# Chapter 3: Small Business Issues





**Please note.** Corrections were made to this workbook through January of 2018. 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 short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.


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## Chapter Summary

There are important distinctions between trade or business income and not-for-profit income. Trade or business income is reported on Schedule C along with associated business expenses and the resulting net income or loss is a component of the taxpayer's taxable income and self-employment (SE) income. Not-for-profit income is reported on Form 1040, line 21 (other income), and expenses are deducted on Schedule A. Not-for-profit income is not subject to SE tax. The factors used to distinguish between these income types are described.

The income and employment tax treatment of sole proprietorships, partnerships, S corporations, and C corporations are described. S corporations offer opportunities to save SE tax on shareholders' distributive income but the transfer of income between taxpayers, particularly for employment tax savings, can be impeded by the assignment of income doctrine.

Securities investors and traders are compared. Absent a "mark-to-market" (MTM) election, both types of taxpayers report trading income on Schedule D and Form 8949. However, whereas investors claim investment-related expenses on Schedule A, traders deduct trading expenses on Schedule C and may also qualify for office in the home deductions. Investment interest deductions, capital loss rules, and MTM transactions are also addressed.

Landlords and real estate professionals both derive income from real estate rentals and are subject to ordinary income tax but not SE tax. Losses of real estate professionals are usually fully deductible, but the passive activity rules may restrict deductible losses for landlords.

Two Code sections provide tax incentives to small business investors. IRC §1202 allows noncorporate taxpayers to exclude a substantial portion of gain from the sale or exchange of qualified small business stock (QSBS). IRC §1244 allows eligible taxpayers disposing of QSBS to reduce ordinary income by up to $50,000 ($100,000 if MFJ) of QSBS losses.

Small business taxpayers utilizing a qualifying medical expense reimbursement plan (i.e., HSA, FSA, or HRA) enjoy significant tax benefits. FSAs are particularly advantageous because pre-tax employee contributions are not subject to employer FICA withholding and are exempt from income and FICA taxes for the employee.

The 2015 PATH Act extended bonus depreciation for eligible property acquired and placed in service before January 1, 2020. The PATH Act also added two new eligible property classes (qualified improvement property and preproduction costs of fruit and nut-bearing plants).

Business property dispositions are subject to loss recapture rules. A net §1231 gain is recharacterized as ordinary income to the extent of the §1231 losses within the preceding five years. IRC §1245 gain is recaptured as ordinary income, to the extent of depreciation previously taken on the asset. For IRC §1250 property, gain is recaptured as ordinary income to the extent that the depreciation previously claimed exceeded straight-line depreciation.

Taxpayers may file either a Form 3115 or an amended return to correct erroneous depreciation deductions in certain situations. Depending on the circumstances, there are automatic and advance consent procedures.

No gain or loss is recognized under the like-kind exchange (LKE) rules, if qualified business or investment property is exchanged for other like-kind property in a qualifying transaction. However, certain adjustments may be required to the basis of the acquired property.

## DEFINING BUSINESS INCOME

**Note.** This chapter discusses trade or business income as reported on Schedule C. Trade or business income may also be reported on Schedule E, Schedule F, or as pass-through income from a partnership or S corporation.



What constitutes trade or business income? Understanding the answer to this question is key to determining the following.

- Whether expenses can be directly or indirectly deducted from income
- Whether expenses in excess of income from an activity can create an ordinary business loss
- Whether the resulting income is subject to self-employment (SE) tax in addition to income tax
- Whether the income qualifies for purposes of the earned income credit

**Caution.** There are a number of nontax consequences to classifying an activity as a business or as a not-for-profit activity. For example, the classification can affect borrowing ability and social security benefits.

Business income generally arises from two types of transactions.

1. Nonemployee income generated from **fee-based services**
2. **Product sales**

Although this seems to narrow the question of whether income is business-related, the Code is not that straightforward.

- If someone drives their neighbor 150 miles to and from the airport and their neighbor pays them $100 for their services, do they have a driving business?
- If someone gets paid by the state to babysit full time for their grandchildren, do they have a babysitting business?
- If someone makes and sells crafts for pleasure with no expectation of profit, do they have a craft business?

The answers to these questions are "probably not," although each scenario would be subject to facts-and-circumstances testing to fully determine whether the activity actually constitutes a trade or business.

### TRADE OR BUSINESS INCOME VS. NOT-FOR-PROFIT INCOME

**Note.** For comprehensive coverage of hobby vs. for-profit activities, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Hobby Losses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Nonemployee income related to the sale of products or services is classified as either trade or business income or not-for-profit income.

As shown in the following table, ordinary and necessary business expenses reduce trade or business income before income and SE taxes are imposed.[1] Not-for-profit income can be offset only up to the amount of income from the activity and only if the taxpayer can itemize deductions. Not-for-profit income is taxed at the taxpayer's ordinary income tax rate. SE tax does not apply.

| | Trade or Business Income | Not-for-Profit Income |
|---|---|---|
| Cost of goods sold | Directly deducted | Reduces gross receipts |
| Deduction for expenses | Directly deducted | Indirectly deducted, but only if the taxpayer can itemize [2] |
| Expenses in excess of income | Loss allowed [3] | No loss allowed [4] |
| Subject to SE tax | Yes [5] | No [6] |
| Where reported on Form 1040 | Schedule C or F | Line 21 (other income) |

**Simply receiving money from selling products or services is not a firm indication that a taxpayer is engaged in a trade or business.** In 1940, the Supreme Court decision in *Deputy v. du Pont* determined that "carrying on any trade or business . . . involves holding one's self out to others as engaged in the selling of goods or services."[7] Taxpayers must openly represent themselves to potential customers as being "in" business.

## Continuity and Regularity

Rev. Rul. 58-112 stipulates two factors that should be considered "in conjunction with other existent facts" when determining whether income arises from a trade or business.[8] Both of these factors must be present for an activity to be considered a trade or business.

1. **Continuity and regularity** of activities, as distinguished from an occasional or sporadic activity.
2. The **purpose of livelihood or profit** from the activity

In this ruling, the IRS determined that income a taxpayer received in four payments from facilitating the sale of his company's stock to a corporation was **not** trade or business income because the taxpayer engaged in this transaction only one time.

Rev. Rul. 55-431[9] states that a person **regularly engaged** in a nonemployee occupation or profession is considered to be engaged in a trade or business. In this ruling, the IRS found that a person who accepts payment for "occasional" speaking engagements is not engaged in a trade or business.

This regularity requirement is also in Rev. Rul. 77–356[10] as it applies to speechmaking. In 1977, a member of Congress requested a ruling on whether he was subject to SE tax on $1,500 he received from 10 speaking engagements during the tax year. The Congress member received frequent invitations to speak but accepted only a limited number of engagements based on his availability.

1. IRC §162.
2. IRS Pub. 535, *Business Expenses*.
3. Ibid.
4. IRC §183(b)(2).
5. IRC §1402.
6. Rev. Rul. 55-258, 1955-1 CB 433.
7. *Deputy et al. v. du Pont*, 308 U.S. 488 (1940), Frankfurter, J., concurring.
8. Rev. Rul. 58-112, 1958-1 CB 323.
9. Rev. Rul. 55-431, 1955-2 CB 312.
10. Rev. Rul. 77-356, 1977-2 CB 317.

The IRS determined the Congress member was engaged in a separate trade or business apart from his Congressional employment and that the income from speechmaking was subject to SE tax. The ruling stated "[t]he frequency of the speaking engagements indicates a degree of recurrence, continuity, and availability for speech making, and the amount received during the year was compensatory."

There is no definitive test to determine the degree of continuity and regularity required to be considered a trade or business. Each case is evaluated on its own unique set of facts and circumstances.



> **Note.** The 2-factor test of Rev. Rul. 58-112 was affirmed by the U.S. Supreme Court in the landmark case, *Comm'r v. Groetzinger.*[11]

## Good-Faith Profit Motive

The IRS clarifies that taxpayers must display a "good faith" profit motive for an activity to rise to the level of a trade or business. It is important to note that the IRS does not stipulate an activity must make a profit, only that the taxpayer **intends** to go into business to make a profit. If an endeavor is unprofitable, the IRS expects the taxpayer "to make ongoing efforts" to make the activity profitable.[12]

Treas. Reg. §1.183-2(b) provides a list of nine relevant factors that normally may be used to assess a taxpayer's profit motive. This list is not considered exhaustive, and the regulation cautions that no single factor determines a profit motive. These rules are often referred to as the "**hobby vs. business**" rules.

The regulation further states that profit motive should not be presumed or discarded based simply on the number of factors for or against a profit motive. The courts accord more weight to objective facts than to the taxpayer's statement of intent.[13]

**Factors Used to Determine Profit Motive.** All facts and circumstances regarding an activity should be taken into account to determine profit motive, including, but not limited to, the following factors.[14]

1. **The manner in which the taxpayer carries on the activity** — If the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records, this may indicate the taxpayer has a profit motive. A change of operating methods, adoption of new technologies, or abandonment of unprofitable methods may also indicate a profit motive.

2. **The expertise of the taxpayer and the taxpayer's advisors** — Preparation for the activity by studying its accepted business, economic, and scientific practices may indicate the taxpayer has a profit motive. If a taxpayer has such preparation or obtains expert advice but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated.

3. **The time and effort the taxpayer expends in carrying on the activity** — The fact that the taxpayer devotes much of their personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of their energies to the activity may also be evidence that the activity is engaged in for profit.

4. **The taxpayer's expectation that assets used in the business may appreciate in value** — The taxpayer may intend to derive a profit from the operation of the activity if an overall profit will result when appreciation in the value of assets used in the activity is realized.

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11. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987); see also *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992).

12. *Business Activities*. Jan. 5, 2017. IRS. [irs.gov/businesses/small-businesses-self-employed/business-activities] Accessed on May 6, 2017.

13. See e.g., *Dreicer v. Comm'r*, 78 TC 642 (1982).

14. Treas. Reg. §1.183-2(b).

5. **The taxpayer's record of prior business successes or failures** — The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that the taxpayer is engaged in the present activity for profit.

6. **The taxpayer's history of income and losses from the particular activity** — If losses are sustained because of unforeseen or fortuitous circumstances that are beyond the control of the taxpayer, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized is strong evidence that the activity is engaged in for profit.

7. **The amount of occasional profits, if any, that are earned** — The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent.

8. **The taxpayer's financial status aside from the activity** — The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit.

9. **The amount of personal pleasure or recreational value the taxpayer receives from the activity** — The presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially when there are recreational or personal elements involved. An activity is not treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit.

**Presumption of Profit.** Under IRC §183, a taxpayer is presumed to have a profit motive if the taxpayer's income from an activity exceeds expenses for the activity in three out of five of the previous consecutive tax years.[15] Taxpayers engaged in breeding, training, showing, or racing horses are presumed to have a profit motive if they show a profit in two out of seven consecutive tax years.[16]

The profit presumption is a semi-safe harbor for taxpayers. The IRS can still argue against the taxpayer's profit motive, but the burden of proof shifts from the taxpayer to the IRS if the taxpayer satisfies the presumption test.[17]

To postpone an IRS decision on whether an activity is engaged in for profit, taxpayers may elect to file Form 5213, *Election to Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit*. If the taxpayer timely files this form, the IRS generally postpones the determination until after the end of the fourth tax year (or sixth tax year for a horse activity). To make the election, the taxpayer must file this form within three years after the due date (excluding extensions) of their return for the first tax year in which they engaged in the activity, or within 60 days after receiving a notice that the IRS proposes to disallow deductions attributable to the activity.[18]

## Trade or Business Income and Expense Reporting

A sole proprietor reports trade or business income on Schedule C, *Profit or Loss From Business*. Ordinary and necessary business expenses can be deducted from trade or business income. The resulting net income or loss is factored into the taxpayer's taxable income and used as the starting point for computing SE tax.

Ordinary and necessary business expenses include noncapital expenses that are appropriate and useful to carrying on the business.[19]

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15. IRC §183(d).
16. Ibid.
17. *IRC §183: Activities Not Engaged in For Profit (ATG).* Jun. 2009. IRS. [irs.gov/pub/irs-utl/irc183activitiesnotengagedin for profit.pdf] Accessed on May 25, 2017.
18. Instructions for Form 5213.
19. *Welch v. Helvering*, 290 U.S. 111 (1933).

**SE Tax Rates.** For sole proprietors, net SE income from Schedule C is reported on Schedule SE, *Self-Employment Tax*. A 15.3% SE tax is imposed on 92.35% of net SE income, if net SE income is $400 or more.

**Note.** For more information on SE tax, see the discussion on SECA tax in the "Individual vs. Entity Income Subject to FICA and SECA" section of this chapter.



**Example 1.** Mary's net 2017 income from her dog grooming business was $10,000. She had no other income subject to SE tax. Mary's 2017 SE tax is computed as follows.

| | |
|---|---|
| Net profit from Schedule C | $10,000 |
| Multiply net profit by 92.35% | × 92.35% |
| Amount subject to SE tax | $ 9,235 |
| Multiplied by 15.3% SE tax rate | × 15.3% |
| SE tax | $ 1,413 |

## Not-for-Profit Income and Expense Reporting

If it is determined that an activity is **not** engaged in for profit, gross income (net of cost of goods sold) from the activity is reported on Form 1040, line 21 (other income), and expenses are deducted on Schedule A, *Itemized Deductions*.

**Gross Income Defined.** Gross income for an activity not engaged in for profit equals gross receipts less the **cost of goods sold,** as long as this practice is consistently followed and conforms to generally accepted acounting methods.[20] Treas. Reg. §1.183-1(e) defines not-for-profit gross income as including the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. This generally includes capital gains and rents received for the use of property held in connection with the not-for-profit activity.

**Expense Categorization.** Treas. Reg. §1.183-1(b) stipulates three ordered categories of deductions for expenses related to not-for-profit activities. All three categories of expenses are deductible on the taxpayer's Schedule A in the following order.

- **Tier 1.** These are expenses that would otherwise be deductible under other sections of the Code, including mortgage interest, real estate taxes, contributions, and casualty and theft losses. These expenses are included in their respective sections of Schedule A.
- **Tier 2.** These are expenses that would be deductible if the activity were engaged in for profit, such as rent, labor costs, and mileage. These expenses are limited to the activity's income minus any expenses related to the activity that are deducted in Tier 1. These expenses are deducted as miscellaneous itemized deductions only to the extent the taxpayer's total miscellaneous itemized deductions exceed 2% of adjusted gross income (AGI).
- **Tier 3.** These are expenses related to basis adjustments, such as depreciation, amortization, partially worthless debts, and casualty loss deductions disallowed in Tier 1. These expenses are allowed only to the extent that the activity's income exceeds Tier 1 and Tier 2 expenses. Tier 3 allowable expenses are deducted as miscellaneous itemized deductions subject to the 2% of AGI limitation. The regulations provide a method for allocating basis adjustments if the deductions in Tier 3 are limited by income from the activity.[21] Comprehensive examples are included in Treas. Reg. §1.183-1.

20. Treas. Reg. §1.183-1(e).

21. Treas. Reg. §1.183-1(b)(2)-(3).

These limitations on how a not-for-profit activity's expenses are deducted and the classification of an activity as not-for-profit impact a number of other tax provisions. The following table summarizes the most significant considerations.

| | Trade or Business | Not Engaged in for Profit |
|---|---|---|
| Payment of SE tax on profit | Yes | No |
| SE health insurance deduction | Yes | No |
| Income qualifies for contribution to retirement plans | Yes | No |
| Standard mileage rate for vehicle expenses allowed | Yes | No |
| Expenses lower AGI | Yes | No [a] |
| Expenses deductible for AMT purposes | Yes | No |
| Expenses deductible for state income tax purposes | Yes | Varies by state |
| Expenses in excess of income deductible | Yes | No |
| Losses on activity can create net operating losses | Yes | No |

[a] AGI affects a number of other factors, including taxation of social security benefits, the deduction for IRA contributions, the deduction for student loan interest, itemized deductions subject to AGI floors, etc.

The following examples illustrate how classifying an activity as a trade or business can reduce a taxpayer's tax burden despite the related SE taxes.

**Example 2.** Marlene and Donna are identical twin sisters who each provide babysitting services on an ongoing basis. Marlene intends to use her babysitting business to supplement her other income. She spends a great deal of time promoting her services. Donna, known to all as Mama D, has a dozen grandchildren and babysits exclusively for family members, who pay her nominally to cover her expenses.

Both sisters' babysitting services meet the test of being more than occasional or sporadic activities. However, only Marlene intends to generate a profit. Mama D's primary intent is to be with her grandchildren. Accordingly, Marlene's babysitting service qualifies as a trade or business and Mama D's does not.

In 2016, Marlene and Mama D have identical income and expenses, as shown in the following table.

| | |
|---|---|
| Income | $5,000 |
| Expenses | |
| Tax preparation fees for business | 100 |
| Supplies (diapers, wipes, paper towels, etc.) | 200 |
| Meals provided | 700 |
| Home office expenses | 1,000 |
| Total expenses | $2,000 |

Both sisters have $25,000 in taxable income from other sources. Their 2016 babysitting income is subject to 15% federal income tax and 3.75% Illinois income tax.

Marlene's babysitting services represent trade or business income, so she reports $5,000 in gross receipts on her Schedule C. Her babysitting income counts toward her social security earnings. Her $3,000 ($5,000 – $2,000) net business income is transferred to Schedule SE, and she is subject to $424 of self-employment tax ($3,000 × 92.35% × 15.3%). As shown later, Marlene's total tax liability from her babysitting business is $947.

Because Mama D babysits solely for her grandchildren and for nominal fees, her babysitting services are deemed to be a not-for-profit activity. Therefore, Mama D reports her $5,000 gross income from babysitting on her Form 1040, line 21. She is not subject to SE tax on her earnings, and consequently, her babysitting income does **not** count toward her social security earnings.

Mama D must report her babysitting expenses on Schedule A. Unfortunately for Mama D, her itemized deductions are less than the $6,300 standard deduction.

A summary comparing Marlene and Mama D's income, expenses, and taxes follows. Despite the differences in how their income and expenses were reported, the net tax result is nearly identical.

| | Marlene | Mama D |
|---|---|---|
| Gross income from daycare | $5,000 | $5,000 |
| Allowable deductions | (2,000) | (0) |
| Deduction for half of SE tax | (212) | |
| Net taxable income | $2,788 | $5,000 |
| Net SE tax | $ 424 | $ 0 |
| Federal income tax on babysitting income at 15% | 418 | 750 |
| Illinois income tax on babysitting income at 3.75% | 105 | 188 |
| Total tax paid | $ 947 | $ 938 |
| Percentage of tax paid on $3,000 (actual net profit) | 31.6% | 31.3% |

**Example 3.** Use the same facts as **Example 2,** except Marlene and Mama D each paid $2,900 in out-of-pocket medical insurance premiums.

Marlene is allowed to deduct the cost of her health insurance premiums as an adjustment to income on page 1 of her Form 1040. The deduction is limited to the amount of her net income from her babysitting business, less the deduction for half of her SE tax and any SE retirement plan contributions.[22]

Marlene's net daycare income is $3,000. She is allowed a $212 deduction for half of her SE tax ($424 ÷ 2). She did not make any retirement plan contributions. This brings her allowable self-employed health insurance deduction to $2,788 ($3,000 – $212).

Marlene claims this $2,788 deduction on Form 1040, line 29, as an adjustment to gross income. Therefore, it lowers her federal and Illinois income taxes by $523 (($2,788 × 15%) + ($2,788 × 3.75%)). It does not affect Marlene's SE tax.

The SE health insurance deduction lowers Marlene's total tax liability on $3,000 of net babysitting income to $424 ($947 – $523). This is 14.1% ($424 ÷ $3,000) of her net daycare income.

Mama D realizes no tax benefit from her medical premiums expense. She would claim her health insurance premiums as an itemized deduction, subject to reduction of 10% of her AGI. Mama D's 2016 AGI is $30,000, so she would reduce her allowable medical deduction by $3,000 ($30,000 × 10%). She has no other medical expenses, so none of her medical premiums exceed the $3,000 threshold.

Marlene's tax on her for-profit activity was $424, compared to Mama D's $938 tax on the same income from her not-for-profit activity. Marlene accrues social security benefits on her net income, while Mama D does not.

**Observation.** The outcomes in **Example 2** and **Example 3** would be much different if the taxpayers did not have any significant expenses related to the income. Without deductible expenses, it may be more beneficial for an activity to be classified as a not-for-profit endeavor despite the various limitations.

**Caution.** The determination of whether an activity is a trade or business must be based on the facts of the situation, not the desired tax result. Very often, the most significant factor is the continuity and regularity of the taxpayer's involvement in the activity. If the taxpayer's involvement is not continuous and regular, the existence of an intent to generate a profit is irrelevant. Because this factor can vary from year to year, tax practitioners should evaluate this issue annually.

22. IRC 162(l)(2).

## INDIVIDUAL VS. ENTITY INCOME SUBJECT TO FICA AND SECA

A trade or business activity can be conducted as one of the following tax entities.

- Sole proprietorship
- Partnership
- S corporation
- C corporation

A limited liability company (LLC) is a legal entity formed in accordance with state law. Although a business organized as an LLC is a separate legal entity under state law, its status for federal tax purposes is determined solely on the basis of the entity classification regulations.[23]

A single-member LLC generally is treated as a sole proprietorship. LLCs with two or more members are considered a partnership unless the members elect corporation status for tax purposes.

The type of tax entity under which a trade or business organizes is important for employment tax purposes. Businesses must pay employment taxes on the wages of employees. Business owners' compensation may be subject to employee payroll taxes or SE taxes depending on the business's entity type and other factors.

> **Observation.** Generally, employers also are subject to federal and state unemployment taxes and worker's compensation insurance contributions based on employee wages. These tax burdens may tempt employers to classify a worker as an independent contractor rather than as an employee. For more information on the importance of worker classification, see the 2017 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Employment Issues.

### FICA AND SECA

FICA and SECA taxes stem from two tax acts.

- The Federal Insurance Contributions Act (FICA)
- The Self-Employed Contributions Act (SECA)

#### FICA Tax

FICA tax is composed of two elements — old age, survivors, and disability insurance (OASDI) and hospital insurance, commonly called Medicare.[24] The overall FICA tax rate is 15.3% of gross taxable wages, of which 12.4% is allocated to OASDI and 2.9% to Medicare. The employee's share is 6.2% of OASDI and 1.45% of Medicare.

Employers withhold the employee's share of FICA taxes from the employee's **gross taxable** wages. Employers are required to match these amounts, reporting and remitting the full FICA tax to the government.

> **Note.** Employers are responsible for collecting and remitting the **entire** amount of FICA tax on wages paid on behalf of employees. If the employer fails to withhold the correct amount of FICA taxes from an employee, the employer still is required to remit the full amount of tax due. Employers who do not comply with employment tax law may be subject to criminal and civil sanctions.[25]

23. Treas. Reg. §§301.7701-1 to 301.7701-3.
24. IRC §3101(b).
25. IRC §§6672 and 7202.

In 2017, social security earnings are capped at $127,200.[26] Earnings above this amount are not subject to the 12.4% OASDI tax. There is no limit on earnings subject to Medicare tax. In fact, the employee's portion of the Medicare tax rate increases by 0.9% on earnings in excess of $200,000 for taxpayers filing under the single, head of household, and qualifying widow(er) statuses, and earning in excess of $250,000 for married filing jointly filers ($125,000 for married filing separately filers).[27]



**The employer is not subject to the Medicare surcharge**, and thus does not have to match contributions on the additional 0.9% tax.[28] However, the employer is required to withhold the 0.9% surtax on employee Medicare wages in excess of $200,000.[29]

> **Observation.** The 0.9% Medicare surtax was imposed under the Patient Protection and Affordable Care Act and amended by the Health Care and Education Reconciliation Act of 2010.

## SECA Tax

The SECA tax rate is 15.3% of 92.35% of **net** earnings from self-employment. The allocation of SECA tax is the same as the allocation of FICA taxes: 12.4% of SE tax is allocated to social security and 2.9% to Medicare. The same $127,200 cap applies to 2017 social security earnings.

The Medicare surtax applies to self-employed taxpayers, but it is not part of the SE tax. This surtax is imposed on the combined total wages and net SE income reported on the tax return.[30]

Self-employed individuals are essentially both employer and employee. Because there is no employer to pay the matching portion of OASDI and Medicare taxes, the self-employed person is responsible for the full amount of tax due on SE income.

Employees do not pay income tax on the employer's matching portion of OASDI and Medicare taxes. This matching portion is 7.65% (15.3% ÷ 2). To equalize this benefit for self-employed taxpayers, they are required to pay taxes on only 92.35% (100% − 7.65%) of their net SE income.

> **Note.** As mentioned earlier, self-employed taxpayers are allowed to deduct half of the amount of the SE tax paid as an adjustment to income on Form 1040, line 27 (an "above the line" adjustment that reduces federal adjusted gross income). Because the SE tax does not include any Medicare surtax, this surtax is not used to compute the SE tax adjustment to gross income.

**Sole Proprietor.** Sole proprietors report income from trade or business activities on Schedule C and pay SE tax on net SE income. As mentioned earlier, if a taxpayer's total combined net SE income is less than $400 ($433 × 92.35%), the taxpayer has no liability for SE tax.[31]

**Partnership.** A partnership, as a pass-through entity, does not pay any income tax. It passes the partnership's income, gains, deductions, losses, and credits through to each partner in accordance with their percentages of partnership interests.

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26. *2017 Social Security Changes.* Social Security Administration. [www.ssa.gov/news/press/factsheets/colafacts2017.pdf] Accessed on June 1, 2017.

27. IRC §3101(b)(2).

28. *Questions and Answers for the Additional Medicare Tax*. Dec. 6, 2016. IRS. [www.irs.gov/businesses/small-businesses-self-employed/questions-and-answers-for-the-additional-medicare-tax] Accessed on Jun. 7, 2017.

29. IRC §3102(f).

30. IRC §1401(b)(2).

31. IRC §1402(b)(2).

Partnerships file Form 1065, *U.S. Return of Partnership Income.* The partnership gives each partner a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* which outlines what each partner must report on their individual returns.

Spouses who operate a business together may elect to treat their business as a **qualified joint venture** instead of a partnership. This election avoids the need to file a partnership return. To qualify for this election:

- Both spouses must materially participate in the ownership and operation of the business,
- There may be no other members of the partnership, and
- Each spouse must separately report their share of the business's income, gain, loss, deductions, and credits.[32]

**Observation.** Many small businesses are operated as sole proprietorships when in fact they are "mom and pop" operations in which both spouses work in the business. When reporting as a sole proprietorship, only one spouse is credited with social security and Medicare earnings from the business. With a qualified joint venture election, both spouses receive credit for their earnings.

**Note.** For a more thorough discussion of partners, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Partner Issues. For a detailed discussion of partnerships, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Partnership Issues.

**S Corporation.** An S corporation is a pass-through entity that generally does not pay tax at the entity level. S corporations file Form 1120S, *U.S. Income Tax Return for an S Corporation*. S corporations provide shareholders with Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*

Unlike a partnership, distributive income from an S corporation is **not** subject to SE tax.[33] However, **an S corporation shareholder who works in the business must be paid reasonable compensation** as a corporate employee before receiving nonwage dividends.[34]

This reasonable compensation requirement eliminates a loophole that would allow active S corporation shareholders to avoid employment taxes. However, unlike sole proprietors and general partners, S corporation shareholders can avoid employment taxes on the profits of the business that exceed a reasonable compensation for their services.

Reasonable compensation varies from industry to industry and shareholder to shareholder. The compensation amount never exceeds the amount directly or indirectly received by the shareholder. However, if the shareholder received cash or property or the right to receive cash or property, a salary amount must be established at a reasonable and appropriate level.[35] Shareholders' compensation is subject to IRS scrutiny when shareholders take distributions from the company and receive little or no compensation for services rendered to the corporation.

**Note.** For detailed information about S corporations, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: S Corporation Entity Issues. For detailed information about S corporation shareholders, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: S Corporation Shareholder Issues.

32. IRC §761(f).

33. Rev. Rul. 59-221, 1959-1 CB 225.

34. *S Corporation Compensation and Medical Insurance Issues.* Mar. 21, 2017. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues] Accessed on Jun. 15, 2017; IRC §3121(d).

35. *Wage Compensation for S Corporation Officers*. Aug. 2008. IRS. [www.irs.gov/uac/wage-compensation-for-s-corporation-officers] Accessed on Jun. 7, 2017.

**C Corporation.** C corporations are taxed at the entity level. Dividends paid to shareholders are taxed twice — once at the corporate level and again at the shareholder level. Because of this double taxation of dividends, C corporations gain an advantage by paying higher salaries, which are deductible by the corporation. For this reason, C corporations may deduct only reasonable compensation paid to shareholder-employees.[36] Wages are subject to employment taxes, but dividend payments are not.



## ASSIGNMENT OF INCOME

The expense of employment taxes compels some taxpayers to search for creative ways to escape this additional tax burden. The assignment of income doctrine prohibits the practice of transferring income to a person or entity that would pay less tax on the income than the person who earned it.[37]

However, there are legal ways to structure the assignment of income from an individual to an entity. The execution of this structure is complex and requires integrating tax law, corporate law, and other laws that regulate specific industries.

*Fleischer v. Comm'r*, a recent tax court case, exemplifies a failed attempt to assign income from an individual to an S corporation for the purpose of limiting employment taxes.[38]

Ryan Fleischer was a financial planner who started his own company after working as an employee managing customers for other firms. On the advice of his attorney and CPA, Fleischer incorporated the investment advisory firm Fleischer Wealth Plan (FWP) on February 7, 2006, electing S corporation status. He was the corporation's sole shareholder and the president, secretary, and treasurer of FWP. Fleischer was licensed to sell securities, but FWP was not licensed.

Five days before FWP was incorporated, Fleischer signed an agreement to represent Linsco/Private Ledger Financial Services (LPL) financial products. He did not register his corporation with LPL. On February, 28, 2006, Fleischer entered into an employment agreement with FWP.

On March 13, 2008, Fleischer entered into a broker contract with Mass Mutual, signing it in his personal capacity and not as an officer of FWP. In fact, FWP was not referenced in the contract at all.

FWP paid Fleischer a salary, on which the corporation paid employment taxes. Fleischer reported this Form W-2 income, as well as his distributive share of income from the S corporation, on his personal tax return. He did not pay employment taxes on the S corporation's distributive share of income.

Fleischer reported the following income from FWP for each of the years in question.

| Tax Year | Wages | Nonpassive Schedule E Income (ordinary business income from the S corporation) |
|---|---|---|
| 2009 | $34,851 | $ 11,924 |
| 2010 | 34,856 | 147,642 |
| 2011 | 34,996 | 115,327 |

The IRS issued a notice of deficiency, on which it asserted that the distributive share of FWP income was actually Fleischer's SE income from sales and that he owed SE taxes on this income. The IRS determined deficiencies for tax years 2009, 2010, and 2011 totaling $41,563.

36. Treas. Reg. §1.162-7(b)(3).

37. *Lucas v. Earl*, 281 U.S. 111 (1930).

38. *Fleischer v. Comm'r,* TC Memo 2016-238 (Dec. 29, 2016).

Generally, income is taxed to the person who earned the income. However, in the case of a corporation and a service-provider employee, the court asks "who controls the earning of the income."[39] Two elements must be found to determine that a corporation controls the income.

1. The service provider must be an employee of the corporation "whom the corporation can direct and control in a meaningful sense."
2. A contract or other indication of an agreement must exist between the corporation and the person or entity using the services that recognizes the corporation's controlling position.

Fleischer argued that FWP could not contract directly with LPL or Mass Mutual because FWP was not licensed to sell securities. However, the court found that securities laws and regulations do not prohibit a corporation from becoming a registered entity.

Fleischer also argued that FWP was a valid corporation and that it should be recognized as a separate taxable entity. The court did not challenge FWP's validity, but relied on *Wilson v. U.S.* to find that the corporation's validity "does not preclude reallocation under the assignment of income doctrine."[40]

The court sided with the IRS, finding that Fleischer failed to establish that a contract existed between FWP and LPL or between FWP and Mass Mutual showing that FWP had meaningful control over Fleischer. Accordingly, Fleisher was liable for SE tax on the distributive share of income he reported from FWP.

> **Note.** For more information on the *Fleischer* case, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Rulings and Cases.

## INDUSTRY-SPECIFIC BUSINESSES

Taxpayers can be engaged in relatively similar activities, but the activities' tax treatment may differ, depending on each taxpayer's circumstances. The following sections describe some of these distinctions as well as background information on some specific types of businesses that can produce different tax treatments.

### INVESTOR VS. TRADER

Securities come in two forms: debt and equity. **Debt securities**, such as bonds and certificates of deposit, represent money owed to the investor from the issuer. Debt securities are also called fixed-income securities.

**Equity securities** represent ownership. An investor who holds a share of stock has equity in the corporation. Stockholders share in the company's profits and losses and generally can vote on who directs the corporation and on major issues affecting their stake.

The term securities as defined in IRC §475(c)(2) includes stock shares; beneficial ownership interests in certain partnerships and trusts; notes, bonds, debentures, or other evidence of indebtedness; and other financial instruments.

**Commodities** represent tangible goods, such as gold, corn, and oil. Commodities are traded like securities, but instead of buying a specifically identifiable security (e.g., Apple stock), commodities buyers purchase a unit of goods (e.g., apples).

39. *Johnson v. Comm'r,* 78 TC 882, 891 (1982).

40. *Wilson v. U.S.*, 530 F. 2d 772, 778 (8th Cir. 1976).

Before the advent of the Internet, trading required the services of a professional stockbroker. After the World Wide Web was introduced in 1990,[41] Internet trading companies sprang up, lowering commission costs and making buying and selling easier and less expensive. Now, anyone with a smart phone or computer and an online trading account can buy and sell securities and commodities anywhere they can get Internet reception.



The ease of transacting security and commodity purchases and sales created the "day trader" phenomenon. **Day traders** try to capitalize on market fluctuations throughout the trading day. They are not interested in long-term growth and generally close out all their positions within a single market day.

Buying and selling securities is generally considered a passive activity. However, some taxpayers have elevated their level of activity when trading securities to the point that their activity constitutes a trade or business. Congress added IRC §475 to the Code in 1993 to adapt to the changing trading environment brought about by Internet transactions.

The distinction between investors (passive activity) and traders (trade or business activity) makes a difference in the manner in which expenses are deducted and the tax rate that applies to gains. It also may make a difference in how gains and losses are computed and how much loss can be deducted.

Distinguishing between investors and traders and the corresponding tax treatment of their trading activity requires a careful analysis of facts and circumstances. The following terms and descriptions help to categorize a taxpayer's level of trading.

- **Investor** — Investors trade casually with an aim toward long-term gain. Investors seek money from dividends and capital appreciation rather than quick market swings.
- **Trader** — Traders approach trading as a full-time business rather than a hobby and generally receive their chief support from trading activities. Their trades are frequent, regular, continuous, and substantial. They trade solely for their own accounts.
- **Dealers** — Dealers make their living trading for customers, rather than trading solely for their own accounts. Dealers and their tax situations are not discussed in this section.

### Investors

Individual investors report their trading transactions on Schedule D, *Capital Gains and Losses;* Form 6781, *Gains and Losses from Section 1256 Contracts and Straddles;* and Form 8949, *Sales and Other Dispositions of Capital Assets.*

**Wash Sales.** Investor transactions are subject to **wash-sale** rules.[42] These rules prevent investors from creating paper losses by selling stocks for a price that is below their basis and then putting themselves in the same investment position by purchasing substantially identical stock within a short period of time.

Wash-sale rules apply to stocks sold at a loss and replaced within a 61-day period extending from 30 days before to 30 days after the loss sale.[43] When a wash sale occurs, investors must adjust the basis of their replacement stock, thereby deferring these losses until the replacement stock is sold (presuming the sale does not create another wash sale transaction).[44]

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41. *History of the Web*. World Wide Web Foundation. [webfoundation.org/about/vision/history-of-the-web] Accessed on Jun. 16, 2017.
42. IRC §1091.
43. IRC §1091(e).
44. IRC §1091(a).

**Investor Expense Deductions.** Investors can claim investment-related expenses on Schedule A, *Itemized Deductions*, as miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation.[45] Investment-related expenses include costs related to producing investment income, such as investment advice, publications, workshop fees, and legal and accounting fees.[46]

Investors also can claim a deduction for investment-related interest expense, but this deduction is limited to total investment income less investment expenses.[47] Investment interest in excess of this limitation carries forward.[48]

Commissions and costs associated with buying and selling specific securities are not deductible investment expenses. Instead, these costs are treated as basis adjustments and are used to compute gain or loss on disposition.[49]

Investors cannot claim a home office deduction, even if they use their office regularly and exclusively for investing.[50]

Investors may lose the advantages of Schedule A deductions if they do not have enough deductions to itemize, their investment expenses do not exceed 2% of their AGI, or their itemized deductions are limited under IRC §68. Investors who are subject to alternative minimum tax (AMT) also lose the tax benefit of their miscellaneous itemized deductions.[51]

**Investor Capital Loss Limitation.** Investors who have capital losses in excess of their capital gains from securities transactions are allowed to deduct the **lesser** of the excess capital loss over any capital gain, or $3,000 per year ($1,500 for taxpayers filing married filing separately (MFS)).[52] Unused capital losses are carried forward until used.[53]

> **Example 4.** Lisa Jones sold 1,000 shares of Taco Takeout on May 6, 2016, for a capital loss of $10,000. On May 30, 2016, she sold 1,000 shares of Sit-down Sushi for a capital gain of $6,000. Lisa filed as single and she had no other security transactions in 2016.
>
> Lisa can claim a capital loss deduction of $3,000 on her 2016 tax return, which is the lesser of her $4,000 ($10,000 − $6,000) excess loss over her capital gains and her $3,000 capital loss limitation.
>
> Lisa carries forward her excess capital loss of $1,000 ($4,000 actual loss − $3,000 allowed loss) to her 2017 return. If Lisa has no other stock transactions in 2017, she can deduct this $1,000 carryforward balance as a $1,000 excess capital loss on her 2017 return. If she has other stock transactions in 2017, she includes this $1,000 carryover loss with her other transactions to aggregate her gains and losses for 2017.

**Investor Tax Rates.** Investors receive favorable capital gains tax rates[54] on their long-term investments (generally investments they have held for more than one year[55]). Investors do not pay SE taxes on their trading income.[56]

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45. Temp. Treas. Reg. §1.67-1T(a)(1)(ii).
46. IRS Pub. 550, *Investment Income and Expenses.*
47. IRC §163(d).
48. IRC §163(d)(2).
49. IRS Pub. 550, *Investment Income and Expenses*.
50. IRS Pub. 587, *Business Use of Your Home*, p. 3 (2016).
51. IRC §56(b)(1)(A)(i).
52. IRC §1211(b).
53. IRC §1212(b).
54. IRC §1(h).
55. IRC §1222(3).
56. *Tax Topic 429 — Traders in Securities (Information for Form 1040 Filers).* May 1, 2017. IRS. [www.irs.gov/taxtopics/tc429.html] Accessed on Jun. 30, 2017.

The table below shows the 2017 capital gains tax rates for each tax bracket.

| Tax Bracket | Long-Term Capital Gains Tax Rate |
|---|---|
| 10% | 0% |
| 15% | 0% |
| 25% | 15% |
| 28% | 15% |
| 33% | 15% |
| 35% | 15% |
| 39.6% | 20% |



**Note.** Effective January 1, 2013, the Affordable Care Act imposed a 3.8% surtax on the net investment income of certain taxpayers, including estates and trusts.[57] This net investment income tax (NIIT) applies to taxpayers with modified AGI exceeding $200,000 for single and head of household filers, $250,000 for qualifying widow(er)s and married filing jointly (MFJ) filers, and $125,000 for married filing separately (MFS) filers.[58]

Net investment income includes, but is not limited to, income derived from trading activities, such as dividends and capital gains. It applies to both investors and traders.[59]

## Traders

Special tax rules apply to traders, i.e., those who have elevated their securities transactions to the point that their trading is considered a business activity. At a minimum, to be deemed a trader, a taxpayer must meet **all** three of the following requirements.[60]

1. Seek profits from daily market movements rather than dividends, interest, or capital appreciation
2. Display substantial trading activity
3. Engage in continuous and regular trading activity

While there are no quantitative values used to define **substantial, continuous, and regular** trading patterns, the IRS considers the following factors when determining whether a taxpayer is deemed a trader or an investor.[61]

- The length of the holding period for securities bought and sold
- The frequency and dollar amount of trades made during the tax year
- The extent to which the taxpayer derives a livelihood from trading activities
- The amount of time the taxpayer devotes to trading activities

The Tax Court denied trader status to a taxpayer who executed 535 trades over 121 days in a tax year. The court decided that the number of trading days "was not substantial" and thereby did not merit trader status.[62]

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57. IRC §1411.
58. Ibid.
59. Ibid.
60. IRS Pub. 550, *Investment Income and Expenses.*
61. Ibid.
62. *Sharon Nelson v. Comm'r,* TC Memo 2013-259 (Nov. 13, 2013).

A taxpayer may be deemed a trader for some securities and an investor for others. Securities that a trader holds for investment do not qualify for the special rules for traders. Traders must separately identify and record any investment securities in their records on the date of purchase.[63]

> **Note.** The IRS advises traders to hold investment securities in a separate brokerage account for ease of identification.[64]

**Trader Expense Deductions.** One advantage to attaining trader status is that the trader can deduct trading expenses on Schedule C, rather than Schedule A. Investment interest is not limited to net investment income on Schedule C, so traders can deduct the full amount of any interest paid in connection with their trading activity.[65]

Commissions and costs associated with buying and selling specific securities are not deductible investment expenses. Instead, these costs are treated as basis adjustments used to compute gain or loss on disposition.[66]

If otherwise qualified, traders are allowed a home office deduction on Schedule C because they are considered to be engaged in a trade or business activity. Although traders report their trading business expenses on Schedule C, they do not report their trading income on this form. If a trader does **not** make a "mark-to-market" (MTM) election (discussed later in this section), the trader reports their trading transactions on Schedule D and Form 8949.[67] If a trader makes the MTM election, they report their trading transactions in part II of Form 4797, *Sales of Business Property.*

> **Caution.** Because traders do not report their income on Schedule C, tax preparation software may limit the home office deduction to the business-use percentage for real estate taxes, mortgage interest, mortgage insurance premiums, and casualty losses. Because no profit is shown on the trader's Schedule C, the operating expenses of the home office (e.g., utilities, insurance, and maintenance) and the depreciation allowance would not be deductible in the current year. However, the instructions for Form 8829, *Expenses for Business Use of Your Home*, (part II, line 8) state that a taxpayer can include in the calculation of the home office deduction any net gains in excess of losses reported on Schedule D (via Form 8949) and Form 4797 that are allocated to the use of the home office for trade or business. Practitioners are advised to consult their specific software instructions for special coding or manual entry requirements needed to properly attribute the trader's income for the home office deduction calculation.

**Trader Capital Loss Limitation.** Traders who do not make an MTM election are treated the same as investors regarding capital loss limitations. The losses of traders who do not make an MTM election are considered capital losses subject to the $3,000 ($1,500 for MFS filers) annual loss limitation. Also, the wash-sale rules (discussed in the "Investors" section) apply to traders who do not make the MTM election.

**Trader Tax Rates.** Even though a trader is considered to have a business, a trader's net trading income is **not subject to SE tax.**[68] The capital gains tax rates that apply to investors also apply to traders who do not make an MTM election.[69]

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63. *Topic 429 — Traders in Securities (Information for Form 1040 Filers)*. May 1, 2017. IRS. [www.irs.gov/taxtopics/tc429.html] Accessed on Jun. 30, 2017; IRS Pub. 550, *Investment Income and Expenses.*

64. Ibid.

65. IRS Pub. 550, *Investment Income and Expenses,* p. 71 (2016).

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

67. IRS Pub. 550, *Investment Income and Expenses*, p. 71 (2016).

68. IRC §475(f)(1)(D).

69. *Topic 429 — Traders in Securities (Information for Form 1040 Filers)*. May 1, 2017. IRS. [www.irs.gov/taxtopics/tc429.html] Accessed on Jun. 30, 2017.

### Mark-to-Market Transactions

Congress added IRC §475(f) to the Code in 1997. This MTM provision allows securities and commodities traders to **elect** to receive the same MTM tax treatment required for dealers. [70]

Generally, recognition of income, gain, or loss only occurs when a stock is sold or exchanged. However, §475(f) allows securities and commodities traders to recognize income on mark-to-market holdings at the end of each tax year based on increases and decreases in the fair market value (FMV) of these holdings.

MTM gains and losses are recognized as **ordinary income.**[71] This means traders lose the advantage of favorable capital gains tax rates in exchange for being able to deduct capital losses in full in the year they are recognized.

> **Observation**. Traders and dealers (i.e., those who trade for a living rather than casually invest in the market) generally do not benefit from the favorable long-term capital gains tax rates because they seldom hold security positions for over a year. Because their trading activities are frequent and often speculative, they also can experience large capital losses. This makes the §475(f) election an attractive option for traders.

When traders make an MTM election, they report all shares held in their trading accounts (i.e., not their investment accounts) as sold for FMV on the last day of the tax year.[72] Traders then report these deemed sales along with their actual **business** trading activity during the year in part II of Form 4797.[73] Expenses allocated to the trading business are reported on Schedule C.[74]

Sales of securities held for **investment** are reported on the trader's Schedule D.[75] **Investor**-related expenses are deducted on Schedule A.[76]

The following table shows the categories of taxpayers eligible for MTM tax treatment.

| Taxpayer Category | Mark-to-Market Tax Treatment |
|---|---|
| Investor | Not eligible |
| Securities trader | Eligible by election under §475(f)(1) |
| Commodities trader | Eligible by election under §475(f)(2) |
| Securities dealer | Mandated by §475(a) |
| Commodities dealer | Eligible by election under §475(e) |

70. Security dealers are required to use mark-to-market reporting under §475(a); commodities dealers may elect MTM treatment under §475(e).

71. IRC §475(d)(3)(A)(i).

72. IRC §475(f)(1)(A)(i).

73. Instructions for Form 4797.

74. IRS Pub. 550, *Investment Income and Expenses*, p. 71 (2016).

75. Ibid.

76. IRS Pub. 550, *Investment Income and Expenses*, p. 35 (2016).

**Manner of Election.** To make the §475(f) election, **taxpayers must include a statement on their tax return for the year prior to the year they wish the election to be effective.**[77] The statement must be attached to the timely filed return (not including extensions) or to the timely filed extension request for that year. It must include all of the following information.[78]

- A declaration that the taxpayer is making the election under IRC §475(f)
- Specific identification of the first tax year for which the election is effective
- Mention of the trade or business for which the election is being made

Taxpayers who wish to receive MTM treatment effective for the **2018** tax year must make the election by April 17, 2018, by attaching a statement to the taxpayer's timely filed **2017** return or **request** for extension. Late elections are rarely allowed.[79]

Along with this election, taxpayers should file Form 3115, *Application for Change in Accounting Method*, using the designated automatic accounting method change number "64."[80]

**Benefits of a §475(f) Election.** Choosing the MTM election offers tax advantages to eligible traders. For example, this election frees the eligible trader from wash-sale rules and capital-loss limitations.[81] Furthermore, because losses are ordinary rather than capital in nature, they can give rise to net operating loss carrybacks and carryforwards.

Because marked positions are deemed sold at FMV, a §475(f) election relieves taxpayers from the burden of tracking historical bases. Marked securities and commodities receive a new basis each year, as if they were reacquired for FMV on the date of the deemed sale.

**Disadvantages of a §475(f) Election.** The most obvious disadvantage of an MTM election is the loss of the preferential capital gains tax rates. However, this is not as detrimental as it appears because most traders do not hold positions long enough to take advantage of this tax break.

Taxpayers electing §475(f) also lose the ability to defer gain or loss by controlling the timing of sales. Deemed yearend sales also can create phantom gains that generate tax liability without generating the cash with which to satisfy the liability.

Traders that elect MTM tax treatment lose the benefit of IRC §1256. This section deems certain contracts and options as sold at yearend for 60% long-term and 40% short-term gain or loss, regardless of how long the positions were held.[82]

> **Note.** Traders who currently have large capital loss carryovers may lose the ability to offset any large gains if they elect the ordinary gain/loss treatment under §475(f). Taxpayers may circumvent this problem by specifically identifying stocks they hold for investment that can be used to take advantage of any unused capital loss carryovers.[83]

77. Instructions for Schedule D.
78. IRS Pub. 550, *Investment Income and Expenses*, p. 71 (2016).
79. *Topic 429 — Traders in Securities (Information for Form 1040 Filers)*. May 1, 2017. IRS. [www.irs.gov/taxtopics/tc429.html] Accessed on Jun. 29, 2017.
80. Rev. Proc. 2017-30, 2017-18 IRB 1131.
81. *Topic 429 — Traders in Securities (Information for Form 1040 Filers)*. May 1, 2017. IRS. [www.irs.gov/taxtopics/tc429.html] Accessed on Jun. 29, 2017.
82. IRC §1256(a).
83. IRC §475(f)(1)(B).

**Revocation of Election.** Until recently, the §475(f) election could be revoked only with IRS consent. Rev. Proc. 2015-14 now allows taxpayers to **automatically** switch from the MTM method to a realization (or cash) method.[84]

The taxpayer requesting revocation must file a "notification statement" by the original due date of the preceding year return, without extensions. The statement can be filed with an extension of time to file the return or with the tax return for the tax year preceding the year of change. This provides an opportunity window of 3.5 months in the beginning of the tax year to decide whether to revoke the election, mirroring the timing allowed to make the §475(f) election.[85]



April 17, 2018, is the deadline to file the notification statement for revocations effective for the 2018 calendar year.

The notification statement must include all of the following:[86]

- Name of taxpayer with 475(f) election in place
- Statement requesting the accounting method change to a realization method
- Beginning and ending dates for year of change
- Types of instruments subject to the method change
- Statement revoking the taxpayer's 475(f) election

The taxpayer must then file Form 3115 with their tax return under standard automatic method change procedures described in Rev. Proc. 2015-13, effective for forms filed on or after January 16, 2017.

In the year preceding the year of revocation, the taxpayer accounts for gain or loss on a "cut-off" basis by making a final mark of any elected securities or commodities for ordinary gain/loss treatment. As a result of the final mark, gain or loss attributable to those securities and/or commodities is recognized on the last business day of the year preceding the year of change. Once the revocation is properly made, the trader must resume the capital gain/loss realization method of accounting for the year of change and all subsequent years.[87]

**A trader may request reinstatement of the §475(f) election after a 5-year waiting period.** Reinstatement is not automatic.[88]

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84. Rev. Proc. 2015-14, 2015-5 IRB 450 (§23.02).
85. Ibid.
86. Ibid.
87. Rev. Proc. 2015-14, 2015-5 IRB 450 (§23.02(5)).
88. Rev. Proc. 2015-14, 2015-5 IRB 450 (§23.02(7)(a)).

**Summary.** The following table summarizes the tax differences between investors and traders, including a comparison of traders who make the MTM election and those who do not make the election.

| | | Trader | |
|---|---|---|---|
| **Tax Attribute** | **Investor** | **No MTM Election** | **With MTM Election** |
| SE tax | No | No | No |
| Gain/loss treatment | Capital | Capital | Ordinary |
| Loss limit | $3,000 ($1,500 MFS) | $3,000 ($1,500 MFS) | Unlimited |
| Market gains | Deferred until disposition | Deferred until disposition | Recognized at the end of tax year (constructive sale) |
| Wash-sale rules | Apply | Apply | Do not apply |
| Where to report income from trading transactions | Form 8949 and Schedule D | Form 8949 and Schedule D | Form 4797, part II |
| Where to report trading expenses | Schedule A miscellaneous itemized deductions subject to 2% of AGI floor | Schedule C | Schedule C |
| Investment interest expense deduction | Limited to investment income | Unlimited | Unlimited |
| Office in the home deduction | Not allowed | Allowable | Allowable |
| IRC §179 deduction | Not allowed | Allowable | Allowable |
| Effect of expenses on AGI | None | Expenses reduce AGI | Expenses reduce AGI |
| Expenses used to reduce AMT | No, misc. itemized deductions are disallowed for AMT | Yes | Yes |
| Losses qualify for NOL | No | No | Yes |

**Caution.** It is important for tax practitioners to be aware of the MTM election and to keep clients informed of their options. In a January 31, 2010 article, Michael Harmon, J.D., CPA, and William Kulsrud, Ph.D., CPA, reported that an accountant was required to pay his former client $2.5 million for negligence because the client was not informed of the MTM election.[89]

89. *Sec. 475 Mark-to-Market Election*. Harmon, Michael and Kulsrud, William. Jan. 31, 2010. The Tax Advisor. [www.thetaxadviser.com/issues/2010/feb/sec475mark-to-marketelection.html#fn_14] Accessed on Jun. 29, 2017.

## LANDLORD VS. REAL ESTATE PROFESSIONAL

Renting real estate is generally a passive activity.[90] Property owners can deduct ordinary and necessary expenses in connection with the operation of their rental activities, including allowed or allowable depreciation on the rental structure and other capital assets connected with the rental activity. Depreciation is not allowed for land.

### Landlords



Landlords are property owners who exchange the use of their property for income. Landlords with profits generally do **not** pay SE taxes on their net rental income.[91] These profits are subject to ordinary income tax.

Landlords with losses may be subject to passive loss restrictions.[92] The amount of the restriction depends on the landlords' level of participation in the rental activity, their percentage of ownership of the property, their AGI, and their filing status.

Landlords' participation in the rental activity can be deemed passive or active. **Active participation** means the landlord owns at least 10% of the rental property[93] and is involved in managing the operation of the rental unit, such as finding tenants, enforcing rental terms, hiring repairmen, etc.[94]

In general, landlords who **actively participate** in a rental activity can deduct up to $25,000 in passive rental losses if their AGI is under $100,000. This passive-loss limitation is reduced for actively participating landlords with an AGI between $100,000 and $150,000, and eliminated for those with an AGI over $150,000. If a landlord's filing status is MFS, the passive-loss limit is $12,500 if their AGI is under $50,000, and the deduction phases out completely at $75,000.[95]

Landlords who do not actively participate in the real estate activity can only deduct passive losses up to the amount of their passive income.[96] Disallowed passive activity losses may be carried forward to the next tax year until used or until the taxpayer disposes of the property.[97]

### Real Estate Professionals

Certain taxpayers can avoid application of the passive-loss rules if they meet the qualifications to be designated as a real estate professional in a real property trade or business.

IRC §469(c)(7)(C) defines **real property trade or business** to encompass any real property:

- Development and redevelopment,
- Construction and reconstruction,
- Acquisition,
- Conversion,
- Rental,
- Operation,
- Management,
- Leasing, and
- Brokerage trade or business.

90. IRC §469(c)(2).
91. IRC §1402(a)(1).
92. IRC §469.
93. IRC §469(i)(6)(A).
94. IRS Pub. 925, *Passive Activity and At-Risk Rules*, p.4 (2016).
95. IRC §469(i); Special limitations apply to surviving spouses and taxpayers with rehabilitation credits, commercial revitalization deductions, and low-income housing credits.
96. IRC §§469(a) and (d)(1).
97. IRC §§469(b) and (g).

To be deemed a real estate professional, a taxpayer must meet two tests.[98]

1. The taxpayer must **materially participate** in real property trades or businesses over half the total time the taxpayer spends on all trades or businesses during the tax year.
2. The taxpayer must perform over 750 hours of service during the tax year materially participating in real property trades or businesses.

Taxpayers may elect to group rental real estate activities for purposes of the above tests.[99] A grouping election may also be necessary to meet the material participation test.

**Material participation**[100] means involvement in the rental operations on a regular, continuous, and substantial basis during the tax year.[101] Time spent as an employee does **not** count toward the material participation tests unless the employee is at least a 5% owner of the company.[102]

A qualified real estate professional is **not** subject to the additional 3.8% NIIT on their rental real estate activity if they qualify for the safe harbor in Treas. Reg. §1.1411-4(g)(7)(i). To qualify for the safe harbor, the real estate professional must:

- Participate in the rental real estate activity for more than 500 hours during the year, or
- Have participated in the activity for more than 500 hours in any five tax years during the 10 tax years immediately preceding the current tax year.

If the real estate professional fails to satisfy the preceding safe harbor requirements, they may still be able to exclude their rental real estate income from net investment income if they can demonstrate that they are excluded from the NIIT under another provision of IRC §1411.[103]

Real estate professionals do not pay SE tax on their rental real estate income.[104]

The rental income for a real estate professional is not considered passive under IRC §469(c)(7). Therefore, the income is **not** considered "disqualified income" for purposes of the earned income credit computation under IRC §32(i).

Real estate professionals report their rental income and expenses on Schedule E, *Supplemental Income and Loss*. They enter the net income or loss of all rental real estate activities in which they materially participated during the tax year on Schedule E, part V, line 43.

> **Note.** For more information about real estate professionals, grouping rules, and material participation, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [taxschool.illinois. edu/taxbookarchive].

98. IRC §469(c)(7)(B).
99. IRC §469(c)(7)(A).
100. IRS Pub. 925, *Passive Activity and At-Risk Rules*, sets forth seven tests for determining material participation.
101. IRC §469(h)(1).
102. IRC §469(c)(7)(D)(ii).
103. Treas. Reg. §1.1411-4(g)(7)(iii).
104. IRC §1402(a)(1).

# SMALL BUSINESS STOCK

Congress uses the Code not only to fund the government, but also to help shape the economy. Two such economy-shaping provisions are contained in IRC §§1202 and 1244. These Code sections encourage investment in qualifying small business corporations by providing tax incentives to investors.



## IRC §1202 QUALIFIED SMALL BUSINESS STOCK

IRC §1202 allows noncorporate taxpayers to exclude a substantial portion of gain from the sale or exchange of qualified small business stock (QSBS). The excludable portion is determined by the acquisition date of the QSBS. Exclusion percentages range from 50% to 100% of gain, as shown in the following table.[105]

| Acquisition Date | Exclusion Percentage |
|---|---|
| August 11, 1993, through February 17, 2009 | 50% [106] |
| February 18, 2009, through September 27, 2010 | 75% |
| September 28, 2010, and after | 100% |

Congress increased the QSBS exclusion percentage to 100% effective September 28, 2010.[107] They also eliminated the AMT adjustment that previously applied.[108] The 3.8% NIIT does not apply to gain from QSBS, because that tax applies only to taxable income.[109] **The 100% exclusion rate was made permanent** by the Protecting Americans from Tax Hikes Act (PATH Act) of 2015.[110]

**Note.** Although the federal government allows 100% of gain from the sale or exchange of QSBS to be excluded from tax, not all states follow federal tax law in this regard.

The exclusion is limited to the greater of $10 million ($5 million for MFS taxpayers) or 10 times the taxpayer's adjusted basis in the QSBS.[111]

Taxpayers report the sale or exchange of QSBS on Form 8949, part II. The letter "Q" is placed in column (f) and the amount of the exclusion is reported as a negative number in column (g).[112]

105. Instructions for Schedule D.

106. This exclusion percentage increased to 60% for QSBS designated as an empowerment zone business. IRC §1202(a)(2)(A).

107. IRC §1202(a)(4)(A).

108. IRC §1202(a)(4)(C).

109. IRC §1411(c)(1)(A)(iii).

110. PL 114-113, Division Q (Dec. 18, 2015).

111. IRC §1202(b).

112. Instructions for Form 8949.

### Stock Qualifications

To qualify for §1202 treatment, QSBS must meet the following criteria.

1. The stock must have been issued by a **C corporation** that as of the date of issue: [113]
   - Did not have aggregate gross assets of $50 million or more both before and immediately after the stock issuance, and
   - Agrees to furnish reports to the government and shareholders verifying its QSBS status.
2. The stock's original issue date must have been after August 10, 1993 (the Revenue Reconciliation Act of 1993's enactment date).[114]
3. The stock must have been acquired by the taxpayer at the stock's **original issue,** directly or through an underwriter, in one of the following manners.[115]
   - In exchange for money or property other than stock
   - As compensation for services provided to the issuing corporation (other than services performed as an underwriter of the stock)
4. The stock must be in a corporation that meets the active business requirement during substantially all of the taxpayer's holding period.[116] This requirement is met if at least 80% of the corporation's assets (by value) are used in the active conduct of one or more qualified trades or businesses.[117] A qualified trade or business means any trade or business **other than** the following.[118]
   - Any field in which the principal asset is the reputation or skill of one or more of the corporation's employees, including services provided in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services
   - Banking, insurance, financing, leasing, investing, or similar activities
   - Farming, including raising or harvesting trees
   - Production or extraction of products from mines, wells, and other natural deposits
   - Hotels, motels, restaurants, and similar businesses
5. The stock must have been held by the taxpayer for **more than five years** before its sale or exchange.[119]

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113. IRC §§1202(d)(1)(A)–(C).
114. IRC §1202(c)(1).
115. IRC §§1202(c)(1)(B)(i)–(ii).
116. IRC §1202(c)(2).
117. IRC §1202(e)(1)(A).
118. IRC §1202(e)(3).
119. IRC §1202(b)(2).

Taxpayers who do not meet the 5-year holding period requirement may elect to defer gain from the sale of otherwise qualifying small business stock in an IRC §1045 rollover. This is accomplished by reinvesting the gain in QSBS within 60 days of the sale or exchange of the former small business stock. Gain is recognized only to the extent the amount realized on the sale exceeds:

- The cost of QSBS purchased by the taxpayer during the 60-day period beginning on the date of the sale, reduced by
- Any portion of the cost previously taken into account under §1045.



To qualify for the §1045 deferment, taxpayers must have held the original stock for more than six months.[120]

### Corporation Qualifications

To be eligible for the §1202 exclusion, stock must be issued by a **domestic C corporation** that is not one of the following.[121]

- A domestic international sales corporation (DISC) or former DISC
- A corporation, or its direct or indirect subsidiary, for which an IRC §936 election (Puerto Rico and possession tax credit) is in effect
- A regulated investment company, real estate investment trust, or real estate mortgage investment conduit
- A cooperative

To determine whether a corporation meets the requirements for a qualified small business, all corporations that are members of the same **parent-subsidiary controlled group** are treated as a single corporation.[122] For this purpose, a parent-subsidiary controlled group means one or more chains of corporations connected through stock ownership with a common parent corporation if:[123]

- Stock possessing more than 50% of the total combined voting power of all classes of stock or more than 50% of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of IRC §1563 (d)(1)) by one or more of the other corporations; and
- The common parent corporation owns stock possessing more than 50% of the total combined voting power of all classes of stock or more than 50% of the total value of shares of all classes of stock of at least one of the other corporations, excluding stock owned directly by such other corporations.[124]

### Ineligible Stock

A corporation's stock is ineligible for the §1202 exclusion if more than 10% of the total value of the corporation's assets consists of real estate not used in the active conduct of a qualified trade or business. Owning, dealing in, or renting real property is not considered the active conduct of a qualified trade or business.[125]

A corporation's stock also is generally ineligible for the §1202 exclusion for any period during which more than 10% of the total value of the corporation's assets in excess of liabilities consists of stocks or securities of other corporations.[126] Stock and debt held in any of the corporation's subsidiaries is disregarded for purposes of this calculation.[127]

120. IRC §1045(a).
121. IRC §1202(e)(4).
122. IRC §1202(d)(3)(A).
123. IRC §1202(d)(3).
124. IRC §1202(d)(3)(B); The provisions of §1563(a)(4), regarding certain controlled groups of life insurance companies subject to tax under §801, do not apply.
125. IRC §1202(e)(7).
126. IRC §1202(e)(5)(B).
127. IRC §1202(e)(5)(A).

However, assets held to meet the reasonably required working capital needs of a qualified trade or business is considered used in the active conduct of a qualified trade or business.[128] Likewise, assets held for investment and that is reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or to finance increases in the working capital needs of a qualified trade or business is considered used in the active conduct of a trade or business.[129] After a corporation exists for two or more years, no more than 50% of the corporation's working capital assets qualify as used in the active conduct of a qualified trade or business.[130]

### Look-Back Provisions

Congress intended the QSBS provision to spur new business development by stipulating that qualifying stock must be newly issued. In order to prevent the reissuance of corporate stock to circumvent this stipulation, two look-back provisions were added to the Code.

The first look-back provision states that stock is not QSBS if, in one or more purchases during the 4-year period beginning on the date two years before the stock was issued, the corporation purchases more than a de minimis amount of its stock either directly or indirectly from the taxpayer or a related party.[131] Related parties are defined for this purpose by IRC §§267(b) or 707(b).[132] A stock purchase exceeds this de minimis threshold if the aggregate amount of the corporation's purchase exceeds $10,000 and the corporation acquires more than 2% of the stock held by the taxpayer and related parties.[133]

The second look-back provision states that stock is not QSBS if, in one or more purchases during the 2-year period beginning on the date one year before the issuance of the stock, the issuing corporation purchases:

- More than a de minimis amount of its stock, and
- The purchased stock has an aggregate value at the time of the respective purchases exceeding 5% of the aggregate value of all of the issuing corporation's stock as of the beginning of the 2-year period.[134]

A stock purchase exceeds this de minimis threshold when the aggregate amount of the stock purchase exceeds $10,000 and more than 2% of all outstanding stock is purchased.[135]

## IRC §1244 LOSSES ON SMALL BUSINESS STOCK

Generally, losses from the sale or exchange of stock are considered capital losses. Capital losses can be used to offset capital gains, and the excess of capital losses over capital gains can be used to reduce $3,000 ($1,500 for MFS taxpayers) of ordinary income per year.[136]

IRC §1244 allows an ordinary loss deduction to the following classes of taxpayers.[137]

- An individual to whom the stock was issued by a small business corporation (defined later)
- An individual who is a partner in a partnership at the time the partnership acquired the stock from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership

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128. IRC §1202(e)(6)(A).
129. IRC §1202(e)(6)(B).
130. Ibid.
131. Treas. Reg. §1.1202-2(a)(1).
132. IRC §1202(c)(3)(A).
133. Treas. Reg. §1.1202-2(a)(2).
134. Treas. Reg. §1.1202-2(b)(1).
135. Treas. Reg. §1.1202-2(b)(2).
136. IRC §1211(b).
137. Treas. Reg. §1.1244(a)-1.

Such taxpayers can **reduce ordinary income** by up to $50,000 ($100,000 if MFJ) of small business stock losses.[138] Losses on qualified §1244 stock in excess of this limitation are treated as capital losses, subject to the capital gains limitation.[139]

> **Example 5.** Greg Thomas, a single filer, sold 1,000 shares of qualified §1244 stock in 2017 at a loss of $55,000. He has one other nonqualified stock transaction during the year with a $1,000 gain.
>
> Greg's total loss on stock transactions is $54,000 ($55,000 – $1,000) in 2017. He claims $50,000 as a §1244 ordinary loss on Form 4797, which leaves him with a $4,000 capital loss on Form 8949. He is limited to a $3,000 capital loss deduction. He carries the unused $1,000 ($4,000 – $3,000) capital loss to 2018. Greg claims $50,000 of ordinary loss and $3,000 of capital loss on his 2017 return.



For purposes of §1244, small business stock must meet the following criteria.

- The stock must be issued by a domestic corporation.[140]
- The stock must be issued in exchange for money or property other than stock or securities.[141]
- The stock must be issued by a **small business corporation,** which means:[142]
  - The aggregate amount of money and other property the corporation received for stock, capital contributions, and paid-in surplus cannot exceed $1 million for all stock issued; and
  - At the time the property is received by the corporation, the amount taken into account is equal to the corporation's adjusted basis of any property (other than money) less any liability to which the property is subject or which the corporation assumes.
- During the most recent five tax years ending before the loss was sustained, the corporation must have derived more than half of its aggregate gross receipts from sources **other than** royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.[143] Gross receipts from the sale or exchange of securities are taken into account only to the extent of gains.[144] The aggregate gross receipts test does not apply if the corporation's deductions exceed its gross income during the 5-year look-back period.[145] Deductions claimed for net operating loss carryover and carryback purposes and the special dividends-received deduction do not count in this calculation.[146]

Any amount treated as an ordinary loss under §1244 is considered attributable to a trade or business of the taxpayer for purposes of the net operating loss deduction.[147]

138. IRC §1244(b).
139. IRC §1244(a).
140. IRC §1244(c).
141. Ibid.
142. IRC §1244(c)(3).
143. IRC §1244(c)(1)(C); For corporations without a 5-year earnings history, see IRC §1244(c)(2)(A).
144. IRC §1244(c)(2)(B).
145. IRC §1244(c)(2)(C).
146. Ibid.
147. IRC §1244(d)(3).

## SMALL BUSINESS DEDUCTIONS FOR FSAs, HRAs, AND HSAs

Generally, for qualifying medical expenses, a taxpayer may reduce tax liability under either of two Code sections.

- Take an itemized deduction for qualifying medical expenses in excess of 10% of AGI under IRC §213
- Use a qualifying medical expense reimbursement plan (MERP) under IRC §105

**Note.** For the 2013 through 2016 tax years, a lower 7.5%-of-AGI threshold applied for itemized deductions if the taxpayer or taxpayer's spouse attained age 65 before the end of the tax year. This provision **expired** and no longer applies for 2017 and subsequent tax years.[148]

**Qualifying medical expenses** are defined in IRC §213 and include expenses to diagnose, treat, or mitigate disease, transportation costs necessary to obtain medical care, amounts paid for prescription drugs or insulin, and medical insurance premiums. Long-term care premiums also qualify, subject to certain limits. For further information on what expenses qualify, see IRS Pub. 502, *Medical and Dental Expenses.*

For taxpayers with small businesses, use of a qualifying MERP may bring important tax advantages. A qualifying MERP can be one of the following.

- Flexible spending arrangement (FSA)[149]
- Health reimbursement arrangement (HRA)[150]
- Health savings account (HSA)[151]

The rules governing each of the preceding three types of qualified MERPs, and their respective advantages to the small business owner, differ. Each qualified MERP is discussed in greater detail in this section.

**Note.** The Archer MSA, which is viewed as the precursor to the HSA, is another qualifying MERP. While it is not possible to establish a new Archer MSA after December 31, 2007, such accounts in existence as of that date were grandfathered. This section discusses only the HSAs, FSAs, and HRAs.[152]

### CAFETERIA PLANS

A **cafeteria plan** is a written employer-sponsored benefits package offering employees a choice between two or more benefits consisting of either cash or qualified benefits that may be excluded from income.[153] MERPs such as an HSA or FSA are commonly offered as part of a cafeteria plan. An HRA cannot be offered as part of a cafeteria plan.[154]

148. IRC §213(f).

149. Treas. Regs. §§1.125-1(a)(3)(B) and 1.125-5.

150. IRS Notice 2002-45, 2002-2 CB 93, amplified by Rev. Rul. 2006-36, 2006-36 IRB 353, modified by IRS Notice 2007-22, 2007-10 IRB 670, amplified by IRS Notice 2008-59, 2008-29 IRB 132.

151. IRC §223.

152. IRC §220(i). See also *Tax-Advantaged Accounts for Health Care Expenses: Comparison, 2013.* Rapaport, Carol. Nov. 8, 2013. Congressional Research Service. [fas.org/sgp/crs/misc/RS21573.pdf] Accessed on Jun. 22, 2017.

153. IRC §125(d) and Prop. Treas. Reg. §1.125-1.

154. Prop. Treas. Reg. §1.125-1(q).

If a cafeteria plan is used, the following rules apply.

- The small business owner, as employer, may not participate in the cafeteria plan[155]
- Certain nondiscrimination rules under IRC §125 apply.

For any cafeteria plan, the small business owner is generally not considered an "employee," and therefore is prohibited from participating in cafeteria plans. Partners in a partnership and more-than-2% shareholders in S corporations are not considered employees and cannot participate in the cafeteria plan.[156] However, shareholders in a C corporation who are also employed by the corporation can participate.[157]

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**Note.** For the definition of a more-than-2% shareholder (referred to as a "2% shareholder"), see IRC §1372(b). While the IRC §318 attribution rules apply to determine who is a 2% shareholder, they do not apply to partners in a partnership.[158] Accordingly, a family member of a partner may participate in the cafeteria plan as long as they are genuinely employed by the partnership.

Some accounts, such as HSAs, may be established on a "stand-alone" basis without the use of a cafeteria plan. Such accounts may generally be used by the small business owner.

In addition, a cafeteria plan may be structured to provide an employee with the ability to accept a reduction in salary and have the reduction amount contributed into qualified benefit accounts. The cafeteria plan may require the employer to make contributions to employee qualified benefit accounts. A cafeteria plan may also be structured to provide employees with a combination of a salary reduction option and the ability to elect how to use employer funds among the qualified benefit account options offered.[159]

## HEALTH FLEXIBLE SPENDING ARRANGEMENT

Generally, an FSA is an account established by the employer for an employee.

An employer may contribute to an FSA, and the employee may also contribute pre-tax dollars through a cafeteria plan salary reduction arrangement.[160] The FSA is used to reimburse the employee for qualifying health care, dependent care, or adoption expenses.[161] FSA distributions to reimburse the employee for qualified expenses are not taxable.[162]

Medical expenses that qualify for FSA reimbursement are those expenses that would otherwise qualify for the medical expense deduction under IRC §213(d).[163] Generally, dependent care expenses must meet the definition found in IRC §129 to qualify for reimbursement.[164] Qualifying adoption expenses are those that qualify under an adoption assistance program, as defined in IRC §137.[165]

**Note.** For further details on FSA qualifying expenses, see Prop. Treas. Reg. §1.125-5, which governs FSAs.

155. Prop. Treas. Reg. §1.125-1(g).
156. Prop. Treas. Reg. §1.125-1(g)(2); IRC §§401(c) and 1372.
157. Ibid.
158. Treas. Reg. §1.125-1(g)(2).
159. Treas. Reg. §1.125-1(c)(1)(iv).
160. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*
161. Treas. Reg. §1.125-5(h).
162. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*
163. IRC §105(b).
164. Prop. Treas. Reg. §1.125-5(i).
165. Prop. Treas. Reg. §1.125-5(j).

The 2017 contribution limit for an FSA is $2,600.[166] This amount is subject to an annual inflation adjustment.

An FSA does not provide the ability to accumulate funds from year to year. The FSA is subject to the "use-it-or-lose-it" rule: The account holder may forfeit any balance remaining in the account at the end of the plan year for which the FSA is established.[167] However, at the employer's option, a grace period may be established to extend the period during which FSA funds must be used before forfeiture. The maximum grace period is 2½ months after the end of the plan year.[168] Furthermore, if the employer does not offer a grace period for the FSA, the employer can provide a $500 rollover of unused funds to the following plan year.[169]

**Note.** For more information about FSAs, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Employment Issues.

### Tax Savings

FSAs funded by employees reduce the **employer's** tax liability, because the amounts contributed to FSAs by employees are not subject to FICA taxation. In addition, FSA contributions are not subject to either income or FICA taxation for the **employee.**[170]

**Observation.** Although FSAs allow for reimbursement of broader types of expenses than those that qualify under an HSA, the FSA contribution limits are lower, which means potential tax savings are less than those available for an HSA.

Reimbursements to the employee for qualified expenses are excluded from the employee's income.[171]

### Limitations on Use by Business Owners

While FSAs for employees can provide small business owners with savings in payroll taxes, many small business owners are prohibited from using an FSA for their own benefit because an individual must be an employee to use an FSA.[172] For purposes of FSA eligibility, the definition of an employee does not include a partner, a 2% shareholder, or a proprietor.[173] However, this prohibition does not apply to business owners operating as C corporations.[174]

## HEALTH REIMBURSEMENT ARRANGEMENTS

An HRA is a plan funded exclusively by the employer that reimburses employees for qualified medical costs.[175] The HRA is a tax-advantaged "self-funded" plan that is subject to nondiscrimination rules.[176]

Employees receive reimbursement for qualified medical expenses up to a maximum dollar amount for a given period, specified in the terms of the HRA.[177] Because the reimbursements are tax-exempt to employees, there is no employee Form 1040 reporting requirement for HRA reimbursement of qualified medical expenses.

166. Rev. Proc. 2016-55, 2016-45 IRB 707.

167. Prop. Treas. Reg. §1.125-5(c); IRS Notice 2005-42, 2005-23 IRB 1204.

168. Prop. Treas. Reg. §1.125-1(e).

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

170. IRC §3121(a)(2).

171. IRC §125(a).

172. Prop. Treas. Reg. §§1.125-5(a)(1) and (g)(1).

173. Treas. Reg. §1.125-1(g).

174. Treas. Reg. §1.105-5(b) and IRC §1372(a).

175. IRS Notice 2002-45, 2002-28 IRB 93, amplified by IRS Notice 2006-36, 2006-15 IRB 756.

176. See IRC §105(h)(2) and Treas. Reg. §1.105-11.

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

If the HRA plan permits employees to roll over unused amounts from year to year, employees have the opportunity to accumulate HRA funds sufficient to cover future medical costs if they arise.[178] However, the employer is not required to offer a rollover provision.

### Qualified Small Employer HRA



The 21st Century Cures Act,[179] signed into law on December 13, 2016, created the qualified small employer HRA, (commonly referred to as the "small employer HRA"). These new small employer HRAs are available effective January 1, 2017.

Market reforms for group health plans prohibit imposing lifetime or annual dollar limits on benefits, based on how the Affordable Care Act defines these prohibitions.[180] Details regarding these market reforms are found in Treas. Reg. §54.9815-2711.

> **Note.** For further information on applicable market reforms for HRAs and other §105 accounts, see the Department of Labor Technical Release No. 2013-03, *Application of Market Reform and other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain other Employer Healthcare Arrangements.* This can be found at **uofi.tax/17b3x2** [www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/technical-releases/13-03].

The 21st Century Cures Act creates a specific exception for the new small employer HRA.[181] Therefore, the eligible small business owner may use a small employer HRA without violating these market reforms.

To receive reimbursements from a small employer HRA, the employee must have minimum essential coverage (MEC). However, an employee that qualifies for the premium tax credit (PTC) will have their PTC reduced by the amount of the employee's permitted HRA benefit.[182]

To qualify as a small employer HRA, the arrangement must meet the following requirements.

- Be funded solely by an eligible small employer (generally an employer with under 50 full-time employees)[183]
- Provide for payment or reimbursement of qualified medical care expenses incurred by the employee (or employee's family members) after the employee provides proof of coverage to the small business employer[184]
- Not pay or reimburse more than $4,950 of expenses for a single employee, or more than $10,000 for an employee with family coverage, for the year.[185] (These dollar amounts are prorated for eligible employees covered by the HRA for less than a year and are subject to future cost-of-living inflation adjustments.)

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178. Ibid.
179. PL 114-255.
180. IRC §9831.
181. IRC §9831(d)(1).
182. IRC §36B(c)(4).
183. IRC §9831(d)(3)(B).
184. IRC §9831(d)(2)(B).
185. Ibid.

An **eligible employee** is generally any employee of the employer. However, employers may exclude certain employees, including those who have not completed 90 days of service or who have not attained age 25. Part-time or seasonal employees may also be excluded.[186]

A small employer HRA must generally provide the same terms to all eligible employees. However, variances in the terms are allowed based on the employee's age and/or the age of family members and the number of family members covered by the arrangement.[187]

**Note.** For further information about small employer HRAs, including the coordination with the PTC, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: New Developments.

## HEALTH SAVINGS ACCOUNT

HSAs are established by individuals with an HSA-qualified high-deductible health plan (HDHP). The HDHP must meet certain requirements to qualify as coverage that may be used with an HSA. These requirements include a minimum annual deductible amount as well as a limit on the annual out-of-pocket expenses the plan holder may incur for the plan year. The amounts for each of these requirements vary for self-only and family coverage and are subject to adjustments for inflation. The following table provides relevant HDHP amounts and applicable contribution limits for 2017.[188]

| HDHP Feature | Self-Only Coverage | Family Coverage |
|---|---|---|
| Minimum annual deductible | $1,300 | $ 2,600 |
| Maximum annual out-of-pocket expenditures | 6,550 | 13,100 |
| Maximum contribution | 3,400 | 6,750 |

**Note.** An individual who attained at least age 55 before the end of the tax year and who is not enrolled in Medicare can also make a "catch-up" contribution of $1,000 to their HSA. This $1,000 amount is not subject to an inflation adjustment.[189]

Contributions to an HSA made by either the taxpayer or the taxpayer's employer are reported on Form 8889, *Health Savings Accounts (HSAs).* HSA distributions are also reported on this form.[190] If a sole proprietor makes contributions to employee HSAs, those contributions are deductible as an employee benefit programs expense on Schedule C.[191]

**Note.** Most of the governing rules for HSAs are found in IRC §223. For additional information about HSAs, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 7: Individual Taxpayer Topics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

186. IRC §9831(d)(3)(A), referencing IRC §105(h)(3)(B).
187. IRC §9831(d)(2)(C).
188. Rev. Proc. 2016-28, 2016-20 IRB 852.
189. IRC §223(b)(3).
190. Instructions for Form 8889.
191. IRC §162(a).

If a taxpayer pays qualified medical expenses using a tax-free HSA distribution, they may not also claim these expenses as a medical expense deduction on Schedule A, *Itemized Deductions.*[192]

Funds within an HSA remain with the employee who owns the account. This is true regardless of whether the employee changes employers.[193] Moreover, any unused funds within the HSA at the end of the year remain in the account and may continue to accumulate year after year until the employee chooses to use them for qualified medical expenses. In addition, if the HSA owner dies, the account may pass to a surviving spouse without immediate tax consequences and the spouse becomes the new account owner.[194]



**Observation.** The ability to accumulate funds within an HSA over a long period means the small business owner may use the HSA for tax-deferral purposes. This ability to accumulate funds is one advantage of the HSA that does not exist with an FSA, because an FSA requires the account holder to use funds contributed each year or lose them (subject to a grace period or an allowable $500 rollover to the following year, as discussed earlier).

**Note.** For further details on HSAs, including the 20% penalty on distributions not used for qualifying medical expenses[195] and the rules regarding excess contributions, see IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

### Comparability Rules and HSAs[196]

Generally, if an employer makes contributions to employee HSAs, comparability rules apply.[197] These rules require the employer to make comparable contributions to all employees with "comparable coverage." Comparable coverage refers to the categories of coverage that employees may have. Generally, the two categories of coverage are self-only coverage and family coverage. However, employees with family coverage may be further categorized based on the relationship and number of family members covered.[198]

However, these comparability rules do not apply to employer contributions made to employee HSAs that are offered through a cafeteria plan. Instead, the cafeteria plan nondiscrimination requirements apply.[199] There is a 35% excise tax on an employer who fails to adhere to the comparability rules.[200]

### HSAs and Entity Types[201]

The tax benefits of HSAs vary by the type of business entity and the individual's role as an employee or an employer.

Employees agree to reduce their salary by the desired HSA contribution amount, and that amount is contributed to their HSA. This is a pretax contribution not subject to income tax or FICA withholding.

192. IRC §223(f)(6).

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

194. IRC §223(f)(8).

195. IRC §223(f)(4)(A).

196. TD 9393, 2008-20 IRB 975; and IRC §4980G.

197. IRC §§4980E(a), (d)(1).

198. Treas. Reg. §54.4980G-1.

199. IRC §§4980E(d) and 4980G; Treas. Reg. §54.4980G-5.

200. Treas. Reg. §54.4980G-1.

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

Employers benefit from savings on the employer portion of FICA on the HSA contribution amounts. They may also save federal unemployment taxes on the contribution amounts. In addition, there may be state-level unemployment tax savings, depending on the applicable rules of the state in which the employer does business.

**Sole Proprietorships and HSAs.** A sole proprietor who makes a contribution to their own HSA may claim an above-the-line deduction on line 25 ("health savings account deduction") of Form 1040 for the amount contributed to the HSA (up to the allowable amount for the year).[202] While the proprietor's contribution to their own HSA is not deductible by the business, HSA contributions made by the proprietorship to employee HSAs are deductible business expenses.[203]

For a pre-tax contribution, the contribution amount is not included as compensation in box 1 of Form W-2, *Wage and Tax Statement,* for the employees, but the contribution amount is shown on each employee's respective Form W-2 in box 12, using code "W" to identify the amount as an HSA contribution made by the employer. The pre-tax contribution amount is not subject to FICA.[204]

**Example 6.** Larry is the owner of Big L's Pizza, a sole proprietorship with three employees. During 2017, Larry contributes $2,000 to his HSA. He also contributes $2,000 to the HSA for each of his three employees, for a total of $6,000 in employee HSA contributions.

On Larry's 2017 tax return, the $2,000 contribution Larry makes to his own HSA is shown on Form 8889, and is deducted on Form 1040, line 25, as an above-the-line deduction. [205]

The $6,000 of employee HSA contributions are deducted as employee benefit program expenses on Larry's Schedule C.[205] These employee HSA contributions are made on a pre-tax basis for each employee. The contribution amount for each employee is shown on their respective Forms W-2 in box 12, using code "W."

**Observation.** Larry's own HSA contribution does not reduce his SE tax,[206] but the contribution amount is tax deductible.[207] The employee contributions reduce Larry's SE tax because they are deducted as business expenses on Schedule C and reduce the amount of FICA in connection with employee compensation.

**Partnerships and HSAs.[208]** A partnership contribution to a partner's HSA could be characterized as a distribution or a guaranteed payment to the partner. The partner's Schedule K-1 reflects the HSA contribution.

**Note.** For additional information about HSAs and partnerships, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Partner Issues.

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

203. IRC §162(a)(1) and Treas. Reg. §1.162-10.

204. See General Instructions for Forms W-2 and W-3.

205. Instructions for Schedule C.

206. IRC §162(l)(4).

207. IRC §162(l)(1).

208. IRS Notice 2005-8, 2005-4 IRB 368.

**S Corporations and HSAs.** Generally, a contribution to a 2% shareholder's HSA by an S corporation is included in the shareholder's taxable income for the year[209] and is deductible by the S corporation.[210] The S corporation may deduct the amount either as compensation or as an employee benefit expense.[211] However, the S corporation shareholder may subsequently deduct the amount of the HSA contribution from income,[212] and the contribution amount is not subject to FICA taxation.[213]



> **Note.** The definition of 2% shareholder is subject to the IRC §318 attribution rules to determine if the 2% threshold is met.[214]

## HSA Tax Advantages

There are several advantages associated with the use of an HSA. These include the following.[215]

- Contributions to the HSA may be made by either the employee or employer.
- Any income earned on the contributions within the HSA is tax-exempt.
- Contributions may be made as late as the tax filing deadline for the year for which the contribution is attributable.
- Amounts withdrawn from the HSA by the employee and used for qualified medical expenses are not taxable.
- If the employer makes contributions to an employee's HSA, the contribution amount is not included in the employee's taxable income and is therefore not subject to FICA.[216]

The contributions by the small business owner to employee HSAs are tax deductible (and, for an employee, pre-tax contributions may be made). For both the employee and the business owner, an HSA contribution can provide advantages that would not accrue to either party from a wage increase.

**Example 7.** Clayton owns Clay's Marine Engine (CME), a sole proprietorship with one employee, Frank. Frank, who is CME's mechanic, has been employed at CME for five years. Frank has a spouse and two minor children and currently has a family health plan that he purchased using his state's health insurance exchange.

In 2016, Frank earned a salary of $67,500, and his marginal tax rate was 25%. Frank and Clayton discuss a 10% raise for 2017. Clayton agrees to give Frank a 10%, or $6,750, increase in salary for 2017. The taxes on this increase are as follows.

| | Clayton | Frank | Total |
|---|---|---|---|
| Social security tax (6.2%) | $419 | $ 419 | $ 838 |
| Medicare tax (1.45%) | 98 | 98 | 196 |
| Federal income tax liability (25% marginal tax rate) | | 1,688 | 1,688 |
| Total | $517 | $2,205 | $2,722 |

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209. See General Instructions for Forms W-2 and W-3.

210. IRS Notice 2005-8, 2005-4 IRB 368 and IRC §707(c).

211. IRC §162(l)(5).

212. IRC §3121(a)(2)(B).

213. IRS Notice 2005-8, 2005-4 IRB 368.

214. IRS Notice 2008-1, 2008-2 IRB 251.

215. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans;* IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*

216. IRC §3401(a)(22).

After income and FICA taxes, Frank's net additional compensation will be $4,545 ($6,750 – $2,205).

Alternatively, Clayton could suggest that Frank use an HSA in conjunction with an HDHP. Under this method, Clayton could use the entire $6,750 to fund Frank's HSA on a pre-tax basis. This would mean the $6,750 increase is not taxable to Frank, which saves him $2,205. Clayton would also save $517, which is the employer portion of FICA on the salary increase.

In addition, any income earned on the $6,750 HSA contribution is tax-exempt. Frank would not pay any income tax on amounts withdrawn from the HSA to cover qualified medical expenses. Clayton could deduct the $6,750 as an employee benefit program expense on his Schedule C for CME.

## BONUS DEPRECIATION

The Protecting Americans from Tax Hikes Act (PATH Act) of 2015[217] extends the ability to claim bonus depreciation and makes some substantive changes to the bonus depreciation rules.

Generally, the PATH Act extends bonus depreciation for eligible property acquired and placed in service before January 1, 2020.[218] However, the bonus rate is phased down, as indicated in the following table.[219]

| Year Eligible Property Placed in Service [a] | Bonus Rate |
|---|---|
| 2015 through 2017 | 50% |
| 2018 | 40% |
| 2019 | 30% |
| 2020 and subsequent years | 0% |

[a] The percentages apply to certain longer-lived and transportation property placed in service one year later.

The PATH Act also makes changes to the definition of eligible property. Eligible property is property placed into service before January 1, 2020, that falls into one of the following categories.[220]

- Modified accelerated cost recovery system (MACRS) property with a recovery period of 20 years or less
- Computer software (as defined in IRC §167(f)(1)(B)) that would otherwise qualify for a depreciation deduction
- Water utility property
- Qualified improvement property (QIP)

**Note.** Under the bonus depreciation property rules, the original use of eligible property must have been by the taxpayer.[221] This differs from the rule for qualifying IRC §179 property, which can be used property acquired by the taxpayer.[222]

217. PL 114-113 (Dec. 18, 2015).
218. IRC §168(k)(2)(A)(iii).
219. IRC §168(k)(6).
220. IRC §168(k)(2).
221. IRC §168(k)(2)(A)(ii).
222. IRC §179(d).

QIP is a new category of property created by the PATH Act.[223] QIP is any improvement to an interior portion of a building that is nonresidential real property. The improvement must be placed in service after the date the building was first placed in service.[224]

Expenditures associated with the following are excluded from the definition of QIP.[225]

- The enlargement of a building
- An elevator or escalator
- A building's internal structural framework



The PATH Act makes permanent the 15-year recovery period[226] on qualified leasehold improvement property (QLIP),[227] qualified restaurant property (QRP),[228] and qualified retail improvement property (QRIP).[229]

Under the changes made by the PATH Act,[230] any QLIP, QRP, or QRIP placed into service after 2015 must meet the definition of QIP to qualify for bonus depreciation. Under the QIP definition, QLIP does not need to be subject to a lease.[231] Moreover, before the PATH Act changes, QLIP needed to be placed in service more than three years after the building was first placed in service. This 3-year requirement no longer applies.[232]

**Note.** For additional details on these PATH Act changes, see **uofi.tax/17b3x3** [www.journalofaccountancy.com/issues/2016/may/new-bonus-depreciation-provisions.html].

## BONUS DEPRECIATION ON PLANTS

The PATH Act also extends bonus depreciation to fruit-bearing and nut-bearing plants. Such plants are generally not considered to be placed in service before they bear fruit or nuts and generate income.[233] Costs incurred before the plants generate income, referred to as "preproduction costs," were previously not eligible for bonus depreciation. Under the PATH Act, such preproduction costs for fruit- and nut-bearing plants either planted or grafted after December 31, 2015, and before January 1, 2020, are eligible for bonus depreciation.[234] The bonus depreciation on such plants is subject to the phase-down rule for the bonus depreciation rate discussed earlier.[235]

**Note.** Once such plants are placed into service, the basis of the plants must be reduced by the amount of bonus depreciation claimed.[236] For further information on bonus depreciation for fruit- and nut-bearing plants, see IRC §168(k)(5) and IRS Pub. 225, *Farmer's Tax Guide.*

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223. IRC §168(k)(3)(A).
224. Ibid.
225. IRC §168(k)(3)(B).
226. IRC §168(e)(3)(E).
227. IRC §168(e)(6).
228. IRC §168(e)(7).
229. IRC §168(e)(8).
230. IRC §168(k)(3) as amended by the PATH Act.
231. Ibid.
232. Ibid.
233. IRS Pub. 225, *Farmer's Tax Guide.*
234. IRC §168(k)(5).
235. IRC §168(k)(5)(F).
236. IRC §168(k)(5)(A)(ii).

## SALE OF BUSINESS ASSETS

Generally, a "capital asset" is defined as property held by the taxpayer, excluding such items as business property or inventory.[237] The sale of a capital asset may lead to a short- or long-term capital gain or loss as defined in the Code.[238] Business asset sales, however, are generally subject to other specific rules discussed in this section, because assets held for use within a trade or business are considered noncapital assets.[239]

Three Code sections must be considered when determining how to correctly report the sale of a business asset. These Code sections are summarized in the following table.

| IRC §1231 | IRC §1245 | IRC §1250 |
|---|---|---|
| • Most depreciable assets used in a trade or business that are held for **more than one year**<br>• Excludes inventory, property held by the taxpayer for sale to customers in the ordinary course of business, and certain other property | • Gain from depreciable personal property (tangible or intangible) and certain specific-purpose real estate<br>• Excludes most buildings or structural components of buildings | • Gain from depreciable real estate that is not IRC §1245 property |

**Note.** For more detailed definitions and exclusions that fall under each of the three Code sections, see IRC §§1231(b), 1245(a)(3) and (b), and 1250(c) and (d).

### IRC §1231 PROPERTY

For §1231 property dispositions, gains and losses are netted each year. If gains for the year exceed losses, those gains and losses are treated as long-term capital gains and losses.[240] However, if losses equal or exceed gains for the year, the gains and losses are treated as ordinary.[241]

The sale or exchange of real or depreciable property used in a trade or business is reported on Form 4797, *Sales of Business Property*. Form 4797 may be filed with an individual, partnership, C corporation, or S corporation return. Generally, gains or losses are shown on Form 4797, part I. Net gains are carried to Schedule D as a long-term capital loss, and net losses are carried to Form 4797, part II, as an ordinary loss.[242]

For years in which there is a net gain, a 5-year look-back period may serve to recharacterize some or all of the year's net gain as ordinary to the extent of the §1231 losses within the 5-year look-back period.[243] The amount of aggregate losses within the 5-year look-back period that has not yet been used to recharacterize any gain is referred to as a **nonrecaptured net §1231 loss.**

237. IRC §1221(a).

238. IRC §1222.

239. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

240. IRC §1231(a)(1).

241. IRC §1231(a)(2).

242. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

243. IRC §1231(c).

**Example 8.** Clarkson Paper (CP) has been gradually selling older paper production equipment since 2012 as part of an overall program to update its production capability. Prior to 2011, CP did not sell any business assets. Most of the asset sales in these prior years resulted in a loss, but some assets were sold at a gain. After netting all such gains and losses, each year has a resulting net loss with the exception of 2014, during which no assets were sold. The following losses are attributable to each of the last five years as a result of these asset sales.



| Year | Amount |
|---|---|
| 2011 | ($ 6,000) |
| 2012 | (4,000) |
| 2013 | (7,000) |
| 2014 | 0 |
| 2015 | (1,000) |
| Total | ($18,000) |

In 2016, CP decides to accept an offer from a local automobile parts distributor to purchase CP's conveyor belt system. Because the conveyor belt system is very valuable to the automobile parts distributor, CP can sell the system at a profit of $32,000. CP accepts the offer and sells the conveyor system, recognizing a $32,000 gain. The conveyor system is the only asset sold in 2016.

In 2016, the total of $18,000 shown in the preceding table is the amount of CP's nonrecaptured net §1231 loss. The 5-year look-back period is 2011 through 2015. While the $32,000 gain from the sale of the conveyor system would normally be characterized under IRC §1231 as long-term capital gain, this gain is recharacterized as ordinary income to the extent of the $18,000 nonrecaptured net §1231 loss.[244] Accordingly, CP reports the 2016 conveyor system gain as follows.

| | |
|---|---|
| Ordinary gain | $18,000 |
| Long-term capital gain | 14,000 |
| Total gain reported | $32,000 |

The relevant portion of CP's 2016 Form 4797 follows.

[244.] Ibid.

**For Example 8**

Form **4797** Department of the Treasury Internal Revenue Service

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

OMB No. 1545-0184
2016
Attachment Sequence No. 27

| Name(s) shown on return | Identifying number |
|---|---|
| Clarkson Paper | 99-1234567 |

1 Enter the gross proceeds from sales or exchanges reported to you for 2016 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) |
|---|---|---|---|---|---|---|
| Conveyor belt system | 01/31/1977 | 12/14/2016 | 142,000 | 15,000 | 125,000 | 32,000 |
| | | | | | | |
| | | | | | | |
| | | | | | | |

| | | |
|---|---|---|
| 3 Gain, if any, from Form 4684, line 39 | 3 | |
| 4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 | 4 | |
| 5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 | 5 | |
| 6 Gain, if any, from line 32, from other than casualty or theft | 6 | |
| 7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: | 7 | 32,000 |

**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 didn't 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 | 18,000 |
| 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 | 14,000 |

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

**Example 9.** Use the same facts as **Example 8,** except in 2014, CP sold an antique printing press to a museum and recognized gain of $20,000. No other assets were disposed of in 2014. Within the 5-year look-back period, CP has an unrecaptured net §1231 loss of $17,000, calculated as follows.

| | |
|---|---|
| 2011 | ($ 6,000) |
| 2012 | (4,000) |
| 2013 | (7,000) |
| Total | ($17,000) |

The $20,000 gain on the sale of the antique printing press in 2014 is treated as ordinary gain up to the amount of the nonrecaptured net §1231 loss of $17,000. The $20,000 gain on the sale in 2014 is reported as follows.

| | |
|---|---|
| Ordinary gain | $17,000 |
| Long-term capital gain | 3,000 |
| Total gain reported | $20,000 |

This leaves no nonrecaptured net §1231 loss amount remaining at the end of 2014 because the accumulated $17,000 IRC §1231 loss was applied against the 2014 IRC §1231 gain on the antique printing press. Accordingly, the only nonrecaptured net §1231 loss amount to be applied against the 2016 conveyor system sale is the $1,000 loss from 2015. Therefore, of the $32,000 gain in 2016, $1,000 is characterized as ordinary gain and the remaining $31,000 is characterized as a long-term capital gain.

### IRC §1245 PROPERTY

The general rule for the disposition of IRC §1245 property requires the recapture of any gain as ordinary income, up to the amount of any depreciation previously taken on the asset.[245] Gain in excess of prior depreciation is considered IRC §1231 gain and is treated as long-term capital gain for assets held more than one year.[246] If the IRC §1245 property is sold at a loss, the loss is considered an IRC §1231 loss and is treated as an ordinary loss, which may be claimed against the taxpayer's ordinary income. Property used in a trade or business with a holding period of one year or less is not IRC §1231 property, and gains or losses are ordinary.[247]



### IRC §1250 PROPERTY

For dispositions of IRC §1250 property, a special rule applies if an accelerated depreciation method is used to generate depreciation deductions in excess of those that would be available under the straight-line method. If an accelerated depreciation method is used, then any gain must be treated as ordinary income to the extent of the past depreciation claimed that exceeds the amount of straight-line depreciation.[248] If the IRC §1250 property held for more than one year is sold at a loss, the loss is considered an IRC §1231 loss and is treated as ordinary, which may be claimed against the taxpayer's ordinary income. If such property has a holding period of one year or less, any resulting gain or loss upon disposition is ordinary.[249]

> **Note.** For further details on nonrecaptured net §1231 gain and the treatment of gains or losses on the disposal of IRC §§1245 and 1250 property, see the instructions to Form 4797 and IRS Pub. 544, *Sales and Other Dispositions of Assets.*

## CORRECTING DEPRECIATION ERRORS

In order to correct an error involving depreciation deductions, it is necessary to take the following three steps.

1. Determine if there has been an adoption of an accounting method
2. Determine whether the required depreciation correction represents a change in accounting method
3. Make the correction

This section explains these steps and includes a review of some of the key IRS guidance in this area.

### ADOPTION OF AN ACCOUNTING METHOD

To correct a depreciation error, it must first be determined whether the taxpayer adopted an accounting method. Generally, an accounting method is adopted when the taxpayer files an initial return.[250] However, a taxpayer adopts a permissible method of accounting when it uses that method once on a tax return. If the taxpayer uses an impermissible method, that method is only adopted upon the filing of two consecutive returns.[251]

> **Note.** For exceptions to the 2-year rule for an impermissible method, see Rev. Proc. 2016-29, modified by IRS Notice 2017-6.

245. IRC §1245(a).
246. IRC §§1231(a)(1) and 1231(a)(3)(A)(ii)(II).
247. Treas. Reg. §1.1221-1(b) and IRC §1231(a)(3)(A)(ii)(II).
248. IRC §1250(a)(1).
249. Treas. Reg. §1.1221-1(b).
250. Treas. Reg. §1.446-1(e)(1).
251. Rev. Rul. 90-38, 1990-1 CB 57 and IRM 4.11.6.3 (2005).

Generally, a **permissible** accounting method includes the cash method, the accrual method, or other methods or combination of permissible methods that clearly reflect income and are consistently used.[252]

Once a taxpayer adopts an accounting method, certain depreciation error corrections may constitute a change in accounting method. The IRS's consent is generally required for the change in accounting method, which the taxpayer obtains by filing Form 3115, *Application for Change in Accounting Method.* An amended tax return may not be used to correct the error for open years.

## CHANGE IN ACCOUNTING METHOD

IRS guidance provides a detailed list of the various types of depreciation changes that constitute a change in accounting method[253] and the types of depreciation changes that do **not** represent a change in accounting method.[254]

The following table summarizes changes in depreciation and indicates whether such changes, if required to correct depreciation errors made in prior years, represent a change in accounting method.[255]

| Change in Accounting Method | Not a Change in Accounting Method |
|---|---|
| • Depreciation method | • A mathematical or posting error[256] |
| • Period of recovery | • A change in the use of the asset that triggers a change in recovery period or method |
| • Convention | • To correct internal inconsistencies (such as identical assets not depreciated identically)[257] |
| • From depreciable to nondepreciable asset (or vice versa) | • Making a late depreciation election or revoking a timely made election |
| • Bonus depreciation amount(s) claimed and corrections in other affected depreciation deductions | • Change in the placed-in-service date[258] |
| • Single-asset depreciation to pooled-asset depreciation (or vice versa) | |
| • Misclassification of an asset | |

**Note.** This IRS guidance on depreciation corrections and changes in accounting method applies for assets placed in service on or after December 30, 2003.[259] For depreciation corrections involving assets placed in service before December 30, 2003, amended returns may be filed to make the necessary corrections for open years or a Form 3115 may be used.[260]

**Note.** A change from expensing to capitalizing an amount also constitutes a change in accounting method. For further details, see CCA 201231004.

252. Treas. Reg. §1.446-1(c).

253. Treas. Reg. §1.446-1(e)(2)(ii)(d)(2).

254. Treas. Reg. §1.446-1(e)(2)(ii)(d)(3).

255. Treas. Reg. §1.446-1(e)(2)(ii)(d).

256. Treas. Reg. §1.446-1(e)(2)(ii)(b). The term "mathematical or posting error" is not defined in the IRS guidance regarding depreciation corrections. However, this same term is defined in IRC §6213(g)(2) in connection with summary assessments for additional tax without notice due to mathematical or posting errors. Presumably, the same definition applies to depreciation errors.

257. *H.E. Butt Grocery Company v. U.S.*, 108 F.Supp. 2d 709 (W.D. Texas 2000).

258. For the special rules applicable to a change in an asset's placed-in-service date, see Treas. Reg. §1.446-1(e)(2)(ii)(d)(3)(v).

259. Treas. Regs. §§1.446-1(e)(4) and 1.167(e)-1.

260. Chief Counsel Notice 2004-007 (Jan. 28, 2004), clarified by Chief Counsel Notice 2004-024 (July 14, 2004).

**Note.** For more information about filing Form 3115 to correct depreciation, including a detailed example with a completed Form 3115, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Depreciation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].



## MAKING THE CORRECTION

If a taxpayer has filed only **one return** using an impermissible method of depreciating property, they have not adopted an accounting method. The taxpayer may file either a Form 3115 or an amended return making the required corrections.[261]

Generally, an IRC §481(a) adjustment may be required by taxpayers who change their accounting method using Form 3115.[262] The adjustment is necessary to prevent duplication or omission of items as a result of the accounting method change.

**Note.** For additional information on IRC §481(a) adjustments, see the instructions to Form 3115, *Application for Change in Accounting Method.*

If a taxpayer filed two or more consecutive returns using an impermissible method, they have adopted an accounting method.[263] This generally means that amended returns cannot be filed to make the necessary correction. The IRS advance or automatic consent procedures, within Form 3115, must be used.[264]

### Automatic Consent

Taxpayers who adopted an accounting method and need to correct depreciation amounts may qualify for **automatic consent** under Rev. Proc. 2017-30.[265] Automatic consent changes do not require the IRS's express approval.

**Note.** Taxpayers who qualify for automatic consent must generally use automatic consent procedures when filing Form 3115. For further details on automatic consent, see the instructions to Form 3115.

To qualify for automatic consent, the taxpayer must generally meet the following requirements.

- The taxpayer must have used an incorrect depreciation method for at least two tax years prior to the year of change.
- The taxpayer is making a change in depreciation that constitutes a change in accounting method.
- The taxpayer owns the depreciable asset at the beginning of the tax year of change.

Exceptions to the preceding requirements exist that may allow other taxpayers who have adopted an accounting method to use Rev. Proc. 2017-30 automatic consent procedures to correct depreciation. For example, a taxpayer may still qualify if they fail to meet the 2-year requirement because they placed the property in service in the year immediately preceding the year of change.[266]

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261. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(1)(b)).
262. IRC §481(a) and Treas. Reg. §1.481-1.
263. Rev. Rul. 90-38, 1990-1 CB 57 and Rev. Proc. 2007-16, 2007-4 IRB 358.
264. Rev. Proc. 2007-16, 2007-4 IRB 358.
265. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(1)(a)).
266. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(1)(b)).

In addition, automatic consent may be available to a taxpayer who seeks an accounting method change in connection with the depreciation of an asset sold during the year if inadequate depreciation was claimed (or if no depreciation was claimed) for that asset.[267]

If the taxpayer qualifies to use the automatic consent procedure under Rev. Proc. 2017-30, the taxpayer may make the necessary corrections using Form 3115 with an appropriate IRC §481(a) adjustment.

**Availability of Automatic Consent.** Automatic consent to correct depreciation under Rev. Proc. 2017-30 is not available in all instances. Rev. Proc. 2017-30 provides a list of changes to which Rev. Proc. 2017-30 does not apply. Among the items in this list are depreciation changes such as the following.[268]

- Changes associated with making or revoking certain elections, including IRC §179
- Changes for property for which depreciation is determined using the asset depreciation range (ADR) depreciation
- Changes for property for which a tax credit was claimed

**Change from One Permissible Method to Another.** Rev. Proc. 2017-30 provides for automatic consent for certain changes from one permissible method to another.[269] Some of the permissible-to-permissible method changes covered under Rev. Proc. 2017-30 that may provide for automatic consent include the following.

- Change in general asset account treatment because of change in use of MACRS property[270]
- Change in qualified nonpersonal use vans and light trucks[271]
- Change for certain leasehold improvements[272]
- Change for dispositions of buildings or structural components[273] and tangible depreciable assets[274]

> **Note.** Rev. Proc. 2017-30 contains the most recent list of changes for which automatic consent is available. This list is extensive and covers many areas that are outside the scope of this section. Practitioners should become familiar with the contents of Rev. Proc. 2017-30 before filing a Form 3115.

## Advance Consent

If the taxpayer, after adopting an accounting method, does not qualify for automatic consent to make the necessary corrections to depreciation amounts claimed, the taxpayer may file Form 3115 under the **advance (nonautomatic) consent provisions** of Rev. Proc. 2015-13.[275] Such a request **requires** IRS consent.

> **Note.** For further details on filing Form 3115 under the advance consent procedures, see Rev. Proc. 2015-13 and the instructions to Form 3115.

267. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.07).
268. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(1)(c)).
269. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.02).
270. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.04).
271. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.06).
272. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.11).
273. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.13).
274. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.15).
275. Rev. Proc. 2015-13, 2015-5 IRB 419.

### Reduced Filing Requirement for Qualified Small Taxpayers

Rev. Proc. 2017-30 provides a reduced filing requirement for qualified small taxpayers.[276] Taxpayers qualify if they have $10 million or less in average annual gross receipts for the three years preceding the year of accounting method change.[277]



> **Note.** The calculation of average annual gross receipts is subject to special rules. For further details, see Treas. Reg. §1.263(a)-3(h)(3).

Qualifying small taxpayers are required to complete only select parts of Form 3115 instead of completing the entire form.[278] If required, such taxpayers make an appropriate §481(a) adjustment[279] and basis adjustment[280] for the affected asset(s).

> **Note.** For additional details on these reduced filing requirements for qualified small taxpayers, see Rev. Proc. 2017-30, Section 6.01(4).

## SALE OF ASSET ACQUIRED IN LIKE-KIND EXCHANGE

Under the like-kind exchange (LKE) rules, no gain or loss is recognized if qualified business or investment property is exchanged for other qualifying property of like kind in a qualifying transaction.

> **Note.** For details on LKE transactions and the qualifying rules, see IRC §1031 and the related regulations.

Generally, in an LKE transaction, the basis of the property relinquished becomes the basis in the property acquired.[281] This **substituted basis** is subject to various adjustments. The basis is decreased by the amount of any money the taxpayer receives in the exchange transaction. Basis is increased by any recognized gain and decreased by any recognized loss on the property exchange transaction. All taxpayers involved in LKE transactions must disclose the details of the transaction to the IRS using Form 8824, *Like-Kind Exchanges*.[282] The basis adjustments are entered in part III of the form.

The basis amount shown on Form 8824, after required adjustments, is the acquirer's beginning basis in the acquired property. This substituted basis amount, after all required adjustments, is the beginning basis amount used for depreciation deduction purposes during the acquirer's holding period.[283]

When the LKE property is sold, the sale is first reported on Form 8824. Any resulting gain or loss is then shown on Form 4797. The sale of the LKE property may be subject to IRC §§1231, 1245, or 1250 rules, depending upon the nature of the property and the acquirer's holding period.

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276. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(4)).
277. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(4)(b)).
278. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(4)(a)).
279. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(5)).
280. Rev. Proc. 2017-30, 2017-18 IRB 1131 (Section 6.01(6)).
281. IRC §1031(d).
282. Instructions for Form 8824.
283. Treas. Reg. §1.1016-10.