Chapter 8: Small Business Issues

Corrections were made to this material through January of 2012. No subsequent modifications were made.

CHANGES EFFECTIVE FOR 2011

FORM 1099 REPORTING REQUIREMENTS

Repeal of Expanded Form 1099 Reporting

"Now you see it, now you don't" describes the effect that H.R. 4[1] (effective April 14, 2011) had on the expanded information reporting requirements for rental property and business owners, which were to become effective in 2011 and 2012, respectively. This is good news, especially for small businesses.

For rental expense payments of $600 or more after December 31, 2010, the Small Business Jobs Act of 2010 (SBJA) expanded the Form 1099 information reporting requirements for rental property owners. **H.R. 4 repealed** these rental property expense reporting requirements.

The Patient Protection and Affordable Care Act (PPACA, or Health Care Act) included a very controversial provision in Section 9006. The provision would require businesses, charities, and governmental units to report payments for purchases of all goods and services of $600 or more. This even applied to purchases from corporations. The provision was to become effective for payments made after December 31, 2011. **H.R. 4 repealed** Section 9006 of the PPACA. Reporting requirements for businesses that existed prior to the passage of the PPACA remain unchanged and apply to payments of $600 or more to service providers.

1. H.R. 4 is also known as the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011.

To offset the lost revenue due to the repeal of the Form 1099 reporting requirements, H.R. 4 amended another controversial provision of the PPACA which will give health insurance premium assistance credits beginning in 2014 to low- and some middle-income taxpayers. The new law changes the calculation and will require more people to return overpayments of the credit. Tax credits (which can be advanced tax credits) are paid directly to the health insurers each year. The amount of credit is determined by examining prior year income tax returns of the taxpayer. If the taxpayer's income rises in subsequent years, the taxpayer may be required to recapture a portion of the credit allowed or increase the future year tax liability. H.R. 4 increases the amount of the excess credit that must be repaid by changing the caps on household incomes contained in the original healthcare bill.

Note. For more information about the changes to the premium assistance credit, see Chapter 13, New Legislation.

Expanded Form 1099 Reporting Requirements Not Repealed by H.R. 4

Form 1099-K. Beginning in calendar year 2011, the Housing Assistance Tax Act of 2008 (HATA) requires gross amounts received through credit and debit card transactions to be reported to the IRS. The new reporting provisions require banks and other payment settlement entities (PSE) to file the new Form 1099-K, *Merchant Card and Third Party Network Payments,* beginning in 2012 for 2011 transactions. Transactions affected include debit cards, credit cards, gift cards, store cards, and e-commerce payments such as PayPal or Bill Me Later. For third-party settlement organizations, a de minimis standard applies.

Reporting via a Form 1099-K is **required only** if the gross amount of total reportable payment transactions exceeds $20,000 **and** the total number of such transactions exceeds 200 for the calendar year.

The following transactions are specifically **excluded** from the Form 1099-K reporting requirements.[2]

- Withdrawal of funds at an automated teller machine (ATM) via payment card, cash advances, or loans against the cardholder's account
- A check issued in connection with a payment card that is accepted by a merchant or other payee
- Any transaction in which a payment card is accepted as payment by a merchant or other payee who is related to the issuer of the payment card

Note. Small businesses may want to change their accounting or bookkeeping practices if they record only net receipts because the new law requires PSEs to report **gross** receipts. Merchants often have chargebacks, issue refunds, or have debit card transactions in which the customer receives cash back. Also, payment processors use Form W-9, *Request for Taxpayer Identification Number and Certification,* to obtain necessary information from merchants. If the merchant fails to provide an EIN (or a correct EIN), they can be subject to backup withholding at the rate of 28%. In addition, backup withholding or garnishment is possible if the merchant is delinquent on any tax payments.

2. Treas. Reg. §1.6050W-1(b)(5).

Merchants may find the new Form 1099-K confusing. Many PSEs have contracted with an electronic payment facilitator (EPF) or third party payer (TPP) to make the actual payments. If a merchant receives a Form 1099-K and has questions regarding the information it contains, they are asked to contact the filer whose information appears on the upper left corner of the form. If they do not recognize the filer, they should contact the PSE whose information appears on the lower left side above the account number.

Total yearly payments must be shown in box 1 of Form 1099-K and payments by month are reported in boxes 5a to 5l.

Example 1. Julie purchases clothing in March, 2011, at Better Dress Shop, Inc., for $750 and charges this to her credit card. In the same transaction, she also received cash back of $50 in order to purchase a matching accessory at another store. The TPP deposits $768 into Better Dress's bank account. The TPP deducted $32 for its processing fee. However, the TPP includes $800 ($750 + $50) in the Box 1 total on the Form 1099-K. The taxable sale for Better Dress is $718 ($750 − $32). Unless Better Dress has detailed records, they may not be reporting amounts on their tax return that match the total of the Forms 1099-K and will possibly receive a CP 2000 letter from the IRS for underreported income.

☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone no. **TPP** **Anywhere, USA 87878** **217-555-8843**	FILER'S federal identification no. **22-2222222** PAYEE'S taxpayer identification no. **33-3333333**	OMB No. 1545-2205 **2011** Form **1099-K**	**Merchant Card and Third Party Network Payments**
	1 Gross amount of merchant card/third party network payments $ **800.00**	2	**Copy B** **For Payee**
If checked, FILER is Payment Settlement Entity (PSE) ☐ OR If checked, FILER is Electronic Payment Facilitator (EPF)/Third Party Payer (TPP) ☐	3	4	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.

PAYEE'S name **Better Dress Shop, Inc.**	5a January $	5b February $
Street address (including apt. no.)	5c March $ **800.00**	5d April $
17 Green Street	5e May $	5f June $
City, state, and ZIP code	5g July $	5h August $
Brownville, AZ 71000	5i September $	5j October $
PSE'S name and telephone number **First Data 610-056-7100**	5k November $	5l December $
Account number (see instructions) **4516789**		

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

For Example 1

Form **1120S**
Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation
▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
▶ See separate instructions.

OMB No. 1545-0130
2011

For calendar year 2011 or tax year beginning , 2011, ending , 20

A S election effective date
B Business activity code number *(see instructions)*
C Check if Sch. M-3 attached ☐

TYPE OR PRINT
Name: **Better Dress Shop, Inc.**
Number, street, and room or suite no. If a P.O. box, see instructions.: **17 Green St.**
City or town, state, and ZIP code: **Brownville AZ 71000**

D Employer identification number: **33-3333333**
E Date incorporated
F Total assets *(see instructions)* $

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed
H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation
I Enter the number of shareholders who were shareholders during any part of the tax year . . . . ▶

Caution. *Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Income
1a Merchant card and third-party payments (see instructions).
b Gross receipts or sales not reported on line 1a (see instructions)
c Total. Add lines 1a and 1b
d Returns and allowances plus any other adjustments (see instructions)
e Subtract line 1d from line 1c
2 Cost of goods sold (attach Form 1125-A)
3 Gross profit. Subtract line 2 from line 1e
4 Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)*
5 Other income (loss) *(see instructions—attach statement)*
6 **Total income (loss).** Add lines 3 through 5
7 Compensation of officers

IRS INSTRUCTION PENDING

> **Note.** As of the publication date of this book, the IRS was still working on completing draft versions of Schedules C and E. In addition, instructions are being revised to indicate where cashback payments and sales tax collected amounts are reported.

Electronic Filing Requirement

If a taxpayer is required to file 250 or more information returns, the returns must be filed electronically. The 250 or more threshold applies separately to each type of form.

Example 2. Fifth Street Bank is required to file 510 Forms 1098, *Mortgage Interest Statement,* and 235 Forms 1099-MISC, *Miscellaneous Income*. The bank is required to file the Forms 1098 electronically but is not required to file the Forms 1099-MISC electronically.

The electronic filing requirement applies separately to original and corrected returns. Original and corrected returns are not aggregated to determine if the threshold for electronic filing was met.

To obtain approval for electronic filing, Form 4419, *Application for Filing Information Returns Electronically (FIRE),* should be filed at least 30 days before the due date of the returns. Each type of return to be filed electronically must be identified on Form 4419 because the IRS will issue a separate Transmitter Control Code for the various types of returns.

Penalties

Penalties for late or improper filing of information returns were increased under the SBJA. The penalties are assessed for failure to file on a timely basis, failure to include all the information required on the return, or including incorrect information on a return. The amount of the penalty is based on when the taxpayer files the correct return. The penalties are:[3]

- $30 per information return if filed within 30 days of the due date, up to a maximum penalty of $250,000 per year ($75,000 for small businesses);
- $60 per information return if filed more than 30 days after the due date but before August 1 of the tax year, up to a maximum penalty of $500,000 ($200,000 for small businesses);
- $100 per information return if filed after August 1 of the tax year, up to a maximum penalty of $1.5 million ($500,000 for small businesses); and
- $250 per information return for intentional disregard of the filing requirement.

An identical penalty applies for failure to furnish payee statements on a timely basis.[4] If businesses both fail to file information returns with the IRS and fail to furnish payee statements, they are subject to separate penalties under both §§6721 and 6722.

If the taxpayer is required to file electronically, a separate penalty of up to $100 per return is assessed. The IRS has the authority to **abate** penalties if the taxpayer can show **reasonable cause.**

NEW HIRE RETENTION CREDIT

The Hiring Incentives to Restore Employment Act (HIRE Act) provides a credit to employers that hire certain previously unemployed workers after February 3, 2010, and before January 1, 2011, and retain them for 52 consecutive weeks. Employers are eligible to claim the new hire retention credit in the tax year during which the 52-week period is met. Therefore, calendar year employers can qualify for the credit in 2011 only and fiscal year taxpayers may qualify in 2010 and/or 2011 fiscal years.

Qualified Employers

Businesses, tax-exempt organizations, public colleges and universities, and Indian tribal governments qualify for the credit. Household employers and federal, state, and local governmental units do not qualify for the new hire retention credit.

3. IRC §6721.

4. IRC §6722.

Qualified Employees

Qualified employees must meet **all** of the following criteria for the employer to be eligible for the new hire retention credit.[5]

1. The employee begins employment with the employer after February 3, 2010, and before January 1, 2011.
2. The employee was unemployed or employed 40 hours or less during the 60-day period ending on the date such employment begins. The employee must certify that they meet this requirement by signing an affidavit (Form W-11, *Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit,* or similar document).
3. The employee is not employed by the employer to replace another employee unless the other employee separated from employment voluntarily or for cause (including downsizing).
4. The employee is not related to the employer in one of the following ways.
   - **a.** Child or descendent of a child
   - **b.** Sibling or stepsibling
   - **c.** Parent or ancestor of a parent
   - **d.** Stepparent
   - **e.** Niece or nephew
   - **f.** Aunt or uncle
   - **g.** Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
   - **h.** A relative of anyone who owns more than 50% of the employer's outstanding stock or capital and profits interest or is a dependent of the employer or a dependent of anyone who owns more than 50% of the employer's stock or capital and profits interest

The IRS has provided additional guidance about qualifying employees.[6] It clarified that there is no minimum age requirement for an individual to be a qualifying employee, no requirement that the individual was ever previously employed and/or lost their job, and that work performed by a self-employed individual does not count as having been employed for purposes of the 40-hour test. Also, an employee who was previously employed and then rehired by the same employer can qualify the employer for the tax credit provided the previously listed criteria are met.

Calculating the Credit

The employer is eligible to claim the credit when the employee has been retained for at least 52 consecutive weeks. The credit is calculated for each eligible employee on Form 5884-B, *New Hire Retention Credit.* The form requires reporting each employee's wage totals for both the first and second 26 consecutive weeks of employment because the wages in the second half of the year must be at least 80% of the wages paid in the first half of the year.

The amount of credit for each employee is the lesser of:

- 6.2% of the employee's wages during the 52-week consecutive period, or
- $1,000.

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5. Form W-11 Instructions.
6. *FAQs about Qualified Employees.* [www.irs.gov/businesses/small/article/0,,id=220749,00.html] Accessed on Jul. 6, 2011.

The accumulation of wage information for calculating the credit requires payroll records from more than one calendar year. Wages of $16,129 during the 52-week consecutive period produces the maximum credit of $1,000 ($16,129 × 6.2% = $1,000).

The new hire retention credit is part of the general business credit claimed on Form 3800, *General Business Credit.* It may be carried forward but may not be carried back to any tax year beginning before March 18, 2010.

The employer does not need to reduce its deduction for compensation because of the credit. Any alternative minimum tax owed by the employer is not reduced by the amount of this credit.

An employer can claim both the work opportunity credit and the new hire retention credit for the same employee.

Example 3. ACME (a calendar-year company) hires three workers after February 3, 2010, and before January 1, 2011. The workers each signed an affidavit (Form W-11) certifying their eligibility for the new hire retention credit. The workers are each employed for 52 consecutive weeks. Based on the following wage information, ACME claims a credit on Form 5884-B.

	Wages	
	First 26 Weeks	**Second 26 Weeks**
Worker 1	$25,000	$25,500
Worker 2	7,200	7,200
Worker 3	32,000	25,000

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For Example 3

Form **5884-B** (December 2010) Department of the Treasury Internal Revenue Service

New Hire Retention Credit

▶ Attach to your tax return.
▶ Use Part II to list additional retained workers.

OMB No. 1545-2202
Attachment Sequence No. 65

Name(s) shown on return	Identifying number
ACME	22-2222222

A credit of up to $1,000 is allowed for each retained worker. A retained worker generally is a qualified employee (see instructions) whose first 52 consecutive weeks of employment ended in the current tax year. However, the worker's wages (as defined for income tax withholding purposes) for the second 26 consecutive weeks must equal at least 80% of the worker's wages for the first 26 consecutive weeks.

Part I **New Hire Retention Credit for Retained Workers**

	Use a separate column for each retained worker. If you need more columns, use Part II and include the totals on line 10.		(a) Retained Worker No. 1	(b) Retained Worker No. 2	(c) Retained Worker No. 3
1	Enter the retained worker's social security number	1	355-55-5555	123-45-6789	
2	Enter the first date of employment from the retained worker's Form W-11 or similar statement	2	04 / 02 / 2010	05 / 10 / 2010	/ / 2010
3	Enter the retained worker's wages for the first 26 consecutive weeks of employment	3	25,000	7,200	
4	Multiply line 3 by 80% (.80)	4	20,000	5,760	
5	Enter the retained worker's wages for the second 26 consecutive weeks of employment. If line 4 is larger than this amount, the qualified employee is not a retained worker and should not be listed on this form	5	25,500	7,200	
6	Add lines 3 and 5	6	50,500	14,400	
7	Multiply line 6 by 6.2% (.062)	7	3,131	893	
8	Maximum credit allowable	8	1,000 00	1,000 00	1,000 00
9	Enter the **smaller** of line 7 or line 8	9	1,000	893	

10	Add columns (a) through (c) on line 9 above and columns (a) through (c) on lines 9 of any attached Parts II	10	1,893
11	Enter the total number of retained workers for whom you are receiving a credit on line 10 (see instructions) — 11: 2		
12	New hire retention credit from partnerships and S corporations (see instructions)	12	
13	**Current year credit.** Add lines 10 and 12. Partnerships and S corporations, report this amount on Schedule K; all others, report this amount on the applicable line of Form 3800 (e.g., line 1aa of the 2010 Form 3800)	13	1,893

For Paperwork Reduction Act Notice, see instructions. Cat. No. 55035V Form **5884-B** (12-2010)

Note. Because Worker 3's wages in the second half of the year ($25,000) were less than 80% of the wages in the first half of the year ($32,000 × 80% = $25,600), ACME does not list this employee on Form 5884-B. Even though the individual is a qualifying employee, ACME is not entitled to a credit for this employee.

HEALTH CARE ACT CHANGES EFFECTIVE IN 2011

Health Insurance Reporting on Form W-2

The PPACA requires that the aggregate cost of employer-sponsored health insurance coverage be reported on Form W-2 for 2011. The IRS provided interim relief for employers by making this provision optional for 2011.[7]

The **aggregate cost** is defined as the value of the health insurance or "applicable premium" under the rules for COBRA continuation coverage.[8] The costs that must be reported include the following.

- Medical plans
- Prescription drug plans
- Dental and vision plans (other than stand-alone plans)
- Executive physicals
- Onsite clinics if they provide more than de minimis care
- Medicare supplemental policies
- Employee assistance programs

If the employee is enrolled in multiple employer-sponsored plans, the aggregate value must be disclosed. Employers are not required to report the breakdown of the various types of coverage but rather only the aggregate cost.

Under the PPACA, the following employer-provided benefits are not required to be reported on Form W-2.

- Long-term care, accident, or disability benefits
- Specific disease or illness policies when the premium is paid on an after-tax basis by the employee
- Archer MSA or HSA contributions of the employee
- Salary-reduction contributions to a health FSA

8

The value of these benefits is reported with a code of "DD" in box 12 of Form W-2. The value of these benefits does not affect the tax liability of the employee but rather is a way to track coverage values for the 40% excise tax, which starts in 2018 on so-called "Cadillac plans."

Over-the-Counter Medication

Effective January 1, 2011, over-the-counter medicine or drugs (other than insulin) cannot be reimbursed by FSAs, HSAs, MSAs, or HRAs unless prescribed by a doctor. This restriction applies to expenses incurred on or after January 1, 2011, without regard to the plan year. The new rule does not apply to medical care items that are not medicine or drugs. Consequently, equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits remain eligible for reimbursement.[9]

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7. IRS Notice 2010-69, 2010-44 IRB 576.

8. See IRC §4980B(f)(4).

9. [www.irs.gov/newsroom/article/0,,id=227308,00.html] Accessed on Jul. 20, 2011.

Penalty Increases on Nonqualified Distributions[10]

Distributions from HSAs after December 31, 2010, that are not used for qualified medical expenses are subject to a **20%** penalty in addition to being included in taxable income. The penalty was previously 10%.

Distributions from Archer MSAs after December 31, 2010, that are not used for qualified medical expenses are also subject to a 20% penalty in addition to being included in taxable income. This penalty was previously 15%.

There is no additional tax on distributions from HSAs or Archer MSAs after the taxpayer reaches age 65, becomes disabled, or dies.

New SIMPLE Cafeteria Plans

The PPACA enacted a new form of an IRC §125 cafeteria plan that is available to small employers for years beginning after December 31, 2010. Similar to SIMPLE §401(k) and SIMPLE IRA plans, some cafeteria plans can now qualify as SIMPLE cafeteria plans and thus avoid the nondiscrimination requirements of classic cafeteria plans under IRC §125(b).

Employers eligible for a SIMPLE cafeteria plan must employ an average of 100 or fewer employees during either of the prior two years. If the employer grows in subsequent years, the employer can continue to sponsor a SIMPLE cafeteria plan; however, in the year following a year in which the employer employs an average of 200 or more employees, the plan must be converted to a classic cafeteria plan. For new employers, eligibility is based on the number of employees the employer is reasonably expected to employ. Aggregation rules apply to controlled groups and affiliated service group employers.

In order to meet the requirements of a SIMPLE cafeteria plan, the employer must make a minimum contribution that a qualified employee could use towards any qualified benefit under the plan. This contribution is required without regard to whether the qualified employee makes any salary reduction contributions.

Plans must provide benefits for qualified employees. Qualified employees are those employees who are **neither** highly compensated **nor** key employees. However, highly compensated or key employees can participate in the plan if desired. Plan contributions are required for the qualified employee participants but not for the highly compensated or key employees. The contribution can be either of the following.[11]

1. **Nonelective contribution method.** This method uses an amount equal to a uniform employer contribution of at least 2% of compensation regardless of whether the qualified employee makes salary reduction contributions to the plan.
2. **Matching contribution method.** This method uses an amount not less than the lesser of:
   - **a.** 6% of the qualified employee's compensation for the year, or
   - **b.** Twice the amount of each qualified employee's salary reduction contributions.

Additional employer contributions can be made, but the rate of any matching contributions for highly compensated or key employees cannot be greater than the rate for employees who are not highly compensated.

10. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

11. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act."* JCX-18-10 (Mar. 2010).

SIMPLE cafeteria plans must meet eligibility and participation requirements. All employees who had at least 1,000 hours of service for the preceding plan year must be eligible to participate, and all eligible employees must have the same election rights under the plan. The plan may exclude employees who:[12]

1. Have not attained age 21 before the end of the plan year,
2. Have fewer than 1,000 hours of service for the preceding plan year,
3. Have been employed less than one year as of any day of the plan year,
4. Are covered by a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer, or
5. Are nonresident aliens working outside the United States whose income did not come from a U.S. source.

With respect to items 1 and 2, an employer may have a younger age and shorter service requirement but only if the younger age or shorter service applies to all employees.

Most small employers offering a health plan through a SIMPLE cafeteria plan and paying a significant portion of the health plan cost will probably meet the minimum contribution requirements for SIMPLE cafeteria plans. Owners/shareholders of sole proprietorships, partnerships, LLCs, and S corporations are currently not eligible to participate in traditional cafeteria plans, but they may establish these plans for their employees.

Insured Group Health Plans Nondiscrimination Requirements

The PPACA changed the discrimination rules for insured group health plans to mirror the nondiscrimination rules that currently apply to self-insured group health plans under IRC §105(h). These new rules were scheduled to become effective for plan years beginning after September 23, 2010, unless the plans are deemed "grandfathered health plans." A grandfathered health plan is a plan that existed on the date of the enactment of the PPACA (March 23, 2010) regardless of whether the coverage is renewed after that date. New employees can enroll in the plan after March 23, 2010, without causing the plan to lose its grandfathered status. The PPACA explicitly prohibits amendments to grandfathered plans but no guidance is currently provided regarding what may cause a plan to lose its grandfathered status.

Currently, discrimination by self-insured plans results in the taxation of the benefits of highly compensated individuals. Under the PPACA, insured plans that fail to comply with the nondiscrimination rules can be subject to an excise tax of $100 for each day of noncompliance multiplied by each individual to whom the failure relates. In addition, civil monetary penalties and/or a civil action to compel it to provide nondiscriminatory benefits can result. Self-insured plans are those insured by the employer although some claims may be paid by a stop-loss carrier.

Self-insured group health plans cannot discriminate in favor of highly compensated individuals. Under IRC §105(h), these plans must meet both a benefits test and an eligibility test.

The **benefits test** is passed if all benefits provided to highly compensated individuals are also provided to all participants. Highly compensated individuals under §105(h) include the following individuals.

- One of the five highest paid officers
- A 10% or more shareholder
- Among the highest paid 25% of all employees

12. Ibid.

The **eligibility test** is passed if **any** of the following apply.

- The plan benefits at least 70% or more of all employees.
- At least 70% of all employees are eligible for the plan, and at least 80% of these eligible employees benefit from the plan's coverage.
- The plan benefits employees in a manner that is deemed not to discriminate in favor of highly compensated individuals.

Employees who can be excluded from the eligibility test computation are those who:

- Have completed less than three years of service,
- Are under age 25,
- Are seasonal workers,
- Work less than 35 hours per week,
- Are nonresident aliens, or
- Are covered by a collective bargaining agreement.

Prior to the enactment of the PPACA, an insured group health plan could discriminate and offer nontaxable benefits to key employees and highly compensated employees that were not offered to other employees. Some of these benefits included the following.

- Purchase of insurance for executives only
- More favorable eligibility rules that provide coverage immediately for executives but delayed coverage for other employees
- More favorable coverage for out-of-pocket medical expenses not covered under health plans available to employees who are not highly compensated
- Extension of benefits after retirement on a more favorable basis than what is generally available to employees who are not highly compensated

Because regulatory guidance is essential to the operation of the statutory provisions, the Treasury Department and the IRS as well as the Departments of Labor and Health and Human Services have determined that compliance for insured group health plans will not be required and sanctions for noncompliance will not apply until after regulations or other administrative guidance is issued. In order to provide insured group health plan sponsors time to implement any changes required as a result of the regulations or other guidance, the IRS anticipates that the guidance will not apply until plan years beginning a specified period after issuance.[13]

13. IRS Notice 2011-1, 2011-2 IRB 259.

ECONOMIC SUBSTANCE DOCTRINE

BACKGROUND

The economic substance doctrine is a common law doctrine which has evolved through litigation in various courts. over the years. The doctrine denies tax benefits for a transaction if the transaction has no economic substance over and above the tax benefits obtained. This common law doctrine has been used extensively by the IRS to address tax shelters and transactions motivated only for tax purposes. The Health Care and Education Affordability Reconciliation Act of 2010 codified this common law doctrine in IRC §7701(o).[14]

Any financial accounting benefit of the transaction is not taken into account as a purpose for entering into the transaction if the origin of the financial accounting benefit is a reduction in federal income taxes.[15]

IRC §7701(o) provides that in the case of any transaction to which the economic substance doctrine is relevant, such a transaction shall be treated as having economic substance only if **both** of the following tests are met.

1. The transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position.
2. The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

Prior to the enactment of §7701(o), the economic substance doctrine test was satisfied if **either** of the above tests were met.

Note. This means that even if a transaction meets all the statutory and administrative requirements, it must also change the taxpayer's economic position by more than the income tax savings it may impart.

Note. For extensive information about the economic substance doctrine, see pages 378–381 in the 2008 *University of Illinois Federal Tax Workbook* and pages 458–459 in the 2010 *University of Illinois Federal Tax Workbook.* These can be found on the accompanying CD.

The new conjunctive tests are applicable to transactions entered into after March 30, 2010. Thus, it is now more difficult for a transaction to meet the economic substance criteria than was the case under previous common law, when the taxpayer only needed to pass one of the above tests.

Taxpayers are not required, per se, to establish a pretax profit motive to satisfy the economic substance doctrine. However, a pretax profit motive is taken into account if the present value of the reasonably expected pretax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[16]

14. IRC §7701(o)(2)(A).

15. IRC §7701(o)(4).

16. IRC §7701(o)(2)(A).

In order for the economic substance doctrine to apply to a particular transaction, it must be relevant. Not all transactions are ones to which the economic substance doctrine is applicable. The Joint Committee on Taxation explanation that accompanied the legislation provided some examples of transactions to which the economic substance doctrine is not relevant and therefore not applicable. These include:

- The choice between capitalizing a business enterprise with debt or with equity,
- A U.S. person's choice between using a foreign or domestic corporation to make a foreign investment,
- Use of corporate organization or reorganization transactions, and
- Use of a related-party entity in a transaction that meets IRC §482 arms-length standards.

The economic substance doctrine as codified applies only to transactions entered into by a trade or business or for the production of income. Consequently, estate tax and charitable planning are generally not subject to the economic substance doctrine.

To encourage compliance with new laws covering economic substance, a strict liability penalty of 40% applies to underpayments attributable to undisclosed transactions lacking economic substance[17] and a 20% penalty applies to disclosed transactions.[18] Also, IRC §6664(c)(2), which generally provides a reasonable cause exception that applies to other penalties, does not apply to an understatement due to a lack of economic substance.

UPDATE

In Notice 2010-62, the IRS indicated that it will continue to rely on relevant case law under the common law economic substance doctrine in applying the 2-prong conjunctive test in §7701(o). Thus, for transactions after March 30, 2010, in which prior case law treated a transaction as having economic substance merely because it satisfies one or the other of the two tests, the IRS will now apply a 2-prong conjunctive test consistent with §7701(o).

The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either does or does not apply. The IRS will not issue any private letter rulings or determination letters regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with §7701(o).[19]

17. IRC §6662(i)(1).

18. IRC §6662(b)(6).

19. IRS Notice 2010-62, 2010-40 IRB 411.

On July 15, 2011, the IRS issued a directive to instruct its examiners and their managers on how to determine when it is appropriate to raise the economic substance doctrine.[20] The directive identifies four steps the examiner must develop and analyze in order to seek the approval of the appropriate director of field operations (DFO) for the application of the economic substance doctrine. The steps are as follows.

> **Note.** This guidance is from the IRS's Large Business & International Division. As such, not all the situations listed in the directive are applicable to a small business. However, the steps mentioned here are intended to help tax practitioners recognize potential situations in which the economic substance doctrine is relevant in order to advise their clients accordingly.

1. Evaluate whether the circumstances in the case are those under which the application of the economic substance doctrine is likely **not** appropriate. These situations include, but are not limited to, the following.
   a. The transaction **is** at arm's length with unrelated third parties.
   b. A transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives.
   c. The transaction **creates a meaningful economic change** on a pretax present-value basis.
   d. The taxpayer's potential for gain or loss **is not** artificially limited.
   e. The transaction **does not accelerate** a loss or duplicate a deduction.
   f. The taxpayer **does not hold** offsetting positions that largely reduce or eliminate the economic risk of the transaction.
   g. The transaction **does not generate** a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset).
   h. The transaction **does not involve** a tax-indifferent counterparty that recognizes substantial income.
   i. The transaction **does not result** in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years.
   j. The transaction **has** a credible business purpose apart from federal tax benefits.
   k. The transaction **has** meaningful potential for profit apart from tax benefits.
   l. The transaction **has** a significant risk of loss.
   m. The tax benefit **is not** artificially generated by the transaction.
   n. The transaction **is not** outside the taxpayer's ordinary business operations.

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[20] *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties.* [www.irs.gov/businesses/article/0,,id=242253,00.html] Accessed on Jul. 19, 2011.

2. Evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction **may be** appropriate. The application of the economic substance doctrine may be appropriate in the following situations.

   a. The transaction **is not** at arm's length with unrelated third parties.

   b. The transaction creates **no meaningful economic change** on a pretax present-value basis.

   c. The taxpayer's potential for gain or loss **is** artificially limited.

   d. The transaction **accelerates** a loss or duplicates a deduction.

   e. The transaction **generates** a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset).

   f. The taxpayer **holds** offsetting positions that largely reduce or eliminate the economic risk of the transaction.

   g. The transaction **involves** a tax-indifferent counterparty that recognizes substantial income.

   h. The transaction **results** in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years.

   i. The transaction **has no** credible business purpose apart from federal tax benefits.

   j. The transaction **has no** meaningful potential for profit apart from tax benefits.

   k. The transaction **has no** significant risk of loss.

   l. The tax benefit **is** artificially generated by the transaction.

   m. The transaction **is** outside the taxpayer's ordinary business operations.

3. If the examiner determines that application of the doctrine may be appropriate, a series of inquiries are provided that an examiner must make before seeking approval to apply the doctrine.

4. If an examiner, their manager, and territory manager determine that application of the doctrine is merited, guidance is provided on how to request DFO approval.

SCHEDULE UTP

The IRS has finalized Schedule UTP, *Uncertain Tax Position Statement,* for use starting with 2010 tax years. The instructions for the form require certain corporations to disclose uncertain tax positions for which a tax reserve is recorded or for which the corporation does not record a reserve because it intends to litigate the position. Corporations are required to file Schedule UTP if they have federal income tax liabilities included in their audited financial statements and have assets that equal or exceed $100 million. Schedule UTP is being phased in over a period of five years with the filing threshold being lowered to include corporations with assets of $50 million for 2012 and $10 million in 2014. The motivation for filing Schedule UTP is to avoid the increase in penalty from 20% for disclosed positions to 40% for undisclosed positions under IRC §6662(i).

The instructions for Schedule UTP indicate that if a complete and accurate disclosure of a tax position has been made on a Schedule UTP, then the disclosure is treated as if the corporation had filed a Form 8275, *Disclosure Statement,* or Form 8275-R, *Regulation Disclosure Statement,* for purposes of avoiding certain accuracy-related penalties.

CONCLUSION

Tax professionals and taxpayers are faced with substantial uncertainty as to the question of how transactions are viewed in light of the new statute. Because there is no "angel list" and the IRS indicates it will continue to rely on court case history to enforce the economic substance doctrine, it appears the courts will continue to play an important role in interpreting increasingly complicated transactions that contain aggressive tax-shelter activities.

Caution. While the purpose of §7701(o) is to allow the IRS to further control tax shelters by the use of substantial penalties, it can be used in any type of tax transaction if the economic substance rule is not met.

Example 4. Darnell trades a year-old piece of equipment for a new model because he has a large tax liability and money in the bank. The old equipment still works well and the new equipment will not increase his efficiency or lead to more profits. The IRS could argue that Darnell's economic position did not change. He only substituted one asset for another asset. Were it not for the tax deduction, he would not have made the trade.

Tax professionals will have to wait until court cases are litigated to determine how far outside the tax-shelter arena the IRS will apply the provisions of §7701(o).

LEASE ISSUES

LEASE VERSUS PURCHASE

When acquiring property, business taxpayers sometimes wish to either lease property or purchase the property. These businesses might wish to use off-balance-sheet financing or strive to derive certain tax benefits from the transaction such as accelerated depreciation or lease expense. Sometimes, businesses enter into transactions that are called leases because this is the only readily available method of financing for the asset being acquired. In these situations, the taxpayer may have no motive about the desired result of the financing and their only purpose is to get the usage of the asset. Regardless of the circumstances, a proper determination must be made as to whether the transaction is a true operating lease or a conditional sales contract (purchase of the property).

IRC §162(a) provides that:

> *There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.*

In deciding whether a taxpayer is entitled to a deduction for any payments as rentals, it is necessary to determine whether by virtue of the agreement the taxpayer has acquired or will acquire title to, or equity in, the property.

Conditional Sales Contract

Although no single test or specific combination of tests always applies, the IRS may consider an agreement to be a conditional sales contract rather than a lease if **any** of the following is true.[21]

- The agreement applies part of each payment toward an **equity interest** the taxpayer will receive.
- The taxpayer **receives title** to the property after making a stated amount of required payments.
- The amount the taxpayer must pay to use the property for a **short time** is a large part of the amount they would pay to obtain title to the property.
- The taxpayer pays much **more** than the **current fair rental value** of the property.
- The taxpayer has an option to buy the property at a **nominal price** compared to the **value** of the property when the option is exercised.
- The taxpayer has an option to buy the property at a **nominal price** compared to the **total payments** under the agreement.
- The agreement designates part of the payments as **interest,** or a portion of the payments is easy to recognize as interest.

Example 5. Kathlyn leases a desktop computer from a national retailer for $150 per month for 24 months. Her total payments are $3,600. If she were to purchase the computer instead of leasing it, the retail price would be $3,300. At the end of the lease term, she has the option to buy the computer for $1.

This lease is actually a purchase agreement. Kathlyn's agreement meets at least one of the conditions to be considered a purchase contract — the option price is nominal compared to the total payments under the agreement. It is not necessary to analyze any of the other factors.

The **Tax Court** recently referenced five specific conditions that might cause a lease to be considered a conditional sales contract.[22]

1. The lease term comprises the equipment's entire **useful life.**
2. The lease is an **open-end lease.** When the taxpayer assumes the risk of fluctuations in the residual value of the property at the end of the lease term, the lease is an open-end lease.
3. The **title automatically passes** to the taxpayer upon conclusion of the lease or when the sum of the rental payments equals the cost of the equipment.
4. The taxpayer has the **option to purchase** the equipment at a nominal or **below-market price.**
5. The lessor has the option to **compel** the taxpayer to purchase the equipment.

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21. *Income and Expenses.* Dec. 20, 2010. [www.irs.gov/faqs/faq/0,,id=199657,00.html] Accessed on Jun. 19, 2011.

22. *Boyce v. Comm'r,* TC Summ. Op. 2010-100 (Jul. 26, 2010).

Boyce v. Comm'r.[23] A Tax Court summary opinion may not be used as precedent in any other case. However, analyzing the IRS arguments and the court's opinion may give tax practitioners insight into the proper income tax treatment of similar transactions.

Boyce is interesting because the taxpayers entered into a lease agreement that they characterized as a purchase for tax purposes. The IRS argued that the agreement was a true lease and the court agreed.

The following facts were presented in the case.

1. During 2004, the taxpayers leased a 2004 Ford Expedition truck from an automotive dealer for business purposes.
2. The contract between the taxpayers and the dealer was entitled "MOTOR VEHICLE LEASE AGREEMENT — CLOSED-END."
3. The contract called for monthly fixed payments of $607 over a 48-month term. The total monthly payments equaled $29,139.
4. The contract permitted the taxpayers to drive the truck only 11,294 miles per year. It also imposed an excess mileage fee.
5. The taxpayers were required to:
   a. Maintain the truck,
   b. Have all necessary repairs made,
   c. Provide insurance coverage, and
   d. Pay all taxes imposed in connection with the truck.
6. At the end of the 48-month term, the taxpayers had an option to purchase the truck for $17,612. In the event they did not exercise that option, they were required to pay a $395 termination fee.
7. Petitioners claimed a $28,749 §179 deduction for the truck on their timely filed 2004 tax return.

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Court Analysis. The court noted that the attributes of a lease and a sale are often the same or similar and that these similarities may blur the distinction between leasing and purchasing. Factors such as maintaining the equipment, carrying insurance, and paying all associated taxes may be consistent with either a sale or a lease. Therefore, these factors are not conclusive.

The court narrowed the analysis to two considerations.

1. If the lessor retains the significant attributes of a traditional lessor, the **form** of the transaction adopted by the parties governs for tax purposes.
2. If the benefits, obligations, and rights of the lessor are essentially those of a secured seller, the **substance** of the agreement governs for tax purposes.

23. Ibid.

The five factors listed previously were used to determine the lessor's status. The court determined the following for each factor.

1. **Useful life.** The lease term did not constitute the entire useful life of the truck.
2. **Open-endedness.** The lease was not an open-end lease. The lessor retained the risk that the market value would be less than the option to purchase at the end of the lease term.
3. **Title.** The title did not automatically pass to the taxpayers at the end of the lease term.
4. **Nominal option price.** The option price was not nominal because it exceeded the estimated residual value of the truck.
5. **Compel.** The lessor did not have the right to compel the taxpayers to purchase the truck at the end of the lease term.

Ruling. The court ruled that the taxpayers had not entered into a purchase agreement. The court found that the lease agreement did not meet any of the five conditions that might require it to be considered a conditional sales contract. Therefore, the IRC §179 deduction was denied.

Examples

It is common for taxpayers to intend to exercise the option to purchase the leased assets at the end of the lease terms. However, as demonstrated by the previous court case, the intent of the taxpayer is not necessarily the determining factor. According to the Tax Court, if the lessor retains the attributes of a traditional lessor, the form of the agreement controls the tax consequences of the agreement. The following examples are taken from actual lease agreements used by taxpayers to acquire assets for their businesses.

Example 6. Avis is preparing to open a spa featuring the latest and greatest in relaxation technologies. She identifies equipment worth $30,000 that she wishes to use in her spa. The equipment is sold by several different retailers.

Avis makes arrangements with a national leasing company. The company purchases the equipment that she has identified and leases it back to her for a term of 48 months at $800 per month. After 48 months, she may purchase the equipment by surrendering the security deposit, which is $1,600.

Avis's tax consultant classifies the lease as a purchase and capitalizes the cost of the equipment. Avis's tax consultant analyzes the lease and determines that the lease agreement meets both the IRS and Tax Court tests to be considered a conditional sales contract because ownership of the equipment automatically passes to Avis after she makes the required number of payments under the contract.

Example 7. Vernon leases a computer from a national retailer for $175 per month for 24 months. His total payments are $4,200. If he were to purchase the computer instead of leasing it, the retail price would be $3,800.

At the end of the lease term, **he has the option to buy the computer for its FMV.** If he does not exercise the option or return the computer, the lease is automatically renewed for an additional 90 days. The lessor determines the FMV.

In addition, the lease agreement also contains the following factors relevant to the IRS's test for a conditional sales contract.

1. **Equity interest.** The lease does not indicate that any of the payments will be applied to an equity interest.
2. **Title.** The title does not pass unless Vernon exercises the purchase option at the FMV.
3. **Interest.** The agreement does not designate any part of the payments as interest.

The contract meets all of the IRS's **objective** tests to be classified as a true lease. However, it is not clear if the agreement meets the subjective tests. The tax practitioner preparing Vernon's return should also consider the following factors.

1. **Term.** The amount Vernon is paying to lease the property for two years is comparable to the amount he would pay to purchase the property. Is a 2-year lease agreement a short time compared to the functional life of a computer?
2. **Fair rental value.** What is the market rate to rent a computer?
3. **Nominal option price.** The option price, specified as the FMV, is not nominal compared to the FMV at the time the option is exercised. However, is it nominal when compared to the total payments under the agreement? Realistically, how much value does a used computer retain after two years?

The tax practitioner should also consider the following additional factors, which were specified by the court in the *Boyce* case to determine if the form or the substance of the contract controls the tax treatment of the agreement.

1. **Useful life.** What is the useful life of a computer? Under MACRS, a computer is 5-year property. However, if the user wishes to use the most current software with the computer, the useful life may be only three years.
2. **Open-endedness.** The contract is an open-end lease. Because the option to purchase is the FMV at the end of the lease term, the lessor is not taking a risk on the FMV at the end of the lease.
3. **Title.** Ownership of the computer does not pass to Vernon automatically at the end of the lease. If he does not exercise the option, the lease renews automatically.

Based on these factors, the proper tax treatment is subject to debate. This lease may be properly considered a conditional sales contract for the following reasons.

- The amount to rent the computer for two years is comparable to the purchase price of the computer.
- The FMV at the end of the lease will probably be nominal compared to the total payments made under the contract.
- Because the contract specifies the purchase price of the equipment, it is easy to recognize the portion of the payments allocable to interest.

However, this lease may be considered a true lease for the following reasons.

- There is no equity accruing during the term of the lease.
- The title does not pass to Vernon until after the end of the lease.
- Vernon must pay FMV to buy the computer at the end of the lease.
- The agreement does not designate any part of the payment as interest.

If Vernon decides it is a purchase agreement, he is entitled to §179 treatment, depreciation, and an operating deduction for interest paid.

If Vernon decides it is a lease agreement, he may deduct the entire payment made for the tax year.

Note. See Chapter 1, Depreciation, for a more in-depth discussion of §179 treatment.

Caution. It is imperative that the practitioner analyze the lease with the taxpayer and assist the taxpayer in arriving at a reasonable conclusion to these types of arrangements.

Observation. It is difficult for a conditional sales contract **disguised as a lease** to pass the tests established by both the IRS and the Tax Court. The IRS may argue that a contract **with** a fixed option price is a sales contract because the price is nominal compared to the FMV or the total lease payments. The IRS may also use the court's argument that a contract **without** a fixed option price (or with FMV as the option price) is a sales contract because the lessor does not bear the risk of market fluctuations.

LEVERAGED LEASES

A leveraged lease is one in which the lessor borrows money from a lender in order to purchase the asset that they will then lease to a lessee. The lessor makes a down payment on the purchase and therefore has an equity interest in the asset. Typically, this equals 20% to 50% of the purchase price. The lender has a security interest in the asset as well as in the lease payments.

These leases typically are net leases (i.e., the lessor pays the costs of ownership). These transactions are usually deemed to be conditional sales contracts rather than leases. The lease terms cover a substantial part of the useful life of the property and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender.

Taxpayers taking part in these kinds of transactions may want to get an advance ruling from the IRS as to the proper treatment of the transaction. Rev. Proc. 2001-28 contains the guidelines that the IRS uses to determine if a leveraged lease is a lease for federal income tax purposes. These guidelines clarify the circumstances in which an advance ruling is ordinarily issued. This assists taxpayers in preparing ruling requests and allows the IRS to issue advance ruling letters as promptly as practicable. The guidelines do not define, as a matter of law, whether a transaction is a lease for federal income tax purposes and are not intended for use in audits. For advance ruling purposes only, the IRS considers the lessor in a leveraged lease transaction to be the owner of the property and the transaction to be a valid lease if all the following conditions are met.

- The lessor must have a minimum unconditional "at risk" equity investment in the property during the entire lease term. A **minimum equity investment** is at least 20% of the cost of the property. **Unconditional** means that after the property is first placed in service or used, the lessor must not be entitled to a return of any portion of the minimum investment through any arrangement, directly or indirectly, with the lessee, a shareholder of the lessee, or any party related to the lessee.
- The lessee may not have a contractual right to purchase the property from the lessor at a price less than FMV at the time the right is exercised.
- The lessee, except as specifically provided, can have no permitted initial investment in the property, cost of improvements, modifications, or additions to the property. Property that could itself be separately leased in a transaction eligible for an advance ruling does not constitute an improvement. Also, severable improvements that can be readily removed without causing material damage to the leased property are permitted.
- The lessee may not lend funds to the lessor to acquire the property or guarantee any indebtedness created in connection with the acquisition of the property by the lessor. A guarantee by a member or owner of the lessee group to pay rent, pay insurance premiums, or properly maintain the property does not constitute a guarantee of the indebtedness of the lessor.
- The lessor must show that it expects to receive a profit apart from the tax deductions, allowances, credits, and other tax attributes arising from the lease. This test is met if a detailed overall profit test is achieved as outlined in Rev. Proc. 2001-28 and the lease provides for a positive cash flow to the lessor.

Example 8. Foundling Foundry, Inc., wants to replace a blast furnace. The new furnace costs $6 million. Foundling does not have the cash for an outright purchase and its bank will only make a loan to Foundling if it has a 50% down payment. Foundling finds a leasing company that is willing to borrow money, purchase the furnace, and then lease it to Foundling over a 10-year period if Foundling makes three lease payments in advance. The leasing company is willing to take more risk than the bank because they will have a higher rate of return on their investment than the bank would have on a loan.

SECTION 467 RENTAL AGREEMENTS

IRC §467 rental arrangements are those involving the lease of tangible property in which the rental payments can increase, decrease, be deferred, or be prepaid. IRC §467 requires that the lessee and the lessor treat the rent payments in the same manner. They must both use the accrual method of accounting for the rental payments, even if they use the cash method for their other tax accounting. **Leases with aggregate rents of $250,000 or less are exempt** from the §467 regulations. Determining whether a rental agreement falls under §467 is very important. The regulations can trigger income recognition in some cases even though the taxpayer has not received a rental payment.

IRC §467 was enacted as part of the Deficit Reduction Act of 1984. Its purpose is to prevent tax avoidance and deferral and to provide for consistent reporting by landlords and tenants. In certain cases, if the IRS can determine that a lease is designed to achieve a tax avoidance purpose, the lessor and lessee may be required to account for rent under a constant rent accrual method in which the rent is treated as accruing ratably over the entire lease term.

IRC §467 applies to rental agreements of tangible property when the total payments under the lease exceed $250,000 and one of the following applies.

- Rents increase during the lease.
- Rents decrease during the lease.
- Rents are deferred. (Rent is payable after the end of the calendar year following the calendar year in which the use occurs and the rent is **allocated.**)
- Rents are prepaid. (Rent is payable before the end of the calendar year preceding the calendar year in which the use occurs and the rent is **allocated.**)

Example 9. Johnson Real Estate Holdings, Inc., owns a warehouse that it rents to Jones Manufacturing, Inc. The 5-year lease allows the lessee to make the $55,000 annual rental payment any time before January 31. The flexibility in the payment schedule was designed to allow the lessee to determine which tax year it wants to use for reporting the deduction. This feature makes the lease a §467 lease because the aggregate rents for the term of the lease total $275,000, which exceeds the $250,000 de minimis exception.

Except in the case of tax avoidance leases, the amount of rent that accrues under a §467 lease agreement for a given year is the amount **allocated** to the period under the terms of the lease agreement. If amounts are allocable to a period but payable after the close of the period, rent and interest are accrued based on present value concepts. If a rental agreement does not provide a specific allocation of rent, the amount of fixed rent **allocated** to a rental period is the amount of fixed rent payable during that period. The effect of stated versus unstated allocations in lease agreements that provide for unequal lease payments can be substantial. Leases, therefore, oftentimes contain provisions called "Rent Allocation for Purposes of Section 467" that indicate how rent is allocated under the lease.

Depressed real estate market conditions have caused many lessors to offer inducements such as rent holidays, which are lower initial rents followed by increases (step rents), or construction allowances to facilitate the leasing of properties. While the lessor and lessee may agree on an economic deal, the tax consequences can sometimes catch both by surprise. Whether a lease is classified as a §467 lease requiring accrual accounting can depend on the presence or absence of language in the lease regarding the allocation of rent. If no allocation provisions are made, generally the lessor and lessee simply report income and expense in accordance with the terms of the lease. Thus, variations in lease wording can produce different results.

Example 10. A 5-year lease calls for the following lease payments and does not contain any lease allocation provisions. The lessor and lessee, although subject to §467, report income and expense under the terms of the lease as follows.

Year	Payment
1	$ 0
2	200,000
3	250,000
4	250,000
5	300,000
Total	$1,000,000

The lease contains a provision for annual rent of $200,000, or allocated rent. IRC §467 requires both the lessor and lessee to report their respective income and deductions as follows.

Year	Rent	Interest	Total
1	$155,325	$ 0	$ 155,325
2	200,000	12,675	212,675
3	200,000	13,709	213,709
4	200,000	10,747	210,747
5	200,000	7,544	207,544
Totals	$955,325	$44,675	$1,000,000

Under §467, the $200,000 of deferred rent for Year 1 must be taken into account in Year 1 to the extent of its present value. This example assumes the appropriate discount rate is 8%.[24]

The biggest difference in what may have been intended by the lessor and lessee is the recognition of income and deductions in Year 1.

When construction allowances or tenant improvements are part of a lease and paid for by the lessor, the tax treatment generally depends on the ownership of the improvements. Ownership can be determined from multiple factors, including the following.

- Which party insures the improvements
- Which party maintains and replaces improvements
- At the expiration of the lease, which party owns the improvements
- How the lease addresses ownership
- Who bears the risk of loss

When the lessee is deemed to be the owner, the allowance is deemed to be income to the lessee. The lessee must depreciate the cost of the improvements over the applicable MACRS period.

The following table shows the tax impact of various lease scenarios on both the lessor and lessee.[25]

24. Stolte, Matthew C. (Sep. 1, 1994). Tax Tips for Structuring Commercial Leases. *Journal of Property Management.*

25. Ibid.

Lease Provides for	Tax Treatment by Lessor	Tax Treatment by Lessee
Rent holiday with no allocation	Deferred rent income	Deferred rent expense
IRC §467 with difference of allocated rent versus rent payable	Rental income on accrual basis, with receivable or payable, and corresponding interest income or expense imputed	Same as lessor except rental expense
Improvements owned and paid for by lessor	Depreciate over MACRS recovery period	No impact
Improvements paid for by lessor and owned by lessee	Lease acquisition costs amortized over life of lease	Recognize income at lease inception and depreciate costs over applicable MACRS period
Improvements paid for and owned by lessee	No impact	Depreciate over applicable MACRS period

CASH METHOD OF ACCOUNTING

Selection of an accounting method by taxpayers is an extremely important decision in income tax planning and compliance. The ability for a new business to use the cash method of accounting for income tax purposes can significantly help the business with its cash flow and working capital requirements. The selection of the cash method, if allowable, is made with the filing of the business's first tax return. In addition, the ability of an existing business to switch its method of accounting to the cash method, if allowable, can provide significant benefits. Conversely, the requirement to switch from the cash method of accounting to an accrual method may have a negative effect on the cash flow and working capital of a business.

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BACKGROUND AND GUIDANCE

The eligibility requirements for use of the cash method of accounting are found in a maze of various Code sections, Treasury regulations and revenue procedures. Some of these rules specify who **cannot** use the cash method and others state who **can** use the cash method.

IRC §446 specifically allows the cash method of accounting as long as taxable income is computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping their financial records. This is not to say that a taxpayer cannot keep books in accordance with generally accepted accounting principles and file its tax returns using the cash method of accounting. In Rev. Rul. 68-35, the IRS held that a corporate taxpayer was allowed to use the cash method of accounting for income tax purposes if they **consistently** used the cash method in a manner that clearly reflects income and if the adjustments required to convert can be readily verified from the books and records. Many accounting software products easily allow for financial statement presentation on both the accrual and cash methods.

Treas. Reg. §1.446-1(a)(4)(i) provides that when the production, purchase, or sale of any kind of merchandise is an income-producing activity, then inventory and/or supplies at both the beginning and end of the year must be taken into account in computing taxable income. The regulation also states that if inventories are present, the taxpayer is required to use the accrual method of accounting for purchases and sales of inventory even if the ending inventory is always zero.[26]

26. Treas. Reg. §1.446-1(c)(2)(i).

IRC §447(a) generally requires C corporations or partnerships with C corporation partners to use the accrual method of accounting when they are engaged in the business of farming. Farming, for purposes of §447(a), does not apply to nursery or sod farms, or to the raising or harvesting of trees (other than fruit and nut trees).

Other exceptions apply to C corporations with prior year receipts of $1 million or less[27] and family farm corporations with prior year receipts of $25 million or less.[28] A **family farm corporation** has at least 50% of all classes of stock owned by members of the same family.[29] Members of the same family include the individual and the individual's:

- Brothers and sisters;
- Aunts, uncles, great aunts, and great uncles;
- Ancestors and lineal descendants of any of the foregoing;
- A spouse of any of the foregoing; and
- The estate of any of the above.[30]

IRC §448 provides additional restrictions applicable to C corporations and tax shelters as to who may use the cash method of accounting. Specifically, it prohibits C corporations and partnerships with C corporations as partners that have average annual gross receipts of $5 million or more[31] and tax shelters[32] from using the cash method. Average annual gross receipts are computed for the 3-year period prior to the year to which the test applies. S corporations are not restricted by §448 unless they are a tax shelter. These restrictions also do not apply to farming businesses[33] and personal service corporations (PSCs).[34] **Farming businesses** are defined in IRC §263(e)(4) and also include the growing and harvesting of trees to which §263(c)(5) applies. **PSCs** are those corporations in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

The IRS has issued a series of revenue procedures that expand and clarify who may use the cash method of accounting. Equally important, the IRS allows automatic approval for the change to the cash method using Form 3115, *Application for Change in Accounting Method*. This avoids the process of paying a user fee and receiving advance consent from the IRS. Some of these revenue procedures are discussed next.

Rev. Proc. 2001-10 relieves taxpayers with average annual gross receipts of $1 million or less from the requirement to use the accrual method under IRC §446 and account for inventories under IRC §471. This revenue procedure allows qualifying taxpayers to automatically change to the cash method provided they still account for inventory as such or as unused materials and supplies. However, taxpayers who do not account for inventories under the terms of this revenue procedure must treat all inventory and supplies as specified in Treas. Reg. §1.162-3. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or physical inventories at the beginning and end of the year are not taken, it is permissible for the taxpayer to include in their expenses the total cost of such supplies and materials as were purchased during the taxable year provided the taxable income is clearly reflected by this method.[35]

27. IRC §447(d)(1).
28. IRC §447(d)(2).
29. IRC §447(d)(2)(c)(i).
30. IRC §447(e)(1).
31. IRC §448(b)(3).
32. IRC §448(a)(3).
33. IRC §448(b)(1).
34. IRC §448(b)(2).
35. Treas. Reg. §1.162-3.

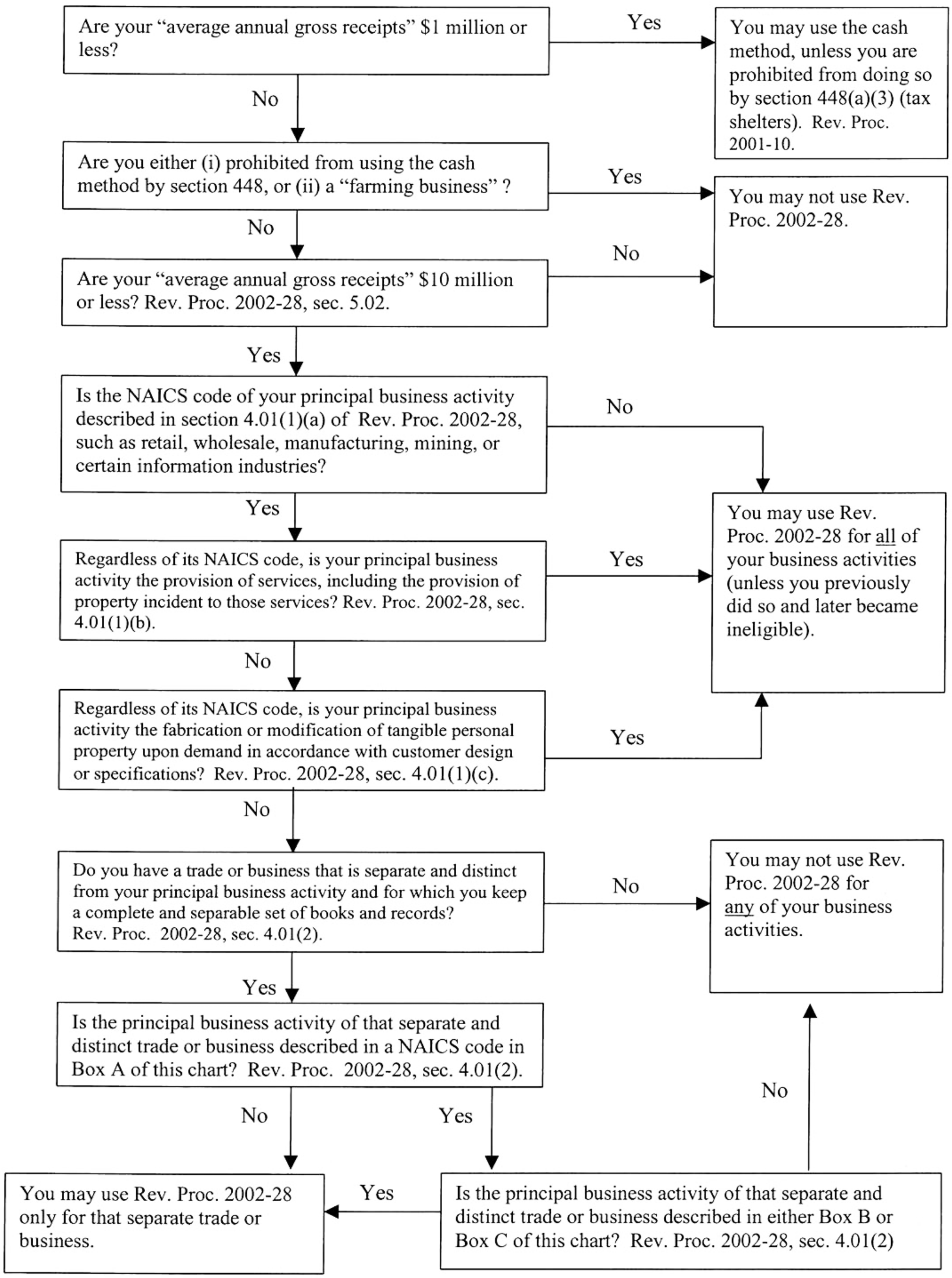
Rev. Proc. 2002-28 expanded Rev. Proc. 2001-10 and allows taxpayers with average annual receipts of $10 million or less to use the cash method provided **one** of the following three tests is met.

1. The principal business activity is the provision of services, including the provision of property incident to those services.
2. The principal business activity is the fabrication or modification of tangible personal property in accordance with customer design or specifications.
3. The taxpayer's principal business activity as defined by the North American Industry Classification System (NAICS) is **not** one of the following.
   - Mining activities (NAICS codes 211 and 212)
   - Manufacturing (NAICS codes 31–33)
   - Wholesale trade (NAICS code 42)
   - Retail trade (NAICS codes 44 and 45)
   - Information industries (NAICS codes 5111 and 5122)

This revenue procedure does not apply to farming businesses and taxpayers prohibited from using the cash method under §448. Taxpayers with inventory are required to account for it as either nonincidental inventory or as materials and supplies. Taxpayers eligible under Rev. Proc. 2002-28 also qualify for automatic consent for changing to the cash method.

The flowchart[36] on the following page illustrates the decision tree in a taxpayer's ability to use the cash method of accounting with reliance on Rev. Proc. 2001-10 and 2002-28.

36. The flowchart is from the appendix to Rev. Proc. 2002-28.


Are your "average annual gross receipts" $1 million or less?
Yes
You may use the cash method, unless you are prohibited from doing so by section 448(a)(3) (tax shelters). Rev. Proc. 2001-10.
No
Are you either (i) prohibited from using the cash method by section 448, or (ii) a "farming business" ?
Yes
You may not use Rev. Proc. 2002-28.
No
No
Are your "average annual gross receipts" $10 million or less? Rev. Proc. 2002-28, sec. 5.02.
Yes
Is the NAICS code of your principal business activity described in section 4.01(1)(a) of Rev. Proc. 2002-28, such as retail, wholesale, manufacturing, mining, or certain information industries?
No
Yes
You may use Rev. Proc. 2002-28 for all of your business activities (unless you previously did so and later became ineligible).
Regardless of its NAICS code, is your principal business activity the provision of services, including the provision of property incident to those services? Rev. Proc. 2002-28, sec. 4.01(1)(b).
Yes
No
Regardless of its NAICS code, is your principal business activity the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications? Rev. Proc. 2002-28, sec. 4.01(1)(c).
Yes
No
Do you have a trade or business that is separate and distinct from your principal business activity and for which you keep a complete and separable set of books and records? Rev. Proc. 2002-28, sec. 4.01(2).
No
You may not use Rev. Proc. 2002-28 for any of your business activities.
Yes
Is the principal business activity of that separate and distinct trade or business described in a NAICS code in Box A of this chart? Rev. Proc. 2002-28, sec. 4.01(2).
No
Yes
No
You may use Rev. Proc. 2002-28 only for that separate trade or business.
Yes
Is the principal business activity of that separate and distinct trade or business described in either Box B or Box C of this chart? Rev. Proc. 2002-28, sec. 4.01(2)

Rev. Proc. 2008-52 provides the procedures to obtain automatic consent for a change in accounting method. Farming businesses are specifically prohibited from using Rev. Proc. 2002-28 for automatic consent to change to the cash method of accounting. They can, however, utilize Rev. Proc. 2008-52 for automatic consent to change to the cash method provided they are not required to use the accrual method under IRC §447 or prohibited by IRC §448. Normally, the taxpayer must compute a §481(a) adjustment (explained later); however, if the farming business elects to change from the crop method,[37] that portion of the change must be made using a cut-off method. Under the cut-off method, expenses reported on the crop method and not deducted prior to the year of change are deducted in the year the related crop is sold.

CHANGE IN ACCOUNTING METHOD

If a taxpayer does not qualify for automatic consent to change accounting methods, then the taxpayer must obtain IRS consent and pay a user fee. Form 3115 is filed in all cases for either automatic or advance consent requests. No user fees are required when the taxpayer qualifies for automatic consent.

When businesses change their accounting methods, an income adjustment is required under §481(a). Rev. Proc. 2008-52 provides that generally under an automatic consent change in accounting method, the adjustment period for a net positive change is four taxable years and the adjustment period for a net negative change is one year. An exception exists for a positive adjustment of less than $25,000 for which the taxpayer can elect on Form 3115 to include all the adjustment in the initial year (de minimis rule). Rev. Proc. 97-27 and Rev. Proc. 2002-19 provide guidance for nonautomatic method changes.

Example 11. The Smart Corporation qualifies under Rev. Proc. 2002-28 to change its accounting method for income tax reporting from the accrual method to the cash method using the automatic consent procedures. Its financial information is as follows.

The accounts receivable at the beginning of the year was $100,000 and the accounts payable was $45,000. The §481(a) adjustment is shown on Form 3115.

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)	$ **-100,000**
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)	**45,000**
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	**NONE**
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.	$ **-55,000**

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.

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37. Under the crop method of accounting, the entire cost of producing a crop is deducted in the year the taxpayer realizes income from the crop.

The §481(a) adjustment of $100,000 for the beginning of the year receivables less the beginning of the year accounts payable of $45,000 results in a negative adjustment which is recognized entirely in the year of change. If the result had been a positive change, then the adjustment would be spread **over four years** unless the de minimis rule applied and Smart Corporation elected to recognize it all in one year.

If the cash basis income for Smart Corporation is $50,000 at the end of the conversion year, after the §481(a) adjustment, Smart has a $5,000 loss for tax purposes.

Observation. Many taxpayers have flexibility to choose accounting methods and in some cases change them with no prior IRS consent. The choice of methods at the inception of a business may help a business defer tax liabilities. Facts, however, often change for business operations that alter the original conclusion about the most favorable accounting method or possibly require a change in accounting method from a method that is unacceptable to one that is acceptable.

EXPENSES UNDER THE CASH METHOD OF ACCOUNTING

Prepaid expenses are deductible in the year in which they apply unless the expense qualifies for the 12-month rule. The 12-month rule provides that prepaid expenses are deductible when they are paid if the rights or benefits to the taxpayer do not extend beyond the earlier of:[38]

- 12 months after the right or benefit begins, or
- The end of the tax year after the tax year the payment is made.

Prepaid interest can be deducted only for the periods to which it relates.[39] Thus, the above regulation that allows current deductions of certain prepaid expenses does not apply to interest.

Accrual basis taxpayers cannot deduct expenses paid to a related party who is a cash basis taxpayer until the amount is included in the income of the recipient.[40] The rule continues to apply even if the parties cease to be related after the expense is accrued.

The ability to deduct purchases made with credit cards by cash basis taxpayers depends on the type of credit card arrangement. For bank-issued credit cards, the taxpayer is deemed to have borrowed money from the bank and used the borrowed funds to pay the expense, which allows the taxpayer to get an immediate deduction when the expense is charged.[41] Credit cards issued by nonbanks (such as department store credit cards) are merely a promise to pay the retailer at a future date. Thus, the taxpayer in these situations is not eligible for an expense deduction until they pay the bill.[42]

ACCOUNTING FOR INVENTORY ACQUIRED IN TRADE

How does a taxpayer account for inventory acquired through a trade-in as partial payment for a sale? Treas. Reg. §1.471-2(a) provides two tests for valuation of inventory.

1. The inventory valuation method must conform as nearly as possible to the best accounting practice in the trade or business.
2. The valuation method must clearly reflect income.

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38. Treas. Reg. §1.263(a)-4(f)(1).
39. IRC §461(g).
40. IRC §267(a)(2).
41. Rev. Rul. 78-39, 1978-1 CB 73.
42. Rev. Rul. 78-38, 1978-1 CB 67.

As a result, inventory valuation rules are not always uniform but rather come within the scope of the best accounting practices used in a particular trade or business. Additionally, the inventory valuation method of the taxpayer should be consistent from year to year in order to clearly reflect income. Greater importance is given to consistency rather than to any particular method or basis of valuation as long as the method or basis used is in accordance with Treas. Regs. §§1.471-1 through 1.471-11.[43]

The most commonly used inventory valuation methods that conform to §471 are cost and the lower of cost or market. **Market** is defined as "the aggregate of the current bid prices prevailing at the date of inventory"[44] for the particular volume in which merchandise is usually purchased by the taxpayer.

In Rev. Rul. 67-107, the IRS provides advice as to how a car dealer should value inventory. This is specifically for used cars taken in trade by a car dealer that employed the accrual method of accounting and values inventories at the lower of cost or market. The ruling indicates that it is common practice for auto dealers to accept trade-ins as part of the payment for a newly sold vehicle and that the dealer should value the trade-in at an amount that is the average wholesale price listed by an official used car guide at the time of trade-in. Additionally, if the vehicle is not sold by the end of the year, the inventory value could possibly be adjusted again to conform to the average wholesale price (AWP) listed at that time. Accordingly, a car dealer may value used cars for inventory purposes at valuations comparable to those listed in an official used car guide.

The IRS also reiterated the concept of AWP in its New Vehicle Dealership Audit Technique Guide (ATG). In the ATG, it is noted that automobile dealerships have a great deal of discretion in what accounting methods they use for various classes of inventory and that industry practices somewhat follow the size of the dealership. Smaller used car dealerships often use a valuation method of lower of cost or market and, accordingly, can value vehicles on an individual basis using 100% of the average wholesale valuation quote.

Example 12. Haveigotadeal4U Motors values its inventory at the lower of cost or market. One car on the lot is listed for $20,000 and is carried in inventory at a cost of $12,000. Therefore, the dealer hopes to make $8,000 when the car is sold. When the car is sold, the dealer accepts a trade-in from a customer that has an AWP of $2,000. Haveigotadeal4U Motors and the customer agree to the following.

Sale price of new vehicle	$19,500
Trade-in value credited	(1,000)
Cash due from customer	$18,500

Haveigotadeal4U Motors was hoping to make an $8,000 profit on the original sale. It winds up with the following profit after reducing the sale price and recording the new inventory at the AWP:

Cash received	$18,500
Trade-in at AWP	2,000
Cost of goods sold	(12,000)
Profit on sale	$ 8,500

Haveigotadeal4U Motors carries the trade-in vehicle at $2,000 on its books. If the AWP declines at the end of the tax year and the vehicle is still in inventory, the inventory valuation amount can be adjusted downward and an additional deduction taken at that time.

43. Treas. Reg. §1.471-2(b).

44. Treas. Reg. §1.471-4(a).

8

CASUALTY LOSSES

Under IRC §165, there are provisions for the deduction of various types of losses. Such losses may create substantial financial problems for the taxpayer and, accordingly, a deduction is often allowed.

Losses incurred in a trade or business may be deductible.[45] A loss from a transaction that was entered into for profit, although not within a trade or business, might also be deductible by the taxpayer.[46] Capital losses are yet another type of loss commonly deductible by taxpayers.[47]

Subject to several limitations, a **casualty loss** may be deducted.[48] Recent unprecedented levels of property damage due to storms, tornadoes, floods, and similar events have made this special category of loss increasingly significant in recent years. In fact, the Code has special rules for these "disaster-related" losses.[49] These special disaster-related loss rules as well as other pertinent rules regarding casualty losses are the subject of this section. Under certain circumstances, a theft can also result in a casualty loss.

CASUALTY LOSS DEFINED

A casualty loss is the complete or partial destruction of property resulting from an identifiable event that is one of the following.

- A **sudden** event is one that is swift as opposed to gradual or progressive.
- An **unexpected** event is one that is ordinarily unanticipated and unintended.
- An **unusual** event is one that does not occur daily and is not typical for the taxpayer's activity.

Casualty losses are further defined in the Treasury regulations as losses arising from fire, flood, storm, shipwreck, and other similar casualties.[50] Damage to property from such events as floods, frost, freezing, insect damage, drought, fire, and wind can result in a casualty loss.

Deductibility of Casualty Losses

In order for a casualty loss to be deductible under §165, the loss must be:

1. **Actually sustained** by the taxpayer,[51]
2. Evidenced by a **closed and complete transaction**, fixed by **identifiable** events,[52]
3. Occur **during the taxable year** (subject to certain exceptions for to disaster-related losses),[53] **and**
4. Result from a **sudden, unusual, or unexpected** event (as discussed previously).

Note. Treas. Reg. §1.165-1 provides additional guidance on factors required for the deduction of a casualty loss.

45. IRC §165(c)(1).
46. IRC §165(c)(2).
47. IRC §165(f).
48. IRC §165(h)(2).
49. IRC §165(h)(3).
50. Treas. Reg. §1.165-7(a)(1).
51. Treas. Reg. §1.165-1(a).
52. Treas. Reg. §1.165-1(b).
53. Treas. Reg. §1.165-1(d)(1).

A loss caused by excessive summer-long rainfalls may not qualify as a casualty loss. However, a loss caused by a flash flood qualifies as a casualty loss, although the loss deduction is limited to the area flooded.[54]

If rainfall causes damage but was not an unexpected event, no casualty loss deduction is available. Similarly, a casualty loss deduction is **not allowed** for loss of anticipated profits or a reduction in value for the balance of the property not impacted by flooding, as seen in the following situations.

- A casualty loss deduction was allowed for flood damage to a harvested hay crop but it was not allowed for an unharvested hay crop.[55]
- A casualty loss was allowed for damage to a dam which was caused by a rain storm.[56]

PERSONAL OR BUSINESS CASUALTY LOSSES

Either a **personal** or **business** casualty loss may be deductible. However, there are differences in the rules for a casualty deduction in each of these categories.

Personal Casualty Losses

Deductible personal casualty losses are subject to **two limits**. First, the initial $100 of the loss is nondeductible. Second, the loss must exceed 10% of the taxpayer's adjusted gross income (AGI). For purposes of the $100 and 10% limitations, a married couple filing jointly is treated as one person. More details on these two limits are found later in this section.

As previously noted, in order to be deductible, casualty losses must also arise from an identifiable event that is sudden, unusual, or unexpected. This is the case for **both** personal and business casualty losses. In addition, it is important to establish the value of the property both before and after the casualty. For example, in one case, the court denied a nonbusiness casualty loss deduction when the taxpayer did not present an appraisal of the property showing the FMV of the property before the casualty.[57]

Principal Residence Casualty Loss. If a principal residence is subject to a casualty loss, amounts received from insurance are nontaxable if used to compensate for the loss of use or occupancy by the taxpayer and members of the taxpayer's household.[58] The amount excludible is the excess of actual expenses above and beyond normal living expenses.[59]

> **Observation.** The amount of insurance proceeds excludible from income cannot be determined until the end of the loss period, with any excess includible in income for the taxable year in which the loss period ends or, if later, the year the excess is received.[60]

54. *Martin Marietta Corp. v. U.S.,* 572 F. Supp. 2d 839 (Ct. Cl. 1983); *Trinity Meadows Raceway, Inc. v. Comm'r,* 99-2 USTC ¶50,754 (6th Cir. 1999).
55. See, e.g., *Lagrone v. Comm'r,* TC Memo 1988-451 (Sep. 20, 1988).
56. *Heltoski v. Comm'r,* TC Memo 1990-382 (Jul. 24, 1990).
57. *Kay v. Comm'r,* TC Memo 2002-197 (Aug. 8, 2002).
58. IRC §123(a).
59. IRC §123(b).
60. Rev. Rul. 93-43, 1993-2, CB 69.

Example 13. Frank owns a cottage in northern Michigan with an FMV of $100,000. During 2011, lightning from a huge storm struck the cottage and severely damaged the property. Frank was not insured and therefore was not made whole from the loss. Frank's cottage is worth only $70,000 after the lightning strike because of its severe damage. Frank does not have a casualty loss for 2011. He has no closed or complete transaction that triggered an actual loss that he sustained. However, if Frank has a qualified appraisal on the home following the storm, he can deduct the loss.

Example 14. Use the same facts as **Example 13,** except after the lightning strikes, Frank sells the cottage for $70,000. Frank has a casualty loss of $30,000 in 2011. Frank has a closed, completed transaction that qualifies as a deductible casualty loss. The transaction provided a means to ascertain the amount of the loss and that loss is attributable to the storm, which was an event that was sudden, unexpected, or unusual.

Example 15. Durden owned a house near a quarry. Blasting was a common occurrence in the quarry and had occurred for years. However, on one occasion, an unusually violent blast caused severe damage to Durden's house. It damaged the foundation and walls, causing substantial cracks and other significant damage. Durden has a casualty loss.[61] While blasting was a common and usual occurrence at the quarry, the unusually violent blast was not.

Example 16. Myra owns a house in New England. She discovers termites have eaten away nearly the entire frame of the back of the house, including the support beams for a porch and the upstairs. The termite damage was the result of several years of termite infestation. Therefore, Myra does not have a casualty loss, because the termite damage resulted in a gradual, progressive deterioration of the back of the house. The damage was not the result of a sudden event.

Note. The line between a deductible and nondeductible casualty loss is often unclear. Courts sometimes arrive at results that are the opposite of what is expected.

Example 17. Justin plans to attend a party. He knows he will be drinking a substantial amount of alcohol. Therefore, he makes arrangements to be driven home after the party. After the party, Justin is driven home by the designated person. After he was back home for awhile, Justin decided to drive to his parents' house. He failed to successfully negotiate a turn in the road and rolled his vehicle over. When he left for his parents' house, he believed that he was not under the influence of alcohol and could drive. The weather was inclement.

The insurance company refused to pay because Justin was negligent. He claimed a casualty loss in connection with the damage to the vehicle. The Tax Court held his casualty loss claim was allowable. The Tax Court stated that his own negligence was not an absolute bar to a casualty loss claim.[62] The Tax Court noted that **gross** negligence may eliminate the taxpayer's ability to claim a casualty loss.

Note. For a thorough explanation of the *Rohrs'* case, see pages 550–551 of the 2010 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

Example 18. Ahsan failed to put a sufficient amount of antifreeze in his car engine. He claimed a casualty loss in connection with the damage done to the vehicle as a result. The Tax Court held that this loss constituted a personal expense attributable to his own neglect instead of qualifying as a casualty loss. His casualty loss claim was denied.[63]

61. See *Durden, Ray, et al. v. Comm'r,* 3 TC 1 (1944).

62. See *Justin M. Rohrs v. Comm'r,* TC Summ. Op. 2009-190 (Dec. 10, 2009). The Tax Court did not directly address the question of whether the casualty loss was allowable under §165 but instead, focused on whether the taxpayer was "negligent" or "grossly negligent" for purposes of allowing the casualty loss claim.

63. *Ahsan Mohiuddin v. Comm'r,* TC Memo 1996-422 (Sep. 18, 1996).

Business Casualty Losses

Losses are deductible if incurred in a trade or business or incurred in a transaction entered into for profit. A casualty loss deduction can also arise from property not connected with a trade, business, or profit activity. The key point is that the taxpayer must sustain physical damage to property. The loss of value to property without an identifiable event that caused damage to the property will not give rise to a casualty loss deduction as seen in the following situations.

- In one case, a denial of a Clean Water Act permit that was needed to develop agricultural land designated as wetland did not give rise to a casualty or other loss deduction. No identifiable event occurred and mere diminution of property value is insufficient to result in a deductible loss.[64]
- In another case, a decline in appraised value as a result of an increased likelihood of avalanches was not a deductible casualty loss, as the increased likelihood was not a permanent change.[65]

In addition, even if a loss of value can be traced to an identifiable event, there still must be physical damage or destruction to the property.[66]

Ordinary wear and tear does not give rise to a casualty loss, nor does damage to property resulting from the owner's willful negligence.

Losses to Business Property For casualty losses to business property, the tax law essentially treats the loss as an "involuntary conversion." The insurance proceeds are normally taxable, but IRC §1033 allows the taxpayer to avoid current taxation on the proceeds if the insurance proceeds are invested in "like-kind" property by the end of the second year after the year the recovery is received. An election under IRC §1033 must be made in order to reinvest in like-kind property. Like-kind property is property that is "similar or related in service or use." If the proceeds are used to continue the same business as before, there generally is no question that the replacement property is like-kind. Issues arise when the proceeds are invested in property for use in a different line of business.

> **Note.** The definition of like-kind property under §1033 is broader than that for like-kind exchanges under §1031.

A taxpayer often incurs expenses to restore business property to the precasualty loss condition. These expenses are not deductible as a **casualty loss.** Instead, they are currently **deductible repair expenses** under IRC §162(a). The expenses are not treated as a capital expenditure under IRC §263 if the repair neither materially adds to the value of the property nor prolongs its life.[67] However, the expense of removing trees, rubbish, debris, and the like, as well as the decrease in value to farmland due to flooding, may be claimed as a loss. If the flooding removed soil, a casualty loss may be claimed for the decrease in value to the land, **if the decrease in value can be substantiated.**

DEDUCTING A CASUALTY LOSS

In order for some or all of the casualty loss to be deductible, the factors outlined earlier must be met. If these factors are not met, the loss is not deductible.

Before claiming a casualty loss, it is necessary to first calculate the amount of the casualty loss. The next step in the process is to determine how much of the loss, if any, is deductible. The following sections explain how to properly calculate a casualty loss.

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64. See, e.g., *Lakewood Associates v. Comm'r,* 109 TC 450 (1997), *aff'd,* 99-1 USTC (CCH) ¶50,127 (4th Cir. 1998).

65. See also *Lund v. U.S.,* 2000-1 USTC (CCH) ¶50,234 (D. Utah 2000).

66. *Chamales v. Comm'r,* TC Memo 2000-33 (Feb. 3, 2000). No casualty loss deduction was available for an alleged decline in value of a home located near the home of a murder suspect (O.J. Simpson) because the taxpayer's home suffered no physical damage. A casualty loss was not available for mere "buyer resistance."

67. Ltr. Rul. 9903030 (Nov. 24, 1998).

Calculate the Amount of the Casualty Loss

As a general rule, the following steps are used to calculate the amount of the casualty loss.[68]

1. Determine the cost basis in the property before the casualty loss occurred.
2. Determine how much the FMV of the property declined as a result of the casualty by comparing the property's FMV before and after the casualty loss. Appraisals or other well-established and generally accepted methods of valuing the property before and after the casualty are frequently needed.
3. From the **lesser** of the amounts found in Steps 1 or 2, subtract the amount of any insurance or other reimbursement received or expected. This result equals the casualty loss amount.

Casualty Loss Equal to Adjusted Cost Basis. The casualty loss amount equals the property's adjusted cost basis if **all of the following apply.**[69]

- The property was used in a trade or business or held for the production of income.
- The property was entirely destroyed by the casualty.
- The FMV of the property immediately before the casualty was less than its adjusted cost basis.

The amount of the adjusted cost basis of the property used in any of the calculations for the casualty loss deduction is limited to the single identifiable property item damaged or destroyed, as shown in the following cases.

- In *Cziraki,* a casualty loss deduction was limited to basis of a destroyed road and not the adjoining real estate.[70]
- In *McClune,* a casualty loss deduction was limited to the basis in a barn as determined by the allocation of the purchase price to the barn when it was acquired along with 80 acres. The barn was completely destroyed by a tornado. The barn was valued at $46,000 before destruction and nothing afterwards. The taxpayer salvaged $2,000 worth of lumber and claimed a casualty loss of $44,000. The deduction was limited to the adjusted basis of the barn. The adjusted basis was $1,350, the part of the purchase price that was allocated to the barn.[71]

The amount derived from the basis calculation is reduced by the amount of insurance received for the damaged or destroyed item. Casualty losses are only deductible to the extent they are not compensated for by insurance. The amount of insurance proceeds received in excess of the property's cost basis is taxable as a capital gain.

Excess Basis not Lost for Tax Purposes. Basis in excess of the insurance proceeds continues to be available for depreciation and other purposes.

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68. Treas. Reg. §1.165-7(b)(1). Also, see IRS Pub. 584, *Casualty, Disaster and Theft Loss Workbook (Personal Use Property),* and IRS Pub. 584-B, *Business Casualty, Disaster, and Theft Loss Workbook.*

69. Treas. Reg. §1.165-7(b)(1)(ii).

70. See, e.g., *Cziraki v. Comm'r,* TC Memo 1998-439 (Dec. 15, 1998).

71. See also, *McClune v. Comm'r,* TC Memo 2005-47 (Mar. 14, 2005).

Example 19. Dynamic Enterprises LLC owns a special-purpose satellite dish that was suddenly destroyed in a wind storm. The following amounts apply to the satellite dish.

Cost Basis	Insurance Proceeds	FMV Before the Casualty	FMV After the Casualty
$695	$400	$800	$600

Insurance proceeds subtracted from the lesser of cost basis ($695) or the decline in FMV ($200) equals the casualty loss amount. Therefore, the casualty loss amount is zero ($200 − $400).

However, the property's new cost basis of $295 ($695 − $400) continues to appear on the business's balance sheet and remains available for depreciation purposes.

Note. With a casualty loss, the basis in the property is **decreased** by any insurance proceeds (or other form of reimbursement. Amounts spent on repairs that restore the property to its precasualty condition are either expensed or capitalized.

For a cash basis farmer, farm inventory items have a zero basis. If these items suffer a casualty, no deduction is available. If insurance proceeds are received, the proceeds are reported on Schedule F, unless the item is subject to replacement. For example, if a farmer receives insurance proceeds for hay destroyed in a fire, which would have been livestock feed, the farmer may defer the reporting of the insurance proceeds into income if the hay is replaced within two years with hay or another type of feed. The farmer then reduces the future hay expense by the amount of the proceeds. If an IRC §1231 asset, such as a combine, is subject to a loss, insurance proceeds received must be reported on Form 4684, *Casualties and Theft Losses,* as well as on Part III of Form 4797, *Sales of Business Property,* unless the combine is replaced and the replacement cost is in excess of the insurance proceeds received.

Determine the Amount of Deductible Casualty Loss

All, a portion, or none of the casualty loss amount calculated in the last section may be deductible even if it meets all of the factors.

As noted earlier, **personal** casualty losses are subject to **two limits**. First, only the amount of loss in excess of $100 is deductible. This $100 threshold applies to each separate loss if more than one loss occurs during the year.

In addition to this $100 threshold, personal casualty losses for the year are only deductible to the extent that the aggregate amount of total losses exceeds 10% of the taxpayer's AGI for the year.

Example 20. Larry owns a waterfront cottage. The cottage has a large boathouse that housed Larry's powerboat. Just outside the boathouse is a dockbox that Larry used to store equipment when needed. During 2011, Larry discovered that termites had been eating away the frame of the cottage for many years. As a result, the entire back side of the cottage was ready to collapse and the remainder of the cottage needed serious structural rehabilitation. During the same year, a very severe thunderstorm caused substantial damage to the boat, boathouse, and dockbox. The following table provides the relevant figures for each item of property. Larry's 2011 AGI is $300,000.

Property	Insurance Proceeds	Adjusted Cost Basis	FMV Before Casualty	FMV After Casualty	Amount of Casualty Loss
Cottage	$ 2,000	$50,000	$100,000	$60,000	$38,000
Boat	5,000	35,000	30,000	5,000	20,000
Boathouse	10,000	40,000	45,000	0	30,000
Dockbox	0	1,500	900	800	100

No part of the $38,000 loss Larry incurred on his cottage is deductible. It does not qualify as a casualty loss because the loss was not caused by a sudden event. The termites caused the damage over a number of years and, therefore, the damage was caused gradually and progressively.

The losses to the boat, boathouse, and dockbox were caused by a thunderstorm which was a sudden, unexpected, or unusual event. The losses to the boat, boathouse, and dockbox are considered casualty losses.

Each of these casualty losses are subject to the $100 limitation. This limitation applies separately to each item of property that is the subject of a casualty loss. The resulting casualty loss amount for the year is calculated as follows.

Property	Casualty Loss	Less: $100 Limitation	After $100 Adjustment
Boat	$20,000	($100)	$19,900
Boathouse	30,000	($100)	29,900
Dockbox	100	($100)	0
Total aggregate casualty losses for 2011			$49,800

Larry's 2011 AGI is $300,000. Of the $49,800 casualty losses, only the amount that exceeds 10% of Larry's AGI, or $30,000 (10% × $300,000) is deductible. Larry's deductible casualty losses are $19,800 ($49,800 − $30,000).

Business casualty losses are not subject to the $100 threshold and 10% AGI limitations.

Example 21. Leanne is a lakeside neighbor of Larry from **Example 20.** She owns a marina building that houses her charterboat business, Deap Laik Anglers. The business is a sole proprietorship. The marina building, boat, boathouse, and dockbox are all business assets. Leanne's marina building suffers from the same termite infestation as Larry's cabin, and her boathouse, boat, and dockbox suffer damage in the same freak thunderstorm.

Although Leanne's assets are business assets, losses to these assets must still meet the qualifications required for casualty losses.

The damage to the marina building is not a casualty loss because it was gradually caused by termites over a number of years.

The losses to Leanne's boathouse, boat, and dockbox associated with the thunderstorm are considered casualty losses. Because the losses are business related, the $100 threshold limitation and the 10% AGI limitation that applies to personal casualty loss deductions **do not** apply.

Leanne's deductible casualty loss for the business is as follows.

Property	Amount of Casualty Loss
Boat	$20,000
Boathouse	30,000
Dockbox	100
Total aggregate casualty losses for 2011	$50,100

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MAKING A CASUALTY LOSS CLAIM

A taxpayer claims a casualty loss deduction on the tax return for the year in which the loss occurred. An exception to this exists for disaster-related casualty losses. Further details on this exception are discussed in the next section.

If the amount of the loss is not ascertained by yearend, an extension of time to file the return should be sought or an estimate of the loss made on the return. If an estimate is made and later proves to be inaccurate, an amended return should be filed for the year of the loss.

A personal casualty loss claim is made on Form 4684, *Casualties and Thefts*. The amount is then itemized on Schedule A.

A claim for a casualty loss in connection with business or income-producing property is reported on Section B of Form 4684. Form 4797, *Sales of Business Property,* is also used, if applicable.

Note. Additional resources related to casualty losses can be found in IRS Pub. 2194, *Disaster Losses Kit for Individuals*, and IRS Pub. 2194B*, Disaster Losses Kit for Businesses*. Both are available on the IRS website.[72]

72. [www.irs.gov/businesses/small/article/0,,id=156138,00.html] Accessed on Aug. 11, 2011.

The taxpayer must be in a position to substantiate the loss claimed. The following information should be available to prove the nature and amount of a casualty loss claim.

1. A description of the nature of the loss
2. The date of the loss
3. A description of the property lost
4. Adjusted cost basis
5. FMV before and after the loss
6. Amount of insurance proceeds received

DISASTER-RELATED LOSSES

> **Note.** See Chapter 3, IRS Update, for additional information on disasters.

A disaster loss is a **personal** or **business** loss resulting from a disaster in an area specifically designated as a federally declared disaster area.

The 10% limitation does not apply for "net disaster losses" occurring in a federally declared disaster area during 2008 and 2009. However, for 2010, the 10% limitation was in effect. Taxpayers have the burden of proving the adjusted cost basis. A "net disaster loss" is the excess of a taxpayer's personal casualty losses attributable to a federally declared disaster between January 1, 2008, and December 31, 2011, over the taxpayer's personal casualty gains.

> **Note.** For the 2009 tax year, the $100 "deductible" was increased to $500. However, it returned to $100 for losses after December 31, 2009.

While the normal rule is that a casualty loss is deductible in the year in which the loss occurs, if the federally declared loss area warrants assistance under the Disaster Relief and Emergency Assistance Act, the loss may, by election, be claimed in the year **preceding** the loss year.[73] The election must be made by the due date of the tax return, without extension, in the year of loss.

> **Note.** See **http://gismaps.fema.gov** to confirm areas eligible for federal disaster assistance.

Legislation enacted in 2008 extended the replacement period to five years for taxpayers who receive insurance or other compensation as a result of compulsory or involuntarily converted property resulting from the Midwestern disaster of 2008. In these situations, the replacement property must be located in the same county as the lost property.

For tax years after 1994, if business or investment property is involuntarily converted after a federally declared disaster, the replacement property need not be related or similar in use but may be any tangible business property.

Taxpayers in a federally declared disaster area can expense the demolition, clean-up, and environmental remediation expenses for such losses occurring between January 1, 2007, and December 31, 2011.

73. IRC §165(i).

If the taxpayer's principal residence is involuntarily converted due to a federally declared disaster, the following rules may apply.

- No gain is recognized from insurance proceeds for unscheduled personal property that was part of the contents of the residence. **Unscheduled personal property** is property that is not specifically listed for coverage within a typical insurance policy. This type of personal property usually consists of items like a lawnmower, snowblower, television, stereo, and kitchen utensils, just to name a few.
- Other insurance proceeds attributable to the residence or its contents can be treated as a common pool of funds received for a single item of property. The taxpayer may elect not to recognize gain currently on the pool of funds to the extent it is reinvested in another home or contents. It must be reinvested on a timely basis (i.e., within four years after the close of the first tax year in which any part of the gain is realized upon conversion).[74]

Example 22. Brooke Stream's farm and residence was destroyed by a flood on June 16, 2011. Brooke's AGI for 2011 is $20,000. The following information was collected by Brooke.

	Insurance Proceeds	Adjusted Cost Basis	FMV Before	FMV After	Casualty Loss/Gain
Residence	$60,000	$70,000	$80,000	$ 0	($10,000)
Personal property	30,000	45,000	33,000	2,000	(1,000)
Combine	60,000	30,000	50,000	0	30,000
Living expense	5,000	N/A	N/A	N/A	N/A

For the residence, Brooke has a loss equal to the lesser of the cost or the decrease in FMV of the residence. The loss of $70,000 is also reduced by the $60,000 insurance proceeds received, resulting in an unreimbursed loss of $10,000.

For the personal property, the loss is the lower of cost or the decrease in FMV. The loss of $31,000 is reduced by insurance proceeds, resulting in an unreimbursed loss of $1,000 (($33,000 – $2,000) − $30,000). If Brooke is in a federally declared disaster area, she may elect to report this loss in 2010.

The losses from the residence and the personal property are combined on Brooke's return and reported on Form 4684, *Casualties and Thefts*. They are subject to the $100 threshold, as well as a reduction for 10% of Brooke's adjusted gross income.

If Brooke had realized a gain on unscheduled personal property, the gain does not have to be recognized.[75]

If Brooke has additional living expenses that exceed the proceeds she received, there is no tax consequence.

If Brooke does not replace the combine, she will have a taxable gain of $30,000 ($60,000 insurance proceeds less the $30,000 adjusted basis) to report on Form 4684, Section B, as well as on Part III of Form 4797.[76]

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74. IRC §1033(h); Rev. Rul. 95-22, 1995-1 CB 145.

75. IRC §1033(h)(1)(A)(i).

76. This example is from Bloether, Bibler and Wilmarth, *2010 Income Tax Manual,* and is used with permission.

Livestock Losses — Related Rules

The normal casualty loss rules apply to livestock. However, there may be situations in which the livestock are not damaged or destroyed by a sudden, unusual, or unexpected event but must be sold due to the consequences of drought, flood, or other weather-related events. In such situations, livestock producers have two options.

1. Make an election in accordance with IRC §451(e) to postpone reporting the taxable gain on the **additional** sales of any livestock for one year; or
2. Make an election in accordance with IRC §1033(e) to postpone the gain incurred from the sale of breeding, draft, or dairy animals if they are replaced within a prescribed period of time.

Specifics of IRC §451(e). To qualify for the 1-year deferral, the taxpayer's principal business must be farming, the taxpayer must use the cash method of accounting, and the taxpayer must reside in a county that was declared eligible for federal disaster assistance. However, the animals need not be raised or sold in the drought area. The election must be made by the due date of the return for the year in which the sale occurred and can be made on all livestock held for sale (raised or purchased) as well as livestock used for draft, dairy, breeding, or sporting purposes and held for less than two years (in the case of cattle and horses) and less than one year (other livestock).

The statement that is attached to the return on which the election is made should specify the following.

- An IRC §451 election is being made
- Evidence of the weather-related condition that caused the sale
- The number of animals that the taxpayer sold under normal business conditions during each of the past three years
- The number of animals that would have been sold during the current tax year under normal business conditions and the number sold because of the weather-related conditions
- Verification that the area where the animals were located was designated as eligible for federal disaster assistance, the date of the designation, and an explanation showing the relationship between the weather-related conditions and the reason for the sale
- Computations of the amount of income that is being deferred

Note. It is not necessary that the sale of the livestock occur **after** the area was designated as eligible for federal disaster assistance. The only requirement is that the weather-related condition that caused the federal disaster designation was the same condition that forced the sale of the livestock.

The election under IRC §451(e) must be made by the due date for the return, including extensions, for the tax year of the sale. In addition, for a timely filed return, the election may be made on an amended return if filed within six months of the due date of the original return (excluding extensions). The election is attached to the amended return and "Filed pursuant to Treas. Reg. §301.9100-2" is written on the top of the return.[77]

Specifics of IRC §1033(e). Involuntary conversion treatment is available for taxpayers whose principal business is farming. There is **no** requirement that the taxpayer use the cash method of accounting, but the livestock (not poultry) must be held for draft, dairy, or breeding purposes. The election is made by attaching a statement to the return that states that the taxpayer is electing to postpone the gain from the sale of the animals consistent with IRC §1033(e). This election may be made at any time during the replacement period. Additional information consistent with that listed previously for the IRC §451(e) election should be contained on the attached statement.

77. IRS Pub. 225, *Farmer's Tax Guide*.

The livestock sold or exchanged must be replaced within two years after the year in which proceeds were received with livestock similar or related in service or use. If it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property (except real estate) used for farming purposes. For livestock replacement property, the new livestock must be held for the same purpose as the animals sold or exchanged because of the weather-related condition. In that event, the gain on the animals disposed of is not subject to tax, but is deferred until the replacement animals are sold or exchanged in a taxable transaction.

The 2-year replacement period is extended to four years in areas designated as eligible for assistance by the federal government. Once the 2-year period is exceeded (if the longer period applies), the replacement property must be livestock that is similar or related in service or use to the animals sold or exchanged. Also, the Treasury Secretary has the authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years.

Note. The IRS provides guidance[78] on how a taxpayer can determine whether the replacement period can be extended beyond four years. The 4-year period is extended for one additional year if severe, extreme, or exceptional drought conditions have been reported for a location in the county that experienced the drought that forced the sale of the livestock or for any location in a neighboring county. The report can be for any weekly period included in the 12-month period ending on August 31 of the year at issue. After consultation with the National Drought Mitigation Center, the IRS publishes a list of counties each year that experienced exceptional, extreme, or severe drought for the 12-month period ending on August 31. Another way to determine if a taxpayer is in an area that experienced exceptional, extreme, or severe drought is to refer to the U.S. Drought Monitor maps that are produced on a weekly basis by the National Drought Mitigation Center. Those maps can be found at **www.drought.unl.edu/dm/archive.html.**

In most instances, the value of the replacement animals will not equal the value of the animals that were sold. If the amount reinvested exceeds the amount received from the sale, the excess becomes the taxpayer's basis in the replacement animals. If less money is reinvested than what was received on the sale, the difference is considered income that must be reported on an amended return for the year in which the excess animals were sold.

Note. The IRS has issued private letter rulings specifying that a taxpayer may revoke a deferral election in order to use the involuntary conversion procedure. The switching of techniques is possible because all of the details for the deferral election were shown at the time that the IRC §451(e) election was made. There is no requirement to file the IRC §1033(e) election by the due date of the return. IRS permission, however, must be received to make the change. However, it is not possible to make an IRC §1033(e) election and then revoke it in order to make an IRC §451(e) election. That is because the IRC §451(e) election must be made by the due date of the return.

NET OPERATING LOSSES (NOLs) — BASIC RULES

Note. This section is intended to be a basic primer on the most common application of the NOL rules. It is not intended to be all-encompassing in scope. For complete coverage of NOLs, see the 2009 *University of Illinois Federal Tax Workbook,* Chapter 7, Net Operating Losses. This can be found on the accompanying CD.

78. IRS Notice 2006-82 (Sept. 25, 2006).

Casualty and Theft Losses

A 3-year general carryback period is available for certain "eligible losses." An **eligible loss** is defined as:[79]

1. The portion of an NOL that relates to personal casualty and theft losses of individual taxpayers;
2. The portion of an NOL attributable to federally declared disasters, incurred by taxpayers operating a nonfarm small business when average annual gross receipts do not exceed $5 million over a 3-year period; [80]or
3. The portion of an NOL attributable to federally declared disasters incurred by farmers.

Elections

Special Election to Relinquish the Carryback Period. Taxpayers could elect to forgo the general 2-year carryback period (or any of the expanded 5-year, 4-year, 3-year or 2-year carryback periods for 2008 or 2009) by filing an election with their tax return for the year of the NOL. The election had to be filed by the due date (including extensions) of the return. Such an election, once made, is irrevocable for the tax year.[81]

> **Note.** All casualty and theft losses are classified as business deductions.[82] Consequently, a large personal casualty or theft loss reported on Form 1040, Schedule A, can create an NOL by itself.

When to Forgo the Carryback Period. The following are situations in which it might be advantageous to forgo the carryback period.

- The taxpayer had little or no taxable income (low marginal tax bracket) in previous (carryback) tax years and has the prospect of substantially greater income (higher marginal tax bracket) in future (carryforward) tax years. A final determination of whether to forgo the carryback period depends on time value of money considerations of an immediate refund versus tax savings over future time periods.
- The taxpayer utilized tax credits (e.g. American opportunity/Hope, lifetime learning credit, child tax credit, etc.) in previous years to offset tax liability. The effect of these nonrefundable tax credits may be negated if the NOL is carried back. If previous tax credits are eligible for carryback or carryforward (e.g. jobs credit, foreign tax credit, general business tax credit, etc.), the taxpayer may still wish to forgo the carryback period if the potential for immediate tax refund is minimal through either carryback of the NOL or further carryback/carryforward of tax credits freed for use by the carryback of the NOL.

> **Note.** An election to forgo a carryback to a particular tax year does not bar the carryback of a subsequent year's NOL to that year.

Farming Losses

A 5-year general carryback period is available for farming losses. A farming loss is defined as the amount of any NOL attributable to the income and deductions of a farming business as defined in IRC §263A(e)(4). A farming business does **not** include contract harvesting of a commodity grown by someone other than the taxpayer, or the buying or selling of farm products raised or grown by others. In addition, a farming loss cannot exceed the taxpayer's NOL for the taxable year.

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79. IRC §172(b)(1)(F)(ii).
80. IRC §448(c).
81. IRC §§172(b)(3), (i)(3) and (j).
82. IRC §172(d)(4)(C).

Special NOL Election for Farmers. Farmers can elect to forgo the 5-year carryback period under IRC §172(i)(3). Because they were also eligible for the expanded 5-year, 4-year, 3-year or 2-year carryback periods for 2008 or 2009 with regard to their NOLs, farmers had many options for their 2009 farm NOLs. If they elected to forgo all of the eligible carryback years, the NOL was carried forward for 20 years. If a taxpayer had both farm and nonfarm NOLs, an election to forgo the carryback of the nonfarm NOLs did not preclude carrying the farm NOLs back under the 5-year election or expanded 5-year, 4-year, 3-year or 2-year carryback periods for 2008 or 2009.

> **Note.** If a return is filed without the election to forgo the applicable carryback period, an amended return to make the election may be filed within six months of the original due date of the return. "Filed pursuant to Treas. Reg. §301.9100-2" should be written on the top of the return.

Specified Liability Losses

There are two types of specified liability losses, both of which qualify for a 10-year carryback period. The first type of loss arises from product liability. The second type arises from specific classes of liabilities under federal or state law and is only applicable to accrual-basis taxpayers.[83]

> **Observation.** When multiple year NOLs exist, they are used in chronological order until completely absorbed.

SMALL BUSINESS HEALTH CARE TAX CREDIT

Apparently the small business health care credit, a part of the Patient Protection and Affordable Care Act, has been overlooked by many taxpayers and tax professionals. The IRS recently made an announcement reminding small businesses they might be eligible for the credit.[84]

The credit may be available to small employers that pay at least half of the premiums for employee health coverage under a qualified arrangement. The credit is available to small businesses and tax-exempt organizations that employ 25 or fewer full-time equivalent employees (FTE) with an average income of $50,000 or less per FTE.

> **Note.** The credit is explained in detail in the *2010 Federal Tax Workbook* on pages 461–467. This can be found on the accompanying CD

When the 2010 workbook was written, the IRS had not released the instructions for Form 8941, *Credit for Small Employer Health Insurance Premiums*. The instructions allow the business to calculate the average wages using three different methods.[85] The business can use a different method to calculate the number of hours worked for each employee. The three methods that can be used are as follows.

1. **Actual paid hours of service worked** (vacation, holidays, etc.).
2. **Days-worked equivalency** (This method credits the employee with eight hours of service for each actual workday in which the employee is credited for at least one hour of service. Work days include vacation days, holidays, etc.)
3. **Weeks-worked equivalency** (This method credits the employee with 40 hours of actual weekly service for each week in which the employee is credited for at least one hour of service.

These methods are illustrated in the example on the following page.

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83. IRC §§172(b)(1)(C) and (f).

84. IRS News Release IR-2011-90 (Sep. 7, 2011).

85. Notice 2010-44 (May 17, 2010).

Example 23. Natural Bisquets Company is a small business that produces upscale organic doggie treats. It has five employees. Its payroll records show the following:

Employee	Days Worked	Actual Hours	Weeks Worked	Wages	Health Insurance Premium	Health Insurance Limit
1	234	2,160	52	$ 41,331	$ 3,840	$ 5,198
2	260	1,814	52	23,628	8,145	5,198
3	253	2,102	50	30,845	0	
4	200	999	52	14,513	0	
5	55	329	12	8,215	0	
Total				$118,532	$11,985	$10,396

Because Employee 5 is a seasonal employee, her wage is not included in the total wages. The total wages are $110,317 ($118,532 − $8,215). The health insurance premium used to compute the credit is the lesser of the actual premiums paid for all employees or the total of the premiums that would have been paid if all employee premiums were the average premiums for the small group market in the employer's state. This example assumes all employees are single and the average state premium is $5,198.

To determine the number of FTEs, the following calculation is used.

	Hours of Service			
Employee	**Actual Hours**	**Based on Days Worked**	**Based on Weeks Worked**	**Hours Used to Compute FTE**
1	**2,080**	1,872	2,080	2,080
2	1,814	2,080	2,080	2,080
3	2,080	2,024	2,000	2,080
4	999	1,600	2,080	2,080
5 (seasonal, not included in totals)	N/A	N/A	N/A	N/A
Total	6,973	7,576	8,240	8,320
Divided by 2,080	3.35	3.64	3.96	4
FTE	3	3	3	4
Average wage ($110,317 ÷ FTE)	$36,772	$36,772	$36,772	$27,579
Rounded average wage	$36,000	$36,000	$36,000	$27,000

Using different methods for different employees results in the business having four FTEs rather than three. Consequently, the credit phaseout reduction is less. The credit is reduced by a percentage using the wages in excess of $25,000 divided by $25,000.

The reduction percentage for 3 FTEs is (36,000 − $25,000) ÷ $25,000 = 44%.

The reduction percentage for 4 FTEs is (27,000 − $25,000) ÷ $25,000 = 8%.

The credit before the wage limitation phaseout is 35% of the allowable insurance premiums. Consequently, the base credit is $3,639 ($10,396 × 35%).

	3 FTEs		4 FTEs	
Base credit	$3,639	$3,639	$3,639	$3,639
Reduction percentage	× 44%		× 8%	
Phaseout	$1,601	(1,601)	$ 291	(291)
Credit		$2,038		**$3,348**

By using 4 FTEs, the business increased its credit by $1,310 ($3,348 − $2,038).