Chapter 3: Small Business Issues

Please note. Corrections were made to this workbook through January of 2020. 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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ACCOUNTABLE PLANS AFTER THE TAX CUTS AND JOBS ACT

EFFECTS OF THE TAX CUTS AND JOBS ACT

Under the law in effect prior to the Tax Cuts and Jobs Act (TCJA),[1] employees could deduct their substantiated expenses[2] paid or incurred under a nonaccountable plan (discussed later), but only as a miscellaneous itemized deduction, subject to a 2% of adjusted gross income (AGI) floor.[3] However, the TCJA suspended miscellaneous itemized deductions, which include most employee business expenses, for tax years 2018–2025.[4] Thus, employee expenses paid or incurred under a nonaccountable plan are not currently deductible. This is also true for unreimbursed employee business expenses incurred by the employee when the employer has no reimbursement policy.

Because of this new tax treatment, it is anticipated that employees will pressure employers to establish accountable plans to reimburse employees for expenses they incur in the course of their employment.

> **Note.** The TCJA eliminated the employer's deduction for entertainment expenses after 2017 and the deduction for meals after 2025. Employers can still deduct 50% of certain meals expenses through December 31, 2025. However, these provisions do not preclude employers from reimbursing their employees in full for entertainment and meals expenses. For more information on the changes to employers' tax deductions for entertainment and meals expenses, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns. For further information on such expenses, see IRS Pub. 535, *Business Expenses.*

TAX BENEFITS

The tax benefits of accountable plans are significant. Employers can reduce their employment taxes by paying **deductible business expenses** instead of compensating the employee with higher wages.

Employees need to understand the value of an accountable plan. With a nonaccountable plan (discussed later), the employee cannot deduct miscellaneous itemized deductions, which include unreimbursed employee expenses. Therefore, the after-tax cost of such expenses is higher.

To reduce the administrative burden, employers can use per diem payments or other simplified methods such as standard mileage rates.

ACCOUNTABLE PLAN REQUIREMENTS

An accountable plan should be in writing and address all major statutory and regulatory requirements. For the IRS to recognize an accountable plan, it must comply with the three following rules.[5]

1. Advances, allowances, and reimbursements must have a **business connection.** This means they must be for expenses incurred while performing services by the employee for an employer in the ordinary course of business.
2. Expenses must be adequately **substantiated** within a reasonable period of time.
3. Any **excess reimbursement or allowance must be returned** within a reasonable time period.

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1. PL 115-97, §11045(a).
2. Under the substantiation rules of Treas. Reg. §1.274-5, Temp. Treas. Reg. §1.274-5T, and Treas. Reg. §1.162-17.
3. IRC §67(a).
4. IRC §67(g), effective for tax years beginning after Dec. 31, 2017.
5. Treas. Reg. §§1.62-2(d), (e), and (f).

Each employee should have a copy of the accountable plan requirements and receive clear instructions on each of the plan's requirements and the impact on the employee's income if plan requirements are not met. An employer may have more than one arrangement with respect to a particular employee, depending on the facts and circumstances.

If all three conditions are **not** satisfied, the reimbursement or advance is treated as paid under a nonaccountable plan and thus taxed to the employee as wages subject to income tax withholding and FICA.

Detailed information for each requirement is discussed next.

Note. The three requirements for accountable plans are applied on an employee-by-employee basis. Therefore, if one employee fails to properly substantiate expenses under an arrangement, this does not cause amounts paid to other employees to be treated as paid under a nonaccountable plan.[6] However, if the expense arrangement fails one or more of the three conditions, this taints all amounts paid under the arrangement to an employee and thus all payments to that employee are treated as paid under a nonaccountable plan.[7]

Business Connection[8]

An arrangement meets the business connection requirement if it provides advances, allowances (including per diem allowances, allowances for meals and incidentals, and mileage allowances), or reimbursements for business expenses that are allowable as deductions under IRC §§161 through 198. The expenses must be paid or incurred (or reasonably expected to be incurred) by the employee in connection with the performance of services as an employee.[9]

Note. The expenses must be paid or incurred while the employee is performing services for the employer. For example, a legal settlement paid after the employee has terminated employment is not paid under an accountable plan.[10]

Forms of Payment. The employee can be paid by the employer, its agent, or a third party for whom the employee performs a service as an employee of the employer. The payment can include amounts charged directly or indirectly to the payor through an employer credit card or similar forms.

In addition, if the employer combines wages and the reimbursement or other expense allowance in a single payment, the reimbursement or other expense allowance must be specifically identified.

Two Arrangements for the Same Employee. In some cases, an arrangement pays deductible expenses and other bona fide expenses related to the employer's business (e.g., travel that is not away from home) that are not deductible under IRC §161 and following sections. In these cases, the payor is treated as maintaining two arrangements. The portion of the arrangement that provides payments for the deductible employee business expenses is treated as an accountable plan. The portion of the arrangement that pays nondeductible employee expenses is treated as a nonaccountable plan.

6. Treas. Reg. §1.62-2.
7. *Namyst v. Comm'r*, 435 F.3d 910 (8th Cir. 2006), *aff'd* TC Memo 2004-263.
8. Treas. Reg. §1.62-2(d).
9. Treas. Reg. §1.62-2(d)(3)(i).
10. See *Bielh v. Comm'r,* 351 F.3d 982 (9th Cir. 2003).

Reimbursement Requirement. The employer must adhere to the following reimbursement rules.

- The employer's payment to the employee must be to reimburse expenses incurred (or those expenses reasonably expected to be incurred).[11]
- When the employee is paid, the reimbursements or allowances must be clearly identified as such. It may be advisable to pay the employee's salary and reimbursements with separate checks. If paid together as salary and wages, the reimbursement or allowance should be indicated on the check stub.
- For a per diem allowance, the per diem calculation should be similar to that used in computing the employee's wages or other compensation, or be commonly used in the industry in which the employee is employed.[12]

Note. Standard business practices can be used to anticipate reasonable expenses when employees are paid by using a per diem (flat rate or stated schedule), even when payments are not supported by actual receipts.[13]

Example 1. Lawrence, Inc., a large economic consulting firm, pays its consultants $400 per day. On those days that a consultant travels away from home on business for the company, Lawrence, Inc. designates $150 of the $400 as paid to reimburse the consultant's travel expenses.

If an employer arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses, the arrangement does not satisfy the reimbursement requirements and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. Because Lawrence, Inc. pays consultants $400 per day regardless of whether the consultant was traveling away from home, the arrangement **does not satisfy** the regulations' reimbursement requirements.

Therefore, no part of the $150 Lawrence, Inc. designated as a reimbursement is treated as paid under an accountable plan. Instead, all payments under the arrangement are treated as paid under a nonaccountable plan. Lawrence, Inc. must report the entire $400 as wages or other compensation on the employees' Forms W-2, *Wage and Tax Statement,* and must withhold and pay employment taxes on the entire $400 when paid.

Example 2. Brix, Inc. pays all its salespersons a salary. Brix also pays a travel allowance under an arrangement that otherwise meets the three requirements of the regulations. This allowance is paid to all salespersons, including salespersons that Brix knows, or has reason to know, do not travel away from their offices on corporation business and would not be reasonably expected to incur travel expenses.

Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) deductible employee expenses but also to other employees, the arrangement **does not satisfy** the reimbursement requirements. Therefore, no part of the allowance Brix designated as a reimbursement is treated as paid under an accountable plan. Instead, all payments under the arrangement are treated as paid under a nonaccountable plan. Brix must report all payments under the arrangement as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the payments.

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11. Treas. Reg. §1.62-2(d)(3)(i).
12. Treas. Reg. §1.62-2(d)(3)(ii).
13. Rev. Proc. 90-60, 1990-2 CB 651 (§3.03); *Trucks Inc. v. U.S.,* 234 F.3d 1340 (11th Cir. 2000), in which the 11th Circuit held, in a motion for summary judgment by the IRS, that reimbursement of lodging expenses to long-haul truckers based on a percentage of load revenue was an acceptable method to anticipate reasonable expenses, and a question that falls within the purview of a jury.

Substantiation[14]

Employees must properly substantiate each business expense to their employer within a reasonable time period, using the requirements of IRC §274(d). IRC §274(d) requires the taxpayer to substantiate the following items.

- Travel
  - Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares
  - Dates of departure and return for each trip away from home, and number of days away from home spent on business
  - Destinations or locality of travel, described by name of city or town or other similar designation
  - Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel
- Entertainment in general
  - Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis
  - Date of entertainment
  - Name, address or location, and designation of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place
  - Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in §274(e)(1), the nature of any business discussion or activity
  - Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish the business relationship to the taxpayer
- Entertainment directly preceding or following a bona fide business discussion
  - Date and duration of business discussion
  - Place of business discussion
  - Nature of business discussion and business reason for the entertainment or nature of business benefit derived as a result of the entertainment
  - Identification of those persons entertained who participated in the discussion
- Gifts
  - Cost of the gift to the taxpayer
  - Date of the gift
  - Description of the gift
  - Business reason for the gift or nature of business benefit derived as a result of the gift
  - Occupation or other information relating to the recipient of the gift, including name, title, or other designation

14. Temp. Treas. Reg. §1.274-5T.

Substantiation Methods. A taxpayer must substantiate each element of an expenditure by adequate records or by sufficient evidence corroborating their own statement except as otherwise provided in §274. The taxpayer should maintain and produce substantiation that constitutes clear proof of an expenditure for travel, entertainment, or gifts referred to in §274.

Substantiation by Adequate Records. To meet the "adequate records" requirements of §274(d), the taxpayer must maintain a contemporaneous account book, diary, log, statement of expense, trip sheet, or similar record and documentary evidence which, in combination, is sufficient to establish each element of an expenditure. It is not necessary to record information in documents that duplicate information reflected on a receipt, as long as the account book and receipt complement each other in an orderly manner.

> **Note**. A credit card statement may not constitute sufficient documentary evidence of an expense. For example, the nature of an expense paid to a car rental company is ordinarily clear on its face. However, for lodging, a credit card statement normally does not segregate deductible lodging expenses from other business expenses that may not be deductible in full (such as meals subject to the 50% partial deduction disallowance of §274(n)) or from personal expenses (such as Internet service, phone calls, or gift purchases) that are not deductible business expenses.[15] Therefore, a credit card statement or charge record alone generally does not constitute acceptable documentary evidence of the amount of a lodging expense.

Substantiation by Other Sufficient Evidence. If a taxpayer cannot comply with the adequate records requirements, the expense must be substantiated by:

- The taxpayer's own statement, whether written or oral, containing specific details as to such element; and
- By other corroborative evidence sufficient to establish such element.

Returning Amounts in Excess of Expenses[16]

Employees must be required to return to the employer within a reasonable period of time any amount paid under the reimbursement arrangement that is in excess of the substantiated expenses. This determination depends on the facts and circumstances.

> **Note.** If an employee does not return advances or reimbursements in excess of those that are substantiated within a reasonable period, only the excess is treated as made under a nonaccountable plan (discussed later).[17]

15. Ltr. Rul. 200103015 (Oct. 16, 2000).
16. Treas. Reg. §1.62-2(f).
17. Treas. Reg. §1.62-2(c)(3)(ii).

ACCOUNTABLE PLAN REPORTING

Under an accountable plan, employers can deduct reimbursed travel and nonentertainment-related meals (subject to a 50% limit) as business expenses rather than wages.

The following portion of a table from IRS Pub. 535 explains how the employer reports reimbursements on the employee's Form W-2.

IF the type of reimbursement (or other expense allowance) arrangement is under an accountable plan with…	…THEN the employer reports on Form W-2
Actual expense reimbursement: Adequate accounting made and excess returned	No amount
Actual expense reimbursement: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1
Per diem or mileage allowance up to the federal rate: Adequate accounting made and excess returned	No amount
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12 — it is not reported in box 1.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting made up to the federal rate only and excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12 — it is not reported in box 1.

Note. A reimbursement under an accountable plan should be reported on Form W-2 using code L in box 12.

Note. Generally, per diem or vehicle/mileage payments up to the federal rate satisfy the adequate accounting requirement, with no resulting excess. Advance allowances can result in excess payments that, if not returned to the employer, result in taxable wages to the employee.[18]

TREATMENT OF PAYMENTS UNDER NONACCOUNTABLE PLANS

Amounts treated as paid under a nonaccountable plan are **included** in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes.[19]

Employee Reporting

Employees who pay employment-related business expenses under a nonaccountable plan report an advance or reimbursement as wages on line 1 of Form 1040, *U.S. Individual Income Tax Return*. Allowable deductions, if any, are claimed on Form 2106, *Employee Business Expenses,* and on Schedule 1, *Additional Income and Adjustments to Income,* as miscellaneous itemized deductions. The employee's meal and entertainment expenses are subject to the 50% limit. However, miscellaneous itemized deductions are suspended under the TCJA for 2018 through 2025.

18. IRS Pub. 463, *Travel, Gift, and Car Expenses.*

19. Treas. Reg. §1.62-2(c)(5).

DISPOSITION OF VEHICLE USING STANDARD MILEAGE RATE

The TCJA modified the tax treatment of like-kind exchanges for personal property used in a business. Any equipment or vehicles used in a business that are traded in after December 31, 2017, on the purchase of equipment or vehicles must be treated as a sale of that asset.[20]

Taxpayers using the standard mileage rate to account for vehicle expenses must calculate the adjusted basis of any vehicle upon disposition (trade-in or sale) to determine gain or loss. A portion of each year's respective IRS mileage rate consists of a depreciation allowance. The adjusted basis of a vehicle using the standard mileage rate cannot be reduced below zero.[21] Once the vehicle's adjusted basis has been reduced to zero, the taxpayer **can continue** to use the applicable IRS mileage rate to deduct vehicle costs. The depreciation component of the IRS standard mileage rate from 2000-2019 is shown in the following table.[22]

Rate of Depreciation Allowed in Standard Mileage Rate

Year(s)	Depreciation Rate per Mile
2019	$0.26
2017–2018	0.25
2015–2016	0.24
2014	0.22
2012–2013	0.23
2011	0.22
2010	0.23
2008–2009	0.21
2007	0.19
2005–2006	0.17
2003–2004	0.16
2001–2002	0.15
2000	0.14

Example 3. Leon purchased a car for $12,000 and placed it in service in 2015. He elected to use the standard mileage rate. The following table shows his business use of the car.

				Standard Mileage Rate Depreciation Component		
Year	Total Miles	Business Miles		Factor		Total
2015	3,000	2,500	×	$0.24	=	$ 600
2016	7,000	6,000	×	0.24	=	1,440
2017	8,000	6,000	×	0.25	=	1,500
2018	9,000	8,100	×	0.25	=	2,025
2019	2,000	1,700	×	0.26	=	442
	29,000	24,300				$6,007

20. TCJA §13303.

21. IRS Pub. 463, *Travel, Gift, and Car Expenses.*

22. IRS Notice 2019-02, 2019-02 IRB 281; IRS Notice 2013-80, 2013-52 IRB 821; Rev. Proc. 2008-72, 2008-50 IRB 1286; Rev. Proc. 2001-54, 2001-48 IRB 530.

This results in a business-use percentage of 84% (24,300 business miles ÷ 29,000 total miles). Leon trades in the vehicle in 2019 and receives a $7,000 trade-in allowance. Leon must report a taxable gain, calculated as follows.

Trade-in allowance		$7,000
Business-use percentage		× 84%
Pro-rated business-use portion of trade-in allowance		$5,880
Original purchase price of car	$12,000	
Business-use percentage	× 84%	
Pro-rated business-use portion of original purchase price	$10,080	
Less: accumulated depreciation component	(6,007)	
Adjusted basis	$ 4,073	(4,073)
Taxable gain		$1,807

Example 4. Use the same facts as **Example 3,** except the miles driven are as follows.

Year	Total Miles	Business Miles		Standard Mileage Rate Depreciation Component Factor		Total
2015	10,000	9,500	×	$0.24	=	$ 2,280
2016	15,000	14,000	×	0.24	=	3,360
2017	22,000	20,000	×	0.25	=	5,000
2018	21,000	18,000	×	0.25	=	4,500
2019	14,000	13,000	×	0.26	=	3,380
	82,000	74,500				$18,520

This results in a business-use percentage of 91% (74,500 business miles ÷ 82,000 total miles). Leon reports the following taxable gain.

Trade-in allowance		$7,000
Business-use percentage		× 91%
Pro-rated business-use portion of trade-in allowance		$6,370
Original purchase price of car	$12,000	
Business-use percentage	× 91%	
Pro-rated business-use portion of original purchase price	$10,920	
Less: accumulated depreciation component	(18,520)	
Adjusted basis	$ 0	(0)
Taxable gain		$6,370

Any gain or loss on a disposition of a vehicle for which used standard mileage rates were used should be reported on Form 4797, *Sales of Business Property*.

Practitioner Planning Tip

Most tax preparation software typically does not automatically calculate the gain or loss on the disposition of vehicles that used standard mileage rates. Therefore, preparers will need to manually calculate the gain or loss and enter the results in their tax preparation software.

PRODUCTION AND SALE OF MARIJUANA AND INDUSTRIAL HEMP

OVERVIEW

Industrial hemp and marijuana are part of the same genus, making them the plant equivalent of cousins. Although they look similar, the hemp plant has longer and thinner leaves and grows almost twice as tall (20 feet versus 10 feet). The major difference between the two is the level of tetrahydrocannabinol (THC), the chemical compound that causes humans to feel a psychoactive high, which each plant contains. The THC content of marijuana ranges from 5-35%. For industrial hemp, the THC content is typically no more than 0.3%.[23] It is impossible to get high from smoking industrial hemp. Instead, industrial hemp is valued for its high content of cannabidiol (CBD), a chemical compound that has been used in epilepsy medications and to treat pain, inflammation, anxiety, and insomnia.[24]

Although the plants originate in central Asia, both industrial hemp and marijuana have a long history in the United States. George Washington reportedly grew industrial hemp at Mount Vernon and used it for making rope, sailing canvas, and thread for clothing.[25] Throughout the years, it was also used as animal feed, paper, and building insulation.[26] Marijuana has mainly been used for getting high, a practice that caught the attention of the American public with the counterculture movement of the 1960s. This led to Congress passing the Controlled Substances Act of 1970,[27] which banned the production and sale of (among other substances) both marijuana and industrial hemp.

On December 20, 2018, Congress passed the Agriculture Improvement Act of 2018[28] (commonly known as the 2018 farm bill), making it legal again to grow industrial hemp in the United States. That legislation, coupled with the surging demand for CBD products, is what makes the subject of industrial hemp relevant today.

Marijuana, on the other hand, remains banned on the federal level as a controlled substance. However, it is now legal for medical purposes in 33 states and the District of Columbia and for recreational purposes in 10 states and the District of Columbia.[29] Illinois will be the 11th state to legalize marijuana for recreational purposes on January 1, 2020.[30] Therefore, a review of the federal tax issues and banking challenges surrounding state-legal marijuana is covered in this section, along with a discussion of industrial hemp.

INDUSTRIAL HEMP

Although the federal government has made it legal to grow industrial hemp, some state regulations still exist. For example, the state of Illinois requires hemp growers to submit a $100 application fee to the Illinois Department of Agriculture. If the registration is granted, an additional registration fee applies. Illinois also requires sampling and testing by an approved laboratory to ensure that THC levels stay at the required maximum of 0.3%. If hemp tests above 0.7% for THC, then the crop must be destroyed.[31]

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23. *Are Hemp and Marijuana the Same?* Ministry of Hemp. [ministryofhemp.com/hemp/not-marijuana] Accessed on Jun. 3, 2019.
24. *Cannabidiol (CBD)—what we know and what we don't.* Grinspoon, Peter. Aug. 24, 2018. Harvard Health Publishing. [www.health.harvard.edu/blog/cannabidiol-cbd-what-we-know-and-what-we-dont-2018082414476] Accessed on Jun. 3, 2019.
25. *Did George Washington Grow Hemp?* Mount Vernon Ladies' Association. [www.mountvernon.org/george-washington/facts/george-washington-grew-hemp] Accessed on Jun. 3, 2019.
26. *Hemp: A New Crop with New Uses for North America.* Small, Ernest and Marcus, David. Purdue University. [www.hort.purdue.edu/newcrop/ncnu02/v5-284.html] Accessed on Jun. 11, 2019.
27. 21 USC § 812.
28. PL 115-334.
29. *State Marijuana Laws in 2019 Map.* Governing Institute. [www.governing.com/gov-data/state-marijuana-laws-map-medical-recreational.html] Accessed on Jun. 3, 2019.
30. PA 101-27.
31. *Industrial Hemp Frequently Ask Questions.* Illinois Dept. of Agriculture. [www2.illinois.gov/sites/agr/Plants/Pages/Hemp-FAQ.aspx] Accessed on Jun. 3, 2019.

Once a farmer meets the state licensing requirements (if any), then the production of hemp is considered a trade or business and is treated no differently than the production of other crops.[32] The grower must include all of their sales in income and is entitled to all ordinary and necessary business expenses incurred in the production of that income.[33]

Example 5. Ned files an application with his state department of agriculture and is granted a license to grow industrial hemp. He incurs the following costs in 2019.

Seed	$ 1,000
Fertilizer	1,500
Land rent	1,000
Repairs	10,000
Depreciation	1,500
Total costs	$15,000

He sells his crop to a CBD extractor for $40,000. Ned's taxable income from the activity is $25,000 for the year ($40,000 sales – $15,000 cost of goods sold (COGS) and ordinary and necessary expenses).

STATE-LEGAL MARIJUANA

There are currently only 17 states in which it is **illegal** to produce and sell marijuana for either medical or recreational purposes.[34]

- Alabama
- Georgia
- Idaho
- Indiana
- Iowa
- Kansas
- Kentucky
- Mississippi
- Nebraska
- North Carolina
- South Carolina
- South Dakota
- Tennessee
- Texas
- Virginia
- Wisconsin
- Wyoming

In other states, certain taxpayers can **legally** produce or sell medicinal and/or recreational marijuana. Because marijuana is still a controlled substance under federal law, there are unique federal tax and business challenges facing these state-legal taxpayers.

32. PL 115-334.

33. IRC §162.

34. *State Marijuana Laws in 2019 Map.* Governing Institute. [www.governing.com/gov-data/state-marijuana-laws-map-medical-recreational.html] Accessed on Jun. 3, 2019.

Federal Tax Issues

Expenses Not Deductible. IRC §280E states:

> *No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.*

Therefore, businesses that traffic in controlled substances are not allowed deductions or credits on their federal income tax return, even if the state has legalized its production and distribution.[35]

Adjustment to Inventory for COGS. IRC §280E denies all ordinary and necessary business expenses paid or incurred in connection with the sale or trafficking of controlled substances listed on Schedule I or II of the Controlled Substances Act. Currently, 21 USC §812(c)(10) lists marijuana as a Schedule I drug. Furthermore, the courts have held that the sale of marijuana constitutes trafficking, regardless of legality at the state level. Thus, the ordinary and necessary deductions available to most businesses (both legal and illegal) are denied to the marijuana industry.[36] However, the Tax Court has allowed COGS adjustments for medical marijuana businesses while denying ordinary and necessary business expenses.[37]

Under uniform capitalization rulesS of the Code, any business required to keep an inventory (whether cash or accrual basis) is permitted to capitalize certain direct and indirect costs and to adjust their sales for COGS. Certain large businesses are required to capitalize certain direct and indirect costs and to adjust their sales for COGS.[38] However, regarding the nondeductibility of certain direct and indirect costs for inventory purposes, IRC §263A(a)(2)(B) expressly states that "any cost which… could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." Because §280E disallows deductions in general for businesses manufacturing or selling controlled substances, the disallowance extends to capitalizing these costs as part of inventory. For example, payroll, rent, and overhead **cannot be included** when determining COGS for the **manufacture** or sales of controlled substances.

Practitioner Planning Tip

When working with **producers** or **resellers** of marijuana, the practitioner may want to include as many direct and indirect costs in COGS as legally allowable. This requires a more sophisticated approach to recordkeeping than is typically used for a traditional farm or retail business. For more information on COGS, see **uofi.tax/19b3x4** [www.irs.gov/businesses/small-businesses-self-employed/deducting-business-expenses] and the discussion of uniform capitalization later in this chapter.

35. IRC §280E.

36. PL 97-248.

37. See, e.g., *M. Olive v Comm'r*, 792 F.3d 1146 (9th Cir. 2015), *aff'g* 139 TC 19.

38. IRC §263A. See also Rev. Proc. 2001-10, 2001-1 CB 272 for businesses with gross receipts of $1 million or less and Rev. Proc. 2002-28, 2002-1 CB 815 for businesses with average gross receipts of more than $1 million but not more than $10 million.

Because a marijuana producer may deduct COGS from its gross income, it is appropriate to apply the same guidance in determining the proper allocation for COGS as would be required for the legal conduct of any business. IRS Pub. 334, *Tax Guide for Small Business,* provides the following table that can be used to determine a business's COGS. Although the publication references cost of goods sold reported on Schedule C, *Profit or Loss From Business,* the basic guidelines for calculating COGS also apply to other types of businesses.

Figuring Cost of Goods Sold on Schedule C, Lines 35 Through 42

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	____________
36	Purchases less cost of items withdrawn for personal use	____________
37	Cost of labor. Do not include any amounts paid to yourself	____________
38	Materials and supplies	____________
39	Other costs	____________
40	Add lines 35 through 39	____________
41	Inventory at end of year	____________
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4	____________

Even though a marijuana business is entitled to adjust their gross sales by COGS, resellers and farmers of state-legal marijuana will still have higher taxable income than if they dealt in non-controlled substances.

> **Example 6.** Use the same facts as **Example 5,** except Ned applied for and received permission to grow medicinal marijuana instead of industrial hemp. After harvesting his crop, he sells it to a state-licensed dispensary. His taxable income for the activity is $37,500 ($40,000 sales – $1,000 seed – $1,500 fertilizer). He is not allowed a deduction for rent, repairs, or depreciation because those expenses cannot be attributed to COGS.

Allocation of Expenses. A strategy that can be employed to reduce the tax burden on state-legal marijuana businesses is to allocate expenses to legal parts of the taxpayer's business (if there are any).

In *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r,*[39] the taxpayer's business was to provide a community center for members with acquired immune deficiency syndrome (AIDS), cancer, and other serious illnesses. The center's primary purpose was to provide caregiving services, such as counseling. The secondary purpose was to provide its members with medical marijuana. Management calculated the membership fee so that the center could provide both of these services essentially at a break-even point. In an audit of their 2002 corporate tax return, the IRS disallowed all deductions, arguing that the taxpayer had a single business purpose of trafficking in medical marijuana and should not be allowed any expenses pursuant to §280E.

However, the court sided with the taxpayer and determined that the organization operated two separate trades or businesses and properly apportioned the income and expenses to each.

One of the reasons the court allowed certain expenses was because "management set the total amount of the membership fees as the amount that management consciously and reasonably judged equaled petitioner's costs of the caregiving services and the costs of the medical marijuana… [T]he record permits us with sufficient confidence to allocate petitioner's expenses between its two trades or businesses on the basis of the number of petitioner's employees and the portion of its facilities devoted to each business."[40]

39. *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r,* 128 TC 173 (2007).

40. Ibid.

Practitioner Planning Tip

Practitioners need to be diligent in helping their clients with this type of business to set up their accounting systems in such a way that it can differentiate between the marijuana business (and its nondeductible expenses) from the non-marijuana business (and its deductible expenses).

Example 7. Ted rents 1,000 acres and plants 900 acres of corn and 100 acres of marijuana. He incurs the following expenses.

Seed (corn)	$ 90,000
Seed (marijuana)	10,000
Fertilizer	50,000
Land rent	250,000
Repairs	100,000
Depreciation	100,000
Total costs	$600,000

Ted keeps separate books and records for the grain operation and the marijuana operation. For expenses that are difficult to separate, he applies a percentage based on the acreage used for the raising of each crop. In this case, 90% (900) of his 1,000 acres rented are used for the production of corn and 10% (100) of his 1,000 acres rented are used for marijuana production.

Ted sells his corn crop for $700,000 and the marijuana crop for $100 million. As long as Ted maintains the proper supporting records, he may allocate his expenses between his corn sales and his marijuana sales. His taxable income from the corn is $160,000 ($700,000 sales – $90,000 cost of seed – $450,000 (90% × ($50,000 fertilizer + $250,000 land rent + $100,000 repairs + $100,000 depreciation)). His taxable income on the marijuana is $99.985 million ($100 million sales – $10,000 seed – $5,000 (10% × $50,000 fertilizer)). He is not entitled to deduct any amount for land rent, repairs, or depreciation connected with the marijuana business.

Practitioner Planning Tip

Taxpayers involved in separate activities such as described in this example should meet with an attorney to discuss establishing separate and distinct entity structures to prevent a situation similar to what transpired in *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r* from occurring. Tax professionals are cautioned, however, not to engage in the illegal practice of law. The entity determination should be made by the client's qualified legal representative.

Business Challenges

The federal prohibition of the distribution and sale of marijuana puts banks in a precarious position. On the one hand, banks want to serve the needs of their customers. However, serving the needs of a state-legal marijuana business exposes the bank to legal and regulatory risk of a money-laundering charge.[41]

U.S. law[42] prohibits the Federal Deposit Insurance Corporation (FDIC) from insuring money from illegal activity, and banks are required to insure all of their depository accounts. Accordingly, if a bank chooses to accept deposits from a marijuana business, it may charge higher fees to match the higher risk of running afoul of federal law. If a marijuana business chooses not to use a bank, then it takes on a significant security risk trying to handle all its cash (of which expenses incurred for security and transportation are not deductible).[43] Additionally, such businesses have difficulties paying payroll, vendors, and remitting payroll tax liabilities in cash.

Caution. Practitioners who may choose to work with state-legal marijuana clients should consider the possibility that the FDIC regulations may extend beyond the marijuana business to other businesses associated with them. Although it is unlikely that the federal government would take action against a landlord, supplier, or accountant servicing a marijuana business, it is a possibility. Therefore, as with banking, the state-legal marijuana business may have to pay a premium for rent, supplies, and professional services compared to farmers or merchants of legal products.

Practitioner Planning Tip

Before accepting an engagement from a producer or seller of state-legal marijuana, it would be wise to make an in-depth study of the issues mentioned in this chapter. In order to best serve a specialized client, the practitioner needs to possess the knowledge and skills necessary to advise the client on many issues in addition to tax compliance, such as accounting systems, security, regulation, banking, etc.

41. *Marijuana and Banking.* American Bankers Association. [www.aba.com/advocacy/issues/pages/marijuana-banking.aspx] Accessed on Jun. 3, 2019.

42. 18 USC §1956.

43. See IRC §280E.

ACCOUNTING METHODS FOR SMALL BUSINESSES

The TCJA amended several provisions applicable to accounting methods for eligible small business taxpayers. Most notably, the TCJA increased the small business taxpayer average gross receipts limit to $25 million (from $5 million under prior law) for tax years ending after December 31, 2017.[44] This change enables more taxpayers to use the cash method of accounting and exempts them from costlier requirements of accounting for inventories,[45] complying with percentage-of-completion rules,[46] and capitalizing costs under the uniform capitalization (UNICAP) rules.[47]

Eligible small business taxpayers for this purpose are those taxpayers, other than tax shelters, that meet the gross receipts test in IRC §448(c). A taxpayer meets this test if they have average annual gross receipts for the three prior tax years of $25 million or less (adjusted for inflation). For testing purposes, an aggregation rule applies.[48] Under this rule, organizations that are members of an affiliated service group or a controlled group of corporations that are treated as a single employer for tax purposes must aggregate their gross receipts to determine whether they meet the gross receipts test.

Accounting methods include an overall plan of accounting, such as the cash method or accrual method, and the treatment of any material item, such as inventory.[49] Accounting method rules are very important for business entities because they impact the amount of income and deductions reported for a particular period and therefore have a direct effect on income tax liability.

Generally, taxpayers can choose their own accounting method, but taxable income must be computed under the method of accounting on the basis of which the taxpayer regularly computes their income in keeping their books.[50]

As a basic rule, the taxpayer's method of accounting must "clearly reflect income."[51] The IRS has authority to substitute a taxpayer's accounting method with one that clearly reflects income.[52] In most cases, a taxpayer must obtain consent from the IRS before changing a method of accounting.[53]

Practitioner Planning Tip

The choice of accounting methods is potentially transformational for a taxpayer's business. Practitioners should review any potential changes with their clients not only to consider the effect for the current year but also for long-term planning purposes.

44. IRC §448(c)(1).
45. IRC §471(c).
46. IRC §460(e)(1)(B).
47. IRC §263A(i).
48. IRC §448(c)(2).
49. Treas. Reg. §1.446-1(e)(2)(ii)(a).
50. IRC §446(a).
51. Treas. Reg. §1.446-1(c)(1)(ii)(C).
52. IRC §446(b).
53. IRC §446(e); Treas. Reg. §1.446-1(e)(2)(i).

This section discusses the following accounting method provisions and changes implemented by the TCJA.[54]

- The cash method requirements under §448 and the procedures to change to the overall cash method
- Inventory accounting rules and the exception to account for inventories under IRC §471
- UNICAP rules and the exception from the requirements to capitalize costs under §263A
- Percentage-of-completion requirements for long-term contracts and the exception from the requirement to account for certain contracts under IRC §460 or to capitalize §263A costs for certain home construction contracts

The IRS revised Form 3115, *Application for Change in Accounting Method,* which must be filed to obtain IRS consent to change an accounting method. The revisions include an updated list of automatic changes in accounting method. The Form 3115 revisions are also discussed in this section.

CASH METHOD

The cash method is one of four permissible accounting methods for determining taxable income (the others are the accrual method, special methods for certain items of income and expenses, and a hybrid method combining one or more of these accounting methods).[55] Most individuals and many small businesses use the cash method due to its simplicity in timing income and deductions. However, if a business produces, purchases, or sells merchandise, it must keep an inventory and use an accrual method for sales and purchases.[56] This rule (and its exceptions) is discussed further in the "Inventory" section.

Cash Method Basics

Under the cash method, a taxpayer recognizes income when they actually or constructively receive items of income. Constructive receipt occurs when income is credited to the taxpayer's account or made available without restriction. **Actual possession is not required.** If the taxpayer authorizes an agent to receive income, it is considered received by the taxpayer when the agent receives it. Income is not constructively received if the control of its receipt is subject to substantial restrictions or limitations.[57]

> **Example 8.** ABC Company, a cash-method taxpayer, performed consulting services for Smith Company in December 2018 and sent an invoice. Smith Company drafted a check, placed it in the mail, and sent it to ABC. ABC received the check in 2018, but did not deposit the check until January 3, 2019. ABC constructively received the check in 2018, when it was made available without restriction.

> **Example 9.** Kelly is a calendar-year taxpayer. Her bank credited and made interest income available to her bank account in December 2018. Kelly did not withdraw the interest or enter it into her books until 2019. She must include the interest in her gross income for 2018, the year she constructively received the interest income.

Deductions are generally recognized when an expense is paid, although there are several important exceptions. For example, cash-method taxpayers (and accrual-method taxpayers) generally cannot deduct prepaid expenses (the 12-month rule exception is discussed later) or amounts paid to acquire or produce a unit of real or personal property[58] or to acquire or create intangibles.[59]

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54. PL 115-97, §13102.
55. IRC §446(c).
56. IRC §471(a).
57. IRS Pub. 538, *Accounting Periods and Methods.*
58. Treas. Reg. §1.263(a)-2(d).
59. Treas. Reg. §1.263(a)-4(b).

For payments to acquire or create tangible assets, the Code requires the taxpayer to capitalize certain costs.

- IRC §263A requires the capitalization of certain costs to property produced or purchased for resale.
- Treas. Reg. §1.162-3 requires the capitalization of nonincidental materials and supplies.
- IRC §263(a) requires the capitalization of improvements to property.

Expenses Paid in Advance

Generally, an expense paid in advance must be capitalized,[60] unless the expense qualifies for the **12-month rule.**[61] Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer that do not extend beyond the earlier of the following.[62]

- 12 months after the right or benefit begins
- The end of the tax year after the tax year in which payment is made

If the taxpayer has not been applying the general rule (i.e., an expense paid in advance is deductible only in the year to which it applies) and/or the 12-month rule to the expenses paid in advance, they must obtain approval from the IRS by filing Form 3115 before using the general rule and/or the 12-month rule.[63]

Example 10. Steve is a calendar-year taxpayer. He paid $6,000 in 2018 for a business insurance policy that is in effect for three years (36 months), beginning on July 1, 2018. The general rule that an expense paid in advance is deductible only in the year to which it applies is applicable to this payment because the payment does not qualify for the 12-month rule.

Steve can deduct $1,000 in 2018 ((6 months in 2018 ÷ 36 total months) × $6,000) in 2018. He can deduct $2,000 in 2019 ((12 months in 2019 ÷ 36 total months) × $6,000). He can also deduct $2,000 in 2020 ((12 months in 2020 ÷ 36 total months) × $6,000). He can deduct the remaining $1,000 in 2021.

Excluded Entities

The following types of entities are generally prohibited from using the cash method.[64]

- C corporation
- Partnership that has a C corporation as a partner
- Tax shelter

60. Treas. Reg. §1.263(a)-4(d)(3).
61. Treas. Reg. §1.263(a)-4(f).
62. Treas. Reg. §1.263(a)-4(f)(1).
63. IRC §446(e).
64. IRC §448(a).

Exceptions. The prohibition on using the cash method does not apply to the following three business types.[65]

1. A farming business is not prohibited from using the cash method. The term **farming business** means:

   a. The trade or business of farming, including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees; or

   b. The raising, harvesting, or growing of trees.[66]

2. A qualified personal service corporation is not prohibited from using the cash method. The term **qualified personal service corporation** means any corporation that meets the "function test" and "ownership test."[67] A corporation meets the function test if substantially all (95% or more of the time spent by employees of the corporation) of the corporation's activities for a tax year involve the performance of services in one or more of the following fields: health, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.

   A corporation meets the ownership test if, at all times during the tax year, substantially all of the corporation's stock (by value) is held, directly or indirectly, by:

   a. Employees performing services for the corporation in one of the fields listed for the function test,

   b. Retired employees who performed such services for the corporation,

   c. The estate of any of the employees described in a or b, or

   d. Others who acquired the stock by reason of the death of one of the employees described in a or b.

3. **Entities that meet the gross receipts test** are not prohibited from using the cash method. A corporation or partnership meets the gross receipts test if the entity's average annual gross receipts for the 3-tax-year period ending with the tax year that precedes such tax year does not exceed $25 million.[68]

Note. Under the TCJA, a small business taxpayer (having $25 million or less in average gross receipts for the preceding three years) may change to the cash method of accounting effective for tax years beginning after December 31, 2017, using the automatic change procedures (discussed later).

Practitioner Planning Tip

Under the TCJA, many more businesses are now eligible for the cash accounting method, which permits them to report income as received and expenses when paid. Businesses in which the accounts receivable exceed accounts payable benefit from the deferral of income until payment is received (or made). In that situation, the reportable net income would match better with the business's actual cash flow. However, the cash method may result in higher taxable income compared to accrual accounting when accounts receivable are eventually collected.

65. IRC §448(b).
66. Temp. Treas. Reg. §1.448-1T(d).
67. Temp. Treas. Reg. §1.448-1T(e).
68. IRC §448(c).

INVENTORY

Generally, a business must keep an inventory when the production, purchase, or sale of merchandise is an income-producing factor.[69] When required to keep an inventory, the taxpayer must use the accrual method to record sales and purchases of merchandise, unless it does not clearly reflect income.[70] To determine taxable income, inventory must be valued using a method that conforms to generally accepted accounting principles and clearly reflects income.[71] Inventory practices must be consistent from year to year.[72]

Small Business Taxpayers

Under the law in effect prior to the TCJA, the use of inventories was required for businesses with 3-year average gross receipts greater than $1 million[73] ($10 million for certain types of businesses[74]). Businesses below this threshold had to treat inventory as nonincidental materials and supplies, meaning they could only deduct the inventory when used or consumed.[75]

Note. For more information on the treatment of nonincidental materials and supplies, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Capitalization or Repair, and the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Capitalization vs. Repair Update. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Under the TCJA, small business taxpayers are not required to keep an inventory.[76] In defining a small business taxpayer, the pre-TCJA $1 million and $10 million thresholds were increased to 3-year average gross receipts of $25 million (adjusted for inflation for tax years beginning after December 31, 2018).

Note. If the taxpayer does not keep an inventory, the business will not be treated as failing to clearly reflect income if the method of accounting treats inventory as nonincidental materials or supplies or conforms to the taxpayer's financial accounting treatment for inventories.[77] If the taxpayer chooses to keep an inventory, an accrual method is required and the inventory must be valued each year to determine cost of goods sold.[78]

69. Treas. Reg. §1.471-1.
70. Treas. Reg. §1.446-1(c)(2)(i).
71. IRS Pub. 538, *Accounting Periods and Methods*.
72. Treas. Reg. §1.446-1(c)(2)(ii).
73. Rev. Proc. 2001-10, 2001-2 IRB 272.
74. Rev. Proc. 2002-28, 2002-20 IRB 941.
75. Treas. Reg. §1.162-3(a)(1).
76. IRC §471(c)(1).
77. IRC §471(c)(1)(B).
78. IRS Pub. 538, *Accounting Periods and Methods*.

Changing the Inventory Accounting Method

In most cases, taxpayers must obtain prior consent from the IRS to change their method of accounting.[79] In some instances, taxpayers can obtain automatic consent from the IRS to change to a certain accounting method.[80] Taxpayers falling within the new thresholds who were previously following the pre-TCJA laws must generally file Form 3115 to take advantage of the more favorable methods. The revised Form 3115 and the automatic change procedures are explained later.

A small business taxpayer can change its method of accounting for inventories using the automatic change provisions to either of the following methods.[81]

1. **Inventory treated as nonincidental materials and supplies under Treas. Reg. §1.162-3.** If the business accounts for inventories as materials and supplies that are not incidental, the amounts paid to acquire or produce the inventoriable items treated as materials and supplies are deducted in the year in which they are first used or consumed in operations.
2. **Conforming to the financial accounting treatment of inventories.** The financial accounting treatment of inventories is determined by the method of accounting used for the "applicable financial statement." If the business does not have an applicable financial statement, the business uses the method of accounting consistent with its books and records that have been prepared in accordance with the company's accounting procedures.[82]

An **applicable financial statement** is a financial statement that is certified as being prepared in accordance with generally accepted accounting principles and that is one of the following.[83]

1. A Form 10-K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the U.S. Securities and Exchange Commission
2. The taxpayer's audited financial statement that is used for credit purposes; reporting to shareholders, partners, or other proprietors, or to beneficiaries; or any other substantial nontax purpose (but only if there is no Form 10-K)
3. A financial statement filed by the taxpayer with any other federal agency for purposes other than federal taxation, but only if there is no statement of the taxpayer described in item 1 or 2

Practitioner Planning Tip

Businesses previously unable to use the cash method due to the inventory requirement can now account for inventory under different rules, allowing them to use the cash method of accounting. For example, a taxpayer who previously was required to use the accrual method of accounting for tax purposes due to a large supply inventory may now be able to use the cash method to recognize revenue and expenses that were deferred under their prior method.

79. IRC §446(e) and Treas. Reg. §1.446-1(e).
80. IRS Pub. 538, *Accounting Periods and Methods*.
81. Rev. Proc. 2018-40, 2018-34 IRB 320.
82. IRS Pub. 538, *Accounting Periods and Methods*.
83. IRC §451(b)(3).

UNIFORM CAPITALIZATION

The UNICAP provisions require the capitalization[84] of direct costs and an allocable share of certain indirect costs incurred to the extent they are properly allocable to real or tangible personal property produced by the taxpayer or real or personal property acquired for resale to customers.[85]

> **Note**. Tangible personal property includes a film, sound recording, video tape, book, or similar property.[86]

Pre-TCJA Law

Prior to the TCJA, small business taxpayers with 3-year average annual gross receipts of $10 million or less were exempt from UNICAP requirements related to personal property acquired for resale. The exemption did not extend to real property manufactured or produced.[87]

TCJA Changes

The TCJA made two significant changes in the UNICAP rules for small businesses. First, the 3-year average gross receipts threshold was raised **from $10 million to $25 million.** Second, any producer or reseller that meets the $25 million gross receipts test is exempt from applying the UNICAP rules, including manufacturers and producers of real property.[88] This is a major change in the law, as it expands the number of entities that qualify for the exception to UNICAP application. Most importantly, these companies no longer have to capitalize the allocable portion of overhead to inventory, allowing them to deduct these costs currently.

Capitalized Costs

IRC §263A requires the capitalization of **direct costs** and certain **indirect costs.**[89] Direct costs that must be capitalized include direct material costs, direct labor costs, and acquisition costs.[90]

Indirect costs include all costs other than direct costs of property purchased for resale. Indirect costs may be allocable to both production and resale activities, as well as other activities not subject to §263A.[91]

The following are examples of indirect costs that must be capitalized.[92]

- Indirect labor costs
- Officers' compensation
- Pension and other related costs
- Employee benefit expenses
- Indirect material costs
- Purchasing costs

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84. For this section, capitalization means, in the case of inventory, to include in inventory costs and in the case of other property, to charge to a capital account or basis. Treas. Reg. §1.263A-1(c)(3).
85. IRC §263A(b).
86. Ibid.
87. Treas. Reg. §1.263A-1(b)(1).
88. IRC §§263A(i) and 448(c).
89. Treas. Reg. §1.263A-1(a)(3)(i).
90. Treas. Reg. §1.263A-1(e)(2).
91. Treas. Reg. §1.263A-1(e)(3)(i).
92. Treas. Reg. §1.263-1(e)(3)(ii).

- Handling costs
- Storage costs
- Rent
- Taxes
- Utilities
- Repairs and maintenance

Certain costs do not have to be allocated to inventory under UNICAP. These include selling, distribution, advertising, and research and experimental expenditures.[93]

Example 11. Star Nursery sells trees, flowers, shrubs, and other plants. Star Nursery's average gross receipts for the last three years was $12 million. In 2017, Kathy, who is in charge of purchasing inventory, earns a salary of $60,000. Accounting records indicate that Kathy reasonably spends about 8% of her time on inventory acquisition matters.

Under the UNICAP rules, 8% of Kathy's salary is subject to capitalization as an inventory cost because Star Nursery's average 3-year gross receipts is more than $10 million.

Example 12. Use the same facts as **Example 11,** except the tax year is 2018. Under the TCJA, Star Nursery is not required to apply the UNICAP rules because its average 3-year gross receipts is less than $25 million.

Practitioner Planning Tip

Because of the changes made to accounting methods under the TCJA, applicable businesses may now choose to expense their UNICAP costs starting in 2018, thereby benefiting from the current expensing of these costs.

PERCENTAGE OF COMPLETION

Generally, income from long-term contracts is determined using either the percentage-of-completion method (PCM) or an exempt method such as the completed contract method. Taxpayers must use the PCM method unless one of the following exceptions applies.[94]

1. An exempt construction contract described in Treas. Reg. §1.460-3(b)
2. Any qualified ship contract described in Treas. Reg. §1.460-2(d) or residential construction contract described in Treas. Reg. §1.460-3(c)

Under the PCM, gross income is computed for each year of the contract, based on the contract price and the estimated percentage of the contract that is completed at the end of the year.[95] Under the completed contract method, income recognition is deferred until the contract is substantially complete.[96]

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93. Treas. Reg. §1.263A-1(e)(3)(iii).

94. IRC §460(a); Treas. Reg. §1.460-1(a)(2).

95. IRC §460(b)(1).

96. Treas. Reg. §§1.460-1(b)(3) and (6).

Percentage-of-Completion Calculation

The following calculation is required to determine the amount of income included in a tax year from a contract under the PCM.[97]

1. Compute the contract's **completion factor**. This is the ratio of the cumulative allocable contract costs incurred by the taxpayer through the end of the tax year to the estimated allocable contract costs that the taxpayer reasonably expects to incur under the contract.
2. Compute the contract's **cumulative gross receipts** by multiplying the completion factor by the total contract price.
3. Compute the amount of **current year gross receipts.** This is the difference between the amount of cumulative gross receipts for the current tax year and the amount of cumulative gross receipts for the immediately preceding tax year (the difference can be a positive or negative number).
4. Take both the current year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.

Example 13. Kargo Company, whose tax year ends December 31, determines the income from long-term contracts using the percentage-of-completion method. During 2016, Kargo Company agrees to manufacture for its customer, PlagerCo, a unique item for a total contract price of $1 million. Under Kargo Company's contract, PlagerCo is entitled to retain 10% of the total contract price until it accepts the item.

By the end of 2016, Kargo Company has incurred $200,000 of allocable contract costs and estimates that the total allocable contract costs will be $800,000. By the end of 2017, Kargo Company has incurred $600,000 of allocable contract costs and estimates that the total allocable contract costs will be $900,000. In 2018, after completing the contract, Kargo Company determines that the actual cost to manufacture the item was $750,000. The following table calculates Kargo Company's income from the contract for each of the three tax years.

	Tax Year					
	2016		2017		2018	
Cumulative incurred costs	$ 200,000		$ 600,000		$ 750,000	
Estimated total costs	÷ 800,000		÷ 900,000		÷ 750,000	
Completion factor	25.00%		66.67%		100.00%	
Total contract price	× 1,000,000		× 1,000,000		× 1,000,000	
Cumulative gross receipts	$ 250,000		$ 666,700		$1,000,000	
Less: cumulative gross receipts for prior year	0		(250,000)		(666,700)	
Current-year gross receipts	$ 250,000	$ 250,000	$ 416,700	$ 416,700	$ 333,300	$ 333,300
Cumulative incurred costs	$ 200,000		$ 600,000		$ 750,000	
Less: cumulative incurred costs for prior year	0		(200,000)		(600,000)	
Current-year costs	$ 200,000	(200,000)	400,000	(400,000)	$ 150,000	(150,000)
Gross income		$ 50,000		$ 16,700		$ 183,300

Kargo Company's gross income from the contract is $50,000, $16,700, and $183,300 for 2016, 2017, and 2018, respectively.

97. Treas. Reg. §1.460-4(b)(2).

Pre-TCJA Law. Before the TCJA, businesses with 3-year average gross receipts of $10 million or less were exempt from the requirement to use the PCM for long-term contracts if they met certain conditions. These businesses were allowed to deduct costs associated with construction when they were paid and to recognize income when the building was completed.[98]

TCJA Changes. The TCJA increased the gross receipts threshold from $10 million to $25 million, effective for contracts entered into after December 31, 2017.[99] The exemption from the requirement to use the PCM is expanded to apply to contracts for the construction or improvement of real property, if the contract meets **two** conditions.

1. It is expected (at the time the contract is entered into) to be completed within two years of commencement of the contract.[100]
2. It is performed by a taxpayer that (for the tax year in which the contract was entered into) meets the $25 million gross receipts test of §448(c).[101]

Practitioner Planning Tip

Contractors with less than $25 million in average gross receipts are now no longer required to use the PCM. Contractors can now choose from other accounting methods, including completed contract or cash basis reporting, which may provide them with the ability to defer revenue recognition.

REVISED FORM 3115

Under IRC §446(e), taxpayers must obtain IRS consent to change an accounting method.[102] The TCJA's change in the definition of a small business taxpayer ($25 million 3-year average gross receipts threshold) expanded the number of small business taxpayers eligible to use the cash method of accounting under §448, and exempted small business taxpayers from the following accounting rules.

- Requirement to keep inventories[103]
- UNICAP rules[104]
- Requirement to use the PCM for construction contracts expected to be completed in two years[105]

Taxpayers use Form 3115 to initiate a change in accounting method. The IRS issued a revised version of Form 3115 in December 2018 (with 29 pages of instructions), reflecting changes introduced by the TCJA.

98. IRC §448(c)(1), prior to amendment by the TCJA.
99. IRC §448(e)(1)(B)(ii).
100. IRC §460(e)(1)(B)(i).
101. IRC §460(e)(1)(B)(ii).
102. IRC §446(e); Treas. Reg. §1.446-1(e)(2).
103. IRC §471(c).
104. IRC §263A(i).
105. IRC §460(e).

For certain changes in accounting method, the IRS provides an **automatic consent procedure.** Rev. Proc. 2015-13[106] provides the general procedures by which a taxpayer may obtain automatic consent from the IRS to change a method of accounting described in the list of automatic changes. Rev. Proc. 2018-31[107] contains the list of automatic changes. Rev. Proc. 2018-40,[108] issued in August 2018, modifies and amplifies Rev. Proc. 2018-31 to provide additional automatic changes in method of accounting and to modify existing automatic changes in method of accounting to assist taxpayers in conforming to the legislative changes introduced by the TCJA.

Rev. Proc. 2018-40 adds four new automatic method changes to the comprehensive list provided by Rev. Proc. 2018-31, with favorable §481(a) adjustment options for taxpayers meeting the $25 million gross receipts threshold. For each automatic method change, the following table shows the effective date, the designated control number (DCN), and the applicable section added to Rev. Proc. 2018-31.

Automatic Method Changes	Effective Date	Designated Control Number	Section of Rev. Proc. 2018-31
Change to discontinue capitalizing costs under §263A	Tax years after 12/31/2017	234	Section 12.16
Change from overall accrual method to overall cash method	Tax years after 12/31/2017	233	Section 15.18
Change to either: • Discontinue using PCM for certain long-term construction contracts under §460, or • Discontinue capitalizing costs under §263A for certain home construction contracts	Contracts entered into after 12/31/2017	236	Section 19.01
Change to discontinue capitalizing inventories under §471 and either: • Treat inventories as nonincidental materials and supplies, or • Follow applicable financial statement method	Tax years after 12/31/2017	235	Section 22.19

Change to a Method that no Longer Capitalizes Costs under IRC §263A[109]

This change applies to a small business taxpayer that capitalizes costs under §263A and wants to change to a method of accounting that no longer capitalizes costs under §263A, including to self-constructed assets, under §263A(i). Rev. Proc. 2018-40 adds a new DCN 234 to effect the change.

106. Rev. Proc. 2015-13, 2015-5 IRB 419, as clarified and modified by Rev. Proc. 2015-33, 2015-24 IRB 1067, as modified by Rev. Proc. 2016-1, 2016-1 IRB 1, and as modified by Rev. Proc. 2017-59, 2017-48 IRB 543.

107. Rev. Proc. 2018-31, 2018-22 IRB 637.

108. Rev. Proc. 2018-40, 2018-34 IRB 320.

109. Rev. Proc. 2018-40, 2018-34 IRB 320.

Change to Overall Cash Method from Overall Accrual Method[110]

This change applies to a small business taxpayer that wants to change its overall method of accounting from the accrual method to the cash method for a trade or business and is otherwise not prohibited from using the overall cash method or required to use another overall method of accounting. A small business taxpayer may be required to use a method of accounting (other than the cash method) for one or more items of income or expense under certain provisions of the Code or regulations, including, for example, IRC §§475 and 1272.

DCN 233 is used to effect the change.

> **Note.** The accrual method or other methods may still be required for certain items or entities, even if the taxpayer meets the gross receipts test.

> **Note.** Taxpayers who file Form 3115 to obtain automatic consent to change a method of accounting are only required to complete certain sections of the form. For information on which sections of the form must be completed, see Rev. Proc. 2018-40 and the instructions to Form 3115.

Change to a Simplified Method for Long-Term Construction Contracts[111]

Taxpayers may change from the PCM to an exempt contract method described in Treas. Reg. §1.460-4(c) for exempt long-term construction contracts described in IRC §460(e)(1)(B). In addition, a taxpayer may choose to stop capitalizing costs under §263A for home construction contracts defined in §460(e)(1)(A). This change is available even for taxpayers who have long-term contracts that are not exempt. Rev. Proc. 2018-40 offers a new DCN 236 to effect the change.

Change in Method of Accounting for Inventory Items[112]

This change applies to a small business taxpayer that wants to change its method of accounting for inventory items to one of the following.

1. Treating inventory as nonincidental materials and supplies under Treas. Reg. §1.162-3
2. Conforming to the taxpayer's method of accounting reflected in its applicable financial statements, as defined in IRC §451(b)(3), with respect to the tax year, or if the taxpayer does not have an applicable financial statement for the tax year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures

DCN 235 is used to effect the change.

CORRECTING DEPRECIATION ERRORS WITH FORM 3115

A depreciation error discovered on a prior return is corrected either by filing Form 1040X, *Amended U.S. Individual Income Tax Return,* or Form 3115.[113] In the following situations, the taxpayer can file Form 1040X to correct depreciation errors.[114]

- Incorrect amount claimed due to a posting error
- Incorrect amount claimed due to a mathematical error
- The taxpayer has not adopted a method of accounting for property placed in service in tax years ending after December 29, 2003

110. Ibid.
111. Ibid.
112. Ibid.
113. Instructions for Form 3115.
114. IRS Pub. 527, *Residential Rental Property*.

If the depreciation error cannot be corrected on an amended return, the taxpayer makes the change by filing Form 3115.[115] There are several advantages to filing Form 3115 rather than Form 1040X.

1. Form 3115 allows an election to claim income from overstated depreciation ratably over four years rather than claiming it entirely in the year of change.[116]
2. Form 3115 can be used to claim depreciation from all years an asset was owned, even if some of those years are closed.[117] Form 1040X can generally only be filed for open tax years (three years after the date the taxpayer filed the original return or two years after they paid the tax, whichever is later).[118]
3. Interest on prior year deduction overstatements is eliminated,[119] while filing an amended return causes interest to be assessed for taxes owed from prior years.[120]

IRC §481(a) Adjustment

When depreciation errors from prior year returns are corrected, an IRC §481(a) adjustment is required. The adjustment is the aggregate amount of income or expense that would have been reported in prior tax years if the new or correct method had been used in those years. To calculate the §481(a) adjustment, the amounts on prior year returns (ignoring the statute of limitations[121]) are compared with the correct amounts for those years.

To report the adjustment, the following rules apply.

- **For a decrease in income, the entire deduction is claimed in the year the error is discovered.[122]**
- For an **increase in income**, the §481(a) adjustment period is **four years** (add one-fourth of the adjustment to income each year). If the entire adjustment is less than $50,000, the taxpayer can elect to include the entire adjustment in the year the error is discovered.[123]
- For an applicant under IRS audit, the §481(a) adjustment period is two tax years for a positive adjustment.[124]
- If the taxpayer has discontinued the trade or business, the remaining balance of the §481(a) adjustment is taken into account in the tax year the business ceased or terminated.[125]

The §481(a) adjustment is reported on Form 3115, part IV, line 26, and the same form or schedule on which the original error was reported.

115. Treas. Reg. §1.446-1(e).

116. Instructions for Form 3115.

117. Rev. Proc. 96-31, 1996-1 CB 714.

118. Instructions for Form 1040X.

119. Ibid.

120. Instructions for Form 1040X.

121. Under §481, "if income escapes taxation because of a change in accounting method, the Commissioner may make an adjustment by including the omitted income in the year of the change." *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568, 570 (5th Cir. 1965).

122. Rev. Proc. 97-27, 1997-21 IRB 10, as modified by Rev. Proc. 2002-19, 2002-13 IRB 696 and Rev. Proc. 2007-67, 2007-35 IRB 467.

123. Rev. Proc. 2015-13, 2015-5 IRB 419.

124. Ibid.

125. Ibid.

Manner of Making the Change in Depreciation Method

A change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting.[126] A taxpayer can change its method of accounting for depreciation for property disposed of in the current tax year if the taxpayer used an impermissible method of accounting for depreciation for the property. An impermissible method of accounting includes situations in which the taxpayer did not take into account any depreciation allowance or did take into account some depreciation but less than the depreciation allowable in the year of change or any prior tax year.[127]

A taxpayer must provide a detailed description of the present and proposed methods of accounting as an attachment to Form 3115. A general description of these methods of accounting is **unacceptable** (e.g., erroneous method to proper method, claiming less than the depreciation allowable to claiming the depreciation allowable).[128]

A taxpayer can change their depreciation method on their timely filed (including any extension) original federal tax return for the year of change, provided the taxpayer files the original Form 3115 in accordance with procedures in Rev. Proc. 2015-13.[129]

A qualified small taxpayer qualifies for a **reduced** Form 3115 filing requirement for DCNs 7, 8, 21, 87, 88, 89, 107, 121, 145, 157, 184–193, 198, 199, 200, 205, 206, 207, and 222. A qualified small taxpayer is a taxpayer with average annual gross receipts that do not exceed $10 million for the three tax years preceding the year of change.[130] A reduced Form 3115 filing requirement involves completing only the following information on Form 3115 to make the change.[131]

- The identification section of page 1 (above Part I)
- The signature section at the bottom of page 1
- Part I
- Part II — all lines except lines 13, 15b, 16c, 17, and 19
- Part IV — all lines except line 25
- Schedule E

In filing Form 3115 to change from an impermissible method to a permissible method of accounting for depreciation, a taxpayer makes a §481(a) adjustment for any unclaimed or excess amount of allowable depreciation. The adjustment is the difference between the total depreciation actually deducted for the property and the total amount allowable prior to the year of change. If no depreciation was deducted, the adjustment is the total depreciation allowable prior to the year of change. The § 481(a) adjustment can be positive or negative.

- A negative §481(a) adjustment results in a decrease in taxable income. It is taken into account in the year of change and is reported on the business tax return as "other expenses."
- A positive §481(a) adjustment results in an increase in taxable income. It generally is taken into account over four tax years and is reported on the business tax return as "other income." However, as mentioned earlier, taxpayers can elect to use a 1-year adjustment period and report the adjustment in the year of change if the total adjustment is less than $50,000.

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126. Treas. Reg. §1.446-1(e)(2)(ii)(d)(2).
127. Instructions for Form 3115.
128. Rev. Proc. 2015-14, 2015-5 IRB 450.
129. Instructions for Form 3115.
130. Ibid.
131. Rev. Proc. 2018-31, 2018-22 IRB 637.

Example 14. Landscape Professionals, Inc. is a landscape company organized as an S corporation. In January 2019, Landscape Professionals disposed of a Ford F-150 pickup truck used in its business. The company had mistakenly failed to claim depreciation on the truck since its acquisition in January 2017. To correct this error, Landscape Professionals files the following Form 3115.

Form **3115** (Rev. December 2018) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

▶ **Go to *www.irs.gov/Form3115* for instructions and the latest information.**

OMB No. 1545-2070

Name of filer (name of parent corporation if a consolidated group) (see instructions) **Landscape Professionals, Inc**	**Identification number** (see instructions) **11-0000001** Principal business activity code number (see instructions) **561730**
Number, street, and room or suite no. If a P.O. box, see the instructions. **5550 First Avenue**	Tax year of change begins (MM/DD/YYYY) **01/01/2019** Tax year of change ends (MM/DD/YYYY) **12/31/2019**
City or town, state, and ZIP code **Atlanta, Georgia 30339**	Name of contact person (see instructions) **Jay L. Corver**
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)	Contact person's telephone number **555-345-0000**

If the applicant is a member of a consolidated group, check this box . . . ▶ ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box . . . ▶ ☐

Check the box to indicate the type of applicant.

- ☐ Individual
- ☐ Corporation
- ☐ Controlled foreign corporation (Sec. 957)
- ☐ 10/50 corporation (Sec. 904(d)(2)(E))
- ☐ Qualified personal service corporation (Sec. 448(d)(2))
- ☐ Exempt organization. Enter Code section ▶
- ☐ Cooperative (Sec. 1381)
- ☐ Partnership
- ☒ S corporation
- ☐ Insurance co. (Sec. 816(a))
- ☐ Insurance co. (Sec. 831)
- ☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. See instructions.

- ☒ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☐ Other (specify) ▶

Caution: To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes **(1)** all relevant information requested on this Form 3115 (including its instructions), and **(2)** any other relevant information, even if not specifically requested on Form 3115.
The taxpayer must attach all applicable statements requested throughout this form.

Part I Information for Automatic Change Request

		Yes	No
1	Enter the applicable designated automatic accounting method change number ("DCN") for the requested automatic change. Enter only one DCN, except as provided for in guidance published by the IRS. If the requested change has no DCN, check "Other," and provide both a description of the change and a citation of the IRS guidance providing the automatic change. See instructions.		
a	(1) DCN: 107 (2) DCN: (3) DCN: (4) DCN: (5) DCN: (6) DCN: (7) DCN: (8) DCN: (9) DCN: (10) DCN: (11) DCN: (12) DCN:		
b	Other ☐ Description ▶		
2	Do any of the eligibility rules restrict the applicant from filing the requested change using the automatic change procedures (see instructions)? If "Yes," attach an explanation.		×
3	Has the filer provided all the information and statements required **(a)** on this form and **(b)** by the List of Automatic Changes under which the applicant is requesting a change? See instructions.	×	
	Note: Complete Part II and Part IV of this form, and, Schedules A through E, if applicable.		

Part II Information for All Requests

		Yes	No
4	During the tax year of change, did or will the applicant **(a)** cease to engage in the trade or business to which the requested change relates, or **(b)** terminate its existence? See instructions.		×
5	Is the applicant requesting to change to the principal method in the tax year of change under Regulations section 1.381(c)(4)-1(d)(1) or 1.381(c)(5)-1(d)(1)?		×
	If "No," go to line 6a. If "Yes," the applicant cannot file a Form 3115 for this change. See instructions.		

Sign Here

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Signature of filer (and spouse, if joint return)	Date	Name and title (print or type)

Preparer (other than filer/applicant)

Print/Type preparer's name	Preparer's signature	Date
Firm's name ▶		

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 19280E Form **3115** (Rev. 12-2018)

For Example 14

Form 3115 (Rev. 12-2018) Page 2

Part II Information for All Requests *(continued)*	Yes	No
6a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any federal income tax return(s) under examination (see instructions)? If "No," go to line 7a.		×
b Is the method of accounting the applicant is requesting to change an issue under consideration (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s))? See instructions.		
c Enter the name and telephone number of the examining agent and the tax year(s) under examination. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
d Has a copy of this Form 3115 been provided to the examining agent identified on line 6c?		
7a Does audit protection apply to the applicant's requested change in method of accounting? See instructions. If "No," attach an explanation.		×
b If "Yes," check the applicable box and attach the required statement. ☐ Not under exam ☐ 3-month window ☐ 120 day: Date examination ended ▶ ______ ☐ Method not before director ☐ Negative adjustment ☐ CAP: Date member joined group ▶ ______ ☐ Audit protection at end of exam ☐ Other		
8a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any federal income tax return(s) before Appeals and/or a federal court? If "No," go to line 9.		×
b Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member)? See instructions. If "Yes," attach an explanation.		
c If "Yes," enter the name of the (check the box) ☐ Appeals officer and/or ☐ counsel for the government, telephone number, and the tax year(s) before Appeals and/or a federal court. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
d Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 8c?		
9 If the applicant answered "Yes" to line 6a and/or 8a with respect to any present or former consolidated group, attach a statement that provides each parent corporation's **(a)** name, **(b)** identification number, **(c)** address, and **(d)** tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a federal court.		
10 If for federal income tax purposes, the applicant is either an entity (including a limited liability company) treated as a partnership or an S corporation, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a federal court, with respect to a federal income tax return of a partner, member, or shareholder of that entity?		×
11a Has the applicant, its predecessor, or a related party requested or made (under either an automatic or non-automatic change procedure) a change in method of accounting within any of the five tax years ending with the tax year of change? If "No," go to line 12.		×
b If "Yes," for each trade or business, attach a description of each requested change in method of accounting (including the tax year of change) and state whether the applicant received consent.		
c If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and returned to the IRS, or the change was not made or not made in the requested year of change, attach an explanation.		
12 Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in method of accounting, or technical advice?		×
If "Yes," for each request attach a statement providing **(a)** the name(s) of the taxpayer, **(b)** identification number(s), **(c)** the type of request (private letter ruling, change in method of accounting, or technical advice), and **(d)** the specific issue(s) in the request(s).		
13 Is the applicant requesting to change its **overall** method of accounting? If "Yes," complete Schedule A on page 4 of the form.		

Form **3115** (Rev. 12-2018)

For Example 14

Form 3115 (Rev. 12-2018) Page **3**

Part II Information for All Requests *(continued)* — Yes / No

14 If the applicant is either **(i) not** changing its overall method of accounting, or **(ii)** changing its overall method of accounting **and** changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following (see instructions):

a The item(s) being changed.

b The applicant's present method for the item(s) being changed.

c The applicant's proposed method for the item(s) being changed.

d The applicant's present overall method of accounting (cash, accrual, or hybrid).

15a Attach a detailed and complete description of the applicant's trade(s) or business(es). See section 446(d).

b If the applicant has more than one trade or business, as defined in Regulations section 1.446-1(d), describe **(i)** whether each trade or business is accounted for separately; **(ii)** the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; **(iii)** the overall method of accounting for each trade or business; and **(iv)** which trade or business is requesting to change its accounting method as part of this application or a separate application.

Note: If you are requesting an automatic method change, see the instructions to see if you are required to complete lines 16a–16c.

16a Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method.

b Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method.

c Include either a discussion of the contrary authorities or a statement that no contrary authority exists.

17 Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions. . . . .
If "No," attach an explanation.

18 Does the applicant request a conference with the IRS National Office if the IRS National Office proposes an adverse response? — No: ×

19a If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460 (see 19b), or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change.

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.
$	$	$

b If the applicant is changing its method of accounting for any long-term contract subject to section 460, in addition to completing 19a, enter the applicant's gross receipts for the 4th tax year preceding the tax year of change:
4th preceding year ended: mo. ________ yr. ____ $ ________________

Form 3115 (Rev. 12-2018) Page **4**

Part IV Section 481(a) Adjustment — Yes / No

25 Does published guidance require the applicant (or permit the applicant and the applicant is electing) to implement the requested change in method of accounting on a cut-off basis? . . . .
If "Yes," attach an explanation and do not complete lines 26, 27, and 28 below.

26 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ► $ **-26,000** Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the application, attach a list of the **(a)** name, **(b)** identification number, and **(c)** the amount of the section 481(a) adjustment attributable to each applicant.

27 Is the applicant making an election to take the entire amount of the adjustment into account in the tax year of change? — No: ×
If "Yes," check the box for the applicable elective provision used to make the election (see instructions).
☐ $50,000 de minimis election ☐ Eligible acquisition transaction election

28 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? . . . . — No: ×
If "Yes," attach an explanation.

For Example 14

11 Other costs

Schedule E—Change in Depreciation or Amortization. See instructions.

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants ***must*** provide this information for each item or class of property for which a change is requested.

Note: See the ***Summary of the List of Automatic Accounting Method Changes*** in the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400I, 1400L, or former section 168. **Do not** file Form 3115 with respect to certain late elections and election revocations. See instructions.

1 Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? . . . . ☐ **Yes** ☒ **No**
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section, such as section 263A? . . . . ☐ **Yes** ☒ **No**
If "Yes," enter the applicable section ▶

3 Has a depreciation, amortization, expense, or disposition election been made for the property, such as the election under sections 168(f)(1), 168(i)(4), 179, 179C, or Regulations section 1.168(i)-8(d)? . . . . ☐ **Yes** ☒ **No**
If "Yes," state the election made ▶

4a To the extent not already provided, attach a statement describing the property subject to the change. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? . . ☐ **Yes** ☒ **No**

c Is the property public utility property? . . . . ☐ **Yes** ☒ **No**

5 To the extent not already provided in the applicant's description of its present method, attach a statement explaining how the property is treated under the applicant's present method (for example, depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, attach a statement of the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information for both the present (if applicable) and proposed methods:

a The Code section under which the property is or will be depreciated or amortized (for example, section 168(g)).

b The applicable asset class from Rev. Proc. 87-56, 1987-2 C.B. 674, for each asset depreciated under section 168 (MACRS) or under section 1400L; the applicable asset class from Rev. Proc. 83-35, 1983-1 C.B. 745, for each asset depreciated under former section 168 (ACRS); an explanation why no asset class is identified for each asset for which an asset class has not been identified by the applicant.

c The facts to support the asset class for the proposed method.

d The depreciation or amortization method of the property, including the applicable Code section (for example, 200% declining balance method under section 168(b)(1)).

e The useful life, recovery period, or amortization period of the property.

f The applicable convention of the property.

g Whether the additional first-year special depreciation allowance (for example, as provided by section 168(k), 168(l), 168(m), 168(n), 1400L(b), or 1400N(d)) was or will be claimed for the property. If not, also provide an explanation as to why no special depreciation allowance was or will be claimed.

h Whether the property was or will be in a single asset account, a multiple asset account, or a general asset account.

Form **3115** (Rev. 12-2018)

For Example 14

Attachment:

Landscape Professionals
Section 481(a) Adjustment
Regular Tax
For the Period January 1, 2019 to December 31, 2019

Business Description

Landscape Professionals, Inc. is a supplier of landscape services for commercial and residential applications, principally in the state of Georgia.

Description of Change in Accounting Method

Landscape Professionals, Inc. acquired a Ford F-150 truck in January 2017 for which it failed to claim depreciation in years 2017–2018. The truck was disposed of in March 2019. A change is requested to record MACRS depreciation for tax years 2017–2018.

Part IV, Line 26:

Prior Method

Asset ID: 034403

Description: Used Ford F150 Truck

Placed in Service: January, 2017

No depreciation taken

Proposed Method

Asset ID: 034403

Description: Used Ford F150 Truck

Placed in Service: January, 2017

MACRS Method: 200% DB, Half-year

Life: 5-yr

Book Cost: $50,000

Beginning Accumulated Depreciation: $26,000

Current Depreciation: $4,800

Ending Accumulated Depreciation: $30,800

Section 481(a) adjustment:

Accumulated depreciation, prior method	$ 0
Accumulated depreciation, proposed method	26,000
§481(a) adjustment, regular tax	(26,000)

Note. For information about changing an accounting method to reclassify assets after a cost-segregation study, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Selected Real Estate Topics.

AFFORDABLE CARE ACT REVIEW

Note. Effective January 1, 2019, the TCJA reduced the tax imposed on individuals who do not maintain health insurance to zero. For more information on this provision, see the 2019 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Individual Taxpayer Issues. No other Affordable Care Act provisions were affected by the TCJA.

HIGH-COST EMPLOYER-SPONSORED HEALTH COVERAGE EXCISE TAX[132]

A provision in the Affordable Care Act (ACA)[133] imposed an excise tax on insurers if the aggregate value of employer-sponsored health insurance coverage for an employee exceeds a threshold amount. The definition of **employee** for purposes of the excise tax includes existing and former employees, surviving spouses, or other primary insured individuals.[134] These high-cost health insurance plans are often called "Cadillac" plans.

The excise tax is equal to 40% of the cost of employee coverage that exceeds the threshold amount. This excise tax was set to become effective in 2018 but was delayed until 2020 by the Consolidated Appropriations Act, 2016.[135] Then, in January 2018, **the effective date was further delayed until 2022.[136]**

The threshold amount for 2018 was $10,200 for self-only coverage and $27,500 for other coverage (including family coverage). These thresholds are subject to several adjustments, including inflation. The 2018 threshold amounts will be adjusted before the 2022 effective date for the excise tax.

IRC §§4980I(c)(1) and (2) provide that the excise tax will be paid by:

- The **health insurance issuer** in the case of applicable coverage under an insured plan,
- The **employer** if the applicable coverage consists of coverage under which the employer makes contributions to a health savings account (HSA) or Archer medical savings account (MSA), and
- The **person that administers the plan benefits** in the case of any other applicable coverage.[137]

Note. For more information about the excise tax on Cadillac health plans, see IRS Notice 2015-16 and the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Healthcare Reform Act. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

132. IRC §4980I.
133. PL 111-148.
134. IRC §4980I(d)(3).
135. PL 114-113, §201.
136. PL 115-120, §4002.
137. IRS Notice 2015-16, 2015-10 IRB 732.

SMALL BUSINESS HEALTH INSURANCE TAX CREDIT[138]

The small business health insurance tax credit is designed to encourage small employers to offer health insurance for the first time or maintain coverage they already have.

A tax credit is provided for a qualified small employer for nonelective contributions to purchase health insurance for its employees. **The tax credit percentage is 50% of employer-paid premiums. For tax-exempt employers, the tax credit percentage is 35%.**[139] An eligible small employer is one that meets all the following criteria.

- The employer has **no more than 25** full-time equivalent (FTE) employees for the tax year.
- The average annual wages of the employees for 2019 **do not exceed** $54,200.[140] (For 2018, the limit was $53,200.[141]) This amount is indexed annually for inflation.
- The employer has a qualifying contribution arrangement under which it must pay a uniform percentage that is at least 50% of the premium cost of the qualified health insurance plan for each enrolled employee.

The credit is generally available **only to small employers that purchase health insurance coverage through a state exchange**, otherwise known as the Small Business Health Options Program (SHOP), and can be claimed for only two consecutive years beginning with the first tax year in or after 2014. The eligible employer attaches a Form 8941, *Credit for Small Employer Health Insurance Premiums,* (discussed later) to its tax return to calculate the credit.[142]

> **Note.** In April 2018, the IRS provided relief to certain employers who first claimed the credit for all or part of 2016 or a later tax year for coverage offered through a state exchange. The relief affects employers that do not have any state exchange plans available to offer to employees for all or part of the credit period because the county where the employer is located has no state exchange plans. For information about the relief, see IRS Notice 2018-27.

The following steps must be followed to determine whether an employer is eligible for the credit.[143]

1. Determine the employees taken into account for purposes of the credit.
2. Determine the number of hours of service performed by the employees.
3. Calculate the number of FTEs.
4. Determine the average annual wages paid per FTE.
5. Determine the premiums paid by the employer that are taken into account for purposes of the credit.

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138. IRC §45R.

139. *Understanding the Small Business Health Care Tax Credit.* Apr. 26, 2019. IRS. [www.irs.gov/affordable-care-act/employers/understanding-the-small-business-health-care-tax-credit] Accessed on May 31, 2019.

140. Rev. Proc. 2018-57, 2018-49 IRB 827.

141. Rev. Proc. 2018-18, 2018-10 IRB 392.

142. *Understanding the Small Business Health Care Tax Credit.* Apr. 26, 2019. IRS. [www.irs.gov/affordable-care-act/employers/understanding-the-small-business-health-care-tax-credit] Accessed on May 9, 2019; *Small Business Health Care Tax Credit Questions and Answers: Who Gets the Tax Credit.* Apr. 26, 2019. IRS. [www.irs.gov/newsroom/small-business-health-care-tax-credit-questions-and-answers-who-gets-the-tax-credit] Accessed on Jun. 17, 2019; IRC §45R(e)(2).

143. IRS Notice 2010-44, 2010-22 IRB 717.

Determining Number of Employees

The term **employee** for purposes of the credit means an individual who is an employee of the eligible small employer under the common law standard described in Treas. Reg. §31.3121(d)-1(c). However, the following persons are not counted in the determination of FTEs and average annual wages.[144]

1. Seasonal workers (unless the seasonal worker works for the employer for more than 120 days during the tax year)
2. Sole proprietors
3. Partners in a partnership
4. Shareholders owning more than 2% of an S corporation
5. Any owner of more than 5% of a business
6. Family members (i.e., lineal descendant, sibling or step-sibling, parent or parent's ancestor, step-parent, niece or nephew, aunt or uncle, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law) of any person described in items 2–5 above

Premiums paid on behalf of these persons are not counted in determining the amount of the credit.[145]

Determining Number of Hours of Service Performed

An employee's hours of service for a year include:

- Each hour for which the employee is paid for the performance of duties for the employer; and
- Each hour for which the employee is paid or entitled to payment for vacation, holiday, illness, incapacity, layoff, jury duty, military duty, or leave of absence. However, no more than 160 hours of service are required to be counted for an employee for any single continuous period during which the employee performs no duties.[146]

An employer can use any of the following methods to calculate the total number of hours of service that must be taken into account for an employee for the year.[147]

Method 1. **Actual paid hours** of service work

Method 2. **Days-worked equivalency.** This method credits the employee with eight hours of service for each actual workday in which the employee is credited with at least one hour of service. Workdays include vacation days, holidays, etc.

Method 3. **Weeks-worked equivalency.** This method credits the employee with 40 hours of weekly service for each week in which the employee is credited with at least one hour of service.

Employers do not have to use the same method for all employees. Instead, the employer may apply different methods for different classifications of employees, if the classifications are reasonable and consistently applied. For example, an employer may use method 1 for all hourly employees and method 3 for all salaried employees.[148] Employers are permitted to change the method for calculating employees' hours of service for each tax year.[149]

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144. Treas. Reg. §1.45R-1.

145. IRC §45R(e)(1).

146. Treas. Reg. §1.45R-2(d).

147. Ibid.

148. *Small Business Health Care Tax Credit Questions and Answers: Determining FTEs and Average Annual Wages.* Apr. 29, 2019. IRS. [www.irs.gov/newsroom/small-business-health-care-tax-credit-questions-and-answers-determining-ftes-and-average-annual-wages] Accessed on May 10, 2019.

149. Treas. Reg. §1.45R-2(d).

No more than 2,080 hours per year can be taken into account for any employee.[150]

Example 15. Smegan Vegan Products (Smegan) is a small business that produces upscale vegan snacks. In 2018, it had four employees. The company's accountant has decided to use method 1 to calculate hours of service for hourly employees and method 3 to calculate hours of service for salaried employees.

			Hours of Service			
Employee	**Classification**	**Wages**	**Actual Hours**	**Weeks Worked**	**Based on Actual Hours**	**Based on Weeks Worked**
Jessica	Hourly	$ 17,000	1,700	52	1,700	
Jenna	Hourly	18,140	1,814	50	1,814	
Kristin	Salaried	52,000	2,102	52		2,080
Nate	Salaried	45,000	1,800	52		2,080
Totals		$132,140			3,514	4,160

The number of hours of service performed for purposes of the health insurance credit is calculated as follows.

Employee	**Hours Used to Compute FTE**
Jessica	1,700
Jenna	1,814
Kristin	2,080
Nate	2,080
Total hours of service	7,674

Calculate the Number of FTEs

The number of FTEs for an employer is calculated by dividing the total hours of service (explained in the preceding section) by 2,080. If the result is not a whole number, it is rounded down to the next whole number.[151]

Example 16. Use the same facts as **Example 15.** Smegan has 3 FTEs (7,674 ÷ 2,080 = 3.69, rounded down to 3) for purposes of the small business health insurance credit.

Determine the Average Annual Wages

Average annual wages are calculated by dividing the total wages[152] paid by the employer to qualified employees by the number of the employer's FTEs for the year. If the result is not a multiple of $1,000, it is rounded down to the nearest $1,000.[153]

Example 17. Use the same facts as **Example 15** and **Example 16.** Smegan's average annual wages are $44,000 ($132,140 total wages ÷ 3 FTEs = $44,047, rounded down to $44,000).

150. Treas. Reg. §1.45R-2(e).

151. Ibid.

152. "Wages" for this purpose means wages as defined under IRC §3121(a), without regard to the wage base limitation under §3121(a)(1).

153. Treas. Reg. §1.45R-2(f).

Determine the Amount of Premiums Paid

Only the portion of health insurance premiums paid by the employer under a qualifying arrangement is counted in calculating the credit. A **qualifying arrangement** is one in which the employer pays at least 50% of the cost of premiums for each employee enrolled in coverage.[154]

Health insurance coverage for purposes of the credit includes the following.[155]

- Medical care under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract offered by a health insurance issuer
- Limited scope dental or vision
- Long-term care, nursing-home care, home-health care, community-based care, or any combination of these
- Coverage only for a specified disease or illness
- Hospital indemnity or other fixed-indemnity insurance
- Medicare supplemental health insurance and certain other supplemental coverage

Computation

The credit is equal to the **lesser** of the following two amounts multiplied by an applicable tax credit percentage.[156]

1. The amount of contributions the employer made on behalf of the employees during the tax year for the qualifying health coverage
2. The amount of contributions that the employer would have made under the same arrangement if the average premium for the small group market in the rating area in which the employee enrolls for coverage were substituted for the actual premium (benchmark premium)

The benchmark premium is multiplied by the number of employees enrolled in coverage and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. As mentioned earlier, the credit is only available if this uniform percentage is at least 50%.

Example 18. Use the same facts as **Example 17.** Smegan pays 80% of the health insurance premiums for its four employees. In 2019, it pays a total of $9,000 in premiums for Jessica and Jenna, who are both single. Smegan pays a total of $15,000 in premiums for Kristin and Nate, who are both married and have family coverage. The benchmark premium for single coverage in the state is $5,000, and the benchmark premium for family coverage is $9,000. Although Smegan pays a total of $24,000 ($9,000 + $15,000) in health insurance premiums for its employees, the amount of health insurance premiums that Smegan can take into account for purposes of the credit is limited to $22,400 (($5,000 benchmark premium for single coverage × 2 employees) + ($9,000 benchmark premium for family coverage × 2 employees) × 80% uniform percentage).

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154. Treas. Reg. §1.45R-2(a).

155. IRS Notice 2010-44, 2010-22 IRB 717.

156. Treas. Reg. §§1.45R-3(a) and (b).

Credit Reduction. For 2019, the credit is reduced for employers with average wages per employee between $27,100 and $54,200.[157] The amount of this reduction is equal to the amount of the credit (determined before any reduction) multiplied by a fraction, the numerator of which is the average annual wages of the employer in excess of $27,100 and the denominator of which is $27,100.[158]

For 2018, the credit is reduced for employers with average wages per employee between $26,600 and $53,200.[159] The amount of this reduction is equal to the amount of the credit (determined before any reduction) multiplied by a fraction, the numerator of which is the average annual wages of the employer in excess of $26,600 and the denominator of which is $26,600.[160]

Example 19. Use the same facts as **Example 18.** Smegan's health insurance tax credit is calculated as follows.

Health insurance premiums	$22,400	
Tax credit percentage	× 50%	
Initial credit amount determined before any reduction	$11,200	$11,200
($44,000 average wages − $27,100) ÷ $27,100	× .62362	
Credit reduction for average annual wages in excess of $27,100	$ 6,985	(6,985)
Total 2019 health insurance credit		$ 4,215

The credit is also reduced for any employer that has more than 10 but not more than 25 FTEs. For an employer with more than 10 FTEs, the reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.[161]

Practitioner Planning Tip

Careful workforce scheduling can increase the allowable tax credit. For employers with few employees, the credit reduction can be reduced by increasing FTE. This can be accomplished by scheduling the employees to work at least one hour per week in order to use the "weeks worked" method to increase FTEs. For **Example 19,** if Jenna had worked two more weeks in 2018, the tax credit would have been $8,762 instead of $4,215.

157. IRC §45R(d)(1); Rev. Proc. 2018-57, 2018-49 IRB 827.

158. Treas. Reg. §1.45R-3(c); Rev. Proc. 2018-57, 2018-49 IRB 827.

159. IRC §45R(d)(1); Rev. Proc. 2018-18, 2018-10 IRB 392.

160. Treas. Reg. §1.45R-3(c); Rev. Proc. 2018-18, 2018-10 IRB 392.

161. Treas. Reg. §1.45R-3(c).

For an employer that has more than 10 FTEs **and** average annual wages in excess of $27,100 for 2019 (or $26,600 for 2018), the total reduction is the sum of the two reduction amounts.[162]

Example 20. In 2018, David Truffle, a sole proprietor, is a qualified employer for purposes of the small business health insurance credit. David has 12 FTEs and average annual wages of $30,000. David pays $96,000 in health insurance premiums for his employees (which does not exceed the average premium for the small-group market in his state) and otherwise meets the requirements for the credit.

David's credit is calculated as follows.

Health insurance premiums	$96,000		
Tax credit percentage	× 50%		
Initial credit amount determined before any reduction	$48,000	$48,000	$48,000
($30,000 average wages − $26,600) ÷ $26,600	× .12782		
Credit reduction for average annual wages in excess of $26,600	$ 6,135		(6,135)
(12 FTEs − 10 FTEs) ÷ 15 FTEs		× .13333	
Credit reduction for FTEs in excess of 10		$ 6,400	(6,400)
Total 2018 health insurance credit			$35,465

Claiming the Credit

For an employer that is not tax-exempt, the credit is calculated on Form 8941, *Credit for Small Employer Health Insurance Premiums,* and is claimed as part of the general business credit on Form 3800, *General Business Credit.*[163] **The credit offsets only an employer's actual income tax liability or alternative minimum tax (AMT) liability for the year.**

An eligible tax-exempt small employer claims the credit by attaching Form 8941 to its Form 990-T, *Exempt Organization Business Income Tax Return.* To claim the credit, a tax-exempt eligible small employer must file a Form 990-T with an attached Form 8941, even if a Form 990-T would not otherwise be required.[164]

Example 21. Use the same facts as **Example 20.** David's 2018 Form 8941 follows.

162. Ibid; Joint Committee on Taxation report JCX-18-10, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act."*

163. Instructions for Form 8941.

164. Treas. Reg. §1.45R-5.

For Example 21

Form **8941** | **Credit for Small Employer Health Insurance Premiums** | OMB No. 1545-2198

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form8941* for instructions and the latest information.

2018

Attachment Sequence No. **65**

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

A Did you pay premiums during your tax year for employee health insurance coverage you provided through a Small Business Health Options Program (SHOP) Marketplace (or do you qualify for an exception to this requirement)? See instructions.

☒ **Yes.** Enter Marketplace Identifier (if any): ______________

☐ **No.** Stop. Do not file Form 8941 (see instructions for an exception that may apply to a partnership, S corporation, cooperative, estate, trust, or tax-exempt entity)

B Enter the employer identification number (EIN) used to report employment taxes for individuals included on line 1 below if different from the identifying number listed above

C Does a tax return you (or any predecessor) filed for a tax year beginning in 2014, 2015, or 2016 include a Form 8941 with line A checked "Yes" and line 12 showing a positive amount?

☐ **Yes.** Stop. Do not file Form 8941 (see instructions for an exception that may apply to a partnership, S corporation, cooperative, estate, trust, or tax-exempt entity) (also see instructions for information about the credit period limitation)

☒ **No.**

Caution: See the instructions and complete Worksheets 1 through 7 as needed.

1	Enter the number of individuals you employed during the tax year who are considered employees for purposes of this credit (total from Worksheet 1, column (a))	1	12
2	Enter the number of full-time equivalent employees (FTEs) you had for the tax year (from Worksheet 2, line 3). If you entered 25 or more, skip lines 3 through 11 and enter -0- on line 12	2	12
3	Average annual wages you paid for the tax year (from Worksheet 3, line 3). This amount must be a multiple of $1,000. If you entered $54,000 or more, skip lines 4 through 11 and enter -0- on line 12	3	30,000
4	Premiums you paid during the tax year for employees included on line 1 for health insurance coverage under a qualifying arrangement (total from Worksheet 4, column (b))	4	96,000
5	Premiums you would have entered on line 4 if the total premium for each employee equaled the average premium for the small group market in which the employee enrolls in health insurance coverage (total from Worksheet 4, column (c))	5	100,000
6	Enter the **smaller** of line 4 or line 5	6	96,000
7	Multiply line 6 by the applicable percentage: • Tax-exempt small employers, multiply line 6 by 35% (0.35) • All other small employers, multiply line 6 by 50% (0.50)	7	48,000
8	If line 2 is 10 or less, enter the amount from line 7. Otherwise, enter the amount from Worksheet 5, line 6	8	41,600
9	If line 3 is $26,000 or less, enter the amount from line 8. Otherwise, enter the amount from Worksheet 6, line 7	9	35,465
10	Enter the total amount of any state premium subsidies paid and any state tax credits available to you for premiums included on line 4. See instructions	10	0
11	Subtract line 10 from line 4. If zero or less, enter -0-	11	96,000
12	Enter the **smaller** of line 9 or line 11	12	35,465
13	If line 12 is zero, skip lines 13 and 14 and go to line 15. Otherwise, enter the number of employees included on line 1 for whom you paid premiums during the tax year for health insurance coverage under a qualifying arrangement (total from Worksheet 4, column (a))	13	12
14	Enter the number of FTEs you would have entered on line 2 if you only included employees included on line 13 (from Worksheet 7, line 3)	14	12
15	Credit for small employer health insurance premiums from partnerships, S corporations, cooperatives, estates, and trusts (see instructions)	15	0
16	Add lines 12 and 15. Cooperatives, estates, and trusts, go to line 17. Tax-exempt small employers, skip lines 17 and 18 and go to line 19. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, stop here and report this amount on Form 3800, Part III, line 4h	16	35,465
17	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)	17	
18	Cooperatives, estates, and trusts, subtract line 17 from line 16. Stop here and report this amount on Form 3800, Part III, line 4h	18	
19	Enter the amount you paid in 2018 for taxes considered payroll taxes for purposes of this credit. See instructions	19	
20	Tax-exempt small employers, enter the **smaller** of line 16 or line 19 here and on Form 990-T, line 50f	20	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37757S Form **8941** (2018)

REQUIREMENTS FOR APPLICABLE LARGE EMPLOYERS

Two ACA provisions apply only to applicable large employers (ALEs).[165]

1. The employer shared responsibility payment (often called the "employer mandate")
2. The employer information reporting provisions for minimum essential coverage (MEC)

An **applicable large employer** is an employer that employed an average of at least 50 full-time employees on business days during the previous calendar year.[166] However, there is an **exemption** available if the employer meets **both** of the following conditions.[167]

- The employer's workforce exceeded 50 full-time employees for 120 or fewer days during the calendar year.
- The employees in excess of 50 employed during the 120-day period were seasonal workers.

For this purpose, a **full-time employee** for any calendar month is an employee who averaged at least 30 hours of service per week during the calendar month or at least 130 hours of service during the calendar month.[168]

Note. For information about determining whether an employer is considered an ALE, including the aggregation rules, relevant definitions, and rules for new employers, see **uofi.tax/19b3x1** [www.irs.gov/affordable-care-act/employers/determining-if-an-employer-is-an-applicable-large-employer].

Employer Shared Responsibility Payment[169]

ALEs are required to offer insurance that provides MEC that is "affordable" and that provides "minimum value" to their full-time employees (and their dependents). An ALE that does not provide such benefits may be required to pay a penalty (called an employer shared responsibility payment) to the IRS. The two penalties are as follows.

1. A penalty under **IRC §4980H(a)** for an ALE that **does not** offer MEC to at least 95%[170] of its full-time employees and their dependents and at least one full-time employee receives the premium tax credit (PTC) for purchasing coverage through the health insurance Marketplace

Note. For information about the PTC, see the 2019 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Individual Taxpayer Issues.

2. A penalty under **IRC §4980H(b)** for an ALE that **does** offer MEC to its full-time employees but one or more of the ALE's full-time employees receives the PTC for purchasing coverage through the Marketplace.

165. *Determining if an Employer is an Applicable Large Employer.* Mar. 18, 2019. IRS. [www.irs.gov/affordable-care-act/employers/determining-if-an-employer-is-an-applicable-large-employer] Accessed on May 15, 2019.

166. IRC §4980H(c)(2)(A).

167. IRC §4980H(c)(2)(B).

168. *Determining if an Employer is an Applicable Large Employer.* Mar. 18, 2019. IRS. [www.irs.gov/affordable-care-act/employers/determining-if-an-employer-is-an-applicable-large-employer] Accessed on May 15, 2019.

169. *Employer Shared Responsibility Provisions.* Mar. 27, 2019. IRS. [www.irs.gov/affordable-care-act/employers/employer-shared-responsibility-provisions] Accessed on May 15, 2019; IRC §4980H.

170. See Treas. Reg. §54.4980H-4(a).

IRC §4980H(a) Penalty. An ALE not offering health insurance coverage faces a penalty if:

1. It fails to offer its full-time employees (and their spouses and dependents) the opportunity to enroll in MEC under an eligible employer-sponsored health plan for any month, **and**
2. It has at least one full-time employee who has been:
   a. Certified to the employer as having enrolled for that month in a qualified health plan obtained through the Marketplace, **and**
   b. The Marketplace coverage obtained by the employee is coverage for which the employee can receive either the PTC or other cost-sharing arrangement.

The ALE must offer coverage to every full-time employee **each day of the calendar month** to avoid the §4980H(a) penalty. If the ALE fails to offer coverage for **any day during the month** to one or more employees, the ALE is treated as failing to offer coverage to those employees for that **entire** calendar month. If an employee terminates employment during the month, the employer is treated as offering coverage for the full month in which employment terminated if coverage would have been offered to the employee had they remained employed for the full calendar month.[171]

Calculating the §4980H(a) Penalty. The penalty for a violation of §4980H(a) is $2,000 annually (indexed for inflation) for each full-time employee, with the first 30 employees excluded from the penalty calculation. The calculation is based on **all** full-time employees (minus 30), including employees who have MEC.[172]

For an ALE that offers coverage to at least 95% of its full-time employees (and their dependents) for some months but not others during the year, the payment is calculated separately for each month. The amount of the penalty for each months equals the number of full-time employees the ALE employed for the month (minus 30) multiplied by one-twelfth of $2,000 (as adjusted for inflation).[173]

Note. For more information about calculating the §4980H(a) penalty, see Treas. Reg. §54.4980H-4.

IRC §4980H(b) Penalty. An ALE offering MEC faces a penalty if that employer:

1. Offers full-time employees (and their spouses and dependents) the opportunity to enroll in MEC under an eligible employer-sponsored plan for any month, and
2. Despite offering that coverage, has one or more full-time employees who have been:
   a. Enrolled in a qualified health plan obtained through a state Marketplace, and
   b. The Marketplace coverage obtained by the employee is coverage for which the employee can receive either the PTC or other cost-sharing arrangement (subsidy).

The MEC offered by an ALE to at least 95% of its full-time employees must meet certain standards. The coverage must:

- Be **affordable coverage** as defined in IRC §36B(c)(2)(C)(i), and
- Provide **minimum value** as defined in IRC §36B(c)(2)(C)(ii).

171. Treas. Reg. §54.4980H-4(c).

172. *Employer Shared Responsibility Provisions.* Mar. 27, 2019. IRS. [www.irs.gov/affordable-care-act/employers/employer-shared-responsibility-provisions] Accessed on May 17, 2019.

173. *Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act.* Mar. 26, 2019. IRS. [www.irs.gov/affordable-care-act/employers/questions-and-answers-on-employer-shared-responsibility-provisions-under-the-affordable-care-act] Accessed on May 17, 2019.

Affordable Coverage. In order for the coverage to be affordable, the employee's required contribution for self-only coverage must not exceed 9.86% of the employee's household income for 2019. This percentage is adjusted annually for inflation.[174] Household income is defined as the sum of the modified adjusted gross income (MAGI) amounts (as defined in IRC §36B(d)(2)(B)) for the full-time employee and for the employee's family (including spouse and dependents) who are required to file a federal tax return.[175]

Employers that provide the opportunity for full-time employees and their dependents to enroll in MEC may take advantage of one or more affordability safe harbors provided by the regulations. Reliance by an employer on an affordability safe harbor ensures the employer will not be subject to a §4980H(b) penalty for the period during which the health coverage is deemed affordable by the safe harbor rule. This deemed affordability safe harbor will prevail even if the coverage is, in fact, not affordable for one or more employees who qualify for a PTC or cost-sharing subsidy.[176]

Under these safe harbors, employers can use the following factors to determine affordability.

1. Form W-2 wages
2. Employee's rate of pay
3. Federal poverty line

> **Note.** For information about the safe harbors, see Treas. Reg. §54.4980H-5 and the IRS question and answer page at **uofi.tax/19b3x2** [www.irs.gov/affordable-care-act/employers/questions-and-answers-on-employer-shared-responsibility-provisions-under-the-affordable-care-act].

Minimum Value. A plan offered by an employer provides minimum value if both of the following apply.[177]

- It is designed to cover at least 60% of the cost of medical services that are expected to be incurred under the plan for a standard population.[178]
- Its benefits include substantial coverage of physician and inpatient hospital services.

ALEs generally must use a minimum value calculator developed by the U.S. Department of Health and Human Services (HHS) to determine if a plan provides minimum value. This calculator can be found at **uofi.tax/19b3x3** [www.cms.gov/cciio/resources/regulations-and-guidance/index.html].[179]

Calculating the §4980H(b) Penalty. The penalty for a violation of §4980H(b) is $3,000 annually (indexed for inflation) for each full-time employee who receives the PTC. The total payment cannot exceed the amount the employer would have owed if it had not offered MEC to at least 95% of its full-time employees (and their dependents).[180]

The §4980H(b) penalty is calculated separately for each month. The amount of the monthly penalty equals the number of full-time employees who receive a PTC for that month multiplied by one-twelfth of $3,000 (as adjusted for inflation). However, the total payment cannot exceed the amount of the penalty under §4980H(a) that the employer would have incurred if it did not offer coverage to its employees.[181]

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174. IRC §36B(c)(2)(C)(i)(II); IRS Pub. 974, *Premium Tax Credit (PTC).*
175. IRC §36B(d)(2).
176. Treas. Reg. §54.4980H-5(e)(2).
177. *Minimum value.* U.S. Centers for Medicare & Medicaid Services. [www.healthcare.gov/glossary/minimum-value] Accessed on May 15, 2019.
178. See Treas. Reg. §1.36B-6.
179. *Minimum Value and Affordability.* Jan 31, 2019. IRS. [www.irs.gov/affordable-care-act/employers/minimum-value-and-affordability] Accessed on May 15, 2019.
180. *Employer Shared Responsibility Provisions.* Mar. 27, 2019. IRS. [www.irs.gov/affordable-care-act/employers/employer-shared-responsibility-provisions] Accessed on May 17, 2019.
181. *Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act.* Mar. 26, 2019. IRS. [www.irs.gov/affordable-care-act/employers/questions-and-answers-on-employer-shared-responsibility-provisions-under-the-affordable-care-act] Accessed on May 17, 2019.

Employer Information Reporting Provisions

ALEs are required to report information about whether they offered coverage to employees and, if so, information about the offer of coverage. ALEs use **Form 1094-C,** *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns,* to report summary information for the ALE and to transmit Forms **1095-C,** *Employer-Provided Health Insurance Offer and Coverage,* to the IRS. ALEs use Form 1095-C to report information about each employee to the IRS and to the employee. The IRS uses Forms 1094-C and 1095-C to determine whether an ALE owes a payment under the employer shared responsibility provisions of §4980H. Form 1095-C is also used to determine an employee's eligibility for the PTC.[182]

QUALIFIED SMALL EMPLOYER HRA

A health reimbursement arrangement (HRA) is a plan funded exclusively by an employer that reimburses employees for qualified medical costs.[183] The HRA is a tax-advantaged "self-funded" plan that is subject to nondiscrimination rules.[184] A **qualified small employer health reimbursement arrangement** (QSEHRA) is an HRA that meets the following requirements.[185]

- It is funded solely by an **eligible small employer** (generally, an employer with under 50 full-time employees).
- Payment or reimbursement of an employee's or family member's medical expenses is made only after the employee provides proof of healthcare insurance coverage. (Allowable medical expenses of the employee (or family members) are the same as those allowed as an itemized deduction, which includes medical insurance premiums.[186])
- In 2019, the arrangement cannot pay or reimburse more than $5,150 of expenses for a single employee, or more than $10,450 for an employee with family coverage, for the year.[187] (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.)
- The arrangement is provided on the same terms to **all eligible employees** of the eligible employer.

> **Note.** For more information on QSEHRAs, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues and the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: New Developments. These chapters can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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.[188]

A QSEHRA 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.[189]

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182. Instructions for Forms 1094-C and 1095-C.
183. IRS Notice 2002-45, 2002-28 IRB 93.
184. See IRC §105(h)(2) and Treas. Reg. §1.105-11.
185. IRC §9831(d)(2).
186. IRC §213(d).
187. Rev. Proc. 2018-57, 2018-49 IRB 827, 838.
188. IRC §9831(d)(3)(A), referencing IRC §105(h)(3)(B).
189. IRC §9831(d)(2)(C).

An **eligible employer** is one that:[190]

- Employed an average of less than 50 full-time employees during the preceding calendar year, and
- Does not offer a group health plan to any of its employees.

NOTIFICATION REQUIREMENTS

Summary Plan Description

As an employee benefit plan, a QSEHRA is required to be established and maintained pursuant to a written instrument or plan.[191] Employers must provide a summary plan description to employees. The summary plan description must include the following items.[192]

- Name and type of administration of the plan
- Name and address of the health insurance issuer responsible for the financing or administration of a group health plan
- Names and addresses of the agent for the legal process and the administrator
- Names, titles, and addresses of any trustee or trustees
- Description of relevant provisions of any applicable collective bargaining agreement
- Eligibility requirements for participation and benefits
- Description of the provisions for nonforfeitable pension benefits
- Circumstances that may result in disqualification, ineligibility, or denial or loss of benefits
- Source of financing of the plan and the identity of any organization through which benefits are provided
- Date of the plan yearend and whether the records are kept on a calendar, policy, or fiscal year basis
- Procedures for presenting benefit claims under the plan including the office at the Department of Labor through which participants and beneficiaries may seek assistance or information regarding their rights under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) for health benefits that are offered through a group health plan; the remedies available under the plan for the redress of claims that are denied in whole or in part; and, if the employer elects, the model notice applicable to the state in which the participants and beneficiaries reside

Practitioner Planning Tip

Although access to the legal documents required to create the QSEHRA is readily and publicly available, it is not advisable for employers to administer the QSEHRA. It is difficult for small employers to find the time to stay up-to-date on changing regulations and challenging to maintain the necessary security for employees' medical information and privacy.[193]

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190. IRC §9831(d)(3)(B).

191. 29 USC §1102.

192. 29 USC §1022.

193. *QSEHRA rules your small-business clients need to know.* Prosek, Alison. Aug. 20, 2018. Accounting Today. [www.accountingtoday.com/opinion/qsehra-rules-your-small-business-clients-need-to-know] Accessed on Apr. 5, 2019.

Employee Plan Summary

An employer that funds a QSEHRA for any year must provide a written notice, or plan summary, to each eligible employee not later than 90 days before the beginning of the year. For an employee who is not eligible to participate in the QSEHRA at the beginning of such year, the employer must provide the summary on the date on which the employee is first eligible. The summary must include the following information.[194]

- The amount of the eligible employee's permitted benefit for the year (A **permitted benefit** is the maximum dollar amount of payments and reimbursements that may be made under the terms of the QSEHRA for an eligible employee during the year.[195])
- A statement that the eligible employee must provide information about the amount of the permitted benefit to any health insurance exchange to which the employee applies for advance payment of the PTC
- A statement that if the employee does not have MEC (an ACA requirement) for any month, the employee may be subject to tax under IRC §5000A for that month and the QSEHRA reimbursements may be includable in gross income

Employers failing to provide their employees with written notice are subject to a $50 penalty per employee per incident of failure. The maximum cumulative employer penalty is $2,500 per calendar year.[196]

Eligible employers may provide written notice to their eligible employees electronically. The electronic notice is subject to the rules on the use of an electronic medium listed in Treas. Reg. §1.401(a)-21.[197]

IRS Notice 2017-67 provides sample language that an employer can use to provide the required information to eligible employees. An excerpt from this notice follows.

> Your permitted benefit for ______ (tax year) is $________ (self-only permitted benefit amount) if you have self-only coverage or $________ (family permitted benefit amount) if any members of your family also have coverage. (These amounts are prorated by month if you are not eligible on the first day of the year.) Your permitted benefit applies to medical expenses incurred on or after January 1 (your eligibility date).
>
> You are required to inform any Marketplace to which you apply for advance payments of the premium tax credit about the amount of your permitted benefit. The amount of your permitted benefit may affect your eligibility for a premium tax credit and will reduce the amount of the premium tax credit for which you are eligible. You should retain this written notice because it may be needed to calculate the premium tax credit on your individual income tax return.
>
> If you do not have minimum essential coverage for any month, you may be liable for an individual shared responsibility payment under IRC §5000A, and all of the reimbursements you receive under this arrangement for expenses incurred in that month will be includible in your gross income. For a list of examples of plans and arrangements that are minimum essential coverage, you may refer to the instructions for IRS Form 8965, *Health Coverage Exemptions,* which are available on the IRS website.

Note. The amount of the shared responsibility payment for individuals failing to maintain MEC has been reduced to $0 for tax years beginning after 2018.[198]

194. IRC §§9831(d)(4)(A) and (B).
195. IRC §9831(d)(3)(C).
196. IRC §6652(o).
197. IRS Notice 2017-67, 2017-47 IRB 517.
198. TCJA §11081.

Practitioner Planning Tip

Employers setting up a QSEHRA have flexibility in deciding what is reimbursed. Employers can reimburse insurance premiums only, cost-sharing medical expenses, and/or certain other medical expenses specified under the arrangement.[199] Employers need to analyze their goals and budget to select the appropriate reimbursement policy.

2% S CORPORATION SHAREHOLDERS[200]

A QSEHRA may only be provided to **employees.** An S corporation shareholder who owns more than 2% of the S corporation[201] and is otherwise an employee is **not** considered an employee for purposes of a QSEHRA. Therefore, an eligible employer may not provide a QSEHRA to a more-than-2% S corporation shareholder.

An S corporation that reimburses the health insurance policy premiums of a more-than-2% shareholder separate from a QSEHRA does not fail the requirements to be an eligible employer because of such reimbursements.

TAX REPORTING

Contributions to HRAs, including QSEHRAs, are deductible by the employer. HRA reimbursements are excluded from the employee's taxable wages.[202]

The employer reports QSEHRA contributions on an employee's Form W-2 by using code FF in box 12.[203] The employer reports the amount of payments and reimbursements that the eligible employee is entitled to receive during the calendar year regardless of the payments or reimbursements actually received.[204]

An eligible employer that provides a QSEHRA is not required to issue Forms 1095-B, *Health Coverage,* to eligible employees.[205]

An eligible employee covered under a QSEHRA who acquires health insurance through a Marketplace may be required to file a Form 8962, *Premium Tax Credit (PTC).* A taxpayer uses Form 8962 to calculate their PTC and reconcile it with any advanced payment of the PTC. No PTC is allowed for any month in which the QSEHRA provides **affordable coverage.**[206] In 2019, coverage is considered affordable if the annual cost for self-only coverage is not more than 9.86% of the tax family's household income for the year.[207] An individual with an **unaffordable** QSEHRA for a month must reduce their monthly PTC by the monthly permitted benefit amount on Form 8962. The taxpayer must write "QSEHRA" in the top margin on page 1 of Form 8962.[208]

Note. See IRS Pub. 974, *Premium Tax Credit (PTC),* for information on determining affordability.

199. IRS Notice 2017-67, 2017-47 IRB 517.
200. Ibid.
201. See IRC §1372.
202. IRS Notice 2013-54, 2013-40 IRB 287; IRC §105(b).
203. General instructions for Forms W-2 and W-3.
204. IRS Notice 2017-67, 2017-47 IRB 517.
205. Ibid.
206. Instructions for Form 8962; IRS Pub. 974, *Premium Tax Credit (PTC).*
207. IRS Pub. 974, *Premium Tax Credit.*
208. Instructions for Form 8962.

A QSEHRA is an applicable self-insured health plan that is subject to the Patient-Centered Outcomes Research Trust Fund (PCORTF) fee.[209] Therefore, plan sponsors of a QSEHRA are required to file Form 720, *Quarterly Federal Excise Tax Return.* Form 720 is due on July 31 of the year following the last day of the policy year or plan year. The fee is applicable to plan years ending before October 1, 2019,[210] and is payable on either a Form 720-V, *Payment Voucher,* or through the electronic federal tax payment system (EFTPS).[211] The PCORTF fee does not apply to years ending after October 1, 2019,[212] and Form 720 is not required.

Example 22. Valley Florals, an S corporation, is a landscape company that provides a QSEHRA to its eight employees. Five of the employees are seasonal (noneligible) and three are full-time. Valley Florals offers its eligible employees $300 per month through the QSEHRA. The policy year ends December 31, 2018. All covered employees were part of the QSEHRA for the entire year.

Valerie is an eligible employee who earns wages of $30,000 in 2018. She is covered by her husband's health insurance. During 2018, Valerie pays $2,500 in medical expenses and submits those expenses to Valley Florals for reimbursement. Valley Florals prepares the following Form W-2 for Valerie.

a Employee's social security number: 333-45-7777	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 37-9999999	1 Wages, tips, other compensation: 30000.00	2 Federal income tax withheld: 3000.00
c Employer's name, address, and ZIP code: Valley Florals 27 Lily Way La Rose, IL 61541	3 Social security wages: 30000.00	4 Social security tax withheld: 1860.00
	5 Medicare wages and tips: 30000.00	6 Medicare tax withheld: 435.00
	7 Social security tips	8 Allocated tips
d Control number	9 Verification code	10 Dependent care benefits
e Employee's first name and initial: Valerie; Last name: Violet; Suff.	11 Nonqualified plans	12a See instructions for box 12 — Code: FF — 3600.00
478 Gardenia Lane, Unit B La Rose, IL 61541	13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
	14 Other	12c Code
f Employee's address and ZIP code		12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL	37-9999999	30000.00	1485.00			

Form **W-2** Wage and Tax Statement **2018**

Department of the Treasury—Internal Revenue Service

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

209. See IRC §4376.

210. IRS Notice 2017-67, 2017-47 IRB 517.

211. Instructions for Form 720-V.

212. *Patient-Centered Outcomes Research Trust Fund Fee (IRC 4375, 4376 and 4377): Questions and Answers.* Nov. 8, 2018. IRS. [www.irs.gov/affordable-care-act/patient-centered-outcomes-research-trust-fund-fee-questions-and-answers] Accessed on Apr. 9, 2019.

Stu is an eligible employee who earns wages of $28,000 in 2018. He is single and has insurance through a health care exchange. His coverage through the exchange is considered affordable and he does not receive a PTC; therefore, Stu does not need to file Form 8962. Stu submits medical expenses of $2,700 but is only reimbursed $2,500 by Valley Florals. Valley Florals reports the entire amount Stu is eligible to receive of $3,600 (the maximum provided) on his Form W-2.

a Employee's social security number: 444-56-8912	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 37-9999999	1 Wages, tips, other compensation: 28000.00	2 Federal income tax withheld: 2800.00
c Employer's name, address, and ZIP code: Valley Florals, 27 Lily Way, La Rose, IL 61541	3 Social security wages: 28000.00	4 Social security tax withheld: 1736.00
	5 Medicare wages and tips: 28000.00	6 Medicare tax withheld: 406.00
	7 Social security tips	8 Allocated tips
d Control number	9 Verification code	10 Dependent care benefits
e Employee's first name and initial: Stu; Last name: Stamen; Suff.	11 Nonqualified plans	12a See instructions for box 12 — Code FF: 3600.00
1468 Lavender Hills, La Rose, IL 61541	13 Statutory employee / Retirement plan / Third-party sick pay	12b Code
	14 Other	12c Code
f Employee's address and ZIP code		12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL	37-9999999	28000.00	1386.00			

Form **W-2** Wage and Tax Statement **2018**

Department of the Treasury—Internal Revenue Service

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

Rhonda is a 25% owner of Valley Florals and works full-time as a landscaper. As a greater-than-2% shareholder, she is ineligible to participate in the QSEHRA.

Valley Florals' QSEHRA plan sponsor files the following Form 720 on behalf of the two employees covered by the QSEHRA and pays the PCORTF fee via EFTPS.

Part II

IRS No.	**Patient-Centered Outcomes Research Fee** (see instructions)	(a) Avg. number of lives covered (see inst.)	(b) Rate for avg. covered life	(c) Fee (see instructions)	Tax	IRS No.
	Specified health insurance policies					
	(a) With a policy year ending before October 1, 2018		$2.39			
	(b) With a policy year ending on or after October 1, 2018, and before October 1, 2019		$2.45			
133	Applicable self-insured health plans				4.90	133
	(c) With a plan year ending before October 1, 2018		$2.39			
	(d) With a plan year ending on or after October 1, 2018, and before October 1, 2019	2	$2.45	4.90		

For Example 22

Form 720 (Rev. 4-2019) Page **3**

Part III

3	Total tax. Add Part I, line 1, and Part II, line 2 ▶		3	4 90
4	Claims (see instructions; complete Schedule C) ▶	4		
5	Deposits made for the quarter ▶ 5			
	☐ Check here if you used the safe harbor rule to make your deposits.			
6	Overpayment from previous quarters ▶ 6			
7	Enter the amount from Form 720X included on line 6, if any ▶ 7			
8	Add lines 5 and 6 ▶	8		
9	Add lines 4 and 8 ▶		9	
10	**Balance Due.** If line 3 is greater than line 9, enter the difference. Pay the full amount with the return (see instructions) ▶		10	4 90
11	**Overpayment.** If line 9 is greater than line 3, enter the difference. Check if you want the overpayment: ☐ **Applied to your next return, or** ☐ **Refunded to you.**		11	

Non-Calendar Plan Year[213]

A QSEHRA with a non-calendar plan year reports a prorated benefit for the calendar year on the Form W-2. The amount is prorated regardless of whether the employee receives payments or reimbursements from the QSEHRA.

Example 23. Minerva Mechanics provides Michael, its sole employee, with a QSEHRA that begins on April 1, 2017. From April 1, 2017, to March 31, 2018, the QSEHRA provides a permitted benefit of $4,000. From April 1, 2018, to March 31, 2019, the QSEHRA provides a permitted benefit of $6,000.

On the 2017 Form W-2, Minerva reports $3,000 ($4,000 × 9/12) in box 12, code FF for calendar year 2017. On the 2018 Form W-2, Minerva reports $5,500 (($4,000 × 3/12) + ($6,000 × 9/12)) in box 12, code FF for calendar year 2018.

213. IRS Notice 2017-67, 2017-47 IRB 517.