

Chapter 4: Special Taxpayers

Employees with Business Expenses..... C127	Internet Businesses..... C157
Buyers and Sellers of Securities C139	Homeowners C161
Armed Forces Reservists C149	

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

4

EMPLOYEES WITH BUSINESS EXPENSES

It is fundamental to U.S. tax law that taxpayers are entitled to deduct business expenses, generally defined by the Code as the “ordinary” and “necessary” expenses incurred in carrying on a trade or business.¹ Eligible nonemployee business expenses are deductible as part of the calculation of the taxpayer’s adjusted gross income (AGI).² Unreimbursed employee business expenses, however, are deductible from income only to the extent that, when combined with other miscellaneous itemized deductions, they total more than 2% of the taxpayer’s AGI.³ The amount of the total miscellaneous itemized deductions that exceeds the 2% floor is entered on line 27 of Schedule A, *Itemized Deductions*.

In recognition of the impact that unreimbursed expenses have on employees, employers often reimburse employees or provide them with an allowance to cover business expenses. As long as this reimbursement or allowance is made under an **accountable plan**, the reimbursement is not includable in the employee’s wages, and the employee does not pay tax on this amount.⁴ If the reimbursement paid to the employee by the employer does not meet the requirements of an accountable plan, it is deemed to have been paid under a **nonaccountable plan**. A reimbursement provided by an employer to an employee under a nonaccountable plan is includable as wages on the employee’s Form W-2, *Wage and Tax Statement*. Employees can then deduct eligible expenses as unreimbursed business expenses.

Depending on the facts and circumstances of the employer-employee payment arrangement, some reimbursements or allowances from an employer to an employee may be made under an accountable plan, while other payments between the same parties may be made under a nonaccountable plan.⁵

ACCOUNTABLE PLAN

An arrangement under which an employer reimburses an employee for expenses or provides an advance or an allowance to the employee to cover the expenses is an accountable plan if **all** the following requirements are met.⁶

1. The expenses have a **business connection**, meaning that the employee incurred the expenses in connection with the performance of services as an employee of the employer and the expenses are allowable as deductions.
2. The employee **adequately substantiates** the expenses by accounting to the employer for these expenses within a **reasonable period of time**.
3. The employee **returns to the employer any excess reimbursement**, advance, or allowance within a **reasonable period of time**.

The determination of whether expenses are paid under an accountable plan is determined on an employee-by-employee basis.

¹ IRC §162(a).

² IRC §62(a)(1).

³ IRC §67(a).

⁴ Treas. Reg. §1.62-2(c)(4).

⁵ Treas. Reg. §§1.62-2(c)(1), (d)(2).

⁶ Treas. Reg. §§1.62-2(d), (e), (f).

Adequate Substantiation

Requirement 2 states that employees must adequately substantiate the expenses paid by their employers through an accountable plan. The following expense categories must be substantiated.⁷

- Travel expenses while away from home, including meals and lodging

Note. The tax rules for deducting travel expenses, including the 50% limitation on meals and entertainment are explained in the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Special Taxpayers.

- Expenses associated with business entertainment, amusement, or recreation, or incurred for a facility used in connection with these types of activity
- Business gifts (The amount deductible by the employer may be limited.)
- Certain “listed property,” including passenger automobiles⁸

Substantiation for travel, entertainment, and gift expenses must include an **adequate accounting** and other evidence to prove the following.⁹

- The amount of the expense or gift
- The time and place of the travel or entertainment, the use of the facility, or the date and description of the gift
- The business purpose of the expense or gift
- The business relationship to the employee of the persons entertained or receiving the gift

The regulations specify that an “adequate accounting” means that an employee must submit to the employer an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the information as to each element of an expenditure is recorded at or near the time of the expenditure.¹⁰ In addition, for all lodging expenses incurred while traveling away from home and for any other expenditure of \$75 or more (with the exception of a transportation charge when documentation may not be readily available), the employee must also submit to the employer documentary evidence such as receipts, paid bills, or similar evidence sufficient to support the expenditure.¹¹

The table on the following page provides a template for an **adequate accounting** by an employee.¹²

⁷ IRC §274(d).

⁸ Listed property is governed by alternative methods for substantiation. See Temp. Treas. Reg. §1.274-6T.

⁹ IRC §274(d).

¹⁰ Treas. Reg. §1.274-5(f)(4).

¹¹ Treas. Reg. §1.274-5(c)(2)(iii).

¹² Treas. Reg. §1.62-2(e).

	Amount	Time	Place or Description	Business Purpose or Relationship
Travel	Costs for each separate expense: lodging, meals, and incidental expenses (which may be grouped into categories such as “tips”)	Days departing and returning and number of days spent on business for each trip	Name of city departing from and arriving to	Business purpose for trip
Transportation	Cost of each separate expense, including mileage for each business use	Date of expense	Business destination	Business purpose for expense
Gifts	Cost of gift	Date gift given	Description of gift	Business reason for gift, including name, title, and business relationship of the recipient
Expenses	Cost of each separate expense	Date of entertainment	Address of entertainment venue, as well as a description of type of entertainment	Business reason for entertainment, including any business discussions taking place and names, titles, and business relationships of attendees

Deemed Substantiation. An **employer** can pay a per diem allowance to an employee instead of reimbursing actual travel expenses to an employee. The amount of the expenses paid for each calendar day is **deemed substantiated** if it does not exceed the lesser of the per diem allowance for that day or the amount computed at the federal per diem rate. If the **employee** provides an adequate accounting to the employer (as described earlier), they are not required to include the amount deemed substantiated in their gross income. The amount deemed substantiated is not reported as wages on the employee’s Form W-2 and is exempt from withholding and payment of employment taxes.¹³

Note. The federal per diem rates are effective October 1 of each fiscal year. These rates can be found at www.gsa.gov/perdiem.

Note. For a detailed explanation of how to calculate appropriate deductions for meals and lodging using the federal per diem rates, including a discussion of the high-low method, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Special Taxpayers.

¹³ Rev. Proc. 2011-47, 2011-42 IRB 520.

For business trips in which the employee uses a personal vehicle, the employee may receive a per-diem advance, allowance, or reimbursement based on federal mileage rates in lieu of substantiating actual costs.¹⁴ For 2014, the federal mileage rate is \$0.56 per mile for business miles driven.¹⁵ This method does not relieve the employee of the requirement to substantiate the business mileage, time, destination, and business purpose of each use.

If the actual business expenses exceed the amount of the per diem, the employee may receive from the employer, under an accountable plan, a reimbursement equal to the actual expense. The actual expenses must be substantiated.

Generally, if the amount of an employee reimbursement under an accountable plan is less than the total amount of the business expenses paid or incurred by the employee and the employer does not reimburse the employee for the excess costs, it may be necessary to allocate the reimbursement. An allocation is necessary when an employer:¹⁶

- Pays the employee a single amount that covers meals and/or entertainment, as well as other expenses; **and**
- Does not clearly identify how much is for deductible meals and/or entertainment.

Example 1. Marta received an allowance of \$1,000 from her employer for business travel under an accountable plan. The employer did not specify how much of the allowance was for meals, entertainment, and lodging. On her business trip, Marta spent \$1,000 for lodging expenses and \$500 for meals and entertainment.

Because Marta spent more than what was paid to her under the accountable plan and because her employer did not specify how much of the allowance was for meals and entertainment, Marta must allocate the reimbursement. Her allocation worksheet follows.¹⁷

1 Employer reimbursements not reported in box 1 of Form W-2		\$1,000	\$1,000
2 Total amount of expenses Marta incurred	\$1,500		
3 Of amount on line 2, amount attributable to meals and entertainment	500		
4 Percentage of total expenses attributable to meals and entertainment (line 3 ÷ line 2)	.333	× .333	
5 Amount of the employer reimbursement attributable to meals and entertainment (line 1 × line 4)		\$ 333	(333)
Amount of the reimbursement attributable to lodging expenses (line 1 – line 5)			\$ 667

Reasonable Period of Time

The regulations provide a safe harbor during which accountable plan actions are treated as taking place within a **reasonable period of time**.¹⁸ The following parameters define the safe harbor period.

- The advance is made within 30 days of when an expense is paid or incurred.
- The employee adequately accounts for expenses within 60 days after the expenses were paid or incurred.
- The employee returns any excess reimbursement within 120 days after the expenses were paid or incurred.
- The employee adequately accounts for outstanding advances or returns excessive advances within 120 days of the date of receiving a quarterly (or more frequent) statement from the employer.

¹⁴ Treas. Reg. §1.274-5(g)(2)(ii).

¹⁵ 2014 Standard Mileage Rates. [www.irs.gov/2014-Standard-Mileage-Rates-for-Business,-Medical-and-Moving-Announced] Accessed on Apr. 7, 2014.

¹⁶ IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

¹⁷ Ibid.

¹⁸ Treas. Reg. §1.62-2(g)(2).

Failure to Meet Requirements

If an advance or reimbursement fails to meet all requirements for an accountable plan, it is deemed to have been paid under a nonaccountable plan and is consequently includable in the employee's income. Several common situations trigger this result.

- **The employee fails to adequately account for expenses within a reasonable period of time.** If an employee fails to adequately account for expenses and provide their employer with the required documentation within a reasonable period of time, the entire advance or reimbursement must be treated as having been paid under a nonaccountable plan. It then is subject to withholding and payment of employment taxes no later than the first payroll period following the expiration of the reasonable period.¹⁹ The employee is required to report that income even if the employer fails to include it on the employee's Form W-2.
- **The employee fails to return excess reimbursements within a reasonable period of time.** When an employee fails to return excess advances or reimbursements to the employer within a reasonable period of time, the excess advance is treated as paid under a nonaccountable plan. An excess reimbursement or advance is any amount the employee received from the employer that exceeds the business-related expenses that the employee adequately accounted for to the employer. This excess amount is subject to withholding and payment of employment taxes no later than the first payroll period following the expiration of the reasonable period.²⁰
- **The employee receives reimbursements for nondeductible expenses.** If an employer advances an amount or reimburses an employee for a nondeductible expense, that amount is treated as having been paid under a nonaccountable plan.

Example 2. Draft Foods provides its employee Darnell with a \$2,000 travel advance to fly to Hawaii for a business trip. Included in the advance is \$1,000 to pay the airfare for Darnell's spouse. The \$1,000 attributable to the employee's airfare satisfies the requirements for payments under an accountable plan. The \$1,000 attributable to Darnell's wife's airfare is a nondeductible expense and is treated as having been paid under a nonaccountable plan. Therefore, Draft Foods includes the \$1,000 paid for Darnell's wife's airfare in box 1 of his Form W-2. The amount Darnell receives for his own airfare under the accountable plan is included in box 12 of his Form W-2, with a code "L," which signifies that the \$1,000 is a nontaxable, substantiated business expense.

Note. Darnell must include a Form 2106 or 2106-EZ with his tax return. These forms are discussed later in this section.

- **The employee receives a per diem allowance that is more than the federal rate.** If an employee receives a per diem advance at a rate higher than the applicable federal rate, the portion of the advance that is greater than the federal rate is considered paid under a nonaccountable plan. It should be included as income in box 1 of the employee's Form W-2. The employee is required to report that income even if the employer fails to include it on the employee's Form W-2.

¹⁹ Ibid.

²⁰ Treas. Reg. §1.62-2(h)(2)(i)(A).

Reimbursement Less Than Actual Expenses

If an employer's accountable plan does not adequately reimburse the employee for the full amount of deductible business expenses, the employee may claim a deduction for the unreimbursed expenses by filing Form 2106, *Employee Business Expenses*, or Form 2106-EZ, *Unreimbursed Employee Business Expenses*.

Example 3. Frugal Company provides Edward with a per diem advance of \$75 per day for his 5-day business trip to San Francisco. Edward's **substantiated** business expenses actually totaled \$300 per day, but the company does not pay the difference to him.

Frugal Company includes \$375 (\$75 per day × 5 days) in box 12 of Edward's Form W-2. This amount is considered paid under an accountable plan. As such, Edward is not required to pay taxes on that amount and does not claim a deduction for the expenses covered by that amount.

Edward may claim the remaining \$1,125 ((\$300 actual expenses per day × 5 days) – \$375 advance) of substantiated business expenses as unreimbursed employee business expenses on Form 2106. However, he may only deduct 50% of the actual costs of his meals and entertainment. He can report this total as a miscellaneous itemized deduction on line 21 of his Schedule A. This amount is subject to the 2% floor.

NONACCOUNTABLE PLAN

A **nonaccountable plan** is any employer-employee expense reimbursement arrangement that does not meet the three statutory requirements for an accountable plan (listed earlier in this chapter). It is the **employer's decision** whether to reimburse an employee under an accountable plan or a nonaccountable plan. The employee cannot "transform" a nonaccountable plan to an accountable plan by substantiating expenses and returning excessive reimbursements to the employer.

When an employer reimburses or advances expenses to an employee under a nonaccountable plan, the amount of the reimbursement or advance should be included in box 1 of the employee's Form W-2 as income. The amount is subject to withholding and employment taxes.²¹

Nonaccountable plan reimbursements that are included in the employee's gross income may be deducted by the employee as unreimbursed employee business expenses. The following section details the procedure for substantiating and reporting these expenses.

Note. Expenses reimbursed under a nonaccountable plan are considered unreimbursed employee business expenses for tax purposes.

DEDUCTING EMPLOYEE BUSINESS EXPENSES

To deduct employee business expenses (either expenses that have not been reimbursed or expenses reimbursed under a nonaccountable plan), a taxpayer generally is required to complete Form 2106 or Form 2106-EZ. The total allowable expenses from Form 2106 or Form 2106-EZ is then entered on Schedule A, line 21. Accordingly, only taxpayers who itemize deductions may claim a deduction for employee business expenses.

An employee can use Form 2106-EZ, rather than the longer Form 2106, if all of the following conditions are met.²²

- The employee is deducting ordinary and necessary expenses attributable to the employee's job.
- The employee was not reimbursed by the employer for their expenses (amounts included in box 1 of the employee's Form W-2 are not considered reimbursements).
- The employee uses the standard mileage rate for any claimed car expenses.

²¹ Treas. Reg. §1.62-2(c)(5).

²² IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

Neither Form 2106 nor Form 2106-EZ is required if:

- All reimbursements, if any, are included in box 1 of the employee's Form W-2; **and**
- The employee is not claiming travel, transportation, meal, or entertainment expenses.²³

If both of the preceding requirements are met, the employee may enter the business expenses (such as those for continuing education courses or union dues) directly on line 21 of Schedule A.

Deduction Limitations

Employee business expenses fall into the category of miscellaneous itemized deductions and are subject to deduction limitations. An employee may only deduct the amount of miscellaneous itemized deductions exceeding 2% of their AGI.²⁴ In addition to being subject to the 2% floor, an employee may generally only include 50% of substantiated meal and entertainment expenses in calculating the total amount of business expenses.²⁵

Note. Workers subject to Department of Transportation hours of service (HOS) limits can deduct 80% of meal costs incurred during the period in which the worker is subject to the HOS limits. For more information about transportation workers, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Special Taxpayers.

Deductible Expenses

Employees may generally deduct business expenses that are “ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. . . .”²⁶ An expense does not have to be required to be considered necessary. Examples of deductible business expenses include the following.²⁷

- Expenses for transportation
- Travel fares
- Lodging while away from home
- Business meals and entertainment
- Continuing education courses
- Subscriptions to professional journals
- Union or professional dues
- Professional uniforms
- Job hunting expenses
- Business use of the employee's home

²³ IRS Pub. 970, *Tax Benefits for Education*.

²⁴ IRC §§67(a), (b).

²⁵ IRC §274(n).

²⁶ Treas. Reg. §1.162-1(a).

²⁷ Temp. Treas. Reg. §1.67-1T(a)(1)(i).

Required Recordkeeping

Employees wishing to deduct unreimbursed business expenses (or those paid under a nonaccountable plan) must maintain records to prove the time, place, business purpose, business relationship (for entertainment expenses and gifts), and the amounts of the expenses,²⁸ as shown in the chart provided earlier. Employees should also keep receipts or other documentation for all lodging expenses and for other business expenses greater than \$75.²⁹

Example 4. Arrowhead, Inc., provided its employee Matthew with an allowance to travel to a business conference in Joplin, Missouri, in October 2013. Arrowhead wanted Matthew to attend the conference to maintain his job skills. Arrowhead paid the conference registration fee directly to the provider but paid Matthew the standard federal per diem allowance for his lodging, meals, and transportation (including lodging at \$83 per night for three nights and meals at \$46 per day for four days).

Arrowhead's accountable plan reimburses mileage at the federal mileage rate, which is \$0.565 for 2013. Matthew drove from his home in Des Moines, Iowa, to Joplin, Missouri (698 miles round trip) to attend the conference; therefore, his reimbursable mileage is \$394 (698 miles \times \$0.565). He left in the early morning hours of October 7, 2013, and arrived in Joplin at 9:00 a.m.

The amount Arrowhead paid for Matthew's travel was \$827, allocated as follows.

Lodging (\$83 per diem \times 3 nights)	\$249
Meals (\$46 per diem \times 4 days)	184
Mileage (698 miles \times \$0.565)	<u>394</u>
Total paid by Arrowhead	\$827

Matthew stayed at the Garden Hotel, which cost \$150 per night. He ate all his meals at the Garden Hotel's restaurant, where the meals cost \$60 per day. He stayed at the hotel for three nights and was away from home for four full days. He left Joplin at 4:00 p.m. on October 10, 2013.

Within 10 days of returning from his trip, Matthew submitted the receipt from his hotel to Arrowhead, along with the following accounting.

²⁸ Temp. Treas. Reg. §1.274-5T(c)(1).

²⁹ IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

Category	Amount	Date	Place	Business Purpose
Lodging	\$450	10/07/2013– 10/10/2013	Garden Hotel, Joplin, Missouri	Travel to business conference required by employer for employee to maintain job skills
Meals	60	10/07/2013	Joplin, Missouri	Travel to business conference required by employer for employee to maintain job skills
Meals	60	10/08/2013	Joplin, Missouri	Travel to business conference required by employer for employee to maintain job skills
Meals	60	10/09/2013	Joplin, Missouri	Travel to business conference required by employer for employee to maintain job skills
Meals	60	10/10/2013	Joplin, Missouri	Travel to business conference required by employer for employee to maintain job skills
Transportation	349 miles × \$0.565 = \$197	10/07/2013	Des Moines, Iowa to Joplin, Missouri	Travel to business conference required by employer for employee to maintain job skills
Transportation	349 miles × \$0.565 = \$197	10/10/2013	Joplin, Missouri to Des Moines, Iowa	Travel to business conference required by employer for employee to maintain job skills

Matthew was satisfied with his mileage rate, but he realized that the actual cost of his trip exceeded the \$827 paid by Arrowhead by \$257, as follows.

Mileage (698 miles × \$0.565)	\$ 394
Hotel (actual cost)	450
Meals (actual cost)	240
Total cost	\$1,084
Amount reimbursed	(827)
Excess costs paid by Matthew	\$ 257

Matthew promptly asked Arrowhead to reimburse the difference, but Arrowhead informed Matthew that it would not do so.

Matthew's 2013 Form W-2 from Arrowhead included \$827 in box 12, which was the amount paid by Arrowhead for Matthew's trip. None of the advance was included in box 1 of his Form W-2.

Because Matthew was reimbursed for part of his expenses under an accountable plan, he must complete Form 2106 to deduct his **unreimbursed** business expenses.

2014 Workbook

It is not difficult to allocate Matthew's unreimbursed expenses between lodging and meals because his accountable plan allowance was allocated between lodging and meals. Matthew's unreimbursed amounts are calculated as follows.

	Lodging	Meals
Actual expenses	\$450	\$240
Less: reimbursed expenses	<u>(249)</u>	<u>(184)</u>
Unreimbursed expenses	\$201	\$ 56

Matthew can only include 50% of his unreimbursed meals in calculating his total deductible expenses on Form 2106, which follows. This is calculated on line 9.

Unless Matthew's job expenses, combined with any other miscellaneous itemized expenses included on lines 21–23 of Schedule A, exceed 2% of his AGI, he cannot deduct his expenses from the trip. If he elects to itemize his deductions, he can only deduct that amount of his miscellaneous itemized expenses that exceed the 2% floor.

For Example 4

Form 2106 Department of the Treasury Internal Revenue Service (99)	<h3>Employee Business Expenses</h3> <p>► Attach to Form 1040 or Form 1040NR. ► Information about Form 2106 and its separate instructions is available at www.irs.gov/form2106.</p>	OMB No. 1545-0074 <div style="border: 1px solid black; padding: 5px; text-align: center;"> 2013 Attachment Sequence No. 129 </div>
Your name Matthew Mullenix	Occupation in which you incurred expenses Computer Programming	Social security number 555 44 5555

Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1 394	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3 450	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	
5 Meals and entertainment expenses (see instructions)		240
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6 844	240

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions).	7 643	184
---	---------------------	------------

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8 201	56
<p>Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.</p>		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	9 201	28
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 21 (or on Schedule A (Form 1040NR), line 7). (Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.)	10	229

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11700N

Form **2106** (2013)

For Example 4

Form 2106 (2013)

Page **2**

Part II Vehicle Expenses					
Section A—General Information (You must complete this section if you are claiming vehicle expenses.)		(a) Vehicle 1		(b) Vehicle 2	
11	Enter the date the vehicle was placed in service	11	05 / 01 / 2012		/ /
12	Total miles the vehicle was driven during 2013	12	8,200 miles		miles
13	Business miles included on line 12	13	698 miles		miles
14	Percent of business use. Divide line 13 by line 12	14	8.5 %		%
15	Average daily roundtrip commuting distance	15	15 miles		miles
16	Commuting miles included on line 12	16	3,375 miles		miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17	4,127 miles		miles
18	Was your vehicle available for personal use during off-duty hours?			<input checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
19	Do you (or your spouse) have another vehicle available for personal use?			<input checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
20	Do you have evidence to support your deduction?			<input checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
21	If "Yes," is the evidence written?			<input checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)					
22	Multiply line 13 by 56.5¢ (.565). Enter the result here and on line 1	22	394		
Section C—Actual Expenses		(a) Vehicle 1		(b) Vehicle 2	
23	Gasoline, oil, repairs, vehicle insurance, etc.	23			
24a	Vehicle rentals	24a			
b	Inclusion amount (see instructions)	24b			
c	Subtract line 24b from line 24a	24c			
25	Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25			
26	Add lines 23, 24c, and 25.	26			
27	Multiply line 26 by the percentage on line 14	27			
28	Depreciation (see instructions)	28			
29	Add lines 27 and 28. Enter total here and on line 1	29			
Section D—Depreciation of Vehicles (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)					
		(a) Vehicle 1		(b) Vehicle 2	
30	Enter cost or other basis (see instructions)	30			
31	Enter section 179 deduction and special allowance (see instructions)	31			
32	Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance).	32			
33	Enter depreciation method and percentage (see instructions)	33			
34	Multiply line 32 by the percentage on line 33 (see instructions)	34			
35	Add lines 31 and 34	35			
36	Enter the applicable limit explained in the line 36 instructions	36			
37	Multiply line 36 by the percentage on line 14	37			
38	Enter the smaller of line 35 or line 37. If you skipped lines 36 and 37, enter the amount from line 35. Also enter this amount on line 28 above	38			

Form **2106** (2013)

BUYERS AND SELLERS OF SECURITIES

The tax treatment of buyers and sellers of securities depends on the taxpayers' specific activities; based upon those activities, the taxpayers should be classified as investors, dealers, or traders. Generally, an **investor** is a casual trader who is not in the trade or business of buying and selling securities. An investor's securities-related income and losses are **treated as capital gains and losses**. A **dealer**, on the other hand, is in the trade or business of marketing securities for sale to customers. As such, dealers incur **ordinary gains and losses** and can deduct business expenses. Somewhere between an investor and a dealer is a trader, sometimes called a day trader. **Traders** are in the actual business of buying and selling securities for their own accounts; they do not have customers or maintain an inventory. Trader status, while difficult to obtain, grants a taxpayer the ability to **deduct expenses and recognize ordinary gains and losses** if the trader elects the **mark-to-market** accounting method.

This section explains the rules governing the classification and tax treatment of investors, dealers, and traders. A chart summarizing the key details regarding each classification follows.

	Investor	Dealer	Trader	
			No Mark-to-Market Election	Mark-to-Market Election
Gain	Capital	Ordinary	Capital	Ordinary
Loss	\$3,000 limit	Ordinary	\$3,000 limit	Ordinary
Reporting income	Schedule D, Form 8949	Form 4797	Schedule D, Form 8949	Form 4797
Wash sale rules	Yes	No	Yes	No
Expenses	IRC §212	IRC §162	IRC §162	IRC §162
Reporting expenses	Schedule A	Schedule C	Schedule C	Schedule C
Dividends/interest	Schedule B	Schedule C	Schedule C	Schedule C
IRC §179 expensing	No	Yes	Yes	Yes
Home office	No	Yes	Yes	Yes
SE tax	No	Yes	No	No
Investment interest	Yes	No	No	No

INVESTORS

Investors buy and sell securities with the expectation of receiving personal income from the resulting dividends, interest, or capital appreciation.³⁰ Investors are not engaged in a trade or business. Individual investors must report their capital gains and losses on Schedule D, *Capital Gains and Losses*, and, if required, on Form 8949, *Sales and Other Dispositions of Capital Assets*.

Note. For detailed information about Schedule D and Form 8949, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses.

³⁰ *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2nd Cir. 1989).

Deducting Losses

Under IRC §1211(b), noncorporate investors may deduct losses from the sales or exchanges of capital assets only to the extent of the gains from such sales or exchanges, plus (if the losses exceed the gains) the lesser of the following.

- \$3,000 (\$1,500 for an individual filing MFS)
- The amount that the losses exceed the gains

Wash Sale Rules

Investors are also subject to IRC §1091 wash sale rules, which are intended to prevent investors from profiting from artificially created losses.³¹ IRC §1091(a) generally prevents investors from deducting any loss from the sale of securities when it appears that the investor purchased substantially similar securities within 30 days of the sale.

Deducting Expenses

Investors may deduct the ordinary and necessary expenses they incur in connection with their investment activities under IRC §212.³² Investment expenses are the allowed deductions (other than interest expense) directly connected with the production of investment income. Investment expenses that are included as a miscellaneous itemized deduction on Schedule A are considered allowable deductions after applying the 2%-of-AGI limit. The allowable amount is the smaller of:

- The investment expenses included on Schedule A, line 23; or
- The amount on Schedule A, line 27.

Common deductible investment expenses include the following.

- Investment advice
- Legal fees
- Accountant fees
- Investment newsletters

Investors are limited to deducting only those expenses incurred in connection with their investment activities. Accordingly, a number of common business deductions are **not available** to investors, including the following.

- The costs of attending conventions, seminars, or similar meetings for investment purposes³³
- A home office used for income-producing activities³⁴
- IRC §179 expensing³⁵ (IRC §179 allows persons involved in a trade or business to deduct, in the first year of use, all or a significant portion of the cost of a long-term depreciable asset purchase.)
- Commission fees or other costs of obtaining securities (These expenses may be applied when calculating gain or loss at disposition.)
- Start-up expenses or those expenses incurred when starting up an income-producing activity

Note. An investor's expenses do not reduce alternative minimum taxable income.³⁶

³¹ Treas. Reg. §1.1091-1.

³² *Arberg v. Comm'r*, 2007 TC Memo 244 (Aug. 27, 2007).

³³ IRC §274(h)(7).

³⁴ IRC §280A(b).

³⁵ IRC §179(b)(3).

³⁶ *Mayer v. Comm'r*, TC Memo 1994-209 (May 11, 1994).

Deducting Investment Interest

Investors may generally deduct **investment interest** (the interest paid on money borrowed to purchase investment property), up to the amount of the investor's **net investment income (NII)** for the taxable year.³⁷ The deduction is generally calculated on Form 4952, *Investment Interest Expense Deduction*, with the total reported as an itemized deduction on Schedule A, line 14. (Form 4952 is discussed later in this section.)

NII is defined as the amount of investment income that exceeds investment expenses.³⁸ **Investment income** generally includes gross income from property held for investment or from its disposition, such as interest, dividends, annuities, royalties, and short-term gain on the disposition of property. Investment income does not include **qualified dividend income**³⁹ or net capital gains unless the taxpayer elects to include them.⁴⁰ Any qualified dividend income the taxpayer elects to include as investment income **may not** be taxed at capital gains rates.⁴¹

Note. A taxpayer wishing to include net capital gain and qualified dividend income as investment income must make such an election on line 4g of Form 4952 on or before the date the return is due (including extensions) for the tax year in which the taxpayer recognizes the gain or receives the qualified dividend income.⁴²

IRC §163(d)(3)(B) excludes the following from investment interest.

- Qualified residence interest⁴³
- Interest which is taken into account under IRC §469 in computing income or loss from a passive activity of the taxpayer

Limitations on Deduction. Any investment interest not allowed as a deduction for a tax year because it exceeded the amount of the taxpayer's NII may be carried over to the following tax year. The interest carried over is treated as investment interest paid or accrued by the investor in the subsequent year.

Example 5. For the 2013 tax year, Molly's investment income from interest and dividends is \$10,000. This includes \$500 of qualified dividends, which she does not elect to treat as investment income. The amount of her investment expenses (other than interest) that exceeds the 2%-of-AGI floor is \$2,400. Her investment interest expense is \$9,000.

Molly's NII, which is also the limit on her investment interest expense deduction, is calculated as follows.

Total investment income	\$10,000
Less: qualified dividends	(500)
Subtotal	\$ 9,500
Less: investment expenses (excluding interest)	(2,400)
NII	\$ 7,100

³⁷ IRC §163(d).

³⁸ IRC §163(d)(4)(A). See also *Arberg v. Comm'r*, 2007 TC Memo 244 (Aug. 27, 2007).

³⁹ IRC §1(h)(11)(B).

⁴⁰ IRC §163(d)(4)(B).

⁴¹ Treas. Reg. §1.163(d)-1(a).

⁴² Treas. Reg. §1.163(d)-1(b).

⁴³ IRC §163(h)(3).

2014 Workbook

Molly may only take an investment interest deduction up to her \$7,100 amount of NII. She may carry forward the excluded amount of \$1,900 (\$9,000 total investment interest expense – \$7,100 allowed deduction) to the 2014 tax year.

Molly's Form 4952 follows.

Form 4952 <small>Department of the Treasury Internal Revenue Service (99)</small>	Investment Interest Expense Deduction ► Information about Form 4952 and its instructions is at www.irs.gov/form4952 . ► Attach to your tax return.	OMB No. 1545-0191 2013 Attachment Sequence No. 51
Name(s) shown on return Molly N. Vestor		Identifying number 777-88-9999
Part I Total Investment Interest Expense		
1	Investment interest expense paid or accrued in 2013 (see instructions)	1 9,000
2	Disallowed investment interest expense from 2012 Form 4952, line 7	2
3	Total investment interest expense. Add lines 1 and 2	3 9,000
Part II Net Investment Income		
4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a 10,000
4b	Qualified dividends included on line 4a	4b 500
4c	Subtract line 4b from line 4a	4c 9,500
4d	Net gain from the disposition of property held for investment	4d
4e	Enter the smaller of line 4d or your net capital gain from the disposition of property held for investment (see instructions)	4e
4f	Subtract line 4e from line 4d	4f 0
4g	Enter the amount from lines 4b and 4e that you elect to include in investment income (see instructions)	4g 0
4h	Investment income. Add lines 4c, 4f, and 4g	4h 9,500
5	Investment expenses (see instructions)	5 2,400
6	Net investment income. Subtract line 5 from line 4h. If zero or less, enter -0-	6 7,100
Part III Investment Interest Expense Deduction		
7	Disallowed investment interest expense to be carried forward to 2014. Subtract line 6 from line 3. If zero or less, enter -0-	7 1,900
8	Investment interest expense deduction. Enter the smaller of line 3 or 6. See instructions	8 7,100

For Paperwork Reduction Act Notice, see page 4.

Cat. No. 13177Y

Form 4952 (2013)

Molly's line 8 investment interest expense deduction of \$7,100 is then entered on line 14 of her Schedule A.

	9	
Interest You Paid Note. Your mortgage interest deduction may be limited (see instructions).	10	Home mortgage interest and points reported to you on Form 1098
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ►
	12	Points not reported to you on Form 1098. See instructions for special rules
	13	Mortgage insurance premiums (see instructions)
	14	Investment interest. Attach Form 4952 if required. (See instructions.)
	15	Add lines 10 through 14
		15 7,100

Tax-Exempt Income. Investors cannot deduct interest and expenses incurred in purchasing tax-exempt investments or producing tax-exempt interest. If the investor has expenses that are for both tax-exempt and taxable income and cannot specifically identify what part of the expenses is for each type of income, they can divide the expenses, using reasonable proportions. The investor must attach a statement to their return showing how they divided the expenses and stating that each deduction claimed is not based on tax-exempt income.⁴⁴

When to Report Investment Interest. Investors using a cash method of accounting may only deduct interest that has actually been paid. Investors using an accrual method can deduct the interest in the period it accrues, regardless of when the interest is paid.

Allocating Interest Expense. If an investor borrows money that is used for business purposes or personal purposes as well as for investment purposes, the interest on the debt must be allocated. Only the interest expense for the portion of the debt used for investment purposes is treated as investment interest.

Example 6. In 2013, Joe borrowed \$10,000 from First Bank. He used the loan proceeds to purchase \$7,500 in stock and pay a separate \$2,500 balance on a loan for his business.

Joe paid \$600 in interest on the loan in 2013. Because he used only 75% ($\$7,500 \div \$10,000$) of the loan for investment purposes, 75% of the interest expense is investment interest. Therefore, Joe's investment interest expense is \$450 ($75\% \times \600).

Form 4952

Individual investors must file Form 4952 to deduct investment interest unless they meet **all** the following conditions.⁴⁵

- The investment income from interest and ordinary dividends minus any qualified dividends is more than the investment interest expense.
- The investor does not have any other deductible investment expenses.
- The investor does not have any carryover of investment interest expense from the prior tax year.

Taxpayers who satisfy the above conditions can deduct their investment interest by reporting it directly on line 14 of Schedule A.

Example 7. Use the same facts as **Example 6**. Joe received \$650 in ordinary dividends on the stock he purchased in 2013. He has no other investment income or expenses and he does not have any carryover investment interest expense from 2012.

Joe's investment interest expense of \$450 may be simply entered on line 14 of Schedule A, without completing a Form 4952, because:

- Joe's investment income of \$650 is more than his allocated investment interest expense of \$450;
- Joe has no other deductible investment expenses; and
- Joe has no carryover investment expense from a prior year.

⁴⁴ IRS Pub. 550, *Investment Income and Expenses*.

⁴⁵ Instructions to Form 4952.

Net Investment Income Tax

Beginning in 2013, many investors are also subject to a net investment income tax (NIIT) on their investment income. For individual taxpayers, the NIIT is 3.8% of the **lesser** of:⁴⁶

1. NII for the tax year, or
2. The amount of modified adjusted gross income (MAGI) in excess of the taxpayer's threshold amount.

The taxpayer's threshold amount depends upon their filing status, as follows.⁴⁷

Filing Status	Threshold Amount
Married filing jointly	\$250,000
Married filing separately	125,000
Single, head of household, qualifying widow(er)	200,000

NII for purposes of the NIIT includes the following types of income.⁴⁸

- Gross income from interest, dividends, annuities, royalties, and rents, unless such income is received in the ordinary course of a trade or business
- Other gross income from any passive trade or business or a trade or business of trading in financial instruments or commodities
- Net capital gain arising from the disposition of property other than property held in a trade or business (For purposes of determining NII, a trade or business **does not** include a taxpayer's **passive activity** under IRC §469 or **trading in financial instruments and commodities** as defined in IRC §475(e)(2). Accordingly, income from these activities is considered investment income.)

From these amounts, taxpayers can take deductions for those expenses properly allocable to income, such as investment interest expenses, brokerage fees, state income tax, and tax preparation fees. Unlike other types of income, unless a deduction is specifically identified as properly allocable to NII in Treas. Reg. §1.411-4(f)(3) or in supplemental guidance issued by the IRS, the deduction is not permitted.⁴⁹

Note. For more information about the NIIT, see the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Affordable Care Act Update.

DEALERS IN SECURITIES

Dealers earn their income from marketing securities for sale to customers. Dealers' profits arise from the markup they charge their customers for their services rather than from fluctuations in the market. Dealers in the trade or business of buying and selling securities report their gains and losses as ordinary gains and losses, not as capital gains and losses.⁵⁰ These gains and losses are reported on Form 4797, *Sales of Business Property*. The IRS requires dealers to use the mark-to-market accounting method in reporting their income, which is explained later in this section.

⁴⁶ IRC §1411(a)(1).

⁴⁷ Treas. Reg. §1.1411-2(d).

⁴⁸ IRC §1411(c).

⁴⁹ TD 9644, 2013-51 IRB 676.

⁵⁰ IRC §§1236 and 1221(a)(1).

Definitions

For purposes of the rules concerning dealers in securities, a **security** is broadly defined as:

*... any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.*⁵¹

A **dealer in securities** is defined by IRS regulations as someone with all the following attributes.⁵²

- Is a merchant of securities (whether an individual, partnership, or corporation)
- Has an established place of business
- Regularly engages in the purchase of securities and their resale to customers

In other words, a dealer in securities is a merchant who buys securities and sells them to customers in the ordinary course of business with a view to earn gains and profits.⁵³ A dealer may or may not maintain an inventory.

A stockbroker who buys and sells on commission for customers is not a dealer. Floor specialists, however, who carry an inventory to sell to stockbrokers, **are** dealers for their floor specialist activities. Floor specialists are not dealers in terms of their other securities holdings. A **floor specialist** is defined by the Code⁵⁴ as a person who:

- Is a member of a national securities exchange,
- Is registered as a specialist with the exchange, and
- Meets the requirements for specialists established by the Securities and Exchange Commission.

Dealing in securities need not constitute a taxpayer's entire business activity. If the securities business is merely a **branch** of the activities carried on by the taxpayer, the securities treated as part of the dealer's inventory only include those securities held for purposes of resale and not investment.⁵⁵ Similarly, individuals are treated as dealers only for their dealer activities. Their personal investments are considered separately.

The following general rules may be helpful in determining whether income is allocable to a dealer.

- If a bank operates a securities department, it may qualify as a dealer only to the extent of its holdings in the securities department, but **not** as to its other investment holdings.
- Taxpayers who buy and sell or hold securities for investment or speculation, regardless of whether their buying or selling constitutes the carrying on of a trade or business, **are not** dealers in securities.⁵⁶
- Officers of corporations and partners in partnerships, who in their individual capacities buy and sell securities for their own accounts, **are not** dealers in securities.⁵⁷
- If a dealer buys and sells securities for personal gain, they must maintain records clearly identifying the securities held for personal gain. The security held for personal gain must not have been held by the dealer primarily for sale to customers in the ordinary course of their trade or business at any time after the close of business on the day the securities are acquired.⁵⁸

⁵¹ IRC §1236(c).

⁵² Treas. Reg. §1.471-5.

⁵³ Ibid.

⁵⁴ IRC §1236(d)(2).

⁵⁵ Treas. Reg. §1.471-5.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ IRC §1236.

Dealers who are individual taxpayers should report their expenses on Schedule C, *Profit or Loss From Business*. They also report the income not associated with the sale of securities on Schedule C. However, they report the gains and losses associated with their sales of securities on part II of Form 4797 using mark-to-market rules.

Mark-to-Market Rules

With several exceptions, IRC §475 requires dealers in securities to use a **mark-to-market** accounting method. Under the mark-to-market (sometimes called “fair market value”) method, any security that is held at the close of the tax year is treated as if it were sold on the last business day of the tax year for its fair market value (FMV).

- Gain or loss is determined based on the difference between the FMV at the close of business on the last day of the tax year and the dealer’s cost basis.
- The gain or loss must be recognized and reported on the dealer’s tax return.⁵⁹

Under this method, subsequent gains or losses are adjusted to reflect earlier-recognized (though not actually realized) gain or loss.

The mark-to-market rules do not apply to the following.

- Any securities held for investment that were clearly identified in the dealer's records before the close of the day on which they were acquired⁶⁰
- Notes, bonds, debentures, and other debt instruments acquired in the ordinary course of a trade or business and not held for resale⁶¹ (These must also be clearly identified in the dealer’s records before the close of the day on which they were acquired.)
- Nonfinancial customer paper (trade receivables) held by a taxpayer who generated them in a business involving the sale of **nonfinancial** goods or services⁶²

Note. Commodities dealers may elect to apply mark-to-market rules to commodities in the same manner that the rules apply to securities held by securities dealers.⁶³ Once a commodities dealer makes such an election, it may be revoked only with IRS consent.⁶⁴

TRADERS

Traders (also called day traders) are distinct from both investors and dealers. Taxpayers who qualify as traders can choose to recognize ordinary, rather than capital, gains and losses. They can then deduct expenses on Schedule C (instead of deducting only the amount that exceeds 2% of their AGI), and their losses are not subject to the \$3,000 capital loss limit. Taxpayers in the actual business of buying and selling securities for their own accounts⁶⁵ can be considered in a trading business, even if they do not have customers or maintain an inventory.

⁵⁹ IRC §475(a)(2).

⁶⁰ IRC §475(b)(1)(A), (b)(2).

⁶¹ IRC §475(b)(1)(B).

⁶² IRC §475(c)(4).

⁶³ IRC §475(e)(1).

⁶⁴ IRC §475(f)(3).

⁶⁵ *Kay v. Comm’r*, TC Memo 2011-159 (Jul. 6, 2011), citing *King v. Comm’r*, 89 TC 445, 457-458 (1987).

Trader Test

The Code does not define “trader.” Rather, the courts have determined that a taxpayer must meet all the following conditions to be considered a trader, or someone in the trade or business of buying and selling securities for their own account.⁶⁶

- The taxpayer must seek to profit from **daily market movements** in the prices of securities and not from dividends, interest, or capital appreciation.
- The taxpayer’s activity must be substantial. (Courts generally look at the **volume** of the trades to determine whether an activity was substantial.)
- The taxpayer must carry on the activity with **continuity and regularity**.

Courts generally consider the following facts and circumstances in determining whether the activity is carried on with **continuity and regularity**.⁶⁷

- The holding periods for securities the taxpayer bought and sold
- The frequency and dollar amount of the taxpayer’s trades during the tax year
- The extent to which the taxpayer pursued the activity to produce income for a livelihood
- The amount of time devoted to the activity

Whether a taxpayer’s activities constitute a trade or business **is a question of fact**.⁶⁸ If the nature of a taxpayer’s activities does not qualify as a business, the taxpayer is considered an investor rather than a trader, regardless of the actual title the taxpayer uses. **It is very difficult for taxpayers to obtain trader status if they have other substantial employment.** The courts usually find that taxpayers who trade on a part-time basis **do not** qualify as traders for tax purposes.⁶⁹

Example 8. Frank was employed full-time as a computer chip engineer when he decided to try his hand at day trading. In one not-so-successful tax year, Frank made 12 trades in January, 133 trades in February, 145 trades in March, 25 trades in April, and four trades in May. He made no other trades that year.

Facing \$84,794 in trading losses for the tax year, Frank sought to retroactively elect mark-to-market rules as a trader so that he could deduct his losses as ordinary losses. If treated as an investor, Frank would be restricted to the \$3,000 per year capital loss limit.⁷⁰

Question. Were Frank’s activities sufficiently substantial, continuous, and regular, such that he is considered to be in the trade or business of being a trader?

Answer. No. In the actual case on which these facts were based, the Tax Court ruled that although Frank did buy and sell with a frequency necessary “to catch the swings in the daily market movements” for part of the year, his activities were not frequent, regular, and continuous for the whole year. The court stated, “In the cases in which taxpayers have been held to be traders in securities, the number and frequency of transactions indicated that they were engaged in market transactions almost daily for a substantial and continuous period, generally exceeding a single taxable year; and those activities constituted the taxpayers’ sole or primary income-producing activity.”⁷¹

⁶⁶ See, e.g., *Holsinger v. Comm’r*, TC Memo 2008-191 (Aug. 11, 2008); *Mayer v. Comm’r*, TC Memo 1994-209 (May 11, 1994); and IRS Pub. 550, *Investment Income and Expenses*.

⁶⁷ IRS Pub. 550, *Investment Income and Expenses*; Topic 429 — *Traders in Securities (Information for Form 1040 Filers)*. [www.irs.gov/taxtopics/tc429.html] Accessed on Mar. 5, 2014.

⁶⁸ *Higgins v. Comm’r*, 312 U.S. 212, 217 (1941); and *Holsinger v. Comm’r*, TC Memo 2008-191 (Aug. 11, 2008).

⁶⁹ See, e.g., *Assaderaghi v. Comm’r*, TC Memo 2014-33. (The petitioner engaged in over 500 trades annually but did not qualify for trader status. He had other full-time employment.)

⁷⁰ IRC §1211(b).

⁷¹ *Frank Chen v. Comm’r*, TC Memo 2004-132 (Jun. 1, 2004).

Example 9. Thomas was the president of a tool company until he retired in 2002. In 2006, he began the new endeavor of purchasing stocks and selling call options on the underlying stock. Thomas's goal was to earn a profit from the premiums received from selling call options against a corresponding quantity of underlying stock that he held. He held the underlying stock as a means to reduce his risk of loss in the event the purchaser of the call option exercised the option.

As a result of employing this strategy, Thomas could hold the underlying stock for a period of time that was much longer than the term of the individual call options. During the years at issue, Thomas held his stocks on average for 35 days. He held a significant number of stocks for well over a year and held some stocks for more than four years. Thomas received dividends of \$51,125 in 2006, \$39,553 in 2007, and \$29,565 in 2008. His trading volume was as follows.

Year	Trades	Trade Days
2006	204	75 days
2007	303	99 days
2008	1,543	112 days

Question. Did Thomas qualify as a trader?

Answer. No. In the case upon which this example is based,⁷² the court found that the number of trades executed by Thomas in 2006 and 2007 was not substantial. The court did find that Thomas executed a substantial number of trades in 2008. The court noted that in the cases in which taxpayers had been held to be in the trade or business of trading in securities for their own account, taxpayers engaged in market transactions on an almost daily basis. The court found that during the 36 months at issue, there were 10 months in which Thomas executed three or fewer trades. As such, the court found that his trading activity was not regular or continuous. The court also found that because Thomas's average holding period for his securities was 35 days, he was not attempting to catch and profit from the swings in the daily market. Accordingly, Thomas's activity did not constitute a business and he was not a trader for tax purposes.

Tax Implications of Trader Status

Because traders are operating a business and are not acting merely as investors, they report their business expenses on **Schedule C**. They are not subject to the Schedule A limitations on investment interest expense, which apply to investors. Furthermore, because dividends, interest from securities, and gain or loss from the sale of capital assets are not considered proceeds from self-employment (SE) income unless received by a **dealer** in stocks and securities in the course of their business, **traders are not subject to SE tax**.

Mark-to-Market Election. Traders are entitled to make a mark-to-market-election under IRC §475(f). If this election is made, gains and losses from the sales of securities are treated as **ordinary gains and losses** reported on part II of Form 4797 (just like those of a dealer). If such an election is not made, the trader's gains and losses from their sales of securities are treated as **capital gains and losses** that must be reported on Schedule D and on Form 8949, as appropriate. Only traders who do not make the mark-to-market election are subject to the \$3,000 limitation on capital losses, as well as the wash sale rules. Under the mark-to-market election (described earlier in the "Dealers in Securities" section), securities held at the end of the year are "marked-to-market," which means they are treated as though they were sold for FMV on the last business day of the year.

⁷² *Endicott v. Comm'r*, TC Memo 2013-199 (Aug. 28, 2013).

Traders make a mark-to-market election by filing a statement with their tax return for the year prior to the year for which the election is sought. For example, if a trader wishes to elect mark-to-market status for 2015, the trader must make the election with their 2014 tax return or their request for an extension, either of which must be filed by April 15, 2015.⁷³ The election statement should be attached to the trader's tax return or request for an extension and include the following information.

- That the taxpayer is making an election under IRC §475(f)
- The first tax year for which the election is effective
- The trade or business for which they are making the election (day trading)

Once traders make the mark-to-market election, they must also file a Form 3115, *Application for Change in Accounting Method*,⁷⁴ and change their accounting method.⁷⁵ After the election is made, it can only be revoked with the written permission of the IRS. This is accomplished by filing another Form 3115 and paying a fee.

Note. A trader's failure to file a Form 3115 after making the mark-to-market election does not invalidate an otherwise valid election.

ARMED FORCES RESERVISTS

Members of a reserve component of the United States Armed Forces are entitled to a number of tax privileges. This applies to those in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard; the Air National Guard; and the Reserve Corps of the Public Health Service.⁷⁶

DEDUCTIONS TO INCOME

Travel Expenses

Subject to certain rules, members of a reserve component may deduct specified unreimbursed travel expenses as an **above-the-line deduction**, rather than as a miscellaneous itemized deduction as normally used for other employee expenses. This deduction is available to members of a reserve component of the Armed Forces who **travel more than 100 miles away from home** in connection with their performance of services as a member of the reserves.⁷⁷ Under this provision, the following rules apply.⁷⁸

- Members may deduct unreimbursed travel expenses as an adjustment to income on line 24 of Form 1040, rather than as a miscellaneous itemized deduction on Schedule A.
- Members may include all unreimbursed expenses from the time they leave home until the time they return home.
- The deduction is limited to the per diem allowances established by the federal government.⁷⁹

Note. If reservists do not travel **more than 100 miles** away from home in connection with their duties, they may still be able to deduct unreimbursed expenses. They must, however, deduct those expenses on line 21 of Schedule A. These expenses are miscellaneous itemized deductions subject to the 2%-of-AGI floor.

⁷³ See Instructions for Schedule D for further information on how to make the election.

⁷⁴ IRS Pub. 550, *Investment Income and Expenses*.

⁷⁵ Rev. Proc. 2011-14, 2011-4 IRB 330.

⁷⁶ IRC §3121(n); and IRS Pub. 3, *Armed Forces' Tax Guide*.

⁷⁷ IRC §62(a)(2)(E).

⁷⁸ IRS Pub. 3, *Armed Forces' Tax Guide*.

⁷⁹ Ibid.

Claiming the Deduction. Taxpayers with reserve-related travel that takes them more than 100 miles away from home must first complete Form 2106, *Employee Business Expenses*, or Form 2106-EZ, *Unreimbursed Employee Business Expenses*, in order to claim these expenses.

Note. Forms 2106 and 2106-EZ are discussed in the “Employees With Business Expenses” section at the beginning of this chapter.

The reservist’s expenses that can be deducted on line 24 of Form 1040 include the following.⁸⁰

- Lodging (the regular federal per diem rate)
- Meals (50% of the regular federal per diem rate)⁸¹
- Incidental expenses (the regular federal per diem rate)

Note. The federal per diem rates for meals and incidental expenses can be found at www.gsa.gov/perdiem.

- Mileage (the federal standard mileage rate, which is \$0.56 for 2014⁸² and \$0.565 for 2013)
- Parking fees, ferry fees, and tolls

Expenses other than those included in the preceding list can be deducted as miscellaneous itemized deductions on line 21 of Schedule A, as long as they meet the general requirements for unreimbursed employee expenses,⁸³ which are discussed earlier in this chapter.

Example 10. Lieutenant Willard Jones is a member of the Army Reserve. He was required to travel 330 miles from his home to perform his duties as a reservist in October 2013. His expenses were not reimbursed.

His travel expenses for the trip consisted of the following.

Mileage (660 round-trip miles × \$0.565)	\$ 373
Meals (\$46 per diem × 7 days)	322
Lodging (\$83 per diem × 6 days)	498
Parking fees	35
Total	<u>\$1,228</u>

Lieutenant Jones also incurred \$452 in deductible mileage during 2013 for reserve-related trips that were within 100 miles of his home.

Lieutenant Jones qualifies to use Form 2106-EZ, which follows.

⁸⁰ IRC §62(a)(2)(E); and IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

⁸¹ IRC §274(n).

⁸² IRS Notice 2013-80, 2013-52 IRB 821.

⁸³ Temp. Treas. Reg. §1.62-1T(e)(3); and IRC §67(a).

For Example 10

Form 2106-EZ Department of the Treasury Internal Revenue Service (99)	Unreimbursed Employee Business Expenses ▶ Attach to Form 1040 or Form 1040NR. ▶ Information about Form 2106 and its separate instructions is available at www.irs.gov/form2106 .	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold;">2013</div> Attachment Sequence No. 129A
Your name Willard Jones	Occupation in which you incurred expenses Army reservist	Social security number <div style="display: flex; justify-content: space-between;"> 987 65 4321 </div>

You Can Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements for this purpose).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2013.

Caution: You can use the standard mileage rate for 2013 **only if:** (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service, or (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

Part I Figure Your Expenses

1 Complete Part II. Multiply line 8a by 56.5¢ (.565). Enter the result here	1	825
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	35
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	498
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	
5 Meals and entertainment expenses: \$ 322 × 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	5	161
6 Total expenses. Add lines 1 through 5. Enter here and on Schedule A (Form 1040), line 21 (or on Schedule A (Form 1040NR), line 7). (Armed Forces reservists, fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.)	6	1,519

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ▶ **05 / 15 / 2011**

8 Of the total number of miles you drove your vehicle during 2013, enter the number of miles you used your vehicle for:

a Business **1,460** **b** Commuting (see instructions) **c** Other

9 Was your vehicle available for personal use during off-duty hours? ☒ **Yes** ☐ **No**

10 Do you (or your spouse) have another vehicle available for personal use? ☒ **Yes** ☐ **No**

11a Do you have evidence to support your deduction? ☒ **Yes** ☐ **No**

b If "Yes," is the evidence written? ☒ **Yes** ☐ **No**

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 20604Q

Form **2106-EZ** (2013)

Example 10 Observations

- The amount on line 1 of Form 2106-EZ consists of \$373 for mileage for Lieutenant Jones's travels in excess of 100 miles from home and \$452 for mileage when he was within 100 miles of his home.
- The meals deduction on line 5 is 50% of the total amount allowed on a per diem basis ($50\% \times \$322$).

Lieutenant Jones attached the Form 2106-EZ to his Form 1040. He entered \$452 on line 21 of Schedule A. This is the allowable deduction for expenses incurred on trips that were within 100 miles of his home. This amount is a miscellaneous itemized deduction and is subject to the 2%-of-AGI floor.

He reported \$1,067 (the amount of his employee business expenses allocable to his travels when he was more than 100 miles from home) on line 24 of Form 1040.

Adjusted Gross Income	23	Educator expenses	23	
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	1,067
	25	Health savings account deduction. Attach Form 8889	25	
	26	Moving expenses. Attach Form 3903	26	
	27	Deductible part of self-employment tax. Attach Schedule SE	27	
	28	Self-employed SEP, SIMPLE, and qualified plans	28	
	29	Self-employed health insurance	29	

Other Transportation Expenses. A member of an Armed Forces reserve unit can deduct the expense of traveling from their primary job to a meeting of their unit if the meeting is held on a day on which the reservist works at their regular job. The reservist usually cannot, however, deduct the transportation expense if they do not work at their regular job on that day. In such a case, the transportation expenses are a nondeductible commuting expense.⁸⁴

Example 11. On Friday, February 28, 2014, reservist Sally traveled 59 miles from her job location as a software engineer with Giant Company to her reserve meeting. Because she is traveling from one workplace to another, Sally can deduct \$33 ($\0.56×59 miles) as an unreimbursed miscellaneous itemized deduction subject to the 2%-of-AGI floor. She cannot deduct mileage for her return trip home.⁸⁵

Example 12. On Saturday, March 1, 2014, reservist Sam traveled 62 miles from his home to a weekend reserve meeting. Because he is traveling from his home to the workplace, this is a nondeductible commuting expense.

Note. For more information about the tax rules for deductible travel expenses, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Special Taxpayers.

Uniform Costs

A reservist may deduct unreimbursed expenses for the purchase and maintenance of uniforms, as long as the employee can wear the uniform only while performing job-related duties.⁸⁶ Unreimbursed uniform expenses are deductible as a miscellaneous itemized deduction subject to the 2%-of-AGI floor.

⁸⁴ Rev. Rul. 76-453, 1976-2 CB 86; and IRS Pub. 3, *Armed Forces' Tax Guide*, p. 14 (2013).

⁸⁵ IRS Pub. 3, *Armed Forces' Tax Guide*, p. 14 (2013).

⁸⁶ Treas. Reg. §1.262-1(b)(8).

MILITARY DIFFERENTIAL PAY

Military differential pay is defined as voluntary payments made to a reservist by their regular employer during a period of time when the reservist is performing active-duty service. Pay is considered military differential pay if it constitutes all or a portion of the reservist's regular wage paid to the reservist who is on active duty for a period longer than 30 days.⁸⁷

Military differential pay is taxable income and should be reported to the reservist as wages in box 1 of Form W-2. Military differential pay cannot be excluded as combat pay.

Note. The employer wage credit for active-duty members of the uniformed services expired on December 31, 2013. This provision allowed a small business employer to receive a tax credit for 20% of the eligible differential wage payments made to a qualified employee serving on active duty.⁸⁸ At the time this book was published, this provision had not been extended.

RETIREMENT PLAN DISTRIBUTIONS

Typically, a withdrawal from a tax-deferred retirement plan before the account owner attains age 59½ is taxed to the recipient as ordinary income. It is also generally subject to a 10% additional tax on early distributions.⁸⁹ However, a **qualified reservist distribution** is not subject to the 10% additional tax.

Qualified Reservist Distribution

A distribution is a **qualified reservist distribution** when the following requirements are met.⁹⁰

- The reservist was ordered or called to active duty after September 11, 2001.
- The reservist was ordered or called to active duty for a period of more than 179 days or for an indefinite period.
- The distribution is from an IRA or from amounts attributable to elective deferrals under a section 401(k) or 403(b) plan or a similar retirement arrangement.
- The distribution was made on or after the date of the order or call to active duty and on or before the close of the active duty period.

Note. For more information about the exceptions to the 10% penalty on early distributions from qualified retirement plans and IRAs, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 1: Select Rules for Retirement Plans.

⁸⁷ IRS Pub. 3, *Armed Forces' Tax Guide*.

⁸⁸ IRC §45P.

⁸⁹ IRC §72(t).

⁹⁰ IRC §72(t)(2)(G)(i).

Qualified Reservist Repayments

A reservist may be able to repay qualified reservist distributions by making contributions to an IRA. These contributions are allowed even when the amount would generally exceed the IRA contribution limit. The repayment contributions can be made if the qualified reservist distribution was from an IRA or from a 401(k) plan, 403(b) plan, or similar arrangement. Qualified reservist repayments are subject to the following rules.⁹¹

- Qualified reservist repayments cannot exceed the amount of the qualified reservist distributions.
- Qualified reservist repayments cannot be made **more than two years after the reservist's active-duty period ends.**
- Qualified reservist repayments are not tax deductible.
- Qualified reservist repayments do not affect the amount deductible as an IRA contribution.
- A reservist repaying a qualified reservist distribution must include the repayment amount with nondeductible contributions on line 1 of Form 8606, *Nondeductible IRAs*.

FLEXIBLE SPENDING ARRANGEMENTS

Unused amounts left in a flexible spending arrangement (FSA) plan at the end of the plan year are typically subject to a “use-it-or-lose-it” rule. However, FSA plans can provide an optional grace period immediately following the end of each plan year, extending the period for incurring expenses for qualified benefits to the 15th day of the third month after the end of the plan year. Benefits not used by the end of the grace period are then forfeited.⁹²

Alternatively, beginning in 2013, a plan sponsor may opt to allow employees to carry over up to \$500 in unused benefits remaining in a health FSA at the end of the year for use in the next benefit period. A plan cannot have both the grace period provision and the carryover provision. The health FSA must be amended to adopt a carryover provision on or before the last day of the plan year from which amounts may be carried over; carryover provisions may be effective retroactively to the first day of that plan year.⁹³

Note. For more information about the revisions to the use-it-or-lose-it rules, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Individual Taxpayer Issues.

Another exception to the use-it-or-lose-it rule allows FSAs to make distributions of all or part of unused health FSA benefits to reservists who are called to active duty for a period exceeding 179 days or for an indefinite period. These distributions must be made during the period beginning with the call to active duty and ending on the last day of the coverage period of the FSA that includes the date of the call to active duty.⁹⁴ The distribution is included in the wages of the reservist and is subject to income and employment taxes.⁹⁵

⁹¹ IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.

⁹² Prop. Treas. Reg. §1.125-1(e)(1).

⁹³ IRS Notice 2013-71, 2013-47 IRB 532.

⁹⁴ IRC §125(h).

⁹⁵ IRS Notice 2008-82, 2008-41 IRB 853.

COMBAT PAY

Taxpayers in active service who are below the grade of commissioned officer in the Armed Forces can exclude certain **combat pay** from income.⁹⁶ Pay qualifying for the combat-zone exclusion is not included in wages reported on Form W-2. A “combat zone” is defined as “any area which the President of the United States by Executive Order designates . . . as an area in which Armed Forces of the United States are or have (after June 24, 1950) engaged in combat.”⁹⁷

An active-duty reservist can exclude the full amount of their compensation for the month if any part of the month was spent in a combat zone. Combat pay is also excludable if the reservist was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone.⁹⁸ This exclusion does not apply to any compensation received for any month of service that begins more than two years after the termination of combatant activities.⁹⁹

The time and place of payment are irrelevant in determining whether the compensation is excludable as combat pay. The compensation can be excluded regardless of whether the taxpayer actually **receives** the combat pay while serving in the combat zone or while hospitalized (or even received it in the same year as when they served in the combat zone), provided that the combat pay is compensation for services rendered while serving in a combat zone.¹⁰⁰

The combat pay exclusion applies to the following.¹⁰¹

- Active duty pay earned in any month the taxpayer served in a combat zone
- A reenlistment bonus if the voluntary extension or reenlistment occurs in a month the taxpayer served in a combat zone
- Pay for accrued leave earned in any month the taxpayer served in a combat zone
- Pay received for duties as a member of the Armed Forces in nonappropriated fund activities
- Awards the taxpayer is entitled to
- Student loan repayments (Student loan repayments must be apportioned to allow the combat pay exclusion for only those repayments made in compensation for service performed in a combat zone. If an entire repayment is made in compensation for a year in which the taxpayer was actively serving in a combat zone, the entire repayment is excluded. If only a portion of that year of service was performed in a combat zone, only part of the repayment qualifies for combat-zone exclusion. For example, if a taxpayer served in a combat zone for six months, half of the taxpayer’s repayment qualifies for the exclusion.)

Pension or retirement pay does not qualify as combat pay.¹⁰²

Note. For IRA purposes, compensation includes nontaxable combat pay. Thus, even though a taxpayer does not have to include the combat pay in taxable income, it does count as compensation when figuring the limits for contributions to IRAs.

⁹⁶ IRC §112(a).

⁹⁷ IRC §112(c)(2).

⁹⁸ IRC §§112(a)(1), (2).

⁹⁹ Treas. Reg §1.112-1(a)(2).

¹⁰⁰ Treas. Reg §1.112-1(b)(4).

¹⁰¹ See IRS Pub. 3, *Armed Forces’ Tax Guide*, p. 9 (2013).

¹⁰² IRC §112(c)(4).

Earned Income Credit

If a taxpayer is otherwise eligible for the earned income credit, a practitioner must assess whether excluding combat pay will make the taxpayer ineligible for the credit. In such a case, the taxpayer may elect to include the combat pay in earned income, in order to qualify for the credit.¹⁰³ Taxpayers must then include **all** the combat pay as earned income, not just a portion.

Note. For more information about the combat pay exclusion, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 5: Special Taxpayers.

DEATH GRATUITY

Death gratuities paid to a survivor of a member of the Armed Forces are excluded from gross income.¹⁰⁴

MOVING EXPENSES

Generally, a taxpayer must meet the time and distance tests to be eligible to deduct moving expenses. However, reservists called to active duty are not required to meet these tests if they move because of a permanent change of station.¹⁰⁵ In such a case, the taxpayer can calculate unreimbursed moving expenses on Form 3903, *Moving Expenses*, and enter the amount on line 26 of Form 1040 for an above-the-line deduction.

A **permanent change of station**¹⁰⁶ includes the following situations.

- A move from the service member's home to the first post of active duty
- A move from one permanent post of duty to another
- The move from the service member's last post of duty to the member's home or to a nearer point in the United States (The move must occur within one year of ending active duty or within the period allowed under the Joint Federal Travel Regulations.)

Any reimbursements provided by the government because of a permanent change of station are not includable in gross income. If the reimbursement amount is greater than the actual moving expenses, the excess is included in wages. If this amount is not included on Form W-2, the taxpayer must include it on line 7 of Form 1040.

Deductible Moving Expenses

If a military reservist called to active duty moves because of a permanent change of station, the reservist can deduct the **reasonable** unreimbursed expenses of moving the household. Qualifying taxpayers can deduct reasonable unreimbursed expenses¹⁰⁷ incurred for the following purposes.

- The expenses of moving household goods and personal effects (through the shortest and most direct route) are deductible. This includes trailer rental, packing expenses, crating expenses, in-transit storage, and insurance. The taxpayer cannot deduct expenses for moving furniture or other goods purchased on the way from the old home to the new home.¹⁰⁸
- Costs for storing and insuring household goods and personal effects can only be deducted for the time period between when the goods and effects are moved from the former home and when they are delivered to the new home. This period can be no more than 30 days.¹⁰⁹

^{103.} IRC §32(c)(2)(B)(vi).

^{104.} IRC §134(b)(1).

^{105.} IRC §217(g)(1).

^{106.} Treas. Reg. §1.217-2(g)(3).

^{107.} Treas. Reg. §§1.217-2(b)(1), (2), (3).

^{108.} Treas. Reg. §1.217-2(b)(3).

^{109.} Treas. Reg. §1.217-2(g)(4).

- Travel expenses incurred while relocating from the old home to the new home are deductible. Deductible travel expenses include lodging, car expenses, airfare, parking fees, and tolls. Meal expenses are not deductible.¹¹⁰ Vehicle expenses can be deducted using either of the following methods.¹¹¹
 - ♦ Actual out-of-pocket expenses
 - ♦ The standard moving mileage rate of \$0.24 per mile for 2013 and \$0.235 for 2014

Note. More detailed information about moving expenses can be found in IRS Pub. 521, *Moving Expenses*.

INTERNET BUSINESSES

Nearly all modern businesses involve the Internet as a component of their business. The focus of this section is on tax issues associated with operating an **exclusively** online business.

Note. In addition to the issues discussed in this section, the tax practitioner must determine whether the taxpayer's Internet activity is, in fact, a business and not a hobby. This determination should be made annually. For more information about hobbies, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Hobby Losses.

DEDUCTIONS OF EXPENSES

Many Internet businesses are operated from the home of the taxpayer. Home-based business owners have a number of deductions available, many of which are mentioned in this section. For information on the home office deduction, see the "Homeowners" section of this chapter.

IRC §179 Deduction

Internet business owners, like other small business owners, may benefit from the IRC §179 expense deduction. Under §179, a taxpayer can elect to deduct all or part of the cost of certain depreciable tangible personal property¹¹² in the year in which it is placed into service. For property placed in service in the tax year beginning in 2014, the deduction is limited to \$25,000.¹¹³ The maximum amount is reduced on a dollar-for-dollar basis when the amount of qualifying property placed in service during the year exceeds \$200,000.¹¹⁴

Note. In June 2014, the House passed a bill that would permanently increase the §179 deduction to \$500,000.¹¹⁵ The Senate is considering an extender bill that would increase the §179 deduction to \$500,000 for two years.¹¹⁶ At the time this book was published, a compromise had not been worked out.

¹¹⁰ IRC §217(b).

¹¹¹ IRS Pub. 521, *Moving Expenses*.

¹¹² IRC §179(d)(1)(A).

¹¹³ IRC §179(b)(1)(C).

¹¹⁴ IRC §179(b)(2)(C).

¹¹⁵ *Code Sec. 179 Expensing, S Corporation Tax Extender Bills Approved by House*. Jun. 13, 2014. CCH. [www.cchgroup.com/wordpress/index.php/tax-headlines/federal-tax-headlines/code-sec-179-expensing-s-corporation-tax-extender-bills-approved-by-house/] Accessed on Jun. 25, 2014.

¹¹⁶ *House Ways and Means Committee Approves Permanent Extension of Research Credit, Other Select Expired Business Tax Provisions*. Apr. 29, 2014. PricewaterhouseCoopers LLP. [www.pwc.com/en_US/us/tax-services/publications/insights/assets/pwc-ways-means-committee-approves-permanent-extender-bills.pdf] Accessed on Jun. 25, 2014.

2014 Workbook

The §179 deduction is further limited to the amount of taxable income derived by the taxpayer from the active participation in any trade or business during the tax year. This includes wages, salaries, tips, and other compensation paid to the taxpayer as an employee of the business.¹¹⁷

The following items, which are typically needed for an online business, are eligible for the §179 expense deduction.

- Computers
- Computer accessories (i.e., modems and routers)
- Office furniture
- Office equipment (printers, copiers, fax machines)

Note. Off-the-shelf computer software qualified for the §179 deduction if it was placed in service in a tax year beginning after 2002 and before 2014.¹¹⁸

A taxpayer makes the election to take the §179 deduction by completing part I of Form 4562, *Depreciation and Amortization*. The amount from Form 4562 is then reported on line 13 of Schedule C.

Note. For comprehensive explanations of depreciation methods, including the IRC §179 expensing method, see the 2011 *University of Illinois Federal Tax Fundamentals*, Chapter 4: Depreciation Basics; and the 2011 *University of Illinois Federal Tax Workbook*, Chapter 1: Depreciation. These can be found at www.taxschool.illinois.edu/taxbookarchive.

Other Expenses

Other deductible expenses incurred by an Internet business can be deducted on Schedule C, shown on the following page. The following table lists potential expenses and the line number on which each expense is reported.

Type of Expense	Line Number
Email lists	8
Marketing expenses	8
Vehicle expenses	9
Contract labor (for services such as website construction and graphic design) ¹¹⁹	11
Business insurance	15
Interest on business loan	16b
Legal and accounting fees (set up business entity, tax return preparation)	17
Office supplies	18
Postage	18
Telephone	25
Web hosting	27a ^a
Internet access	27a ^a
Educational seminars	27a ^a
PayPal, eBay, credit card processing fees	27a ^a
Home office	30

^a These expenses should be listed in Part V and the total entered on line 27a.

¹¹⁷. Treas. Reg. §1.179-2(c)(6).

¹¹⁸. IRC §179(d)(1)(A)(ii).

¹¹⁹. Under IRC §6041, a business owner who employs a contractor to provide services valued at more than \$600 for the tax year must issue a Form 1099-MISC, *Miscellaneous Income*, to that contractor.

**SCHEDULE C
(Form 1040)**Department of the Treasury
Internal Revenue Service (99)**Profit or Loss From Business**
(Sole Proprietorship)► For information on Schedule C and its instructions, go to www.irs.gov/schedulec.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2013Attachment
Sequence No. **09**

Name of proprietor		Social security number (SSN)	
A Principal business or profession, including product or service (see instructions)		B Enter code from instructions <div style="border: 1px solid black; width: 100px; height: 20px; margin-top: 5px;"></div>	
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), (see instr.) <div style="border: 1px solid black; width: 100px; height: 20px; margin-top: 5px;"></div>	
E Business address (including suite or room no.) ► City, town or post office, state, and ZIP code			
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►			
G Did you "materially participate" in the operation of this business during 2013? If "No," see instructions for limit on losses . . . <input type="checkbox"/> Yes <input type="checkbox"/> No			
H If you started or acquired this business during 2013, check here . . . <input type="checkbox"/>			
I Did you make any payments in 2013 that would require you to file Form(s) 1099? (see instructions) . . . <input type="checkbox"/> Yes <input type="checkbox"/> No			
J If "Yes," did you or will you file required Forms 1099? . . . <input type="checkbox"/> Yes <input type="checkbox"/> No			

Part I Income

1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . <input type="checkbox"/>	1	
2 Returns and allowances . . .	2	
3 Subtract line 2 from line 1 . . .	3	
4 Cost of goods sold (from line 42) . . .	4	
5 Gross profit. Subtract line 4 from line 3 . . .	5	
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions) . . .	6	
7 Gross income. Add lines 5 and 6 . . .	7	

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

8 Advertising . . .	8	18 Office expense (see instructions)	18	
9 Car and truck expenses (see instructions). . .	9	19 Pension and profit-sharing plans . . .	19	
10 Commissions and fees . . .	10	20 Rent or lease (see instructions):	20a	
11 Contract labor (see instructions)	11	a Vehicles, machinery, and equipment	20a	
12 Depletion . . .	12	b Other business property . . .	20b	
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions). . .	13	21 Repairs and maintenance . . .	21	
14 Employee benefit programs (other than on line 19) . . .	14	22 Supplies (not included in Part III) . . .	22	
15 Insurance (other than health)	15	23 Taxes and licenses . . .	23	
16 Interest:	16a	24 Travel, meals, and entertainment:	24a	
a Mortgage (paid to banks, etc.)	16a	a Travel . . .	24a	
b Other . . .	16b	b Deductible meals and entertainment (see instructions) . . .	24b	
17 Legal and professional services	17	25 Utilities . . .	25	
		26 Wages (less employment credits) . . .	26	
		27a Other expenses (from line 48) . . .	27a	
		b Reserved for future use . . .	27b	
28 Total expenses before expenses for business use of home. Add lines 8 through 27a . . .		28		
29 Tentative profit or (loss). Subtract line 28 from line 7 . . .		29		
30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 . . .		30		
31 Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.		31		
32 If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.		32a <input type="checkbox"/> All investment is at risk. 32b <input type="checkbox"/> Some investment is not at risk.		

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2013

ONLINE AUCTIONS

A number of Internet businesses are involved in buying and selling property. Unless certain exceptions are met, income from online auctions is taxable.

Casual Sales

Casual and occasional Internet auction sales, like an occasional garage sale, do not generally result in a taxable event.¹²⁰ Most occasional sales involve household items that are sold at a price less than the cost basis. Therefore, these transactions actually involve nondeductible losses.

When a taxpayer sells an appreciated capital asset (such as a piece of artwork or an antique), a taxable event does occur, and the casual seller must pay capital gains taxes on the profit.

Note. For detailed information about reporting capital gains, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses.

TRADE OR BUSINESS SALES

Taxpayers engaged in an actual trade or business of selling items online can deduct business expenses and must pay ordinary income tax on their net income.¹²¹ The sole proprietor is also liable for SE tax.

FORM 1099-K

Beginning in January 2012, all payment settlement entities (PSE) are required to report the following transactions on Form 1099-K, *Payment Card and Third Party Network Transactions*.¹²²

- All payments made in settlement of payment card transactions (e.g., credit and debit cards)
- Payments in settlement of third-party network transactions if both of the following conditions are met
 - ♦ Gross payments to a participating payee exceed \$20,000.
 - ♦ There are more than 200 transactions with the participating payee.

Online merchants generating enough card payment transactions to meet the preceding thresholds will receive a Form 1099-K from each PSE with which the online merchant did sufficient business. PSEs can take one of two forms.¹²³

1. A **merchant acquiring entity** is a bank or other organization that has the contractual obligation to make payment to participating payees in settlement of payment card transactions.
2. A **third-party settlement organization** is the central organization that has the contractual obligation to make payment to participating payees of third-party network transactions.

Companies such as Amazon and PayPal qualify as PSEs and issue Forms 1099-K.

The PSE is required to file Forms 1099-K and send a corresponding statement to the merchant payee. The information provided on the Form 1099-K should be used by the online merchant in conjunction with their other tax records to determine the correct amount of income to report on their Schedule C.

^{120.} *Tax Tips for Online Auction Sellers*. [www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tax-Tips-for-Online-Auction-Sellers] Accessed on Mar. 14, 2014.

^{121.} See IRS Pub. 334, *Tax Guide for Small Business*.

^{122.} *1099-K Reporting Requirements for Payment Settlement Entities*. [www.irs.gov/Businesses/New-1099-K-Reporting-Requirements-for-Payment-Settlement-Entities] Accessed on Mar. 6, 2014.

^{123.} *General FAQs on Payment Card and Third Party Network Transactions*. [www.irs.gov/uac/General-FAQs-on-New-Payment-Card-Reporting-Requirements] Accessed on Mar. 6, 2014.

If the merchant believes the information reported on a Form 1099-K is incorrect or the form has been issued in error, they should contact the filer, whose name appears in the upper left corner of the form. Alternatively, the merchant can contact the PSE, whose name and phone number are shown in the lower left corner of the form. If a merchant cannot get the Form 1099-K corrected, they can attach an explanation to their tax return and report the income correctly.¹²⁴

If a merchant has not supplied a tax identification number to the PSE, the merchant is subject to backup withholding.

SALES TAX

Generally, an Internet business must collect sales tax only from those customers in states where the business has a physical presence. This general rule stems from a United States Supreme Court case¹²⁵ in which the court ruled that North Dakota could not, on Commerce Clause grounds, require a mail order company to collect and pay use taxes to a state in which the company did not maintain a physical presence. The mail order company generated \$1 million in annual sales to about 3,000 North Dakota customers.

This rule means that most brick and mortar stores with retail outlets in multiple states are required to collect sales tax from customers for their online purchases in all of those states, whereas an online competitor with no physical presence in those states has no such obligation. Some states have passed laws¹²⁶ to require large online retailers (such as Amazon.com and Overstock.com) to collect sales tax from their customers, on the grounds that the companies have a sufficient nexus with the state so that the law does not violate the Commerce Clause. The United States Supreme Court recently declined to hear a challenge to the New York state law.¹²⁷

Although federal legislation to address the fairness issue has been under debate for some time, nothing had been enacted at the time this book was published.

Generally, small Internet businesses, while continuing to be aware of the changing landscape, do not need to collect sales tax at this point from **customers in other states**.

HOMEOWNERS

There are numerous issues involved with the ownership of a principal residence. Many of these issues are not explained in detail in this chapter, but the information provided in this section allows the reader to research any issues with which they are not familiar.

- Mortgage interest payments
- Points
- Mortgage insurance
- Mortgage interest credit certificate
- Sale of a principal residence
- Home offices
- Residential energy credits
- Cancellation of debt
- Repayment of first-time homebuyers credit

¹²⁴ Ibid.

¹²⁵ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

¹²⁶ See, e.g., N.Y. Tax Law §1101(b)(8)(vi).

¹²⁷ *Amazon.com LLC v. New York State Department of Taxation and Finance, et al.*, Docket Nos. 13-252 & 13-259.

MORTGAGE INTEREST PAYMENTS

Qualified residence interest is interest the taxpayer pays on a loan secured by their main home or a second home. Interest paid on the following loans is qualified residence interest under IRC §163(h)(3), and the taxpayer can deduct all of the interest paid on these loans.¹²⁸

1. **Grandfathered debt** is a mortgage the taxpayer took out on or before October 13, 1987.
2. **Acquisition indebtedness** is any indebtedness incurred after October 13, 1987, in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and which is secured by the residence. For purposes of the interest deduction, this type of debt is **limited to a total of \$1 million** plus any grandfathered debt. The limit is \$500,000 for taxpayers who are married filing separately (MFS).¹²⁹
3. **Home equity indebtedness** is any indebtedness (other than acquisition indebtedness) incurred after October 13, 1987, which is secured by a qualified residence. For purposes of the interest deduction, this type of debt is **limited to \$100,000** (\$50,000 for MFS taxpayers).¹³⁰ The aggregate amount of home equity indebtedness cannot exceed:
 - a. The FMV of the qualified residence, reduced by
 - b. The amount of acquisition indebtedness for the residence.

The limits on acquisition debt and home equity debt apply to the **combined** mortgages on the taxpayer's qualified residences. A **qualified residence** refers to the taxpayer's principal residence¹³¹ and a secondary residence chosen by the taxpayer.¹³² A recent court case illustrates how the limits on qualified residence interest are applied.

In *Charles Sophy et al. v. Comm'r*,¹³³ Charles Sophy and Bruce Voss purchased a house together in Rancho Mirage, California, which was financed by a mortgage. The taxpayers later purchased a second house in Beverly Hills, California, which was also financed by a mortgage. In 2003, they obtained a \$300,000 home equity line of credit for the Beverly Hills house. The total average balance in 2006 for the two mortgages and the home equity loan was \$2,703,568. Sophy paid interest on these loans of \$94,698, and Voss paid \$85,962. In 2007, the total average balance for the two mortgages and the home equity loan was \$2,669,136. Sophy paid interest on these loans of \$99,901, and Voss paid \$76,635.

Sophy and Voss each claimed deductions for qualified residence interest on their individual federal income tax returns for 2006 and 2007. The IRS audited their returns for these years and disallowed portions of the interest deductions because the amount of the debt exceeded the limits imposed by IRC §163.

Sophy and Voss contended that the IRC §163(h)(3) limitations are properly applied on a per-taxpayer basis for residence co-owners who are not married to each other. According to their argument, they should **each** be allowed a deduction for interest paid on up to \$1.1 million of acquisition and home equity indebtedness for the residences that they jointly own.

The IRS position, which was upheld by the Tax Court, is that the debt limitations are properly applied on a per-residence basis, regardless of whether the co-owners are married to each other. Under this interpretation, the co-owners should collectively be limited to a deduction for interest paid on a maximum of \$1.1 million of acquisition and home equity debt for each residence that they own.

¹²⁸. *Topic 505 — Interest Expense*. [www.irs.gov/taxtopics/tc505.html] Accessed on Feb. 4, 2014.

¹²⁹. IRC §163(h)(3)(B)(ii).

¹³⁰. IRC §163(h)(3)(C)(ii).

¹³¹. As defined in IRC §121.

¹³². IRC §163(h)(4)(i).

¹³³. *Charles Sophy et al. v. Comm'r*, 138 TC No. 8 (2012).

Accordingly, Sophy's deductible mortgage interest for the years at issue is calculated as follows.

	2006	2007
Total qualified loan limit	\$1,100,000	\$1,100,000
Total average balance of all mortgages on all qualified loans	÷ 2,703,568	÷ 2,669,136
Limitation ratio	40.687%	41.212%
Total interest paid by Sophy	× 94,698	× 99,901
Deductible mortgage interest	\$ 38,530	\$ 41,171

Voss's deductible mortgage interest is calculated in the same manner.

	2006	2007
Total qualified loan limit	\$1,100,000	\$1,100,000
Total average balance of all mortgages on all qualified loans	÷ 2,703,568	÷ 2,669,136
Limitation ratio	40.687%	41.212%
Total interest paid by Voss	× 85,962	× 76,635
Deductible mortgage interest	\$ 34,975	\$ 31,583

Refinancing

Interest on new mortgage amounts equal to prior balances of acquisition debt are tax deductible as interest on acquisition debt.

A single debt may qualify as part acquisition indebtedness and part home-equity indebtedness. If a taxpayer incurs a debt that is secured by their qualified residence and uses a portion of the debt proceeds to refinance existing acquisition indebtedness, that portion qualifies as acquisition indebtedness. If the remaining portion of the proceeds is used for purposes other than the substantial improvement of the residence, that portion generally qualifies as home-equity indebtedness, subject to the \$100,000 limitation (\$50,000 for MFS taxpayers) on home-equity indebtedness.¹³⁴

Example 13. In 2010, Otis and Beth purchased a home for \$400,000 and took out a mortgage of \$300,000. They file joint federal tax returns each year. In 2013, they decided to refinance the home for \$400,000 when the home had a FMV of \$450,000. At the time of the refinancing, the original debt was \$250,000. They plan to use the balance of the proceeds to pay off credit card debt and take a trip to Europe.

Of the new loan amount of \$400,000, \$250,000 qualifies as acquisition indebtedness. The home-equity portion of the refinanced debt is calculated as follows.

FMV of the home	\$450,000
Amount of acquisition debt	(250,000)
Difference	\$200,000
Lesser of difference or \$100,000 limitation	\$100,000

Interest on the remaining proceeds of \$50,000 (\$400,000 refinancing – \$250,000 acquisition debt – \$100,000 home-equity debt) is nondeductible personal interest.

¹³⁴ IRS Notice 88-74, 1988-2 CB 385.

Prepaid Interest

Prepaid interest is not deductible if it is for a period beyond the end of the tax year. If the home mortgage is paid off early, any prepayment penalty qualifies as mortgage interest.¹³⁵

POINTS

Points may be charged at the closing of the home loan. These may be called loan origination fees, maximum loan charges, loan discount, or discount points. Normally, the amount paid as points is deducted over the life of the loan because points are prepaid interest. Exceptions to this rule allow the points to be deducted in the year they are paid if the taxpayer meets **all** of the following tests.¹³⁶

1. The loan is secured by the taxpayer's principal residence.
2. Paying points is an established business practice in the area where the loan is made.
3. The points paid were not more than the points generally charged in that area.
4. The taxpayer uses the cash method of accounting.
5. The points were not paid in place of amounts that ordinarily are stated separately on the closing statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6. The funds the taxpayer provided at or before closing, plus any points paid by the seller, are at least as much as the points charged. Points are not deductible if paid with borrowed funds.
7. The loan must be used to **purchase or construct** the taxpayer's principal residence.
8. The points are computed as a percentage of the principal amount of the loan.
9. The amount is clearly shown on the closing statement as points charged for the mortgage.

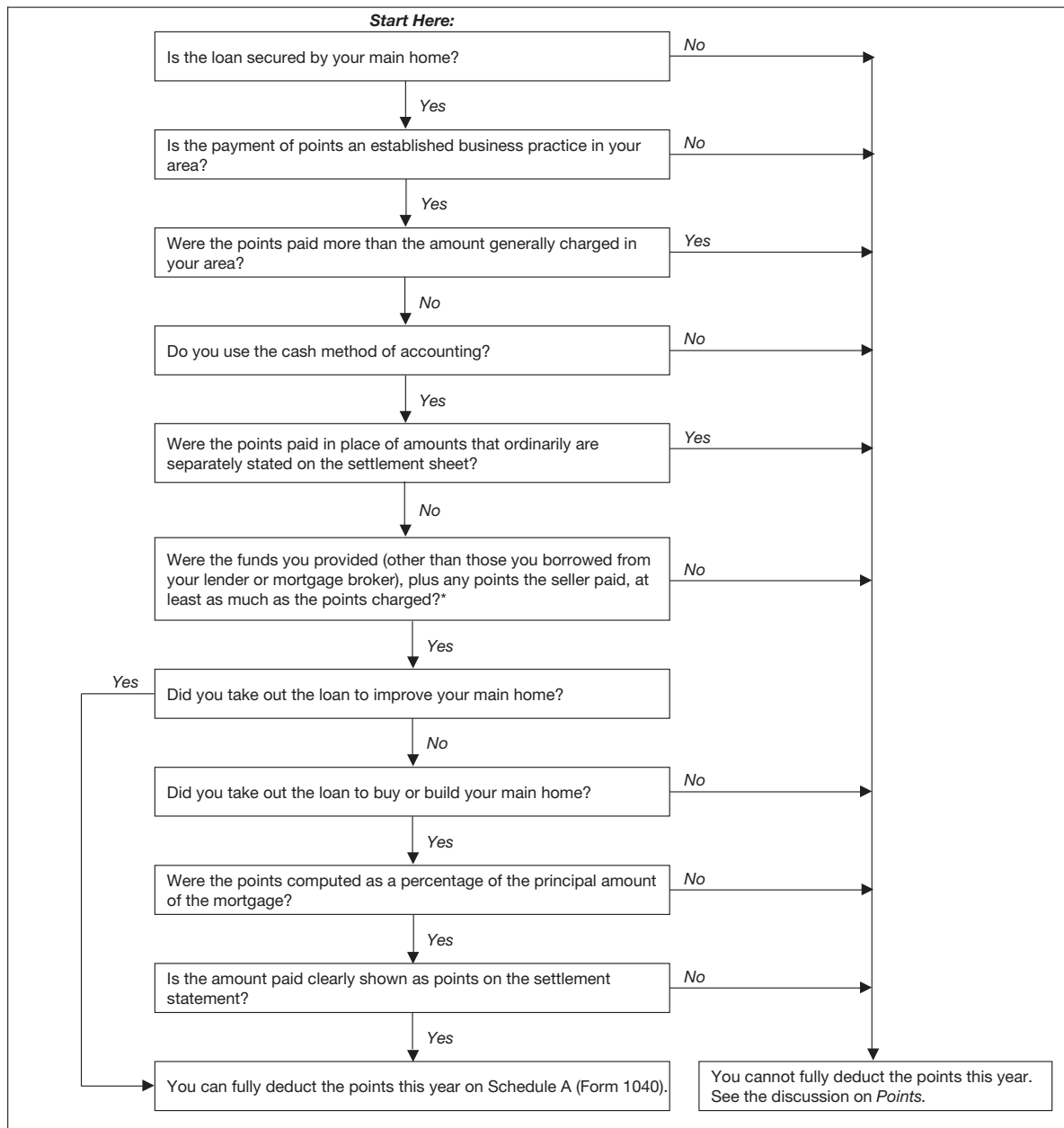
Taxpayers meeting these tests can either deduct the full amount of the points in the year paid or deduct them over the life of the loan.

The following flowchart illustrates the tests that must be met in order to deduct points in the year paid.¹³⁷

¹³⁵. IRS Pub. 936, *Home Mortgage Interest Deduction*.

¹³⁶. Ibid.

¹³⁷. IRS Pub. 530, *Tax Information for Homeowners*.



MORTGAGE INSURANCE

Payments made for mortgage insurance premiums are **not deductible** if the insurance contract was issued before January 1, 2007, or after December 31, 2013. The insurance must be in connection with home-acquisition debt and must be provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or a private mortgage insurance company.

MORTGAGE INTEREST CREDIT CERTIFICATE

The purpose of the mortgage interest credit is to help lower-income individuals afford home ownership. To qualify for the credit, an individual must be issued a mortgage credit certificate by a state or local governmental unit or agency.¹³⁸

The nonrefundable credit is claimed each year for a portion of the mortgage interest paid during the year. It is calculated on Form 8396, *Mortgage Interest Credit*.

Note. More information on the mortgage interest credit can be found in the 2009 *University of Illinois Federal Tax Workbook*, Chapter 4: Individual Taxpayer Problems. This can be found at **www.taxschool.illinois.edu/taxbookarchive**.

SALE OF PRINCIPAL RESIDENCE

Taxpayers who file MFJ may exclude from their income up to \$500,000 of gain on the sale of their principal residence. Single or MFS taxpayers may exclude up to \$250,000.¹³⁹ To qualify, the taxpayer must have used the dwelling as their principal residence for at least two years during the 5-year period ending on the date of the sale of the residence. A reduced exclusion amount is available if certain qualifications are met.

Note. More information about the sale of a principal residence can be found in the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses.

HOME OFFICE

A deduction for the use of a home office (whether the home is rented or owned) is available to taxpayers who meet certain requirements. Until recently, taking the home office deduction required the calculation, allocation, and substantiation of allowable expenses using the **actual expense method**, which often proved to be a complex and burdensome task. To alleviate this burden, the IRS recently announced a new method for claiming home office expenses. For tax years starting on or after January 1, 2013, taxpayers may elect to use the new **safe harbor method** to determine the amount of deductible expenses for their home offices.

Claiming a deduction for business use of the home using either method requires that a portion of the home be used for conducting a trade or business. The business area of the home must meet **one** of the following requirements.¹⁴⁰

1. Used exclusively and regularly as the principal place of business
2. Used exclusively and regularly as a place to meet or deal with patients, clients, or customers in the normal course of the trade or business
3. In the case of a separate structure not attached to the home, used in connection with the trade or business
4. Used on a regular basis as a storage unit for the taxpayer's inventory, but only if the dwelling unit is the sole fixed location of that trade or business

Actual Expense Method

To claim the home office deduction using the actual expense method, the **business percentage** must be calculated. The business percentage determines the amount of household expenses that can be deducted because they are attributable to the business area of the home. The business percentage is calculated by comparing the area (square footage) of the business-use portion of the home with the total area of the entire home.

¹³⁸. IRC §25.

¹³⁹. IRC §121.

¹⁴⁰. Prop. Treas. Reg. §1.280A-2.

Home office expenses are **fully deductible** without any limitation if gross business revenue exceeds:

- The regular business operating expenses not related to the home (excluding the 50% self-employment tax deduction), plus
- The business portion of expenses related to the home.

If the home office and other business expenses exceed gross revenue, the deduction for home office expenses is **limited**. When this limitation applies, the taxpayer's business expenses are applied against profits of the business using a special set of ordering rules. To understand how these ordering rules apply, it is useful to categorize the taxpayer's home office expenses into three classes.

Class	Description	Examples
Class 1	The business portion of home expenses that the taxpayer could deduct as itemized expenses on Schedule A even if the taxpayer did not have a business	<ul style="list-style-type: none"> • Mortgage interest • Property taxes
Class 2	Expenses attributable to the home office, not including depreciation	<ul style="list-style-type: none"> • Insurance • Utilities • Repairs and maintenance • Rent (if the residence is rented and not owned)
Class 3	Depreciation	Depreciation on the business portion of the home

Once the taxpayer's home office expenses are categorized into these three classes, the following ordering rules apply in the calculation of the home office deduction on Form 8829, *Expenses for Business Use of Your Home*.

1. Class 1 expenses are deducted fully from the net income of the business, even if the result is a loss. The deduction limit does not affect class 1 expenses.

Note. If the taxpayer deducts the business portion of mortgage interest and property taxes as part of a home office deduction and also itemizes expenses on Schedule A, the amounts claimed on Schedule A are **reduced** by the amounts claimed as a home office deduction. This prevents the home office portion from being deducted twice.

2. The class 2 home office expenses are deducted up to the amount of any net income remaining after deducting class 1 expenses. Deduction of class 2 expenses cannot create a loss, and any amount not deducted is **carried forward** to the following year. The same limitation applies in the following year for class 2 expenses.
3. Next, class 3 expenses (depreciation) are deducted up to the amount of any remaining net income. Deduction of depreciation cannot create a loss, and any depreciation that cannot be deducted is **carried forward** to the following year. The following year is subject to the same limitation.

Note. The deduction limits prevent home office expenses and/or depreciation from creating or increasing a loss within the current tax year. This prevents the expenses from being used to shelter otherwise taxable income received in the year. Excess deductions are carried over to subsequent years.

2014 Workbook

Example 14. Kyong Mee is a tax preparer. In January 2013, she began using one room in her residence exclusively and regularly to meet with clients, provide accounting services, and prepare tax returns. She qualifies to claim a home office deduction.

Kyong has a 340 square foot room she uses for her business. This is 20% of her 1,700 square foot home ($340 \div 1,700$).

In 2013, Kyong's business income and general business expenses (expenses not related to her home) are as follows.

Gross income		\$15,000
Expenses:		
Advertising	\$ 400	
Business telephone	700	
Office expense	1,700	
Professional license	300	
Equipment rental	400	
Supplies	1,500	
Legal fees	1,500	
Total expenses	\$6,500	(6,500)
Net income		\$ 8,500

Her home office and household expenses are as follows.

Expense	Total Amount	Class
Mortgage interest	\$20,000	1
Real estate tax	3,000	1
House insurance	600	2
Home repairs	1,200	2
Utilities	1,100	2

Kyong uses the following information to calculate her depreciation.

FMV of home	\$175,000
Cost basis of home and lot	150,000
Cost basis of lot	50,000

Kyong calculates and reports her business expenses and home office expenses as follows.

1. Because Kyong is a sole proprietor, she reports her business income and general business expenses on Schedule C, *Profit or Loss From Business*. Before deducting the expenses for business use of her home, she has a net profit of \$8,500.
2. Kyong's business percentage for her home, which is 20%, is shown in part I of Form 8829.
3. The business portion of Kyong's mortgage interest and property taxes (class 1 expenses) are calculated in part II of Form 8829 by multiplying these expenses by her business percentage, which results in \$4,600 ($(\$20,000 + \$3,000) \times 20\%$). This amount is subtracted from her \$8,500 profit (from item 1), leaving \$3,900 of remaining profit. This amount can be used for deducting class 2 and 3 expenses.

Note. Kyong can deduct the remainder of the mortgage interest and property taxes on Schedule A.

4. Kyong's class 2 expenses consist of insurance, home repairs, and utilities. These are indirect expenses because they relate to her entire house and not just the business portion of the house. Accordingly, the business percentage is applied to these expenses, which are entered in column b of part II. After deducting these indirect expenses, there is \$3,320 ($\$3,900 - ((\$600 + \$1,200 + \$1,100) \times 20\%)$) of profit remaining for class 3 expenses.

If Kyong had expenses that related only to the business portion of her home, these amounts would be considered direct expenses and reported in column a of part II.

5. Part III of Form 8829 shows the depreciation calculation for the business portion of Kyong's home. The business percentage is applied to the basis of the building only, because land cannot be depreciated. Kyong refers to the instructions for Form 8829 to find the depreciation percentage for line 40. Because she used the home for all of 2013, the applicable depreciation percentage is 2.461%. The table from the instructions for line 40 is shown here.

Line 40

IF you first used your home for business in the following month in 2013...	THEN enter the following percentage on line 40*...
January	2.461%
February	2.247%
March	2.033%
April	1.819%
May	1.605%
June	1.391%
July	1.177%
August	0.963%
September	0.749%
October	0.535%
November	0.321%
December	0.107%

***Exception.** If the business part of your home is qualified Indian reservation property (as defined in section 168(j)(4)), see Pub. 946, How To Depreciate Property, to figure the depreciation.

The depreciation deduction is calculated as follows:

$$((\$150,000 \text{ total cost basis} - \$50,000 \text{ basis of lot}) \times 20\%) \times 2.461\% = \$492$$

6. Kyong's total home office deduction of \$5,672 is calculated on Form 8829. This is shown on line 35 and is also entered on her Schedule C, line 30. After the applicable home office deduction, Kyong's business net income is \$2,828, which is shown on line 31 of Schedule C. This amount is then entered on her Form 1040, line 12.

Kyong's Form 8829 and Schedule C follow.

For Example 14

Form 8829 Department of the Treasury Internal Revenue Service (99)	Expenses for Business Use of Your Home ▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year. ▶ Information about Form 8829 and its separate instructions is at www.irs.gov/form8829 .	OMB No. 1545-0074 <div style="border: 1px solid black; padding: 5px; text-align: center;"> 2013 Attachment Sequence No. 176 </div>		
Name(s) of proprietor(s) Kyong Mee		Your social security number 333-22-4444		
Part I Part of Your Home Used for Business				
1 Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)		1 340		
2 Total area of home		2 1,700		
3 Divide line 1 by line 2. Enter the result as a percentage		3 20 %		
For daycare facilities not used exclusively for business, go to line 4. All others go to line 7.				
4 Multiply days used for daycare during year by hours used per day		4		
5 Total hours available for use during the year (365 days x 24 hours) (see instructions)		5 8,760		
6 Divide line 4 by line 5. Enter the result as a decimal amount		6		
7 Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶		7 20 %		
Part II Figure Your Allowable Deduction				
8 Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home and shown on Schedule D or Form 4797, minus any loss from the trade or business not derived from the business use of your home and shown on Schedule D or Form 4797. See instructions See instructions for columns (a) and (b) before completing lines 9-21.		8 8,500		
		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th style="width: 50%;">(a) Direct expenses</th> <th style="width: 50%;">(b) Indirect expenses</th> </tr> </table>	(a) Direct expenses	(b) Indirect expenses
(a) Direct expenses	(b) Indirect expenses			
9 Casualty losses (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">9</td> <td style="width: 50%;"></td> </tr> </table>	9		
9				
10 Deductible mortgage interest (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">10</td> <td style="width: 50%; text-align: right;">20,000</td> </tr> </table>	10	20,000	
10	20,000			
11 Real estate taxes (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">11</td> <td style="width: 50%; text-align: right;">3,000</td> </tr> </table>	11	3,000	
11	3,000			
12 Add lines 9, 10, and 11	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">12</td> <td style="width: 50%; text-align: right;">23,000</td> </tr> </table>	12	23,000	
12	23,000			
13 Multiply line 12, column (b) by line 7	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">13</td> <td style="width: 50%; text-align: right;">4,600</td> </tr> </table>	13	4,600	
13	4,600			
14 Add line 12, column (a) and line 13	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">14</td> <td style="width: 50%; text-align: right;">4,600</td> </tr> </table>	14	4,600	
14	4,600			
15 Subtract line 14 from line 8. If zero or less, enter -0-	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">15</td> <td style="width: 50%; text-align: right;">3,900</td> </tr> </table>	15	3,900	
15	3,900			
16 Excess mortgage interest (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">16</td> <td style="width: 50%;"></td> </tr> </table>	16		
16				
17 Insurance	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">17</td> <td style="width: 50%; text-align: right;">600</td> </tr> </table>	17	600	
17	600			
18 Rent	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">18</td> <td style="width: 50%;"></td> </tr> </table>	18		
18				
19 Repairs and maintenance	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">19</td> <td style="width: 50%; text-align: right;">1,200</td> </tr> </table>	19	1,200	
19	1,200			
20 Utilities	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">20</td> <td style="width: 50%; text-align: right;">1,100</td> </tr> </table>	20	1,100	
20	1,100			
21 Other expenses (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">21</td> <td style="width: 50%;"></td> </tr> </table>	21		
21				
22 Add lines 16 through 21	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">22</td> <td style="width: 50%; text-align: right;">2,900</td> </tr> </table>	22	2,900	
22	2,900			
23 Multiply line 22, column (b) by line 7	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">23</td> <td style="width: 50%; text-align: right;">580</td> </tr> </table>	23	580	
23	580			
24 Carryover of operating expenses from 2012 Form 8829, line 42	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">24</td> <td style="width: 50%; text-align: right;">0</td> </tr> </table>	24	0	
24	0			
25 Add line 22, column (a), line 23, and line 24	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">25</td> <td style="width: 50%; text-align: right;">580</td> </tr> </table>	25	580	
25	580			
26 Allowable operating expenses. Enter the smaller of line 15 or line 25	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">26</td> <td style="width: 50%; text-align: right;">580</td> </tr> </table>	26	580	
26	580			
27 Limit on excess casualty losses and depreciation. Subtract line 26 from line 15	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">27</td> <td style="width: 50%; text-align: right;">3,320</td> </tr> </table>	27	3,320	
27	3,320			
28 Excess casualty losses (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">28</td> <td style="width: 50%;"></td> </tr> </table>	28		
28				
29 Depreciation of your home from line 41 below	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">29</td> <td style="width: 50%; text-align: right;">492</td> </tr> </table>	29	492	
29	492			
30 Carryover of excess casualty losses and depreciation from 2012 Form 8829, line 43	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">30</td> <td style="width: 50%;"></td> </tr> </table>	30		
30				
31 Add lines 28 through 30	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">31</td> <td style="width: 50%; text-align: right;">492</td> </tr> </table>	31	492	
31	492			
32 Allowable excess casualty losses and depreciation. Enter the smaller of line 27 or line 31	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">32</td> <td style="width: 50%; text-align: right;">492</td> </tr> </table>	32	492	
32	492			
33 Add lines 14, 26, and 32	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">33</td> <td style="width: 50%; text-align: right;">5,672</td> </tr> </table>	33	5,672	
33	5,672			
34 Casualty loss portion, if any, from lines 14 and 32. Carry amount to Form 4684 (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">34</td> <td style="width: 50%;"></td> </tr> </table>	34		
34				
35 Allowable expenses for business use of your home. Subtract line 34 from line 33. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">35</td> <td style="width: 50%; text-align: right;">5,672</td> </tr> </table>	35	5,672	
35	5,672			
Part III Depreciation of Your Home				
36 Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">36</td> <td style="width: 50%; text-align: right;">150,000</td> </tr> </table>	36	150,000	
36	150,000			
37 Value of land included on line 36	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">37</td> <td style="width: 50%; text-align: right;">50,000</td> </tr> </table>	37	50,000	
37	50,000			
38 Basis of building. Subtract line 37 from line 36	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">38</td> <td style="width: 50%; text-align: right;">100,000</td> </tr> </table>	38	100,000	
38	100,000			
39 Business basis of building. Multiply line 38 by line 7	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">39</td> <td style="width: 50%; text-align: right;">20,000</td> </tr> </table>	39	20,000	
39	20,000			
40 Depreciation percentage (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">40</td> <td style="width: 50%; text-align: right;">2.461 %</td> </tr> </table>	40	2.461 %	
40	2.461 %			
41 Depreciation allowable (see instructions). Multiply line 39 by line 40. Enter here and on line 29 above	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">41</td> <td style="width: 50%; text-align: right;">492</td> </tr> </table>	41	492	
41	492			
Part IV Carryover of Unallowed Expenses to 2014				
42 Operating expenses. Subtract line 26 from line 25. If less than zero, enter -0-	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">42</td> <td style="width: 50%;"></td> </tr> </table>	42		
42				
43 Excess casualty losses and depreciation. Subtract line 32 from line 31. If less than zero, enter -0-	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">43</td> <td style="width: 50%;"></td> </tr> </table>	43		
43				

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 13232M

Form **8829** (2013)

For Example 14

**SCHEDULE C
(Form 1040)**Department of the Treasury
Internal Revenue Service (99)**Profit or Loss From Business**
(Sole Proprietorship)► For information on Schedule C and its instructions, go to www.irs.gov/schedulec.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2013
Attachment
Sequence No. **09**

Name of proprietor

Kyong Mee

Social security number (SSN)

333-22-4444**A** Principal business or profession, including product or service (see instructions)**Accountant****B** Enter code from instructions**C** Business name. If no separate business name, leave blank.**D** Employer ID number (EIN), (see instr.)**E** Business address (including suite or room no.) ► **21 E. Liberty**City, town or post office, state, and ZIP code **Anywhere, IA 11111****F** Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►**G** Did you "materially participate" in the operation of this business during 2013? If "No," see instructions for limit on losses . ☒ Yes ☐ No**H** If you started or acquired this business during 2013, check here . ☐**I** Did you make any payments in 2013 that would require you to file Form(s) 1099? (see instructions) . ☐ Yes ☒ No**J** If "Yes," did you or will you file required Forms 1099? . ☐ Yes ☐ No**Part I Income**

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ► <input type="checkbox"/>	1	15,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	15,000
4	Cost of goods sold (from line 42)	4	
5	Gross profit. Subtract line 4 from line 3	5	15,000
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	Gross income. Add lines 5 and 6 ►	7	15,000

Part II Expenses

Enter expenses for business use of your home only on line 30.

8	Advertising	8	400	18	Office expense (see instructions)	18	1,700
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	400
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	1,500
15	Insurance (other than health)	15		23	Taxes and licenses	23	300
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17	1,500	25	Utilities	25	700
28	Total expenses before expenses for business use of home. Add lines 8 through 27a ►	28	6,500	26	Wages (less employment credits)	26	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	8,500	27a	Other expenses (from line 48)	27a	
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	5,672	27b	Reserved for future use	27b	
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.	31	2,828				
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.						

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2013

Safe Harbor Method

For tax years starting on or after January 1, 2013, Rev. Proc. 2013-13 provides an optional safe harbor method (also referred to as the “simplified” method) that taxpayers can use to determine the amount of deductible expenses attributable to the business use of a residence.¹⁴¹ The safe harbor deduction is limited to **\$5 per square foot of home office space, up to a maximum of 300 square feet**. Therefore, **the deduction is limited to \$1,500 per year**. The deduction may not exceed the gross income from the business. Any excess deduction cannot be carried forward to the following year.

One advantage of the safe harbor method is that the home mortgage interest and real estate taxes remain deductible as an itemized deduction. In addition, taxpayers are **not** required to substantiate the expenses incurred for their home. Another advantage is that it is not necessary to recapture depreciation (as discussed later in this section).


The election to use the safe harbor method is an annual election that must be made on a timely filed original return using Schedule C. The election is made simply by using this method. However, once made, **the election is irrevocable for that tax year**.

Observation. For further details and limitations regarding the safe harbor method, see the 2013 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues.

¹⁴¹. Rev. Proc. 2013-13, 2013-6 IRB 478.

Example 15. Use the same facts as **Example 14**, except Kyong Mee did not keep track of the expenses incurred for her home. Rather than take time away from her accounting practice to compile the records, she decides to use the safe harbor method to determine the amount of her home office deduction. She completes the following worksheet from the Schedule C instructions.

Simplified Method Worksheet

Keep for Your Records 

1. Enter the amount of the gross income limitation. See Instructions for the Simplified Method Worksheet	1.	8,500
2. Allowable square footage for the qualified business use. Do not enter more than 300 square feet. See Instructions for the Simplified Method Worksheet	2.	300
3. Simplified method amount		
a. Maximum allowable amount	3a.	\$5
b. For daycare facilities not used exclusively for business, enter the decimal amount from the Daycare Facility Worksheet; otherwise, enter 1.0	3b.	1.0
c. Multiply line 3a by line 3b and enter result to 2 decimal places	3c.	5
4. Multiply line 2 by line 3c	4.	1,500
5. Allowable expenses using the simplified method. Enter the smaller of line 1 or line 4 here and include that amount on Schedule C, line 30. If zero or less, enter -0-	5.	1,500
6. Carryover of unallowed expenses from 2012 that are not allowed in 2013.		
a. Operating expenses. Enter the amount from your 2012 Form 8829, line 42	6a.	0
b. Excess casualty losses and depreciation. Enter the amount from your 2012 Form 8829, line 43	6b.	0

Instructions for the Simplified Method Worksheet

Use this worksheet to figure the amount of expenses you may deduct for a qualified business use of a home if you are electing to use the simplified method for that home. If you are not electing to use the simplified method, use Form 8829.

Line 1. If all gross income from your trade or business is from this qualified business use of your home, figure your gross income limitation as follows.

A. Enter the amount from Schedule C, line 29	8,500
B. Enter any gain derived from the business use of your home and shown on Form 8949 (and included on Schedule D) or Form 4797	0
C. Add lines A and B	8,500
D. Enter the loss (as a positive number) shown on Form 8949 (and included on Schedule D) or Form 4797 that are allocable to the business, but not allocable to the use of the home	0
E. Gross income limitation. Subtract line D from line C. Enter the result here and on line 1	8,500

If some of the income is from a place of business other than your home, you must first determine the part of your gross income (Schedule C, line 7, and gains from Form 8949, Schedule D, and Form 4797) from the business use of your home. In making this determination, consider the amount of time you spend at each location as well as other facts. After determining the part of your gross income from the business use of your home, subtract from that amount the total expenses shown on Schedule C, line 28, plus any losses shown on Form 8949 (and included in Schedule D) or Form 4797 that are allocable to the business in which you use your home but that are not allocable to the use of the home. Enter the result on Line 1.

Note. If you had more than one home in which you conducted this business during the year, include only the income earned and the deductions attributable to that income during the period you owned the home for which you elected to use the simplified method.

Line 2. If you used the same area for the entire year, enter the smaller of the square feet you actually used and 300. If you and your spouse conducted the business as a qualified joint venture, split the square feet between you and your spouse in the same manner you split your other tax attributes. If you shared space with someone else, used the home for business for only part of the year, or the area you used changed during the year, see [Figuring your allowable expenses for business use of the home](#) before entering an amount on this line. Do not enter more than 300 square feet on this line.

Line 3b. If your qualified business use is providing daycare, you may need to account for the time that you used the same part of your home for other purposes. If you used the part of your home exclusively and regularly for providing daycare, enter 1.0 on line 3b. If you did not use the part of your home exclusively for providing daycare, complete the [Daycare Facility Worksheet](#) to figure what number to enter on line 3b.

Line 6. Since you are using the simplified method this year, you cannot deduct the amounts you entered on lines 6a and 6b this year. If you file Form 8829 next year for your qualified business use of this home, you will be able to include these expenses when you figure your deduction.

2014 Workbook

Lines 1–29 of Kyong’s Schedule C are the same as in **Example 14**. To elect the safe harbor method, she completes the bottom part of Schedule C as follows.

17	Legal and profes...	27b	
28	Total expenses before expenses for business use of home. Add lines 8 through 27a	28	6,500
29	Tentative profit or (loss). Subtract line 28 from line 7	29	8,500
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: <u>1,700</u> and (b) the part of your home used for business: <u>340</u> . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	1,500
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.	31	7,000
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.	32a	<input type="checkbox"/> All investment is at risk.
		32b	<input type="checkbox"/> Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P Schedule C (Form 1040) 2013

By using the safe harbor method, Kyong increases her net Schedule C income by \$4,172 (\$7,000 – \$2,828). However, she can deduct the full amount of her mortgage interest and real estate taxes on Schedule A, which increases her itemized deductions by \$4,600.

Depreciation Issues. Taxpayers who use the safe harbor method **cannot** deduct any depreciation for the qualified home office for that tax year. The depreciation deduction **allowable** for the home office portion of the home for that tax year is deemed to be zero.

If a taxpayer uses the safe harbor method for one year and uses the actual expense method for any subsequent year, the taxpayer must calculate the depreciation deduction allowable in the subsequent year by using the appropriate optional depreciation table for the property. This is true regardless of whether the taxpayer used an optional depreciation table for the property in the year it was placed in service. The optional depreciation tables for MACRS property are provided in IRS Pub. 946, *How To Depreciate Property*. Which optional depreciation table is appropriate depends on the depreciation system, depreciation method, recovery period, and convention applicable to the property at the time it was placed in service.

The allowable depreciation deduction is calculated in the subsequent year by multiplying the remaining adjusted depreciable basis of the home office by the annual depreciation rate specified in the appropriate optional depreciation table. The applicable year to use in the table (e.g., year 1, year 2) is based on the placed-in-service date of the property.

Example 16. Use the same facts as **Example 15**. In 2014, Kyong tracks her home expenses and determines that using the actual expense method is more beneficial. To calculate the depreciation portion of the 2014 deduction, she first must determine her remaining adjusted basis of the home-office portion of the home. When she placed the home office in service in 2013, the portion of the home’s basis allocable to the home office was \$20,000 ((\$150,000 total cost basis – \$50,000 basis of lot) × 20% business percentage). Using the safe harbor method, the allowable depreciation for 2013 was \$0. Therefore, her remaining adjusted basis at the beginning of 2014 is still \$20,000.

The appropriate optional depreciation table in IRS Pub. 946 is A-7a, which follows. It shows that the depreciation rate for year two is 2.564%. Accordingly, Kyong’s 2014 depreciation deduction for the home office is \$513 (\$20,000 × 2.564%). Her adjusted depreciable basis at the end of 2014 is \$19,487 (\$20,000 – \$513).

Table A-7a. **Nonresidential Real Property
Mid-Month Convention
Straight Line—39 Years**

Year	Month property placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2–39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

Note. For more information about the home office deduction, see the 2013 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues; and the 2012 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 7: Office in Home.

RESIDENTIAL ENERGY CREDITS

Residential energy credits are composed of the following two **nonrefundable** credits.

- The IRC §25C **nonbusiness energy property credit** is only available for qualifying improvements made to the taxpayer's existing principal residence before January 1, 2014. The credit was not available for a newly constructed home.
- The IRC §25D **residential energy efficient property credit** is available for both existing homes and homes under construction. The property must be placed in service on or before December 31, 2016.

Note. The §§25C and 25D credits are described in detail in the 2012 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 2: Credits. This can be found at www.taxschool.illinois.edu/taxbookarchive.

IRS Notice 2013-70¹⁴² provides guidance for both of these credits in question-and-answer format. Some key points contained in the notice are as follows.

- A taxpayer may not claim the §§25C or 25D credits until the year the property is **installed**. The installation must be completed before the end of 2013 for the §25C credit and before the end of 2016 for the §25D credit.
- Improvements made to a second home are not eligible for the §25C credit. Under §25D, fuel cell property credits are not available for second homes. However, a taxpayer can claim a §25D credit for other qualifying properties (solar electric property, solar water heating property, small wind energy property, and geothermal heat pump property) installed in or on a dwelling unit used as a second home or a vacation home.
- A taxpayer can claim a §25D credit if qualifying property is installed in or on an existing home or a newly constructed home. To determine the cost of the qualifying property for a newly constructed home, the taxpayer can request that the homebuilder make a reasonable allocation. Alternatively, the taxpayer may use any other reasonable method to determine the cost of the property that is eligible for the §25D credit.

CANCELLATION OF DEBT

In recent years, many homeowners have had difficulty in making payments on their home mortgages. Many homeowners have had their residences repossessed; other owners have voluntarily turned their homes over to the lenders. In other cases, lenders have modified the mortgage terms so that taxpayers could retain ownership in their homes. These circumstances can result in cancellation of indebtedness income.

¹⁴². IRS Notice 2013-70, 2013-47 IRB 528.

The Mortgage Forgiveness Debt Relief Act of 2007 allows taxpayers to exclude up to \$2 million of qualified principal residence indebtedness (QPRI) from income. To be eligible for the QPRI exclusion, the debt must have been incurred for the purchase, construction, or substantial improvement of the taxpayer's principal residence, or to refinance debt incurred for those purposes. The exclusion expired at the end of 2013.

Note. Details on the QPRI exclusion can be found in the 2013 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Financial Distress.

REPAYMENT OF FIRST-TIME HOMEBUYER CREDIT¹⁴³

First-time homebuyers who purchased their principal residence after April 8, 2008, and before January 1, 2009, were eligible for a maximum first-time homebuyer credit (FTHBC) of \$7,500. However, it was not a traditional credit. It instead operated as an interest-free loan; the taxpayer was required to repay (recapture) the credit over a 15-year period. The repayments are equal to 6.67% of the amount of the credit received and increase the taxpayer's federal tax liability by that amount during the recapture period. The 15-year recapture period commenced with the second year following the year the credit was received. If the home is sold (or ceases to be the principal residence) before the end of the 15-year period, the recapture is accelerated, and the entire unpaid balance is due.

For homes purchased after December 31, 2008, and before May 1, 2010, the rules are different. There is no requirement to repay the credit if the home is owned and occupied by the taxpayer for a 3-year period from the date of purchase. If the home ceased to be the taxpayer's principal residence during this 3-year period, the entire amount of the credit must be repaid.

Regardless of the date that the taxpayer purchased a home, the recapture of the FTHBC is limited to the amount of gain from the sale of the home to an unrelated person. The basis of the home is reduced by credit amounts claimed and basis is restored by credit repayments.

The following are exceptions to the recapture rules.

- No repayment is required after the date of the **taxpayer's death**.
- If there is an **involuntary or compulsory conversion of the home**,¹⁴⁴ no accelerated recapture is required if the taxpayer acquires a new principal residence within two years of the date that the taxpayer disposes of the residence or ceases to use it as their principal residence. However, recapture provisions apply to the new principal residence during the recapture period in the same manner that they applied to the converted residence.
- If a **home is transferred between spouses or incident to divorce**, the accelerated recapture provisions do not apply. However, for tax years after the transfer, the recapture provisions apply to the transferee in the same manner that they applied to the transferor.
- If a home is disposed of or ceases to be the taxpayer's principal residence on or **before** December 31, 2008, **in connection with government orders for extended duty service received by a member of the Armed Forces**, the taxpayer is not required to repay the FTHBC.
- If a home is disposed of or ceases to be the taxpayer's principal residence **after** December 31, 2008, **in connection with government orders for extended duty service received by a member of the Armed Forces**, the accelerated recapture provisions do not apply.

Note. For more information about the FTHBC, see the 2010 *University of Illinois Federal Tax Workbook*, Chapter 4: Tax Aspects of Home Ownership. This can be found at www.taxschool.illinois.edu/taxbookarchive.

¹⁴³. IRC §36.

¹⁴⁴. Compulsory or involuntary conversion is defined in IRC §1033(a) as destruction in whole or in part, theft, seizure, or requisition or condemnation.