Chapter 2: Individual Taxpayer Issues

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

CLAIM OF RIGHT

Occasionally, a taxpayer may be required to repay income that was included on a previous year's tax return. Examples include earned income, investment income, or unemployment income when legal proceedings or other circumstances create a need for repayment of claimed income. If the repayment occurs in the same year that the income was received, no adjustment is required. If the repayment occurs in a subsequent year, the taxpayer must account for the repayment according to the rules of the claim of right doctrine.

The claim of right doctrine was established in large part by the *North American Oil Consolidated v. Comm'r*[1] Supreme Court decision. This court decision indicated that a taxpayer must report the receipt of income for the time that they have control over it even though they may have to repay it at a later time. The courts limited the claim of right doctrine to preclude the IRS from requiring taxpayers to recognize income if there are significant restrictions on the taxpayer's disposition of the income, as occurred in *Smarthealth Inc. v. Comm'r.*[2]

The claim of right is applicable to income taxation when the taxpayer receives funds and treats them as belonging to the taxpayer. The fact that the claim is subsequently found to be invalid by a court does not change the fact that the claim did exist.[3] If the taxpayer concedes that there is an obligation to return or repay the income at the time they receive it, they are not subject to the claim of right doctrine. The doctrine is applicable when the repayment obligation occurs subsequent to the time the income is received, or if the taxpayer did not concede that there is a repayment obligation when they originally claimed the income.

If the amount of repayment is **$3,000 or less,** the claim of right doctrine under IRC §1341 does not apply. Therefore, the amount repaid is deducted in the year of repayment. The repayment is generally deducted on the same form or schedule on which it was previously included.[4] For example, if it had been reported as self-employment income on Schedule C, *Profit or Loss from Business,* it is deducted on Schedule C. If it was reported as wages, taxable unemployment compensation, or other nonbusiness ordinary income, it is deducted on Schedule A, *Itemized Deductions,* as a miscellaneous itemized deduction, subject to the 2% of AGI limitation.[5] However, the taxpayer may not receive any tax benefit because of the 2% threshold, they do not itemize deductions, or they are subject to the alternative minimum tax.

1. *North American Oil Consolidated v. Comm'r,* 286 U.S. 417 (1932).
2. *Smarthealth Inc. v. Comm'r,* TC Memo 2001-145 (Jun. 20, 2001).
3. *Edwin E. Healy et al. v. Comm'r,* 345 U.S. 278 (1953).
4. IRM 21.6.6.3.12.2 (2003).
5. IRS Pub. 525, *Taxable and Nontaxable Income.*

If the amount of the repayment **exceeds $3,000,** the taxpayer has two options available and can use the option that results in the lowest tax.[6]

Method 1. The taxpayer can compute the tax **claiming a deduction** for the repaid amount.

Method 2. The taxpayer can **claim a credit** for the repaid amount. The following steps must be followed.

1. Compute the tax for the current tax year without deducting the repaid amount.
2. Recalculate the tax from the earlier year without including in income the amount that the taxpayer repaid in the current tax year.
3. Subtract the tax in item 2 from the tax shown on the taxpayer's return for the earlier year. **This is the amount of the credit.**
4. Subtract the result in step 3 from the tax for the current tax year calculated without the deduction.

If the tax calculated in **method 1** is lower, the repayment is generally deducted on the same form or schedule on which it was previously included. If the amount must be deducted as a miscellaneous itemized deduction, it is entered on line 28 and is **not** subject to the 2% of AGI limitation.

If the tax calculated in **method 2** is lower, the credit is reported on Form 1040, line 71 (2013), or line 73 (2014). **"Sec. 1341"** should be entered next to the applicable line.

If the taxpayer uses the cash method of accounting, they can take the deduction (or credit) for the tax year in which they actually make the repayment. If the taxpayer uses the accrual method, they are entitled to the deduction or credit in the tax year in which the repayment obligation accrues.[7]

These repayment rules do not apply to the following.[8]

- Deductions for sales to customers, such as returns and allowances
- Deductions for theft losses due to fraud or embezzlement
- Deductions for legal fees that are a result of contesting the repayment of income
- Deductions for bad debts

Example 1. Jackson is a self-employed writer. For 2012, he had taxable income of $74,000. Included in his gross income for the year was $40,000 of royalties that he reported on Schedule C. After being accused of plagiarism, Jackson returned $30,000 of the royalties in 2013. His taxable income for 2013 before taking the $30,000 repayment into account was $50,000. His filing status for both tax years is single.

Jackson's income and tax for both 2012 and 2013 are as follows.

	2012		2013	
	With Returned Income	Without Returned Income	Without Deduction	With Deduction
Taxable income	$74,000	$44,000	$50,000	$20,000
Tax	19,875	9,638	12,113	3,684

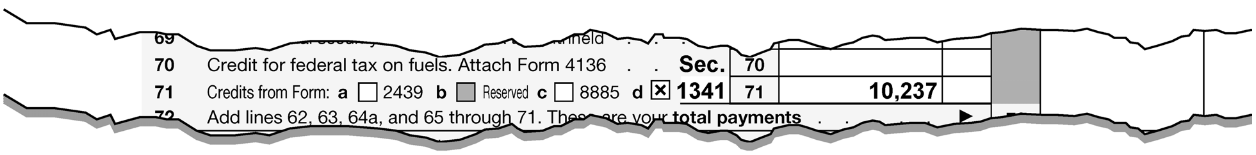
Under method 1, Jackson's tax is $3,684.

6. Ibid.
7. Ibid.
8. Ibid.

Under method 2, his tax is calculated as follows.

Tax for 2013 without deducting the repaid amount		$12,113
Tax originally shown on 2012 return	$19,875	
Tax for 2012 without including the amount of income repaid in 2013	(9,638)	
Amount of credit	$10,237	(10,237)
Tax for 2013 after deducting credit		$ 1,876

Jackson's tax under method 2 is $1,876. Because this amount is less than the tax calculated using method 1, he should take a credit for the repayment in 2013. He does this by reporting the $10,237 credit on line 71 of his **2013** Form 1040 as shown below.



70	Credit for federal tax on fuels. Attach Form 4136 . . **Sec.**	70	
71	Credits from Form: **a** ☐ 2439 **b** ☐ Reserved **c** ☐ 8885 **d** ☒ **1341**	71	10,237
72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments**		

QUALIFIED TUITION PROGRAM

As the cost of college tuition continues to increase, more parents and grandparents are contributing to qualified tuition programs. A qualified tuition program (QTP) is a program established and maintained by either a state government or an eligible educational institution. **Contributions or payments to a QTP are not deductible;** however, any distributions and earnings are tax-free if distributions do not exceed the designated beneficiary's qualified education expenses.

IRC §529 grants special tax status to QTPs. Accordingly, these programs are also called "section 529 plans" and must meet certain requirements.

Amounts contributed to a QTP must be held in a qualified trust, and the plan must receive a ruling or determination from the IRS that indicates the program satisfies the applicable requirements. There are several requirements that must be met in order to be considered a QTP.

- Contributions to the plan must be made in cash.[9] ("Cash" includes checks, money orders, credit cards, or electronic transfers from banks or investment accounts.)
- The plan must provide separate accounting for each designated beneficiary.[10]
- Neither the account owner nor the beneficiary is allowed to direct the investment of the account.[11] However, account owners are permitted to choose between broad-based investment strategies and to change investment strategies **only once per year.**
- The QTP plan cannot be pledged or used as security for a loan.[12]
- The plan must have adequate safeguards in place to prevent contributions greater than the amount reasonably expected to be necessary for the beneficiary's higher education expenses.[13]

Unlike other education tax benefits, there are **no income limitations with QTP accounts.**

9. IRC §529(b)(2).
10. IRC §529(b)(3).
11. IRC §529(b)(4).
12. IRC §529(b)(5).
13. IRC §529(b)(6); Prop. Treas. Reg. §1.529-2(i)(1).

ACCOUNT OWNERS

The account owner[14] has complete ownership of the QTP account. The account owner:

- Can change beneficiaries at any time and for any reason (with certain tax consequences), and
- May distribute funds at any time and for any reason (with certain tax consequences).

Under federal tax law, account owners can be individuals, corporations, partnerships, trusts, estates, §501(c)(3) organizations, Uniform Gifts to Minors Act (UGMA) accounts, and Uniform Transfers to Minors Act (UTMA) accounts. Federal law has no income, age, or residency restrictions on who can own a QTP account.

> **Note.** Some states may define **account owner** differently than federal law, and they may have age or residency restrictions.

Federal law does not allow joint ownership of QTP accounts. Married couples can establish two separate QTP accounts, or they may title the account in one spouse's name with the other spouse listed as a contingent or successor account owner.

DESIGNATED BENEFICIARY

The individual for whom the QTP is intended to provide benefits is called the designated beneficiary (DB). If a state, local government, or tax-exempt organization purchases an interest in a QTP as part of a scholarship program, the DB is the person who receives the interest as a scholarship.[15]

CONTRIBUTIONS ARE GIFTS

Contributions are treated as **completed gifts** that are eligible for the $14,000[16] federal annual gift tax exclusion.[17] However, states may set limits on plan contributions.

Donors may elect to prorate their contribution over five years so they do not exceed the annual gift tax exclusion. This effectively allows contributions totaling five times the annual gift tax exclusion ($70,000 for individuals and $140,000 for split gifts made in 2013 and 2014) without gift tax consequences.[18] A gift tax return (Form 709) must be filed to elect this provision.

> **Example 2.** In 2013, Arabelle contributes $70,000 to a QTP naming her grandson, Houston, as beneficiary. She elects to prorate this contribution over five years on her 2013 gift tax return.
>
> In 2014, Arabelle gives Houston $2,000 in cash. This is a taxable gift because her $14,000 annual exclusion was used by the 2013 QTP contribution.

If the donor dies during the 5-year period, the donor's estate includes on the gift tax return only that portion of the contributions allocable to years after the donor's death.[19]

IRC §529 allows another qualifying member of the family to be re-designated as the beneficiary without penalty. There is no federal income tax consequence on beneficiary changes to **qualified family members,** nor is there any gift tax consequence unless the new beneficiary is in a younger generation than the prior beneficiary.[20]

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14. Prop. Treas. Reg. §1.529-1(c).
15. IRC §529(e)(1)(c).
16. The annual gift tax exclusion is subject to annual adjustments for inflation. The exclusion amount for 2013 and 2014 is $14,000. See Rev. Proc. 2013-35, 2013-47 IRB 537.
17. IRC §529(c)(2)(A)(i).
18. IRC §529(c)(2)(B).
19. IRC §529(c)(4)(C).
20. IRC §529(c)(5)(B).

The DB's qualified family members include the following persons.[21]

1. Spouse
2. Son, daughter, stepchild, foster child, adopted child, or a descendent of any of them
3. Brother, sister, stepbrother, or stepsister
4. Father or mother or ancestor of either
5. Stepfather or stepmother
6. Nephew or niece
7. Uncle or aunt
8. Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
9. The spouse of any individual listed above
10. First cousin

Example 3. Use the same facts as **Example 2.** Arabelle's QTP has an account balance of $75,000, which includes $70,000 of contributions and $5,000 of earnings. In 2014, Arabelle decides to change the account's beneficiary. Her grandson Houston was arrested multiple times for drag racing and throwing eggs at a neighbor's house, and Arabelle wants to teach him a lesson.

Arabelle names her granddaughter Jasmine as beneficiary of the QTP account. There are no income or gift tax consequences on this beneficiary change because Jasmine is in the same generation as Houston.

If the new beneficiary is in **a younger generation,** the change in beneficiary designation is **considered a gift** from the **prior beneficiary** to the new beneficiary.[22] This gift is eligible for the special 5-year proration.[23]

Example 4. Use the same facts as **Example 3,** except Arabelle changes the beneficiary to her **great-grandson** Dallas. There are no income tax consequences on this beneficiary change.

However, this beneficiary change is considered a gift from Houston to Dallas. This gift is eligible for the special 5-year proration. Accordingly, Houston is deemed to have made a taxable gift in 2014 to Dallas. The total gift is $75,000 ($70,000 contributions + $5,000 earnings). The 5-year proration is $70,000 ($14,000 × 5). The taxable gift is deemed to be $5,000 ($75,000 – $70,000).

LIMITATION ON CONTRIBUTIONS

Contributions to a QTP on behalf of a beneficiary cannot be more than the amount necessary to provide for the qualified higher education expenses of the beneficiary. Proposed reliance regulations provide a safe harbor in connection with the amount of contributions under this rule. A state QTP may need to prevent excess contributions to the plan. Generally, the contributions may not exceed an actuarial estimate of the amount required for tuition, fees, and room and board for five undergraduate years at the highest-cost institution that is covered by the state plan. There are no income restrictions on the individual contributors.

A taxpayer can contribute to both a QTP and a Coverdell education savings account (ESA) in the same year for the same DB.

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21. IRC §529(e)(2).
22. Prop. Treas. Reg. §1.529-5(b)(3)(ii) .
23. IRC §529(c)(5)(B).

ELIGIBLE EDUCATIONAL INSTITUTION

For purposes of a QTP, an eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

> **Note.** A searchable list of eligible educational institutions is found at **fafsa.ed.gov/FAFSA/app/schoolSearch.**

ROLLOVERS

Distributions from a QTP are not taxable if they are rolled over within 60 days to another QTP for the same DB or for the benefit of a member of the DB's family. The rollover treatment only applies to one transfer within any 12-month period for the same beneficiary.[24]

> **Note.** The qualifying family members for purposes of a QTP rollover are the same as those listed earlier in this section under "Contributions are Gifts."

Example 5. Jamie's parents made substantial contributions to a QTP for his benefit. However, Jamie was awarded a full scholarship to Harvard University. Consequently, he did not use any of the QTP funds. In order to avoid paying tax on the distribution of the amount in his QTP account, Jamie contributed the same amount to his sister's QTP within 60 days of the distribution.

CHANGING THE DESIGNATED BENEFICIARY

There are no income tax consequences if the DB of a QTP is changed to a member of the DB's family.

Example 6. Use the same facts as **Example 5.** Instead of closing his QTP and paying the distribution into his sister's QTP, Jamie could have instructed the trustee of his account to change the name of the beneficiary on his account to that of his sister.

QUALIFIED DISTRIBUTIONS

The portion of a distribution representing the amount contributed to a QTP is not included in income. This is a return of the investment in the plan.

The DB generally does not have to include in income any earnings distributed from a QTP if the total distribution does not exceed the adjusted qualified education expenses (AQEE). AQEE is calculated by reducing the total qualified higher education expenses (QHEE) by the amount of any tax-free educational assistance.

QHEE consists of the following.[25]

- Tuition, fees, books, supplies, and equipment required by the eligible educational institution
- Expenses for special-needs services required by a special-needs beneficiary
- For students enrolled at least half-time, the greater of the following room and board expenses
  - The allowance for room and board that the educational institution uses in the cost of attendance for federal financial aid purposes
  - The actual amount charged to a student residing in housing owned or operated by the eligible institution

> **Note.** The eligible educational institution can be contacted to obtain qualified room and board costs.

24. IRC §529(c)(3)(C)(iii).

25. IRC §529(e)(3).

Caution. For tax years after 2010, an expenditure for computer technology or equipment is only a QHEE if the computer technology or equipment is **required** for enrollment or attendance at an eligible institution.

QHEE must be **reduced** by all of the following tax-free benefits to arrive at AQEE.

- The tax-free part of a scholarship or fellowship
- Veterans' educational assistance
- Pell grants
- Employer-provided educational assistance
- Any other nontaxable payments (other than gifts or inheritances) received as educational assistance

The administrator or bank that manages the QTP issues a Form 1099-Q, *Payments From Qualified Education Programs (Under Sections 529 and 530),* reporting the amount of the distribution, the earnings portion, and the basis. Forms 1099-Q must be mailed to the recipient by January 31 following the year of a distribution.

Calculating the Taxable Portion of a Distribution

Calculating the taxable portion of a QTP distribution is a 3-step process.

Step 1. Determine the AQEE by reducing the total qualified higher education expenses (QHEE) by the amount of any tax-free educational assistance.

$$\textbf{AQEE} = \textbf{QHEE} - \textbf{Tax-free education benefits}$$

Step 2. Calculate the tax-free earnings amount by multiplying the total distributed earnings shown in box 2 of Form 1099-Q by a fraction. The numerator is the amount calculated in **step 1 (**AQEE paid during the year) and the denominator is the total amount distributed during the year.

$$\textbf{Tax-free earnings amount} = \textbf{Earnings portion of distribution} \times \frac{\textbf{AQEE}}{\textbf{Total distribution}}$$

Step 3. Subtract the amount computed in **step 2** from the earnings portion of the distribution.

$$\textbf{Taxable QTP} = \textbf{Earnings portion of distribution} - \textbf{Tax-free earnings amount}$$

The result is the amount the DB must include in income. This amount is reported on line 21 (other income) of Form 1040.

Example 7. Emily uses a distribution from her QTP to pay her educational expenses in 2013. Her parents contributed $50,000 to the account over the years. At the time of the distribution, the account had a balance of $60,000.

In 2013, she paid QHEE of $20,500. She received money from the following sources to pay her college expenses.

Tax-free tuition scholarship	$ 6,000
QTP distribution	15,000

Emily receives the following Form 1099-Q.

☐ CORRECTED (if checked)

PAYER'S/TRUSTEE'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no. **Best 529 Plans** **99 First St.** **Springfield, IL 62222**		1 Gross distribution $ **15000.00** 2 Earnings $ **2500.00**	OMB No. 1545-1760 **2013** Form **1099-Q**	**Payments From Qualified Education Programs (Under Sections 529 and 530)**
PAYER'S/TRUSTEE'S federal identification no. **22-7777777**	RECIPIENT'S social security number **555-44-3333**	3 Basis $ **12500.00**	4 Trustee-to-trustee transfer ☐	**Copy B** **For Recipient**
RECIPIENT'S name **Emily Woods** Street address (including apt. no.) **529 University Street** City or town, province or state, country, and ZIP or foreign postal code **Urbana, IL 61801**		5 Check one: • Qualified tuition program— Private ☐ or State ☒ • Coverdell ESA ☐	6 If this box is checked, the recipient is not the designated beneficiary ☐	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 this income is taxable and the IRS determines that it has not been reported.
Account number (see instructions)		If the fair market value (FMV) is shown below, see **Pub. 970**, Tax Benefits for Education, for how to figure earnings.		

Form **1099-Q** (keep for your records) www.irs.gov/form1099q Department of the Treasury - Internal Revenue Service

Step 1. Emily's AQEE is calculated as follows.

$$\begin{aligned} \textbf{AQEE} &= \textbf{QHEE} - \textbf{Tax-free education benefits} \\ &= \$20{,}500 - \$6{,}000 \\ &= \$14{,}500 \end{aligned}$$

Because the AQEE is less than the amount of the QTP distribution, part of the earnings are taxable. Her Form 1099-Q shows that $2,500 of the distribution is earnings.

Step 2. The tax-free earnings amount is calculated as follows.

$$\begin{aligned} \textbf{Tax-free earnings amount} &= \textbf{Earnings portion of distribution} \times \frac{\textbf{AQEE}}{\textbf{Total distribution}} \\ &= \$2{,}500 \times \frac{\$14{,}500}{\$15{,}000} \\ &= \$2{,}417 \end{aligned}$$

Step 3. Calculate the taxable portion of the QTP as follows.

$$\begin{aligned} \textbf{Taxable QTP} &= \textbf{Earnings portion of distribution} - \textbf{Tax-free earnings amount} \\ &= \$2{,}500 - \$2{,}417 \\ &= \$83 \end{aligned}$$

Emily must include the $83 in income on line 21 of her 2013 Form 1040.

ADDITIONAL TAX ON EXCESS DISTRIBUTIONS

If distributions are made in excess of the AQEE, an additional 10% tax must generally be paid on the amount included in income. The additional tax is reported on **Form 5329,** *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.

Example 8. After Jonathan completed his first year of college, he decided to abandon any additional education. He took a distribution of $48,000 in 2013 from his QTP and closed the account. Because $8,000 of the distribution is from earnings, it is taxable on his return. The remaining $40,000 is a nontaxable return on investment.

Jonathan must report the $8,000 of earnings on line 21 of his 2013 Form 1040. He also files the following Form 5329 to report the additional 10% tax of $800.

Form **5329**

Department of the Treasury
Internal Revenue Service (99)

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Form 5329 and its separate instructions is at *www.irs.gov/form5329*.

OMB No. 1545-0074
2013
Attachment Sequence No. 29

Name of individual subject to additional tax. If married filing jointly, see instructions.	Your social security number
Jonathan	**111-22-9999**

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return ▶

Home address (number and street), or P.O. box if mail is not delivered to your home		Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).		If this is an amended return, check here ▶ ☐
Foreign country name	Foreign province/state/county	Foreign postal code

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 58, or Form 1040NR, line 56, without filing Form 5329. See the instructions for Form 1040, line 58, or for Form 1040NR, line 56.

Part I Additional Tax on Early Distributions

Complete this part if you took a taxable distribution before you reached age 59½ from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: ________	2	
3	Amount subject to additional tax. Subtract line 2 from line 1	3	
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	4	
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Part II Additional Tax on Certain Distributions From Education Accounts

Complete this part if you included an amount in income, on Form 1040 or Form 1040NR, line 21, from a Coverdell education savings account (ESA) or a qualified tuition program (QTP).

5	Distributions included in income from Coverdell ESAs and QTPs	5	8,000
6	Distributions included on line 5 that are not subject to the additional tax (see instructions)	6	
7	Amount subject to additional tax. Subtract line 6 from line 5	7	8,000
8	**Additional tax.** Enter 10% (.10) of line 7. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	8	800

Additional Tax on Excess Contributions to Traditional IRAs

The 10% additional tax **does not apply** to distributions made in the following circumstances.[26]

1. The distribution is paid to a beneficiary (or to the estate of the DB) on or after the death of the DB.
2. The distribution is made because of the disability of the DB.
3. The distribution is included in income because the DB received one of the following.
   a. A tax-free scholarship or fellowship
   b. Veteran's educational assistance
   c. Employer-provided educational assistance
   d. Any other nontaxable (tax-free) payments (other than gifts and inheritances) received as educational assistance
4. The distribution is made for attendance of the DB at a U.S. military academy. This applies only to the extent that the amount of distribution does not exceed the costs of advanced education attributable to such attendance.
5. The distribution is included in income only because the qualified educational expenses were taken into account in determining the American opportunity or lifetime learning credit.

Example 9. Use the same facts as **Example 7.** Because the amount of Emily's AQEE was only higher than her QTP distribution after taking into account the $6,000 tax-free scholarship she received, she is not liable for the 10% additional tax. She reports the exception on Form 5329 as follows.

Form **5329**

Department of the Treasury
Internal Revenue Service (99)

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Form 5329 and its separate instructions is at *www.irs.gov/form5329*.

OMB No. 1545-0074
2013
Attachment Sequence No. 29

Name of individual subject to additional tax. If married filing jointly, see instructions.	Your social security number
Emily Woods	**555-44-3333**

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street), or P.O. box if mail is not delivered to your home		Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).		If this is an amended return, check here ▶ ☐
Foreign country name	Foreign province/state/county	Foreign postal code

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 58, or Form 1040NR, line 56, without filing Form 5329. See the instructions for Form 1040, line 58, or for Form 1040NR, line 56.

Part I Additional Tax on Early Distributions

Complete this part if you took a taxable distribution before you reached age 59½ from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: ______	2	
3	Amount subject to additional tax. Subtract line 2 from line 1	3	
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	4	
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Part II Additional Tax on Certain Distributions From Education Accounts

Complete this part if you included an amount in income, on Form 1040 or Form 1040NR, line 21, from a Coverdell education savings account (ESA) or a qualified tuition program (QTP).

5	Distributions included in income from Coverdell ESAs and QTPs	5	83
6	Distributions included on line 5 that are not subject to the additional tax (see instructions) . . .	6	83
7	Amount subject to additional tax. Subtract line 6 from line 5	7	0
8	**Additional tax.** Enter 10% (.10) of line 7. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	8	0

Part III Additional Tax on Excess Contributions to Traditional IRAs

[26] IRS Pub. 970, *Tax Benefits for Education.*

COORDINATION WITH EDUCATION CREDITS

2

The American opportunity or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP, as long as the same expenses are not used for both benefits. This means that after the beneficiary reduces QHEE by tax-free educational assistance, they must further reduce QHEE by the expenses taken into account in determining the credit.

Example 10. Use the same facts as **Example 7,** except Emily's parents claimed an American opportunity credit of $2,500 (based on $4,000 of expenses).

Step 1. Emily's AQEE is calculated as follows.

$$\begin{aligned}\textbf{AQEE} &= \textbf{QHEE} - \textbf{Tax-free education benefits} - \begin{array}{c}\textbf{Expenses used in computing}\\ \textbf{American opportunity credit}\end{array}\\ &= \$20{,}500 - \$6{,}000 - \$4{,}000\\ &= \$10{,}500\end{aligned}$$

Step 2. The tax-free earnings amount is calculated as follows.

$$\begin{aligned}\textbf{Tax-free earnings amount} &= \textbf{Earnings portion of distribution} \times \frac{\textbf{AQEE}}{\textbf{Total distribution}}\\ &= \$2{,}500 \times \frac{\$10{,}500}{\$15{,}000}\\ &= \$1{,}750\end{aligned}$$

Step 3. Calculate the taxable portion of the QTP as follows.

$$\begin{aligned}\textbf{Taxable QTP} &= \textbf{Earnings portion of distribution} - \textbf{Tax-free earnings amount}\\ &= \$2{,}500 - \$1{,}750\\ &= \$750\end{aligned}$$

Emily must include $750 in income on Form 1040, line 21. This represents the distributed earnings not used for AQEE.

COORDINATION WITH COVERDELL ESA DISTRIBUTIONS

If a DB receives distributions from both a QTP and a Coverdell ESA in the same year and the total of these distributions is more than the beneficiary's AQEE, the expenses must be allocated between the distributions.

Example 11. Use the same facts as **Example 10,** except instead of receiving $15,000 from a QTP distribution, Emily received $10,000 from the QTP and $5,000 from her Coverdell ESA. She must allocate her $10,500 of AQEE expenses between the two distributions.

$$\begin{aligned}\textbf{AQEE from ESA} &= \textbf{ESA distribution} \times \frac{\textbf{AQEE}}{\textbf{Total distribution}}\\ &= \$5{,}000 \times \frac{\$10{,}500}{\$15{,}000}\\ &= \$3{,}500\end{aligned}$$

$$\begin{aligned}\textbf{AQEE from QTP} &= \textbf{QTP distribution} \times \frac{\textbf{AQEE}}{\textbf{Total distribution}}\\ &= \$10{,}000 \times \frac{\$10{,}500}{\$15{,}000}\\ &= \$7{,}000\end{aligned}$$

Emily then computes the taxable portion of her Coverdell ESA distribution based on AQEE of $3,500 and the taxable portion of her QTP distribution based on AQEE of $7,000.

LOSSES ON QTP INVESTMENTS

If there is a loss in a QTP account, the taxpayer may be able to claim the loss on their income tax return. The loss can only be claimed when **all** amounts from the account have been distributed and the total distributions are less than the unrecovered basis on the account. The basis is the total amount of contributions to the QTP. The loss is claimed on Schedule A as a miscellaneous itemized deduction, subject to the 2%-of-AGI threshold.

If there are distributions from more than one QTP account during the year, the information from all the accounts must be combined in order to determine the taxable earnings for the year. In this way, the loss from one QTP reduces the distributed earnings from any other QTP accounts.

Example 12. In 2014, Michelle received a final distribution of $4,000 from QTP 1. She has no other QTP distributions for the year. Her unrecovered basis before the distribution was $6,000. If Michelle itemizes her deductions, she can claim the $2,000 loss on Schedule A as a miscellaneous itemized deduction.

Example 13. Use the same facts as **Example 12,** except Michelle also had a distribution of $7,000 from QTP 2 in 2014, giving her total distributions of $11,000 for 2014. Her total basis in these distributions was $10,500 ($6,000 from QTP 1 and $4,500 from QTP 2). Her AQEE for 2014 totaled $10,000. In order to compute her total taxable earnings, she combines the two accounts and determines her taxable earnings as follows.

Total distributions	$11,000
Less: basis portion of distributions	(10,500)
Earnings included in distributions	$ 500
Less: tax-free earnings ($500 earnings × ($10,000 AQEE ÷ $11,000 distribution))	(455)
Taxable earnings	$ 45

Michelle must include $45 in income on Form 1040, line 21. Because Michelle's accounts must be combined, she cannot deduct her $2,000 loss from QTP 1 on Schedule A. Instead, the $2,000 loss reduces the total earnings that were distributed, thereby reducing her taxable earnings.

HEALTH FSA: CHANGE TO "USE-IT-OR-LOSE-IT" RULES

Health flexible spending arrangements (FSA) permit employees to be reimbursed for medical expenses. Health FSAs are usually funded through voluntary salary reduction agreements, but the employer may also contribute. For plan years beginning after December 31, 2012, **salary reduction contributions to a health FSA are limited to $2,500 per year** (as indexed for cost-of-living adjustments).[27]

Following are some of the advantages of having a health FSA.[28]

- Contributions made by an employer can be excluded from an employee's gross income. (However, contributions an employer makes in order to provide coverage for long-term care insurance must be included in the employee's income.)
- No employment or federal income taxes are deducted from the employee's contributions.
- Withdrawals are tax-free if they are used to pay qualified medical expenses.
- An employee can withdraw funds from the account to pay qualified medical expenses even if they have not yet placed the funds in the account.

A disadvantage of health FSAs is that they are generally use-it-or-lose-it plans. This means that any money paid into the plan but not withdrawn for medical expenses during the plan year generally cannot be carried over to the next year.

GRACE-PERIOD RULE

In 2005, the IRS and the Treasury Department modified the use-it-or-lose-it rule by adopting the **grace-period rule.** A health FSA plan can provide for a grace period of up to two months and 15 days after the end of the plan year.[29] If the plan has a grace period, qualified medical expenses incurred by an employee during that period can be paid from any amounts left in the employee's account at the end of the previous year. Employers are not allowed to refund any part of the remaining balance to employees.

Note. A grace period is different than a **"run-out-period."** A run-out-period is a period immediately following the end of a plan year during which a participant can submit a claim for reimbursement of qualified expenses incurred during the preceding plan year. By contrast, a grace period is a period of up to two months and 15 days immediately following the end of a plan year during which a participant can use amounts remaining from the previous plan year to pay qualified expenses incurred during the grace period.[30]

Example 14. In 2012, Darnell contributed $100 per month from his pay to a health FSA plan that had a 2½-month grace period. His medical expenses only totaled $900 in 2012. He incurred another $100 in medical expenses during the plan's grace period, which ran from January 1, 2013, through March 15, 2013. Because Darnell's total medical expenses were only $1,000, he **lost** $200 of his contribution (($100 contribution per month × 12 months) – $1,000 expenses).

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27. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*
28. Ibid.
29. IRS Notice 2013-71, 2013-47 IRB 532.
30. Ibid.

CARRYOVER RULE

On October 31, 2013, the IRS and Treasury Department issued Notice 2013-71, which further modified the use-it-or-lose-it rules for health FSAs for plan years beginning after December 31, 2012.[31] To provide added flexibility, employers are now permitted to amend their plans to allow plan participants to carry over up to $500 of their unused health FSA balances remaining at the end of a plan year. This is called a **"carryover."** The carryover amount may be used to pay or reimburse qualified medical expenses that the employee incurs in the following plan year. The carryover does not affect the maximum amount of salary reduction contributions that an employee is permitted to make. In order to take advantage of the carryover provision, there must be a written amendment to the plan providing for the carryover.

The amount that a participant may carry over to the following plan year is equal to the **lesser** of the following.[32]

- Any unused amounts from the immediately preceding plan year
- $500 (or a lower amount specified in the plan).

Any unused amount in excess of $500 (or a lower amount specified in the plan) that remains unused by the participant at the end of the plan year is forfeited.

Example 15. Dana contributed $2,500 to a health FSA in 2013. The plan provides for carryovers of up to $500. Dana's medical expenses totaled $1,900 in 2013. She can carry over $500 of the unused amount to 2014, but she forfeits $100 of her 2013 contributions ($2,500 contribution − $500 maximum carryover − $1,900 used in 2013).

A health FSA plan is allowed to treat reimbursements of expenses incurred in the current plan year as reimbursed first from unused amounts credited for the current plan year. After exhausting the current plan year amounts, expenses are reimbursed from unused amounts carried over from the preceding plan year. Any unused amounts from the prior plan year that are used to reimburse a current year expense:[33]

1. Reduce the amounts available to pay prior plan year expenses during the run-out period,
2. Must be counted against the permitted carryover of up to $500, and
3. Cannot exceed the permitted carryover.

Example 16. Sybil's employer sponsors a §125 cafeteria plan and health FSA with a calendar plan year, an annual run-out period from January 1 through March 31 in which participants can submit claims for expenses incurred during the preceding plan year, and an annual open-enrollment season in November in which participants elect a salary reduction amount (not to exceed $2,500) for the following plan year. The plan is timely amended to provide for a carryover that allows all participants to apply up to $500 of unused health FSA amounts remaining at the end of the run-out period to expenses incurred at any time during that plan year. The plan does not provide for a grace period for the health FSA.

In November 2014, Sybil elects a salary reduction amount of $2,500 for 2015. By December 31, 2014, Sybil's unused amount from the 2014 plan year is $800. On February 1, 2015, Sybil submits claims and is reimbursed for $350 of expenses incurred during the 2014 plan year, leaving a carryover on March 31, 2015 (the end of the run-out period) of $450 ($800 – $350) of unused health FSA amounts from 2014. The $450 amount is not forfeited; instead, it is carried over to 2015 and available to pay claims incurred in that year. Therefore, $2,950 ($2,500 + $450) is available to pay claims incurred in 2015.

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31. *Treasury Modifies "Use-or-Lose" Rule for Health Flexible Spending Arrangements.* Oct. 31, 2013. Department of the Treasury. [www.treasury.gov/press-center/press-releases/Pages/jl2202.aspx] Accessed on Feb. 18, 2014.

32. IRS Notice 2013-71, 2013-47 IRB 532.

33. Ibid.

Sybil incurs and submits claims for expenses of $2,700 during the month of July 2015 and does not submit any other claims during 2015. Sybil is reimbursed for the $2,700 claim, leaving $250 ($2,950 – $2,700) as a potential unused amount from 2015 (depending upon whether Sybil submits claims during the 2015 run-out period in early 2016).[34]

Example 17. Use the same facts as **Example 16,** except Sybil's expenses of $2,700 are incurred and submitted in January 2015 instead of July 2015. The plan may treat $500 of the $800 that is unused as of December 31, 2014, as available to pay current year expenses. Accordingly, Sybil is reimbursed for the $2,700 claim. The plan treats the first $2,500 of the claim as reimbursed with health FSA contributions for 2015 and the remaining $200 of the claim as reimbursed with the unused amounts from 2014. The unused amount remaining from 2014 from which claims for expenses incurred during the 2014 plan year may be reimbursed during the run-out period in early 2015 is reduced to $600 ($800 − $200).

On February 1, 2015, Sybil submits, and is reimbursed for $350 of claims for expenses incurred during the 2014 plan year. After this reimbursement, the unused amount remaining for 2014 from which claims for expenses incurred during the 2014 plan year may be reimbursed during the run-out period is reduced to $250 ($600 − $350).

Sybil submits no further claims for 2015. The amount carried over to 2016 is $250.[35]

Note. For more examples showing how the carryover and run-out periods interact, see IRS Notice 2013-71.

ADMINISTRATIVE ISSUES

A health FSA that incorporates a carryover provision may not also provide for a grace period in the plan year to which unused amounts may be carried over. Accordingly, if a plan allows amounts that were unused in a plan year to be carried over to the following plan year, the plan is not allowed to provide for a grace period in that following plan year.[36]

Example 18. The Frick and Frack Partnership has a calendar-year health FSA plan that permits a carryover to 2015 of unused 2014 health FSA amounts. The Frick and Frack health FSA plan is not permitted to also have a grace period in 2015.

If a plan has previously provided for a grace period and is being amended to add a carryover provision, the plan must also be amended to eliminate the grace-period provision by no later than the end of the plan year from which amounts may be carried over.[37]

COMPARISON OF GRACE-PERIOD RULE AND CARRYOVER RULE

The following table summarizes the key features of the grace-period rule and the carryover rule.

	Grace-Period Rule	Carryover Rule
Contribution limit	$2,500 (indexed for inflation)	$2,500 (indexed for inflation)
Carryover limit	All unused amounts may be carried over but must be used during grace period (no more than 2½ months)	Up to $500 (not counted against the $2,500 contribution limit) may be used during entire following plan year
Unspent funds	Any amount that remains in FSA at end of grace period is forfeited	Amount over $500 that remains in FSA at end of original plan year is forfeited

34. Adapted from an example in IRS Notice 2013-71.

35. Ibid.

36. IRS Notice 2013-71, 2013-47 IRB 532.

37. Ibid.

Example 19. Beth contributed $2,500 to her health FSA in 2013. Her total medical expenses totaled $1,800 in 2013. Beth did not contribute any money to her health FSA in 2014. Under the **grace-period rule,** she could be reimbursed up to $700 ($2,500 − $1,800) for medical expenses incurred between January 1, 2014, and March 15, 2014.

Example 20. Use the same facts as **Example 19,** except the health FSA plan offered by Beth's employer contained the **carryover provision** rather than the grace-period provision. Beth can be reimbursed for only $500 of her 2014 medical expenses. The remaining unused amount of $200 is forfeited. However, Beth can be reimbursed for medical expenses incurred at any time during 2014.

LIFE INSURANCE TAXATION ISSUES

SURRENDER OF A WHOLE LIFE POLICY[38]

Whole life policies, unlike term life insurance policies, create cash value. Whole life policy premium payments serve two purposes. Part of the premium is applied to the **cost of insurance** and the other portion funds a **savings account.** Earnings on the savings account portion of the policy are tax-deferred. However, the tax deferral on the savings account earnings ceases if the policy is surrendered to the issuing life insurance company prior to the death of the insured.

The accumulated savings account balance is the **cash value** of the whole life policy. The **surrender value** is the cash value less any surrender fees stated in the policy. In most cases, the basis in the policy is the total premiums paid less any nontaxable cash dividends and policy loans received prior to the surrender.

When a life insurance policy is surrendered for cash, the policyholder must include in income any proceeds that are more than the basis of the policy. The policyholder should receive a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* that shows the total proceeds and the taxable portion. These amounts are reported on lines 16a and 16b of Form 1040.[39]

Example 21. Martin is the insured and owner of a whole life policy that he bought in 1980. He used his policy dividends to buy additional paid-up insurance. In order to pay for his daughter's wedding, he surrendered his policy to the insurer in 2013. His life insurance company determines Martin's $51,000 **taxable gain on the surrender** as follows.

Total premiums paid prior to surrender	$ 75,000
Less: nontaxable loans or dividends received prior to surrender	(0)
Martin's basis in the policy	$ 75,000
Surrender value of the policy (no surrender fees charged)	$126,000
Less: basis in policy	(75,000)
Taxable gain due to the surrender	$ 51,000

38. Rev. Rul. 2009-13, 2009-21 IRB 1029.

39. IRS Pub. 17, *Your Federal Income Tax.*

Martin receives the following 2013 Form 1099-R from the insurance company.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, province or state, country, and ZIP or foreign postal code **Tri-State Life Insurance Company**		**1** Gross distribution $ **126000.00** **2a** Taxable amount $ **51000.00**	OMB No. 1545-0119 **2013** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☒	**Copy 1 For State, City, or Local Tax Department**
PAYER'S federal identification number **41-4356789**	RECIPIENT'S identification number **123-45-0001**	**3** Capital gain (included in box 2a) $	**4** Federal income tax withheld $ **5100.00**	
RECIPIENT'S name **Martin**		**5** Employee contributions /Designated Roth contributions or insurance premiums $ **75000.00**	**6** Net unrealized appreciation in employer's securities $	
Street address (including apt. no.)		**7** Distribution code(s) **7D** IRA/SEP/SIMPLE ☐	**8** Other $ %	
City or town, province or state, country, and ZIP or foreign postal code		**9a** Your percentage of total distribution %	**9b** Total employee contributions $	
10 Amount allocable to IRR within 5 years $	**11** 1st year of desig. Roth contrib.	**12** State tax withheld $ $	**13** State/Payer's state no.	**14** State distribution $ $
Account number (see instructions)		**15** Local tax withheld $ $	**16** Name of locality	**17** Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

Martin reports the surrender of his policy on his 2013 Form 1040 as follows.

get a W-2, see instructions.	**15a** IRA distributions .			**b** Taxable amount . . .	**15b**	
	16a Pensions and annuities	**16a**	**126,000**	**b** Taxable amount . . .	**16b**	**51,000**
	17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E				**17**	

Observations for Example 21

1. The $51,000 gain is reported as **ordinary income** on line 16b of Martin's 2013 Form 1040. It is also subject to the 3.8% NIIT and must be reported on Form 8960, line 7.
2. The insurance company is responsible for calculating the taxable gain from the surrender and for issuing Form 1099-R to report that gain to the taxpayer.
3. The $126,000 surrender value takes into account a subtraction for the cost of insurance protection that Martin received from the inception of the policy to the date of surrender.

If the surrender value is less than the basis in the whole life policy, the loss is considered a **nondeductible personal loss.** This situation could occur if surrender fees or nontaxable policy loans and cash dividends are significant.

> **Note.** For the tax implications of **selling** a life insurance policy (as opposed to surrendering it), see pages 248–249 in the 2011 *University of Illinois Federal Tax Workbook*. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

ESTATE TAX PLANNING

In general, life insurance proceeds paid upon the death of the **insured owner** of a life insurance policy are **included as part of the decedent's gross estate.** However, an **exception** is made if the **policy owner** is one of the following.

1. An irrevocable life insurance trust that is also the beneficiary of the policy
2. An individual other than the decedent who is also the beneficiary of the policy

Note. Once established, the irrevocable life insurance trust cannot be altered or amended.

In most estate tax planning situations, the exception is satisfied by using an irrevocable life insurance trust.

Example 22. Ron is single and his net worth is $8 million. He is advised to buy life insurance to ensure that funds are available to pay the estate taxes that will be due when he dies. If Ron buys a life insurance policy that **designates him as the insured and the owner,** any life insurance proceeds paid upon his death will be included in his gross estate.

Instead, Ron establishes an irrevocable life insurance trust. **The trust is both the owner and beneficiary of the life insurance policy that designates Ron as the insured.** When Ron dies, the life insurance proceeds are paid to the trust. The proceeds are excluded from Ron's gross estate because he never had any ownership rights in the policy.

Note. The use of life insurance proceeds in estate tax planning is a complex legal matter. Any wealthy individual like Ron is advised to consult with an experienced estate tax attorney who can devise a life insurance planning strategy that complies with existing estate tax law. For more information, see pages B232–B234 in the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Succession Planning. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

INSURANCE COMPANY DEMUTUALIZATION

Background Information

Mutual Insurance Companies. A mutual life insurance company has no shareholders. Instead, the policyholders own the mutual insurance company and they have both **ownership rights** and **policyholder rights.** Ownership rights include voting and sharing in distributions made by the mutual insurance company. Policyholder rights are the contractual insurance rights.

Company profits belong to the policyholders. Some of the profit is usually returned to the policyholders as dividends, which has the effect of reducing premium payments. The balance of the annual profit is retained as surplus. The purpose of mutual insurance is to provide policyholders with coverage at the lowest possible cost.

Demutualization. Any mutual insurance company can convert to a publicly traded corporation in order to raise additional capital through an initial public offering (IPO). The popularity of demutualization accelerated beginning in the 1990s. **When an insurance company demutualizes, it issues stock to the policyholders to compensate them for the loss of their mutual ownership rights.** Many former mutual insurance companies have demutualized, including Prudential, Metropolitan Life (MetLife), and Sun Life Assurance Company of Canada (Sun Life).

Demutualization Tax Issue

Demutualization has created a contentious tax issue: When a former mutual insurance policyholder sells the stock received in the publicly traded insurance company, what is the allowable cost basis of this stock?

Any taxpayer who previously owned a mutual insurance policy has a cost basis in the policy equal to the total premiums paid minus any nontaxable dividends, policy loans, or premium refunds received. Treasury regulations[40] state that a taxpayer must allocate the cost basis in the mutual insurance policy to the following two assets.

1. The stock received for the loss of mutual **ownership rights**
2. **Policyholder rights** (the contractual insurance rights)

The IRS Zero Cost Basis Position. The IRS contends that former mutual insurance policyholders did not pay an additional amount for their mutual ownership rights and did not have a realistic expectation of demutualization. The IRS further contends that all the premiums paid by the mutual insurance policyholder were paid to purchase the policy (the policyholder rights). Therefore, a taxpayer's cost basis in the stock received in the publicly traded insurance company is zero. The sales price of such stock, less any expenses of sale, represents a taxable capital gain.

In 2008, the Court of Federal Claims ruled against the IRS in *Fisher, et al. v. U.S.*[41] The court held that the plaintiff's cost basis in the insurance policies that were converted into common stock upon demutualization was determined by the amount of premiums paid.

In a January 2013 District Court case, the plaintiff in *Reuben v. U.S.*[42] relied heavily on the *Fisher* decision. However, **the zero cost basis position of the IRS was upheld in *Reuben*** because the taxpayer failed to show that he had any cost basis in the shares of stock received in the demutualization. This court case was a significant victory for the IRS.

Pro-Taxpayer Decision. Shortly after the **pro-IRS decision** in *Reuben*, the **pro-taxpayer *Dorrance v. U.S.* decision**[43] was released in District Court in March 2013. The rationale of the *Dorrance* court case is important for preparers as they attempt to file accurate amended returns for clients who used the zero cost basis position to calculate capital gains from post-demutualization stock sales.

In 1996, Bennett Dorrance, an heir to the Campbell Soup Company fortune, **purchased numerous life insurance contracts from five mutual insurers** as part of his estate tax planning. All five insurers later demutualized and converted to stock companies. In 2000 and 2001, Mr. Dorrance received stock in the insurance companies as compensation for his loss of mutual rights.

Mr. Dorrance sold the stock received from the five demutualizations in 2003. Consistent with the IRS zero cost position, he and his wife treated the entire sales price of $2.249 million as a long-term capital gain on their joint 2003 tax return. **In 2007, the taxpayers filed an amended 2003 tax return requesting a refund, arguing that they did have a basis in the stock they sold.**

The five mutual life insurance companies demutualized into stock companies to raise additional capital through an IPO, which occurred at the same time as demutualization. When determining how many shares of stock to give to mutual policyholders, the life insurance companies calculated:

1. A **fixed component** for the loss of voting rights, and
2. A **variable component** for the loss of other rights, measured by the policyholder's past and projected future contributions to the company's surplus.

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40. Treas. Reg. §1.61-6(a).

41. *Fisher, et al. v. U.S.,* 82 Fed. Cl. 780 (2008).

42. *Timothy D. Reuben v. U.S.*, No. 2:11-cv-09448 (C.D. Calif. 2013).

43. *Dorrance v. U.S.,* No. 2:09-cv-01284 (D. Ariz. 2013).

Of the **variable component**, the companies estimated that **60%** represented each policyholder's **past contributions to surplus** as of the calculation date. The remaining **40%** was an estimate of **future contributions to surplus.**

When the premiums were paid, Mr. Dorrance had voting rights and the ability to participate in any distribution of the companies' surpluses, regardless of whether that distribution was triggered by a future demutualization. The key question is how to properly allocate cost between mutual **ownership rights** and **policyholder rights** under Treas. Reg. §1.61-6(a).

The court determined that the basis in the stock sold in 2003 was equal to:

1. 100% of the IPO value of the fixed shares received ($3,164), plus
2. 60% of the IPO value of the variable shares received ($1.075 million).

The total basis of the stock was calculated by the court as $1.078 million. Therefore, the taxpayers' 2003 corrected long-term capital gain was $1.171 million ($2.249 million sales price − $1.078 million cost basis). The taxpayers are entitled to a refund of 2003 taxes of $161,719 ($1.078 million cost basis × 15% capital gains tax rate).

Observations Regarding the *Dorrance* Decision

1. The court treated **past contributions to surplus** (60%) as an allowable cost basis. However, **future contributions to surplus** (40%) were omitted in calculating the allowable cost basis.
2. The taxpayers' **total basis** in the stock they sold in 2003 was **slightly greater than 60% of the IPO value** of the shares they received in 2000 and 2001 due to demutualization.

Example 23. Using the facts in the *Dorrance* court case (for only the MetLife stock), the taxpayers received **10 fixed shares** and **2,711 variable shares** of MetLife stock. The IPO price of MetLife stock after the demutualization was $14.25.

- The allowable cost basis in the 10 fixed shares was $143 (**10 shares × $14.25, which was 100% of the IPO price**).
- The allowable cost basis in the 2,711 variable shares was $23,179 (**2,711 shares × $14.25 × 60%**).
- The total allowable cost basis in the 2,721 MetLife shares received was $23,322 ($143 + $23,179).

In addition to receiving the fixed and variable common shares as compensation for the loss of their mutual rights, many former mutual policyholders were given a notice with instructions similar to the following.

> *[Name of the mutual life insurance company]* is in the process of converting to a stock corporation. You will receive a total of 43 shares of *[name of the new stock life insurance corporation]* common stock on *[date]* as compensation for the loss of your mutual rights. Because the shares you will receive are less than 100, you have the right to buy 57 additional shares of *[name of the new stock life insurance corporation]* at the initial public offering (IPO) price. The IPO price will be established on *[date].* If you elect to buy the additional 57 shares, you must return the enclosed form to us no later than *[date].* Once your election to purchase the additional 57 shares is received by us, it cannot be revoked. After the IPO price is established, we will issue a statement to you that computes the amount you must remit to us for the additional 57 shares. No commission will be charged to purchase the additional 57 shares.

A practitioner whose client sells exactly 100 shares of a new stock life insurance corporation should inquire as to whether optional additional shares were purchased. If so, the additional cost must be considered in determining the total cost basis of the 100 shares that were sold.

> **Note.** Preparers should consider filing amended returns for all open years for clients who used the IRS's zero cost basis position in calculating capital gains on sales of stock received due to demutualization. The *Dorrance* case can be cited as authority. Use the formula shown in **Example 23** to arrive at the cost basis of the fixed and variable shares received by the taxpayers.

ACCELERATED DEATH BENEFITS[44]

A life insurance policyholder who is **"terminally ill"** or **"chronically ill"** may decide to surrender the policy to the insurer in order to pay medical bills or other personal expenses. Life insurance companies have recognized this contingency and have designed policies with **accelerated death benefit** (ADB) clauses. This extra protection generally is in the form of a **policy rider** that allows the policyholder the option to accelerate payment of a certain percentage of the death benefit.

The insurance company deducts the ADB payment from the death benefit amount that is ultimately paid to the beneficiary. Events that can trigger the ADB clause include a medical diagnosis of a terminal illness, a diagnosis of a chronic illness, or mental or physical incapacity that requires long-term care.

When a life insurance policy does **not** contain an ADB clause, a **terminally ill** policyholder may decide to sell the policy to a **viatical settlement company.** These companies specialize in buying life insurance policies from terminally ill policyholders.

> **Note.** The instructions for Form 1099-LTC, *Long-Term Care and Accelerated Death Benefits*, refer to "viatical settlement providers" rather than "viatical settlement companies."

In a viatical settlement, the viatical settlement company buys the **terminally ill** policyholder's life insurance contract. In return, the company pays the policyholder a percentage of the death benefit. The payment is typically 50–80% of the stated death benefit. **The viatical settlement company becomes the beneficiary of the policy and receives the full death benefit upon the death of the insured person.** The company is also responsible for paying all remaining premiums.

> **Note.** It is often more beneficial for a policyholder to obtain a policy loan from the insurer rather than selling the policy to a viatical settlement company. This is especially true if the cash surrender value is substantial.

IRC §101(a) provides that **accelerated death benefits and viatical settlements are excluded from gross income** if they are paid "by reason of the death of the insured." The tax advantages differ for **terminally ill** and **chronically ill** policyholders.

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44. IRC §101(g).

Tax Treatment for Terminally Ill Policyholders

Exclusion for Terminal Illness. Accelerated death benefits, including viatical settlement proceeds, are fully excludable from gross income if the insured is a **terminally ill** individual.[45] A terminally ill individual is one who has been certified by a physician as having an illness or physical condition **that can reasonably be expected to result in death within 24 months** from the date of certification.[46] This test of terminal illness is applied in the year of the life insurance or viatical settlement payment.

> **Example 24.** Ellen is diagnosed by her physician as **terminally ill** on August 15, 2013. She is the insured owner of a whole life insurance policy issued by Guaranty Life Insurance Company. It has a stated death benefit of $250,000 and an ADB rider. Ellen never received any policy loans.
>
> The ADB rider states that the insurance company will pay 50% of the death benefit to Ellen due to her terminally ill status. The balance of the death benefit of $125,000 will be paid to Ellen's named beneficiary.
>
> Ellen is advised by her attorney to exercise the ADB option to help her pay unreimbursed medical expenses. She receives the $125,000 ADB payment in 2013. **This amount is excluded from her 2013 gross income.** It does not matter how she spends the $125,000 or whether she recovers from her terminally ill diagnosis and regains her health.
>
> Ellen's 2013 Form 1099-LTC and page 2 of Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*, follow.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no. **Guaranty Life Insurance Company**	1 Gross long-term care benefits paid $ 2 Accelerated death benefits paid $ **125000.00**	OMB No. 1545-1519 **2013** Form **1099-LTC**	**Long-Term Care and Accelerated Death Benefits**	
PAYER'S federal identification number **42-0123456**	POLICYHOLDER'S identification number **333-44-5555**	3 ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no. **333-44-5555**	**Copy B** **For Policyholder** 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 this item is required to be reported and the IRS determines that it has not been reported.
POLICYHOLDER'S name **Ellen** Street address (including apt. no.) City or town, province or state, country, and ZIP or foreign postal code		INSURED'S name **Ellen** Street address (including apt. no.) City or town, province or state, country, and ZIP or foreign postal code		
Account number (see instructions) **3601487**	4 Qualified contract ☐ (optional)	5 (optional) ☐ Chronically ill ☒ Terminally ill	Date certified **08/15/2013**	

Form **1099-LTC** (keep for your records) www.irs.gov/form1099ltc Department of the Treasury - Internal Revenue Service

45. IRC §101(g)(2)(A).

46. IRC §101(g)(4)(A).

For Example 24

Form 8853 (2013) Attachment Sequence No. 39 Page 2

Name of policyholder (as shown on Form 1040)	Social security number of policyholder ▶
Ellen	333-44-5555

Section C. Long-Term Care (LTC) Insurance Contracts. See **Filing Requirements for Section C** in the instructions before completing this section.

If more than one Section C is attached, check here ▶ ☐

14a Name of insured ▶ Ellen **b** Social security number of insured ▶ 333-44-5555

15 In 2013, did anyone other than you receive payments on a per diem or other periodic basis under a qualified LTC insurance contract covering the insured or receive accelerated death benefits under a life insurance policy covering the insured? ☐ **Yes** ☒ **No**

16 Was the insured a terminally ill individual? ☒ **Yes** ☐ **No**

Note: *If "Yes" and the* ***only*** *payments you received in 2013 were accelerated death benefits that were paid to you because the insured was terminally ill, skip lines 17 through 25 and enter -0- on line 26.*

17	Gross LTC payments received on a per diem or other periodic basis. Enter the total of the amounts from box 1 of all Forms 1099-LTC you received with respect to the insured on which the "Per diem" box in box 3 is checked			17	
	Caution: ***Do not*** *use lines 18 through 26 to figure the taxable amount of benefits paid under an LTC insurance contract that is not a* ***qualified*** *LTC insurance contract. Instead, if the benefits are not excludable from your income (for example, if the benefits are not paid for personal injuries or sickness through accident or health insurance), report the amount not excludable as income on Form 1040, line 21.*				
18	Enter the part of the amount on line 17 that is from **qualified** LTC insurance contracts			18	
19	Accelerated death benefits received on a per diem or other periodic basis. Do not include any amounts you received because the insured was terminally ill (see instructions)			19	
20	Add lines 18 and 19			20	
	Note: *If you checked "Yes" on line 15 above, see* ***Multiple Payees*** *in the instructions before completing lines 21 through 25.*				
21	Multiply $320 by the number of days in the LTC period	21			
22	Costs incurred for qualified LTC services provided for the insured during the LTC period (see instructions)	22			
23	Enter the **larger** of line 21 or line 22	23			
24	Reimbursements for qualified LTC services provided for the insured during the LTC period	24			
	Caution: *If you received any reimbursements from LTC contracts issued before August 1, 1996, see instructions.*				
25	Per diem limitation. Subtract line 24 from line 23			25	
26	**Taxable payments.** Subtract line 25 from line 20. If zero or less, enter -0-. Also include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "LTC" and the amount			26	0

Form **8853** (2013)

Note. The U.S. Department of Health and Human Services has stated that policyholders cannot be forced to request ADB payments before qualifying for Medicare. However, once ADB payments are received, those funds could be considered income that negatively affects eligibility for Medicaid.[47]

47. *Q & A: What You Need to Know about Accelerating Life Insurance Benefits.* American Council of Life Insurers. [www.acli.com/Consumers/Life%20Insurance/Pages/Accelerating%20Benefits.aspx?PF=true&Pub=false] Accessed on Jan. 7, 2014.

Example 25. Use the same facts as **Example 24,** except Ellen's whole life insurance policy does **not** contain an ADB rider. Her attorney advises her to sell her policy to a viatical settlement company. After much research to find a reputable company, the attorney suggests that Ellen sell her policy to New England Viatical, Inc. The company offers to buy the policy for 75% of the death benefit amount.

Ellen agrees and sells the policy to New England Viatical, Inc., in 2013 for $187,500 (75% of the $250,000 death benefit). **This $187,500 is excluded from Ellen's 2013 gross income.** Her 2013 Form 1099-LTC follows. (Page 2 of Ellen's Form 8853 is the same as in **Example 24.**)

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no. **New England Viatical Inc.**	1 Gross long-term care benefits paid $ 2 Accelerated death benefits paid $ **187500.00**	OMB No. 1545-1519 **2013** Form **1099-LTC**	**Long-Term Care and Accelerated Death Benefits**
PAYER'S federal identification number **14-0123456** / POLICYHOLDER'S identification number **333-44-5555**	3 ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no. **333-44-5555**	**Copy B For Policyholder**
POLICYHOLDER'S name **Ellen** Street address (including apt. no.) City or town, province or state, country, and ZIP or foreign postal code	INSURED'S name **Ellen** Street address (including apt. no.) City or town, province or state, country, and ZIP or foreign postal code		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 this item is required to be reported and the IRS determines that it has not been reported.
Account number (see instructions) **LC4521** / 4 Qualified contract ☐ (optional)	5 (optional) ☐ Chronically ill ☒ Terminally ill	Date certified **08/15/2013**	

Form **1099-LTC** (keep for your records) www.irs.gov/form1099ltc Department of the Treasury - Internal Revenue Service

> **Note.** Viatical settlement companies are not affiliated with the life insurance industry. Most state insurance departments regulate and license them. There have been numerous documented instances of fraud perpetrated by these companies. Careful research and caution must be exercised before a client is advised to sell a policy to a viatical settlement company.

Tax Treatment for Chronically Ill Policyholders

Exclusion for Chronic Illness. If the insured individual is **chronically ill,** accelerated death benefits paid against costs incurred for qualified long-term care services are **fully excludable** from gross income. However, if these benefits are paid on a per diem or other periodic basis, they are excludable up to a limit. **This limit is applied to the total of the accelerated death benefits plus any periodic payments received from long-term care insurance contracts.**[48]

> **Note.** In most cases, any accelerated death benefits paid to a chronically ill insured individual are made on the per diem basis without regard to actual expenses incurred.

Per Diem Limit. The per diem limit for qualified long-term care is **$320** for 2013[49] and **$330** for 2014[50] multiplied by the number of days in the long-term care period.

48. IRS Pub. 525, *Taxable and Nontaxable Income.*

49. Rev. Proc. 2012-41, 2012-45 IRB 539.

50. Rev. Proc. 2013-35, 2013-47 IRB 537.

Definition of Chronically Ill. A chronically ill individual is one who was certified within the previous 12 months by a licensed health care practitioner as one of the following.[51]

1. A person who is unable to perform at least two activities of daily living for at least 90 days without substantial assistance due to a loss of functional capacity (Activities of daily living include eating, bathing, dressing, toileting, transferring, and continence.)
2. A person who requires substantial supervision in order to be protected from threats to health and safety due to severe cognitive impairment

Example 26. Chad is the insured owner of a whole life insurance policy issued by Lake Erie Life Insurance Company. The policy contains an ADB rider. One of the provisions in the rider states that if Chad is diagnosed as chronically ill, the policy will pay a $175 per diem payment to him. **The $175 per diem payment is to begin 30 days after a physician's diagnosis of chronic illness.** The per diem payment will be made for a maximum of 500 days.

Chad was diagnosed by his physician as **chronically ill** with dementia on December 1, 2012. He entered a nursing home on January 1, 2013, and remained there for all of 2013. The insurance company made the $175 ADB per diem payments to Chad's conservator beginning January 1, 2013. The total of the per diem payments received by the conservator in 2013 was $63,875 ($175 × 365 days). **This amount is excludable from gross income because it is less than the 2013 per diem limit of $116,800** ($320 × 365 days in the 2013 long-term care period).

Note. For life insurance policies that contain an ADB rider, the **monthly benefit** that can be used for nursing home care is typically equal to **2%** of the policy's face value.[52]

Chad's conservator paid the nursing home a total of $73,000 in 2013 ($200 per day × 365). Chad's 2013 Form 1099-LTC and page 2 of his Form 8853 follow.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, province or state, country, ZIP or foreign postal code, and telephone no. **Lake Erie Life Insurance Company**	**1** Gross long-term care benefits paid $ **2** Accelerated death benefits paid $ **63875.00**	OMB No. 1545-1519 **2013** Form **1099-LTC**	**Long-Term Care and Accelerated Death Benefits**
PAYER'S federal identification number **31-2222222** / POLICYHOLDER'S identification number **343-34-3434**	**3** ☒ Per diem ☐ Reimbursed amount	INSURED'S social security no. **343-34-3434**	**Copy B For Policyholder**
POLICYHOLDER'S name **Chad** Street address (including apt. no.) City or town, province or state, country, and ZIP or foreign postal code	INSURED'S name **Chad** Street address (including apt. no.) City or town, province or state, country, and ZIP or foreign postal code		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 this item is required to be reported and the IRS determines that it has not been reported.
Account number (see instructions) **89079** / **4** Qualified contract ☐ (optional)	**5** (optional) ☒ Chronically ill ☐ Terminally ill	Date certified **12/01/2012**	

Form **1099-LTC** (keep for your records) www.irs.gov/form1099ltc Department of the Treasury - Internal Revenue Service

51. IRC §7702B(c)(2).

52. *Using Life Insurance to Pay for Long-Term Care*. U.S. Department of Health and Humans Services. [http://longtermcare.gov/costs-how-to-pay/using-life-insurance-to-pay-for-long-term-care] Accessed on Jan. 7, 2014.

For Example 26

Form 8853 (2013) Attachment Sequence No. 39 Page 2

Name of policyholder (as shown on Form 1040)	Social security number of policyholder ▶
Chad	343-34-3434

Section C. Long-Term Care (LTC) Insurance Contracts. See **Filing Requirements for Section C** in the instructions before completing this section.

If more than one Section C is attached, check here . . . . ▶ ☐

14a	Name of insured ▶ Chad **b** Social security number of insured ▶ 343-34-3434				
15	In 2013, did anyone other than you receive payments on a per diem or other periodic basis under a qualified LTC insurance contract covering the insured or receive accelerated death benefits under a life insurance policy covering the insured? . . . ☐ Yes ☒ No				
16	Was the insured a terminally ill individual? . . . ☐ Yes ☒ No **Note:** *If "Yes" and the* ***only*** *payments you received in 2013 were accelerated death benefits that were paid to you because the insured was terminally ill, skip lines 17 through 25 and enter -0- on line 26.*				
17	Gross LTC payments received on a per diem or other periodic basis. Enter the total of the amounts from box 1 of all Forms 1099-LTC you received with respect to the insured on which the "Per diem" box in box 3 is checked . . .			17	
	Caution: ***Do not*** *use lines 18 through 26 to figure the taxable amount of benefits paid under an LTC insurance contract that is not a* ***qualified*** *LTC insurance contract. Instead, if the benefits are not excludable from your income (for example, if the benefits are not paid for personal injuries or sickness through accident or health insurance), report the amount not excludable as income on Form 1040, line 21.*				
18	Enter the part of the amount on line 17 that is from **qualified** LTC insurance contracts . . .			18	
19	Accelerated death benefits received on a per diem or other periodic basis. Do not include any amounts you received because the insured was terminally ill (see instructions) . . .			19	63,875
20	Add lines 18 and 19 . . .			20	63,875
	Note: *If you checked "Yes" on line 15 above, see* ***Multiple Payees*** *in the instructions before completing lines 21 through 25.*				
21	Multiply $320 by the number of days in the LTC period . . .	21	116,800		
22	Costs incurred for qualified LTC services provided for the insured during the LTC period (see instructions) . . .	22	73,000		
23	Enter the **larger** of line 21 or line 22 . . .	23	116,800		
24	Reimbursements for qualified LTC services provided for the insured during the LTC period . . .	24	0		
	Caution: *If you received any reimbursements from LTC contracts issued before August 1, 1996, see instructions.*				
25	Per diem limitation. Subtract line 24 from line 23 . . .			25	116,800
26	**Taxable payments.** Subtract line 25 from line 20. If zero or less, enter -0-. Also include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "LTC" and the amount . . .			26	0

Form **8853** (2013)

Observations

1. The ADB rider should be seriously considered when purchasing a life insurance policy. The extra premium paid for the rider is usually a relatively small amount. The extra cost is often a percentage of the base premium.
2. An ADB rider does not replace a qualified long-term care insurance contract; the latter protects an individual from depleting their potential life insurance benefits or other forms of savings.
3. A terminally or chronically ill individual may also be able to obtain funds from a reverse mortgage, especially if the equity in their home is substantial.

EMPLOYMENT OF HOUSEHOLD EMPLOYEES

Employment of a household employee (or "domestic worker") results in some special tax issues. Tax practitioners advising taxpayers who employ household employees (HE) must be aware of the following items, which are discussed in this section.

- Whether the worker is an employee or an independent contractor
- The preliminary steps required in connection with the hiring of an HE
- The tax withholding obligations of the employer
- The identity of the employer
- The exemptions for family members and minors

EMPLOYEE OR INDEPENDENT CONTRACTOR

The threshold question regarding a domestic worker is whether the worker is an employee or an independent contractor. If the worker is an HE, the taxpayer who hired the HE is the employer and an employer-employee relationship is deemed to exist. A worker is an employee for federal tax purposes if the worker qualifies as an employee under common law.[53] Under common law, an employer-employee relationship exists when the firm or person for whom the services are performed has the **right to control** and direct the worker in how the services are performed.[54] Right to control refers to the degree of control over the means and details of the worker's tasks. Such control is the hallmark of an employer-employee relationship. It is not necessary for the employer to actually exercise this control. Merely having the **right** to control the worker is sufficient to conclude that the worker is an employee and not an independent contractor.[55]

After reviewing several cases and rulings that followed this common law approach, the IRS identified **20 factors** that it uses to determine whether a worker is an employee or an independent contractor. The IRS notes that these factors are only a guide and that the degree of importance of each factor varies depending on the particular circumstances of each case. The following factors[56] indicate the various aspects of a typical work relationship.

1. **Degree of control over worker services.** A larger degree of control over when, where, and how the worker performs work is indicative of an employer-employee relationship. Independent contractors have more control over their work.
2. **Training and meetings.** Providing worker training and requiring the worker to attend meetings indicates the existence of an employer-employee relationship.
3. **Integration of work performed into firm operations.** Strong integration of the worker's services into other operations of the person who hired the worker is indicative of an employer-employee relationship.
4. **Personal performance of services.** Employees must personally perform services. The same requirement might not be expected of an independent contractor, although there are exceptions. This factor alone is frequently not determinative.
5. **Personnel control.** A firm's control over the hiring, supervision, and payment of the worker's assistants is suggestive of an employer-employee relationship. Independent contractors typically maintain and control their own staff.
6. **Length of working relationship.** A continual, long-term work relationship is indicative of an employer-employee relationship. Such a long-term relationship may also exist with an independent contractor. Therefore, this factor taken alone is not determinative.

53. Rev. Rul. 87-41, 1987-1 CB 296.

54. Ibid.

55. Ibid.

56. Ibid.

7. **Work schedule.** An established work schedule for the worker indicates that an employer-employee relationship exists. Independent contractors generally retain more freedom in scheduling the performance of their services to a firm.

8. **Hours of service required.** Requiring a lengthy period of time from the worker in the performance of services to the firm is indicative of full-time employment within an employer-employee relationship. Conversely, part-time hours worked for one firm or person while the worker also provides work hours for other firms or persons indicates that the worker may be an independent contractor.

9. **Location of services.** Requiring the worker to perform services at the firm's or person's own location tends to suggest an employer-employee relationship. However, because some types of work can only be performed at the firm's or person's worksite or home, this factor alone is not determinative.

10. **Control over work technique.** Control by the firm or person over the worker's technique or order of tasks indicates that an employer-employee relationship exists. A worker who has control over the technique or task order in the performance of services indicates that the worker may be an independent contractor.

11. **Periodic reporting.** Requiring regular, periodic written or verbal reports from the worker to other firm personnel or persons associated with the person for whom services are provided is indicative of an employer-employee relationship. However, requiring progress reports by an independent contractor is also common. Therefore, this factor alone is not determinative.

12. **Payment method.** Payment at regular intervals (hourly, weekly, or monthly) suggests an employer-employee relationship. Alternatively, payment to the worker based on the particular job or project, or based on invoices issued by the worker, is indicative of an independent contractor relationship.

13. **Work-related expenses.** Payment of the worker's business and travel expenses suggests an employer-employee relationship. However, this type of arrangement may also exist between a firm or person and an independent contractor.

14. **Provision of tools.** Tools furnished by the worker indicate that the worker is an independent contractor. Providing the worker with tools suggests the existence of an employer-employee relationship.

15. **Work facilities.** A worker who invests in and provides work facilities is likely to be an independent contractor, particularly if the facilities are of a type not generally maintained by employees.

16. **Profit potential and risk of loss.** Workers who profit from the success of a business and bear the risk of loss from failure are more likely to be independent contractors than employees. Employees are typically paid a fixed amount without regard to profits or losses.

17. **Providing services to multiple firms.** An employee tends to provide services to a single firm or person. In contrast, an independent contractor frequently provides services to a number of firms or persons.

18. **Restrictions on customers.** Workers who regularly and consistently offer their services to the public are more likely to be independent contractors.

19. **Firm's right of termination.** The ability of a firm or person to terminate the worker for any reason and without penalty suggests an employer-employee relationship. The presence of penalties to the firm upon termination without cause may be indicative of a higher degree of worker independence, which is more characteristic of an independent contractor relationship.

20. **Worker's right of termination.** Having the ability to terminate the relationship with the firm or person at any time without penalty is indicative of an employer-employee relationship.

Note. The IRS applies these 20 factors to a wide variety of employment and independent contractor situations. Some factors may be more directly applicable than others to a typical household employment situation.

Tax Court Test

To determine whether a worker is an employee or independent contractor, the Tax Court considers the following **seven factors.**[57]

1. The degree of the firm's (or person's) control over the worker
2. The worker's investment in work facilities
3. Profit or loss potential for the worker
4. The degree of ease with which the firm or person can discharge the worker
5. The degree of integration of the worker's services to the firm's (or person's) principal function
6. The temporary or permanent nature of the relationship
7. The parties' understanding of the nature of their relationship

> **Note.** The IRS "20 factor" test is outlined by the IRS in a revenue ruling. The Tax Court is not bound by pronouncements in revenue rulings. The weight the Tax Court gives to a revenue ruling in a case depends upon "the persuasiveness and consistency" of the IRS's position with respect to the revenue ruling over time.[58]

PRELIMINARY STEPS

The tax practitioner advising a taxpayer who intends to employ an HE needs to be aware of several preliminary requirements, which include citizenship documentation and obtaining an employer identification number (EIN).

U.S. Citizenship and Immigration Requirements

As with any U.S. employer, the employer of an HE must ensure that the HE can legally work in the United States under laws enforced by the U.S. Citizenship and Immigration Services (USCIS) by completing USCIS Form I-9. To complete the form, the employer must examine documents of the employee that constitute sufficient proof of the employee's ability to lawfully work in the United States.

> **Note.** USCIS Form I-9 outlines a list of documents that may be accepted by the employer as sufficient proof of the employee's ability to lawfully work in the United States. This form may be found at **www.uscis.gov/sites/default/files/files/form/i-9.pdf.** Form I-9 is not filed with the USCIS but must be retained by the employer for the later of three years after the hiring date or for one year after the termination of the employee's services.

There may be substantial civil penalties for failure to complete Form I-9. The penalties generally range from $375 per violation to $16,000 for repeated violations.[59] Criminal penalties may also be imposed, which include fines and up to six months in prison per violation.[60]

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57. *Herman v. Comm'r*, TC Memo 1986-590 (Dec. 18, 1986).
58. *Taproot Administrative Services, Inc. v. Comm'r,* 133 TC 202 (2009), *aff'd* 679 F.3d 1109 (9th Cir. 2012).
59. *Penalties.* Nov. 23, 2011. U.S. Citizenship and Immigration Services. [www.uscis.gov/i-9-central/penalties] Accessed on Apr. 15, 2014.
60. Ibid.

Application for Employer Identification Number

Employment of an HE requires the employer to obtain an EIN from the IRS.[61] The employer must have an EIN to use in connection with the tax withholding obligations associated with the compensation paid to the employee (discussed in the next section). An EIN may be obtained by either of the following two methods.

- Complete and file Form SS-4, *Application for Employer Identification Number*
- Use the online EIN application system provided by the IRS through its website at **https://sa1.www4.irs.gov/modiein/individual/index.jsp**

TAX WITHHOLDING OBLIGATIONS OF THE EMPLOYER

If a taxpayer pays an HE cash wages of $1,900 or more for 2014 ($1,800 during 2013),[62] they must generally withhold 6.2% of social security and 1.45% of Medicare taxes from those wages and transmit that amount (along with a matching employer's share of social security and Medicare taxes) directly to the IRS.

Instead of withholding the HE's share of the tax, the taxpayer may instead choose to pay the HE's share of social security and Medicare taxes from the taxpayer's own funds. If the taxpayer chooses to pay the HE's share of the social security and Medicare taxes, the taxpayer must "gross up" the HE's income in the amount of the taxes paid on their behalf.

Example 27. Debbie broke her ankle when the clasp on her porch swing snapped. Denny was hired to assist Debbie over her long recovery period. Denny needed all his salary in order to make ends meet, so Debbie agreed to pay his share of social security and Medicare taxes. Denny's wages and deductions are calculated as follows.

Wages	$20,000 [a]
Social security and Medicare (7.65%)	1,530
Wages reported in Box 1 of W-2	$21,530

[a] Reported in Box 3 and Box 5 of the W-2.

Denny's Form W-2 follows.

61. *Do You Need an EIN?* Jan. 3, 2014. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Do-You-Need-an-EIN] Accessed on Apr. 16, 2014.

62. IRS Pub. 926, *Household Employer's Tax Guide.*

For Example 27

a Employee's social security number: 111-22-3333	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 11-9996633	**1** Wages, tips, other compensation: 21530.00	**2** Federal income tax withheld
c Employer's name, address, and ZIP code: Debbie Carry, 123 Payne Lane, Ray, IL 69999	**3** Social security wages: 20000.00	**4** Social security tax withheld: 1240.00
	5 Medicare wages and tips: 20000.00	**6** Medicare tax withheld: 290.00
	7 Social security tips	**8** Allocated tips
d Control number	**9**	**10** Dependent care benefits
e Employee's first name and initial / Last name / Suff.: Denny Mayer, 900 Village St., Ray, IL 69999	**11** Nonqualified plans	**12a** See instructions for box 12 (Code)
	13 Statutory employee / Retirement plan / Third-party sick pay	**12b** (Code)
	14 Other	**12c** (Code)
f Employee's address and ZIP code		**12d** (Code)

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL	11-9996633	21530.00				

Form **W-2** **Wage and Tax Statement** 2014

Department of the Treasury—Internal Revenue Service

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

The employer may report the social security and Medicare taxes on Schedule H, *Household Employment Taxes.* Generally, this form is attached to the employer's Form 1040, and the liability for the social security and Medicare taxes is included on the Form 1040 and paid with the return. However, if the employer is not required to file a Form 1040, Schedule H may be signed and filed separately with an accompanying payment.

> **Note.** The appropriate address that should be used to file Schedule H separately (when it does not accompany the employer's Form 1040) depends on the employer's state of residence and can be found in the Schedule H instructions. The address is generally different from the Form 1040 filing address.

Alternate Procedure

The employer of an HE may have a business through which social security and Medicare taxes are withheld in connection with compensation paid to the employees of the business. Instead of using Schedule H, the employer may choose to report the HE's withholding amounts along with those of the business employees if the business files one of the following forms.[63]

- Form 941, *Employer's Quarterly Federal Tax Return*
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*
- Form 944, *Employer's Annual Federal Tax Return*

> **Note.** This procedure does not make the expenses for the HE tax deductible.

The employer must also provide the HE with a Form W-2, *Wage and Tax Statement,* in connection with the HE's compensation for the year.

63. Instructions for Schedule H.

Federal Unemployment Tax Obligation

The employer of an HE is liable for the payment of federal unemployment tax (FUTA) if compensation of $1,000 or more was paid in any current or prior quarter in connection with the HE's compensation. The FUTA rate for 2013 and 2014 is 6% and is payable only on the first $7,000 of wages paid to the HE. However, a credit of up to 5.4% may be taken by employers that also pay state unemployment taxes, resulting in a net FUTA rate of 0.6%.

> **Example 28.** Geraldo is 81 years old and resides in Illinois. He requires assistance with preparing meals and household chores because of his health issues. He hires Larissa to provide the necessary assistance in his home each day. Larissa is paid $2,000 per month during 2013. Larissa does not request that Geraldo withhold income tax. Because Larissa is paid more than $1,800 during 2013, Geraldo must withhold and pay social security and Medicare tax in connection with Larissa's compensation. However, because Larissa did not request income tax withholding, Geraldo is not obligated to withhold any income tax from Larissa's compensation. Geraldo's tax preparer Ramona prepares the following Form W-2 for Larissa and the Schedule H that is attached to Geraldo's 2013 tax return.

a Employee's social security number **945-45-4545**	OMB No. 1545-0008	This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.

b Employer identification number (EIN) **38-1234567**	**1** Wages, tips, other compensation **24000.00**	**2** Federal income tax withheld
c Employer's name, address, and ZIP code **Geraldo Lazzarro** **125 Maple Road** **Chicago, IL 63303**	**3** Social security wages **24000.00**	**4** Social security tax withheld **1488.00**
	5 Medicare wages and tips **24000.00**	**6** Medicare tax withheld **348.00**
	7 Social security tips	**8** Allocated tips
d Control number	**9**	**10** Dependent care benefits
e Employee's first name and initial Last name Suff. **Larissa M. Edwards** **5656 West Boulevard** **Chicago, IL 63303**	**11** Nonqualified plans	**12a** See instructions for box 12 Code
	13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	**12b** Code
	14 Other	**12c** Code
f Employee's address and ZIP code		**12d** Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL	38-1234567	24000.00				

Form **W-2** Wage and Tax Statement **2013**

Department of the Treasury—Internal Revenue Service

Copy C—For EMPLOYEE'S RECORDS (See *Notice to Employee* **on the back of Copy B.)**

Safe, accurate, FAST! Use IRS e-file

For Example 28

SCHEDULE H (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

▶ Attach to Form 1040, 1040NR, 1040-SS, or 1041.

▶ Information about Schedule H and its separate instructions is at *www.irs.gov/form1040*.

OMB No. 1545-1971

2013

Attachment Sequence No. **44**

Name of employer: Geraldo Lazzarro

Social security number: 056 55 5999

Employer identification number: 38 1234567

Calendar year taxpayers having no household employees in 2013 do not have to complete this form for 2013.

A Did you pay **any one** household employee cash wages of $1,800 or more in 2013? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions before you answer this question.)

☒ **Yes.** Skip lines B and C and go to line 1.
☐ **No.** Go to line B.

B Did you withhold federal income tax during 2013 for any household employee?

☐ **Yes.** Skip line C and go to line 7.
☐ **No.** Go to line C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2012 or 2013 to **all** household employees? (**Do not** count cash wages paid in 2012 or 2013 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Do not file this schedule.
☐ **Yes.** Skip lines 1-9 and go to line 10.

Part I **Social Security, Medicare, and Federal Income Taxes**

1	Total cash wages subject to social security tax	1	24,000		
2	Social security tax. Multiply line 1 by 12.4% (.124)			2	2,976
3	Total cash wages subject to Medicare tax	3	24,000		
4	Medicare tax. Multiply line 3 by 2.9% (.029)			4	696
5	Total cash wages subject to Additional Medicare Tax withholding	5			
6	Additional Medicare Tax withholding. Multiply line 5 by 0.9% (.009)			6	
7	Federal income tax withheld, if any			7	
8	**Total social security, Medicare, and federal income taxes.** Add lines 2, 4, 6, and 7			8	3,672

9 Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2012 or 2013 to **all** household employees? (**Do not** count cash wages paid in 2012 or 2013 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Include the amount from line 8 above on Form 1040, line 59a. If you are not required to file Form 1040, see the line 9 instructions.

☒ **Yes.** Go to line 10.

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 12187K **Schedule H (Form 1040) 2013**

For Example 28

Schedule H (Form 1040) 2013 Page 2

Part II Federal Unemployment (FUTA) Tax

			Yes	No
10	Did you pay unemployment contributions to only one state? (If you paid contributions to a credit reduction state, see instructions and check "No.")	10	×	
11	Did you pay all state unemployment contributions for 2013 by April 15, 2014? Fiscal year filers see instructions	11	×	
12	Were all wages that are taxable for FUTA tax also taxable for your state's unemployment tax?	12	×	

Next: If you checked the **"Yes"** box on **all** the lines above, complete Section A.
If you checked the **"No"** box on **any** of the lines above, skip Section A and complete Section B.

Section A

13	Name of the state where you paid unemployment contributions ▶ IL				
14	Contributions paid to your state unemployment fund	14	697		
15	Total cash wages subject to FUTA tax			15	7,000
16	**FUTA tax.** Multiply line 15 by .6% (.006). Enter the result here, skip Section B, and go to line 25			16	42

Section B

17 Complete all columns below that apply (if you need more space, see instructions):

(a) Name of state	(b) Taxable wages (as defined in state act)	(c) State experience rate period From	(c) To	(d) State experience rate	(e) Multiply col. (b) by .054	(f) Multiply col. (b) by col. (d)	(g) Subtract col. (f) from col. (e). If zero or less, enter -0-.	(h) Contributions paid to state unemployment fund

18	Totals	18			
19	Add columns (g) and (h) of line 18	19			
20	Total cash wages subject to FUTA tax (see the line 15 instructions)			20	
21	Multiply line 20 by 6.0% (.060)			21	
22	Multiply line 20 by 5.4% (.054)	22			
23	Enter the **smaller** of line 19 or line 22 (Employers in a credit reduction state must use the worksheet on page H-7 and check here) ☐			23	
24	**FUTA tax.** Subtract line 23 from line 21. Enter the result here and go to line 25			24	

Part III Total Household Employment Taxes

25	Enter the amount from line 8. If you checked the "Yes" box on line C of page 1, enter -0-	25	3,672
26	Add line 16 (or line 24) and line 25	26	3,714

27 Are you required to file Form 1040?

☒ **Yes. Stop.** Include the amount from line 26 above on Form 1040, line 59a. **Do not** complete Part IV below.

☐ **No.** You may have to complete Part IV. See instructions for details.

Part IV Address and Signature— Complete this part **only** if required. See the line 27 instructions.

Address (number and street) or P.O. box if mail is not delivered to street address | Apt., room, or suite no.

City, town or post office, state, and ZIP code

Under penalties of perjury, I declare that I have examined this schedule, including accompanying statements, and to the best of my knowledge and belief, it is true, correct, and complete. No part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Employer's signature ▶ Date

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

Schedule H (Form 1040) 2013

Note. The unemployment rules and contribution rates vary between the states and the tax practitioner should consult these rules for the state in which the HE is employed. Some states are **"credit reduction states,"** in which only a partial credit for state unemployment contributions is allowed against FUTA. For further details, see the instructions to Schedule H.

After completing the Schedule H to accompany Geraldo's return, Ramona ensures that Geraldo's social security, Medicare, and FUTA tax liability of $3,714 is properly shown on Geraldo's Form 1040, as follows.

Other Taxes	56		56	
	57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919	57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
	59a	Household employment taxes from Schedule H	59a	3,714
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b	
	60	Taxes from: **a** ☐ Form 8959 **b** ☐ Form 8960 **c** ☐ Instructions; enter code(s)	60	
	61	Add lines 55 through 60. This is your **total tax** ▶	61	

Note. The employer must also take into account any state income tax and unemployment tax obligations. For example, in Illinois, income tax must generally be withheld whenever the employer must withhold federal income tax.[64] Payment may be made with the Illinois state income tax return. Further details on the Illinois tax withholding and filing requirements may be found in Illinois Department of Revenue Pub. 121, *Illinois Income Tax Withholding for Household Employees.*

IDENTITY OF THE EMPLOYER

Generally, the employer is the person for whom the HE performs household services, regardless of the nature of the services provided.[65] Typically, the person who has the right of control over the HE under the right-of-control test (discussed earlier) is the employer, even if that person does not actually exercise control over the HE.[66] The right to terminate the HE is also an important factor in determining the identity of the employer.[67] However, if the person for whom the HE provides services does not control the payment of compensation to the HE, then the employer is the person who **does** control compensation payments.[68] When it is unclear who the employer is, an examination of the facts and circumstances may be necessary to determine the identity of the employer.[69]

Observation. Particularly in family situations, it is essential for the tax practitioner to clearly identify who the employer is, because it is the employer who has reporting and withholding obligations for the HE's employment.[70] Issuing a hiring letter that makes it clear who the employer is and making compensation payments consistently from an appropriate account belonging to the employer helps eliminate issues that could arise because of lack of clarity regarding the identity of the employer.

Example 29. Use the same facts as **Example 28,** except Geraldo's daughter, Norina, pays Larissa from her own checking account. Norina stops by Geraldo's house each month to meet with her father and Larissa and to give Larissa her monthly paycheck. Even if Geraldo supervises Larissa and instructs her daily on how to complete the household chores, Norina is the employer because she controls the payment of compensation to Larissa. Norina, as the employer, is the person with the tax withholding and reporting obligations. Accordingly, a Schedule H must accompany Norina's tax return.

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64. *Withholding Income Tax for Household Employees.* Illinois Department of Revenue. [http://tax.illinois.gov/Individuals/SpecialFilingRequirements/householdemployer.htm] Accessed on Apr. 16, 2014.

65. IRC §3401(d).

66. Treas. Reg. §31.3401(c)-1(b).

67. Ibid.

68. IRC §3401(d)(1); and Treas. Reg. §31.3401(d)-1(f).

69. Treas. Reg. §31.3401(c)-1(d).

70. Treas. Reg. §31.3401(d)-1(h).

Example 30. Use the same facts as **Example 29,** except Norina pays Larissa by issuing a check from Geraldo's account. She can sign the checks because she has Geraldo's power of attorney. However, Geraldo could sign checks himself if necessary. It is likely that Geraldo will be considered the employer because he not only has the right of control over Larissa's employment duties, but he also has the legal authority to pay her. Accordingly, as the employer, Geraldo has the reporting and tax obligations associated with Larissa's employment.

EXEMPTIONS FOR FAMILY EMPLOYEES AND MINORS

Most types of employment are subject to social security and Medicare taxation, and the employer is obligated to withhold and pay these amounts based on the employee's compensation.[71] However, there is an exception for any HE who is the employer's:

- Spouse,
- Child under the age of 21,
- Parent, or
- Employee who was under the age of 18 at any time during the year.[72]

However, a parent's wages are subject to social security and Medicare taxation if **both** of the following conditions apply.[73]

- The son or daughter employing the parent has a child living in the home who is under age 18 or had a mental or physical condition that required the personal care or the supervision of an adult for at least four continuous weeks during the calendar quarter in which the parent provides employment services.
- The son or daughter employing the parent is a widow or widower, or is divorced and has not remarried, or has a mentally or physically impaired spouse living in the home who is incapable of caring for the child during a continuous 4-week period during the calendar quarter.

In addition, if the employer's HE is related to that employer in one of the following ways, compensation to that HE is exempt from FUTA taxataion.

- Spouse
- Parent
- Child under the age of 21[74]

Amounts subject to the preceding exceptions are not shown within the appropriate sections of Schedule H relating to social security and Medicare taxes or FUTA tax.

> **Note.** Although the preceding federal exceptions are available for employees who are family members and minors, the tax practitioner must consult state rules to determine whether any exemptions exist for state tax withholding or state unemployment contributions. Federal and state rules frequently differ in this area, and the rules vary from state to state.

71. IRC §3121.
72. Instructions for Schedule H; and IRC §3121(b)(3).
73. Instructions for Schedule H.
74. IRC §3306(c)(5).

MASTER LIMITED PARTNERSHIPS

INTRODUCTION

A master limited partnership (MLP) is a publicly traded partnership (PTP), or a limited partnership in which the interests are traded on public securities exchanges. The term MLP generally applies to PTPs that operate active businesses.[75]

Due to the recent increase in the number of MLP investments available and the number of MLP investors, it is more important than ever for tax practitioners to understand both the nature of these investments and their tax treatment. There are currently close to 130 MLPs trading on major exchanges or, in a few cases, over the counter.[76]

The following table illustrates the changes in industry concentration for MLPs from 1990 to 2013.[77]

Industry	1990	2013
Oil and gas midstream and downstream	10%	51%
Oil and gas exploration and production (upstream)	21%	12%
Propane	0%	3%
Oil and gas marine transportation	1%	5%
Coal leasing of production	0%	4%
Other natural resources	5%	7%
Real estate: income properties	14%	2%
Real estate: developers, homebuilders	4%	0%
Real estate: mortgage securities	13%	2%
Hotels, motels, restaurants	12%	0%
Investment/financial	6%	9%
Other businesses	15%	4%

HISTORY

The first MLP was formed in 1981. MLPs were designed to raise capital from smaller investors by offering a partnership investment in an affordable and liquid security.[78] The first MLPs were involved in oil and natural gas exploration and production, restaurants, and other consumer activities.[79] Examples of MLP operations include the following.[80]

- Motels (La Quinta Motor Inns Limited Partnership/Aircoa Hotel Partners, LP)
- Real estate (National Realty LP)
- Amusement parks (Cedar Fair, LP)
- Cable television systems (Falcon Cable Systems Company)
- Casinos (Sahara Casino Partners LP)
- Professional sports teams (Boston Celtics Limited Partnership)

75. *Investors' Frequently Asked Questions*. National Association of Publicly Traded Partnerships. [www.naptp.org/InvestorRelations/IRFAQs.htm] Accessed on Jan. 29, 2014.

76. *Master Limited Partnerships 101: Understanding MLPs*. Oct. 4, 2013. National Association of Publicly Traded Partnerships. [www.naptp.org/documentlinks/Investor_Relations/MLP_101.pdf] Accessed on Jan. 24, 2014.

77. Ibid.

78. Ibid.

79. *MLP Primer Fifth Edition*. Oct. 31, 2013. Wells Fargo Securities, LLC. [www.naptp.org/documentlinks/Investor_Relations/WF_MLP_Primer_V.pdf] Accessed on Jan. 24, 2014.

80. *Master Limited Partnerships — 101*. Latham & Watkins LLP. [www.lw.com/MLP-Portal/101] Accessed on Jan. 24, 2014.

As MLPs became more popular in the early 1980s, Congress enacted legislation to restrict the types of businesses that could operate as MLPs. Congress acted in order to stem the perceived loss of tax revenue from MLPs, which, unlike corporations, do not pay federal income taxes. As flow-through entities, the income earned by MLPs is passed through to its investors, who pay income tax at their individual rates.[81]

The Revenue Act of 1987 mandated that publicly traded partnerships (e.g., MLPs) be treated as corporations for federal income tax purposes. An exception was provided for certain partnerships that earn at least 90% of their gross income from natural resource activities. If the MLP **fails** to meet the 90% test, it is taxed as a corporation.[82] The 90% test is discussed later.

Today, most MLPs operate in the energy sector. Approximately 80% of MLPs earn income from natural resources.[83]

STRUCTURE

An MLP consists of the limited partners, known as **unitholders,** and a general partner. Unitholders are entitled to cash distributions from the business, but they do not actively manage the business or control the assets of the partnership. General partners also own units in the partnership, which entitles them to distributions, and they receive compensation for the management of the partnership.

General partners typically receive incentive distributions. These are typically based on quarterly distributions paid to the unitholders. Usually, under the incentive formula, the higher the quarterly distributions paid to the unitholders, the higher the management fee paid to the general partner, which can be an incentive for the general partner to pursue income-producing projects in an effort to maximize distributions.[84]

INVESTMENT ADVANTAGES

Several factors support an investment in an MLP.

- The tax-deferral aspect of an MLP for the program sponsor also provides a “tax shield” to the investors. At the time of the IPO, there is a focus on the relationship between the amount of cash distributions by the MLP and the amount of taxable income allocated to its unitholders. The excess of the cash distributed over the amount of taxable income allocated to the common unitholders is treated as a nontaxable return of basis. This is referred to as the “tax shield.”[85] By taking advantage of this tax shield, the MLP can build and operate low-return assets and still provide a rate of return that will attract investors.[86]

Example 31. L&M Energy is an MLP. When it sells its initial units in an IPO, it provides for a 10% yield and an 80% tax shield. At the IPO, the units sell for $30 each. Its investors receive a yield of $3 per share ($30 × 10% yield rate). Of this $3 yield, $2.40 (80% tax shield rate × $3) is a nontaxable return of basis, and the remaining $0.60 is income.

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81. *Master Limited Partnerships (MLPs): A General Primer.* Fenn, Tim. Jul. 2012. Latham & Watkins LLP. [www.lw.com/admin/Upload/Documents/MLP/Resources/Latham%20Master%20Limited%20Partnerships%20Primer.pdf] Accessed on Jan. 24, 2014.

82. IRC §7704.

83. *Midstream Energy MLPs Primer 3.0.* Apr. 17, 2013. Morgan Stanley. [www.morganstanleyfa.com/public/projectfiles/4735a09e-c35d-4545-a059-8873c8d057f0.pdf] Accessed on Jan. 27, 2014.

84. *Strong Parents Make Healthy MLPs.* Gue, Elliott H. Oct. 10, 2009. Investing Daily. [www.investingdaily.com/12833/strong-parents-makehealthy-mlps] Accessed on Jan. 27, 2014.

85. Ibid.

86. *MLP Parity Act: Disrupting Distributed Energy.* Pentland, William. Jun. 10, 2013. Forbes. [www.forbes.com/sites/williampentland/2013/06/10/mlp-parity-act-disrupting-distributed-energy] Accessed on Jan. 31, 2014.

- Most MLPs distribute cash far in excess of the amount of taxable income they distribute to the unitholders.[87]
- An MLP is a tax-efficient way to invest in the energy sector and receive current income with a lower risk.[88]
- Investors generally receive quarterly distributions and a consistent cash flow.
- MLP distributions are an incentive for the general partner to grow the business. Most MLP general partners receive a greater share of cash flow as the cash distributions to withholders increase. This gives general partners an incentive to increase distributions to withholders.[89]
- MLP depreciation is not a cash expense but does reduce taxable income, which allows larger cash distributions.
- Upon the death of an investor, the heirs acquire the MLP units on a stepped-up basis to their fair market value (FMV).

INVESTMENT DISADVANTAGES

Investors should be aware of the potential disadvantages to MLPs.

- The tax advantages of an MLP are lost if the MLP is held by a tax-exempt investor such as an IRA or 401(k) account. This is because most of the income produced by the MLP is unrelated business taxable income (UBTI), which triggers a reporting obligation and subjects the tax-exempt investor to income tax on their share of the MLP's UBTI.[90]
- Non-U.S. persons should also avoid investing in an MLP. The investment requires them to file a U.S. income tax return because the ownership of units is considered "effectively connected income" (ECI). They would be required to pay income tax at ordinary rates on their share of net income or gain. The Code requires MLPs to withhold taxes on quarterly gross distributions to foreign investors at the highest federal tax rate, even if the income allocation is substantially less than the actual gross distribution.[91]
- Mutual funds that are operated as regulated investment companies have a limited ability to invest in MLPs. Under IRC §851(b)(3)(B), no more than 25% of the value of the mutual fund's total assets can be invested in MLP securities. If the mutual fund fails this test, it will lose its pass-through status for federal income tax purposes and be taxed as a corporation.[92]
- When the investment in an MLP is sold, a large portion of the gain is depreciation recapture taxed at ordinary income rates.
- Tax reporting of an MLP investment is considerably more complex than an investment in stocks and bonds.
- The MLP may have operations in a number of states. Technically, the investor may be required to file tax returns in all of these states. However, for most investors, the amount of income allocated for each state is small enough that they are not required to file these state income tax returns.[93]
- Many MLP Schedules K-1 suggest that a unitholder may have an IRC §§751 and/or 754 disclosure requirement. Tax practitioners should study the Schedule K-1 carefully to determine whether these types of disclosures may be required.[94]

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87. *Master Limited Partnerships — 101.* Latham & Watkins LLP. [www.lw.com/MLP-Portal/101] Accessed on Jan. 24, 2014.

88. *Master Limited Partnerships: Primer 2nd Edition.* Aug. 23, 2005. Wachovia Capital Markets, LLC. [www.naptp.org/documentlinks/05Wacovia.pdf] Accessed on Jan. 31, 2014.

89. *Benefits of MLPs.* Morningstar, Inc. [http://news.morningstar.com/classroom2/course.asp?docId=145579&page=4&CN=] Accessed on Jan. 31, 2014.

90. *Master Limited Partnerships — 101.* Latham & Watkins LLP. [www.lw.com/MLP-Portal/101] Accessed on Jan. 24, 2014.

91. Ibid.

92. Ibid.

93. *Investors' Frequently Asked Questions.* National Association of Publicly Traded Partnerships. [www.naptp.org/InvestorRelations/IRFAQs.htm] Accessed on Jan. 29, 2014.

94. *A Practical Guide to the Tax Issues of Investing in Master Limited Partnerships.* Magana, Adam. Aug. 1, 2008. AICPA. [www.aicpa.org/publications/taxadviser/2008/aug/pages/apracticalguidetothetaxissuesofinvestinginmasterlimitedpartnerships.aspx] Accessed on Jan. 31, 2014.

ENTITY COMPARISON

There are major differences between a corporation, LLC, and MLP. These are shown in the following table.[95]

Characteristic	Corporation	LLC	MLP
Passthrough entity	No	Yes	Yes
Method of tax reporting	Form 1099-DIV	Schedule K-1	Schedule K-1
Management control	Officers	Members	General partner
Investor voting rights	Yes	Yes	No
Taxation at entity level	Yes	No	No
Tax-deferred distributions	No	Yes	Yes
Incentive distribution rights	No	No	Yes

BASIS

The basis of an MLP investment is calculated the same as for any other partnership. The beginning basis is the price paid for the investment. The basis is increased by the unitholder's share of the profits, partnership debts, and any additional money invested in the partnership. The basis is decreased by the unitholder's share of the losses, any reduction in debt, or any money distributed.

Example 32. In March 2013, Fredrick invested in C & M Energy LP (C&M), which is an MLP. He purchased 1,000 units for $18 per unit. During 2013, C&M allocated income of $0.36 per unit, which consisted of $2 of income minus $1.64 of depreciation. C&M distributed $1,440 of cash ($1.44 per unit) to Fredrick in 2013. At the end of 2013, Frederick has a basis in C&M of $16,920.

Beginning basis		$ 0
Capital contributions ($18 × 1,000 units)		18,000
Income ($2 × 1,000 units)	$2,000	
Less: depreciation ($1.64 × 1,000 units)	(1,640)	
Current year income (loss)	$ 360	360
Less: distributions ($1.44 × 1,000 units)		(1,440)
Ending basis		$16,920

An MLP's distributions normally exceed its earnings. Therefore, the investor's basis decreases each year. When the investor's basis is reduced to zero, the distributions are fully taxable as capital gains.

When an investor sells their units, the taxable gain is the difference between the sales price and the investor's adjusted basis. The gain is taxed as follows.[96]

1. The portion of the gain attributable to depreciation recapture is taxed at ordinary income rates.
2. The portion of the gain attributable to "ordinary income" assets (e.g., substantially appreciated inventory and unrealized receivables) is also taxed as ordinary income.
3. The remainder of the gain is taxed at capital gain rates.

95. *Master Limited Partnerships 101: Understanding MLPs.* Oct. 4, 2013. National Association of Publicly Traded Partnerships. [www.naptp.org/documentlinks/MLP_101.pdf] Accessed on Jan. 24, 2014.

96. *Basic Tax Principles for MLP Investors.* National Association of Publicly Traded Partnerships. [www.naptp.org/PTP101/Print/Basic_Tax_Principles.pdf] Accessed on Jan. 27, 2014.

Example 33. Use the same facts as **Example 32.** In January 2014, Fredrick sold his 1,000 units of C&M for $20 each. His gain is calculated as follows.

Sale of units in 2014 (1,000 units × $20)	$20,000
Basis on December 31, 2013	(16,920)
Total gain	$ 3,080

Of the $3,080 gain, $1,640 is depreciation recapture and $1,440 is capital gain.

MLP INCOME

Under IRC §7704, a PTP is treated as a corporation if its interests are traded on an established securities market or if the interests are readily tradable on a secondary market.[97] There is an exception for partnerships with passive-type income meeting the **90% gross qualifying income test.** The exception does not apply to a partnership with the principal activity of buying and selling commodities, options, futures, or forwards with respect to commodities.[98]

Qualifying Income

Qualifying income, for purposes of IRC §7704, includes the following.[99]

1. Interest
2. Dividends
3. Real property rents
4. Gain from the sale or other disposition of real property
5. Income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel (as defined in IRC §6426(b), (c), (d), or (e)), alcohol fuel (as defined in §6426(b)(4)(A), or biodiesel fuel (as defined in IRC §40A(d)(1))
6. Any gain from a sale or disposition of a capital asset held for the production of income, as described in the preceding items 1–5

PASSIVE LOSS

As mentioned earlier in this section, an MLP unitholder is a limited partner. As such, they do not materially participate in the operation. This means that **any losses incurred are passive losses, which can only be used to offset passive gains.**

In addition, more restrictive passive loss rules apply to MLPs. A passive activity limitation is applied **separately** to items from each MLP. **A net passive loss from an MLP cannot be deducted from other passive income.** Instead, an MLP's net passive loss is suspended and carried forward to be applied against passive income from the same MLP in subsequent years.[100]

If the unitholder has an overall gain from an MLP, the net gain is nonpassive income. The nonpassive income is included in investment income to calculate the unitholder's investment interest expense deduction.[101]

97. IRC §§7704(a) and (b).
98. IRC §7704(c)(3).
99. IRC §7704(d)(1).
100. Partner's instructions for Schedule K-1 (Form 1065).
101. Ibid.

Passive income, gains, or losses from an MLP are **not** reported on Form 8582, *Passive Activity Loss Limitations.* Instead, the tax preparer should use the following rules to calculate and report the income, gains, and losses from the passive activities of each MLP owned by the taxpayer during the tax year.[102]

1. Combine any current year income, gains, and losses and any prior year unallowed losses to determine whether the taxpayer has an overall loss from the MLP.
2. If the taxpayer has an overall gain, the net gain is nonpassive income. All gains and allowed losses from the activity are reported on the forms or schedules normally used. "From PTP" should be entered to the left of each entry space.

Example 34. Phyllis owns units in Oil and Gas MLP (O&G). For 2013, she has $8,000 of income from O&G. She also has a Form 4797 prior year unallowed loss of $3,500 from O&G's passive activities. She has an overall gain of $4,500 ($8,000 − $3,500), which is **nonpassive income.** This is reported as follows.

- The net gain of $4,500 is reported on Schedule E, *Supplemental Income and Loss,* as nonpassive income in part II (line 28, column j).
- The remaining Schedule E gain of $3,500 ($8,000 − $4,500) is reported as passive income in part II of Schedule E (line 28, column g).
- The prior year unallowed loss is reported on Form 4797, *Sales of Business Property.*

Schedule E (Form 1040) 2013 Attachment Sequence No. **13** Page **2**

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

Your social security number **999-88-7777**

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II **Income or Loss From Partnerships and S Corporations** **Note.** If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(e)** on line 28 and attach **Form 6198.** See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section. ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if any amount is not at risk
A	**Oil and Gas MLP**	**P**	☐	**36-9999999**	☐
B			☐		☐
C			☐		☐
D			☐		☐

	Passive Income and Loss		**Nonpassive Income and Loss**		
	(f) Passive loss allowed (attach **Form 8582** if required)	**(g)** Passive income from **Schedule K–1**	**(h)** Nonpassive loss from **Schedule K–1**	**(i)** Section 179 expense deduction from **Form 4562**	**(j)** Nonpassive income from **Schedule K–1**
A		**From PTP 3,500**			**From PTP 4,500**
B					
C					
D					
29a Totals		**3,500**			**4,500**
b Totals					

30	Add columns (g) and (j) of line 29a	**30**	**8,000**
31	Add columns (f), (h), and (i) of line 29b	**31**	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	**32**	**8,000**

Income or Loss From Estates and Trusts

102. Ibid.

For Example 34

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return.
▶ Information about Form 4797 and its separate instructions is at *www.irs.gov/form4797.*

OMB No. 1545-0184
2013
Attachment Sequence No. 27

Name(s) shown on return: **Phyllis** | Identifying number: **999-88-7777**

1 Enter the gross proceeds from sales or exchanges reported to you for 2013 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
PTP Adjustment						**(3,500)**

3 Gain, if any, from Form 4684, line 39 . . .	3	
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . .	4	
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . .	5	
6 Gain, if any, from line 32, from other than casualty or theft. . . .	6	
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: . . .	7	**(3,500)**

3. If the taxpayer has an overall loss (but did not dispose of their entire interest in the MLP during the tax year), the losses are allowed only to the extent of the income. Any excess loss is carried forward to use in a future year in which the taxpayer has income to offset it. The amount of the passive loss that is equal to the income is reported on the schedule or form normally used. The income is reported as passive income on the form or schedule normally used.

Example 35. Lucinda owns units in Keyrock MLP. For 2013, Lucinda has a Schedule E loss of $13,000 and a Form 4797 gain of $6,200 from the passive activities of Keyrock. This is reported as follows.

- The $6,200 gain is reported on the appropriate line of Form 4797.
- $6,200 of the $13,000 loss is reported on Schedule E as a passive loss (column f of part II).

Lucinda's unallowed loss of $6,800 ($13,000 − $6,200) is carried forward to 2014.

4. If the taxpayer has an overall loss and disposed of their entire interest in the MLP to an unrelated person in a fully taxable transaction during the tax year, their losses (including prior year suspended losses) from the activity for the year are not limited by the passive loss rules. A fully taxable transaction is one in which the taxpayer recognizes all of their realized gain or loss. The income and losses are reported on the forms and schedules normally used.

Example 36. Maynard Krebs purchased 100 shares of Oneknock Partners, LP, on June 9, 2009. Oneknock is a PTP. Maynard's individual income tax returns for 2009–2012 have limited the deduction for losses to the income of Oneknock in each year. Maynard has unallowed losses that are allocated as follows.

Schedule E, line 28	$670
Form 4797, Part I (short-term)	40
Schedule D, Part I (short-term capital loss)	125
Total Losses	$835

Maynard received the following Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* from Oneknock showing the 2013 activity.

For Example 36

651113

☒ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **2013**

Department of the Treasury
Internal Revenue Service

For calendar year 2013, or tax year beginning ________, 2013 ending ________, 20____

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
43-2222222

B Partnership's name, address, city, state, and ZIP code
Oneknock Partners, LP
1 Oil Rig Way
Dallas, TX 43222

C IRS Center where partnership filed return
Ogden, UT

D ☒ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
555-55-5555

F Partner's name, address, city, state, and ZIP code
Maynard Krebs
1405 Gillis St.
Torrance, CA 55555

G ☐ General partner or LLC member-manager ☒ Limited partner or other LLC member

H ☒ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? **Individual**

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here (see instructions) ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	.000142 %	.000000 %
Loss	.000142 %	.000000 %
Capital	.000142 %	.000000 %

K Partner's share of liabilities at year end:

Nonrecourse	$ 0
Qualified nonrecourse financing	$
Recourse	$

L Partner's capital account analysis:

Beginning capital account	$ 4,485
Capital contributed during the year	$ 0
Current year increase (decrease)	$ (3,588)
Withdrawals & distributions	$ (897)
Ending capital account	$ 0

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☒ No
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	**(1,680)**
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Guaranteed payments	
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
7	Royalties	
8	Net short-term capital gain (loss)	**(48)**
9a	Net long-term capital gain (loss)	
9b	Collectibles (28%) gain (loss)	
9c	Unrecaptured section 1250 gain	
10	Net section 1231 gain (loss)	**(370)**
11	Other income (loss)	
12	Section 179 deduction	
13	Other deductions	
14	Self-employment earnings (loss)	
15	Credits	
16	Foreign transactions	
17	Alternative minimum tax (AMT) items	A **110**; B **0**
18	Tax-exempt income and nondeductible expenses	C **10**
19	Distributions	**1,480**
20	Other information	

*See attached statement for additional information.

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For Paperwork Reduction Act Notice, see Instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2013

Maynard sold his 100 shares of Oneknock on August 20, 2013, for $14,315. Maynard's basis in the partnership interest at the beginning of 2013 was $4,485.

Because the combination of the current year income, gain, and losses any prior year unallowed losses results in an overall loss from the PTP, the losses are reported on the return as passive losses.

	Prior Year Loss	Current Year Loss	Total Per Return
Schedule D, Part I	$125	$ 48	$173
Form 4797, Part I	40	370	410

Maynard's basis for the purposes of calculating the gain or loss from the sale is calculated as follows.

Adjusted basis at the beginning of the year	$4,485
Current year cash distributions	(1,480)
Current year ordinary business loss	(1,680)
Net short-term capital loss	(48)
Net §1231 loss	(370)
Nondeductible expenses	(10)
Adjusted basis on August 20, 2013	$ 897

The resulting long-term capital gain of $13,418 ($14,315 sale price − $897 basis) is reported on Schedule D.

Observation. Many investors experience tax consequences similar to those of Maynard. The investor realizes an increase in the value of the investment during the period that the investment is held. However, allocated losses from the PTP are not allowed to reduce income until the year of complete disposition. Losses may be allowed to the extent of income in the intervening years, and the unallowed losses offset the investment gain in the year of the sale.

SAMPLE MLP TAX PACKAGE

Although the information presented on a typical partnership Schedule K-1 does not intimidate most tax preparers, the same may not be true for a Schedule K-1 for an MLP. This is because the complexity of an MLP operation also complicates the reporting mandated on the Schedule K-1. However, many MLPs provide detailed instructions for the investor. The following is a sample tax package given to investors in a Kinder Morgan MLP.[103] Many MLPs produce similar packages.

103. Used by permission of Kinder Morgan.

KINDER MORGAN ENERGY PARTNERS, L.P.
(NYSE:KMP)

TEST K1 JANUARY 2012
1001 LOUISIANA STREET SUITE 1000
HOUSTON, TX 77002

February 17, 2013

Dear Unitholder:

Enclosed is your Kinder Morgan Energy Partners, L.P. (KMP or Partnership) tax package for 2012. The information contained in this package is being provided to you because the Partnership has been notified either by your broker or the Partnership's transfer agent that you were an owner of Partnership units during the 2012 tax year. Accordingly, if the information provided by your broker or the transfer agent is incorrect, the information being reported to you and the Internal Revenue Service (IRS) will be incorrect. To that end, it is important that you carefully review the information included in this package and, in particular, the Transaction Schedule (explained below) to ensure it is consistent with the information sent to you by your broker or transfer agent for 2012. If you have not received a 2012 brokerage statement reflecting that you owned Partnership units, please contact KMP's Tax Package Support (contact information below) so that the Partnership can update its records.

The information contained in this package is more voluminous than what you may be use to receiving from your traditional equity investments in corporations. This is largely attributable to the more tax-favorable structure of KMP as a publicly-traded partnership (PTP) under the U.S. tax laws. As a PTP, the Partnership generally does not pay taxes like a corporation, thereby allowing for more cash to be distributed to its unitholders. Such favorable tax treatment creates some additional complexity compared with traditional investments in a corporation. For example, the Form 1099 issued by corporations merely reports interest and dividends. Partnerships, however, are required to separately report many different items of income, gain, loss, deduction and credit on a Schedule K-1. Careful attention to the information contained herein and, if needed, the assistance of a tax advisor, should allow you to report this information on your tax return with little difficulty. Also, please note that additional guidance is provided on the KMP Website, which may be accessed at www.kindermorgan.com and clicking **Investors, Investor Tools,** and **K-1 Information**.

Specifically, the following documents are being provided in this package:

1. **Schedule K-1 and Instructions:** The most important document in the Package, the Schedule K-1, provides your share of the Partnership's 2012 income, deductions, credits, and related items. The K-1 information is to be included in your tax return to be filed for the 2012 tax year. Because of certain reporting limitations on the K-1, the Partnership also provides other important operating results needed in the preparation of your tax return in the **Additional Information Statement** described below. Also note, if applicable, that Box 1 of the Schedule K-1 includes Internal Revenue Code (Code) Section 743(b) adjustments. The Partnership has made a Code Section 754 election to adjust the basis of partnership property when property is distributed or when a partnership interest is transferred (under Code Section 743(b)).

2. **Additional Information Statement:** This Statement provides the K-1 box number, the code, the description, and the dollar amount for those items in boxes 13, 16 and 20 marked in the Schedule K-1 with an asterisk and STMT. More specifically:

- Box 13 items relate to the Code Section 199 Deduction and Intangible Drilling Costs. Further information regarding these items can be found in the **Frequently Asked Questions (FAQs)** document included in the tax package.
- Box 16 items relate to the Partnership's operations in both Canada and Mexico.
- Box 20 items relate to the following:
  Gross Receipts - Required for S Corporations
  Depletion - Informational only
  State bonus depreciation adjustment
  Mexican withholding capital account adjustment – Informational only

3. **State Information:** Since the Partnership has operations in more than 41 states, you may be required to file an income tax return with those states. The Partnership is subject to and does pay the Texas Franchise (Margin) Tax, which is treated as a state income tax for federal income tax purposes. This State Information is not a tax return document.

4. **Transactions Schedule and Sales Worksheet:** These two important schedules contain your history of KMP units bought or sold by date and number of units, as reported to the Partnership by your broker or the Partnership's transfer agent. In addition, if you sold KMP units during the 2012 tax year, the Sales Worksheet is provided to calculate your gain or loss from the disposition of Partnership units. The 2012 Sales Worksheet provides specific instructions to calculate your ordinary and capital gain or loss, as the case may be. In addition, if you reported ordinary income from the sale of your units, you will need to file a Code Section 751 Statement; an example is provided on the Sales Worksheet.

Also included for your assistance in better understanding the tax reporting rules for taxpayers receiving K-1s are: **FAQs and Graphic Guide**. The FAQs addresses general tax-related issues associated with you receiving a Schedule K-1, rather than a Form 1099. The Graphic Guide links the information reflected on the Schedule K-1 to the specific tax forms that may be required in the filing of your 2012 federal income tax return.

Finally, you should note that (1) your K-1 continues to reflect certain nonrecourse liabilities of the Partnership being allocated to you likely resulting in an increase in your tax basis, (2) the Partnership continues to claim bonus depreciation in 2012 resulting in an increased allocation of the related depreciation deduction, and (3) allocations of income for 2012 will be affected by two significant transactions the Partnership engaged in associated with the (a) FTC-mandated divestiture of certain Rocky Mountain assets for approximately $1.8 billion in cash and (b) the Partnership's acquisition of 100% of Tennessee Gas Pipeline and 50% of El Paso Natural Gas Pipeline for approximately $6.22 billion. (Refer to the FAQs for more information).

Any corrections to this information or any other information reflected in this package must be submitted to the Partnership by **May 15, 2013** in any one of the following ways:

1. Mail to Kinder Morgan Energy Partners, L.P., Attention: Tax Package Support, P.O. Box 799060, Dallas, TX 75379-9060;
2. Call Tax Package Support at 1-800-232-1627; or
3. Submit corrections online through the Partnership's website at www.kindermorgan.com. At this site, click **Investors,** then **Investor Tools,** and then **K-1 Information,** which takes you to the Partnership's Tax Reporting Package logon screen. There you will be able to view your 2012 tax schedules, request changes to incorrect information, print your tax package, transfer K-1 information to IRS forms, and print blank IRS forms. Also, please note that for the **first time** unitholders may elect to receive their K-1 Information exclusively through the Partnership's website by clicking the link named "Go Paperless" located on the registered user's home page.

Failure to submit corrections by **May 15th** may require you to include in your federal income tax return Treasury Form 8082 - "Notice of Inconsistent Treatment or Administrative Adjustment".

Thank you for your investment in KMP.

Kinder Morgan Energy Partners, L.P.

While KMP invests hundreds of million of dollars each year to grow the company and operate our assets safely, we have always taken pride in being prudent with how we spend your money. To that point, this will be the fifth consecutive year that we will not print and mail hard copies of our annual report. Instead, we will once again publish Chairman and CEO Richard D. Kinder's unitholder letter on our web site at www.kindermorgan.com. Both the letter and KMP's Form 10-K will be available online by early March. We hope that the resulting cost savings, along with the benefit of reducing our impact on the environment, outweighs any inconvenience. Please direct any inquiries to Investor Relations at (800) 324-2900 or (713) 369-9490.

651112

☐ Final K-1 ☐ Amended K-1

OMB No. 1545-0099

Schedule K-1 (Form 1065) 2012

Department of the Treasury
Internal Revenue Service

For calendar year 2012, or tax year beginning ________, 2012 ending ________, 20____

Partner's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
76-0380342

B Partnership's name, address, city, state, and ZIP code
KINDER MORGAN ENERGY PARTNERS LP
1001 LOUISIANA STREET SUITE 1000
HOUSTON, TX 77002

C IRS Center where partnership filed return
OGDEN

D ☒ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
760-38-0342

F Partner's name, address, city, state, and ZIP code
TEST K1 JANUARY 2012
1001 LOUISIANA STREET SUITE 1000
HOUSTON, TX 77002

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☒ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? (see instructions) Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here (see instructions) ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	0.000000 %	0.000379 %
Loss	0.000000 %	0.000379 %
Capital	0.000000 %	0.000379 %

K Partner's share of liabilities at year end:

Nonrecourse	$ 8,984
Qualified nonrecourse financing	$
Recourse	$

L Partner's capital account analysis:

Beginning capital account	$ 0
Capital contributed during the year	$ 82,310
Current year increase (decrease)	$ -12,124
Withdrawals & distributions	$ (4,850)
Ending capital account	$ 65,336

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☒ No
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	-13,283
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Guaranteed payments	
5	Interest income	126
6a	Ordinary dividends	66
6b	Qualified dividends	66
7	Royalties	
8	Net short-term capital gain (loss)	
9a	Net long-term capital gain (loss)	
9b	Collectibles (28%) gain (loss)	
9c	Unrecaptured section 1250 gain	
10	Net section 1231 gain (loss)	1,613
11	Other income (loss)	
12	Section 179 deduction	
13	Other deductions	
	H	68
	J*	STMT
	*	STMT
14	Self-employment earnings (loss)	
15	Credits	
16	Foreign transactions	
	*	STMT
17	Alternative minimum tax (AMT) items	
	A	1,422
	B	-8
18	Tax-exempt income and nondeductible expenses	
	C	9
19	Distributions	
	A	4,850
20	Other information	
	A	192
	V	-13,823
	Y*	STMT

*See attached statement for additional information.

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This list identifies the codes used on Schedule K-1 for all partners and provides summarized reporting information for partners who file Form 1040. For detailed reporting and filing information, see the separate Partner's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.

		Report on
	Passive loss	See the Partner's Instructions
	Passive income	Schedule E, line 28, column (g)
	Nonpassive loss	Schedule E, line 28, column (h)
	Nonpassive income	Schedule E, line 28, column (j)
2.	**Net rental real estate income (loss)**	See the Partner's Instructions
3.	**Other net rental income (loss)**	
	Net income	Schedule E, line 28, column (g)
	Net loss	See the Partner's Instructions
4.	**Guaranteed payments**	Schedule E, line 28, column (j)
5.	**Interest income**	Form 1040, line 8a
6a.	**Ordinary dividends**	Form 1040, line 9a
6b.	**Qualified dividends**	Form 1040, line 9b
7.	**Royalties**	Schedule E, line 4
8.	**Net short-term capital gain (loss)**	Schedule D, line 5
9a.	**Net long-term capital gain (loss)**	Schedule D, line 12
9b.	**Collectibles (28%) gain (loss)**	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
9c.	**Unrecaptured section 1250 gain**	See the Partner's Instructions
10.	**Net section 1231 gain (loss)**	See the Partner's Instructions
11.	**Other income (loss)**	
	Code	
	A Other portfolio income (loss)	See the Partner's Instructions
	B Involuntary conversions	See the Partner's Instructions
	C Sec. 1256 contracts & straddles	Form 6781, line 1
	D Mining exploration costs recapture	See Pub. 535
	E Cancellation of debt	Form 1040, line 21 or Form 982
	F Other income (loss)	See the Partner's Instructions
12.	**Section 179 deduction**	See the Partner's Instructions
13.	**Other deductions**	
	A Cash contributions (50%)	See the Partner's Instructions
	B Cash contributions (30%)	
	C Noncash contributions (50%)	
	D Noncash contributions (30%)	
	E Capital gain property to a 50% organization (30%)	
	F Capital gain property (20%)	
	G Contributions (100%)	
	H Investment interest expense	Form 4952, line 1
	I Deductions—royalty income	Schedule E, line 19
	J Section 59(e)(2) expenditures	See the Partner's Instructions
	K Deductions—portfolio (2% floor)	Schedule A, line 23
	L Deductions—portfolio (other)	Schedule A, line 28
	M Amounts paid for medical insurance	Schedule A, line 1 or Form 1040, line 29
	N Educational assistance benefits	See the Partner's Instructions
	O Dependent care benefits	Form 2441, line 12
	P Preproductive period expenses	See the Partner's Instructions
	Q Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
	R Pensions and IRAs	See the Partner's Instructions
	S Reforestation expense deduction	See the Partner's Instructions
	T Domestic production activities information	See Form 8903 instructions
	U Qualified production activities income	Form 8903, line 7b
	V Employer's Form W-2 wages	Form 8903, line 17
	W Other deductions	See the Partner's Instructions
14.	**Self-employment earnings (loss)**	

Note. *If you have a section 179 deduction or any partner-level deductions, see the Partner's Instructions before completing Schedule SE.*

	A Net earnings (loss) from self-employment	Schedule SE, Section A or B
	B Gross farming or fishing income	See the Partner's Instructions
	C Gross non-farm income	See the Partner's Instructions
15.	**Credits**	
	A Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Partner's Instructions
	B Low-income housing credit (other) from pre-2008 buildings	
	C Low-income housing credit (section 42(j)(5)) from post-2007 buildings	
	D Low-income housing credit (other) from post-2007 buildings	
	E Qualified rehabilitation expenditures (rental real estate)	
	F Other rental real estate credits	
	G Other rental credits	
	H Undistributed capital gains credit	Form 1040, line 71; check box a
	I Alcohol and cellulosic biofuel fuels credit	See the Partner's Instructions

	Code	*Report on*
	J Work opportunity credit	See the Partner's Instructions
	K Disabled access credit	
	L Empowerment zone and renewal community employment credit	
	M Credit for increasing research activities	
	N Credit for employer social security and Medicare taxes	
	O Backup withholding	
	P Other credits	
16.	**Foreign transactions**	
	A Name of country or U.S. possession	Form 1116, Part I
	B Gross income from all sources	
	C Gross income sourced at partner level	
	Foreign gross income sourced at partnership level	
	D Passive category	Form 1116, Part I
	E General category	
	F Other	
	Deductions allocated and apportioned at partner level	
	G Interest expense	Form 1116, Part I
	H Other	Form 1116, Part I
	Deductions allocated and apportioned at partnership level to foreign source income	
	I Passive category	Form 1116, Part I
	J General category	
	K Other	
	Other information	
	L Total foreign taxes paid	Form 1116, Part II
	M Total foreign taxes accrued	Form 1116, Part II
	N Reduction in taxes available for credit	Form 1116, line 12
	O Foreign trading gross receipts	Form 8873
	P Extraterritorial income exclusion	Form 8873
	Q Other foreign transactions	See the Partner's Instructions
17.	**Alternative minimum tax (AMT) items**	
	A Post-1986 depreciation adjustment	See the Partner's Instructions and the Instructions for Form 6251
	B Adjusted gain or loss	
	C Depletion (other than oil & gas)	
	D Oil, gas, & geothermal—gross income	
	E Oil, gas, & geothermal—deductions	
	F Other AMT items	
18.	**Tax-exempt income and nondeductible expenses**	
	A Tax-exempt interest income	Form 1040, line 8b
	B Other tax-exempt income	See the Partner's Instructions
	C Nondeductible expenses	See the Partner's Instructions
19.	**Distributions**	
	A Cash and marketable securities	See the Partner's Instructions
	B Distribution subject to section 737	
	C Other property	
20.	**Other information**	
	A Investment income	Form 4952, line 4a
	B Investment expenses	Form 4952, line 5
	C Fuel tax credit information	Form 4136
	D Qualified rehabilitation expenditures (other than rental real estate)	See the Partner's Instructions
	E Basis of energy property	See the Partner's Instructions
	F Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
	G Recapture of low-income housing credit (other)	Form 8611, line 8
	H Recapture of investment credit	See Form 4255
	I Recapture of other credits	See the Partner's Instructions
	J Look-back interest—completed long-term contracts	See Form 8697
	K Look-back interest—income forecast method	See Form 8866
	L Dispositions of property with section 179 deductions	See the Partner's Instructions
	M Recapture of section 179 deduction	
	N Interest expense for corporate partners	
	O Section 453(l)(3) information	
	P Section 453A(c) information	
	Q Section 1260(b) information	
	R Interest allocable to production expenditures	
	S CCF nonqualified withdrawals	
	T Depletion information—oil and gas	
	U Amortization of reforestation costs	
	V Unrelated business taxable income	
	W Precontribution gain (loss)	
	X Section 108(i) information	
	Y Other information	

2012 SCHEDULE K-1 ADDITIONAL INFORMATION STATEMENT

KINDER MORGAN ENERGY PARTNERS, L.P.

PARTNER NAME:	TEST K1 JANUARY 2012
PARTNER ACCOUNT NUMBER:	MAN 215201343110
PARTNER FEDERAL ID/ENTITY:	760-38-0342 / Individual
CUSTODIAN FEDERAL ID:	
PARTNERSHIP FEDERAL ID:	76-0380342

K-1 CODES	DESCRIPTION	AMOUNT/SOURCE
13J1	Intangible Drilling Cost	377
13J2	Intangible Drilling Cost M&D	162
13T1	Domestic Production Gross Receipts (DPGR) - All Source	3,767
13T2	COGS Allocable to DPGR - All Source	14
13T3	Directly Allocable Deductions - All Source	4,100
13T4	Indirectly Allocable Deductions - All Source	284
13T5	Domestic Production Gross Receipts (DPGR) - Oil & Gas related	3,225
13T6	COGS Allocable to DPGR - Oil & Gas related	14
13T7	Directly Allocable Deductions - Oil & Gas related	2,378
13T8	Indirectly Allocable Deductions - Oil & Gas related	125
13V	Employer's Form W-2 wages	0
16A1	Name of country or U.S. possession	CANADA
16E1	General category	1,311
16J1	General category	1,539
16M1	Total foreign taxes accrued (Other information)	5
16A2	Name of country or U.S. possession	MEXICO
16E2	General category	49
16J2	General category	41
16M2	Total foreign taxes accrued (Other information)	7
20Y1	Gross Receipts	36,103
20Y2	Depletion Included in Box 1	215
20Y3	State Bonus Depreciation Addition	1,582
20Y4	Mexico Withholding Tax	18

The Form 8903 requires oil-related production activities to be broken out separately in computing the Domestic Production Activities Deduction. Codes 13T-1 through 13T-4 include information that should be reported in column B of Form 8903 and Codes 13T-5 through 13T-8 should be reported on the same lines in Column A in accordance with instructions in the FAQs.

For tax year 2012, the Partnership has elected to take bonus depreciation for qualifying assets placed into service for federal income tax purposes. However there are certain states (non-conforming states) that do not allow the federal bonus depreciation adjustment. If you reside in one of the non-conforming states, when preparing your resident state income tax return you must adjust the amount reported on Box 1 of your Schedule K-1 by the bonus depreciation adjustment provided in the Schedule K-1 Supplemental Information Box 20. See the FAQs for a listing of the non-conforming states.

2012 STATE INFORMATION

KINDER MORGAN
ENERGY PARTNERS, L.P.

PARTNER NAME: TEST K1 JANUARY 2012
PARTNER ACCOUNT NUMBER: MAN 215201343110
PARTNER FEDERAL ID/ENTITY: 760-38-0342 Individual
CUSTODIAN FEDERAL ID:
PARTNERSHIP FEDERAL ID: 76-0380342

State Information

State	(1) NET ORDINARY INCOME OR LOSS (-)	(2) PORTFOLIO DIVIDEND INCOME	(3) PORTFOLIO INTEREST INCOME	(4) INVESTMENT INTEREST EXPENSE	(5) FOREIGN TAXES ACCRUED	(6) GROSS RECEIPTS	(7) STATE INCOME TAX
AL	-9	0	0	0	0	27	0
AR	-73	0	1	0	0	248	0
AZ	-87	1	1	1	0	297	0
CA	-222	1	3	1	0	757	1
CO	-556	3	6	3	1	1,651	2
CT	-3	0	0	0	0	10	0
FL	-182	1	2	1	0	619	1
GA	-17	0	0	0	0	56	0
IA	-6	0	0	0	0	21	0
ID	0	0	0	0	0	1	0
IL	-246	2	3	2	0	839	1
IN	-55	0	1	0	0	186	0
KS	-51	0	1	0	0	151	0
KY	-43	0	1	0	0	147	0
LA	-721	4	7	4	1	2,138	2
MA	-31	0	0	0	0	107	0
MD	-17	0	0	0	0	58	0
MI	-1	0	0	0	0	5	0
MN	-7	0	0	0	0	25	0
MO	-66	0	1	0	0	195	0
MS	-152	1	2	1	0	517	1
NC	-58	0	1	0	0	199	0
ND	-11	0	0	0	0	34	0
NE	-337	2	3	2	0	1,001	1
NH	-3	0	0	0	0	11	0
NJ	-139	1	2	1	0	475	1
NM	-156	1	2	1	0	462	0
NY	-72	0	1	0	0	247	0
OH	-81	1	1	1	0	277	0
OK	-14	0	0	0	0	43	0
OR	-35	0	0	0	0	118	0
PA	-182	1	2	1	0	539	1
RI	-3	0	0	0	0	10	0
SC	-57	0	1	0	0	195	0
TN	-42	0	1	0	0	144	0
UT	-25	0	0	0	0	75	0
VA	-182	1	2	1	0	620	1
WI	-3	0	0	0	0	10	0
WV	-4	0	0	0	0	12	0

KINDER MORGAN ENERGY PARTNERS, L.P.

TRANSACTIONS SCHEDULE

NOTE: THIS TRANSACTIONS SCHEDULE IS NOT PROOF OF OWNERSHIP NOR SHOULD IT BE CONSTRUED AS PROOF OF OWNERSHIP IN KINDER MORGAN ENERGY PARTNERS, L.P.

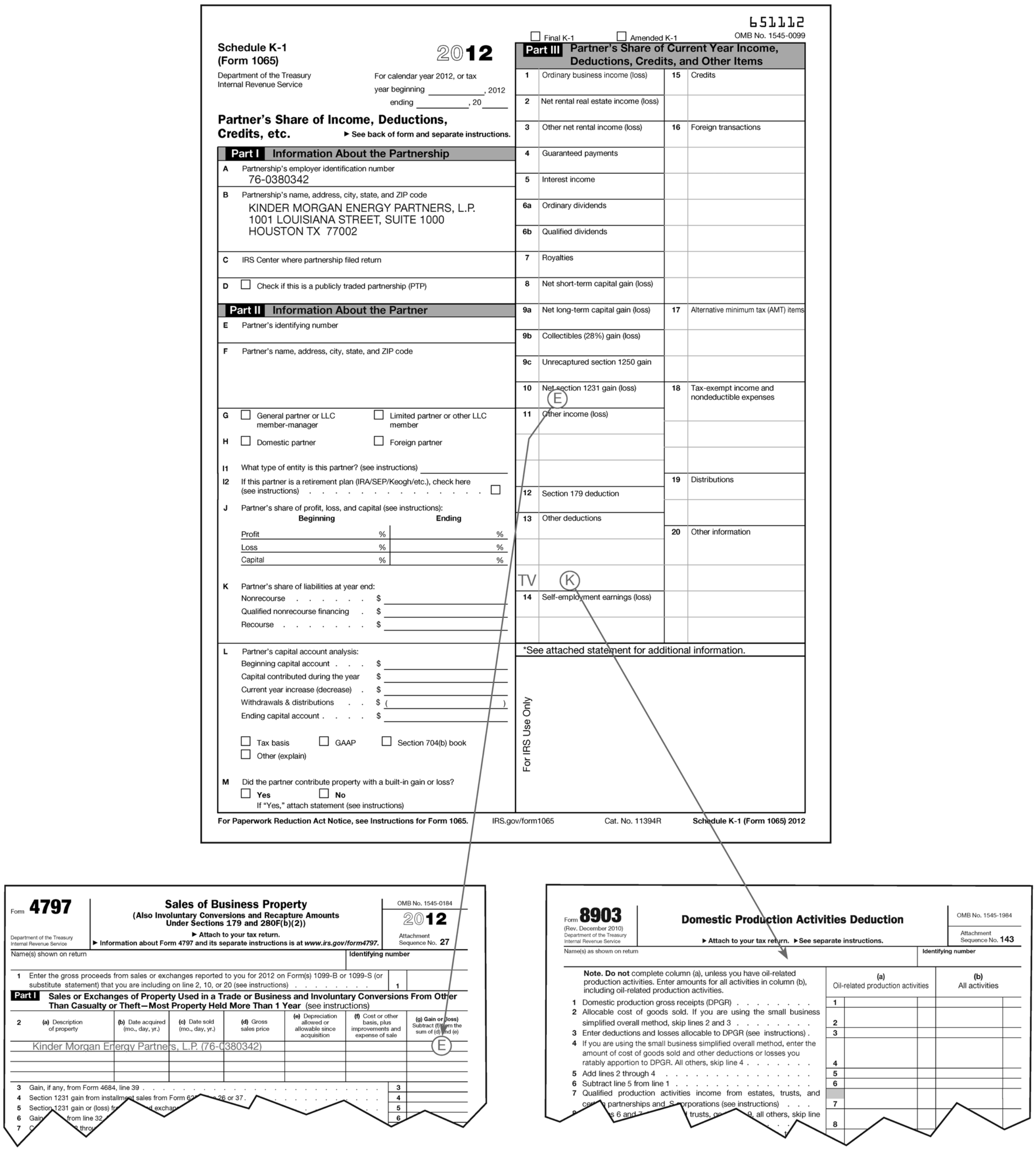
PARTNER NAME:	TEST K1 JANUARY 2012	
PARTNER ACCOUNT NUMBER:	MAN 215201343110	
PARTNER FEDERAL ID/ENTITY:	760-38-0342	Individual
CUSTODIAN FEDERAL ID:		
PARTNERSHIP FEDERAL ID:	76-0380342	

TRANSACTION				
DESCRIPTION		DATE	BROKER OR CERTIFICATE NUMBER	UNITS
AC	BUY	1/1/2012	BROKER-MAN	1,000.0000
END OF YEAR UNITS				1,000.0000

2012 GRAPHIC GUIDE

The amounts reported on your 2012 Federal Schedule K-1 are represented by letters. Follow the arrows for each letter to locate the line on the appropriate federal form in which to report your federal amounts.

*If the sum of boxes 1, 2, 3, 4, 8, 9a, 10, 11, 12, and 13J on your Schedule K-1 result in a negative number (a passive activity loss) do not report any of the amounts from boxes 1, 2, 3, 4, 8, 9a, 9b, 9c, 10, 11, 12, 13J, 15, and 17 on your 2012 federal tax return unless you sold all of your partnership units prior to January 1, 2013. If the sum of boxes 1, 2, 3, 4, 8, 9a, 10, 11, 12, and 13J on your Schedule K-1 result in a positive number, or if you sold units in the current year, see page 4 of the enclosed partner's instructions for Schedule K-1 for instructions regarding Publicly Traded Partnerships. You may also want to consult your Tax Advisor.



651112

Schedule K-1 (Form 1065) 2012

Department of the Treasury
Internal Revenue Service

For calendar year 2012, or tax year beginning ________, 2012 ending ________, 20___

Partner's Share of Income, Deductions, Credits, etc. ► See back of form and separate instructions.

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss)
2 Net rental real estate income (loss)
3 Other net rental income (loss)
4 Guaranteed payments
5 Interest income
6a Ordinary dividends
6b Qualified dividends
7 Royalties
8 Net short-term capital gain (loss)
9a Net long-term capital gain (loss)
9b Collectibles (28%) gain (loss)
9c Unrecaptured section 1250 gain
10 Net section 1231 gain (loss) E
11 Other income (loss)
12 Section 179 deduction
13 Other deductions
TV K
14 Self-employment earnings (loss)
15 Credits
16 Foreign transactions
17 Alternative minimum tax (AMT) items
18 Tax-exempt income and nondeductible expenses
19 Distributions
20 Other information

*See attached statement for additional information.

For IRS Use Only

Part I Information About the Partnership

A Partnership's employer identification number
76-0380342

B Partnership's name, address, city, state, and ZIP code
KINDER MORGAN ENERGY PARTNERS, L.P.
1001 LOUISIANA STREET, SUITE 1000
HOUSTON TX 77002

C IRS Center where partnership filed return

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number

F Partner's name, address, city, state, and ZIP code

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? (see instructions)

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here (see instructions) ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

K Partner's share of liabilities at year end:
Nonrecourse $
Qualified nonrecourse financing $
Recourse $

L Partner's capital account analysis:
Beginning capital account $
Capital contributed during the year $
Current year increase (decrease) $
Withdrawals & distributions $ ( )
Ending capital account $

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☐ No
If "Yes," attach statement (see instructions)

For Paperwork Reduction Act Notice, see Instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2012

Form **4797** **Sales of Business Property**
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return.
► Information about Form 4797 and its separate instructions is at www.irs.gov/form4797.
OMB No. 1545-0184 2012 Attachment Sequence No. 27
Department of the Treasury Internal Revenue Service
Name(s) shown on return | Identifying number

1 Enter the gross proceeds from sales or exchanges reported to you for 2012 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

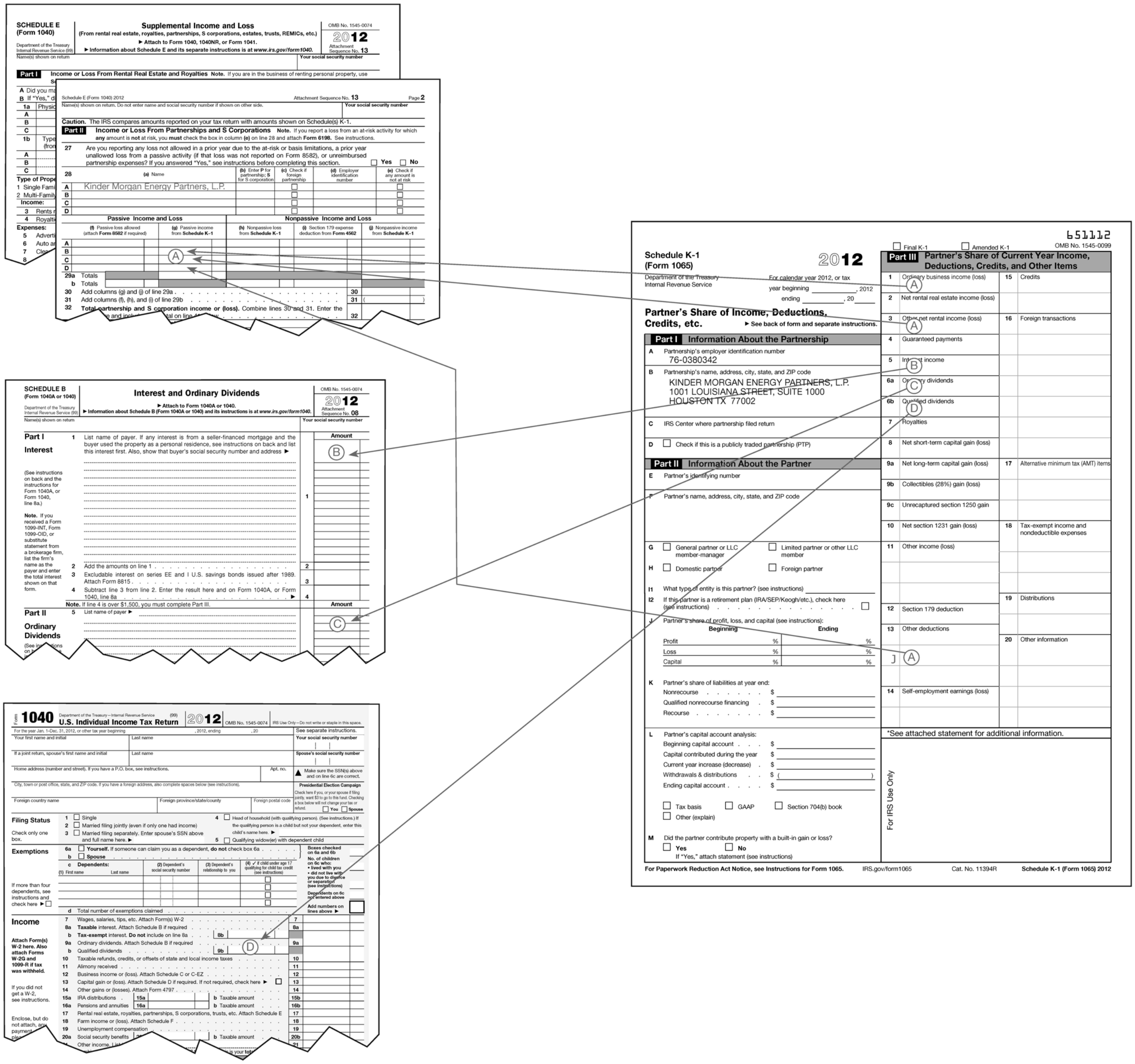
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

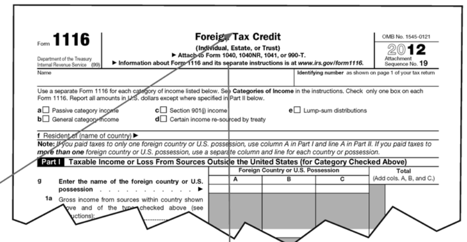
2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
Kinder Morgan Energy Partners, L.P. (76-0380342)						E

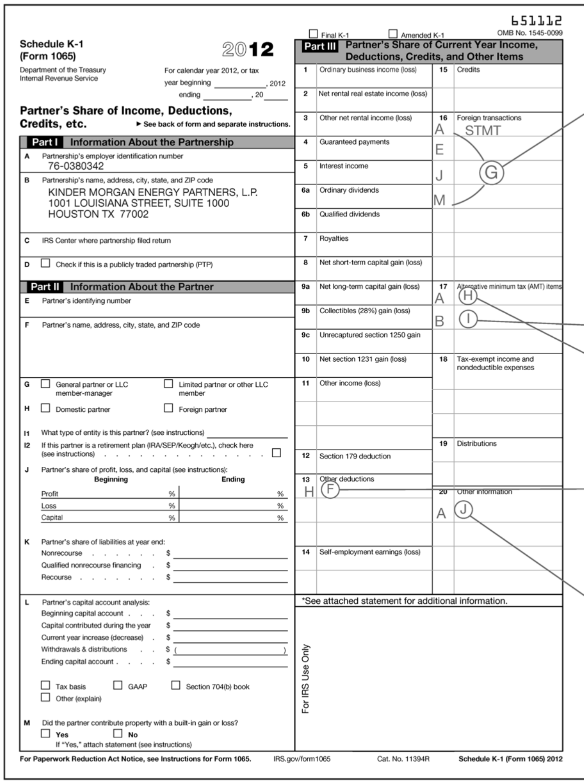
3 Gain, if any, from Form 4684, line 39 3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 4
5 Section 1231 gain or (loss) from like-kind exchanges ... 5
6 Gain ... from line 32 ... 6
7 C...

Form **8903** **Domestic Production Activities Deduction**
(Rev. December 2010)
Department of the Treasury Internal Revenue Service
► Attach to your tax return. ► See separate instructions.
OMB No. 1545-1984 Attachment Sequence No. 143
Name(s) as shown on return | Identifying number

Note. Do not complete column (a), unless you have oil-related production activities. Enter amounts for all activities in column (b), including oil-related production activities.		(a) Oil-related production activities	(b) All activities
1 Domestic production gross receipts (DPGR)	1		
2 Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3	2		
3 Enter deductions and losses allocable to DPGR (see instructions)	3		
4 If you are using the small business simplified overall method, enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR. All others, skip line 4	4		
5 Add lines 2 through 4	5		
6 Subtract line 5 from line 1	6		
7 Qualified production activities income from estates, trusts, and certain partnerships and S corporations (see instructions)	7		
8 ... lines 6 and 7 ... trusts, ... all others, skip line	8		

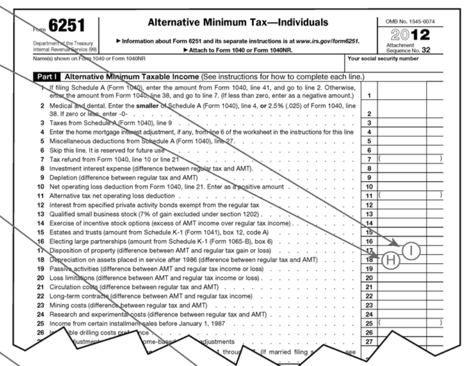

SCHEDULE E (Form 1040)
Supplemental Income and Loss
2012
Part II Income or Loss From Partnerships and S Corporations
Kinder Morgan Energy Partners, L.P.
Passive Income and Loss
Nonpassive Income and Loss
A
SCHEDULE B (Form 1040A or 1040)
Interest and Ordinary Dividends
2012
Part I Interest
B
Part II Ordinary Dividends
C
1040 U.S. Individual Income Tax Return
2012
Filing Status
Exemptions
Income
D
651112
Schedule K-1 (Form 1065)
2012
Partner's Share of Income, Deductions, Credits, etc.
Part I Information About the Partnership
76-0380342
KINDER MORGAN ENERGY PARTNERS, L.P.
1001 LOUISIANA STREET, SUITE 1000
HOUSTON TX 77002
Part II Information About the Partner
Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items
1 Ordinary business income (loss)
2 Net rental real estate income (loss)
3 Other net rental income (loss)
5 Interest income
6a Ordinary dividends
6b Qualified dividends
J
*See attached statement for additional information.

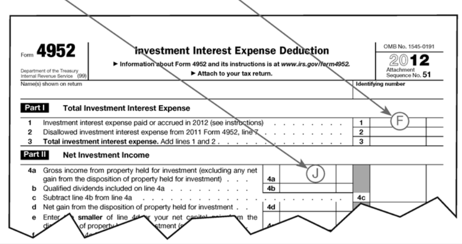




Foreign Transaction Information Reporting

Foreign Transaction Information Reporting Schedule K-1 Box 16	Form 1116 Reporting **Canada**	Form 1116 Reporting **Mexico**
Code 16A	Part I, Line g, column A	Part I, Line g, column B
Code 16E	Part I, Line 1a, column A	Part I, Line 1a, column B
Code 16J	Part I, Line 2, column A	Part I, Line 2, column B
Code 16M	Part II, Line A, column (r)	Part II, Line B, column (r)





FREQUENTLY ASKED QUESTIONS

Q: Are the cash distributions I received from the Partnership taxable?

A: In general, cash distributions received from the Partnership are not taxable. You are required to report in your tax return only those items of income, gain, loss, deduction or tax credit as reflected on your Schedule K-1.

Q: Why is the amount of cash I received different than my allocable share of Partnership income, gain, loss deduction or credit?

A: The Partnership distributes available cash determined by the Partnership agreement. The calculation of cash available for distribution differs from the calculation of taxable income to be reported to the partners. For example, depreciation is an expense that reduces taxable income reported to the partners but does not reduce cash available for distribution.

Q: If I sell my Partnership units, how is my tax basis determined for computing gain or loss?

A: Your tax basis is the original amount paid for the Partnership units, adjusted as follows:

- Increased by the cumulative amounts of income and gain reported to you on Schedule K-1;
- Reduced by the cumulative amounts of loss, deduction and credit reported to you on Schedule K-1;
- Increased by the non recourse debt allocated to you on the Schedule K-1;
- Reduced, but not below zero, by the cumulative amounts of cash distributions received from the Partnership; and
- Reduced for amounts paid to Servicio de Administración Tributaria (SAT) on your behalf.

Q: Does the Schedule K-1 show my tax basis in Partnership units?

A: No. However, the Schedule K-1 Box L – Partner's Capital Account Analysis, may provide an approximation of your ending tax basis for all units owned at December 31. The amount reflected in the Ending Capital Account includes your original cost of units, as reported to the Partnership by your broker, and other adjustments affecting tax basis. However, brokers do not always report original cost to the Partnership, or the original cost reported may be incorrect. When brokers do not report original cost to the Partnership, the low closing price for the month in which you purchased units is assumed to be the cost. This assumption, or incorrect reporting by the broker, can cause this year end amount to be different than your actual tax basis at December 31. The current year increase(decrease) amount for Box L is computed as follows: sum of boxes 1, 2, 3, 4, 5, 6a, 7, 8, 9, 10, 11, 12, 13H, 13J, 16M1, 16M2 and 18C.

Q: If I sell my Partnership units at a gain, why is part of the gain treated as ordinary income rather than capital gain?

A: A sale of Partnership units is treated as if there was a sale of the partner's allocable share of each of the Partnership's assets. Gain on the sale of assets from which depreciation or depletion deductions have been taken is treated as ordinary income rather than capital gain. The ordinary income on sale of units represents the depreciation and depletion deductions previously allocated to you.

Q: If my Schedule K-1 reports a passive activity loss from Partnership operations, does this mean the Partnership was not profitable?

A: No. The net income of the Partnership for 2012 before certain items was $2.24 billion and $1.36 billion, including certain items. Any operating loss reported to partners for tax purposes is due principally to tax depreciation expense in excess of GAAP depreciation expense.

Q: What additional forms may be required for filing of my tax return?

A: Form 1040 US Individual Income Tax Return
Form 1040 Schedule B - Interest and Ordinary Dividends
Form 1040 Schedule E - Supplemental Income and Loss
Form 1116 Foreign Tax Credit
Form 4797 Sales of Business Property
Form 4952 Investment Interest Expense Deduction
Form 6251 Alternative Minimum Tax – Individuals
Form 8082 Notice of Inconsistent Treatment or Administrative Adjustment Request
Form 8903 Domestic Production Activities Deduction

Q: Are there any foreign taxes being paid by KMP on my behalf?

A: Due to favorable changes recently made to the United States/Canada Income Tax Treaty, the Partnership does not expect its Canadian subsidiaries to have to submit withholding tax to the Canada Revenue Agency on interest paid by such subsidiaries to the Partnership for tax years subsequent to 2010. However, interest payments made by the Partnership's Mexican affiliate in 2012 are subject to a 15% withholding tax.

Q: What is the Section 199 deduction referred to in the Schedule K-1 Additional Information Statement?

A: For the tax year ending December 31, 2012, Section 199(a)(1) generally allows a deduction equal to nine percent of the lesser of a taxpayer's qualified production activities income (QPAI) or the taxpayer's taxable income determined without regard to the Section 199 deduction. Section 199(d)(9), however, limits the deduction of taxpayers with oil-related qualified production activities to 6% for tax years beginning after 2009. An individual taxpayer's QPAI deduction generally is limited to the individual's adjusted gross income.

The deduction allowed under Section 199 is determined at the partner level. Accordingly, the Partnership is reporting the information below to assist each partner in computing its Section 199 deduction. In order for a partner to compute QPAI, the information reported by the Partnership generally should be aggregated with a partner's qualified production activities occurring outside the Partnership. The at-risk rules (Section 465), the passive activity loss rules (Section 469), the publicly traded partnership rules (Section 469(k)), and other limitations under Section 199 may affect the proper tax reporting of the Section 199 information provided to you by the Partnership.

Section 199 Information	Form 8903 Reporting
Code 13T-1 - Domestic Production Gross Receipts (DPGR)	Line 1
Code 13T-2 - COGS Allocable to (DPGR)	Line 2
Code 13T-3 - Directly Allocable Deductions	Line 3
Code 13T-4 - Indirectly Allocable Deductions	Line 4
Code 13V - Employer's W-2 Wages	Line 16

Q: Is there any unique tax reporting required for the Partnership's oil and gas operations?

A: Yes, as there are qualified intangible drilling costs (IDC) incurred by the Partnership's oil and gas operations to which an election under Section 59(e) may apply. This amount has not been deducted from the amount in your Schedule K-1, Box 1. Generally, Section 59(e) allows each partner to elect to deduct IDC from oil and gas properties ratably over a 60-month period, rather than deducting the full amount in the current year. If you make this election, it may be beneficial to you for other tax planning purposes or in reducing the amount of Alternative Minimum Tax (AMT) since this item will not be treated as an adjustment or tax preference item for purposes of the AMT. Because each partner decides whether to make the election under Section 59(e), the Partnership cannot provide you with the amount of the tax preferences related to IDC. You must decide both how to claim the expenses on your return and compute the resulting tax preference item.

Schedule K-1, Box 13J provides the information necessary for you to compute your tax preference for IDC. For all taxpayers, line 13J1 represents qualified IDC incurred by the Partnership's oil and gas operations to which an election under Section 59(e) may apply. Line 13J2 represents mining and development cost incurred by the Partnership to which an election under Section 59(e) may apply. You may also want to consult your tax advisor for appropriate treatment of these costs.

Q: What is a nonrecourse liability and how does it affect my tax basis in the Partnership?

A: A partnership liability is treated as a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for such liability. A partner's tax basis in the partnership includes its share of the partnership's nonrecourse liabilities.

Q: **What is bonus depreciation?**

A: Favorable federal tax legislation passed in 2010 allows the Partnership to accelerate depreciation for certain qualifying property placed in service prior to January 1, 2013 resulting in larger tax deductions for the 2011 and 2012 tax years. Such benefit, however, has not been adopted by all states; accordingly, this tax package may include information for both conforming and non-conforming states.

Q: **Which states are non-conforming?**

A: The following states are non-conforming: Arizona, Arkansas, California, Connecticut, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, Wisconsin.