Chapter 6: Special Taxpayers

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Please note. Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

TRUCK DRIVERS

Transportation industry workers must abide by specific rules. For someone to be considered a transportation industry worker for tax purposes, their job must meet the following requirements.[1]

- Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck
- Regularly requires traveling away from home and, during any single trip, usually involves traveling to an area or areas eligible for different standard meal allowance rates

A truck driver is a classic example of a transportation industry worker.

Note. The information in this section about tax home and deductible expenses is also applicable to railroad workers, who are discussed later.

TAX HOME

The location of the truck driver's **tax home** generally determines whether they can deduct certain travel expenses. As a general rule, necessary and ordinary expenses incurred for traveling while away from the taxpayer's tax home are deductible (as long as those expenses are not lavish or extravagant).[2] This rule is sometimes referred to as the **away-from-home requirement.**[3]

1. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses.*
2. IRC §162.
3. See Rev. Rul. 54-147, 1954-1 CB 51.

Generally, a truck driver's tax home is defined as either:

- The principal place of business, or
- The regular abode (if there is no principal place of business because of the nature of the truck driver's work).[4]

> **Note.** These tax-home rules apply to truck drivers who work either as employees or as self-employed owner-operators (independent contractors). An employed truck driver's principal place of business is the employer's principal place of business.

If the truck driver performs work at a regular place of business, that place of business is their tax home. (This is true regardless of where the truck driver's regular abode is located.)[5] However, for a truck driver who has no identifiable principal place of business but who maintains an abode from which they are sent on temporary assignments, the place of abode is their tax home.[6]

> **Note.** The location of the truck driver's tax home is **always** subject to a **facts and circumstances** analysis.[7] Some of the general rules applied in this analysis are discussed later in this chapter. No clear definition of the term **tax home** applies to all taxpayers, and application of the following general rules has been the subject of significant litigation.

The truck driver's tax home includes the **entire city or general area** in which the tax home is located.[8] Accordingly, the truck driver must be outside this tax-home area to meet the away-from-home requirement.

> **Note.** The extent of the surrounding territory included in the taxpayer's tax home is not always clear. For example, various courts have held that the tax-home area includes the entire city or town,[9] the greater metropolitan area of a major city,[10] a county,[11] and even a port area.[12]

Work Assignments

Generally, the principal place of business is the tax home for a truck driver who works from that principal business location. However, a truck driver may be required to work from another post of duty rather than from that principal place of business. Such a work assignment may be either **temporary** or **indefinite.**

A truck driver with a **temporary** assignment may meet the away-from-home requirement necessary for deducting the travel expenses associated with performing their job from the temporary post of duty. However, for a truck driver with an **indefinite** assignment, the new post of duty is generally considered the new tax home. In this case, the driver does not meet the away-from-home requirement and cannot deduct their job-related travel expenses.[13]

> **Note.** Even if the taxpayer meets the away-from-home requirement, their ability to deduct particular travel expenses also depends on whether those expenses otherwise qualify under the applicable rules for deductible travel costs. These rules are discussed later in this chapter.

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4. Rev. Rul. 75-432, 1975-2 CB 60.
5. IRS Pub. 17, *Your Federal Income Tax*.
6. Rev. Rul. 75-432, 1975-2 CB 60.
7. Ibid.
8. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.
9. *Smith v. Comm'r*, 21 TC 991 (1954); *Podems v. Comm'r*, 24 TC 21 (1955).
10. *Amoroso v. Comm'r*, 193 F.2d 583 (1st Cir. 1952), *cert. denied,* 343 U.S. 926.
11. *J. Summerour v. M. H. Allen*, 99 F.Supp. 318 (M.D. Ga. 1951).
12. *Steinhort v. Comm'r*, 335 F.2d 496 (5th Cir. 1964).
13. *Comm'r v. Mooneyhan*, 404 F.2d 522 (6th Cir. 1968).

Under IRS guidelines, **unless facts or circumstances indicate otherwise,** being employed in a single location away from the truck driver's tax home is considered a **temporary** assignment if **both** the following conditions apply.[14]

- The truck driver **realistically expects the assignment to last one year or less.**
- The assignment **actually lasts one year or less.**

If the truck driver's work assignment at a single location away from home lasts longer than one year, it is generally considered **indefinite.**[15] Furthermore, a work assignment that the truck driver realistically expects to last for more than one year is considered indefinite, regardless of whether it actually exceeds one year.[16]

However, a work assignment that is initially considered temporary may become indefinite due to changed circumstances. In such a case, the assignment is considered temporary until the time that the expectation regarding the nature of the assignment changes.[17] In addition, a series of short-term assignments to the same post of duty that together cover a long period may be considered indefinite.[18]

Example 1. Samantha is a truck driver employed by Monrovia Transport, LLC (MT). She works each day from MT headquarters in downtown Chicago hauling farm produce to major grocery stores. To facilitate the loading of trucks with goods from ships, MT is headquartered about six miles south of downtown Chicago near piers on Lake Michigan.

During 2015, Samantha works from MT's Chicago headquarters from January through September. In October, her supervisor informs her that she is being transferred to the Schaumburg office "for two or three months" because of the increased demand for trucked goods west of Chicago. (Chicago and Schaumburg are both located in Cook County.)

At the time Samantha's supervisor informs her of the Schaumburg assignment, she realistically believes that the assignment will end in December 2015 and that she will resume working from MT's Chicago headquarters in January 2016. In fact, however, Samantha resumes working from MT's Chicago headquarters on March 1, 2016. She also incurs additional travel expenses because of her assignment to the Schaumburg terminal, such as the costs of mileage and meals.

For the first nine months of 2015, Samantha's tax home is MT's headquarters because this is the principal place of business from which she works. MT's headquarters continues to be Samantha's tax home during her assignment to the Schaumburg terminal. (Case law related to a similar set of facts held that working in different locations within the same county did not affect the taxpayer's tax home.)[19]

Samantha does not meet the away-from-home requirement necessary for deducting the additional travel expenses associated with her assignment to the Schaumburg location. Accordingly, Samantha cannot deduct these additional travel expenses.

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14. Rev. Rul. 93-86, 1993-2 CB 71.
15. IRC §162(a).
16. Rev. Rul. 93-86, 1993-2 CB 71.
17. Rev. Rul. 93-86, 1993-2 CB 71; *H. H. Johnson, Jr. v. Comm'r,* TC Memo 1999-153 (May 5, 1999).
18. Ibid.
19. *J. Summerour v. M. H. Allen*, 99 F.Supp. 318 (M.D. Ga. 1951).

Example 2. Use the same facts as **Example 1,** except Samantha is assigned to work from MT's terminal in Champaign, Illinois. (Champaign is approximately 135 miles away from MT's Chicago headquarters.) In addition, before making the assignment, Samantha's supervisor tells her that she will be working from the Champaign location "until the Chicago terminal at headquarters is expanded, which should take several years."

Champaign is not within the same general area as Chicago for tax-home purposes. In addition, the supervisor's statement to Samantha clearly indicates that her Champaign work assignment will last more than one year. Samantha should realistically expect the work assignment to last more than one year.

The Champaign assignment is therefore considered indefinite. Champaign is Samantha's new tax home. Therefore, she cannot deduct any of the travel expenses she incurs as a result of working from Champaign.

Example 3. Use the same facts as **Example 2,** except Samantha's supervisor tells her that she will work from Champaign for the next two months, filling in for another employee who is on leave.

Samantha's Champaign assignment actually lasts for the anticipated 2-month duration. The assignment is therefore considered temporary. Samantha had a realistic belief that the assignment would be temporary, and the assignment lasted for one year or less.

While Samantha works from Champaign, her tax home continues to be Chicago. She is entitled to deduct travel expenses associated with working from the Champaign location.

Observation. Having a **realistic belief** that a work assignment will last one year or less is an element of a temporary work assignment. It may be prudent for a truck driver to **document** reasons for having a realistic belief because that element may later become an issue if their deducted travel expenses are subject to an IRS examination. Obtaining a letter from the employer or making appropriate notations in a log or journal may provide adequate documentation.

Example 4. Use the same facts as **Example 3.** Samantha works from Champaign for the 2-month temporary assignment during October and November 2015. However, before the end of November, her supervisor tells her that she will be working from Champaign for another three months.

Samantha continues to work in Champaign during December 2015, and during January and February 2016. Her supervisor contacts her again on February 15, 2016, and states that she will continue to work from Champaign for the rest of 2016.

The supervisor's communication to Samantha on February 15, 2016, eliminates Samantha's realistic belief that her assignment is temporary. **On that date, her assignment becomes indefinite.** However, her work from Champaign before February 15, 2016, is characterized as temporary. Samantha can deduct her travel expenses for the period from October 2015 through February 15, 2016. (She can do so as long as she meets all the other requirements for deducting travel expenses.)

Multiple Work Locations

Some truck drivers work from two or more business or employment locations. Such an individual must determine which location constitutes their tax home to determine if and when they meet the away-from-home requirement for deducting certain travel expenses.

For a transportation worker, their tax home is typically the terminal at which they usually begin and end trips. The IRS has deemed that, for a long-haul truck driver, the home terminal and surrounding vicinity comprises the tax home.[20]

Travel expenses incurred while traveling to and living at or near the principal place of business or employment are not deductible because the away-from-home requirement is not met. However, travel costs incurred at or near a minor business or employment site that is outside the tax-home area are deductible. This is true as long as the truck driver's job duties require them to be at that minor location and the expenses qualify for deduction. The truck driver is considered away from home even if they maintain a residence at or near the minor business location. The only travel expenses allowed are those associated with living expenses necessary for the truck driver to perform their job duties.[21]

Furthermore, a truck driver may generally deduct the costs of travel between business or employment locations without regard to the tax-home rules (as long as the travel is for business or employment purposes.) However, the costs of commuting from the truck driver's residence to a workplace are not deductible.[22]

Example 5. Georgina lives in Arlington, Virginia, and is employed as a truck driver for Anywhere Logistics, Inc. (AL). Georgina's job duties consist primarily of completing short-haul assignments directly from AL's warehouse in Washington, DC. However, each Wednesday and Friday at noon, she travels approximately 60 miles round trip between AL's warehouse in Washington, DC and AL's satellite logistics office in Bethesda, Maryland. While at the satellite office, she performs administrative duties.

The AL warehouse in Washington, D.C., is Georgina's tax home, and the satellite office is likely considered within its surrounding general area for tax purposes. However, Georgina may deduct the cost of any travel between the warehouse and the satellite office that is necessary to perform her job duties. Georgina **cannot deduct** the costs of travel each day between her home and the AL warehouse.

Note. If Georgina completed the administrative duties from her home instead of the Bethesda, Maryland satellite office, the costs of traveling to her home from the Washington, D.C., warehouse would not be deductible. These expenses are considered nondeductible personal expenses.[23]

If a truck driver works from more than one place of business or employment, their tax home is determined by a facts and circumstances analysis.[24] The following factors are considered when making this determination.[25]

- The total amount of time the driver ordinarily spends in each location
- The level of business or job activity the driver performs in each location
- Whether the driver earns a significant amount of income at each location
- Whether the driver's employment at one location is temporary
- The location of the driver's permanent residence

20. Rev. Rul. 55-236, 1955-1 CB 274.
21. Rev. Rul. 55-604, 1955-2 CB 49.
22. Treas. Reg. §1.162-2(e).
23. *Mazzotta v. Comm'r*, 57 TC 427 (1971), *aff'd per curiam,* 465 F.2d 1399 (2nd Cir. 1972).
24. Rev. Rul. 75-432, 1975-2 CB 60.
25. *Ziporyn v. Comm'r*, TC Memo 1997-151 (Mar. 24, 1997).

Example 6. Frank is employed as a truck driver with JGT Trucking, Inc. (JGT). He works from JGT's headquarters in New York City from May through December each year. From January through April, he works from a JGT logistics office in El Paso, Texas. Frank is salaried and earns $4,000 per month.

Thus, from January through April, while working from El Paso, he earns $16,000 ($4,000 per month × 4 months). From May through December, while working in New York City, he earns $32,000 ($4,000 × 8 months).

Although Frank works from two different locations, his tax home is New York City for two reasons: He spends more time working from the New York City headquarters, and he earns more of his income from his work at that location. Therefore, Frank may deduct allowable travel expenses incurred while in El Paso. During the months he works from El Paso, Frank is considered to be away from his New York City tax home.

No Main Place of Job or Business

If a truck driver has no main place of business, it is necessary to determine whether their abode may serve as their tax home. The relevant inquiry is whether the truck driver has a "regular place of abode in a real or substantial sense."[26]

The IRS uses a **3-factor test** to determine whether a truck driver's abode is their tax home when they do not have a principal place of business.

1. Part of the truck driver's business or job duties are performed in the area of their main home, and they use that home for lodging while conducting business in that area.
2. The truck driver has duplicate living expenses because of being away from that home on business.
3. The truck driver:
   a. Has not abandoned the area in which their historical place of lodging and claimed main home are located,
   b. Has family members living at the main home, **or**
   c. Often uses that home for lodging.

If all three factors apply to the truck driver, the tax home is their residence. If two of the three factors apply, additional facts and circumstances must be considered to determine whether the driver has a tax home. **If only one of the three factors applies, the driver is considered itinerant.**[27]

The tax home of an itinerant taxpayer is wherever the taxpayer works, and travel expenses are not deductible. The Tax Court has held that a truck driver may be categorized as an itinerant.[28]

Note. For a recent case in which the Tax Court held that a truck driver is an itinerant worker, see *Jacobs v. Comm'r*.[29] This case is discussed in the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 7: Rulings and Cases.

26. Rev. Rul. 75-432, 1975-2 CB 60.
27. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses.*
28. *Howard v. Comm'r,* TC Memo 2015-38, (Mar. 19, 2015).
29. *Jacobs v. Comm'r,* TC Summ. Op. 2015-3 (Jan. 20, 2015).

Example 7. Larson is an owner-operator who owns his own truck and works for various businesses as an independent contractor. Customers pay him using either a mileage rate or a flat fee.

Larson parks his truck next to his home in Effingham, Illinois. He stores his business records and copies of customer contracts in his house. In addition, if his work requires him to travel a long distance away from his Effingham home, he pays for his lodging and meals. Larson also spends time at his house in Effingham during holidays and vacations, as well as weekends that he chooses not to work.

Larson does not have a principal place of business. His Effingham residence (place of abode) serves as his tax home because it satisfies all three factors. In addition, Larson's Effingham home is a regular place of abode in a real or substantial sense. Accordingly, Larson's Effingham home is his tax home.

Included in Larson's tax home is the surrounding general area, such as locations within Effingham county. Larson may deduct travel expenses incurred when he meets the away-from-home requirement (along with any other requirements for deducting travel expenses).

Example 8. Carson is an owner-operator who lives in his truck. He accepts only long-haul jobs that require him to be on the road for lengthy periods. Because Carson has no principal place of business and no place of abode, he is considered an itinerant. Carson cannot meet the away-from-home requirement and generally cannot deduct travel expenses.

SUBSTANTIATION OF TRAVEL AND MEALS EXPENSES

Generally, a truck driver must adequately substantiate deductible travel expenses by including the following elements of each expense.[30]

- The **amount** of the expense (The costs of meals and other incidental expenses, such as gas and oil costs and taxi fares, can be combined if reasonably identified.)
- The **date** of the expense (including the trip departure and return dates and the number of days spent on job or business activities away from the tax home)
- The **place** of travel (The name of the city or town or another similar designation is sufficient.)
- The **business purpose** of the trip (or the nature of the business benefit expected as a result of the trip)

> **Note.** Adequate records of expenses may include an account book, diary, log, statement of expense, trip sheets, or similar records.[31] These records must be created at or near the time of the expenditure. A log maintained on a weekly basis is considered "at or near the time" of such use. For more details on the substantiation requirements that apply to travel and entertainment expenses, see Treas. Reg. §1.274-5.

Although taxpayers should always follow the strict documentation requirements set forth by IRC §274, owner-operators may be able to deduct certain expenses, even when they have failed to provide specific documentation.

30. Temp. Treas. Reg. §1.274-5T(b)(2).

31. Temp. Treas. Reg. §1.274-5T(c)(2)(ii)(A).

In June 2014, the Tax Court allowed an owner-operator to prove certain expenses with "rough estimates that were made years after the fact without documentation." *In Baker v. Comm'r,*[32] the Tax Court found that the taxpayer's fuel, truck maintenance, truck insurance, oil changes, truck storage fees, truck license plates, and heavy highway use taxes were not subject to the heightened substantiation requirements of IRC §274(d)(4). This section, the court found, applied only to expenses related to "listed property," and the owner-operator's truck was not listed property. Consequently, the court allowed the taxpayer to prove the expenses related to his truck under the relaxed requirements established in *Cohan v. Comm'r.*[33] Under *Cohan,*[34] a taxpayer must present "sufficient evidence" for the court to form an "estimate" of the proper deduction. In *Baker,* the Tax Court relied solely on the taxpayer's testimony in allowing the deduction for the truck-related expenses. The court found that the taxpayer did not present sufficient evidence to substantiate the maintenance, storage, taxes, and travel expenses he sought to deduct.

> **Caution.** *Cohan* should be viewed only as a last resort for establishing a taxpayer's claimed deductions for nonlisted property. Practitioners should counsel their clients to abide by strict documentation standards.

OPTIONS FOR CALCULATING MEAL DEDUCTIONS

To be deductible, the cost of a meal must:

- Be incurred under circumstances when it is necessary to stop for substantial sleep or rest to perform job or business duties while traveling away from the taxpayer's tax home, or
- Be business-related entertainment.

In addition, the meal cannot be lavish or extravagant.[35]

To calculate the deduction for a qualifying meal, the truck driver can use either of the following methods.[36]

- Actual cost method
- Standard meal allowance method

Under the **actual cost method,** the truck driver bases the deduction on the actual amount expended for a qualifying meal. The truck driver must be able to substantiate this amount (in addition to meeting the other substantiation requirements noted earlier.) The actual cost method can be used for both meals and incidental expenses.

> **Note.** Incidental expenses include ancillary costs associated with travel, such as fees and tips and the costs of mailing receipts and other expense documentation. **Incidental expenses do not include costs incurred for laundry, cleaning or pressing clothes, lodging taxes, and telephone calls.**

Alternatively, the truck driver may use the **standard meal allowance method.** This method requires using established per diem rates (known as **federal per diem rates**) for meals. A truck driver can use federal per diem rates for each full 24-hour period they are away from their tax home. Each year, the IRS issues a notice that updates the federal per diem rates effective for the 12-month period beginning on October 1 of that year.

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32. *Baker v. Comm'r,* TC Memo 2014-122 (Jun. 18, 2014).
33. *Cohan v. Comm'r,* 39 F.2d 540, 543-544 (2d Cir.1930).
34. IRC §274 overrides the *Cohan* rule with regard to certain expenses.
35. IRC §162.
36. Treas. Reg. §1.274-5(j).

Federal per diem rates may be used by truck drivers who are employees and by those who are independent contractors. However, federal per diem rates may not be used if the employer and the truck driver-employee are related parties.[37] IRC §267(b) defines the related-party relationships that preclude using federal per diem rates. For purposes of this rule, a truck driver and a corporation are related parties if the truck driver owns at least 10% of the corporation (rather than the 50% threshold in IRC §267(b)).[38]

Note. Federal per diem rates are available at **uofi.tax/15a6x1** [www.gsa.gov/portal/content/104877]. These rates are also published each year in an IRS notice.[39] Updated rates are effective on October 1 of each year.

To the extent that standard allowances are used, the driver is deemed to have met the substantiation requirement as to the amount. Even so, the driver is **still obligated to substantiate the other factors** (i.e., the date, place, and business purpose), as required by Treas. Reg. §1.274-5.

Note. If an employee-driver receives a per diem allowance that exceeds standard rates, the employer must include the excess when reporting the employee's gross income. This excess amount is subject to federal income, social security, and Medicare taxation.

Special Per Diem Rates for Transportation Industry

Most employees must treat unreimbursed employment or business expenses as miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) threshold. In addition, most taxpayers are subject to the 50% limitation on the deductibility of meals and entertainment expenses. However, certain taxpayers are eligible to treat some or all of their employment or business expenses under other tax rules.

A truck driver subject to U.S. Department of Transportation hours-of-service (HOS) regulations may be entitled to a higher deduction. **An 80% deduction for meals and entertainment expenses is applicable to an HOS truck driver** who travels away from the business tax home if the expenses are incurred while performing work subject to federal HOS regulations.

Note. A summary of the current HOS regulations and which drivers are subject to the HOS limits can be found at **uofi.tax/15a6x2** [www.fmcsa.dot.gov/rules-regulations/topics/hos/index.htm].

Options for Truck Drivers. To substantiate expenses incurred while traveling away from home, a truck driver can use either of the following per diem methods.

- The method using special transportation industry meal and incidental expenses (M&IE) rates
- The high-low method

The special transportation industry M&IE rate for the 12 months beginning October 1, 2014, is $59 per day for travel within the continental United States (CONUS). The rate is $65 for any locality of travel outside the continental United States (OCONUS).[40]

37. Rev. Proc. 2011-47, 2011-42 IRB 520.
38. Ibid.
39. See, e.g., IRS Notice 2014-57, 2014-42 IRB 723.
40. IRS Notice 2014-57, 2014-42 IRB 723.

Using the high-low method, a truck driver uses rates in IRS tables that divide localities into high-cost and low-cost areas. Under the high-low method, the standard rates for those high-cost areas listed in the IRS tables are $65 for M&IE and $259 for M&IE plus lodging.[41] Any localities not listed in the tables are deemed low-cost areas. For these areas, the rates are $52 for M&IE and $172 for M&IE plus lodging.[42] These rates are effective for the year beginning October 1, 2014.

Annual rates are effective from October 1 to September 30 of the following year. This means that the rates for the final three months of the year (October through December) may be different than those in effect for the first nine months of the year (January through September).

Special **transition rules** apply to truck drivers who use the January through September rates for expense reimbursement purposes. An employer that reimburses employees under the per diem rate method during the first nine months of the year (January 1 through September 30) must continue to use the same per diem method through the end of that calendar year.[43] However, for travel from October 1 through December 31, the employer may reimburse employees using the new rates or finish the year using the rates in effect for the first nine months of the year.

> **Note.** Other rules on using standard rates for meals and lodging are provided in Rev. Proc. 2011-47 and Rev. Proc. 2010-39.

For the **departure date** and the **return date,** the truck driver may either:

- Deduct 75% of the standard meal allowance ($44.25 CONUS; $48.75 OCONUS for the year beginning October 1, 2014), or
- Prorate the standard meal allowance using any method that aligns with reasonable business practice and that is consistently applied.

Unreimbursed Per Diem. A truck driver **who itemizes** can deduct any part of the per diem that is not reimbursed by their employer. Unreimbursed expenses are deductible on Schedule A, *Itemized Deductions,* subject to the 2% of AGI limit.

To calculate the unreimbursed per diem, the employer's reimbursement (if any) is subtracted from the applicable per diem rate and multiplied by the number of full days the driver was on the road. Any partial days are added to that amount.

Example 9. Tonya Trucker is an over-the-road trucker in the continental United States. During 2015, she was on the road for 100 full days. Her employer reimbursed her $19 per diem. Her unreimbursed per diem was $4,000 (($59 CONUS rate – $19 reimbursement rate) × 100 days), which can be reported on her Schedule A if she itemizes.

Example 10. Use the same facts as **Example 9,** except in addition to being on the road for 100 full days during 2015, Tonya also traveled 10 partial days (i.e., days at the beginning or end of trips). Including these partial days adds $442.50 ($44.25 partial-day CONUS rate × 10 days) to her unreimbursed amount, for a total of $4,442.50 ($4,000 + $442.50), which can be reported on her Schedule A if she itemizes.

> **Caution.** Truck drivers must maintain proper logs to prove the number of nights they spend away from home during the year. **Some trucking companies keep only electronic logs and only for six months' time.** These logs are therefore not available if requested during an IRS audit. Drivers are required by IRS rules to maintain their own copies of paper or electronic logs for three years. It may be good practice to maintain records for seven years.

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41. Ibid.

42. Ibid.

43. IRS Pub. 436, *Travel, Entertainment, Gift, and Car Expenses*.

TRUCK DRIVERS TRAVELING WITH SPOUSES OR DEPENDENTS[44]

Generally, the travel expenses of a spouse, dependent, or other individual accompanying the truck driver on a trip are not deductible. An exception is made if the person who accompanies the truck driver:

1. Is an employee of the truck driver,
2. Has a bona fide business purpose for accompanying the truck driver, and
3. Incurs travel expenses that qualify for deduction on their own return.

If the person accompanying the truck driver is a **business associate,** they are not required to be an employee. (In this case, only items 2 and 3 of the preceding list must be met for travel expenses to be deductible by the truck driver.)[45]

A business associate is generally defined as a person with whom the truck driver could reasonably expect to engage in trucking business. Examples include a truck driver's customer or client, supplier, or professional advisor. A **potential** customer or client, supplier, or professional advisor also qualifies as a business associate.

TRUCK DRIVERS AND WORKER CLASSIFICATION[46]

In most cases, a truck driver is either an employee who receives a Form W-2, *Wage and Tax Statement,* or an independent contractor who receives a Form 1099-MISC, *Miscellaneous Income*. A truck driver who is engaged in business as an owner-operator is an independent contractor and therefore self-employed.

For federal tax purposes, a truck driver is an employee if they qualify as such under common law. Under **common law,** an employer-employee relationship exists when the firm or person(s) for whom the services are performed has the right to control and direct the truck driver in how the services are performed.

Control over the means and details of the truck driver's work-related tasks is the hallmark of an employer-employee relationship. It is not necessary for the employer to actually exercise this control. Merely having the **right to control** the truck driver is sufficient to determine that the truck driver is an employee — not an independent contractor.

IRS Factors

Determining whether a truck driver is an employee or an independent contractor is important for tax purposes. After reviewing several cases and rulings that use the common-law approach, the IRS identified **20 factors** used to determine whether a truck driver is an employee or an independent contractor. The IRS notes that these factors serve only as a guide and that each factor's degree of importance varies depending on the particular circumstances of each case.

The 20 factors consider the degree of control that a firm has over a truck driver across various aspects of a typical work relationship. The factors are explained in the following table.[47]

> **Note.** For further details on how these factors should be applied, see Rev. Rul. 87-41. These factors are not unique to truck drivers; they apply to all employer-employee relationships. Accordingly, if a truck driver hires someone to work for them, these factors may be used to determine whether that person is an employee or an independent contractor of the truck driver.

44. IRC §274(m)(3).
45. Treas. Reg. §1.274-2(g).
46. Rev. Rul. 87-41, 1987-1 CB 296.
47. Ibid.

Factor	Explanation
Control of when, where, and how the worker performs services	Providing instructions for when, where, and how a worker is to work is indicative of an employer-employee relationship. An independent contractor tends to have control over the time, place, and method with which they perform job obligations.
Training	Training a worker, requiring them to perform services with other workers, and requiring them to attend meetings are all indicative of an employer-employee relationship. Independent contractors use their own methods and receive no training from the purchasers of their services.
Integration into firm operations	The integration of a worker's services into the operations of the business indicates the direction and control generally found in an employer-employee relationship.
Requirement that services be performed personally	Requiring services to be performed by a specified individual is indicative of an employer-employee relationship. Independent contractors are often not required to personally perform the services they provide.
Control over assistants	An employer-employee relationship is indicated when the firm has the right to hire, supervise, and pay a worker's assistants. An independent contractor hires, supervises, and pays assistants under a contract that requires the contractor to provide materials and labor and to be responsible only for the result.
Length of relationship	A long-term, continuing relationship may indicate an employer-employee relationship.
Work schedule	A worker being assigned a set work schedule indicates the control of an employer in an employer-employee relationship. An independent contractor sets their own schedule.
Number of hours of service required	The amount of time a worker is required to spend providing services to an employer is indicative of their status. Full-time employment and control by the firm over the time a worker spends working are indicative of an employer-employee relationship. A worker who provides part-time services for the firm while also providing services for others is not under such control. This type of relationship suggests one involving an independent contractor.
Location where services are performed	Requiring that a worker provides services on the firm's premises suggests an employer-employee relationship. However, some types of services and work tasks cannot be performed elsewhere (for example, making improvements to the firm's facilities). Independent contractors may perform the work wherever they desire as long as the contract requirements are met.
Control over work technique or sequence	Having control over the technique or sequence a worker uses to perform required tasks suggests the existence of an employer-employee relationship. Independent contractors perform the work in whatever order or sequence they may desire.
Reports to firm	A worker's submission of regular or periodic oral or written reports suggests that the firm has a degree of control over them. This is indicative of an employer-employee relationship.

Factor	Explanation
Payment method	The interval of payment may be indicative of an employer-employee relationship. Paying a worker by the hour, week, or month suggests that an employer-employee relationship may exist. Paying a worker by the job or based on the invoices they submit is indicative of an independent contractor relationship.
Work-related expenses	Paying a worker's business and travel expenses suggests the existence of an employer-employee relationship. However, reimbursing business and travel expenses pursuant to a contract might be part of an arrangement between an independent contractor and a firm.
Tools	Whether the worker is required to furnish their own tools is an important consideration. The provision of tools and equipment by the firm suggests that an employer-employee relationship is in place.
Work facilities	A worker's investing in and providing work facilities indicates an independent contractor relationship. This is especially true if the facilities are of a type not generally maintained by an employee.
Profit and loss potential	A worker who is paid a fixed rate based on time and has no possibility of profit or loss is likely an employee. A worker who will likely profit from the success of an enterprise and risks experiencing a loss upon its failure is usually an independent contractor.
Multiple employers	An individual who works for multiple employers, rather than a single firm, is likely an independent contractor.
Restrictions on customers and clients	A worker who offers their services to the public on a regular, consistent basis is less likely to be an employee than a worker employed by a single firm. A worker who can perform services only for a specific firm is probably an employee.
Termination of worker	A firm's ability to terminate its relationship with a worker indicates an employer-employee relationship. An independent contractor cannot be fired as long as they produce results that meet the contract specifications.
Termination of relationship by worker	A worker's ability to end a working relationship at any time without penalty is indicative of an employer-employee relationship. A worker's liability for terminating a relationship without cause or for reasons not permitted by the working agreement may indicate an independent contractor relationship.

Tax Court Factors

To determine whether a worker is an employee or an independent contractor, the Tax Court considers the following **seven factors.**[48]

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

Some firms incorrectly categorize truck drivers as independent contractors, rather than employees. The issue of whether truck drivers are employees or independent contractors was considered by the Tax Court in *Peno Trucking, Inc. v. Comm'r*.[49]

In this case, Peno Trucking (PT) owned 15 trucks and leased them to OTC Transport. PT used these trucks to provide OTC with hauling services. PT agreed to provide drivers and to ensure that their work was performed in accordance with the leases. PT obtained drivers to fulfill its obligations to OTC. PT hired, fired, disciplined, and supervised the drivers. PT also determined the days the drivers could work and required them to maintain commercial driving licenses, driving logs, and other documents. PT negotiated the rate of pay with each driver. In addition, PT's contract with each driver indicated that it was not possible for the driver to become indebted to PT in any way. PT provided drivers with the necessary equipment, although drivers were free to provide extra equipment at their own cost. PT paid for all fuel, tolls, and truck maintenance and repairs.

To provide the hauling services required by the OTC agreement, PT offered drivers the opportunity to accept hauls each day. A driver was free to decline any haul that was offered. However, if the driver accepted, PT provided directions to the driver regarding pick-up and delivery locations and times. PT provided drivers with beepers to keep in contact with them on the road.

In each driver's contract, PT designated them as an independent contractor. Each year, PT issued each driver a Form 1099-MISC, that reported the driver's annual pay. PT did not withhold federal taxes, social security, or Medicare taxes from any driver's pay.

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48. *Herman v. Comm'r*, TC Memo 1986-590 (Dec. 18, 1986).

49. *Peno Trucking, Inc. v. Comm'r,* TC Memo 2007-66 (Mar. 21, 2007), *rev'd* 296 Fed. Appx. 449 (6th Cir. 2008).

The Tax Court addressed the issue of whether the drivers were independent contractors or employees. In applying the **seven factors,** the Tax Court concluded the following.

1. PT had a substantial **right to control** the drivers. PT hired, fired, supervised, paid, and disciplined them. PT also confirmed with OTC that the work of the drivers was properly performed. PT determined the days the drivers worked. PT required the drivers to have appropriate licenses, logs, and other documents and provided them with directions for their hauls. PT was responsible for all truck repairs and maintenance — not the drivers. PT even required drivers to carry beepers to maintain contact with them. This right to control the drivers and the details of their work indicates an employer–employee relationship, not one involving independent contractors.

2. The drivers **invested** minimal amounts in their own equipment and licenses. PT made the **substantial investment** in the trucks and paid for all fuel, oil, tolls, and other expenses. Doing so indicates that the drivers are employees, not independent contractors. Independent contractors would likely invest heavily in their own equipment.

3. The drivers **bore no risk of loss,** which made them more like employees than independent contractors. In fact, their contracts specifically indicated they had no chance of becoming indebted in the course of working for PT. The drivers were only compensated for the hauls they accepted and did not risk losing any money.

4. PT had the right to fire drivers, and the drivers could **terminate their relationships** with PT. No facts in this case indicated that these termination rights stemmed from anything other than a legal employer-employee relationship.

5. The drivers completed hauls, which is precisely the service offered by PT. The drivers' services were therefore **highly integrated** into PT's principal function. This fact indicates the existence of an employer-employee relationship.

6. The drivers worked consistently for PT and did not have transitory relationships with the company. This **permanency of relationship** is indicative of an employer-employee relationship.

7. Nothing in this case indicated that PT or the drivers **intended** that an independent contractor relationship existed. If a genuine employer-employee relationship existed and the parties described it as something different, that alternate description would be immaterial. Therefore, the PT contracts identifying the drivers as independent contractors are irrelevant.

The Tax Court concluded that the truck drivers were employees, not independent contractors. The 6th Circuit upheld that finding. The circuit court did, however, reverse the Tax Court's finding that the trucking company was not entitled to IRC §530 tax relief. The 6th Circuit ruled that the trucking company had a reasonable basis for treating the workers as independent contractors.

Owner-Operators

Owner-operators are classified as independent contractors. They typically receive Forms 1099-MISC and must pay their own income taxes. Additionally, owner-operators are subject to self-employment (SE) tax.

An owner-operator must file a Schedule C, *Profit or Loss From Business,* with their personal income tax return to report their trucking activity for the year.[50] An owner-operator can deduct almost all of their work-related expenses on Schedule C. The following chart shows some of the deductions that owner–operators often overlook.[51]

Category	Deduction
Cleaning supplies	Air freshener, paper towels, trash bags, window cleaner
Miscellaneous supplies	Bedding, first aid supplies, refrigerator, coffee maker
Clothing	Hangers, laundry soap, uniforms, laundry bag
Electronics	GPS unit, power cords
Tractor supplies	Bunk heaters and fan, de-icer
Tools	Crowbar, duct tape
Protective clothing	Boots, thermal underwear, rain gear
Fees	Drug testing, Department of Transportation (DOT) physical, hazardous materials (hazmat) background check
Driver hygiene	Shower shoes, showers
Office supplies	Clipboard, log book
Transportation expenses	Airfare, bus fare, hotel/motel expenses
Load securement	Bunge cords, locks, "wide load" flag

Misclassification of Employees[52]

If a truck driver is misclassified as an independent contractor without a reasonable basis, the firm may be held liable for the driver's employment taxes.[53] If there is a reasonable basis for not treating a driver as an employee, the firm may be relieved from paying these employment taxes. To be eligible for this relief under IRC §530, the firm must file all required federal tax returns (including information returns) consistent with treating the driver as an independent contractor.[54]

If the status of the worker is unclear, the worker or the firm can obtain an IRS determination letter resolving this issue.[55] A request is made by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.* The request can be made to determine the status of a single worker or an entire class of workers. No fee is required to make such a request.

Form SS-8 asks for details about the nature of the worker's services and the relationship between the worker and the firm. Several of the questions focus on the degree of control the firm has over the worker's performance of services.

50. *Owner Operator Tax Deductions.* Gates, Corinne. CB39.org. [www.cb39.org/info_pages/owner-operator-tax-deductions.html] Accessed on Apr. 30, 2015.

51. *Truck Driver Tax Deductions.* CB39.org. [www.cb39.org/info_pages/Truck-Tax-Deduction-pdf.pdf] Accessed on Apr. 30, 2015.

52. *Independent Contractor (Self-Employed) or Employee?* Oct. 2, 2014. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Self-Employed-or-Employee] Accessed on May 1, 2015.

53. IRC §3509.

54. IRS Pub. 1976, *Do you Qualify for Relief Under Section 530?*

55. See Instructions for Form SS-8.

After receiving a completed Form SS-8, the IRS acknowledges its receipt. The determination of worker status for federal tax purposes affects the worker, the firm, and perhaps other parties. The IRS may attempt to obtain further relevant details from other affected parties by sending them blank Forms SS-8 and requesting information. The IRS may also request information from other unaffected parties who can clarify the relationship between the worker and the firm. Information on the first Form SS-8 that was filed may be shared with other parties.

An IRS technician reviews the information from the various Forms SS-8 submitted. The technician applies the relevant law and issues a decision on the worker's status by issuing a **formal determination letter** to the firm. A copy of the determination letter is also forwarded to the worker. The determination letter applies only to the worker or class of workers who are the subject of the request, and the determination is binding on the IRS.

Note. The IRS may issue an **information letter** instead of a determination letter. Unlike a determination letter, an information letter is **not** binding on the IRS. It may be used by the parties to ensure that all payroll and income tax obligations are fulfilled.

The IRS will not issue a determination letter in connection with a tax year for which the statute of limitations has expired. Similarly, the IRS will not issue a determination letter in regard to a hypothetical or proposed set of circumstances.

The Form SS-8 determination process — including the acquisition of additional information and the review of relevant records — does not constitute an audit of a tax return. This means that the stipulations of a letter of determination cannot be appealed. However, a disagreeing party can request a **redetermination.**

A driver who believes they have been misclassified as an independent contractor can file Form 8919, *Uncollected Social Security and Medicare Tax on Wages.* This form is used to calculate and report the employee's share of social security and Medicare taxes. In addition, the driver must meet one of the following criteria indicating they were an employee while performing the services for which they were compensated.[56]

- The driver has filed a Form SS-8 and has received a determination letter from the IRS stating they are an employee of the company.
- The driver was designated as a §530 employee by their employer or by the IRS prior to January 1, 1997.
- The driver has received communication from the IRS indicating they should be classified as an employee.
- The driver was previously treated as an employee by the firm and is still performing services in a similar capacity and under similar direction and control.
- The driver's coworkers are performing similar duties under similar direction and control and are classified as employees.
- The driver's coworkers are performing similar services under similar direction and control and filed Form SS-8 for the firm and received a determination that they were employees.
- The driver has filed Form SS-8 with the IRS and has not yet received a reply.

[56] IRS News Rel. IR-2007-203 (Dec. 20, 2007).

Voluntary Classification Settlement Program

A company that wants to reclassify workers as employees for future tax periods and get partial relief from federal employment taxes may participate in the Voluntary Classification Settlement Program (VCSP). To be eligible for the VCSP, a company must currently classify workers as independent contractors and want to prospectively classify them as employees.[57] To participate in the VCSP, a company must have consistently treated the drivers as independent contractors. (This includes filing all required Forms 1099 for the previous three years.)

To be eligible for participation in the VCSP, a company cannot currently be under an IRS employment tax audit. Similarly, a company cannot be under an audit regarding classification of workers by the U.S. Department of Labor or a state government agency. If a company was previously under an audit regarding employment classification, it is eligible for the VCSP if it complied with the results of the audit and is not currently contesting the classification in court.

An eligible company files Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*. The application must be filed at least 60 days before the date the company wants to start treating its workers as employees.

Once the application is approved, the company enters into a closing agreement with the IRS. At that time, the company must pay any amount due under the closing agreement. Under the closing agreement, the company will:

- Pay 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of IRC §3509(a);
- Not be liable for any interest and penalties on the amount; and
- Not be subject to an employment tax audit with respect to the classification of the workers being reclassified under the VCSP for prior years.

Reduced IRC §3509(a) Rates. Under IRC §3509(a), the effective tax rate for compensation up to the social security wage base is generally 10.68% (lower rates applied in 2011 and 2012). The effective rate for compensation **above** the social security wage base is 3.24%. The rate breakdown is as follows.[58]

Description	§3509(a) Percentage for Years Other than 2011 and 2012 Up to the Social Security Wage Base	§3509(a) Percentage for Compensation Paid Above the Social Security Wage Base
Federal income tax withholding	1.5	1.5
Employee social security tax	1.24	0
Employer social security tax	6.2	0
Employee Medicare tax	0.29	0.29
Employer Medicare tax	1.45	1.45
Total	10.68	3.24

57. *Voluntary Classification Settlement Program (VCSP)*. Nov. 13, 2014. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program] Accessed on May 1, 2015.

58. *Voluntary Classification Settlement Program (VCSP) Frequently Asked Questions*. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program-VCSP-Frequently-Asked-Questions] Accessed on Aug. 12, 2015.

Employee Liability under IRC §3509.[59] Employee FICA (social security and Medicare) tax liability is not affected by §3509. The employer is not entitled to recover from the employee any part of the tax assessed under §3509. Treas. Reg. §31.3102-1(d) provides that the employee is responsible for their share of FICA until it is collected by the employer. Because IRC §3509 prohibits the employer from collecting the tax from the employee, the employee remains liable for the FICA tax on their Form 1040.[60]

The employee may file a claim for refund of any SE tax that is attributable to the employee reclassification. The SE tax refund is offset by the employee's share of FICA tax imposed as a result of the application of Treas. Reg. §31.3102-1(d).

The SE tax rate is 15.3%. The reclassified worker computes the amount of FICA taxes due on Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, and attaches it to their Form 1040. Ultimate liability is on the employee until the tax is collected from either the employee or the employer.[61]

Note. IRS Notice 989, *Commonly Asked Questions When IRS Determines Your Work Status is "Employee,"* provides instructions to the reclassified worker on how to file the claim for refund.

Example 11. Carlos earns compensation of $45,000 as a truck driver. During the year, he incurs $9,900 of related business expenses. Carlos pays SE tax on the net earnings of $32,415 (($45,000 − $9,900) × (100% − 7.65% employee share of employment tax)). During a subsequent examination, the IRS reclassified Carlos' earnings from SE income to gross wages of $45,000. Carlos is allowed an SE tax refund of $1,516, which is calculated as follows.

SE tax ($32,415 × 15.3%)	$4,959
Less: employee FICA tax ($45,000 × 7.65%)	(3,443)
Allowable SE tax refund	$1,516

Expenses that the reclassified worker claimed on Schedule C are eliminated but may be deductible on Form 2106, *Employee Business Expenses,* and/or Schedule A, subject to the 2%-of-AGI limitation. Adjustments on page 1 of Form 1040 for half of the SE tax (line 27) and SE health insurance (line 29) are also eliminated. Eliminating the related business expenses subject to the 2%-of-AGI limit increases the taxable income and possibly the federal income tax. Certain expenditures, such as medical insurance, cannot be claimed as miscellaneous deductions on Schedule A when a worker is reclassified as an employee. Any additional federal income tax from these changes offsets the SE tax refund.

If the period of limitations for the SE tax or FICA tax is expired, the refund or payment is allowed under IRC §6521. The employer may be entitled to an abatement of the employee share of FICA tax if the employee paid SE tax and the statute has expired for claiming a refund of such tax.

59. IRM 4.23.8.5.3 (2013).

60. See Rev. Rul. 86-111, 1986-2 CB 176.

61. Ibid.

Tax Issues

The issue of whether a truck driver is an employee or independent contractor is important because the required tax reporting is very different for each of these two statuses. The following table summarizes how truck drivers claim meal deductions as an employee or an independent contractor.

Employed Truck Drivers	Self-Employed Truck Drivers
• Can only use per diem rates to calculate a deduction for amounts unreimbursed by the employer • Must itemize deductions on Schedule A in order to claim deductions (subject to the 2%-of-AGI floor)	• The total deductible amount is claimed on Schedule C • Meals deduction reduces amount of SE tax liability

For employed truck drivers, the employer must withhold and remit payroll taxes (social security and Medicare). The employer is responsible for payment of the employer's share of such taxes as well. However, the self-employed truck driver pays these amounts through the SE tax. Given the differences in tax reporting for each status, proper categorization of a truck driver as either employee or independent contractor is essential.

LUMPER FEES

Laborers who are paid to load and unload containers are referred to as **lumpers.** Lumpers often work independently of trucking companies, although employee-drivers can perform loading and unloading services for additional compensation.

Reimbursement

An employee-driver who pays lumper fees is entitled to reimbursement. Requiring a truck driver to pay for unloading services without providing reimbursement is illegal.[62]

Lumpers who are independent contractors can establish their own fees. The rates typically depend on the product and location of delivery and range between $60 and $350.[63] Truck drivers who pay lumpers should retain receipts to substantiate these expenses. Self-employed truckers who pay $600 or more for services (e.g., lumpers) must issue Forms 1099-MISC.

ESTIMATED TAX PAYMENTS

A driver who is an independent contractor receives a Form 1099 from each company to which they provide services. Moreover, no taxes are withheld from the payments the driver receives. Any driver who expects to owe taxes of $1,000 or more when they file their annual return is required to pay estimated taxes throughout the year at regular intervals.[64] A driver who is an independent contractor must pay SE tax in addition to income tax if their net business income is more than $400.

Note. For a thorough discussion of estimated taxes, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 4: Estimated Taxes. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

62. 49 USC §14103.

63. *Lumpers: Service or Scam?* Skaggs, Ken. Jan. 31, 2015. Big City Driver. [http://bigcitydriver.com/2015/01/lumpers-service-or-scam/] Accessed on Jun. 11, 2015.

64. *Estimated Taxes.* May 18, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estimated-Taxes] Accessed on Jun. 11, 2015.

EQUIPMENT DEPRECIATION

A **tractor** is a highway vehicle designed to tow a vehicle, such as a trailer or semitrailer. It does not carry cargo on the same chassis as the engine.[65] A tractor is depreciated over three years.[66]

A **truck** is a highway vehicle designed to transport a load on the same chassis as the engine, even if it is also equipped to tow a vehicle (such as a trailer or semitrailer).[67] A truck is depreciated over five years.

A **trailer or semitrailer** is customarily used in connection with a vehicle that is equipped to tow it.[68] A trailer is the vehicle pulled by a tractor in hauling freight.[69] A trailer or trailer-mounted container is depreciated over five years.[70]

Trucks, tractors, and trailers are eligible for expensing under IRC §179.

> **Note.** The Tax Increase Prevention Act of 2014 increased the annual §179 limit for 2014 to $500,000. The 2015 limit is $25,000. For more information about depreciation, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Depreciation.

RAILROAD EMPLOYMENT

> **Note.** Information on determining a taxpayer's tax home and identifying deductible expenses for transportation workers can be found in the "Truck Drivers" section of this chapter.

RAILROAD EMPLOYMENT TAXES

Railroad employers are subject to a separate and distinct system of employment taxes than the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) systems that cover most other employers. Some parts of the system are the responsibility of the IRS. Other parts are the responsibility of the Railroad Retirement Board (RRB), which is an independent governmental agency.

The RRB maintains earnings records for each railroad employee in a manner similar to those maintained by the Social Security Administration (SSA). Payments subject to railroad retirement taxes are specifically excepted from FICA, FUTA, and the Self-Employment Contributions Act (SECA).[71]

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65. Treas. Reg. §145.4051-1(e)(1).

66. IRS Pub. 946, *How To Depreciate Property.*

67. Treas. Reg. §145.4051-1(e)(2).

68. Instructions for Form 2290.

69. *Trucking Industry Overview—Complete Version,* Mar. 3, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Trucking-Industry-Overview---Complete-Version] Accessed on Jun. 12, 2015.

70. IRS Pub. 946, *How To Depreciate Property.*

71. *Railroad Retirement Tax Act (RRTA) Desk Guide (January 2009).* Jun. 29, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Railroad-Retirement-Tax--Act-%28RRTA%29-Desk-Guide-%28January-2009%29#2] Accessed on Jul. 20, 2015.

Railroad Retirement System[72]

Railroad employment taxes consist of employer and employee taxes. The employer and employees pay certain taxes at different rates. Some of the taxes are paid by either the employee or the employer, although all taxes are collected and deposited by the employer.

1. **Railroad Retirement Tax Act (RRTA).** RRTA taxes fund railroad worker retirement benefits. The IRS has the responsibility of collecting these taxes.
2. **Railroad Retirement Act (RRA).** RRA is the benefit system through which payments are made to retired railroad workers. The RRA administers these benefits.
3. **Railroad Unemployment Insurance Act (RUIA).** The RUIA system provides unemployment and sickness insurance benefits for railroad workers. The RRB administers the system and collects the taxes.
4. **Railroad Unemployment Repayment Tax (RURT).** When the RUIA account is insufficient to cover payments of unemployment benefits, funds are advanced to the RUIA account from the RRTA account. The RURT is then collected to repay the advance. Thus, this tax is in effect only when it is needed. When in effect, this tax is imposed by chapter 23A of the Code (IRC §§3321 and 3322).
5. **Tax on Employee Representatives.** Certain individuals perform services as official representatives or officers of railway labor organizations for purposes of representing employees under the Railway Labor Act. These individuals are subject to RRTA taxes, and they file a separate return to report the wages and RRTA taxes.

The discussion in this section focuses only on RRTA taxes.

RRTA Tiers and Rates. The railroad retirement system replaces the social security system for railroad workers. There are two tiers of railroad retirement system taxes.

- Tier I uses social security benefit formulas and is based on combined railroad retirement and social security credits. The amount a beneficiary receives is reduced by any social security payments they receive. This prevents paying dual benefits to a railroad worker who also accrued sufficient time in a job covered by social security.
- Tier II is comparable to pensions that are paid in other industries. The amount an employee receives is based solely on their railroad service.

The tax rates for these two tiers are as follows.

	2015[73]		2014[74]	
	Earnings Base	Tax Rate	Earnings Base	Tax Rate
Tier I wage base/rate[a]	$118,500	6.20%	$117,000	6.20%
Tier I Medicare[a]	Unlimited	1.45%	Unlimited	1.45%
Tier II employer wage base/rate	$ 88,200	13.10%	$ 87,000	12.60%
Tier II employee wage base/rate	$ 88,200	4.90%	$ 87,000	4.40%

[a] Assessed on both employer and employee

Note. The tier II rates create a significant difference between the tax rates paid by railroad and nonrailroad employers. Therefore, railroad employers have an incentive to classify workers as independent contractors or nonrailroad workers, rather than employees.

Note. In addition to the 1.45% tier I Medicare rate, employers are required to **withhold** the tier I additional Medicare tax of 0.9% from compensation greater than $200,000 in a calendar year. The additional tax is imposed only on the employee.

72. Ibid.

73. *Railroad Retirement Board Reminders for 2015.* U.S. Railroad Retirement Board. [www.rrb.gov/pdf/g34.pdf] Accessed on Jan. 25, 2015.

74. *Program Letter 2014-02.* Jun. 20, 2014. U.S. Railroad Retirement Board. [www.rrb.gov/AandT/pl/pl1402.asp] Accessed on Jan. 25, 2015.

RRTA Compensation

IRC §3231(e) provides the definition of compensation for RRTA purposes. Although there are historical differences between the FICA and RRTA statutes, there are also significant similarities. Legislation enacted over the years has made the RRTA tier I tax identical to the FICA tax. The tier I wage ceiling also conforms to the FICA wage ceiling.

The exclusions from the definition of compensation under RRTA generally mirror the exclusions from the definition of wages under FICA. These exclusions include nonmonetary benefits such as fringe benefits, meals and lodging excludable under IRC §119, and employer-paid life insurance premiums for group-term life insurance under $50,000.

Tier I benefits are designed to be equivalent to social security benefits. They are subject to federal income taxation in the same manner as social security benefits. For purposes of computing RRTA taxes, the term **compensation** has the same meaning as the term **wages** under IRC §3121(a), except as specifically limited by the RRA or regulations.[75]

Industry Compensation Issues[76]

Annual Productivity Fund Payments. To reduce costs, some railroad employers have negotiated agreements with their employees to reduce the size of the crew operating the train. In return for agreeing to reduce the size of the crew, the employees receive additional payments from the employer.

The employer agrees to set aside a certain amount of money throughout the course of the year, based on the number of trains operated with a reduced crew. Then, after yearend, each employee who participated in operating a train with a reduced crew receives a pro-rata share of the funds set aside by the employer.

Employers have attempted to classify these payments as other than compensation for services and therefore not subject to RRTA.[77] The IRS has taken the position that these payments represent compensation for services rendered and are subject to RRTA.[78]

Employee Achievement Awards. Employers frequently reward employees for safety, perfect attendance, and other similar types of achievement by giving them tangible personal property (other than cash, a gift certificate, or an equivalent item). Generally, the value of these awards can be excluded from income. The excludable amount of the award is limited to the employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards received during the year.[79]

> **Note.** The exclusion from income does not apply to all types of awards. See IRS Pub. 525, *Taxable and Nontaxable Income,* for more information.

A **qualified plan award** is an achievement award given as part of an established written plan. The plan cannot favor highly compensated employees for eligibility or benefits.[80]

Segregation.[81] Segregation is a concept used for the separation of employees subject to FICA taxes from those subject to RRTA taxes. The purpose of segregation is to obtain a fair and reasonable application of law. However, it cannot be applied if the records are inadequate or if the railroad and nonrailroad work is so commingled that they cannot be identified separately.

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75. Treas. Reg. §31.3231(e)-1(a)(1).

76. *Railroad Retirement Tax Act (RRTA) Desk Guide (January 2009).* Jun. 29, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Railroad-Retirement-Tax--Act-%28RRTA%29-Desk-Guide-%28January-2009%29#2] Accessed on Jul. 21, 2015.

77. Employers generally base their position on Rev. Rul. 58-301, 1958-1 CB 23, modified and superseded by Rev. Rul. 2004-110, 2004-2 CB 960.

78. Rev. Rul. 75-44, 1975-1 CB 15.

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

80. IRS Pub. 535, *Business Expenses.*

81. Treas. Reg. §31.3231(a)-1; *Railroad Retirement Tax Act (RRTA) Desk Guide (January 2009).* Jun. 29, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Railroad-Retirement-Tax--Act-%28RRTA%29-Desk-Guide-%28January-2009%29#2] Accessed on Jul. 21, 2015.

RAILROAD RETIREMENT SYSTEM

Retirement Benefits

Retirement benefits under tier I were designed to take the place of social security. For a worker to be eligible for retirement benefits through the RRB, they must have worked **at least 10 years in covered service** for the railroad industry or at least five years after 1995.[82] A worker with fewer than 10 years of covered service or fewer than five years after 1995 is not vested under the railroad retirement program. Such a worker's account is transferred into social security.[83]

As with social security benefits, railroad retirement benefits are generally first payable at age 62. The full retirement age (FRA) ranges from 65 to 67, depending on the retiree's year of birth. Benefit reductions for early retirement between age 62 and the FRA for someone with **less than 30 years of service** are the same as those for social security.[84]

A retirement earnings test also applies to railroad retirement benefits received before reaching the FRA. This test is performed using the same thresholds and reductions as for the social security test. The retirement earnings test calculates benefits for an individual who has earnings greater than an exempt amount and who is below the FRA.[85] Prior to the year the FRA is reached, benefits are reduced $1 for every $2 earned over the annual exempt amount (which is $15,720 in 2015).[86] In the year the FRA is reached, the reduction is $1 for every $3 earned over the annual exempt amount (which is $41,880 in 2015).[87] This reduction applies only in the months before reaching the FRA.

Every survivor claim requires a determination of jurisdiction (that is, which agency is responsible for administering the benefit). The RRB has jurisdiction if the worker meets the vesting requirements (more than 10 years of railroad service or less than 10 years but more than five years after 1995) and was employed in a railroad industry job covered by the RRB until retirement or death. If these conditions are not met, the RRB awards jurisdiction to the SSA.[88]

RRB retirement benefits differ from social security benefits in that early retirement deductions **do not apply** if the worker has **at least 30 years of service** in RRB-covered employment.[89] In such a case, the individual can begin receiving benefits as early as age 60 with no age-based reduction.

Another **difference between RRB retirement benefits and social security benefits** is that the RRB pays a supplemental annuity if an employee had at least 25 years of service that began before October 1, 1981, and has a current connection to the railroad.[90] Eligibility for this annuity begins at age 60 if the employee has at least 30 years of creditable service and at age 65 if the employee has 25 to 29 years of service. The fixed maximum amount of the supplemental annuity is $43 per month.[91]

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82. *Railroad Retirement and Survivor Benefits*. Feb. 2015. U.S. Railroad Retirement Board. [www.rrb.gov/pdf/opa/ib2.pdf] Accessed on May 15, 2015.

83. *An Overview of the Railroad Retirement Program*. 2008. Social Security Administration. [www.ssa.gov/policy/docs/ssb/v68n2/v68n2p41.html] Accessed on Jun. 19, 2015.

84. *Retired Employee and Spouse Benefits*. Aug. 7, 2014. U.S. Railroad Retirement Board. [www.rrb.gov/lmo/conference/eeandsp/retired/30years.asp] Accessed on Jun. 19, 2015.

85. *Exempt Amounts Under The Earnings Test*. Social Security Administration. [www.ssa.gov/oact/cola/rtea.html] Accessed on Jul. 9, 2015.

86. *Railroad Retirement Board Reminders for 2015*. U.S. Railroad Retirement Board. [www.rrb.gov/pdf/g34.pdf] Accessed on May 21, 2015.

87. Ibid.

88. *An Overview of the Railroad Retirement Program*. 2008. Social Security Administration. [www.ssa.gov/policy/docs/ssb/v68n2/v68n2p41.html] Accessed on Jul. 2, 2015.

89. Ibid.

90. Ibid.

91. Ibid.

Disability Benefits

The RRB and the SSA both use the same definition of total disability and the same formula to calculate disability annuities.[92] A person is considered disabled if:[93]

1. They cannot do the work they did before,
2. They cannot adjust to other work because of their medical condition(s), **and**
3. Their disability has lasted or is expected to last for at least one year or to result in death.

The annuity for **total and permanent disability** is payable for any employee under the FRA with at least 10 years of railroad service or with five years of service after 1995. However, the individual's combined credits for work under the social security program and the railroad retirement program must meet the eligibility requirements for social security disability benefits.[94]

> **Note.** For more information about the eligibility requirements for social security disability benefits, see the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Social Security and Retirement Planning. This is available at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive/].

Occupational Disability. In addition to total disability benefits, the RRB offers occupational disability benefits that do not exist under social security. Occupational disability benefits cover disabilities that prevent an individual from working in their **regular railroad position.**

This annuity is payable at any age to a worker with at least 20 years of service and a current connection to the railroad industry. It is also available to a worker between age 60 and the FRA with at least 10 years of service and a current connection to the railroad industry.[95] The occupational disability annuity is calculated in the same manner as the total disability annuity.

Spousal Benefits

Tier I benefits are also provided to spouses of employees who qualify for railroad retirement benefits. A spousal annuity is initially calculated to equal half of the worker's unreduced tier I benefit but can be reduced based on applicable factors, such as early receipt.[96] For a spouse to be eligible based on a current marriage, the couple must be married for at least one year or they must have conceived a child and the spouse must cease any employment covered by the RRB.[97]

Spousal benefits are subject to the same age and service rules as retirement benefits. However, for the spouse of an employee with less than 30 years of service, the reductions are larger than those applied to workers' retirement benefits.[98] Consistent with social security rules, a spouse can also receive benefits at any age if they are caring for a child under age 16 or a child who became disabled before age 22. A divorced spouse is eligible for tier I spousal benefits under the same conditions as those that apply to social security.

> **Note.** A list of the various spousal reductions under different circumstances is available at **uofi.tax/15a6x3** [www.rrb.gov/forms/PandS/rb30/rb30early.asp].

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92. Ibid.

93. *Disability Planner: What We Mean By Disability.* Social Security Administration. [www.ssa.gov/planners/disability/dqualify4.html]. Accessed on May 15, 2015.

94. *An Overview of the Railroad Retirement Program.* 2008. Social Security Administration. [www.ssa.gov/policy/docs/ssb/v68n2/v68n2p41.html] Accessed on May 21, 2015.

95. Ibid.

96. Ibid.

97. Ibid.

98. Ibid.

Survivor Benefits

For a survivor to be eligible for railroad retirement benefits, the deceased employee must have at least 10 years of covered service or five years of covered service after 1995, and have a current connection to the railroad at the time of their retirement or death.[99] If these conditions are not met, the credits for work earned in the RRB-covered employment used in computing survivor benefits are transferred to social security. RRB survivor benefits can be paid to the following.[100]

- Widows and widowers
- Divorced spouses
- Dependent parents
- Children who are under age 18
- Children who are 18 or 19 years old and full-time students (12th grade or below)
- Children who are disabled before age 22
- Dependent grandchildren if both parents are disabled or deceased

A surviving divorced spouse is eligible to receive benefits if they **meet all** the following conditions.[101]

1. The marriage lasted at least 10 consecutive years.
2. The surviving divorced spouse is unmarried or remarried after age 60 (or a disabled surviving divorced spouse who remarried after age 50).
3. The surviving divorced spouse is age 60 or older (age 50 or older if disabled).

A surviving divorced spouse who is unmarried can qualify at any age if they are caring for the employee's child who is under age 16 or disabled. This condition applies regardless of how many years the marriage lasted.[102]

To be eligible for widow or widower benefits, the recipient must not have remarried, unless the remarriage occurred after age 60 or after age 50 if the recipient was disabled before the remarriage. However, remarrying before age 60 (or age 50 if disabled) does not prevent eligibility if the remarriage ends.[103]

Under the RRA, a child can receive benefits only if the employee is deceased. Under social security rules, the child of a retired or disabled employee can also receive benefits. However, the RRA includes a special minimum guaranty provision to ensure that the families of workers covered under the RRA do not receive less in benefits than if they were covered by social security. The provision increases the employee's benefit to reflect the amount social security would pay the family, unless the railroad annuity is already more than that amount.[104]

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99. Ibid.

100. Ibid.

101. *Railroad Retirement and Survivor Benefits*. Feb. 2015. U.S. Railroad Retirement Board. [www.rrb.gov/pdf/opa/ib2.pdf] Accessed on May 21, 2015.

102. *An Overview of the Railroad Retirement Program.* 2008. Social Security Administration. [www.ssa.gov/policy/docs/ssb/v68n2/v68n2p41.html] Accessed on May 14, 2015.

103. Ibid.

104. *Railroad Retirement and Survivor Benefits*. Feb. 2015. U.S. Railroad Retirement Board. [www.rrb.gov/pdf/opa/ib2.pdf] Accessed on May 21, 2015.

Tier II Benefits

Tier II benefits are structured to provide additional benefits comparable to private, multiemployer pension plans. Tier II benefits are subject to the same federal income tax rules as private pensions.

As mentioned earlier, the 2015 tier II rate is 4.9% for employees and 13.1% for employers.[105] The monthly tier II benefit is calculated using the highest 60 months of earnings (up to the tier II maximum, which is $88,200 for 2015) as follows.[106]

Monthly tier II benefit = .007 × Average monthly earnings × Years of service

Example 11.[107] Earline retired in December 2014 with 35 years of service. For tier II purposes, her earnings for the five years ending in 2014 were $403,800. This 5-year period was also her highest 60 months of earnings. Therefore, her average monthly earnings were $6,730 ($403,800 ÷ 60 months). Earline's tier II monthly benefit is $1,648.85, which is calculated as follows.

Monthly tier II benefit = .007 × $6,730 average monthly earnings × 35 years of service

Tier II benefits generally have the same age restrictions as tier I benefits. Tier II benefits are reduced by 25% for beneficiaries who qualify for both railroad retirement and social security benefits.[108]

Tier II benefits are provided to current spouses and survivors. However, divorced spouses can receive these benefits only as part of a property settlement.[109] The spousal benefits are equal to 45% of the employee's tier II benefits.[110]

For tax purposes, tier II benefits are treated as amounts received from a qualified employee plan. This allows for the nontaxable recovery of employee contributions from tier II benefits.[111]

Medicare

A qualified railroad retirement beneficiary is automatically entitled to Medicare part A (hospital insurance) benefits on the same basis as a person entitled under social security (i.e., they have reached age 65 or are disabled).[112]

As mentioned earlier, employees pay 1.45% of all earnings to Medicare. As is the case for workers subject to social security, there is no cap on the taxes that railroad retirement program participants pay to cover Medicare.[113]

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105. *Railroad Retirement and Unemployment Insurance Taxes in 2015.* Dec. 4, 2014. U.S. Railroad Retirement Board. [www.rrb.gov/opa/pr/pr1408.asp] Accessed on May 15, 2015.

106. *Calculating Railroad Retirement Employee Annuities: Benefit Information.* Feb. 18, 2014. U.S. Railroad Retirement Board. [www.rrb.gov/opa/cal_rr_ann/CalcRRAnn.asp] Accessed on Jun. 19, 2015.

107. Ibid.

108. *Calculating Railroad Retirement Employee Annuities: Benefit Information.* Feb. 18, 2014. U.S. Railroad Retirement Board. [www.rrb.gov/opa/cal_rr_ann/CalcRRAnn.asp] Accessed on May 21, 2015.

109. *An Overview of the Railroad Retirement Program.* 2008. Social Security Administration. [www.ssa.gov/policy/docs/ssb/v68n2/v68n2p41.html] Accessed on Jul. 2, 2015.

110. Ibid.

111. IRS Pub. 575, *Pension and Annuity Income.*

112. Soc. Sec. Act §226(a); *Medicare for Railroad Workers and Their Families.* Jan. 29, 2015. U.S. Railroad Retirement Board. [www.rrb.gov/forms/opa/rb20/rb20.asp] Accessed on Jun. 30, 2015.

113. *An Overview of the Railroad Retirement Program.* 2008. Social Security Administration. [www.ssa.gov/policy/docs/ssb/v68n2/v68n2p41.html] Accessed on May 21, 2015.

Social Security

For purposes of social security benefits, earnings from railroad employment are counted at the death or retirement of a worker if the worker does not qualify under the railroad retirement program. For example, when a railroad worker retires with less than 120 months of railroad service and less than 60 railroad service months after December 31, 1995, no railroad retirement annuity is payable. However, any railroad earnings after 1936 are considered in determining the worker's rights to social security disability or retirement benefits.[114]

Taxable Benefits

Taxable benefits are included in the gross income of the person who is entitled to receive them. Generally, this is the worker who earned the benefits.

Tier I. The following components of tier I benefits are subject to tax.[115]

1. The amount of the annuity equal to the social security benefits that would have been paid if the employee had been eligible for social security
2. The special guaranty amount (also called the **"overall minimum" formula),** which guarantees that the railroad retirement annuity is not less than what would be paid in social security benefits[116]

To the extent that tier I benefits exceed the social security equivalent, they are treated as distributions from a qualified plan. This excess amount is combined with tier II benefits and shown in box 4 of Form RRB-1099-R.[117]

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE **UNITED STATES RAILROAD RETIREMENT BOARD** 844 N RUSH ST CHICAGO IL 60611-2092	**2014** 3. Employee Contributions		**ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD**	
PAYER'S FEDERAL IDENTIFYING NO.				
1. Claim Number and Payee Code	4. Contributory Amount Paid		**COPY B -** **REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN.** **THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.**	
2. Recipient's Identification Number	5. Vested Dual Benefit			
Recipient's Name, Street Address, City, State, and Zip Code	6. Supplemental Annuity			
	7. Total Gross Paid (Sum of boxes 4, 5, and 6)			
	8. Repayments			
	9. Federal Income Tax Withheld			
	10. Rate of Tax		11. Country	12. Medicare Premium Total

Sample

FORM RRB-1099-R

> **Note.** An individual whose only income during the year consists of tier I benefits will probably not have to file an income tax return. However, the benefits may be taxable to a recipient who has other income if their adjusted gross income (AGI) exceeds a certain level.

114. *Social Security Handbook.* Aug. 8, 2011. Social Security Administration. [www.socialsecurity.gov/OP_Home/handbook/handbook.09/handbook-0967.html] Accessed on Jul. 2, 2015.

115. IRC §86(d)(4).

116. *Information About the Taxation of Railroad Retirement Annuities.* Sep. 10, 2012. U.S. Railroad Retirement Board. [www.rrb.gov/forms/PandS/tax/tb85.asp] Accessed on Jul. 14, 2015.

117. IRS Pub. 575, *Pension and Annuity Income.*

Tier II. Tier II benefits are taxed in the same manner as distributions from a qualified employer plan. Therefore, all but the portion represented by employee contributions is taxable.[118]

Tier II benefits are financed by payroll taxes paid by the railroad employer and by the employee. The payroll tax percentages are determined under IRC §3241, and the taxes are paid on earnings up to a maximum dollar amount. The tier II benefit amount is combined with the tier I portion in excess of the social security equivalent and shown in box 4 of Form RRB-1099-R.

Tax Reporting

Railroad retirement benefits are included in gross income only if the recipient's provisional income exceeds a specified amount, called the **base amount** or **adjusted base amount.** Under the **50% rules,** the amount of tier I railroad retirement benefits includable in gross income is the lesser of: [119]

- 50% of the annual tier I benefits received equivalent to social security, or
- 50% of the taxpayer's provisional income in excess of a specified base amount.

Provisional income is the total of:

1. 50% of the tier I railroad retirement benefits received equivalent to social security, plus
2. Modified adjusted gross income (MAGI). For this purpose, MAGI is calculated by adding the following items to the taxpayer's AGI.[120]
   a. Exclusions for interest from U.S. savings bonds used to pay higher education expenses
   b. Exclusions for employer-provided adoption assistance
   c. Deductions for interest on qualified educational loans
   d. Deductions for domestic production activities
   e. Deductions for qualified tuition and related expenses
   f. Exclusions for foreign-earned income or foreign housing
   g. Exclusions for income earned by bona fide residents of American Samoa or Puerto Rico
   h. Tax-exempt interest

AGI is determined without including any railroad retirement benefits.

The amount of benefits included in taxable income depends on whether the provisional income is greater than a **base amount** (up to 50% included) or an **adjusted base amount** (up to 85% included).

Up to 50% of benefits can be included in taxable income if the recipient's provisional income is more than the following **base amounts** (but less than the adjusted base amount).

- $32,000 for a married couple filing a joint return (MFJ)
- $25,000 for single individuals, qualifying surviving spouses, heads of household, and married individuals filing separately (MFS) who lived apart from their spouse for the entire tax year
- $0 for an MFS taxpayer who did not live apart from their spouse during the entire tax year

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118. IRC §72(r).

119. IRC §86(a) and (b).

120. IRC §86(b)(2).

If the taxpayer's provisional income **does not exceed** the applicable base amount, no part of the social security benefits or equivalent railroad retirement benefits is taxed.

Example 12. John and Jane Jangles have rental income of $24,000 for 2014 and file a joint return. John is retired and receives tier I railroad retirement benefits of $7,200 per year. John and Jane also receive $6,000 from mutual funds that invest solely in tax-exempt municipal bonds. Their tax professional makes the following calculation to determine how much of John's benefits must be included in their gross income for the 2014 tax year.

Rental income	$24,000	
Plus: tax-exempt interest	6,000	
MAGI	$30,000	
Plus: one-half of tier I railroad retirement benefits ($7,200 × 50%)	3,600	$3,600
Provisional income	$33,600	
Less: base amount for MFJ taxpayers	(32,000)	
Excess above base amount	$1,600	
	× 50%	
One-half of excess above base amount	$ 800	800
Amount includable in gross income (lesser of amounts in right column)		**$ 800**

Up to 85% of an individual's tier I railroad retirement benefits may be includable in gross income if the taxpayer's income exceeds the **adjusted base amounts.** The **adjusted base amounts** are as follows.[121]

- $44,000 for MFJ taxpayers
- $34,000 for single individuals, qualifying surviving spouses, heads of household, and MFS taxpayers who lived apart from their spouse for the entire tax year
- $0 for an MFS taxpayer who did not live apart from their spouse during the entire tax year

A taxpayer whose provisional income exceeds the adjusted base amount must include in income the lesser of:

1. 85% of the annual tier I benefits received that are equivalent to social security benefits; or
2. 85% of the provisional income in excess of the applicable adjusted base amount **plus** the lesser of:
   a. The statutory amount of $4,500 (single, head of household, surviving spouse, or MFS individual who did not live with their spouse) or $6,000 (MFJ taxpayer), or
   b. The amount calculated under the 50% rules.

[121] IRC §86(c)(2).

Example 13. Use the same facts as **Example 12,** except the Jangles' provisional income is $53,600. The amount includable in gross income is calculated as follows.

Step 1.			
Tier I railroad retirement benefits	$ 7,200		
	x 85%		
	$ 6,120		$ 6,120
Step 2.			
Provisional income	$53,600		
Adjusted base amount	(44,000)		
Excess above adjusted base amount	$ 9,600		
	x 85%		
85% of excess	$ 8,160	$ 8,160	
Plus: the **lesser** of:			
Step 2(a).			
Statutory amount	$ 6,000		
Step 2(b). 50% rules			
Amount includable **lesser** of:		3,600	
• 50% of benefits received ($7,200 × 50% = **$3,600**), or			
• 50% of the excess of provisional income less base amount (($53,600 – $32,000) × 50% = **$10,800**)	$ 3,600		
Total of Step 2 amounts		$11,760	$11,760
Amount includable in gross income (lesser of Step 1 or Step 2)			**$ 6,120**

Note. See Worksheet 1 in IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits,* for additional guidance on calculating the amount of tier I benefits includable in gross income.

OIL AND GAS TAXPAYERS

OVERVIEW

The increased production of oil and gas on privately owned property in recent years means that an increased number of landowners receive payments from oil and gas companies. It is important for tax practitioners to understand the various types of payments a client may receive and the tax consequences that may apply due to the nature of the income.

The consequences include two relatively new taxes that can apply to payments associated with oil and gas. These new taxes are the additional **0.9% Medicare tax** on active income[122] and the additional **3.8% net investment income tax** (NIIT) on passive income.[123]

122. IRC §3101(b)(2).

123. IRC §1411.

An oil and gas lease is created when the owner of an operating right (referred to as a **working interest**) assigns all or a portion of the right to another person and retains a continuing nonoperating interest in production. The owner may assign the right for no immediate consideration or for cash or its equivalent.

Generally, the lease runs for an **initial period** (for example, five years). However, if the property is placed in production during the initial period, the lease generally continues for as long as production continues. The lease is eventually terminated under the terms of the lease or in accordance with local (state) law when production ceases.

The income from the oil and gas property is commonly divided between the mineral interest owner (the **royalty owner**) and the operator (the **working interest owner**). In a typical lease arrangement, the royalty owner retains one-eighth (12.5%), and the working interest owner holds the other 87.5%. (This comprises the balance of the production or income that remains after the royalty interest owner's share has been satisfied.)[124]

The **working interest owner** bears the entire cost of exploration for minerals, plus the development and production costs. The **royalty owner** bears none of the exploration, development, or operational costs.

The funding necessary for the working interest owner to develop the oil and gas property is provided by **investors.** They receive an interest in the activity in exchange for their capital investment. The costs of the activity borne by the working interest owner are allocated to the investors. These costs include geological survey costs, tangible costs (such as the drilling equipment and well), and intangible drilling costs (IDCs). As discussed later, these costs can be currently deducted, rather than capitalized.

The relationship between the working interest owner and the investors is typically a joint venture that is classified as a **partnership** for tax purposes. Thus, the partnership passes through the costs of the activity to the investors on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* In the early years of the activity, the partnership typically passes through large losses to the partners. Because the partners are merely investors in the activity, the losses in their hands are **passive losses**. These losses are limited under the passive loss rules.[125] They are deductible only to the extent that the investor has passive income.

However, the working interest owner (who owns the interest directly or through an entity that does not limit liability for the interest) is treated as being engaged in a nonpassive activity regardless of their participation.[126] Likewise, for an investor who holds both general and limited partnership interests, the investor's entire interest in each well drilled under the working interest is treated as an interest in a nonpassive activity, regardless of whether they materially participate.

Caution. Given the broad definition of partnership in the Code, investors in the working interest activity will likely have income from the activity that is subject to self-employment tax even though they do not materially participate in the activity.[127]

124. See, for example, *Mineral Rights*. King, Hobart. Geology.com. [http://geology.com/articles/mineral-rights.shtml] Accessed on Jul. 19, 2015.

125. IRC §469.

126. Temp. Treas. Reg. §1.469-1T(e)(4)(i). For this purpose, a working interest in oil or gas property is defined in reference to the depletion rules. For example, the production of fuel from a landfill does not qualify as a working interest in oil and gas property. Also, it is possible for a general partner to be indemnified against liability that exceeds their capital contribution for any of the partnership's costs and expenses with respect to their working interest. In such a case, the general partner would not be deemed passive and could deduct IDCs that passed through without limitation.

127. See, for example, *Methvin v. Comm'r,* TC Memo 2015-81 (Apr. 27, 2015).

TAX ISSUES FOR LESSORS AND LESSEES

Bonus Payment

The lessee typically makes a lump-sum cash **bonus payment** during the initial lease term (predrilling) for the rights to acquire an economic interest in the minerals. This is the basic consideration the lessee pays to the lessor when the lease is executed. The lessor reports the bonus payment on Schedule E, *Supplemental Income and Loss.*

> **Example 14.** Jed owns 160 acres of an oil-contaminated swamp in the Ozarks. He enters into a lease with the O.K. Oil Company (O.K.) that gives O.K. the right to drill for oil in the swamp. Jed receives $400,000 as a bonus payment. The lease provides for an initial term of five years and will continue as long as oil is produced on the property. O.K. assumes all development and operating costs and will pay Jed one-eighth of the proceeds when production begins. Jed will report the $400,000 bonus payment on Schedule E as ordinary income subject to cost depletion (discussed later).

Tax Consequences to the Lessor. A bonus payment is reported as rent to the lessor in box 1 of Form 1099-MISC, *Miscellaneous Income.* This payment constitutes net investment income (NII), which is potentially subject to the additional 3.8% NIIT.[128] The lessor reports the payments on Schedule E, and the amount flows to line 17 of Form 1040, *U.S. Individual Income Tax Return.* The lessor may be allowed to deduct cost depletion (discussed later) against the bonus payment. Bonus payments are not eligible for percentage depletion (discussed later).

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Typically, a bonus payment is ordinary income (rather than capital gains) that is not subject to SE tax. A recent Tax Court case illustrates the difficulty lessors have in characterizing bonus payments as capital gains. In *Dudek v. Comm'r*,[129] the petitioner entered into an oil and gas lease agreement with an independent company. Under the agreement, Dudek received an up-front bonus payment of over $800,000 and a royalty payment that equaled 16% of the net profits of oil and gas extracted from his property. The bonus payment was not tied to production. The petitioner reported the payment as a long-term capital gain based on his contention that a sale, rather than a lease, was involved. However, the IRS recharacterized the payment as ordinary income and assessed an accuracy-related penalty. In addition, the petitioner argued for a depletion deduction, which the IRS also disallowed.

The court determined that a lease, not a sale, was involved because the petitioner retained an economic interest in the deposits. Specifically, Dudek was entitled to a royalty interest equal to a percentage of the extracted oil and gas. The court also agreed with the IRS about the treatment of the depletion deduction attributable to the lease bonus income. IRC §613A(d)(5) bars a percentage depletion deduction for income that is payable without regard to production.[130] Although the bonus payment could have been eligible for cost depletion under Treas. Reg. §1.612-3(a)(1), the court held that the petitioner did not provide evidence of the amount of royalty interest he expected to receive.

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128. However, the U.S. Court of Appeals for the 9th Circuit has held that a cash bonus received for an oil and gas lease is not a royalty that is treated as passive investment income (*Swank & Sons, Inc. v. U.S.,* 522 F.3d 981 (9th Cir. 1975), *aff'g,* 362 F. Supp. 897 (D. Mt. 1973)). The court determined that the payment of a bonus upon execution of an oil and gas lease does not constitute "personal holding company income." The court also determined that the terms **bonus** and **royalty** have particular meanings in the realm of oil and gas and do not mean the same thing. The court viewed a bonus payment as active income derived from active management of the land and a royalty income as entirely passive. The court's holding is contrary to the holdings of the D.C. Circuit and the 5th Circuit.

129. *Dudek v. Comm'r,* TC Memo 2013-272 (Dec. 2, 2013).

130. See also Treas. Reg. §1.613A-3(j).

Note. The IRS allows a depletion allowance to the owner of mineral resources (or a taxpayer who has an economic interest in the mineral property) to account for the reduction (production) of the reserves as they are produced and sold. This allowance is a form of cost recovery for the capital investment. A taxpayer can compute the depletion allowance in two ways: cost depletion and percentage depletion. A royalty owner can use either approach.

The **cost depletion** method allows the taxpayer to deduct the portion of the original capital investment (less prior deductions) equal to the fraction of the estimated remaining recoverable reserves that have been produced and sold during the tax year. **The cumulative maximum amount recovered cannot exceed the taxpayer's original capital investment.**

The **percentage depletion** method provides a deduction that is a fixed percentage of the revenue from the sale of the oil or gas. For a royalty owner, the deduction is 15% of gross income based on the average daily production of crude oil or natural gas up to the quantity of depletable oil or natural gas. The deduction is limited to the lesser of 100% of taxable income from the property (computed without the depletion deduction) or 65% of taxable income from all sources (computed without the depletion allowance). Under the percentage depletion method, the **cumulative deductions can exceed the capital amount** spent to acquire the property.

More information on cost depletion and percentage depletion is provided later.

There is authority for claiming cost depletion when it is not possible to reasonably estimate future royalties. This could happen in a wildcat area,[131] for instance, when there is no evidence to indicate that production will occur during the lease term. In *Collums v. U.S.*,[132] the court held that a zero estimate of future royalties was reasonable. Based on this holding, the court allowed a cost depletion deduction in the year the lease bonus was received equal to the entire basis in the leases at issue. The IRS does not agree with the court's opinion.[133]

Perhaps the taxpayer in *Dudek* could have claimed cost depletion if the transaction had been structured differently and he participated in advance planning. For purposes of claiming cost depletion, **the buyer should allocate the cost basis to mineral rights when land and minerals are purchased together.** The allocation is useful to the buyer for purposes of claiming cost depletion of the minerals and claiming a deduction if the minerals become worthless. Indeed, the IRS asserts that there is no separate cost basis for minerals.

An exception is made if, at the time the minerals were acquired, one of the following conditions exists.[134]

1. The seller's cost included a stipulated amount for the mineral rights.
2. The seller's basis was the result of an estate tax valuation in which the minerals and the surface were separately valued.
3. The seller's cost basis can be properly allocated between the surface and the minerals because there is substantial evidence of the value of the minerals on the acquisition date.

131. A wildcat area is one that has no concrete historic production records and has been unexplored as a site for potential oil and gas output.

132. *Collums v. U.S.,* 480 F. Supp. 864 (D. Wyo. 1979).

133. Tech. Adv. Memo. 8532011 (May 7, 1985). The court's opinion is that no future production is likely synonymous with no mineral deposit existing, which means cost depletion is not available.

134. IRM 4.41.1.2.1.2 (Dec. 3, 2013).

In any event, the burden is on the taxpayer to prove the basis allocable to minerals.[135]

Observation. It may be advantageous for the taxpayer to separate the royalty interest from the working interest, if possible, before beginning negotiations with the oil company. The royalty interest can be transferred to a third party who is related to the transferor. Then, the working interest can be transferred to the developer/explorer subject to the preexisting overriding royalty interest that the related party holds. The purpose for structuring the transaction in this manner is to provide the taxpayer with the argument that they have "sold" the working interest without retaining an economic benefit from the royalty interest. Doing so may strengthen the argument for capital gain treatment. However, structuring the arrangement in this manner could bring a step-transaction challenge by the IRS, unless a legitimate business purpose exists for carving out the royalty interest.

Other related lease expenses — such as attorney fees, land-surveying costs, deed and title work, and property taxes — are deductible in the year in which they are incurred.

Tax Consequences to the Lessee. For the lessee, a bonus payment is not deductible even if it is paid in installments. It must be capitalized as a leasehold acquisition cost. However, a bonus payment may be subject to cost depletion (discussed later).

Note. If the lessee deducts percentage depletion with respect to the mineral interest acquired (discussed later), they must reduce depletable gross income from the property by a proportion of the bonus paid. The reduction is the part of the bonus paid in the tax year (or any prior tax year) allocable to the product sold during the tax year.[136] A bonus payment is considered part of the lessor's gross income from the property. Thus, the lessee must reduce the gross income from the property by the amount of bonus payments applicable to the oil and gas lease. To this extent, neither the lessee nor the lessor is entitled to percentage depletion.[137]

Installment Bonus Payments. A bonus payment may be paid annually for a fixed number of years, regardless of production. If the lessee **cannot avoid making the payments by terminating the lease,** the payments are termed a **lease bonus payable in installments.** These payments are also consideration for granting a lease. They are advance payments for oil, and each installment is typically larger than a normal delay rental (discussed next).

A cash-basis lessee must capitalize these payments. In addition, the fair market value (FMV) of the contract in the year the lease is executed is ordinary income to the lessor if the right to the income is transferable.[138] However, if the bonus payments are made under a contract that is nontransferable and nonnegotiable, a cash-basis lessor can defer recognizing the payments until they are received.[139]

Delay Rentals

A **delay rental** is paid for the privilege of deferring development of the property by extending the initial period of the lease to allow additional time for drilling operations to begin. A delay rental can be avoided by abandoning the lease or by starting development operations (that is, drilling for oil or obtaining production).

A delay rental payment is "pure rent." It is simply a payment to defer development, rather than a payment for oil.

135. Rev. Rul. 69-539, 1969-2 CB 141.

136. Treas. Reg. §1.613-2(c)(5)(ii).

137. A depletion deduction cannot be claimed on the federal return. However, some states allow a depletion deduction attributable to lease payments.

138. Rev. Rul. 68-606, 1968-2 CB 42.

139. See, for example, *Kleberg v. Comm'r,* 43 BTA 277 (1941), *non. acq.* 1952-1 CB 5.

Tax Consequences to the Lessor. A delay rental is ordinary income regardless of whether it is based on production. However, if it is not based on production, it is not depletable gross income for the lessor.[140] **Depletable gross income** for the lessor is the royalty income they receive. Royalty income is based on production.[141]

Delay rental payments are reported in the same manner as bonus payments. They are reported to the lessor in box 1 of Form 1099-MISC and constitute NII, which is potentially subject to the additional 3.8% NIIT. The lessor reports the payments on Schedule E, and the amount flows to line 17 of Form 1040.[142]

> **Example 15.** Use the same facts as **Example 14.** Under the lease that O.K. Oil Company enters into with Jed, annual delay rental payments of $5 per acre are payable to Jed. O.K. did not develop the leased property within one year after the lease commenced. Thus, under the terms of the lease, O.K. paid Jed $800 ($5 × 160 acres) for the next year to give the company additional time to develop the property. Jed reports the $800 as **ordinary income on Schedule E.**

Tax Consequences to the Lessee. Under Treas. Reg. §1.612-3(c), a delay rental is similar in nature to rent, which the lessee can deduct as a current expense.[143] However, the IRS maintains that IRC §263A applies to delay rentals, which requires the payments to be capitalized.[144] According to this view, delay rental payments are paid for periods in which drilling does not occur. In these situations, delay rentals constitute indirect preproduction costs. As such, they must be capitalized up to the depletable basis of the property to which they relate, in accordance with Treas. Reg. §1.263A-2(a)(3)(ii).

The only exception to capitalization applies if the taxpayer has credible evidence establishing that the leasehold was acquired for some reason other than development.

> **Note.** Prop. Treas. Reg. §1.612-3(c)(2) indicates that to the extent the delay rental is **not** required to be capitalized under IRC §263A, the lessee can deduct it or charge it to a depletable capital account under IRC §266.

Royalty Income

A **landowner royalty** is the right to the oil, gas, or minerals in place that entitles the owner to a specified percentage of gross production (if and when production occurs) free of the expenses of development and operations. A **royalty interest** is a continuing **nonoperating** interest in oil and gas. Thus, a royalty payment is a payment for oil and gas.

Tax Consequences to the Lessor. A royalty payment is a payment received for the extraction of minerals from the property that the landowner (as lessor) owns.[145] A royalty is paid as an agreed-upon percentage of the resource extracted (and thus based on production).

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140. Treas. Reg. §1.612-3(c)(2).

141. If the delay rentals paid are not based on production, they do not reduce the lessee's depletable gross income. Treas. Reg. §1.613-2(c)(5). The same applies to shut-in rents (that is, royalties paid for acreage surrounding a nonproducing well). See, for example, *Johnson v. Phinney,* 287 F.2d 544 (5th Cir. 1961); Rev. Rul. 68-361, 1968-2 CB 264.

142. Because the payments are in the nature of rents, the payments are not subject to depletion.

143. The lessee may also opt to capitalize or expense delay rentals on nonproductive properties, per IRC §266. Doing so involves either a new election every year or a property-by-property election every year.

144. See, for example, Tech. Adv. Memo. 9602002 (Sept. 19, 1995). The IRS maintains that the Code contains a "priority-ordering directive" that dictates that the capitalization provisions take precedence over a specific provision and require that an expenditure be capitalized even when it otherwise might be deemed deductible (*Idaho Power Co. v. Comm'r,* 418 U.S. 1 (1974)).

145. The gross amount of royalties received is not reduced by any part of the cost of the rights under which the royalties are received. Moreover, the gross amount of royalties received is not reduced by any amount allowable as a deduction in computing taxable income (Treas. Reg. §1.1362-2(c)(5)(ii)(A)(1)).

A royalty payment is ordinary income, which is reported to the lessor in box 2 of Form 1099-MISC. A royalty payment may be reduced by percentage or cost depletion (discussed later). The lessor reports the royalty income on Schedule E.

Royalty payments are included in NII and are subject to the additional 3.8% NIIT if the taxpayer's gross income is above the applicable threshold.[146] Royalty payments **are not** subject to SE tax.

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

Tax Consequences to the Lessee. The lessee can deduct royalty payments as a trade or business expense. In addition, if the lessee pays **ad valorem taxes** (taxes based on the property's value) on mineral property, this payment constitutes an additional royalty to the lessor to the extent that it is covered by income from production.

The payment of such taxes by the lessee is excluded from the lessee's gross income to the extent that it is additional royalty income to the lessor. Otherwise, the payment is additional rent, which is not subject to depletion.[147]

Advance Royalties. The terms of an oil and gas lease may provide the mineral owner with an advance royalty of the operating interest, although this is not common. In such a case, an advance royalty is paid before the production of minerals occurs. It can be paid to the lessor in a lump sum or periodically until production begins. Once production begins, no additional royalties are paid until the lessee has recovered the advance royalties from the lessor's share of production.[148]

Example 16. Bob enters into a lease with an energy company. The lease has an initial period of 10 years, and it provides that Bob will be paid a one-eighth production royalty. It also specifies that Bob will be paid a royalty of $100,000 at the beginning of each of the first three years of the lease.

In the first year of the lease, the production royalty is $20,000. The advance royalty is then $80,000 ($100,000 advance royalty − $20,000 production royalty).[149]

An advance royalty occurs when:[150]

1. The lessee is required to pay a royalty on a specified number of units of minerals each year, irrespective of whether the minerals are extracted within the year;
2. The lessee can apply any amount paid because of units not being extracted during the year against the royalty on the minerals that are later extracted (recoupable from production); and
3. The payment is avoidable (that is, the lessee can avoid the advance royalty by canceling the lease).

Tax Treatment. The **lessee** deducts the advance royalty payments in the year in which the mineral production (for which it was paid) is sold.[151]

An advance royalty payment is ordinary income to the **lessor,** and the lessor is not entitled to percentage depletion on it. However, the lessor is entitled to cost depletion in the year a payment is made to the extent it exceeds production. (Percentage and cost depletion are discussed later.)

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146. IRC §1411.
147. Rev. Rul. 72-165, 1972-1 CB 177, *revoking* Rev. Rul. 64-91, 1964-1 CB 219.
148. Treas. Reg. §1.612-3(b).
149. This example is based on an example contained in IRM 4.41.1.2.2.3.4 (Jul. 31, 2002).
150. *Oil and Gas Industry.* Internal Revenue Service. [www.irs.gov/pub/irs-mssp/oilgas.pdf] Accessed on Jul. 18, 2015.
151. See Rev. Rul. 72-165, 1972-1 CB 177. However, advanced royalties that result from a minimum royalty provision may, at the payor's option, be deducted in the year paid or accrued.

Advance Minimum Royalties. An advance minimum royalty meets the same conditions as an advance royalty, but there is also a minimum royalty provision in the contract. This provision requires that a substantially uniform amount of royalties be paid at least annually over the life of the lease or for a period of at least 20 years.

Tax Treatment. For the **lessor,** the tax treatment for an advance minimum royalty is the same as for an advance royalty.

The **lessee** can deduct an advance minimum royalty from gross income in the year the oil or gas is sold or recovered. The lessee also has the option of deducting the payment in the year it is paid or accrued.[152]

> **Note.** Advance royalty provisions are rare in oil and gas leases. Even so, they are often used in leases with longer initial periods such as those involving coal and lignite.

Shut-in Royalties. A lease may provide for payments to the lessor when a well is shut in (that is, turned off because of lack of market or marketing facilities) but still capable of producing in commercial quantities. The lessee is entitled to deduct the shut-in royalty payment, and the lessor must report the payment as income.

Damage Payments

When a well is drilled, the nearby surface area sometimes suffers damage, which may entitle the landowner to compensation. To determine the income tax consequences of any payment for surface damage, the governing instrument (such as the lease) may provide guidance.

Compensatory damages associated with lost profits are taxable as ordinary income. (For example, a payment for crop damage is treated as a sale of the crop.) To the extent the damage payment represents damages for destruction of business goodwill, the payment is nontaxable up to the taxpayer's basis in the affected property. The amount of the damage payment that exceeds the taxpayer's basis is taxable as IRC §1231 gain. Payments for **anticipated damages** (but when no actual damage occurs) are reported as ordinary income.[153]

Production Payments

Most landowners retain only a royalty interest in minerals. However, a landowner who has a working (operating) interest in the production may also receive a production payment.

A **production payment** results from a transaction in which the owner of an oil and gas interest sells a specific volume of production from an identifiable property until a specified amount of money or minerals has been received. For example, a production payment may require that 80% of production be paid to the holder until $50,000 plus 11% interest is received.[154] A production payment is payable only out of the working interest's share of production.

There are two types of production payments.

1. **Retained production payment.** A retained production payment results when the owner of a mineral interest assigns the interest and retains a production payment. The payment is payable out of future production from the assigned property interest.
2. **Carved-out production payment.** A carved-out production payment is created when the owner of a mineral interest assigns a production payment to another person but retains the interest in the property from which the production payment is assigned.

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152. Treas. Reg. §1.612-3(b)(3).

153. See, for example, *Gilbertz v. U.S.,* 808 F.2d 1374 (10th Cir. 1987), *rev'g* 574 F. Supp. 177 (Wyo. 1983).

154. *Oil and Gas Industry.* Internal Revenue Service. [www.irs.gov/pub/irs-mssp/oilgas.pdf] Accessed on Apr. 15, 2015.

Tax Treatment. Retained production payments are treated as ordinary income and are subject to the 3.8% NIIT. The lessor is entitled to cost or percentage depletion. Generally, a **carved-out production payment** is treated under IRC §636 as a mortgage (nonrecourse) loan on the property. As such, it does not qualify as an economic interest in the property.

The **lessee** treats a carved-out production payment as principal repayment and interest expense. The **lessor** treats such a payment received as principal and interest income. Thus, the producer does not recognize taxable income at the time the transaction is entered into. The lessor continues to be treated as the owner of the burdened properties. As the production occurs and is delivered to the holder of the production payment, the lessor is treated as having sold the production for its FMV and having applied the proceeds to repay the principal and interest due to the holder.

As previously mentioned, a carved-out production payment is treated under §636 as nonrecourse debt (a mortgage loan) that is secured by the burdened property. It is not a depletable economic interest in the mineral property. To qualify for loan treatment, the production payment must convey a right to a specified share of the production from minerals in place or to the proceeds from such production.

It may burden more than one mineral property, the holder may look only to the production from such burdened properties for payments under the agreement. At closing, the production payment must have an expected economic life of shorter duration than the economic life of one or more of the mineral properties that are burdened.

The consideration given for the production payment may be **pledged for development**[155] of the property or the **production payment may be retained** when the property is leased. In either case, the payment qualifies as an economic interest. The payments that the lessor receives via the production payment agreement are therefore ordinary income, which is subject to cost or percentage depletion.[156] The lessee capitalizes the payments.[157]

Note. For a taxpayer to get an advance ruling from the IRS that a contract is a production payment treated as a loan, they must show:

1. That at the time the right is created, it can be reasonably expected that it will terminate upon the production of not more than 90% of the reserves then known to exist with respect to the burdened property;
2. That the present value of the production expected to remain after the right terminates is 5% or more of the present value[158] of the entire burdened property determined at the time the right is created;
3. That the right is limited by a specified dollar amount, a specified amount of mineral, or a specified period of time; and
4. That the right is an economic interest in the mineral in place, as defined in Treas. Reg. §1.611-1(b), without regard to the application of IRC §636.[159]

155. Treas. Reg. §1.636-1(b) limits the definition of "for development." The proceeds of a production payment are treated as carved out for exploration and development only to the extent that they are required to be used or pledged for use in future exploration or development of the burdened property. The proceeds may not be used for the exploration or development of any other property or for any other purpose. A production payment to the operator reduces their intangible drilling cost deduction or the amount capitalized for equipment. The holder of the production payment does not get a deduction for intangible drilling costs. Expenditures for the exploration and development of burdened property include those to ascertain the existence, location, extent, or quality of a deposit of mineral. Such expenditures also include those incident to and necessary for the preparation of the deposit for production. They do not include costs relating primarily to production of the mineral.

156. IRC §636(c); Treas. Reg. §1.636-2(b).

157. Treas. Reg. §1.636-2(a).

158. The determination of present value takes into account all the facts and circumstances (Treas. Reg. §1.611-2(e)).

159. Rev. Proc. 97-55, 1997-2 CB 582.

In some instances, the transaction may be treated as the sale of an overriding royalty interest. For example, this may occur when a production payment is pledged for the exploration and development of the property if the land is undeveloped and mineral reserves have not been established and proven in sufficient quantities to generate enough income to retire the production payment (including interest) before the lease is abandoned. In that event, the payment is not classified as a loan or as a production payment pledged for development.

Treas. Reg. §1.636-3 requires the life of the production payment to be shorter than the life of the property. Thus, for an unexplored property, if no minerals are discovered or the reserves are so small that they will never meet the production payment, the life of the payment will last until the lease has been abandoned. Once this occurs, the transaction is treated by the lessee as a purchase of an overriding royalty interest. It is capitalized by the lessee and treated as capital gain by the lessor.

Note. The taxpayer is responsible for proving that the production payment will be retired before the time the lease is abandoned. Doing so is nearly impossible before a producing well has been drilled on the lease.

Payments for "Shooting Rights"

In some situations, an operator may not want to incur the costs of entering into a lease on the property (to avoid lease bonuses, for example). Consequently, the operator may enter into a contract with the landowner to pay a smaller amount that gives the operator a right to conduct exploration activities on the property. The contract does not grant any drilling or production rights, however. The payments that the landowner receives under this type of arrangement are reportable as ordinary income.

Expenses

Most lessors are able to claim only those depletion expense deductions that are associated with the royalty amounts they receive. If a lessor also has a working (operating) interest in the production of oil or gas, then additional expenses are deductible. The common expenses that are currently deductible or must be capitalized by the working interest owner include the following.

- **Geological and geophysical expenses.** These are expenses incurred through acquiring and maintaining properties for oil/gas exploration and development. Usually, these costs must be capitalized.
- **Intangible drilling and development costs.** These necessary and incidental expenses are incurred in preparing wells for production and in drilling wells. Necessary and incidental expenses include wages, fuel, repairs, hauling, and supplies. These expenses are usually deducted in the tax year in which they are incurred, unless the taxpayer wishes to capitalize and amortize over a 60-month period.
- **Operating expenses.** These expenses are incurred in the day-to-day operations of the oil/gas enterprise. Currently deductible expenses include labor, maintenance, repairs, supplies, utilities, vehicle expenses, taxes, insurance, depreciation of operating equipment, and legal and accounting fees.

Note. Depreciation of drilling equipment for the working interest owner is discussed more fully later.

Depletion Deduction

Owner-lessors and operator-lessees can claim depletion associated with the production of oil and gas. Although the depletion deduction is conceptually similar to depreciation, it differs in significant ways. The **depletion deduction** is based on the depletion of the mineral resource. In contrast, **depreciation** is based on the exhaustion of an asset that is used in the taxpayer's trade or business.

Requirements for the Deduction. To claim a depletion deduction, the taxpayer must have:

1. An economic interest in the mineral property, **and**
2. The legal right to the income from the oil and gas extraction.[160]

If these two requirements are met, the deduction is allowed upon the sale of the oil and gas when income is reported. For the owner–lessor, the deduction can offset royalty payments but not bonus lease payments. (The reason is that the deduction is allowed only when oil or gas is actually sold and income is reportable.) For the operator–lessee, the depletable cost is the total amount paid to the lessor (the lease bonus) and other costs that are not currently deducted (such as exploration and development costs and intangible drilling costs).

When a lease of minerals is involved, the depletion deduction must be **equitably apportioned** between the lessor and the lessee.[161] If a life estate is involved (that is, the property is held by one person for life with the remainder going to another person), the deduction is allowed to the life tenant but not the remainderman. For property held in a trust, the deduction is apportioned between the income beneficiaries and the trustee in accordance with the terms of the trust. If the trust instrument **does not** contain such provisions, the deduction is apportioned on the basis of the trust income allocable to each. For a decedent's estate, the deduction is apportioned between the estate and the heirs on the basis of the estate income allocable to each.

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> **Note.** Conceptually, the taxpayer is entitled to a deduction against the revenue received as the income tax basis in the mineral property is depleted. For the owner-lessor, a cost basis in the minerals must have been established at the time that basis in the taxpayer's property (surface and mineral estate) was established. This may have occurred as part of an estate tax valuation in which the minerals and surface were separately valued or upon allocation of the purchase price at the time of acquisition. For the operator-lessee, depreciation is tied to the operator's historical investment cost (explained later).

Computation Methods. The depletion deduction can be computed using two methods: the **cost depletion method** and the **percentage depletion method.** The tax practitioner should compare the results provided by the two methods and use the one that provides the greatest deduction.

Cost Depletion. For the owner-lessor, the cost depletion method is a units-of-production approach that is associated with the owner's basis in the property. Like depreciation, the cost depletion cannot exceed the taxpayer's basis in the property. The basis includes the value of the land and any associated capital assets (such as timber, equipment, buildings, and oil and gas reserves).[162] The taxpayer's basis also includes any other expenses incurred in acquiring the land (such as attorney fees, surveys, etc.).[163]

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160. Treas. Reg. §1.611-1(b).

161. IRC §611(b).

162. See IRC §612, which refers to IRC §1011 for adjustments to basis. Included in basis are the purchase price of the property, lease bonus payments, incidental costs, capitalized intangible drilling and development costs (except for the election under IRC §59(e)), and capitalized carrying charges.

163. Mineral property can be acquired in three ways: via purchase (purchase price basis), inheritance (basis equals the property's FMV at the time of the decedent's death), and gift (carryover basis from the donor).

The taxpayer's basis is allocated among the various capital assets and determined after accounting for the following items.

1. Amounts recovered through depreciation deductions, deferred expenses, and deductions other than depletion
2. The residual value of the land and improvements at the end of operations
3. The cost or value of the land acquired for purposes other than mineral production

Note. A landowner without an established cost basis may be able to claim percentage depletion (discussed later). It is common for a landowner **not** to allocate any part of the property's basis to the oil and gas reserves. Thus, percentage depletion may be the only depletion available.

Under the cost depletion approach, the taxpayer must know the total recoverable mineral units in the property's natural deposit and the number of mineral units sold during the tax year. The **total recoverable units** equals the sum of the number of mineral units remaining at the end of the year plus the number of mineral units sold during the tax year.[164] The number of mineral units sold during the tax year depends on the accounting method the taxpayer uses (cash or accrual). Many taxpayers — particularly landowners — are likely to use the cash method. For these taxpayers, the units sold during the year are the units for which payment was received.

Under the cost depletion approach, the basis applicable to the mineral property is computed annually by dividing the unrecoverable depletable cost at the end of the year by the estimated remaining recoverable units at the beginning of the year. The cost per unit is then multiplied by the number of units sold during the year. The formula is represented as follows.

$$\text{Depletion deduction} = \frac{\text{Unrecoverable depletable cost at end of year}}{\text{Estimated remaining recoverable units at beginning of year}} \times \text{\# units sold during year}$$

Example 17. Billie Jo's father died in 2014. In his will, he left a 640-acre tract of land to Billie Jo. The value of the land was $6.4 million, as reported for estate tax purposes on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.* Of that amount, $1 million was allocated to the mineral rights in the land.

In 2015, a well drilled on the property produced 300,000 barrels of oil. Geological and engineering studies determined that the deposit contained 2 million barrels of usable crude oil at the beginning of the year. In 2015, the 300,000 barrels produced were sold. Billie Jo's cost depletion deduction for 2015 is $150,000 and is calculated as follows.

$$\text{Billie Jo's 2015 cost depletion deduction} = \frac{\$1{,}000{,}000}{2{,}000{,}000} \times 300{,}000$$
$$= \$150{,}000$$

Billie Jo deducts the $150,000 on her 2015 Schedule E. Her adjusted basis in the mineral deposit for 2016 that is eligible for cost depletion is $850,000 ($1 million − $150,000).

164. The landowner must estimate or determine the recoverable units of mineral product using the current industry method and the most accurate and reliable information available. A safe harbor can be elected to determine the recoverable units (Rev. Proc. 2004-19, 2004-10 IRB 563). The mechanics of the computation are contained in Treas. Reg. §1.611-2.

Example 18. Acme Drilling Corporation paid Bubba $300,000 to acquire all the oil rights associated with his land. The $300,000 was Acme's only depletable cost. Geological and engineering studies estimated that the deposit contains 800,000 barrels of usable crude oil.

In 2015, 200,000 barrels of oil were produced and 180,000 were sold. Acme's cost depletion deduction for 2015 is $67,500 and is calculated as follows.

$$\textbf{Acme's 2015 cost depletion deduction} = \frac{\$300{,}000}{800{,}000} \times 180{,}000 = \$67{,}500$$

Percentage Depletion. As noted previously, the amount allowed as a depletion deduction is the **greater of the cost or the percentage depletion** computed for each property[165] for the tax year.[166]

Under the percentage depletion method, the taxpayer (the owner-lessor or a producer that is not a retailer or refiner) uses a percentage of gross income (presently set at 15%) from the oil/gas property.[167] That percentage is limited to the **lesser** of the following.[168]

- 100% of the taxable income from the oil/gas property
- 65% of the taxpayer's taxable income from all sources

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Note. For percentage depletion purposes, total taxable income is a function of gross income. Gross income from the property includes, among other things, the amount received from the sale of the oil or gas in the immediate vicinity of the well.[169] Gross income does not include lease bonuses, advance royalties, and other amounts payable without regard to production from the property.[170]

Any amount not deductible due to the 65% limitation can be carried over to the following year, subject to the same limitation. Any amount carried over is added to the depletion allowance before any limits are applied for the carryover year. IRC §613A and the underlying regulations set forth a detailed multi-step process that is used to compute the percentage depletion allowed to independent producers and royalty owners.

Observation. A production limit also applies. For a partnership, the total depletion is computed at the partner level, not by the partnership.[171] The partnership must allocate the adjusted basis of its oil and gas properties to the partners in accordance with their respective interests in capital or income.

165. **Property** is defined in IRC §614(a) as each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Under IRC §614(d), a **separate interest** is an operating mineral interest in which the production costs must be taken into account for purposes of computing the taxable income limitation of percentage depletion. An operating interest is always separate from a nonoperating interest owned in the same property (IRC §614(b)(1)(B) and Treas. Reg. §1.614-8(a)).

166. IRC §§613 and 613A and Treas. Reg. §1.611-1(a).

167. For an operator–lessee, this is defined as gross income from the property less expenses attributable to the property other than depletion and the production deduction but including an allocation of general overhead.

168. IRC §613A(d). This amount is computed without taking into account any depletion on production, any IRC §199 deduction, NOL carryback to the tax year, or capital loss carryback to the tax year.

169. Treas. Reg. §1.613-3.

170. IRC §613A(d)(5).

171. Prop. Treas. Reg. §1.613A-3(e).

Example 19. In 2015, Rusty receives $50,000 of royalty income from a well on his farm. His taxable income from all sources in 2015 is $432,000. Of that amount, $300,000 is income from crops and livestock. The remaining $82,000 is from other sources.

Rusty computes his percentage depletion deduction by multiplying his $50,000 gross income from the oil/gas property by 15%, which is $7,500. His taxable income from the property is $8,000. His taxable income from all sources is $432,000, and 65% of that amount is $280,800. Thus, Rusty's depletion deduction is the lesser of $7,500, $8,000, or $280,800. Rusty can claim the $7,500 deduction on line 18 (depreciation expense or depletion) of his 2015 Schedule E.

Example 20. Hammerhead Drilling Company (Hammerhead) leases land from Jethro for a one-eighth royalty interest. In 2015, Hammerhead realizes a total of $500,000 in sales proceeds from the well, of which $62,500 is paid to Jethro as a royalty. That year, the company also incurs $200,000 of production expenses. Hammerhead's depletion deduction for 2015 is determined as follows.

Gross receipts from the property	$500,000
Less: royalty paid to Jed	(62,500)
Gross income	$437,500
Less: production expenses	(200,000)
Taxable income	$237,500
Less: depletion ($437,500 × 15%)	(65,625)
Taxable income from well	$171,875

If Hammerhead's 2015 taxable income from all sources is only $80,000, the depletion deduction is limited to $52,000 ($80,000 × 65%).

Depreciation

Oil and gas property is subject to the normal MACRS rules of IRC §168 with the recovery periods and class lives specified in Rev. Prov. 87-56. Thus, most oil and gas property is classified as 7-year property subject to the 200% declining balance method and an applicable depreciation convention of either midyear or midquarter.[172]

IRC §179 expense method depreciation is available for oil and gas property. For 2015, it is capped at $25,000, with the phaseout beginning at $200,000 of qualifying property purchases.

Oil and gas property is also eligible for bonus depreciation (when it is available) if it has a recovery period of 20 years or less and the original use begins with the taxpayer.[173] An election can be taken to accelerate the minimum tax credit and the research credit in lieu of deducting bonus depreciation (when available). Bonus depreciation is generally not available for 2015.

Note. For more information about depreciation, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Depreciation.

172. Gathering lines for natural gas are also depreciable over seven years, per *Duke Energy Natural Gas Corp. v. Comm'r,* 172 F.3d 1255 (10th Cir. 1999), *non. acq,* 1999-47 IRB 573. See also *Saginaw Bay Pipeline Company v. U.S.,* 338 F.3d 600 (6th Cir. 2003); *Clajon Gas Co., L.P. v. Comm'r,* 354 F.3d 786 (8th Cir. 2004).

173. IRC §179 expense method depreciation is tied to the taxpayer's tax year, whereas bonus depreciation is tied to the calendar year.

The taxpayer can also elect to depreciate oil and gas property under the unit-of-production method or any depreciation method not expressed in terms of years. This election applies to lease and well equipment and can be made on a property-by-property basis. In essence, the election gives the taxpayer flexibility in determining the depreciation deduction for a particular property without affecting the recovery allowances claimed on all other eligible property the taxpayer may place in service in a given year. The calculation is similar to that used for cost depletion.

Domestic Production Activities Deduction

The IRC §199 **domestic production activities deduction (DPAD)** is 6% of **domestic production gross receipts (DPGR)** from oil and gas activities. (Such activities include production, refining, processing, transportation, and distribution but not income from the sale of land or leasehold rights.)[174]

The DPAD is limited to 50% of the wages reported on Form W-2, that are attributable to qualified production activities. The DPAD is also limited to the lesser of qualified production activities income (QPAI) and taxable income. Thus, the DPAD is limited to the lesser of QPAI or taxable income, or 50% of W-2 wages paid.

For a partnership, QPAI and W-2 wages are calculated at the partnership level except for qualifying in-kind partnerships, which include oil and gas partnerships.[175]

Note. For a detailed discussion of the DPAD, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Agricultural Issues and Rural Investments.

Uniform Capitalization Rules

IRC §263A applies a uniform set of capitalization rules to all costs incurred in manufacturing and constructing property and in purchasing and holding property for resale. Costs related to real and tangible personal property produced by the taxpayer and the purchasing and holding of property for resale are subject to uniform capitalization (UNICAP) rules.

Produced Property. The rules provided in §263A generally apply to the construction of assets used (or to be used) in a trade or business. These rules also apply to IRC §1231 assets.

Note. Rev. Rul. 68-226[176] defines an oil and gas leasehold as an interest in real property. This ruling supports the IRS's position that historically, mineral interests have been treated as real property. Thus, a taxpayer who acquires and develops oil or gas property is engaged in a developmental activity within the meaning of IRC §263A.

174. CCA 201208029 (Dec. 1, 2011). However, income from the sale of the well is DPGR and so are intangible drilling costs if they were capitalized.

175. See Rev. Proc. 2007-34, 2007-23 IRB 1345 and Treas. Reg. §1.199-3(i)(7).

176. Rev. Rul. 68-226, 1968-1 CB 362.

Produced property[177] can include geological and geophysical data, acquiring and developing the leasehold mineral interest, constructing tangible and surface well equipment, and carrying oil and gas inventory (barrels of oil and MCF (thousand cubic feet) of gas). It does not include acquiring undeveloped leases.

Predevelopment Expenses. Many oil operators maintain inventories of undrilled leases for resale to others or transfer to limited partnerships. Exploration, drilling, and development activities can be construed as activities that improve property.

> **Note.** The Tax Court has held in various decisions[178] that exploration and developmental drilling cannot be distinguished for the purposes of intangible drilling costs. Yet the court has also held that exploration is considered a separate activity from development and production.[179]

Intangible drilling costs are specifically exempt from the UNICAP rules of §263A. However, the rules may apply to oil production if an inventory of oil is on hand at the end of the year. An appropriate share of indirect costs should be allocated to geological and geophysical activities. Treas. Reg. §1.263A-1(b) identifies the costs that are exempted from the UNICAP rules.

There are additional §263A costs. They include the following.

- **Direct costs** include costs of labor and materials that are directly related to a property. Direct materials are those that are a part of the property or consumed in the activity. Direct labor costs are those associated with the property or activity, including fringe benefits. These costs have traditionally been capitalized.
- **Indirect costs** include all other costs that directly benefit production or are incurred because of the production activity. If they benefit more than one activity, they should be allocated on a reasonable basis to the various activities involved.[180]

> **Note.** The Code and Treasury Regulations do not specify **how** indirect costs are to be allocated — just that the allocation must be reasonable. The regulations provide several "simplified" methods that are available to the taxpayer. In essence, the indirect costs should be matched with the activities that benefit from the incurred costs. The taxpayer should use the same method for allocating overhead. The allocation method should be used consistently and for all federal tax purposes.

- **Mixed service costs** include costs of administrative, service, and support departments and activities that benefit more than one activity. These costs must be allocated on a reasonable basis to the activities that benefitted from them.
- **Interest costs** incurred to finance the production of property must be capitalized if the property produced is:
  1. Real property,
  2. Personal property with a MACRS life of 20 years or more,
  3. Personal property with an estimated production period of more than two years, **or**
  4. Personal property with an estimated production period of more than one year and the estimated production cost exceeds $1 million.

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177. As described in IRC §263A(g), the term **produce** means "construct, build, install, manufacture, develop, or improve." Historically, IRC §341(b) also contains this same language: "manufacture, construction, or production of property." Rev. Rul. 57-346, 1957-2 CB 236 holds, under IRC §341(b)(1), that a corporation engaged in the acquisition and development of oil properties is considered to be involved in the construction or development activities that increased the value of the properties.

178. See, for example, *Sun Company, Inc. & Subs. v. Comm'r,* 74 TC 1481 (1980), *aff'd* 677 F.2d 294 (3rd Cir. 1982), *acq.* 1983-2 CB 1.

179. *Shell Oil Co. v. Comm'r,* 89 TC 371 (1987), *rev'd* 952 F.2d 885 (5th Cir.1992).

180. Treas. Reg. §1.263A-1(e)(3)(ii) provides an extensive list of indirect costs that must be capitalized.

Interest Capitalization. Treas. Reg. §1.263A-13 sets forth the interest capitalization rules. The interest to be capitalized is the interest that would have been avoided if the production expenditures relating to the property or activity had not been made and the funds had been used to repay the taxpayer's debts. Debt that can be traced specifically to an activity is allocated to that activity. If the production expenditures relating to an activity exceed the debt traced to the activity, other debt must be allocated to the activity. Interest on debt allocable to leasehold costs should be capitalized during the production period, because mineral leases are real property.

For onshore activities, the production period for a unit begins on the first date that physical site preparation activities are undertaken for that unit. Examples of these activities include building an access road, leveling a site for a drilling rig, and excavating a mud pit.

For offshore activities, the production period for a unit begins on the first date that physical site preparation activities are undertaken (for example, drilling to drive the piles) other than activities undertaken with respect to expendable wells. An expendable well is a well drilled solely to determine the location and delineation of hydrocarbon deposits. The production period ends when the well is ready to produce.

> **Note.** Intangible drilling costs are excluded from the application of interest capitalization. However, if the taxpayer uses their own drilling equipment (rather than a contract driller), the basis of the drilling equipment (but not the depreciation of the equipment) is included in the accumulated production expenditures. It is therefore subject to interest capitalization.

An exception from the interest capitalization rule applies when the production period does not exceed 90 days. In addition, a de minimis exception applies when the total production expenditures do not exceed $1 million divided by the number of days in the production period.