Chapter 5: Small Business Issues

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.

EMPLOYER HEALTH REIMBURSEMENT PLANS AND THE ACA[1]

Federal law has long allowed employees to enjoy tax-advantageous healthcare benefits from their employers. This advantage has also been extended to self-employed persons,[2] partners in a partnership,[3] and S corporation shareholders.[4]

Generally, an employee's gross income does not include employer-provided coverage under an accident or health plan.[5] Federal regulations[6] clarify that an employee's gross income does not include contributions the employer makes to an accident or health plan for compensation (through insurance or otherwise) for personal injury or sickness to the employee or their spouse or dependents.[7]

IRC §105(e) provides that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance. An accident or health plan is **any** arrangement for the payment of amounts to employees in the event of personal injury or sickness.[8]

Employee gross income does not include amounts paid, directly or indirectly, to the taxpayer as reimbursement for expenses they incurred for their own medical care or the medical care of their spouse or dependents or any child of the taxpayer under the age of 27.[9]

Small employers that may not have been in a position to offer affordable group health insurance to their employees have long relied on these provisions to give their employees other tax-free healthcare benefits. These benefits are generally offered through various healthcare reimbursement plans, including health reimbursement arrangements (HRA), medical expense reimbursement plans (MERP), healthcare flexible spending accounts (FSA), and employer payment plans.[10]

1. Some of the information in this section was adapted from materials prepared by Iowa State University's Center for Agricultural Law and Taxation.
2. See IRC §162(l). See also CCA 200524001 (May 17, 2005).
3. See, e.g., CCA 201228037 (May 1, 2012).
4. IRS Notice 2008-1, 2008-2 IRB 251.
5. IRC §106(a).
6. Treas. Reg. §1.106-1.
7. Defined in IRC §152.
8. Treas. Reg. §1.105-5(a).
9. IRC §105(b).
10. PL 111-148, §2702, 124 Stat. 119, 318-319 (2010), amended by the Health Care and Education Reconciliation Act (HCERA), PL 111-152.

HEALTH REIMBURSEMENT ARRANGEMENTS

HRAs are employer-established accounts authorized by IRC §§105 and 106. HRAs are employer-funded plans that reimburse employee medical expenses, including health insurance premiums. An HRA **cannot be funded by voluntary employee salary reductions;** it must be funded **solely** by the employer. The employee is then reimbursed tax free from these funds (up to a maximum dollar amount each coverage period) for qualifying medical expenses incurred by the employee or their family. HRAs require formal plan documents and are often administered by a third party.

An employer can also establish an HRA for a retired employee or for the spouse or dependents of a deceased employee. The funds paid into an HRA by an employer are not taxed to the employee. As stated previously, any money paid by an employer to reimburse the employee for expenses incurred for medical care are excluded from the employee's gross income under §105.

MEDICAL EXPENSE REIMBURSEMENT PLANS

Also authorized under §105, MERPs reimburse employee medical expenses. These plans are generally less formal than HRAs. No set fund or employee savings account is created. Expenses are reimbursed as they accrue up to a stated dollar amount, and unused amounts are not carried over to subsequent years. Many small family businesses have long used MERPs to provide their employees with tax-free healthcare benefits.

HEALTHCARE FLEXIBLE SPENDING ACCOUNTS

Under a healthcare FSA, as authorized by the cafeteria plan rules of IRC §125, employers and employees contribute pretax dollars to the plan. For 2015, employee contributions are limited to $2,550.[11] Distributions from an FSA generally must be paid only to reimburse employees for qualified medical expenses.

> **Note.** For more information about FSAs, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues.

EMPLOYER PAYMENT PLANS

Under a typical employer payment plan authorized by §106, the employer reimburses the employee for substantiated health insurance premiums. These payments are then excluded from the employee's income. Under this arrangement, the employee purchases an individual health insurance plan with the funds provided by the employer.

MARKET REFORM REQUIREMENTS

The Affordable Care Act (ACA) requires all employers that offer health insurance coverage to their employees to ensure that their plans comply with numerous **market reforms**, or benefits requirements. These market reforms apply to coverage provided by large employers subject to the employer mandate, as well as coverage provided voluntarily by small employers. The ACA penalizes employers that offer health insurance plans that do not comply with applicable market reforms. The majority of market reforms became mandatory in 2014.

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11. Rev. Proc. 2014-61, 2014-47 IRB 860.

If an employer offers coverage that violates one or more of the dictated reforms, the employer is subject to severe penalties. The market reforms are complex. The following reforms are required for all nongrandfathered health plans.

- A plan may not discriminate on the basis of health status.[12]
- Dependent coverage must be available to married and unmarried children under age 26 (but not to dependents' spouses).[13]
- Insurance may not be rescinded when an enrollee becomes sick or injured.[14]
- Preventive care — such as contraceptives for women, colonoscopies, and many vaccines — must be offered without required copayments or deductibles.[15]

Note. The guidelines concerning contraceptive coverage do not apply to group health plans sponsored by religious employers or other eligible organizations.[16]

- Coverage may not exclude preexisting health conditions.[17]
- A plan may not place an annual dollar limit or a lifetime dollar limit on essential health benefits.[18]

IRS NOTICE 2013-54

Although the ACA was passed in 2010, much debate continued as to the impact the market reform requirements would have on nongroup employer healthcare arrangements. On September 13, 2013, the IRS and the Department of Labor issued joint guidance, which clarified that the impact would be severe. IRS Notice 2013-54[19] essentially eliminated a number of healthcare reimbursement plans that had long been popular among small employers. These changes, for the most part, became effective January 1, 2014. Transitional relief issued in February 2015 (discussed later) provides limited penalty relief for employers that continued to offer certain noncompliant plans in 2015.

Health Reimbursement Plans Are Group Health Plans

The ACA market reforms apply to a "**group health plan** and a health plan insurance issuer offering group or individual health insurance coverage."[20] As such, a key issue has been determining whether particular employer healthcare arrangements constitute group health plans.

Part of the difficulty in interpreting the ACA is the fact that it was integrated into existing law — namely, the Internal Revenue Code (Code),[21] the Public Health Service Act (PHSA), and the Employee Retirement Income Security Act (ERISA).[22] The actual text of the ACA was written into the PHSA.[23] These market reform provisions were incorporated by reference into ERISA and the Code, primarily for enforcement purposes. No agency guidance currently exists as to how these new provisions interact.

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12. 42 USC §300gg-4.
13. 42 USC §300gg-14.
14. 42 USC §300gg-12.
15. 42 USC §300gg-13.
16. *Women's Preventive Services Guidelines.* U.S. Department of Health and Human Services, Health Resources and Services Administration. [www.hrsa.gov/womensguidelines/#footnote2] Accessed on May 1, 2015.
17. 42 USC §300gg-3.
18. 42 USC §300gg-11.
19. IRS Notice 2013-54, 2013-40 IRB 287; and DOL Technical Release 2013-03. (These two releases are the same.)
20. See, e.g., 42 USC §300gg-11(a)(1).
21. See IRC §9815.
22. 29 USC §1185d.
23. 42 USC §§18001 et seq.

However, IRS Notice 2013-54 did clarify that employer-provided account-based reimbursement plans and employer payment plans are **group health plans**[24] within the meaning of the Code, the PHSA, and ERISA.[25]

The PHSA defines a **group health plan** as:[26]

> *…an employee welfare benefit plan (as defined in section 3(1) of [ERISA]) to the extent that the plan provides medical care (as defined in [section 2791(a)(2) of the PHSA] and including items and services paid for as medical care) to employees or their dependents (as defined under the terms of the plan) directly or through insurance, reimbursement, or otherwise.*

As noted previously, unless specifically excepted, all group health plans are subject to the market reform rules of the ACA. These rules dictate that a group health plan may not place an annual limit on the dollar amount of essential health benefits provided to any individual.[27] The rules also require group health plans to provide a host of preventive services, such as vaccinations and colonoscopies, without a cost-sharing requirement (such as a copayment).[28]

Employer Healthcare Arrangements That Violate Market Reforms

IRS Notice 2013-54 explains that a stand-alone employer healthcare reimbursement plan offering nonexcepted benefits violates two specific ACA market reform requirements.

1. It imposes an annual limit up to the cost of the benefit provided through the plan, thereby violating the annual dollar-limit prohibition.
2. It fails to comply with the preventive services requirements of the ACA because it does not provide preventive services without cost sharing in all instances.

Specifically, IRS Notice 2013-54 provides that the following employer healthcare reimbursement plans violate the annual dollar-limit prohibition and the preventive services requirements of the ACA.

- Stand-alone HRAs (those not integrated with employer-provided group health insurance)
- Stand-alone MERPs providing benefits that are not excepted[29]
- Employer payment plans that reimburse individual health insurance premiums (from the individual insurance market or through the Marketplace)
- IRC §125 health FSAs that are not excepted benefits

> **Note.** Question 7 of IRS Notice 2013-54 specifies that the market reforms do not apply to health FSAs that provide only excepted benefits. This portion of the notice also states that if the FSA does not provide excepted benefits, it **violates the preventive services market reform requirements.** Footnote 9 of the notice states that a health FSA is not subject to the annual dollar limit. A health FSA not offered through a §125 plan is, however, subject to the annual dollar limits (question 8).

24. IRS Notice 2013-54 states that the plans are **group health plans** for purposes of IRC §9832(a); §733(a) of ERISA (29 USC §1191b(a)(1); and §2791(a) of the PHSA (42 USC §300gg-91(a)(1)).
25. IRS Notice 2013-54, 2013-40 IRB 287.
26. Section 2791(a)(1) of the PHSA, 42 USC §300gg-91.
27. PHSA §2711.
28. PHSA §2713.
29. Although IRS Notice 2013-54 specifically references HRAs, the same principles apply to MERPs that are noncompliant with the market reforms.

Under IRS Notice 2013-54, all **stand-alone** employer healthcare reimbursement plans violate the ACA and cannot be continued after 2013 unless they are specifically excepted from ACA requirements through other statutory provisions.

Excepted benefits are those benefits not subject to the ACA group or health plan requirements, such as the lifetime limit or preventive services requirements mentioned earlier. Examples of excepted benefits include vision and dental coverage, long-term care benefits, and home healthcare benefits. Excepted benefits are discussed later in this chapter.

> **Note.** Excepted benefits fall into four basic categories under applicable regulations. For further details on the definition of excepted benefits and the four categories, see TD 9697.[30]

Plans That Do Not Violate Market Reforms

If an employer provides an ACA-compliant group health insurance plan to its employees, the insurer, not the employer, is responsible for meeting the ACA policy requirements. Small employers can also offer small business health options program (SHOP) group health plans to their employees without worrying about the market reforms. However, employers who provide self-funded healthcare benefits to their employees must ensure that these benefits comply with the applicable ACA requirements, including the market reforms.

As described previously, a number of these benefits do not comply with the ACA requirements. This section discusses three types of plans **excepted from the ACA market reform requirements.**

1. Plans that meet the requirements for the **retiree-only exception** (1-employee plans)
2. Plans that provide only **excepted benefits**
3. Plans in which the self-funded benefits are properly **integrated with a group health insurance plan** offered by the employer

If an employer plan falls into one of these categories, it does not violate the market reform provisions of the ACA and it can continue providing the benefit without penalty.

Retiree-Only Exception. IRS guidance[31] clarifies that the **retiree-only exception** included in the Code, ERISA, and the PHSA exempts certain plans from the reach of the ACA market reforms. This is the same exemption that applies to the Health Insurance Portability and Accountability Act of 1996 (HIPAA).[32] The provision is called the **retiree-only exception** because it was written primarily to except plans providing benefits only to retirees. It reads as follows.[33]

> *The requirements of this chapter shall not apply to . . any group health plan if, on the first day of such plan year, such plan has less than* ***two participants*** *who are current employees.*

Although this is known as the retiree-only exception, **it can be applied to a 1-participant plan when that participant is a current employee.**

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30. TD 9697, 2014-43 IRB 729.

31. IRS Notice 2015-17 and IRS Notice 2013-54.

32. HIPAA was written into the PHSA, and the ACA's additions to the PHSA were essentially revisions and additions to HIPAA.

33. IRC §9831(a).

Because of the language of the exception, any group health plan with fewer than two participants who are current employees is excepted from the ACA market reform requirements. Consequently, a company with only one employee can continue to offer, for example, an otherwise noncompliant employer payment plan to reimburse that employee for healthcare coverage. Such plans are excepted from the market reform requirements.

Note. A plan excepted from compliance with the ACA market reforms is treated as **minimum essential coverage** for employees (unless it provides only excepted benefits). Therefore, coverage by such a plan prevents the covered employee from obtaining premium tax credits when purchasing insurance in the Marketplace.[34] Because the plan constitutes minimum essential coverage, however, it shields the participant from liability for the individual mandate. For more information about minimum essential coverage, the individual mandate, and other aspects of the ACA, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: New Developments and the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

Participant. The definition of the term **participant** is crucial to the interpretation and evaluation of which health plans are subject to this exception.[35]

> *The term "participant" means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.*

Given the breadth of this definition, any person who may become eligible for a benefit from an employee benefit plan should be counted in determining the number of participants in the plan.

Nondiscrimination Testing. For plans based on IRC §105 (HRAs and MERPs), the nondiscrimination rules of IRC §105(h) should be considered when determining the number of plan participants. If an employer violates the nondiscrimination rules in offering a plan, the persons excluded from the plan may be deemed **participants,** thereby disqualifying the plan from the retiree-only exception. Generally, §105(h) prohibits employers from discriminating in favor of highly compensated employees when offering self-insured health benefits. The following types of employees, if not receiving employer healthcare benefits, may be excluded from consideration when counting the number of participants.[36]

- Employees who have not completed three years of service
- Employees who are younger than age 25
- Part-time employees (generally, those who work fewer than 25 hours per week)
- Seasonal employees (generally, those who work less than seven months per year)
- Employees who are covered by a collective bargaining agreement
- Employees who are nonresident aliens with no income from U.S. sources

Classes of Employees. Employers may not group employees into separate classes for the purpose of meeting the retiree-only exception. Creating valid defined-contribution classes is permissible. However, these classes must be created based on a valid distinction, such as geographic location or full- versus part-time status.

34. IRS Notice 2013-54, 2013-40 IRB 287.

35. 29 USC §1002(7).

36. IRC §105(h)(3)(B).

Excepted Benefits. Plans that provide only **excepted** benefits are exempt from the ACA market reform requirements.[37] These excepted benefits, which are deemed **not** to constitute **medical care,** include the following.

- Accident-only coverage
- Disability income insurance
- Supplemental liability insurance, including automobile liability coverage
- Workers' compensation or similar insurance
- Automobile medical payment insurance
- Limited-scope dental and vision benefits offered in a separate policy
- Benefits for long-term care, nursing home care, home healthcare, and community-based care
- Coverage only for a specific disease or illness
- Hospital indemnity or other fixed indemnity insurance
- Medicare supplemental health insurance if offered as a separate insurance policy
- Benefits under an employee assistance program if the program does not provide significant benefits in the nature of medical care or treatment[38]
- Health FSAs[39] in which the employer also offers group health insurance coverage to its employees and the maximum benefit payable to an employee does not exceed the **greater** of the following
    - Two times the employee's salary reduction election for the year
    - $500 plus the amount of the employee's salary reduction election

HRA Integrated with Employer Group Health Insurance Plan.[40] Even if an employer-provided HRA violates the preventive services and annual dollar-limit requirements of the ACA as a stand-alone plan, it can be **integrated** with an ACA-compliant employer-sponsored group health plan.[41] In such cases, the HRA also complies with the ACA. For this reason, employers that offer group health insurance coverage to their employees can continue to offer the HRAs through which they can reimburse additional out-of-pocket expenses.

> **Note**. An employer-sponsored reimbursement plan **cannot be integrated** with individual market coverage even if that coverage is purchased from the Marketplace.

IRS Notice 2013-54 provides two specific situations in which an HRA can be integrated with another group plan.

1. The other group health insurance plan does **not** reimburse at least 60% of employee expenses **(no minimum value required).**
2. The other group health insurance plan does reimburse at least 60% of employee expenses **(minimum value required).**

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37. IRC §9832(c).
38. IRS Notice 2013-54, 2013-40 IRB 287 (answer to question 9).
39. 26 CFR §54.9831-1(c)(3)(v), 29 CFR §2590.732(c)(3)(v), and 45 CFR §146.145(c)(3)(v).
40. Although the guidance discusses HRA integration, it is likely that the integration rules equally apply to MERPs.
41. IRS Notice 2013-54, 2013-40 IRB 287.

Specifically, a group health insurance plan provides **minimum value** if its share of the total allowed costs of benefits provided is at least 60% of such costs.[42] In other words, the amount of money that the employee pays through deductibles, coinsurance, copayments, and other out-of-pocket expenses cannot exceed 40% of the value of benefits under the plan.

The cost of premiums is excluded from the minimum-value calculation. U.S. Department of Health and Human Services (HHS) regulations[43] allow this calculation to be made using a minimum-value calculator (available at **uofi.tax/15b5x1** [http://cciio.cms.gov/resources/regulations/index.html]).

A plan in the small group market provides minimum value if it meets the requirements for **any** of the following coverage levels defined at 45 CFR 156.140(b).

- **Bronze** benefits, which are actuarially equivalent to 60% of the full actuarial value of benefits provided under the plan
- **Silver** benefits, actuarially equivalent to 70% of the full actuarial value of benefits provided under the plan
- **Gold** benefits, actuarially equivalent to 80% of the full actuarial value of benefits provided under the plan
- **Platinum** benefits, actuarially equivalent to 90% of the full actuarial value of benefits provided under the plan

At the end of 2014, the IRS announced that HHS would amend 45 CFR 156.145 in 2015. The revision will state that a plan does not provide minimum value if it excludes substantial coverage for either inpatient hospitalization services or physician services.[44]

No Minimum Value Required. According to IRS Notice 2013-54, an HRA is integrated with a group health plan that does not provide minimum value for both the annual dollar-limit prohibition and the preventive services requirements if all the following conditions are met.

- The employer offers a group health plan (other than the HRA) to the employee that does not consist solely of excepted benefits.
- The employee receiving the HRA is enrolled in a group health insurance plan (other than the HRA) that does not consist solely of excepted benefits, regardless of whether the employer sponsors the group plan.
- The HRA is available only to employees who are also enrolled in non-HRA group coverage, regardless of whether the employer sponsors the non-HRA group coverage. (For example, the non-HRA group coverage may be sponsored by the employer of the employee's spouse.)

Note. This means that an employee can choose to be enrolled in the group health insurance plan (that provides essential healthcare benefits) of their spouse's employer and still be entitled to coverage through their own employer's HRA if the employer also offers a group health insurance plan that provides essential healthcare benefits. The employee must attest to their employer that the HRA benefits will be used solely to pay copayments, coinsurance, deductibles, or premiums under the health insurance plan of their spouse's employer or to pay for medical care that is not an essential healthcare benefit.

42. IRC §36B(c)(2)(C)(ii).

43. 45 CFR 156.140(b).

44. IRS Notice 2014-69, 2014-48 IRB 903.

- The HRA is limited to reimbursement of one or more of the following.
    - Copayments
    - Coinsurance
    - Deductibles
    - Premiums under the non-HRA group coverage
    - Medical care that does not constitute essential health benefits

Note. The essential health benefits mandated by the ACA include ambulatory patient services; emergency services; hospitalization; maternity and newborn care; mental health and substance use disorder services, including behavioral health treatment; prescription drugs; rehabilitative and habilitative services and devices; laboratory services; preventive and wellness services and chronic disease management; and pediatric services, including oral and vision care.

- Under the terms of the HRA, an employee may permanently opt out of and waive future reimbursements from the HRA at least annually. Upon termination of employment, either the remaining amounts in the HRA are forfeited or the employee is permitted to permanently opt out.[45]

Minimum Value Required. Alternatively, an HRA may be integrated with another group health insurance plan for both the annual dollar-limit prohibition and the preventive services requirements if all the following conditions are met.

- The employer offers its employees a group health insurance plan that provides minimum value (as previously defined) to its employees.[46]
- The HRA-covered employee is enrolled in a group health insurance plan providing minimum value. (This plan need not be sponsored by the employer. It may be sponsored by another provider, such as a spouse's employer.)

Note. This means that an employee can enroll in minimum-value group coverage sponsored by their spouse's employer and attest to their employer that they are covered by another group plan providing minimum value. Even though the two employers are not treated as a single employer, the minimum-value group plan from the spouse's employer and the employer's HRA are integrated for both the annual dollar-limit prohibition and the preventive services requirements.

- The HRA is available only to employees enrolled in minimum-value group coverage.
- An employee (or former employee) may permanently opt out of and waive future reimbursements from the HRA at least annually. Upon termination of employment, the employee may either forfeit the remaining amount in the HRA or permanently opt out and waive future HRA reimbursements.[47]

45. IRS Notice 2013-54, 2013-40 IRB 287.

46. IRC §36B(c)(2)(C)(ii).

47. IRS Notice 2013-54, 2013-40 IRB 287.

CONSEQUENCES OF A NONCOMPLIANT PLAN

The possible penalties for violating the market reforms of the ACA are significant. In May 2014, the IRS posted the following question and answer (Q&A) on its website. The answer suggests that the prohibitions of IRS Notice 2013-54 will be strictly enforced.[48]

> ***Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?***
>
> *Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee (which is $36,500 per year, per employee) under section 4980D of the Internal Revenue Code.*

Excise Tax

As stated in the preceding IRS Q&A, employers that violate the ACA market reforms face substantial penalties. IRC §4980D imposes a tax for "any failure of a group health plan" to meet the ACA's new group health plan requirements (including market reforms). This excise tax is imposed against employers (large or small) who offer benefits that are not compliant with market reforms.

The maximum excise tax imposed on an employer for offering a plan that violates a market reform requirement for one year is $36,500 per employee.

> **Note.** Employers providing group health insurance coverage to their employees solely through a contract with a health insurance issuer are not liable for the tax for any failure based solely on the health insurance coverage offered by the issuer.

Excise Tax Limitations. For single employers, the Code places a cap on the potential excise tax for unintentional failures. This cap is the **lesser** of:

1. 10% of the aggregate amount paid or incurred by the employer (or predecessor employer) during the preceding tax year for group health plans, or
2. $500,000.[49]

In the case of a failure that was due to reasonable cause and not to willful neglect, the IRS may also waive part or all of the excise tax imposed.

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48. *Employer Health Care Arrangements.* Updated Apr. 16, 2015. Internal Revenue Service. [www.irs.gov/uac/Newsroom/Employer-Health-Care-Arrangements] Accessed on Apr. 30, 2015.

49. IRC §4980D(c)(3)(A)(ii).

Reporting the Violation

IRC §4980D(c)(1) provides that no tax will be imposed for any violation of a market reform provision during any period for which it is established to the IRS's satisfaction that the person otherwise liable for the tax did not know, and exercising reasonable diligence would not have known, that such failure existed. However, once an employer discovers (or through reasonable diligence could have discovered) a nonwillful violation of the market reform requirements, **they have 30 days to correct the problem.**[50] After 30 days, the employer must self-report the violation on Form 8928, *Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code.* **An excise tax of $100 per day applies to each violation for each individual to whom the failure relates until the violations are resolved.**[51]

If an employer can show that the violation was due to reasonable cause and not willful neglect and the failure was corrected within 30 days, no excise tax is assessed. However, once the 30 days has passed without resolution of the violation, the excise tax begins to accrue, even for nonwillful failures.

A violation is corrected if the following requirements are met.

- The failure is retroactively undone to the extent possible.
- The person to whom the failure relates is placed in a financial position that is as good as they would have been in had the failure not occurred.[52]

Observation. The law appears not to require the filing of Form 8928 for any unintentional failure corrected within 30 days of when the violation was discovered (or should have been discovered). However, Form 8928 suggests such a filing. Line 21 of Form 8928 provides for the reporting of $0 liability when the failure was not discovered despite exercising reasonable diligence or was corrected within the 30-day period upon discovery. Filing Form 8928 in such an instance is likely prudent to trigger the statute of limitations period for tax assessment.

Advising Clients with Noncompliant Plans

Tax professionals must be aware of the requirements set forth in IRS Notice 2013-54. Moreover, they must be able to help clients identify violations and understand the consequences of offering noncompliant plans. Once a tax professional has informed the client of a violation, the 30-day window for correcting the noncompliant plan begins.

Observation. Tax professionals should guard against offering advice that may cross into the realm of legal advice. They should advise clients facing difficult questions regarding the legality of a particular plan to seek legal counsel.

Correcting the Violation. During 2014, it was widely believed that an employer could correct a noncompliant plan by recharacterizing the healthcare reimbursement as wages. It was thought that if the benefit was not offered on a tax-free basis, it would not be considered a healthcare benefit, it would not violate the market reforms, and it would not be subject to the excise tax.

50. IRC §4980D(c)(2)(B)(i).

51. IRC §4980D(b)(1).

52. IRC §4980D(f)(3).

In November 2014, the U.S. Department of Labor (DOL) issued an FAQ eliminating that option for correcting noncompliant plans.[53] In the FAQ (which follows), the DOL clarified that **without regard to whether the employer treats the money as pre- or post-tax to the employee,** an employer's reimbursement of the cost of an employee's individual insurance policy is a violation of the ACA market reforms. As such, the violation triggers penalties such as excise taxes under IRC §4980D.

> ***Compliance of Premium Reimbursement Arrangements***
>
> ***Q1: My employer offers employees cash to reimburse the purchase of an individual market policy. Does this arrangement comply with the market reforms?***
>
> ***No.*** *If the employer uses an arrangement that provides cash reimbursement for the purchase of an individual market policy, the employer's payment arrangement is part of a plan, fund, or other arrangement established or maintained for the purpose of providing medical care to employees, without regard to whether the employer treats the money as pre-tax or post-tax to the employee. Therefore, the arrangement is group health plan coverage within the meaning of Code section 9832(a), Employee Retirement Income Security Act (ERISA) section 733(a) and PHS Act section 2791(a), and is subject to the market reform provisions of the Affordable Care Act applicable to group health plans. Such employer health care arrangements cannot be integrated with individual market policies to satisfy the market reforms and, therefore, will violate PHS Act sections 2711 and 2713, among other provisions, which can trigger penalties such as excise taxes under section 4980D of the Code. Under the Department's prior published guidance, the cash arrangement fails to comply with the market reforms because the cash payment cannot be integrated with an individual market policy.*

According to the DOL, an employer cannot give an employee cash to purchase insurance coverage on the individual market. Doing so is prohibited even if the employer treats the cash as wages and withholds income tax and pays applicable employment taxes. Essentially, the DOL directs employers to stay out of the health insurance arena completely unless purchasing group health insurance plans for their employees.

IRS Notice 2013-54 specified that employers could forward post-tax payments to private health insurance companies at the request of their employees for the purchase of employees' individual health insurance. The notice referred to this as a "payroll practice" that was still acceptable.[54] This most recent FAQ issued by the DOL clarifies that this payroll practice exception is very narrow.

Example 1. Happy Days Preschool informs its employees that although it does not provide them with group health insurance, it will reimburse them for the premiums for policies they purchase on their own. To receive reimbursement, an employee must submit a receipt each month showing that they paid their premium. Happy Days treats the reimbursement amount as wages and pays employment taxes on it.

This arrangement is not acceptable under current IRS guidance.

Example 2. Daniel Dentistry does not provide group health insurance to its employees. However, as a convenience to employees, Daniel Dentistry's payroll department will, if requested by an employee, forward a portion of their after-tax wages to the health insurance provider of their choice for the purchase of a health insurance policy. The employer does not contribute to the cost of this insurance.

This arrangement is acceptable under current IRS guidance.

53. *FAQs about Affordable Care Act Implementation (Part XXII)*. Nov. 6, 2014. U.S. Department of Labor. [www.dol.gov/ebsa/faqs/faq-aca22.html] Accessed on Apr. 30, 2015.

54. IRS Notice 2013-54 states that the payroll practice must comply with the requirements of 29 CFR §2510.3-1(j).

Subsequent guidance has also established that there is no link between the tax treatment of employer healthcare arrangements and whether they violate the market reforms. In IRS Notice 2015-17, the IRS clarified that the ACA did not change the tax treatment of healthcare reimbursements provided by an employer to an employee. As long as the reimbursements meet the conditions set forth by Rev. Rul. 61-146, the payments are excluded from the employees' gross income under §106.[55] This remains true regardless of whether the employer includes the reimbursements as wages on Form W-2, *Wage and Tax Statement.* Likewise, this remains true regardless of whether the employer has violated the market reforms by offering the reimbursement.

> **Note.** This means that an employee who receives a healthcare reimbursement from a noncompliant employer plan can continue to exclude that reimbursement from the income they report on their tax return. Their employer, however, is subject to the significant excise taxes explained previously.

In light of this guidance, a tax professional who discovers a noncompliant plan should counsel their client to terminate the plan immediately. For the 2015 tax year, the IRS is less likely to waive the excise tax for a plan that clearly violates the market reforms (such as premium reimbursement plans). It will be hard to argue "reasonable cause" for a law that has been in place for more than a year. However, as long as the violation was not due to willful neglect, a client that corrects the violation within the 30-day window can argue reasonable cause and request that no penalty be imposed. Filing Form 8928 triggers the beginning of the statute of limitations period to assess the penalty.

Example 3. Molly Wrigley is a sole proprietor running a small ditch-digging business. She has two employees, for whom she does not provide health insurance. On July 1, 2015, faced with competitive pressure to retain good workers, Molly decided to implement a new employee benefit. She began reimbursing each employee $500 per month for the cost of the health insurance they purchased on their own.

When Molly met with her tax accountant on October 1, the accountant informed her that the reimbursement practice was not allowed under the ACA. Molly immediately ended the reimbursement plan, informing her employees that it could no longer continue.

Because the plan Molly offered for three months did not comply with market reforms, there was a plan failure, which she is required to report to the IRS. Accordingly, Molly's accountant completes the following Form 8928 for the 2015 tax year. Molly asserts that her failure was for reasonable cause and that she corrected the failure within 30 days of its discovery; thus, she reports a $0 penalty. There is no guarantee that the IRS will agree with Molly's determination. However, the highest penalty she would have to pay is $300, or 10% of the amount of benefits paid. Her employees are not subject to taxes on the reimbursements they received.

55. This determination is based on Rev. Rul. 61-146, 1961-2 CB 25, which is still in effect.

For Example 3

Form **8928** (Rev. December 2013) Department of the Treasury Internal Revenue Service

Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code
(Under sections 4980B, 4980D, 4980E, and 4980G)
▶ Information about Form 8928 and its separate instructions is at *www.irs.gov/form8928.*

OMB No. 1545-2148

Filer's tax year beginning **01/01** , **2015** and ending **12/31** , **2015**

A Name of filer (see instructions) **Molly Wrigley**	**B** Filer's employer identification number (EIN) **36-1234567**
Number, street, and room or suite no. (if a P.O. box, see instructions) **128 Peacock Lane**	
City or town, state or province, country, and ZIP or foreign postal code **Brigham, MO 98765**	**E** Plan sponsor's EIN **37-9876543**
C Name of plan **Wrigley Employee Premium Reimbursement Plan**	**F** Plan year ending (MM/DD/YYYY) **12/31/2015**
D Name and address of plan sponsor **Molly Wrigley, 128 Peacock Lane, Brigham, MO 98765**	**G** Plan number **001**

Part I **Tax on Failure To Satisfy Continuation Coverage Requirements Under Section 4980B**

Complete a separate Part I, lines 1 through 6, for failures due to reasonable cause and not to willful neglect, and a separate Part I, lines 12 through 14, for other failures, for each qualifying event for which one or more failures to satisfy continuation coverage requirements that occurred during the reporting period (see instructions).

			For IRS Use Only		
	Section A – Failures Due to Reasonable Cause and Not to Willful Neglect				
1	Enter the total number of days of noncompliance in the reporting period			1	**90**
2	Enter the number of qualified beneficiaries for which a failure occurred as a result of this qualifying event	2 **2**			
3	If you entered 2 or more on line 2, multiply line 1 by $200. Otherwise, multiply line 1 by $100			3	**18,000**
4	If the failure was not discovered despite exercising reasonable diligence or was corrected within the correction period and was due to reasonable cause, enter -0- here, and go to line 5. Otherwise, enter the amount from line 3 on line 6 and go to line 7			4	**0**
5	If the failure was not corrected before the date a notice of examination of income tax liability was sent to the employer and the failure continued during the examination period, multiply $2,500 by the number of qualified beneficiaries for whom one or more failures occurred (multiply by $15,000 to the extent the violations were more than *de minimis* for a qualified beneficiary). If the failures were corrected before the date a notice of examination was sent, enter -0-			5	**0**
6	Enter the smaller of line 3 or line 5			6	**0**
7	If there was more than one qualifying event, add the amounts shown on line 6 of all forms, and enter the total on a single "summary" form. Otherwise, enter the amount from line 6 above			7	**0**
8	Enter the aggregate amount paid or incurred during the preceding tax year for a single employer group health plan or the amount paid or incurred during the current tax year for a multiemployer health plan to provide medical care	8 **3,000**			
9	Multiply line 8 by 10% (.10)			9	**300**
10	Amount from section 4980B(c)(4)			10	**500,000**
11	Enter the smallest of lines 7, 9, or 10. For a third-party administrator, HMO, or insurance company, the amount you enter on this line filed for all plans you administer during the same tax year cannot exceed $2 million; reduce the amount you would otherwise enter on this line to the extent the amount for all plans would exceed this limit			11	**0**
	Section B – Failures Due to Willful Neglect or Otherwise Not Due to Reasonable Cause				
12	Enter the total number of days of noncompliance in the reporting period			12	
13	Enter the number of qualified beneficiaries for which a failure occurred as a result of this qualifying event	13			
14	If you entered 2 or more on line 13, multiply line 12 by $200. Otherwise, multiply line 12 by $100.			14	
15	If there was more than one qualifying event, add the amounts shown on line 14 of all forms, and enter the total on a single "summary" form. Otherwise, enter the amount from line 14 above			15	
	Section C – Total Tax Due Under Section 4980B				
16	Add lines 11 and 15 ▶		126	16	

For Paperwork Reduction Act Notice, see instructions. Cat. No. 37742T Form **8928** (Rev. 12-2013)

IRS NOTICE 2015-17 TRANSITIONAL RELIEF

In February 2015, the IRS issued Notice 2015-17, which provides additional guidance regarding employer healthcare arrangements. Recognizing that many employers were wholly unprepared to implement the requirements of IRS Notice 2013-54 and that many violations had occurred, the IRS offered transitional relief. IRS Notice 2015-17 also answered some pending questions, clarified some requirements, and left other questions unanswered until a future date.

Small Employer Reimbursement of Healthcare Premiums

IRS Notice 2015-17 reaffirms that employer **reimbursement of individual healthcare premiums** to employees constitutes an improper employer payment plan. In addition, it provides transitional relief to employers that are not applicable large employers. **Applicable large employers** are generally those with 50 or more full-time employees.

Small employers who continued to offer an employer payment plan after January 1, 2014, were not required to file Form 8928 and were not liable for the excise tax **through June 30, 2015.** Beginning July 1, 2015, however, these employers may be liable for the penalty if they do not reform their illegal plans. A tax professional who discovers an improper employer payment plan after June 30, 2015, must counsel their client to terminate the plan and file Form 8928.

IRS Notice 2015-17 states that this transitional relief applies both to the reimbursement of Medicare Part B or Part D premiums and to reimbursements of individual health insurance policy premiums.

IRS Notice 2015-17 does not provide transitional relief to small employers that offered stand-alone HRAs or other medical expense reimbursement plans that violated the market reforms. Consequently, a tax professional should advise such a client to terminate the plan and file Form 8928 to report the violation.

2% Shareholders

After IRS Notice 2013-54 was issued, tax professionals have questioned how the guidance applies to shareholders who own more than 2% of an S corporation.

Traditional Treatment of Health Insurance Premiums. When health insurance premiums are paid by an S corporation, IRC §1372(a) requires that the S corporation be treated as a partnership. In addition, any shareholder who owns more than 2% of the outstanding stock or more than 2% of the combined voting power must be treated as a partner.

Thus, health insurance premiums paid by the S corporation are deductible by the S corporation as compensation to the more-than-2% shareholder and included in their Form W-2 as wages.

Above-the-Line Deduction. IRC §162(l)(5) allows the more-than-2% shareholder the same above-the-line deduction for health insurance costs as a self-employed individual (even though the more-than-2% shareholder's wages are treated as earned income) if all the other provisions of IRC §162(l) are met. Under IRC §162(l)(2)(B), an above-the-line deduction is not allowed for any calendar month for which the shareholder is eligible to participate in any subsidized health plan maintained by any employer of the shareholder or the spouse of the shareholder.

For the requirements of IRC §162(l)(5) to be met, IRC §1372 (the partnership taxation rules mentioned previously) must apply. For IRC §1372 to apply, the S corporation must establish a plan providing medical care coverage. If the shareholder purchases their own health insurance with their own funds, a plan has not been established by the S corporation. Therefore, an IRC §162(l) deduction is not allowed.

In late 2007, the IRS issued Notice 2008-1, which sets forth the criteria for more-than-2% shareholder-employees to qualify for the IRC §162(l)(5) deduction. The notice provides that a plan providing medical care coverage is **established** by the S corporation (and thus allows the shareholder to take the §162(l)(5) deduction) if:

- The S corporation makes the premium payments for the accident and health insurance policy covering the more-than-2% shareholder-employee (and their spouse or dependents, if applicable) in the current tax year; or
- The more-than-2% shareholder makes the premium payments and furnishes proof of the payments to the S corporation and then the S corporation reimburses them for the premium payments in the current tax year.

Note. If the accident and health insurance premiums are not paid directly by the S corporation or reimbursed to the employee by the S corporation and included in the more-than-2% shareholder-employee's gross income, a plan providing medical care coverage for the shareholder-employee is not established by the S corporation. In this situation, the more-than-2% shareholder-employee is not allowed the deduction under §162(l).

FICA Taxation. The health insurance premiums paid by an S corporation on behalf of its more-than-2% shareholder-employees are included as wages for income tax purposes. However, the value of these premiums has long been excluded from wages for FICA (social security and Medicare tax) purposes. IRS Announcement 92-16 clarified that accident and health insurance payments made under a plan to benefit employees are exempt from FICA tax under IRC §3121(a). The announcement states (in relevant part):

> *(a) For purposes of this chapter, the term **wages** means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term **shall not include**—*
>
> > *(2) the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to, or on behalf of, an employee or any of his dependents **under a plan or system established by an employer which makes provision for his employees generally** (or for his employees generally and their dependents) or for a class or classes of his employees (or for a class or classes of his employees and their dependents), on account of—*
> >
> > > *(B) medical or hospitalization expenses in connection with sickness or accident disability.*

This statute thus exempts from FICA tax liability those payments made to employees under an employer's plan for medical or hospitalization expenses. IRS Announcement 92-16 states:

> *For this exclusion to apply, the payments must be made under a plan or system for employees and their dependents generally or for a class (or classes) of employees and their dependents. Thus, whether amounts of this type are actually subject to social security or Medicare tax depends on whether in the particular case the taxpayer satisfies the requirements for the exclusion.*

ACA Impact. IRS Notice 2008-1 has not been rescinded or changed. However, the ACA (primarily through IRS Notice 2013-54) made employer payment plans impermissible. These plans are considered group health plans that violate the ACA market reforms, thus subjecting their employer-sponsors to the substantial excise taxes mentioned earlier.

Consequently, several questions have arisen: May an S corporation continue to reimburse its S corporation shareholders for health insurance premiums paid outside of a group health plan arrangement? Do the same rules preventing this reimbursement to regular employees apply to S corporation shareholders?

The FICA exclusion and §162(l) deduction described earlier both require the existence of an **employer-sponsored plan.** Thus, the logical conclusion can be reached that such a plan is a **group health plan** subject to the market reforms. Given the onerous penalties imposed for violations, this issue creates great concern.

IRS Notice 2015-17 did not answer the big question of whether the reimbursement of individual premiums of S corporation shareholder-employees who own more than 2% are subject to market reforms. Nonetheless, IRS Notice 2015-17 did offer relief from the immediate uncertainty. The notice states that **unless and until any further guidance is issued (and certainly through the end of 2015), no excise tax will be asserted for any failure to satisfy the market reforms solely as a result of having a more-than-2% shareholder-employee healthcare arrangement.**

Therefore, **at least through 2015,** it is not necessary to file Form 8928 solely because the employer offered a more-than-2% shareholder-employee healthcare reimbursement arrangement. This does not apply to reimbursements of individual health insurance premiums for employees of S corporations who do not own more than 2%. However, these arrangements were eligible for the transitional relief applicable through June 30, 2015, as long as the S corporation was not an applicable large employer.

IRS Notice 2015-17 also states that tax preparers may continue to rely on IRS Notice 2008-1 for the tax treatment of more-than-2% shareholder-employee healthcare arrangements **unless and until additional guidance provides otherwise.**

Finally, IRS Notice 2015-17 provides that if an S corporation maintains a health reimbursement arrangement under which a more-than-2% shareholder-employee and a non-2% shareholder-employee are both covered, this constitutes a group health plan for the current employee and does not fall under the retiree-only (i.e., fewer than two participants who are current employees) exception. **This is true even if the corporation attempts to reimburse the classes of employees through separate plans.** The different arrangements are considered one plan for purposes of the retiree-only exception. Therefore, the reimbursement of the nonshareholder employee is not allowed and is subject to the excise penalty after June 30, 2015.

Family Coverage for Retiree-Only Exception

IRS Notice 2015-17 clarified that if an employee is covered under a reimbursement arrangement with their spouse or dependent (who are also employees), this arrangement is considered to cover only one employee. Accordingly, a small family business with no other employees may continue to reimburse for a family plan and fall under the retiree-only (i.e., fewer than two participants who are current employees) exception to the market reforms.

Although the notice did not address this issue, it is also arguable that a corporation wholly owned by spouses who are the only employees is also exempt from the ACA market reform rules.

Part A of the ACA[56] implements the market reforms discussed previously. Each market reform applies only to group health plans and to health insurance issuers offering group or individual health insurance coverage. For purposes of the ACA, the term **group health plan** refers to an employee welfare benefit plan as defined by ERISA.[57] The scope of ERISA excludes plans offered by businesses in which an individual and their spouse are the sole owners and the sole employees.[58] It is therefore arguable that such plans are also outside the scope of the ACA market reforms.

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56. Title XXVII of the PHSA (42 USC §300gg et seq.).

57. Section 1301(b)(3) of the ACA (42 USC §18021) provides that in this title, the term **group health plan** has the meaning given such term by section 2791(a) of the Public Health Service Act. (42 USC §300gg–91(a)) "This title" is title I of PL 111–148, Mar. 23, 2010, 124 Stat. 130 (the Patient Protection and Affordable Care Act).

58. 29 CFR §2510.3-3.

Some argue that the relevant definition of **group health plan** is in the Code section that establishes the excise penalty. That definition[59] states that a **group health plan** is:[60]

> *a plan (including a self-insured plan) of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families.*

Although this definition is broader than that from ERISA, it cannot supplant the definition from the section of the ACA that actually implements the market reforms. The Code provision exists to allow collection of an excise tax for violation of the ACA requirements. It does not establish the requirements. The market reform requirements apply only to group health plans as defined by ERISA.

IRC §9815(a)(2) provides that "to the extent any provision of this subchapter conflicts with a provision of such part A with respect to group health plans … the provisions of such part A shall apply." Consequently, the Code definition of **group health plan** should not supplant the part A definition of the term. Therefore, **a plan covering spouses that is exempt from ERISA should also be exempt from the ACA market reforms.**

Reimbursement of Medicare Part B or Part D Premiums

IRS Notice 2015-17 stated that the reimbursement of Medicare Part B or Part D premiums **does** constitute an employer payment plan that **violates** market reforms. The reimbursement plan may not be integrated with the underlying Medicare plan to satisfy the reforms. However, the notice did provide a method for integrating this reimbursement with an employer group plan (to make it permissible). That method has the following requirements.

- The employer offers a group health plan (other than the employer payment plan) to the employee that does not consist solely of excepted benefits and offers coverage providing minimum value.
- The employee participating in the employer payment plan is actually enrolled in Medicare Parts A and B.
- The employer payment plan is available only to employees who are enrolled in Medicare Part A and Part B or Part D.
- The employer payment plan is limited to reimbursement of Medicare Part B or Part D premiums and excepted benefits, including Medigap premiums.

Additional Guidance Forthcoming

IRS Notice 2015-17 stated that further guidance regarding HRAs and other aspects of employer payment plans will be provided.

59. IRC §4980D(f)(1) provides that for purposes of the excise penalty, the definition of **group health plan** is that set forth in IRC §9832(a). IRC §9832(a) applies the definition from IRC §5000(b)(1).

60. IRC §5000(b)(1).

SALE OF AN ACCOUNTING PRACTICE

At some point, most owners of tax and accounting practices decide to retire or transition out of the business. If they decide to sell their practices, they must consider a number of issues. This section provides a general overview of the issues facing an accountant transitioning out of a practice.

TIMING A SALE

Deciding when to place a practice on the market can be difficult. The time of year can make a difference in how long it takes to find a buyer. If the practice is predominantly tax oriented, the owner may wish to sell immediately after a tax season ends, when most of the annual billing has been completed.

Retaining a tax practice during the off-season generally results in negative cash flow. Buyers also realize that a tax practice normally does not generate much revenue in the off-season. Therefore, most buyers prefer to wait until fall to make a purchase.

Some practices sell quickly, whereas other practices take much longer. The location of the practice, its reputation, and the number of its competitors are important factors that affect the potential sale.

Owners who are able to sell their own practices often reap higher sales prices. When an estate sells a practice, it is typically discounted. Unlike a work of art, a tax or accounting practice is worth more if it is sold while the owner is still living. This is especially true when the principal agrees to continue working for a specified period. Once clients hear that their tax preparer or accountant has died, they usually begin looking for a replacement. Uncertain of the future of the business, staff members also may begin searching for new employment. Some may even decide to open their own businesses and solicit clients from their former employer.

VALUATION OF A PRACTICE

After deciding to sell, the first major question to consider is how to value the practice. Price is usually based on a percentage (multiple) of the practice's gross receipts. However, certain other factors also enter into the valuation process, including the following.

- Will the current owner continue to be associated with the business? If so, will the owner be paid for the time spent working with former clients, or will that time be included in the sales price? If the former owner continues working with the firm for a certain period, fewer clients are generally lost in the transition. The duration of any transition period may also factor into the valuation.
- Will the price be fixed at the time of sale, or will it be set later based on client retention? If the price is based on client retention, the multiple will usually be higher. Agreeing to fix the price after calculating client retention decreases the buyer's risk but increases the seller's risk.
- Where is the practice located? A practice in metro Chicago may sell for a higher price than one in a rural area.
- Does the overall price include office furniture and fixtures? Usually, the sale of furniture and fixtures is negotiated separately, unless a large practice is being sold. The seller should keep in mind that the market for used office furniture and equipment is not good, and the fair market value (FMV) for these goods will usually be substantially less than what was paid.
- Is an office building included in the transaction? The sale of real estate should be a separate transaction. If the seller owns a building, they may choose either to sell or lease it to the buyer. If the seller leases a building, they may be able to transfer the existing lease to the buyer.

> **Note.** Several logical methods may be used to value a business. Generally, these methods follow an asset-based, market-based, or income-based approach. Guidelines applicable to IRS examiners regarding business valuation may be found at IRM 4.48.4.

ALLOCATION OF SALES PRICE

Tax and accounting practices are often composed of different types of assets. These assets are taxed differently depending upon their character.

An allocation of sales price is required when assets are sold. The following discussion does not address the sale of business stock.

Tangible Assets

If tangible assets (such as office equipment and real estate) are included in the sales price, the prices of these items should be stated separately in the sales contract. Preparing the tax returns for both the buyer and the seller will be easier if such items are listed individually by price and description.

Intangible Assets

Two of the most common intangible assets[61] included in the sales price of an existing business are goodwill and a covenant not to compete. Other intangible assets may include the workforce in place, business books and records, computer operating systems and databases, and franchise fees.

Goodwill. Treas. Reg. §1.197-2(b) defines **goodwill** as the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. In practice, the amount of the purchase price allocated to goodwill is often made by default. This is because any remaining amount not separately stated in the negotiated contract is allocated to goodwill.

Noncompete Agreement. Having an agreement or covenant not to compete is crucial for the buyer if the seller plans to continue to work as an accountant after selling the practice. A covenant not to compete is a written agreement that restrains a seller from competing against a buyer for the same customer base after a sale is transacted. Usually, a covenant not to compete specifies that a seller must refrain from doing business within a certain geographic location for a specified period of time. The terms of these covenants are generally governed by state law. These terms generally must be reasonable with respect to scope and duration. Enforcability of such agreements varies widely, depending on state law.

A covenant not to compete is an IRC §197 intangible asset when it is entered into in connection with the acquisition of an interest in a trade or business.[62] As such, the buyer must amortize the purchase price over a 15-year period. The price paid by the buyer for the noncompete agreement is ordinary income to the seller.[63]

The IRS often scrutinizes noncompete agreements to determine whether they have any demonstrable value. The factors considered include the following.[64]

- Whether the seller would desire to compete with the buyer in the absence of the covenant
- The ability of the seller to compete effectively with the buyer in the activity
- The feasibility of effective competition by the seller within the time and area specified in the covenant, in view of the activity and market in question

Ideally, the noncompete agreement should be separate from the contract for the sale of a business's assets, such as equipment, buildings, and goodwill. If the buyer defaults on payments for these assets, repossession may be required.

If the seller is incorporated, there is often the concern that a shareholder might compete with the buyer, which the corporation could not prevent. The buyer may eliminate that concern by entering into a separate noncompete agreement with the shareholder. In exchange for that agreement, the buyer makes a payment to the shareholder.

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61. See IRC §197.

62. IRC §197(d)(1)(E).

63. *Muskat v. U.S.,* 554 F.3d 183 (1st Cir. 2009).

64. Rev. Rul. 77-403, 1977-2 CB 302.

A noncompete covenant may have a higher value in its first year than in later years. For example, a seller who enters into competition with a buyer will more likely retain or regain their clients if they compete with the buyer during the year following the sale, rather than several years later.

For sales transacted on or after August 11, 1993, the allocation of the purchase price between goodwill and a noncompete covenant is of no tax consequence to the buyer because both are amortized over 15 years.[65] However, the allocation has significant tax consequences to the seller. Specifically, the amount allocated to goodwill is eligible for capital gain treatment, and the amount allocated to the noncompete covenant is taxed as ordinary income.[66]

Asset Acquisition Statement

When a practice is sold, the buyer and the seller may each be required to attach a completed Form 8594, *Asset Acquisition Statement Under Section 1060,* to their income tax return. Form 8594 is required to report the transfer of a group of assets that make up a trade or business if both of the following conditions are met.[67]

1. Goodwill (or going concern value) attaches or could attach **to the assets.**
2. A purchaser's basis in the assets is determined only by the amount paid for the assets.

Filing this form is required regardless of whether the group of assets constitutes a trade or business in the hands of the buyer, the seller, or both.

Asset Classifications. The overall transfer price of a group of assets must be allocated between the following seven asset classes.

Class I. Cash and general deposit accounts, other than certificates of deposit

Class II. Actively traded personal property,[68] with the exception of stock of the seller's affiliates (other than actively traded stock described in IRC §1504(a)(4)), certificates of deposit, and foreign currency

> **Note.** Certificates of deposit and foreign currency are included, regardless of whether they are actively traded personal property.

Class III. Debt instruments (including accounts receivable) and assets that the taxpayer marks-to-market at least annually

Class IV. Inventory and similar property held for sale to customers in the ordinary course of business

Class V. Assets that do not fall into any other class, such as equipment, furniture, fixtures, vehicles, buildings, and land

Class VI. IRC §197 intangible assets, **other than** goodwill and going-concern value

- IRC §197 assets **include** intangibles such as covenants not to compete, workforce in place, business books and records, operating systems and databases, franchise, and others[69]
- IRC §197 assets **do not include** intangibles such as interests in corporations, partnerships, trusts, or estates; interests under certain financial contracts; interests in land; certain computer software; interests under leases of tangible property; and others[70]

Class VII. Goodwill and going-concern value

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65. IRC §197.
66. See, e.g., *Muskat v. U.S.,* 554 F.3d 183 (1st Cir. 2009).
67. See the instructions for Form 8594.
68. This term is used within the meaning of IRC §1092(d)(1) and Treas. Reg. §1.1092(d)-1 without regard to IRC §1092(d)(3).
69. See IRC §197(d) for more information.
70. See IRC §197(e) for more information.

With the exception of goodwill and going-concern value (class VII), the amount allocated to an asset cannot exceed the asset's FMV on the purchase date. The amount allocated is also subject to any applicable limit under the Code or general principles of tax law.

The total consideration should be allocated in class order, starting with Class I and continuing through Class VI, if applicable. Any residual consideration should be allocated to Class VII (goodwill). Consideration is allocated within each class to individual assets in proportion to the FMV of each on the purchase date. If an asset could be included in more than one class, it should be assigned to the lowest-numbered class (e.g., if an asset could be included in class III or IV, assign it to class III).

Note. Form 8594 must be amended if there is an increase or decrease in the buyer's cost or the seller's amount realized from the sale. See the instructions for Form 8594 for more information regarding the reallocation of consideration.

CONTINGENT SALE PAYMENTS

If the sale of a practice is contingent on retained business, the seller receives a down payment at closing that is a percentage of the maximum agreed-upon sales price. The actual price is usually determined the year after the sale, based on the amount of retained business. At that time, the seller receives the balance of the recalculated sales price over the number of years stipulated by the contract.

Example 4. Debbie, a sole proprietor, decided to sell her tax business to Doug in 2013. Doug agreed to purchase the intangible assets of the business for a maximum price of $495,000, or 110% of Debbie's 2013 gross billings of $450,000. However, the actual sales price was contingent on the amount of retained business. The final price was to be determined one year after the date of sale, based on 110% of Doug's gross billings for the first year.

The sales contract called for Doug to pay Debbie 75% of the maximum selling price at the time of closing. The balance was to be paid in equal annual installments over a 5-year period. Interest was stated separately.

Doug gave Debbie a down payment of $371,250 ($495,000 × 75%) at closing. At the end of the first year, Doug's gross billings were $385,000. This set the final sales price at $423,500 ($385,000 × 110%). Doug owed Debbie a balance of $52,250 ($423,500 – $371,250), or $10,450 per year for five years ($52,250 ÷ 5), plus interest.

REPORTING THE SALE

Tangible Assets

The sale of a practice's tangible assets is reported on Form 4797, *Sales of Business Property.* The sale is reported in the same manner as if the assets had been sold in the ordinary course of business.

Intangible Assets

Noncompete Covenant. Income received from a noncompete covenant is reported on Form 4797, part II. It is subject to ordinary income tax rates but not self-employment tax.

Goodwill. Purchased goodwill and other §197 assets are amortized on a **straight-line basis** over a period of **15 years.**[71] The subsequent sale of these amortized assets is reported on Form 4797 as IRC §1245 property. Any gain realized up to the amount of allowed or allowable amortization is taxable as ordinary income (Form 4797, part II). The portion of the sales price that exceeds the original cost, if any, is §1231 gain reported on Form 4797, part I.

71. Treas. Reg. §1.197-2.

Installment Sale

Reporting the sale of a practice can be somewhat confusing when the practice is sold contingent on the retention of business. The delay involved in determining the final contract price usually requires the sale to be reported on the **installment method.**[72]

Example 5. Use the same facts as **Example 4,** except the $495,000 maximum contract sales price was allocated first to a $50,000 covenant not to compete, and the balance was allocated to goodwill. Debbie purchased her client base for $15,000, and her unamortized basis was $10,667. She sold her fully depreciated office furniture and equipment **separately** for $5,000.

The contract price would not be finalized until the end of the first year; therefore, the installment method had to be used to report this sale. Because the value of the noncompete covenant was fixed in the contract, the amount allocated to the purchase of goodwill had to be modified in 2014. The 2013 down payment was allocated as follows.

	Noncompete Covenant	Goodwill	Total
Maximum sales price	$50,000	$445,000	$495,000
Down payment rate	× 75%	× 75%	× 75%
Down payment amount	$37,500	$333,750	$371,250

The sale of goodwill and the covenant not to compete were reported as separate installment sales. To report these sales in 2013, Debbie completed the following Forms 6252, *Installment Sale Income,* Form 4797, and Form 8594.

72. Temp. Treas. Reg. §15a.453-1.

For Example 5

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Information about Form 6252 and its instructions is at *www.irs.gov/form6252.*

OMB No. 1545-0228 — **2013** — Attachment Sequence No. **79**

Name(s) shown on return: **Debbie Seller** — Identifying number: **123-45-9999**

1	Description of property ▶	Purchased goodwill	
2a	Date acquired (mm/dd/yyyy) ▶ 7/01/2009	b Date sold (mm/dd/yyyy) ▶	10/01/2013
3	Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4	☐ Yes ☒ No	
4	Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale	☐ Yes ☐ No	

Part I — Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest, whether stated or unstated			5	445,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	445,000		
8	Cost or other basis of property sold	8	15,000		
9	Depreciation allowed or allowable	9	4,333		
10	Adjusted basis. Subtract line 9 from line 8	10	10,667		
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12	4,333		
13	Add lines 10, 11, and 12			13	15,000
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	430,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	0
16	**Gross profit.** Subtract line 15 from line 14			16	430,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	445,000

Part II — Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions			19	.9663
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	333,750
22	Add lines 20 and 21			22	333,750
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	322,503
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	322,503

Part III — Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) ▶
- b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- d ☐ The second disposition occurred after the death of the original seller or buyer.
- e ☐ It can be established to the satisfaction of the IRS that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2013 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2013)

For Example 5

Form **6252** Department of the Treasury Internal Revenue Service	**Installment Sale Income** ▶ Attach to your tax return. ▶ Use a separate form for each sale or other disposition of property on the installment method. ▶ Information about Form 6252 and its instructions is at *www.irs.gov/form6252.*	OMB No. 1545-0228 **2013** Attachment Sequence No. **79**

Name(s) shown on return: **Debbie Seller** — Identifying number: **123-45-9999**

1 Description of property ▶ **Noncompete agreement**

2a Date acquired (mm/dd/yyyy) ▶ **7/01/2009** b Date sold (mm/dd/yyyy) ▶ **10/01/2013**

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☐ Yes ☒ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest, whether stated or unstated			5	50,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	50,000		
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	50,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	0
16	**Gross profit.** Subtract line 15 from line 14			16	50,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	50,000

Part II Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions			19	1.0000
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	37,500
22	Add lines 20 and 21			22	37,500
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	37,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	37,500

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) . . . ▶

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2013 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2013)

5

For Example 5

Form **4797** | **Sales of Business Property** | OMB No. 1545-0184

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ **Attach to your tax return.**

▶ **Information about Form 4797 and its separate instructions is at *www.irs.gov/form4797*.**

Department of the Treasury
Internal Revenue Service

2013

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Debbie Seller	123-45-9999

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

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

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

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	322,503
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	322,503

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

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

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

From Form 6252						37,500

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	9,333
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	46,833
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	46,833

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2013)

For Example 5

Form 4797 (2013) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Office furniture & equipment	Various	10/01/13
B Purchased goodwill	07/01/09	10/01/13
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	5,000	445,000		
21 Cost or other basis plus expense of sale	21	15,000	15,000		
22 Depreciation (or depletion) allowed or allowable	22	15,000	4,333		
23 Adjusted basis. Subtract line 22 from line 21	23		10,667		
24 Total gain. Subtract line 23 from line 20	24	5,000	434,333		
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	15,000	4,333		
b Enter the **smaller** of line 24 or 25a	25b	5,000	4,333		
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	439,333
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	9,333
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6 See Form 6252	32	N/A

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2013)

For Example 5

Form **8594**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

▶ Attach to your income tax return.
▶ Information about Form 8594 and its separate instructions is at *www.irs.gov/form8594*

OMB No. 1545-1021
Attachment Sequence No. **169**

Name as shown on return	Identifying number as shown on return
Debbie Seller	**123-45-9999**

Check the box that identifies you:
☐ Purchaser ☒ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Doug Buyer	**999-12-3456**

Address (number, street, and room or suite no.)
765 5th Ave.

City or town, state, and ZIP code
Watertown, MO 76887

2 Date of sale	3 Total sales price (consideration)
10/1/2013	**495,000**

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$ 495,000	$ 495,000
Total	$ 495,000	$ 495,000

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☒ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☒ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . ☒ Yes ☐ No

If "Yes," attach a statement that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 12-2012)

Example 6. Use the same facts as **Example 5.** After the first year's gross billings were calculated, the final sales price was determined in 2014. The selling price decreased from a maximum of $495,000 to the final price of $423,500. Thus, the gross profit ratio for the installment sale had to be recalculated.[73] The allocation of the recalculated profit follows.

	Noncompete Covenant	Goodwill	Total
Final sales price	$50,000	$373,500	$423,500
Less: 2013 down payment	(37,500)	(333,750)	(371,250)
Remaining balance due	$12,500	$ 39,750	$ 52,250
Remaining payment period (years)	÷ 5	÷ 5	÷ 5
Installment payment amount	$ 2,500	$ 7,950	$ 10,450

The recalculated gross profit ratio for goodwill follows. Debbie attached this statement to her 2014 return.

Debbie Seller

123-45-9999

Attachment to Form 6252:

2014 final sale price for purchased goodwill		$373,500
Less: 2013 payments		(333,750)
Balance due		$ 39,750
Original basis	$15,000	
Less: basis recovered in 2013 (75%)	(11,250)	
Remaining basis	$ 3,750	(3,750)
New gross profit		$ 36,000
Balance due		÷ 39,750
New gross profit percentage		90.57%
Balance due		$ 39,750
Number of remaining payments		÷ 5
2014 payment		$ 7,950
New gross profit percentage		× 90.57%
Taxable gain in Year 2		$ 7,200

The sales price for the noncompete agreement was not contingent on Doug's 2014 billings. Accordingly, the sales price did not change in 2014. Debbie's 2014 Forms 6252 and the amended Form 8594 follow.

73. See Temp. Treas. Reg. §15a.453-1(c).

For Example 6

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Information about Form 6252 and its instructions is at *www.irs.gov/form6252*.

OMB No. 1545-0228 — 2014 — Attachment Sequence No. 79

Name(s) shown on return: **Debbie Seller** — Identifying number: **123-45-9999**

1	Description of property ▶ Purchased goodwill		
2a	Date acquired (mm/dd/yyyy) ▶ 7/01/2009	**b** Date sold (mm/dd/yyyy) ▶ 10/01/2013	
3	Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4	☐ Yes ☒ No	
4	Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale	☐ Yes ☐ No	

Part I — Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest, whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

Part II — Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions See Statement			19	.9057
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	7,950
22	Add lines 20 and 21			22	7,950
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	333,750		
24	**Installment sale income.** Multiply line 22 by line 19			24	7,200
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	7,200

Part III — Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) ▶
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the IRS that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2014 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2014)

For Example 6

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Information about Form 6252 and its instructions is at *www.irs.gov/form6252.*

OMB No. 1545-0228 — **2014** — Attachment Sequence No. **79**

Name(s) shown on return: **Debbie Seller** — Identifying number: **123-45-9999**

1	Description of property ▶ Noncompete agreement				
2a	Date acquired (mm/dd/yyyy) ▶ 7/01/2009	**b** Date sold (mm/dd/yyyy) ▶ 10/01/2013			
3	Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4	☐ Yes ☒ No			
4	Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale	☐ Yes ☐ No			

Part I — Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest, whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

Part II — Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions			19	1.0000
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	2,500
22	Add lines 20 and 21			22	2,500
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	37,500		
24	**Installment sale income.** Multiply line 22 by line 19			24	2,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	2,500

Part III — Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) ▶
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the IRS that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2014 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2014)

5

For Example 6

Form **8594** (Rev. December 2012) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return.
▶ Information about Form 8594 and its separate instructions is at *www.irs.gov/form8594*

OMB No. 1545-1021
Attachment Sequence No. 169

Name as shown on return	Identifying number as shown on return
Debbie Seller	123-45-9999

Check the box that identifies you:
☐ Purchaser ☒ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Doug Buyer	999-12-3456

Address (number, street, and room or suite no.)
765 5th Ave.

City or town, state, and ZIP code
Watertown, MO 76887

2 Date of sale	3 Total sales price (consideration)
10/1/2013	423,500

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$ 423,500	$ 423,500
Total	$ 423,500	$ 423,500

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☒ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☒ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . ☒ Yes ☐ No

If "Yes," attach a statement that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 12-2012)

For Example 6

Form 8594 (Rev. 12-2012) Page 2

Part III **Supplemental Statement—**Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

2013 Form 1040

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$ **495,000**	$ **(71,500)**	$ **423,500**
Total	$ **495,000**		$ **423,500**

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

The sales price was contingent on retained business. After the first year, the final price was determined and the sales price was reduced by $71,500.

Form **8594** (Rev. 12-2012)

5

TRANSFER OF CLIENT FILES

Generally, state law specifies whether a client's permission must be obtained before transferring their files to a new owner. The buyer usually needs to have the practice's prior records to adequately serve clients. Therefore, the contract should provide the buyer with rights to access the files to resolve any problems with work performed while the seller owned the business. Both the buyer and the seller are advised to consult with their respective legal counsels and any applicable regulatory agencies regarding the transfer of files.

> **Note.** IRC §7216 governs the disclosure and use of taxpayer information in various circumstances, including in connection with the sale of a tax practice. For further information, see this Code section and related regulations.

MAINTAINING RECORDS

IRC §6107 requires a tax return preparer to keep a copy of each return or claim for refund they prepare. Alternatively, a preparer may maintain a list of the names and taxpayer identification numbers of all the taxpayers for whom they prepared such returns or claims. This information must be made available to the IRS upon request.

These returns or lists must be kept for a period of three years after the close of the return period. A **return period** is defined as the 12-month period beginning July 1 and ending the following June 30.[74] Information regarding extended returns due after July 1 must be retained until the end of the 3-year period that includes the extended due date.

Example 7. Michael prepares 250 individual tax returns for the 2015 tax year between January 1, 2016, and April 15, 2016. Michael extends 10 returns for the 2015 tax year, which he completes in May 2016.

The due date for the unextended returns is April 15, 2016. This means that Michael must maintain records of these returns until June 30, 2019 (three years after the return period ending June 30, 2016). The 10 extended returns, which are due October 16, 2016, must be kept until June 30, 2020 (three years after the return period ending June 30, 2017).

Rev. Rul. 79-400 provides guidance on the transfer of records when an accounting or tax practice is sold. The ruling states that it is permissible for the preparer to transfer copies of tax returns to the purchaser of the practice.

> **Note.** Rev. Rul. 79-400 holds the seller responsible for maintaining business records in compliance with §6107. If the buyer fails to comply with an IRS request for any year that the seller was the paid preparer, the seller is responsible for any noncompliance penalties. Although the contract between the seller and the buyer may require such compliance, the seller is still ultimately responsible.

Corporations and Partnerships

If a business is dissolved before the end of a 3-year return period, the person responsible for settling the business's affairs is also responsible for maintaining any necessary records. If state law does not specify who is responsible for maintaining records, the responsibility generally falls on the business's directors or partners. These parties may be held jointly and severally liable for penalties relating to any failure to maintain necessary records.

74. IRC §6060(c).

SELF-RENTAL

Before 1986, a taxpayer could generally deduct losses arising from rental activities and other trade or business activities. This was true regardless of whether the taxpayer materially participated in those activities. Taxpayers often took advantage of this by creating tax shelters or artificial passive losses against which wages and other income could be offset.[75]

The Tax Reform Act of 1986 (TRA) implemented rules for passive activity losses. These rules were designed to prevent the creation of tax shelters by limiting taxpayers' ability to deduct losses from businesses in which they do not materially participate.[76] Under IRC §469(c)(2), income earned from a rental activity is generally **passive** income, regardless of whether the taxpayer is actively involved in the rental activity. This rule prevents taxpayers from offsetting active (nonpassive) income with losses derived from passive rental income. For example, these passive loss rules prevent a taxpayer from offsetting income derived from wages with losses from a house they own and rent to tenants.

There are some exceptions to the general rule that income earned from rental activity is passive. One exception applies to real estate professionals.[77] Persons qualifying as real estate professionals under the Code can treat income and losses from their real estate activities as **active** instead of passive. Another exception to the general passive income rule applies to self-rental activities. Unlike the real estate professionals' exception, the self-rental rule characterizes self-rental activity differently depending on whether it generates a profit or a loss.

> **Note.** For more information about real estate professionals, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

SELF-RENTAL RULE

Immediately after the TRA was implemented, a number of new tax shelters arose. A common arrangement involved using self-rental arrangements to generate passive income to offset passive losses. The self-rental rule[78] was created to prevent taxpayers from shifting active income to passive income by renting property to a trade or business in which the taxpayer materially participates.

Specifically, the self-rental rule **recharacterizes as nonpassive** a taxpayer's net rental activity income from an item of property if the property is rented for use in a trade or business activity in which the taxpayer materially participates.[79]

> **Note.** The self-rental rule has received renewed attention in the past several years because of the enactment of the net investment income tax (NIIT). As discussed later in this chapter, the IRS has determined that the NIIT does not apply to self-rental income.

75. *IRS Passive Activity Loss Audit Technique Guide.* Internal Revenue Service. [www.irs.gov/pub/irs-mssp/pal.pdf] Accessed on May 25, 2015.

76. IRC §469.

77. IRC §469(c)(7).

78. Treas. Reg. §1.469-2(f)(6).

79. *Williams v. Comm'r,* TC Memo 2015-76 (Apr. 16, 2015).

Applicability of Self-Rental Rule

To fall within the scope of the self-rental rule, the income must be received by the taxpayer for property that is:

- Rented for use in a trade or business activity[80] in which the taxpayer **materially participates,** and
- Is not property rented **incidental to a development activity.** (As described in Treas. Reg. §1.469-2(f)(5), this involves material or significant participation in an activity for the purposes of enhancing the value of the property if the property is rented during the year of its sale.)

Treas. Reg. §1.469-5(f) provides that any work done by an individual in connection with an activity in which they **own an interest** at the time the work is performed is treated as participation by the individual in the activity. A taxpayer **materially participates** in an activity if any of the following seven tests are met.[81]

1. The taxpayer worked more than 500 hours in the business during the year.
2. The taxpayer's participation in the activity constitutes substantially all the participation in the activity.
3. The taxpayer worked more than 100 hours during the year, and no one else worked more hours.
4. The taxpayer has several passive activities in which they participate between 100 and 500 hours each; the total time participating in these activities is more than 500 hours.
5. The taxpayer materially participated in the activity for any five of the 10 preceding years.
6. The taxpayer materially participated in a personal service activity for any three prior years.
7. The facts and circumstances indicate that the taxpayer is materially participating. This test is not met if the taxpayer participated in the activity for 100 hours or less during the year. The test is also not met if anyone other than the taxpayer received compensation for managing the activity or if anyone spent more hours than the taxpayer managing the activity.

Note. For a thorough discussion of the seven tests for material participation, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

For purposes of applying the passive loss rules, a taxpayer's activities include those conducted through C corporations that are subject to IRC §469, S corporations, and partnerships.[82] IRC §469(a)(2) states that the rules under this Code section apply specifically to individuals, estates, trusts, certain C corporations, and personal service corporations. No such reference is made to S corporations, however.

The Tax Court recently held that activities conducted through S corporations are also subject to the passive loss rules (including the self-rental rules), as are the other entities specifically mentioned.[83] In its opinion, the Tax Court noted several previous cases in which taxpayer activities conducted through S corporations were subject to passive activity rules.

80. This term is used within the meaning of Treas. Reg. §1.469-2(e)(2).

81. Temp. Treas. Reg. §1.469-5T(a).

82. Treas. Reg. §1.469-4.

83. *Williams v. Comm'r,* TC Memo 2015-76 (Apr. 16, 2015).

Example 8. Madge Juniper operates a construction business as a sole proprietor. Juniper, LLC (of which Madge is the 100% owner) owns an office building. Juniper, LLC, rents the office building to Madge's construction business at a fair rental price.

This arrangement is subject to the self-rental rule. The building owned by the LLC is rented by the construction company for use in a trade or business in which Madge materially participates.

Example 9. Harry Ruffcorn is a 1% shareholder in Imagine That, Inc., an S corporation that runs an advertising business. Harry does not materially participate in the business. Harry is also a 50% owner of a building that Imagine That, Inc., rents for its offices.

This arrangement is not subject to the self-rental rules because Harry does not materially participate in the business of Imagine That, Inc.

Self-Rental Income and Losses

Self-Rental Income Is Nonpassive. As previously stated, a taxpayer's rental income from an item of property rented for use in a trade or business activity in which the taxpayer materially participates is recharacterized as nonpassive.

Self-Rental Losses Remain Passive. Conversely, the self-rental rule does not recharacterize as nonpassive a loss incurred through such a rental. A loss from a self-rental arrangement retains its character as passive.[84]

Passive activity losses are reported using Form 8582, *Passive Activity Loss Limitations.* A passive activity loss generally may not be deducted by the taxpayer in the year in which it occurs. Rather, the loss is **suspended** and carried forward for possible deduction in subsequent tax years.[85] The carry-forward period is indefinite.

The self-rental rule applies to an **item of property**, not an activity. This distinction remains even if the taxpayer has grouped activities as a single unit under the passive loss grouping rules.[86] This means that the taxpayer cannot calculate net income or loss for all self-rental activities within their business.

Example 10. June and Leland are married taxpayers who jointly own two commercial properties. They leased one property to FallsCo, an S corporation in which they materially participate. They leased the other property to SteelCo, a second S corporation in which they also materially participate. June and Leland grouped their rental activities to constitute a single activity.

June and Leland earned $100,000 from the property rented to SteelCo in 2014. They lost $30,000 on the property they rented to FallsCo.

Under the self-rental rule, the $100,000 in rental income received from SteelCo is recharacterized as nonpassive income. The $30,000 loss from the FallsCo property remains a passive loss. As such, the loss from the FallsCo property cannot offset the income from the SteelCo property.

The $30,000 loss from FallsCo is suspended because June and Leland do not have any additional passive income against which the loss can be applied. The $100,000 in self-rental income characterized as nonpassive income is **not** reported as income on Form 8582.

June and Leland's Schedule E, *Supplemental Income and Loss,* and Form 8582 follow.

84. IRC §469(a)(1)(A).

85. IRC §469(b).

86. Treas. Reg. §1.469-4(c)(1).

For Example 10

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

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
▶ **Attach to Form 1040, 1040NR, or Form 1041.**
▶ **Information about Schedule E and its separate instructions is at *www.irs.gov/schedulee.***

OMB No. 1545-0074
2014
Attachment Sequence No. 13

Name(s) shown on return: **June and Leland Mensching**
Your social security number: **999-88-7777**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No
B If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

1a	Physical address of each property (street, city, state, ZIP code)
A	132 Restaurant Lane, Lansing, IN 87890
B	134 Steel Lane, Lansing, IN 87890
C	

1b	Type of Property (from list below)
A	7
B	7
C	

2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the **QJV** box only if you meet the requirements to file as a qualified joint venture. See instructions.

	Fair Rental Days	Personal Use Days	QJV
A	365		☐
B	365		☐
C			☐

Type of Property:
1 Single Family Residence
2 Multi-Family Residence
3 Vacation/Short-Term Rental
4 Commercial
5 Land
6 Royalties
7 Self-Rental
8 Other (describe)

Income: Properties:		A	B	C
3 Rents received	3	25,000	150,000	
4 Royalties received	4			
Expenses:				
5 Advertising	5			
6 Auto and travel (see instructions)	6			
7 Cleaning and maintenance	7			
8 Commissions	8			
9 Insurance	9	4,000	7,000	
10 Legal and other professional fees	10	5,000	5,000	
11 Management fees	11	10,000	10,000	
12 Mortgage interest paid to banks, etc. (see instructions)	12			
13 Other interest	13			
14 Repairs	14	20,000		
15 Supplies	15			
16 Taxes	16			
17 Utilities	17		15,000	
18 Depreciation expense or depletion	18	16,000	13,000	
19 Other (list) ▶	19			
20 Total expenses. Add lines 5 through 19	20	55,000	50,000	
21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file **Form 6198**	21	(30,000)	100,000	
22 Deductible rental real estate loss after limitation, if any, on **Form 8582** (see instructions)	22	( )	( )	( )

23a Total of all amounts reported on line 3 for all rental properties	23a	175,000
b Total of all amounts reported on line 4 for all royalty properties	23b	
c Total of all amounts reported on line 12 for all properties	23c	
d Total of all amounts reported on line 18 for all properties	23d	29,000
e Total of all amounts reported on line 20 for all properties	23e	105,000
24 **Income.** Add positive amounts shown on line 21. **Do not** include any losses	24	100,000
25 **Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	(0)
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26	100,000

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11344L **Schedule E (Form 1040) 2014**

For Example 10

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.
▶ Information about Form 8582 and its instructions is available at *www.irs.gov/form8582*.

OMB No. 1545-1008
2014
Attachment Sequence No. 88

Name(s) shown on return	Identifying number
June and Leland Mensching	999-88-7777

Part I **2014 Passive Activity Loss**

Caution: *Complete Worksheets 1, 2, and 3 before completing Part I.*

	Rental Real Estate Activities With Active Participation (For the definition of active participation, see **Special Allowance for Rental Real Estate Activities** in the instructions.)				
1a	Activities with net income (enter the amount from Worksheet 1, column (a))	1a			
b	Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	(30,000)		
c	Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	( )		
d	Combine lines 1a, 1b, and 1c			1d	(30,000)
	Commercial Revitalization Deductions From Rental Real Estate Activities				
2a	Commercial revitalization deductions from Worksheet 2, column (a)	2a	( )		
b	Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	( )		
c	Add lines 2a and 2b			2c	( )
	All Other Passive Activities				
3a	Activities with net income (enter the amount from Worksheet 3, column (a))	3a			
b	Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	( )		
c	Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c	( )		
d	Combine lines 3a, 3b, and 3c			3d	
4	Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used			4	(30,000)

If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
- Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

Caution: *If your filing status is married filing separately and you lived with your spouse at any time during the year,* **do not** *complete Part II or Part III. Instead, go to line 15.*

Part II **Special Allowance for Rental Real Estate Activities With Active Participation**

Note: *Enter all numbers in Part II as positive amounts. See instructions for an example.*

5	Enter the **smaller** of the loss on line 1d or the loss on line 4			5	(30,000)
6	Enter $150,000. If married filing separately, see instructions	6	150,000		
7	Enter modified adjusted gross income, but not less than zero (see instructions)	7	160,000		
	Note: *If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.*				
8	Subtract line 7 from line 6	8			
9	Multiply line 8 by 50% (.5). **Do not** enter more than $25,000. If married filing separately, see instructions			9	
10	Enter the **smaller** of line 5 or line 9			10	0

If line 2c is a loss, go to Part III. Otherwise, go to line 15.

Part III **Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities**

Note: *Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.*

11	Enter $25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	11	
12	Enter the loss from line 4	12	
13	Reduce line 12 by the amount on line 10	13	
14	Enter the **smallest** of line 2c (treated as a positive amount), line 11, or line 13	14	

Part IV **Total Losses Allowed**

15	Add the income, if any, on lines 1a and 3a and enter the total	15	0
16	**Total losses allowed from all passive activities for 2014.** Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return	16	0

For Paperwork Reduction Act Notice, see instructions. Cat. No. 63704F Form **8582** (2014)

5

SELF-RENTAL RULE AND THE NET INVESTMENT INCOME TAX

Effective January 1, 2013, the Affordable Care Act[87] imposed a 3.8% tax on net investment income for high-income taxpayers. Investment income typically includes rental income and other passive business income. However, the final NIIT regulations[88] clarified that rental income recharacterized as nonpassive under the self-rental rule[89] is also treated as nonpassive for purposes of the NIIT.[90] Accordingly, **self-rental income is not subject to the NIIT.**

> **Example 11.** Using same facts as **Example 10,** except Leland had $300,000 in Form W-2 wages and $3,000 of interest income. June and Leland's NIIT is reported on Form 8960, which follows.

Form **8960** — Department of the Treasury, Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to your tax return.
▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

OMB No. 1545-2227 — 2014 — Attachment Sequence No. 72

Name(s) shown on your tax return: **June and Leland Mensching** — Your social security number or EIN: **999-88-7777**

Part I Investment Income
☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	3,000
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	100,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	(100,000)		
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property (see instructions)	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	3,000
Part II	**Investment Expenses Allocable to Investment Income and Modifications**				
9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	
Part III	**Tax Computation**				
12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-			12	3,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	463,000		
14	Threshold based on filing status (see instructions)	14	250,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	213,000		
16	Enter the smaller of line 12 or line 15			16	3,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). **Enter here and include on your tax return** (see instructions)			17	114
	Estates and Trusts:				

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87. PL No. 111-152, §1402(a)(1), 124 Stat. 1029.

88. IRS Ann. 2014-18, 2014-17 IRB 983.

89. Treas. Reg. §1.469-2(f)(6).

90. Treas. Reg. §1.1411-5(b)(2)(i).

SELF-RENTAL RULE AND SELF-EMPLOYMENT TAX

Rentals from real estate and from personal property leased with real estate are excluded from the definition of self-employment (SE) income.[91] This means that **income from self-rental properties does not trigger SE tax.**

This exclusion does not apply to the rental of farmland when the owner materially participates in the farming operation.[92] Rentals involving the production of agricultural or horticultural commodities are subject to SE tax if the taxpayer materially participates in the production or the management of production on the land.

> **Note.** For more information about farm real estate rentals and the SE tax issue, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 6: Rental Activities. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Example 12. Bill owns a parcel of farmland in his own name. He rents the farmland to FarmCo, a C corporation he owns with his son. Both Bill and his son materially participate in the farming operation. Bill is subject to SE tax on the rent he receives from FarmCo.

REPORTING OF CERTAIN CASH PAYMENTS

IRC §6050I requires a person engaged in a trade or business to report a transaction in which more than $10,000 in cash is received. Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business,* is used for this purpose. Reporting is also required if more than $10,000 in cash is received during **any 12-month period** in two or more related transactions.

To understand the reporting requirements, it is necessary to know the definitions of several key terms.[93] The most important terms are the following.

- Person
- Cash
- Transaction
- Related transactions
- Designated reporting transaction

> **Note.** In addition to IRC §6050I and Treas. Reg. §1.6050I-1, IRS Pub. 1544, *Reporting Cash Payments of Over $10,000 (Received in a Trade or Business),* is a helpful resource for the definitions used in these reporting rules.

For purposes of this rule, the term **person** is defined as an individual, trust, estate, partnership, association, company, or corporation.[94]

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91. IRC §1402(a)(1).

92. Ibid.

93. Treas. Reg. §1.6050I-1(c).

94. Treas. Reg. §1.6050I-1(a)(1)(i); IRC §7701(a).

Cash is defined as either of the following.

- U.S. or foreign currency received in **any transaction**
- A cashier's check, money order, bank draft, treasurer's check, bank check, certified check, or traveler's check with a face amount of **$10,000 or less** that is received by the person in one of the following ways
  - In a **designated reporting transaction**
  - In **any transaction** in which the person receiving the payment knows that the payor is attempting to avoid the reporting of the transaction under these rules

Note. Cash does not include a payor's check drawn on the payor's own account, regardless of the amount of the check. In addition, **credit card payments**, **wire transfers**, **ATM card payments,** and **automatic electronic payments** received from a customer's account **do not constitute cash payments** under these rules.[95] Moreover, a cashier's check, money order, bank draft, or traveler's check with a face amount of **more than $10,000** that is received in a designated reporting transaction is **not** considered cash under these rules. According to IRS Notice 2014-21, virtual currency (such as Bitcoin) is treated as property and is not considered currency.

A **transaction** includes the following.

- A purchase of property or services
- The payment of a debt
- The exchange of cash for a negotiable instrument
- The receipt of cash to be placed in a trust or an escrow account

A single transaction may not be divided into a series of multiple transactions to avoid the reporting requirement.

Related transactions include transactions that occur within a 24-hour period. For example, if a person receives more than $10,000 in cash from two or more transactions with the same party within a 24-hour period, those transactions must be treated as a single transaction. This type of activity may result in a requirement to file Form 8300.

In addition, two or more transactions connected to the purchase of the same goods or services must also be treated as one transaction even if those transactions occurred more than 24 hours apart. Generally, if the recipient of the payments has reason to believe that two or more transactions are connected, those transactions must be treated as a single transaction. If the total amount of cash received within 12 months exceeds $10,000, a filing requirement exists.[96]

95. *Report of Cash Payments Over $10,000 Received in a Trade or Business – Motor Vehicle Dealership Q&As.* Jun. 10, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Cash-Payments-Over-10000-Received-in-a-Trade-or-Business-Motor-Vehicle-Dealership-QAs] Accessed on Aug. 10, 2015.

96. Ibid.

Example 13. Sierra is a travel agent. She receives $8,000 in U.S. currency from Ben for the purchase of airfare, hotel lodging, and related items for a conference. Ben and three others in his office will attend the conference. A week later, Ben meets with Sierra to let her know that two more people in the office will attend. Ben gives Sierra a money order for $4,000 for the costs associated with the two additional persons going on the same trip.

These two transactions are related transactions because each relates to purchases for the same trip. They must be treated as a single transaction. Because more than $10,000 in cash was received ($8,000 + $4,000 = $12,000), Sierra must use Form 8300 to report the receipt of the cash from Ben.

Observation. It may not always be clear to the recipient of payments whether multiple transactions with one customer are connected. There is no clear definition of "connected." This creates a gray area with respect to whether a filing requirement exists. To ensure compliance with filing rules, the recipient may consider asking the customer relevant questions or reporting payments that exceed $10,000 within a 12-month period in any event.

A **designated reporting transaction** is a retail sale of a consumer durable, a collectible, or a travel or entertainment activity.[97] These items are defined in the following table.

Consumer Durable	Collectibles	Travel or Entertainment Activity
Tangible personal property that is reasonably expected to remain useful for at least one year under ordinary usage and that has a sales price of more than $10,000	Generally, any works of art, rugs, antiques, gems, stamps, coins, or alcoholic beverages that have a sales price of more than $10,000	A travel or entertainment item relating to a single trip for which the sales price of all items included in a single transaction (or related transactions) is more than $10,000

Note. These reporting rules use the definition of **collectible** provided under IRC §408(m)(2), which pertains to IRA distributions. IRC §408(m)(3) provides exceptions to the IRA rules for acquisition of collectibles treated as a distribution by the IRA. These exceptions generally include coins made of precious metals and precious metal bullion. However, these excepted items under §408(m)(3) are **included** for purposes of these reporting requirements. For further details, see Treas. Reg. §1.6050I-1(c)(3) and IRC §§408(m)(2) and 408(m)(3).

Example 14. A customer purchases a car from EZ Auto Sales (EZ) in January 2015. The same customer purchases a second car from EZ in July 2015. Each car costs $7,500. The customer pays cash for each car. If EZ has no reason to believe the two purchases are connected, they may be considered separate transactions. EZ does not have a filing requirement because the amount of cash it received in each transaction is under $10,000.

However, if EZ has reason to believe these two purchases are connected, it must treat them as a single transaction. In this situation, the transaction is a designated reporting transaction in which more than $10,000 was received. Therefore, EZ has a reporting requirement.

97. Treas. Reg. §1.6050I-1(c)(1)(iii).

Example 15. Marissa is a travel agent, and Thoroughbred Enterprises, LLC (TE), is one of her largest clients. Clark is a member of TE and is planning a promotional event for 16 TE customers. TE will furnish the 16 customers with paid flights to Miami. From there, they will embark on a 2-day boat cruise to Key West. In Key West, TE will provide the 16 customers with tickets to an exclusive horse show. Some of TE's horses will compete in the show.

Clark contacts Marissa and asks her to make the necessary arrangements. Marissa informs Clark that the total cost is $17,200. Clark sends Marissa a cashier's check for this amount. Even though this is a designated reporting transaction, the cashier's check is not considered cash because it has a face value of more than $10,000. Marissa is not required to file Form 8300.

Example 16. Barry purchases silver coins from FX Coin Dealers (FX). The total purchase price is $11,500. Barry pays for the coins with $5,500 cash and a $6,000 money order he obtained from his bank. The sale of the coins is a retail sale of a collectible item and is thus a designated reporting transaction. Because the sale is a designated reporting transaction, the money order is treated as cash. More than $10,000 in cash is received in the transaction; therefore, FX must report this transaction.

Example 17. Use the same facts as **Example 16,** except Barry purchases the coins from Jeff. Jeff is a partner at the accounting firm where Barry works. Jeff does not operate a trade or business engaged in coin dealing. Jeff collects coins and agrees to sell the coins to Barry. This is not a retail sale; therefore, the sale is not a designated reporting transaction. Jeff is not required to report this transaction.

Example 18. Use the same facts as **Example 16,** except Barry pays FX for the coins using $9,000 cash and a personal check in the amount of $2,500. The check is drawn on Barry's personal checking account. The personal check does not fall under the definition of cash. Therefore, this is not considered a designated reporting transaction in which more than $10,000 of cash is received. FX does not need to report the transaction.

A designated reporting transaction generally **does not** include the following.

- A payment from a bank representing loan proceeds

Note. The recipient of the payment may rely on loan documents, a written statement from the bank, or similar documentation to treat an amount as loan proceeds.

- Certain payments in connection with installment sales
- Payments made for certain down-payment plans

Note. Guidance about Form 8300 uses the term "installment sales" in a general sense for sales involving periodic payments (i.e., this term does not refer to sales made using the installment method under IRC §453). For further details regarding the preceding exceptions, see Treas. Reg. §§1.6050I-1(c)(1)(iv), (v), and (vi) and IRS Pub. 1544, *Reporting Cash Payments of Over $10,000 (Received in a Trade or Business).*

Example 19. Vinny is engaged in the trade or business of selling used cars. Francine purchases a used car from Vinny for $14,000. On January 6, 2015, she pays Vinny $5,000 in cash. She also gives Vinny a cashier's check for $9,000. The cashier's check represents the proceeds of a car loan that Francine has arranged through her bank. The cashier's check is payable to both Vinny and Francine. It is accompanied by a letter from Francine's bank instructing Vinny to register a lien on the car title as security.

The sale of the car is a designated reporting transaction. However, because the $9,000 cashier's check represents loan proceeds, it is not considered cash. Vinny does not need to report the receipt.

Example 20. Use the same facts as **Example 19,** except Francine pays Vinny $5,000 in cash. To make full payment for the $14,000 car, she also gives him a $9,000 cashier's check. Francine did not require a loan for the car purchase. Because Vinny receives more than $10,000 in U.S. currency in this transaction, he must report the receipt.

HOW TO REPORT A TRANSACTION[98]

A transaction is reported using Form 8300. This form must generally be filed no later than the 15th day after the cash is received. If this date falls on a Saturday, Sunday, or legal holiday, the form is due on the next business day.

Note. Receipt of multiple payments relating to a single reportable transaction may result in a different due date or multiple due dates. This topic is discussed later.

Furnishing Required Information to the Buyer

The filer of Form 8300 must also provide a **single, annual, written statement** to the payor advising them that the receipt of their cash payment has been reported.[99] This written statement must be furnished to the payor on or before **January 31** of the year following the calendar year covered by the statement. This written statement must include the following information.

- The name and address of the Form 8300 filer (cash recipient)
- The name and phone number of the contact person for the business
- The aggregate amount of reportable cash received by the filer from the payor in all transactions between them during the year
- A statement indicating that the information is being reported to the IRS

Verification and TINs

The filer must **verify** the payor's identity. Generally, the use of any identification document sufficient for the cashing of a check (such as a driver's license or credit card) is acceptable.[100] However, for a payor who is not a U.S. citizen, a passport, alien identification card, or other official nationality or residence document must be used.[101]

Form 8300 is generally filed by mailing it to the following IRS office.

Internal Revenue Service
Detroit Computing Center
P.O. Box 32621
Detroit, MI 48232

Note. Alternatively, Form 8300 may be filed electronically using FinCEN's online filing system. For further details, go to **uofi.tax/15b5x2** [www.fincen.gov/news_room/nr/html/20120919.html]. The filer must register to use this online system.

98. Treas. Reg. §1.6050I-1(e) and the instructions for Form 8300.
99. Treas. Reg. §1.6050I-1(f).
100. Treas. Reg. §1.6050I-1(e)(3).
101. Ibid.

If the payor engaged in only one transaction with the filer in which Form 8300 was required, a copy of the form may be furnished to them in satisfaction of the requirement for a single annual written statement. However, furnishing copies of two or more Forms 8300 in connection with each transaction does not satisfy the requirement. A single written notice must be prepared for all transactions occurring during the year that required a Form 8300.[102]

Note. Filing a copy of Form 8300 to meet the single annual written statement requirement is not an advisable means of compliance even in a situation in which it is allowed. Form 8300 includes sensitive information about the vendor, such as their social security number or employer identification number. Accordingly, it is advisable to prepare an alternative statement that may be used in lieu of a copy of Form 8300. The governing regulation does not prescribe the format of an alternative statement, but it does outline the information that must be furnished. The required information is generally parallel to the substantive information on Form 8300. For further details on alternative form requirements, see Treas. Reg. §1.6050-1(f).

The payor's taxpayer identification number (TIN) must be provided on Form 8300. If the filer is unable to obtain the payor's TIN, they should still file the form. The filer may avoid penalties for failing to provide the TIN if the failure to obtain it was reasonable under the circumstances. At a minimum, the filer should take the following steps.[103]

- Request the payor's TIN at the time of the transaction. If the payor refuses the request, the filer should inform them that failing to provide their TIN may subject them to a $50 penalty under IRC §6723.
- Contemporaneously document this TIN request and maintain those records so they can be provided to the IRS at a later date, if requested.
- File Form 8300 without the TIN but include an explanation of why it is not included.
- The same request for the payor's TIN must be made again on or before December 31 of the year in which the transaction occurred (or on or before January 31 for a transaction occurring in the preceding December).

Note. For further information about the steps that must be taken if the payor's TIN cannot be obtained, see Treas. Reg. §301.6724-1(e).

Example 21. Use the same facts as **Example 20.** This was the only transaction with Francine during 2015 in which Vinny received reportable cash. Because Vinny received over $10,000 in cash in a designated reporting transaction on January 6, 2015, he must file Form 8300 to report receipt of this cash on or before January 21, 2015.

This was Vinny's only reportable transaction with Francine during 2015; therefore, he may furnish Francine with a copy of Form 8300. Doing so satisfies the requirement to provide her with a single, annual, written statement of the disclosure. Francine's copy of Form 8300 must be furnished to her on or before January 31, 2016.

Vinny's completed Form 8300 follows.

Note. For further details on filing Form 8300, see the Form 8300 instructions and IRS Form 8300 Reference Guide (available at **uofi.tax/15b5x3** [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/IRS-Form-8300-Reference-Guide]).

Note. Form 8300 is available at **uofi.tax/15b5x5** [www.irs.gov/pub/irs-pdf/f8300.pdf].

102. IRM 4.26.10.7.2 (2012).

103. *Report of Cash Payments Over $10,000 Received in a Trade or Business – Motor Vehicle Dealership Q&As.* Jun. 10, 2015.Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Cash-Payments-Over-10000-Received-in-a-Trade-or-Business-Motor-Vehicle-Dealership-QAs] Accessed on Aug. 10, 2015; IRM 4.26.10.10.4.1 (2012).

For Example 21

IRS Form **8300** (Rev. August 2014) Department of the Treasury Internal Revenue Service

Report of Cash Payments Over $10,000 Received in a Trade or Business

▶ See instructions for definition of cash.
▶ Use this form for transactions occurring after August 29, 2014. Do not use prior versions after this date.
For Privacy Act and Paperwork Reduction Act Notice, see the last page.

FinCEN Form **8300** (Rev. August 2014) OMB No. 1506-0018 Department of the Treasury Financial Crimes Enforcement Network

1 Check appropriate box(es) if: a ☐ Amends prior report; b ☐ Suspicious transaction.

Part I Identity of Individual From Whom the Cash Was Received

2 If more than one individual is involved, check here and see instructions . . . ▶ ☐

3 Last name	4 First name	5 M.I.	6 Taxpayer identification number
Lazzarro	Francine	K	1 2 3 4 5 6 7 8 9

7 Address (number, street, and apt. or suite no.)	8 Date of birth (see instructions) ▶ MMDDYYYY
545 Gates Street, Apt. #456	0 6 0 7 1 9 6 0

9 City	10 State	11 ZIP code	12 Country (if not U.S.)	13 Occupation, profession, or business
Brooklyn	N Y	11201		Interior Designer

14 Identifying document (ID) a Describe ID ▶ Driver's License b Issued by ▶ Dept. of Motor Vehicles
c Number ▶

Part II Person on Whose Behalf This Transaction Was Conducted

15 If this transaction was conducted on behalf of more than one person, check here and see instructions . . . ▶ ☐

16 Individual's last name or organization's name	17 First name	18 M.I.	19 Taxpayer identification number

20 Doing business as (DBA) name (see instructions)	Employer identification number

21 Address (number, street, and apt. or suite no.)	22 Occupation, profession, or business

23 City	24 State	25 ZIP code	26 Country (if not U.S.)

27 Alien identification (ID) a Describe ID ▶ b Issued by ▶
c Number ▶

Part III Description of Transaction and Method of Payment

28 Date cash received MMDDYYYY	29 Total cash received	30 If cash was received in more than one payment, check here . . . ▶ ☐	31 Total price if different from item 29
0 1 0 6 2 0 1 5	$ 14,000 .00		$ .00

32 Amount of cash received (in U.S. dollar equivalent) (must equal item 29) (see instructions):

a	U.S. currency	$ 5,000 .00	(Amount in $100 bills or higher $ .00)
b	Foreign currency	$ .00	(Country ▶)
c	Cashier's check(s)	$ 9,000 .00	Issuer's name(s) and serial number(s) of the monetary instrument(s) ▶
d	Money order(s)	$ .00	
e	Bank draft(s)	$ .00	
f	Traveler's check(s)	$ .00	

33 Type of transaction
a ☒ Personal property purchased
b ☐ Real property purchased
c ☐ Personal services provided
d ☐ Business services provided
e ☐ Intangible property purchased
f ☐ Debt obligations paid
g ☐ Exchange of cash
h ☐ Escrow or trust funds
i ☐ Bail received by court clerks
j ☐ Other (specify in item 34) ▶

34 Specific description of property or service shown in 33. Give serial or registration number, address, docket number, etc. ▶ 2012 Buick Enclave, White MV Reg. #B-89876-456 VIN 1P3BP49K7JF111960

Part IV Business That Received Cash

35 Name of business that received cash	36 Employer identification number
Vinny's Auto Sales and Service	3 8 7 7 7 8 7 8 7

37 Address (number, street, and apt. or suite no.)	Social security number
316 Northern Avenue	

38 City	39 State	40 ZIP code	41 Nature of your business
Brooklyn	N Y	11202	Car Dealership

42 Under penalties of perjury, I declare that to the best of my knowledge the information I have furnished above is true, correct, and complete.

Signature ▶ Authorized official Title ▶

43 Date of signature MMDDYYYY	44 Type or print name of contact person	45 Contact telephone number
0 1 2 1 2 0 1 5	Vinny Molinaro	212-555-6667

IRS Form **8300** (Rev. 8-2014) Cat. No. 62133S FinCEN Form **8300** (Rev. 8-2014)

5

MULTIPLE PAYMENTS[104]

Special rules exist for transactions in which multiple payments are received in a single (or two or more related) transaction(s). The timing and amount of such payments determines the filing frequency and deadlines.

If the business receives multiple payments in a designated reporting transaction and the first payment is less than $10,000 of cash (as cash is defined under these rules), the business must add the first payment to later payments made within 12 months of the date the first payment was received. When these total cash payments exceed $10,000, Form 8300 must be filed to disclose the first payment and subsequent payments. This Form 8300 must be filed within 15 days of the receipt of the **last** payment that caused the total to exceed $10,000.

After filing this Form 8300, the business begins a new count of cash payments from the same customer. Any time more than $10,000 in cash payments has been received within a 12-month period from that customer in a designated reporting transaction, Form 8300 must be filed.

The following table summarizes these rules.

Nature of Payments in Multiple Payment Transaction	Rule
Initial payment exceeds $10,000	Recipient must file Form 8300 within 15 days of receipt of initial payment.
Initial payment is $10,000 or less	Initial payment and subsequent payments made within a 12-month period are aggregated. If the aggregate amount exceeds $10,000, a filing requirement is triggered. Form 8300 must be filed within 15 days of receipt of the payment that caused the aggregate amount to exceed $10,000.
Additional payments after filing Form 8300	After filing Form 8300, an additional Form 8300 is required each time previously unreported amounts total more than $10,000 in any 12-month period.

104. Treas. Reg. §1.6050I-1(b).

Example 22. Louis purchases a powerboat from Landlocked Marine Sales (LMS) for $36,000. The terms include making a down payment of $15,000 on July 1, 2014. Louis provides $6,000 of cash and a $9,000 certified check for the down payment. Louis is also required to make regular monthly installments of $1,500 for the next 14 months, starting in August 2014. Each monthly payment is due on the first day of the month. The schedule of payments follows.

Date		Payment Due
2014	July	$15,000 down payment
	Aug	1,500
	Sep	1,500
	Oct	1,500
	Nov	1,500
	Dec	1,500
2015	Jan	1,500
	Feb	1,500
	Mar	1,500
	Apr	1,500
	May	1,500
	Jun	1,500
	Jul	1,500
	Aug	1,500
	Sep	1,500
Total payments		$36,000

Louis does not finance the boat. He makes the subsequent monthly payments using money orders.

LMS must file Form 8300 to disclose receipt of the $15,000 down payment. Doing so is required because the down payment is a cash receipt of more than $10,000 in a designated reporting transaction. This Form 8300 must be filed on or before July 16, 2014.

The monthly payments are considered cash because Louis is using money orders to make monthly payments in a designated reporting transaction. In January 2015, LMS has received a total of six money orders for monthly payments (from August 2014 through January 2015), which total $9,000 (6 × $1,500). None of these amounts is reportable because the total does not exceed $10,000.

In February 2015 (when the seventh monthly payment is received), the total of the monthly payments is $10,500 (7 × $1,500). Because this payment causes the total monthly unreported cash payments to exceed $10,000, a Form 8300 filing requirement is triggered. The amount in excess of $10,000 was received within a 12-month period. The Form 8300 to report the seven monthly payments is due on February 16, 2015.

LMS must also ensure that it provides Louis with a single, annual, written statement for 2014 indicating that the down payment was reported. LMS must also provide a separate statement to Louis for the payments reported in 2015. Each written statement to Louis is due January 31 of the year following the year in which the payments were received.

SUSPICIOUS TRANSACTIONS

A **suspicious transaction** is a transaction in which it appears that a person is attempting to cause the recipient of the payment either to file a false Form 8300 or to refrain from filing this form.[105]

Even if less than $10,000 in cash is received, the recipient of the payment may voluntarily file Form 8300 to report the suspicious transaction. The filer does this by checking the box that is immediately above part I of Form 8300, which indicates the filer is reporting a suspicious transaction.

105. Instructions for Form 8300.

PENALTIES

IRC §§6721 and 6722 outline the civil penalties for failure to file Form 8300. The penalties are summarized in the following table.[106]

Violation	Code Section	Penalty Amount
Failure to file	IRC §§6721(a)(1) and 6721(d)(1)(A)	• $100 per return not filed • Annual limit of $1.5 million (businesses with gross receipts of more than $5 million) • Annual limit of $500,000 (businesses with gross receipts of $5 million or less)
Failure to file with intentional disregard	IRC §6721(e)(2)(C)	• The greater of $25,000 or the amount of cash received in the transaction (up to a maximum of $100,000) • No annual limit
Failure to furnish written statement to payor	IRC §§6722(a)(1) and 6722(d)(1)(A)	• $100 per violation • Annual limit of $1.5 million (businesses with gross receipts of $5 million or less) • Annual limit of $500,000 (businesses with gross receipts not exceeding $5 million)
Failure to furnish written statement to payor with intentional disregard	IRC §6722(e)	• The greater of $250 per violation or 10% of the aggregate amount required to be reported correctly • No annual limit

Note. The penalties under IRC §§6721(a)(1) and 6722(a)(1) may be reduced if a failure to file is corrected on or before 30 days of the filing date. For further details, see IRC §§6721(b)(1) and 6722(b)(1).

Criminal penalties may be assessed for the following.[107]

- Willful failure to file Form 8300
- Filing a false or fraudulent Form 8300
- Stopping, or trying to stop, a Form 8300 from being filed
- Setting up, helping to set up, or trying to set up, a transaction in a way that would make it seem unnecessary to file Form 8300

106. *Form 8300 Penalties Increase.* Apr. 2, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Form-8300-Penalties-Increase] Accessed on Apr. 6, 2015.

107. See IRC §§7203 and 7206.