled time.[92] However, it is possible to make a change to delay a payment or to change the form of payment if the election meets certain requirements:

- The election must be made at least 12 months before the date on which it takes effect.
- The change must defer the first payment subject to the election by at least five years from the date it would otherwise have been made.
- The election must not be made less than 12 months before the date of the first scheduled payment.[93]

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[90] IRC §409A(a)(4)(ii).

[91] IRC §409A(a)(4)(iii).

[92] IRC §409A(a)(3).

[93] IRC §§409A(4)(C)(i-iii).

## REPORTING RULES

### Employee Deferrals

It is not necessary to report amounts deferred under a nonqualified deferred compensation plan subject to §409A on Form W-2. However, if the §409A amounts are reported, code Y should be entered in box 12 of Form W-2.[94]

### Employee Distributions

For employees that receive a distribution from a nonqualified deferred compensation plan, the employer must report the amount of the payment on the employee's Form W-2 in box 12 using code Z, and include the amount in box 1. If the employee receives a Form 1099 instead of a Form W-2, the employer must report the nonqualified deferred compensation received in box 15b and also in box 7.

In addition, any amount that is included in an employee's income due to a violation of §409A is subject to withholding, regardless of whether the amount is actually paid to the employee.[95]

**Observation.** Generally, the employee will already have income above the OASDI wage base ($106,800 for 2010). However, the deferred compensation will be currently subject to the Medicare portion of FICA tax (the 2.9% portion) due to the unlimited wage base.

### Failing to Meet the IRC §409A Requirements

The regulations provide that each taxable year is analyzed independently of other taxable years when determining the includible amount.[96] A continuing plan violation may force inclusion in income even though the statute of limitations has expired for the original year of the violation.

**Example 31.** Brandon Cattell has a balance of $0 in his nonqualified deferred compensation plan in 2011, $100,000 in 2012, and $250,000 in 2013. The plan fails to meet the requirements in 2012 and 2013. Thus, Brandon includes income of $100,000 in 2012 and $150,000 in 2013. In addition, Brandon cannot avoid including $100,000 in 2012 by including $250,000 in 2013. If the statute of limitations on assessment has expired for 2012, then Brandon includes $250,000 in 2013 because the $100,000 for 2012 was never included in his income.[97]

If a nonqualified deferred compensation plan provides for payment at alternative times or in alternative forms, the time and form that generates the highest value must be used.

**Example 32.** Lisa Carr is entitled to a single sum-lump payment on the earlier of January 1, 2015, or her separation from service. In 2015, the nonqualified deferred compensation plan fails to qualify with §409A and on the last day of the 2012 taxable year, Lisa has not separated from service. Thus, the total amount deferred for 2012 is the greater of the amount that would be payable on December 31, 2012, or the present value of the amount that would be payable on January 1, 2015.[98]

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[94] IRS Notice 2008-115, 2008-52 IRB.

[95] IRC §3401(a).

[96] Prop. Treas. Reg. §1.409A-4.

[97] This example is based on Prop. Treas. Reg. §1.409A-4(a)(1)(iii) and the examples that it contains, and assumes that none of the qualified deferred compensation is subject to a substantial risk of forfeiture.

[98] This example is based on Prop. Treas. Reg. §1.409A-4(b)(2).

## IMPACT OF THE IRC §409A RULES ON SMALL BUSINESSES

IRC §409A applies to more than large corporations. If not drafted properly, business-planning documents for small, closely-held businesses that are owned solely or primarily by a single owner can be subject to the §409A rules.

### Deferred Compensation Plans and Small Businesses

Establishing a nonqualified deferred compensation plan may not be a good tax move for small business owners. Obviously, any small business structured as a pass-through entity does not benefit from deferral. However, practitioners may encounter small business clients that have a deferred compensation plan. The following are situations in which a deferred compensation plan might be utilized by a small business:

- **Concerns Over Cash Flow.** A nonqualified deferred compensation plan may allow an owner-employee to receive compensation for services even if the business lacks current cash flow to make such payments. If, for example, a rough financial year is anticipated, the owner-employee might want to defer compensation. The downside to the strategy is that if the business fails, the owner-employee is only a general unsecured creditor.
- **As an Aid in Succession Planning.** A nonqualified deferred compensation plan can be used to generate liquidity to meet the owner-employee's retirement needs. In addition, the employer may be able to deduct the payments as reasonable compensation if the owner-employee was underpaid in prior years.[99]
- **As a Means of Compensating and Retaining Key Employees.** A nonqualified deferred compensation plan can be used to provide a stream of income for such a person after their retirement.

**Example 33.** Bill Bard, president of ACME Construction, makes an oral promise to pay a $50,000 bonus to each of the company superintendents for leading the company out of a very unprofitable situation. Because of bonding and lending covenants, he cannot pay the bonuses until the company improves its working capital provisions and renews the loan and bonding line in 12 months. With Bill's oral promise, the company created a nonqualified deferred compensation plan under §409A, because the promise meets the requirements of the statute.

### Special Areas of Concern for Small Businesses

**Covenants Not to Compete.** Covenants not to compete are common in the small business world. To avoid §409A problems, the deferred payment should be structured as a lump-sum payment in the year the noncompete agreement is signed.[100] However, that may not be practical inasmuch as the agreement may need to be entered into in a previous year with payment delayed until the noncompete period concludes. According to the IRS, that triggers application of §409A.[101] In addition, because a noncompete agreement involves the nonperformance of services, it is subject to §409A.

**Stock Options and Stock-Appreciation Rights.** Stock options can run afoul of §409A. While statutory stock options (including stock options under an employee stock-purchase plan subject to §423) are not subject to §409A,[102] nonstatutory stock options can be caught by §409A's restrictions.

**Note.** Options granted under an employee stock-purchase plan or an incentive-stock option (ISO) are considered statutory stock options. IRS Pub. 525, *Taxable and Nontaxable Income,* describes the differences between statutory and nonstatutory stock options and the tax rules associated with both types of stock options. In general, a nonstatutory stock option is less advantageous to the employer from a tax standpoint, but it is less restrictive and easier to establish and administer.

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[99] See *Elliotts, Inc. v. Comm'r,* 716 F.2d 1241 (9th Cir. Sep. 26, 1983).

[100] Treas. Reg. §1.409A-1(b)(4)(i).

[101] TD 9321, 2007-19 IRB 1123.

[102] Treas. Reg. §1.409A-1(b)(5)(ii).

In general, if the exercise price at least equals the stock's FMV on the date of the grant and the number of shares subject to the option is fixed, then §409A is not implicated.[103] Under the regulations, stock value that is based on a reasonable application of a reasonable valuation method is treated as reflecting the FMV of the stock. Whether a valuation method is reasonable is based on the facts and circumstances as of the valuation date and whether the valuation method takes into consideration all available information regarding the company's value. The regulations specify that three valuation methods are presumed reasonable:

- A valuation determined by an independent appraisal as of a date that is not more than 12 months before the date of the grant
- A valuation based on a formula that will not lapse, provided that the stock is valued the same way for all purposes relating to the transfer of any shares of such class of stock to the issuer or any person who owns 10% or more of the total combined voting power of all classes of stock of the issuer
- A valuation of illiquid stock of a start-up company that is not subject to any put or call right, that is made reasonably and in good faith and is evidenced by a written report that takes into account the relevant factors

**Example 34.** On June 1, 2010, XYZ Corp. is valued at $100 per share. On June 1, 2010, XYZ grants its CEO, Wanda Rinn, an option to buy 100 XYZ shares at $100 per share. Wanda may exercise the option any time during the next five years. The option granted is a nonstatutory stock option, and is not subject to §409A because the exercise price is at least equal to the stock's FMV on the date the option was granted and the number of shares is fixed at 100.

**Note.** Valuing XYZ stock is important in order to avoid the restrictions of §409A. Remember, the exercise price must be at least equal to the stock's FMV on the date the option was granted. Because there is no ready market for closely-held stock, the regulations allow the use of any reasonable valuation method to determine the stock's value on the date of the grant of the option.[104] An appraisal may be necessary, and the appraisal should account for any valuation discounts that might apply.

Stock-appreciation rights are similar to stock options, but the employee is entitled to an amount equal to the stock appreciation.[105] The employee does not have the right to buy the stock itself. To avoid the complications of IRC §409A, the employee cannot receive any compensation except the excess of the FMV of the stock on the date of the exercise less the FMV on the date of the grant of the stock-appreciation right.[106] The number of the shares must be fixed at the date of the grant.

**Note.** The exceptions for nonqualified stock options and stock-appreciation rights apply only to common stock and only the class of common stock that, as of the date of the grant, has the highest aggregate value of any class of common stock of the corporation outstanding, or a class of common stock substantially similar to such class of stock (ignoring differences in voting rights). Also, in general, nonqualified stock options and/or stock-appreciation rights should not be modified.

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[103] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

[104] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(1).

[105] See Rev. Rul. 80-300, 1980-2, CB 165.

[106] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

**Profits Interests.** A common way to compensate members of partnerships or LLCs that are taxed as partnerships is with a profits interest which entitles the employee to share in the profits of the business without giving the employee an ownership interest in the business.[107] Profits interests can be established in a manner that results in the employee not being taxed on the interest when it is received. This is the result, provided the interest is not related to a substantially certain and predictable stream of income, the recipient does not dispose of the interest within two years, and the partnership is not a publicly-traded limited partnership. Of course, any profits that are actually received by the employee must be reported as gross income.

There is little guidance concerning the application of §409A to partnerships and other pass-through entities. Many issues remain, including:

- Arrangements between partnerships and partners providing services to the partnership[108]
- Guaranteed payments
- Payments made in liquidation of the interest of a retiring or deceased partner
- Options to purchase partnership interests
- Appreciation rights with respect to partnership interests
- Transfers of partnership interests
- Distributions upon a change in ownership or effective control of a partnership

**Observation.** Profits interests can be a useful business and estate planning tool. The employee can continue to own the profits interest even after employment ceases. The current owners retain control, and the profits can be shared with the employee or former employee. This can be used as a succession planning or retirement income tool.

**Reimbursing Dues or Fees.** Employee reimbursements can be treated in various ways for tax purposes.[109] If the employment agreement specifies that the employer will reimburse the employee for specified dues or fees for the employee's year of separation and for several future years up to a certain amount, §409A could apply. In order for the reimbursed amounts to be considered on a fixed schedule to meet the payment requirements of §409A, a payment in one year cannot affect the amount of a payment in another year.[110]

## APPLICATION OF IRC §409A TO SCHOOLS AND TEACHERS

When teachers (and other taxpayers with similar part-year work periods) are given an annualization election and they choose the 12-month period, they are deferring part of their income from one year to the next. An annualization election is a choice between being paid only during the school year and being paid over a 12-month period.

**Example 35.** Martha works as a teacher. Her school district's 9-month school year begins on September 1, 2010, and ends on May 31, 2011. She earns $5,000 per month, or $45,000 per year. If Martha was paid over nine months, she would receive $20,000 for 2010 (for the months of September through December), and would receive $25,000 in 2011 (for the months of January through May).

If Martha instead chose to be paid over 12 months, she would receive $3,750 per month. In that event, she would receive only $15,000 in 2010 and $30,000 in 2011. Thus, $5,000 that Martha earned in 2010 is paid in 2011 (i.e., $5,000 is deferred until 2011), and the arrangement is considered deferred compensation subject to §409A.

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[107] See, for example, Rev. Proc. 93-27, 1993-2 CB 343.

[108] Some guidance on this issue was provided by the IRS in Notice 2005-1, Q&A-7.

[109] See IRC §274(a)(3).

[110] For an example of this problem, see Example 8 of Treas. Reg. §1.409A-3(i)(1)(vi).

The rules do not require that an employee be provided an election regarding how to be paid. Therefore, a school district may decide all teachers are paid over 12 months, without providing any election to the teachers. The §409A rules do not apply in that situation and no additional taxes are triggered. However, if a school district allows teachers a choice between payment over nine or 12 months, the district must follow the election deadlines of §409A. That means that a deferral election must be made no later than the end of the prior year (i.e., for salary earned in 2010 to be deferred to 2011, the election must have been made by the end of 2009).

School districts must describe in writing how teachers are paid for the compensation earned for the rest of the scheduled work period (i.e., for the remainder of the school year).

For schools and their employees, the following §409A rules must be followed:

- The teacher must give a written (or electronic) election to the school district that notifies the district that the teacher wants to spread the compensation over 12 months.
- The election must be made before the beginning of the work period (the first day of the school year for which the teacher is paid).
- The election must be irrevocable, so that it cannot be changed after the work period begins.
- The election must state how the compensation will be paid if the election is made (for example, ratably over 12 months starting with the beginning of the school year).

No particular form is necessary for the election, and the election need not be filed with the IRS. However, if an election is not submitted, or is submitted late, the teacher must be paid in the same way as other teachers who do not make the election (paid during the school year only). In addition, the election need not be made each year. An arrangement may provide that a pre-existing election remains in place until the teacher changes the election. However, the change must be made before the beginning of the school year to which the change applies.

On July 1, 2008, the IRS issued Notice 2008-62.[111] The notice largely eliminates the 20% penalty on employee-deferred amounts. It provides an example of a school district employing a teacher from August 1, 2008, through May 31, 2009. The teacher is paid over the 12-month period beginning August 1, 2008 (either because that is the way the school district contracts are established or the employee elected to be paid over the 12-month period beginning on the commencement of employment). The IRS states that the compensation arrangement would not provide for deferred compensation for purposes of §457(f) unless the teacher earns more than $186,000 for the school year. That is because, under the contract, the teacher would receive $77,500 in 2008 and $108,500 in 2009. As a result, the amount the employee earns during 2008 that is paid in 2009 ($15,500 ($93,000 – $77,500)) does not exceed the applicable dollar amount under §402(g)(1)(B) for 2008 ($15,500). Consequently, the arrangement would not provide for deferred compensation for purposes of §457(f).

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[111] Notice 2008-62 (July 1, 2008).

## ISSUE 9: FICA TAX ON SEVERANCE PAY

**Note.** The term **FICA tax** refers to withholding amounts for social security (6.2%) and Medicare (1.45%).

There were several cases in the last decade in which the courts were asked to decide whether severance pay is considered wages for federal payroll tax purposes. The disputes are largely centered on the tax treatment of supplemental unemployment benefits (SUB pay). SUB pay was first used in the 1950s as a means for employers to supplement state unemployment compensation for employees who lost their jobs due to workforce reductions. Over the years, the IRS changed course several times and issued various revenue rulings to reflect its changing position on whether SUB pay is exempt from federal payroll taxation.

It seemed that this issue was settled after the *CSX* decision in 2008;[112] however, the contrary ruling in the 2010 *Quality Stores* case[113] in a Michigan District Court brought this issue to the forefront again. The district court made a taxpayer-friendly ruling that severance payments to involuntarily-separated employees are not subject to FICA taxation.

### HISTORICAL OVERVIEW

Following is a history of important recent rulings on this issue.

1. ***CSX Corp.* (2002).**[114] CSX, an affiliated group of railroad companies, experienced financial difficulties during the 1980s and sought to deal with its problems in part by reducing the number of its employees. The company established a variety of programs that encouraged employees to voluntarily separate from the company. The tax consequences of those separation plans are the subject of the dispute in this case, which was tried in the Court of Federal Claims.

   CSX's position was that its payments to employees separated from employment or whose hours were reduced are not taxable for FICA or RRTA purposes because the payments were not "wages." The trial court held that some of the payments for certain employee groups constituted wages, while payments to other employee groups did not. Both CSX and the government appealed the case.

   The trial court inferred from IRC §3402(o) that **SUB payments are not wages** subject to FICA and RRTA as long as the following conditions of §3402(o) are satisfied:

   a. Amounts paid to employees are pursuant to a plan

   b. Employees are involuntarily separated from employment (either temporarily or permanently)

   c. Separation from employment results directly from workforce reduction, plant closing, or another similar condition

2. ***CSX Corp.* (2008).**[115] The Federal Circuit Court of Appeals reversed the Federal Claims Court decision that payments falling within the definition of SUB pay under §3402(o) are not wages. The court held that payments to the various employee groups who received benefits in connection with CSX's reduction in force were all wages for purposes of FICA and RRTA taxation.

   In making its ruling, the court noted the potential conflict in interpreting §3402(o) as suggesting that all payments that fall within the statutory definition of SUB pay must be deemed nonwages for FICA purposes. The court stated that nothing in the text of §3402(o) requires that the statute be construed as going to that length. Congress's intent in §3402(o) was to apply the general rule for SUB payments for purposes of federal income tax withholding only.

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[112] *CSX Corp. v. U.S.*, 518 F.3d 1328 (Fed. Cir. 2008).

[113] *U.S. v. Quality Stores Inc. et al.*, No. 1:09-cv-44 (W.D. Mich. 2010).

[114] *CSX Corp., Inc. v. U.S.*, 52 Fed. Cl. 208 (2002).

[115] *CSX Corp. v. U.S.*, 518 F.3d 1328 (Fed. Cir. 2008).

3. ***Quality Stores* (2010).**[116] Quality Stores sought the refund of $1 million in FICA taxes paid on severance payments to former employees. The case was first heard in Bankruptcy Court,[117] with a judgment in favor of Quality Stores determining that payments made to employees under the severance programs were not wages for purposes of FICA taxation.

   Hearing this case on appeal, the U.S. District Court in the Western District of Michigan affirmed the decision of the Bankruptcy Court and concluded that the severance payments at issue are not properly classified as wages and therefore not subject to FICA taxation.

### PROTECTIVE CLAIMS

Following the decision in *CSX* 2002, many companies across the nation filed protective refund claims for FICA taxes that they had paid on severance benefits. The IRS held these claims in abeyance pending appeal. After the Federal Circuit Court reversed the Federal Claims Court decision, the IRS began disallowing the claims previously filed.

Two years after the reversal decision in *CSX* 2008, the Michigan District Court rejected the reasoning of the Federal Circuit Court in that case and instead accepted the rationale of the court in *CSX* 2002. The government will almost certainly appeal this *Quality Stores* decision to the 6th Circuit. Even if the circuit court affirms the district court's decision, the IRS will probably not apply the case beyond the 6th Circuit (Michigan, Ohio, Kentucky, and Tennessee). However, there are hundreds of millions of dollars at stake, and this issue is likely to be litigated across the country for years to come.

Employers who paid FICA taxes on severance benefits must keep in mind that a claim for credit must be filed by the taxpayer within three years from the time the return was filed or two years from the time the tax was paid, whichever period is later.[118] Any quarterly payroll tax return is considered filed on April 15 of the succeeding year. For example, the statute of limitations on a timely-filed Form 941, *Employer's Quarterly Federal Tax Return*, for any quarter in 2007 expires on April 15, 2011.

An employer can file a protective claim to preserve the refund window while a court case is pending. To file a protective claim for FICA taxes on SUB pay, employers should use Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*. A separate Form 941-X must be filed for each quarter for which a company wishes to protect its claim to a refund of FICA taxes paid on SUB pay. The words "PROTECTIVE CLAIM" should be written on the top of the return.

An initial protective claim can be filed using estimates of the applicable taxes. The exact amount of the refund claim can then be determined and the claim perfected within a reasonable period of time.

If an employer receives a claim denial from the IRS after filing a refund claim, the employer should file an appeal of the denial as soon as possible to preserve its rights in the matter.

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[116] *U.S. v. Quality Stores Inc. et al.*, No. 1:09-cv-44 (W.D. Mich. 2010).

[117] *In re Quality Stores, Inc.*, 383 BR 67 (Bankr. W.D. Mich. 2008).

[118] IRC §6511(a).

## PERFECTING A CLAIM

There is no requirement to perfect a claim at the time of filing an initial protective claim. However, before a refund or credit for FICA or RRTA taxes can be **paid,** the employer must either repay the affected employees for their share of the employment taxes or obtain the employees' consent to the claim for refund on their behalf.[119] If the employer cannot locate some of the employees or certain employees will not provide consent, the employees' portion of the FICA taxes must be excluded from the employer's refund claim.

Each employee's written consent form should be retained as part of the employer's records and the consent form must:

- Certify that the employee consents to the employer filing a claim for refund on his behalf;
- Certify that the employee has not claimed refund or credit of the amount of the overcollected taxes, or that the employee's claim has been rejected; and
- Confirm that the employee will not claim a refund or credit for the taxes.[120]

**Example 36.** Cititeam, Inc., closed a plant and laid off 200 employees in the first quarter of 2007. The company has a severance package for its workers and paid approximately $156,000 in SUB pay in March 2007. To protect its claim for the refund of FICA taxes on the SUB pay benefits, the company files a Form 941-X.

Following are Cititeam's original Form 941 for the first quarter of 2007, which was filed on April 30, 2007, and its Form 941-X, which it files on April 11, 2011.

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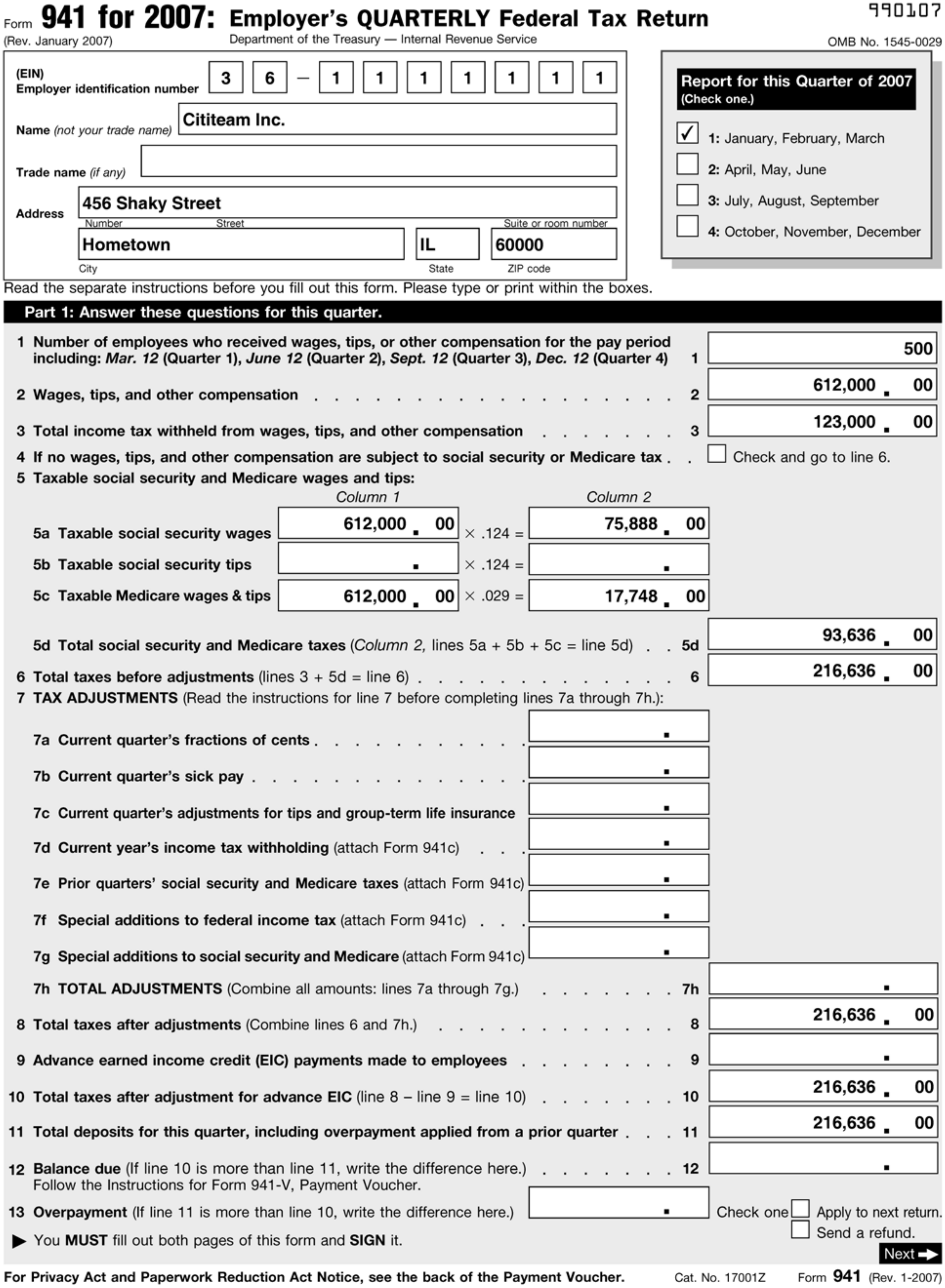
[119] Treas. Reg. §31.6402(a)-2(a)(2)(i).

[120] Treas. Reg. §31.6402(a)-2(a)(2)(ii).

## For Example 36



Form **941 for 2007: Employer's QUARTERLY Federal Tax Return**
(Rev. January 2007)
Department of the Treasury — Internal Revenue Service

990107

OMB No. 1545-0029

**(EIN) Employer identification number** 3 6 – 1 1 1 1 1 1 1

**Name** *(not your trade name)* Cititeam Inc.

**Trade name** *(if any)*

**Address** 456 Shaky Street
Number Street Suite or room number
Hometown IL 60000
City State ZIP code

**Report for this Quarter of 2007**
**(Check one.)**

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

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

**Part 1: Answer these questions for this quarter.**

| | | |
|---|---|---|
| **1** Number of employees who received wages, tips, or other compensation for the pay period including: ***Mar. 12*** (Quarter 1), ***June 12*** (Quarter 2), ***Sept. 12*** (Quarter 3), ***Dec. 12*** (Quarter 4) | 1 | 500 |
| **2** Wages, tips, and other compensation | 2 | 612,000 . 00 |
| **3** Total income tax withheld from wages, tips, and other compensation | 3 | 123,000 . 00 |

**4** If no wages, tips, and other compensation are subject to social security or Medicare tax . . ☐ Check and go to line 6.

**5** Taxable social security and Medicare wages and tips:

| | *Column 1* | | *Column 2* |
|---|---|---|---|
| **5a** Taxable social security wages | 612,000 . 00 | × .124 = | 75,888 . 00 |
| **5b** Taxable social security tips | . | × .124 = | . |
| **5c** Taxable Medicare wages & tips | 612,000 . 00 | × .029 = | 17,748 . 00 |

| | | |
|---|---|---|
| **5d Total social security and Medicare taxes** (*Column 2,* lines 5a + 5b + 5c = line 5d) | 5d | 93,636 . 00 |
| **6 Total taxes before adjustments** (lines 3 + 5d = line 6) | 6 | 216,636 . 00 |

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

| | |
|---|---|
| **7a Current quarter's fractions of cents** | . |
| **7b Current quarter's sick pay** | . |
| **7c Current quarter's adjustments for tips and group-term life insurance** | . |
| **7d Current year's income tax withholding** (attach Form 941c) | . |
| **7e Prior quarters' social security and Medicare taxes** (attach Form 941c) | . |
| **7f Special additions to federal income tax** (attach Form 941c) | . |
| **7g Special additions to social security and Medicare** (attach Form 941c) | . |

| | | |
|---|---|---|
| **7h TOTAL ADJUSTMENTS** (Combine all amounts: lines 7a through 7g.) | 7h | . |
| **8 Total taxes after adjustments** (Combine lines 6 and 7h.) | 8 | 216,636 . 00 |
| **9 Advance earned income credit (EIC) payments made to employees** | 9 | . |
| **10 Total taxes after adjustment for advance EIC** (line 8 – line 9 = line 10) | 10 | 216,636 . 00 |
| **11 Total deposits for this quarter, including overpayment applied from a prior quarter** | 11 | 216,636 . 00 |
| **12 Balance due** (If line 10 is more than line 11, write the difference here.) Follow the Instructions for Form 941-V, Payment Voucher. | 12 | . |

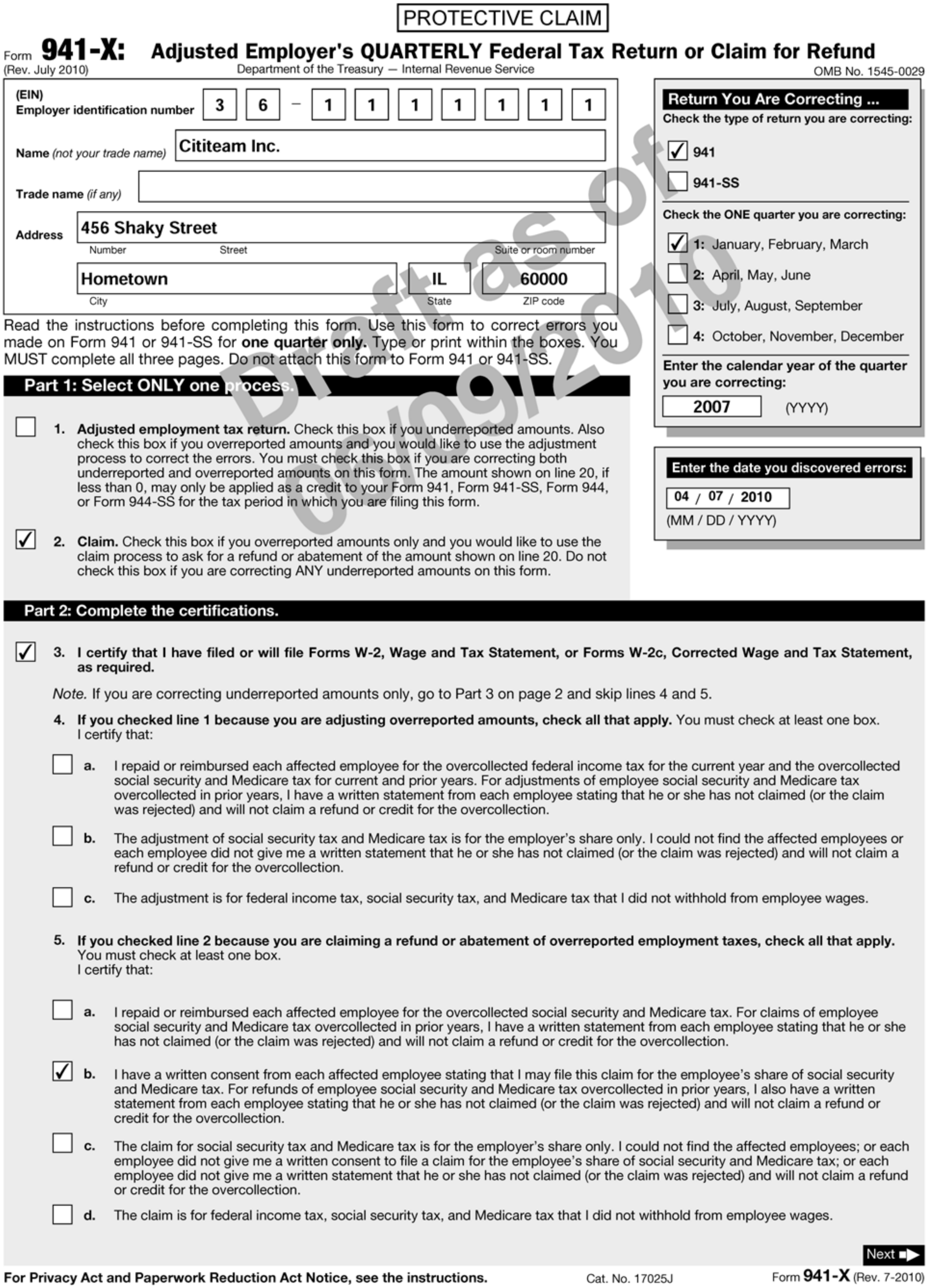
**13 Overpayment** (If line 11 is more than line 10, write the difference here.) . Check one ☐ Apply to next return. ☐ Send a refund.

▶ You **MUST** fill out both pages of this form and **SIGN** it.

Next ➡

**For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher.** Cat. No. 17001Z Form **941** (Rev. 1-2007)

**For Example 36**



PROTECTIVE CLAIM

Form **941-X:** **Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund**
(Rev. July 2010) Department of the Treasury — Internal Revenue Service
OMB No. 1545-0029

**(EIN) Employer identification number** 3 6 – 1 1 1 1 1 1 1

**Name** *(not your trade name)* Cititeam Inc.

**Trade name** *(if any)*

**Address** 456 Shaky Street
Number Street Suite or room number

Hometown IL 60000
City State ZIP code

Read the instructions before completing this form. Use this form to correct errors you made on Form 941 or 941-SS for **one quarter only.** Type or print within the boxes. You MUST complete all three pages. Do not attach this form to Form 941 or 941-SS.

**Return You Are Correcting ...**

**Check the type of return you are correcting:**

☑ **941**

☐ **941-SS**

**Check the ONE quarter you are correcting:**

☑ **1:** January, February, March

☐ **2:** April, May, June

☐ **3:** July, August, September

☐ **4:** October, November, December

**Enter the calendar year of the quarter you are correcting:**

2007 (YYYY)

**Enter the date you discovered errors:**

04 / 07 / 2010
(MM / DD / YYYY)

**Part 1: Select ONLY one process.**

☐ **1. Adjusted employment tax return.** Check this box if you underreported amounts. Also check this box if you overreported amounts and you would like to use the adjustment process to correct the errors. You must check this box if you are correcting both underreported and overreported amounts on this form. The amount shown on line 20, if less than 0, may only be applied as a credit to your Form 941, Form 941-SS, Form 944, or Form 944-SS for the tax period in which you are filing this form.

☑ **2. Claim.** Check this box if you overreported amounts only and you would like to use the claim process to ask for a refund or abatement of the amount shown on line 20. Do not check this box if you are correcting ANY underreported amounts on this form.

**Part 2: Complete the certifications.**

☑ **3. I certify that I have filed or will file Forms W-2, Wage and Tax Statement, or Forms W-2c, Corrected Wage and Tax Statement, as required.**

*Note.* If you are correcting underreported amounts only, go to Part 3 on page 2 and skip lines 4 and 5.

**4. If you checked line 1 because you are adjusting overreported amounts, check all that apply.** You must check at least one box.
I certify that:

☐ **a.** I repaid or reimbursed each affected employee for the overcollected federal income tax for the current year and the overcollected social security and Medicare tax for current and prior years. For adjustments of employee social security and Medicare tax overcollected in prior years, I have a written statement from each employee stating that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.

☐ **b.** The adjustment of social security tax and Medicare tax is for the employer's share only. I could not find the affected employees or each employee did not give me a written statement that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.

☐ **c.** The adjustment is for federal income tax, social security tax, and Medicare tax that I did not withhold from employee wages.

**5. If you checked line 2 because you are claiming a refund or abatement of overreported employment taxes, check all that apply.** You must check at least one box.
I certify that:

☐ **a.** I repaid or reimbursed each affected employee for the overcollected social security and Medicare tax. For claims of employee social security and Medicare tax overcollected in prior years, I have a written statement from each employee stating that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.

☑ **b.** I have a written consent from each affected employee stating that I may file this claim for the employee's share of social security and Medicare tax. For refunds of employee social security and Medicare tax overcollected in prior years, I also have a written statement from each employee stating that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.

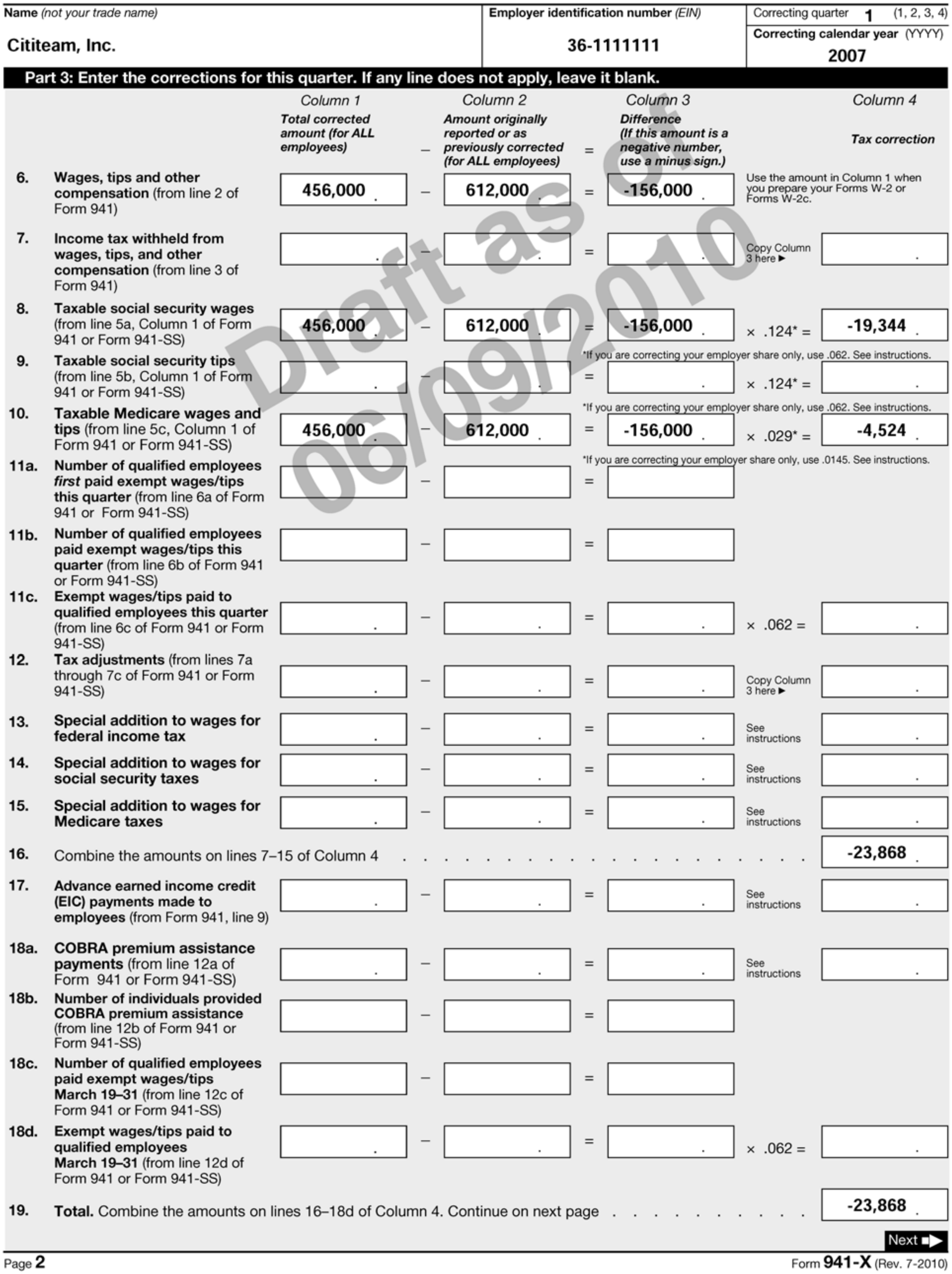
☐ **c.** The claim for social security tax and Medicare tax is for the employer's share only. I could not find the affected employees; or each employee did not give me a written consent to file a claim for the employee's share of social security and Medicare tax; or each employee did not give me a written statement that he or she has not claimed (or the claim was rejected) and will not claim a refund or credit for the overcollection.

☐ **d.** The claim is for federal income tax, social security tax, and Medicare tax that I did not withhold from employee wages.

Next ▶

**For Privacy Act and Paperwork Reduction Act Notice, see the instructions.** Cat. No. 17025J Form **941-X** (Rev. 7-2010)

## For Example 36



| Name (not your trade name) | Employer identification number (EIN) | Correcting quarter (1, 2, 3, 4) |
|---|---|---|
| Cititeam, Inc. | 36-1111111 | 1 |
| | | Correcting calendar year (YYYY)<br>2007 |

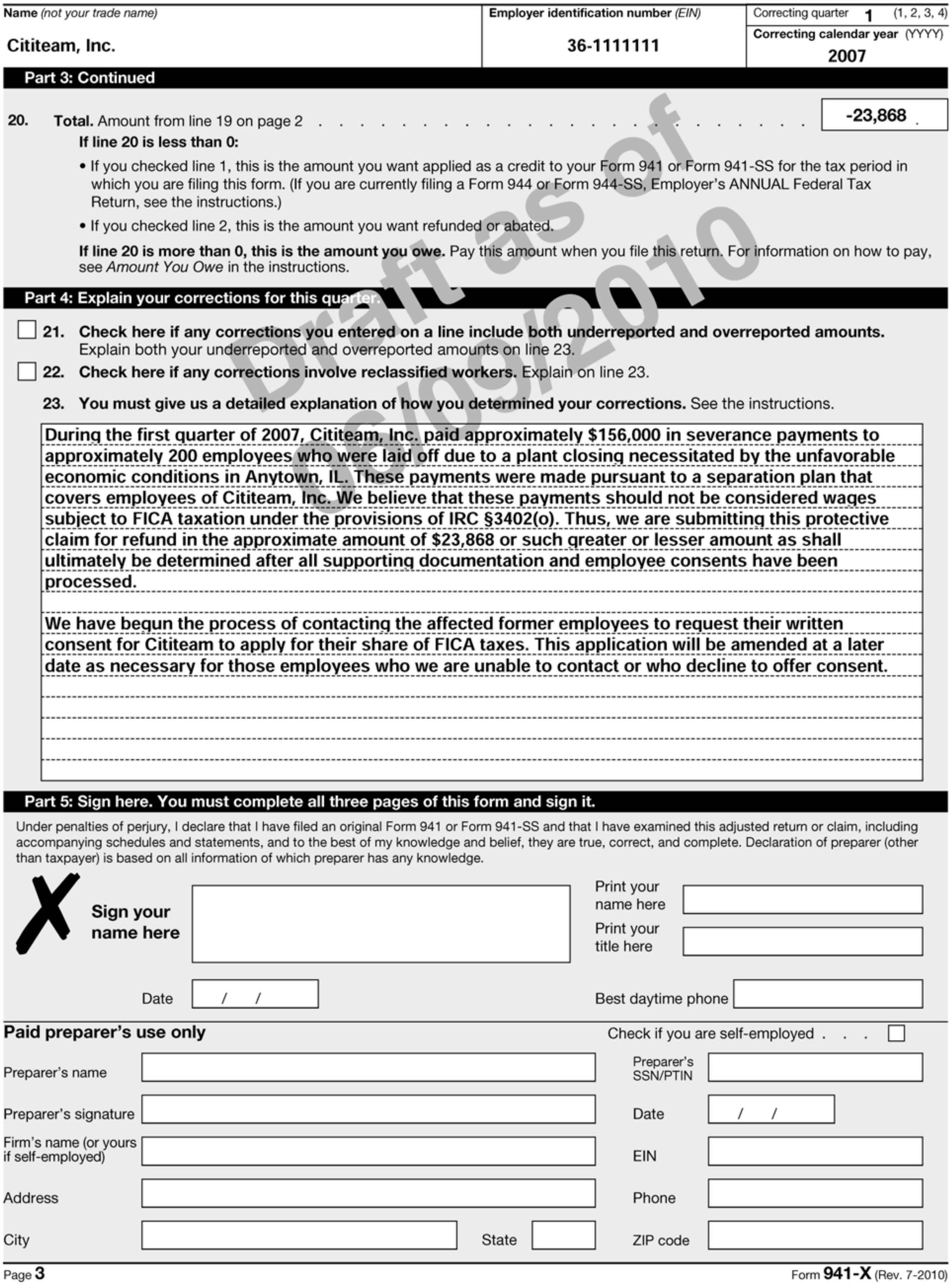
**Part 3: Enter the corrections for this quarter. If any line does not apply, leave it blank.**

| | | Column 1<br>Total corrected amount (for ALL employees) | | Column 2<br>Amount originally reported or as previously corrected (for ALL employees) | | Column 3<br>Difference (If this amount is a negative number, use a minus sign.) | | Column 4<br>Tax correction |
|---|---|---|---|---|---|---|---|---|
| 6. | **Wages, tips and other compensation** (from line 2 of Form 941) | 456,000 | – | 612,000 | = | -156,000 | Use the amount in Column 1 when you prepare your Forms W-2 or Forms W-2c. | |
| 7. | **Income tax withheld from wages, tips, and other compensation** (from line 3 of Form 941) | | – | | = | | Copy Column 3 here ▶ | |
| 8. | **Taxable social security wages** (from line 5a, Column 1 of Form 941 or Form 941-SS) | 456,000 | – | 612,000 | = | -156,000 | × .124* = | -19,344 |
| | | | | | | *If you are correcting your employer share only, use .062. See instructions. | | |
| 9. | **Taxable social security tips** (from line 5b, Column 1 of Form 941 or Form 941-SS) | | – | | = | | × .124* = | |
| | | | | | | *If you are correcting your employer share only, use .062. See instructions. | | |
| 10. | **Taxable Medicare wages and tips** (from line 5c, Column 1 of Form 941 or Form 941-SS) | 456,000 | – | 612,000 | = | -156,000 | × .029* = | -4,524 |
| | | | | | | *If you are correcting your employer share only, use .0145. See instructions. | | |
| 11a. | **Number of qualified employees *first* paid exempt wages/tips this quarter** (from line 6a of Form 941 or Form 941-SS) | | – | | = | | | |
| 11b. | **Number of qualified employees paid exempt wages/tips this quarter** (from line 6b of Form 941 or Form 941-SS) | | – | | = | | | |
| 11c. | **Exempt wages/tips paid to qualified employees this quarter** (from line 6c of Form 941 or Form 941-SS) | | – | | = | | × .062 = | |
| 12. | **Tax adjustments** (from lines 7a through 7c of Form 941 or Form 941-SS) | | – | | = | | Copy Column 3 here ▶ | |
| 13. | **Special addition to wages for federal income tax** | | – | | = | | See instructions | |
| 14. | **Special addition to wages for social security taxes** | | – | | = | | See instructions | |
| 15. | **Special addition to wages for Medicare taxes** | | – | | = | | See instructions | |
| 16. | Combine the amounts on lines 7–15 of Column 4 | | | | | | | -23,868 |
| 17. | **Advance earned income credit (EIC) payments made to employees** (from Form 941, line 9) | | – | | = | | See instructions | |
| 18a. | **COBRA premium assistance payments** (from line 12a of Form 941 or Form 941-SS) | | – | | = | | See instructions | |
| 18b. | **Number of individuals provided COBRA premium assistance** (from line 12b of Form 941 or Form 941-SS) | | – | | = | | | |
| 18c. | **Number of qualified employees paid exempt wages/tips March 19–31** (from line 12c of Form 941 or Form 941-SS) | | – | | = | | | |
| 18d. | **Exempt wages/tips paid to qualified employees March 19–31** (from line 12d of Form 941 or Form 941-SS) | | – | | = | | × .062 = | |
| 19. | **Total.** Combine the amounts on lines 16–18d of Column 4. Continue on next page | | | | | | | -23,868 |

Next ▶

Page **2** Form **941-X** (Rev. 7-2010)

## For Example 36



| Name (*not your trade name*) | **Employer identification number** (*EIN*) | Correcting quarter **1** (1, 2, 3, 4)<br>**Correcting calendar year** (YYYY) |
|---|---|---|
| Cititeam, Inc. | 36-1111111 | 2007 |

**Part 3: Continued**

**20.** **Total.** Amount from line 19 on page 2 . . . . . . . . . . . . . . . . . . . . . . . . -23,868 .

**If line 20 is less than 0:**

- If you checked line 1, this is the amount you want applied as a credit to your Form 941 or Form 941-SS for the tax period in which you are filing this form. (If you are currently filing a Form 944 or Form 944-SS, Employer's ANNUAL Federal Tax Return, see the instructions.)
- If you checked line 2, this is the amount you want refunded or abated.

**If line 20 is more than 0, this is the amount you owe.** Pay this amount when you file this return. For information on how to pay, see *Amount You Owe* in the instructions.

**Part 4: Explain your corrections for this quarter.**

☐ **21.** **Check here if any corrections you entered on a line include both underreported and overreported amounts.** Explain both your underreported and overreported amounts on line 23.

☐ **22.** **Check here if any corrections involve reclassified workers.** Explain on line 23.

**23.** **You must give us a detailed explanation of how you determined your corrections.** See the instructions.

During the first quarter of 2007, Cititeam, Inc. paid approximately $156,000 in severance payments to approximately 200 employees who were laid off due to a plant closing necessitated by the unfavorable economic conditions in Anytown, IL. These payments were made pursuant to a separation plan that covers employees of Cititeam, Inc. We believe that these payments should not be considered wages subject to FICA taxation under the provisions of IRC §3402(o). Thus, we are submitting this protective claim for refund in the approximate amount of $23,868 or such greater or lesser amount as shall ultimately be determined after all supporting documentation and employee consents have been processed.

We have begun the process of contacting the affected former employees to request their written consent for Cititeam to apply for their share of FICA taxes. This application will be amended at a later date as necessary for those employees who we are unable to contact or who decline to offer consent.

**Part 5: Sign here. You must complete all three pages of this form and sign it.**

Under penalties of perjury, I declare that I have filed an original Form 941 or Form 941-SS and that I have examined this adjusted return or claim, including accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

**Sign your name here**

Print your name here

Print your title here

Date / /

Best daytime phone

**Paid preparer's use only**

Check if you are self-employed . . . ☐

Preparer's name

Preparer's SSN/PTIN

Preparer's signature

Date / /

Firm's name (or yours if self-employed)

EIN

Address

Phone

City

State

ZIP code

Page **3**

Form **941-X** (Rev. 7-2010)

## ISSUE 10: DEDUCTIBLE REPAIRS VERSUS CAPITALIZATION[121]

### RULES OF THUMB

The rules concerning what expense is a **repair** and, therefore, currently deductible, compared to expenditures that must be capitalized and depreciated have never been crystal clear. In general, any expense associated with the business is currently deductible as a repair if the cost involves incidental repairs. These repairs neither materially add to the value of the property nor appreciably prolong its life. They instead keep it in an ordinarily efficient operating condition.[122] Thus, amounts incurred for maintenance and repairs are deductible as ordinary and necessary business expenses.

**Note.** Questions often arise concerning the proper handling of expenses associated with tires and tools. For tires, the IRS provides a safe-harbor method of accounting for the cost of original and replacement tires.[123] In general, the cost of small tools is currently deductible if income is not materially distorted and it would not be practical to require the taxpayer to maintain records for depreciating the tools.

Any cost that produces a benefit lasting for more than one year (such as expenses for improvements that increase the property's value) is generally not currently deductible, but must be depreciated or amortized over the period of benefit or use.

**Observation.** A review of the cases and rulings on the issue, as well as the applicable regulations, reveal that the IRS takes the following positions:

- **Deductible repairs** are expenditures that keep the property in an ordinarily efficient, operating condition.
- **Capital** expenditures add to the value of the property, substantially prolong the useful life of the property, or adapt the property to a new or different use.

The cases, rulings, and regulations indicate that the amount of the expenditure is immaterial to the issue of whether the expenditure is currently deductible or must be capitalized.

The following discussion focuses on the most significant rulings, regulations, and court opinions regarding the distinction between currently-deductible repairs and expenditures that must be capitalized.

### IRS GUIDANCE

In Rev. Rul. 2001-4,[124] the IRS discussed the issue of deductibility versus capitalization in the context of three different scenarios involving heavy maintenance that an airline performed on its airplanes. The IRS noted that costs requiring capitalization were those that the airline incurred as part of a general plan of rehabilitation — those designed to materially increase the value of an airplane and prolong its useful life. However, the ruling also indicates that the IRS's view could result in what otherwise would be a currently-deductible repair expense being required to be capitalized if the expense was incurred as part of an overall plan of rehabilitation.

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[121] For a more complete discussion of the points made in this issue and from which portions of the text are adapted, see Roger A. McEowen and Philip E. Harris, "Income Tax," seminar materials prepared for the 2010 summer seminar of the Center for Agricultural Law and Taxation, June 10-11, 2010, Estes Park, CO and section of manual on repairs vs. capitalization authored by Harris. The materials are on file with the authors and the Center for Agricultural Law and Taxation.

[122] Treas. Reg. §1.162-4.

[123] Rev. Proc. 2002-27, 2002-11 CB 802. Rev. Proc. 2002-27 has been modified and/or amplified numerous times, most recently in Rev. Proc. 2005-9, 2005-1 CB 303.

[124] Rev. Rul. 2001-4, 2001-1 CB 295.

Section 2.08 of Rev. Proc. 2009-39 provides automatic consent procedures for taxpayers to reclassify repair and maintenance expenditures which were incorrectly capitalized. Under these procedures, the remaining basis of an incorrectly capitalized item may be deducted as a current year expense. Form 3115 must be filed in accordance with the specific instructions contained in this revenue procedure. These instructions are in addition to the Form 3115 instructions.

**Note.** See Issue 7 in this chapter for more information about Form 3115.

## TREASURY REGULATIONS

The regulations provide guidance on the distinction between a currently-deductible repair and an expenditure that must be capitalized. Under Treas. Regs. §§1.263(a)-1, (b)-2, and 1.461-1(a)(2), an expenditure must be capitalized if the item has a benefit to the taxpayer extending substantially over one year, or if it adapts the property to a new or different use.

Treas. Reg. §1.162-4 specifies that the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense. Consequently, repairs that stop deterioration of a property's condition and prolong the life of the property are capitalized and depreciated under IRC §167 or charged against the property's depreciation reserve account (if maintained).

**Note.** In general, based on the regulations, expenditures for major replacements (such as structural replacements) are not currently deductible unless they merely maintain the property.

The IRS identified several key issues related to the distinction between a currently-deductible expense and an expenditure that must be capitalized. In Notice 2004-6,[125] the IRS sought comment on:

- The proper determination of a unit of property,
- The beginning point for determining enhancement of value of an asset,
- How to determine a material increase in value,
- Whether an asset's useful life was substantially prolonged,
- How that determination is made, and
- How to determine whether an expenditure adapts property to a new or different use.

In the notice, the IRS indicated that forthcoming regulations would clarify the proper handling of repairs as well as expenditures for improving and rehabilitating property.

The IRS issued proposed regulations in 2006, the preamble of which stated that "amounts paid that keep property in ordinarily efficient operating condition are not necessarily deductible repair costs, particularly if the useful life is extended."[126]

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[125] Notice 2004-6, 2004-1 CB 308.

[126] 71 Fed. Reg. 48590 (Aug. 21, 2006).

In 2008, the IRS withdrew the regulations and proposed new regulations. The 2008 proposed regulations recommend significant changes to the regulations covering IRC §263.[127] Under the proposal, the IRS clarifies the distinctions between items that may be expensed and items that may be capitalized.[128] However, the proposed regulations expressly indicate that the changes included in the proposal will **not** become effective **except for tax years that begin on or after the date that the regulations are finalized.**

**Observation.** It may be advisable for taxpayers to review their depreciation schedules for expenditures capitalized as improvements to see if any might qualify as deductible repairs under the current or proposed regulations. Taxpayers should also review the automatic change procedure for improperly capitalized repair and maintenance costs.[129] If, after considering the facts related to the expenditure, the current rules are more lenient, taxpayers should file Form 3115 as soon as possible before the more stringent regulations take effect. The automatic consent procedures stipulate that when the governing regulations are finalized, the final regulations will override the rules explained in the procedures.

The **proposed** regulations also set forth a **de minimis rule** that is intended to minimize the compliance burden for qualifying taxpayers.[130] If the criteria are satisfied, a de minimis amount spent to acquire property that is expensed on the business' books can also be deducted on the business' income tax return. There is no maximum dollar amount specified, but the IRS will likely examine higher-dollar amounts under the distortion-of-income standard. The proposed regulation also includes a safe harbor for the application of the distortion-of-income standard.[131] The de minimis rule does **not** apply to amounts paid to improve property, amounts paid for property included in other property produced or acquired for resale, and amounts paid for land. As an alternative, a taxpayer can elect to capitalize the cost of de minimis items on an asset-by-asset basis.

**Observation.** The de minimis rule might be worth considering for the cost of relatively low-value items so that such items do not have to be depreciated.

There is no recordkeeping requirement for using the de minimis rule. The taxpayer's books and records must be reasonably sufficient to determine all of the following:

- The total amount paid and deducted as materials and supplies
- The total amount paid and not capitalized under the rule
- The computation of the safe-harbor amount
- That taxable income was not distorted if the safe-harbor amount was exceeded
- That the requirements for an applicable financial statement and written procedures for expensing de minimis acquisition costs were met

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[127] 73 Fed Reg. 19450-19451 (Apr. 10, 2008).

[128] Prop. Treas. Reg. §1.263(a)-3.

[129] Section 2.08 of Rev. Proc. 2009-39, 2009-38 IRB 371.

[130] Prop. Treas. Reg. §1.263(a)-2(d)(4).

[131] Prop. Treas. Reg. §1.263(a)-2(d)(4)(iv).

A key issue in making the determination of whether an expense is currently deductible or must be capitalized is whether the expenditure adapts the unit of property to a new or different use. Under the proposed regulations,[132] **the following categories of costs are classified as an improvement to property**:

1. Costs that result in a **betterment** to a unit of property
2. Costs that **restore** a unit of property
3. Costs that **adapt** a unit of property to a new or different use

Costs that fall in any of these categories must be capitalized.

**Observation.** In determining whether an expenditure constitutes a betterment of an item of property, the condition of the property immediately after the expenditure must be compared with the condition of the property before the expenditure was incurred.[133]

If the expenditure is made to correct normal wear and tear, the condition of the property immediately after the last time the property was maintained is the appropriate comparison.

If the expenditure is to correct for wear and tear the first time the property is maintained, the condition of the property at the time the taxpayer placed it in service is the appropriate comparison.

The regulations also focus on the **betterment** of an item of property irrespective of the expenditure involved. The preamble to the 2008 regulations states that the IRS and the Treasury Department "think that whether an amount paid should be capitalized as a betterment depends upon the purpose, the physical nature, and the effect of the work for which the amounts were paid, and not upon an analysis of the fair market value of the property before and after the work." Consequently, if the condition of the property is **materially improved,** the 2008 proposed regulations require the cost to be capitalized regardless of whether the betterment increases the property's FMV.

The 2008 proposed regulations list the following events as a restoration of property (meaning that the costs involved must be capitalized):

- Replacement of a component part for which the taxpayer has deducted a noncasualty loss;
- Replacement of a component part for which the taxpayer's adjusted basis in the part has been taken into account for gain or loss purposes;
- Repairs made to damaged property for which the taxpayer has made adjustments to basis due to the casualty;
- Repairs made to nonfunctional property that restore it to its operating condition;
- The rebuilding of property to a "like-new" condition after its economic useful life has ended; or
- The replacement of a major component or a substantial structural part of the unit of property.[134]

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[132] Prop. Treas. Reg. §1.263(a)-3.

[133] Prop. Treas. Reg. §1.263(a)-3(f)(2)(iii).

[134] The regulations specify that a "major component part" or "substantial structural part" is deemed to be replaced if the replacement cost is 50% or more or the replacement cost of the entire unit of property, or if the replacement part or parts constitute 50% or more of the physical structure of the property.

### The Regulations — Summary Points

The following points summarize the major points of the regulations:

- As for casualty losses, the regulations require taxpayers that have suffered a casualty loss to property to capitalize the costs of restoring the property to its functioning state.
- A new or different use is defined as one that is inconsistent with the taxpayer's intended use of the property at the time the property was placed in service.[135]
- Currently deductible repairs are those that don't improve the property.
- Routine maintenance costs are those that are incurred on several occasions over the property's lifetime that keep the property in efficient operating condition.[136]
- Routine maintenance does not include amounts paid to restore a property's efficient operating condition from a state of disrepair.[137]

**Note.** Prop. Treas. Reg. §1.263(a)-3(e)(2)(iv) specifies that routine maintenance does not include amounts paid to return a unit of property to its former ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.[138]

## JUDICIAL OPINIONS

The U.S. Court of Appeals for the 9th Circuit summarized the difference between current deductibility of expenditures and capitalization (as developed in the repair expense context) as:

> *The often-litigated distinction between repair expenses and capital improvements has been characterized as the difference between 'keeping' and 'putting' a capital asset in good condition: The test which normally is to be applied is that if the improvements were made to **'put'** the particular capital asset in efficient operating condition, then they are capital in nature. If, however, they were made merely to **'keep'** the asset in efficient operating condition, then they are repairs and are deductible.*[139] (emphasis added)

**Note.** Expenditures associated with certain types of qualifying personal property that cannot be currently deducted as a repair expense (under the taxpayer's facts) may qualify to be expensed under IRC §179. By capitalizing the expenditures and then making the expense-method depreciation election, the end result for the taxpayer may be similar to currently deducting the expenditures. In addition, the IRS stated that taxpayers may make an IRC §179 election on an amended return through 2010.[140] In the revenue procedure, the IRS stated that the Treasury intends to amend Treas. Reg. §1.179-5(c) to clarify that an IRC §179 election can be made on an amended return for tax years beginning before 2011. However, until the regulation is amended, the IRS stated in the revenue procedure that taxpayers may rely on the revenue procedure. **Deducting costs as repair expenses can create a business loss, and use of the IRC §179 election cannot.**

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[135] See Treas. Reg. §1.263(a)–(h) and the examples contained therein.

[136] Certain factors are taken into account in determining whether costs incurred were for routine maintenance. Those factors include how frequently the expenses are incurred for particular property, the taxpayer's experience, industry practice (if applicable), manufacturer recommendations and how the taxpayer treats the activity on an "applicable financial statement."

[137] Prop. Treas. Reg. §1.263(a)–(e)(2)(iv). See also Prop. Treas. Reg. §1.263(a)–(f), Ex. 9.

[138] See also Prop. Treas. Reg. §1.263(a)-(f), Ex. 9.

[139] *Moss v. Comm'r,* 821 F.2d 833 (9th Cir. 1987), *revg.,* TC Memo 1986–128 (Mar. 31, 1986)

[140] Rev. Proc. 2008-54, 2008-2, CB 722.

The Tax Court has rendered numerous decisions that illustrate the distinction between currently-deductible expenses and costs that must be capitalized. One of the most illustrious cases, which happened to arise in an agricultural context, points out that amounts incurred for maintenance and repairs are deductible as ordinary and necessary business expenses. Under the facts of *Schroeder*,[141] the taxpayer resilvered the roof of a barn and replaced approximately 5% of the barn's tin roof. In addition, the taxpayer repaired a barn wall by replacing two of the three structural support rods, repounded nails, renailed the roof, caulked the nail holes, applied wood sealer, and prepped and painted the outside of the barn. Other than fixing the one wall, however, the taxpayer did not alter the structure of the barn. The expenses totaled $15,500, with the installation of the two support rods comprising $1,500 of the $15,500 total.

The taxpayer also incurred expenses associated with a second barn. On this barn, she resealed and painted the wood, installed new windows, fixed the doors and roof (resilvering, caulking, installing lightning rods, and replacing less than 2% of the tin), and divided a horse stall into two foaling stalls. She also demolished a sheep shed and a cow stable that was attached to the barn. The expenses associated with the second barn totaled $5,700, with $100 of that amount incurred in the division of the stall and $900 incurred for demolition of the sheep shed and cow stable.

The court determined that most of the taxpayer's expenditures did not amount to capital expenditures, but were simply maintenance expenses that kept the barns (which were already in operating condition) suitable for their present use. The bulk of the expenses did not enhance the barns' value.

> **Note.** Expenditures that restore a building to its previous condition without adding to the value of the building or prolonging its life are properly deductible.[142]

However, the taxpayer's expenditures incurred in replacing two support rods in one barn and creating two foaling stalls in the second barn were capital improvements.

The court ruled that the demolition costs were nondeductible. Demolition costs add to the basis of the underlying land.[143]

Therefore, of the $21,200 total expenses, $18,700 were currently deductible as repairs, $1,600 had to be capitalized, and $900 were not deductible.

> **Observation.** Importantly, the taxpayer continued to use the barns for the same purpose after the expenditures were made, and many of the expenditures were not substantial. The court determined that the taxpayer did not incur the expenses in the course of a general plan of rehabilitation. The IRS commonly argues, in cases involving facts similar to *Schroeder*, that the taxpayer was engaged in a general plan of rehabilitating the taxpayer's property and because of that, the expenses are not currently deductible.

## OTHER ISSUES

### Component Parts and Engine Overhauls

Recent cases provide useful authority for the position that major engine or transmission overhauls should be currently deductible as repairs. Under these court opinions, engines and transmissions (as component parts) are generally treated as part of the larger machine. This means that the economic life of the engine or transmission is associated with the economic life of the larger machine (e.g., a tractor or combine). Because the larger machine cannot function without an engine or transmission, overhaul of the engine or transmission while affixed to the machine can give rise to a current deduction.

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[141] *Schroeder v. Comm'r*, TC Memo 1996-336 (July 24, 1996). For a reproduction of the court's opinion and discussion of the case, see McEowen and Harl, *Principles of Agricultural Law*, §6.05[1].

[142] See *Campbell v. Comm'r*, TC Summ. Op. 2002-117; (Sep. 6, 2002) (court allowed roof repairs on a rented home as deductible repairs).

[143] IRC §280B.

In 2005, the United States Court of Appeals for the 6th Circuit crafted a 4-part test for determining whether an item of property constitutes a single unit of property under the repair regulations.[144] In the case, the taxpayer deducted millions of dollars of expenses incurred for heavy maintenance and repair of jet aircraft engines. The IRS challenged the deduction, claiming that the engines were separate units of property and that their useful life was prolonged by the maintenance work. The court ruled that the engines and the aircraft were a single unit of property, and that the maintenance costs were ordinary and necessary business expenses that preserved but did not prolong the aircraft's economic useful life.

On this point, whether repairs are currently deductible depends on whether:

- The taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes;
- The economic useful life of the component part is coextensive with the economic useful life of the larger unit of property;
- The larger unit of property and the smaller unit of property can function without each other; and
- The component part can be and is maintained while affixed to the larger unit of property.

In the *Ingram Industries* case, the Tax Court held that engine overhaul expenses are currently deductible.[145] Under the facts of the case, the court allowed current deductions for the cost of overhauling the taxpayer's towboat diesel engines that were out of operation for only 10–12 days.

The 2008 proposed regulations provide guidance on how to handle expenses associated with component parts. Under the regulations, all property is grouped into two categories — buildings and other property. A building and its components are generally a single unit of property, except for individual units in a multi-unit building.

Components are generally treated as functionally interdependent if placing one component in service is dependent on placing the other component in service. A unit of property for tax purposes can include only the components that have the same useful life for financial statement purposes. Similarly, if components of a unit of property are depreciated by the taxpayer under different MACRS classes or using different recovery methods, the components cannot be treated as a single unit of property. Simply recording various components separately on the taxpayer's depreciation schedule does not trigger either of these rules.

### New or Different Use

In general, alterations that modify an item of real or personal property so that it can function in a different manner constitute capital improvements on the theory that the change in the property to meet the taxpayer's specific needs is synonymous with the purchase of a new asset.[146]

### Low-Cost Capital Items

While there is no specific monetary point which, once crossed, requires expenditures to be capitalized, the Tax Court has ruled that expensing capital items that **cost less than $500** was not proper because doing so would not clearly reflect income.[147]

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[144] *FedEx Corporation v. U.S.,* 412 F.3d 617 (6th cir. 2005), *aff'g,* 291 F.Supp.2d 699 (W.D. Tenn., 2003).

[145] *Ingram Industries, Inc. & Subs. v. Comm'r,* TC Memo 2000-323 (Oct. 18, 2000).

[146] See, for example, *Coors Porcelain Co.,* 52 TC 682 (1969) (conversion of a machine from oscillating to rotary action); *West Virginia Steel Corp.,* 34 TC 851 (1960) (rewiring of a factory and storage area to rearrange equipment for more efficient operation).

[147] *Alacare Home Health Services, Inc. v. Comm'r,* TCM 2001-49 (2001).

## Additions to Value

A repair that is a currently-deductible expense adds value to the property by correcting some deficiency in the property. The Tax Court, in several older cases, used a before-and-after test.[148] Under that test, the key is whether the expenditure materially enhances the value of the property as compared to the property's value before the expenditure was incurred. The Tax Court also indicated that incurring a low-cost expenditure to enhance an item of property rather than replacing it or restoring it indicates that the expenditure is a currently-deductible repair.[149] According to the Tax Court, using a lower-cost means to enhance property instead of replacing it or spending more to restore it indicates the expense is a currently-deductible repair.

## Tobacco Barns

In parts of the country where tobacco farming exists, relatively new federal and state regulations may require a grower to either retrofit his tobacco barns (which are used to cure the tobacco) with a new burner system or construct new barns that are in compliance with the regulations. Costs incurred in retrofitting an existing barn clearly should be currently deductible because the expense neither extends the life of the barn nor converts it to a new use. Also, building a new barn that meets the specifications of the regulations should likewise be deductible, particularly if that option is more cost effective.

> **Observation.** A tobacco barn is somewhat of a unique structure. It is not a single-purpose agricultural or horticultural structure and, as such, may be classified as a building that is not eligible to be expensed under IRC §179.[150] However, actual use of the structure must be analyzed in each situation to determine whether the structure could actually satisfy the requirements of IRC §1245 and be eligible for expense-method depreciation.

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[148] *Overman Mfg. Co.*, 47 TC 471 (1967).

[149] *Hudlow*, 30 TCM 894 (1971).

[150] See *Hart v. Comm'r*, TC Memo 1999-236 (July 21, 1999).