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Business Expenses

For use in preparing
1994 Returns

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Important Changes for 1994

The following list highlights some changes in the tax law for 1994.

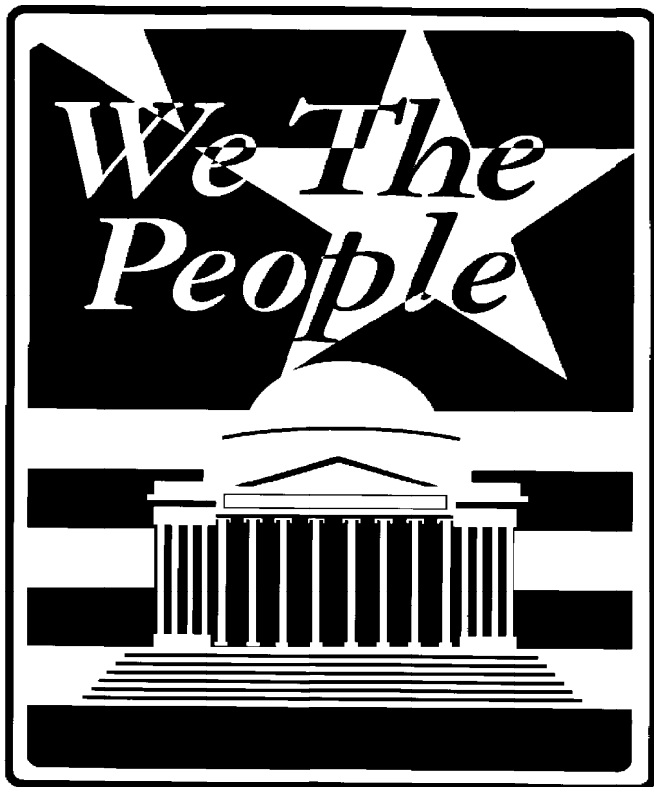
Educational assistance programs. The exclusion from employees' income for educational assistance programs expires after December 31, 1994. See Chapter 5.

Health insurance for self-employed persons. The 25% deduction for health insurance costs for self-employed persons expired for tax years beginning after December 31, 1993.

Caution. At the time this publication went to print, Congress was considering legislation to extend the 25% health insurance deduction for self-employed persons. See Publication 553, *Highlights of 1994 Tax Changes*, for more information.

Standard mileage rate. The standard mileage rate for 1994 is 29 cents a mile for all business miles put on a passenger automobile (including vans, pickups, or panel trucks). See Chapters 4 and 16.

Environmental clean up costs. Costs you incur to clean up land and to treat groundwater contaminated with hazardous waste resulting from your business operations may be deductible as a trade or business expense. See Chapter 16.



Meal and entertainment expenses. Beginning in 1994, you can deduct only 50% of the cost of your business meal and entertainment expenses. See Chapter 16.

Employer-reimbursed moving expenses. You can now exclude from your employees' gross income moving expense reimbursements you make for expenses paid or incurred by your employees after 1993. These amounts may be excludable as a fringe benefit if certain requirements are met. See Chapter 4.

Club membership dues. You are not allowed any deduction for dues paid or incurred after 1993 for membership in any club organized for business, pleasure, recreation, or other social purpose. See Chapter 16.

Lobbying expenses. Beginning in 1994, you cannot take a business expense deduction for certain lobbying and political expenses. See Chapter 16.

New compensation limit. Compensation of a participant that can be taken into account for computing contributions to a Keogh or SEP plan is generally limited to \$150,000 for plan years beginning on or after January 1, 1994. See *Deduction Limits* under *Keogh Plans* in Chapter 6 for more information.

Important Reminders

Amortization of goodwill and certain other intangibles. You may have to amortize goodwill and certain other intangible property over a period of 15 years. See Chapter 12.

This amortizable property is called section 197 property and if held for more than one year, may qualify for capital gain treatment on its sale or other disposition. See Publication 544, *Sales and Other Dispositions of Assets*.

Deductions for clean-fuel vehicles and certain refueling property. Deductions are allowed for clean-fuel vehicles and certain clean-fuel vehicle refueling property placed in service after June 30, 1993. For more information, see Chapter 15.

Credit for qualified electric vehicles. A tax credit is available for qualified electric vehicles placed in service after June 30, 1993. For more information, see Chapter 15.

Introduction

This publication discusses common business expenses and explains what is and is not deductible. The general rules for deducting business expenses are discussed in the opening chapter. The chapters that follow list other publications and forms you may need and examine particular kinds of business expenses.

Ordering publications and forms. To order free publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS

Forms Distribution Center nearest you. Check your annual income tax package for the address.

Telephone help. You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or you can call toll-free 1-800-829-1040.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call 1-800-829-4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

1. Deducting Business Expenses

Topics

This chapter discusses:

- What can be deducted
- How much can be deducted
- When to deduct
- Not-for-profit activities

Useful Items

You may want to see:

Publication

- 529** Miscellaneous Deductions
- 534** Depreciation
- 536** Net Operating Losses
- 538** Accounting Periods and Methods
- 547** Nonbusiness Disasters, Casualties, and Thefts
- 551** Basis of Assets
- 587** Business Use of Your Home
- 917** Business Use of a Car
- 925** Passive Activity and At-Risk Rules
- 936** Home Mortgage Interest Deduction

Form (and Instructions)

- Sch A** (Form 1040) Itemized Deductions
- 5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit

Business expenses are the costs of carrying on a trade, business, or profession. These expenses are usually deductible if the business is operated to make a profit.

The general rules for deducting business expenses are given in this chapter. These

rules apply to every type of business expense, both those discussed here and those discussed in other publications. They cover the kinds of expenses you can deduct, the year in which you can deduct them, and the limits on how much can be deducted.

What Can Be Deducted?

To be deductible, a business expense must be both ordinary and necessary. An **ordinary** expense is one that is common and accepted in your field of business, trade, or profession. A **necessary** expense is one that is helpful and appropriate for your trade, business, or profession. An expense does not have to be indispensable to be considered necessary.

It is important to separate business expenses from:

- 1) The expenses used to figure the cost of goods sold, and
- 2) Capital expenses.

In addition, keep business expenses separate from personal expenses. If you have an expense that is partly for business and partly personal, separate the personal part from the business part.

Cost of Goods Sold

If your business manufactures products or purchases them for resale, some of your expenses are for the products you sell. You use these expenses to figure the cost of the goods you sold during the year. Subtract cost of goods sold from the total amount your business takes in to figure its gross profit for the year. If you use an expense to figure cost of goods sold, you cannot deduct it again as a business expense.

Among the expenses that go into figuring cost of goods sold are the following:

The cost of products or raw materials in your inventory, including the cost of having them shipped to you,

The cost of storing the products you sell,

Direct labor costs (including contributions to pension or annuity plans) for workers who produce the products,

Depreciation on machinery used to produce the products, and

Factory overhead expenses.

You may have to include certain indirect costs of production and resale in your cost of goods sold. Indirect costs include rent, interest, taxes, storage, purchasing, processing, repackaging, handling, and administrative costs. This rule on indirect costs does not apply to personal property you acquire for resale if your average annual gross receipts for the preceding 3 tax years is not more than \$10 million.

For more information, see *Inventories* in Publication 538. See section 1.263A of the Income Tax Regulations for information on the uniform capitalization rules.

Capital Expenses

You must capitalize, rather than deduct, some costs. These costs are a part of your investment in your business and are called “capital expenses.” There are, in general, three types of costs you capitalize:

- 1) Going into business,
- 2) Business assets, and
- 3) Improvements.

Basis. When you make a capital expense, it becomes part of your “basis” in your business and its assets. Basis is a way of measuring your investment in an asset for tax purposes. Among other things, you use it to figure depreciation, casualty losses, and gain or loss on an eventual sale of the asset. See Publication 551 for information on how to figure basis.

Recovery. Although you generally cannot directly deduct a capital expense, you may be able to take deductions for the amount you spend through a method of depreciation, amortization, or depletion. These methods allow you to deduct part of basis each year over a number of years. In this way you are able to “recover” your capital expense. See *Amortization* (Chapter 12) and *Depletion* (Chapter 13) in this publication. For information on depreciation, see Publication 534.

Going Into Business

The costs of getting started in business, before you actually begin business operations, are capital expenses. This may include expenses for such things as advertising, travel, utilities, repairs, or employees' wages. These are often the same kinds of costs that can be deducted when you have them after you open for business.

If you go into business. When you go into business, treat all costs you had to get it started as capital expenses. They are part of your basis in the business. You generally recover costs for particular assets through depreciation deductions. You generally cannot recover other expenses until you sell or otherwise go out of business.

However, you can choose to amortize certain costs you have in setting up your business. See *Going Into Business* in Chapter 12 for more information on business start-up costs.

If you do not go into business. If your attempt to go into business is not successful, the expenses you had in trying to establish yourself in business fall into two categories.

- 1) The costs you had before making a decision to acquire or begin a specific business. These costs are personal and non-deductible. They include any costs incurred in the course of a general search

for, or preliminary investigation of, a business or investment possibility.

- 2) The costs you had in your attempt to acquire or begin a specific business. These costs are capital expenses and can be deducted as a capital loss.

The costs of any assets acquired during your unsuccessful attempt to go into business are a part of your basis in the assets. You cannot take a deduction for these costs. Your costs in these assets will be recovered when you dispose of them.

Business Assets

What you spend for any asset you will use in your business for more than one year is a capital expense. There are many different kinds of business assets, such as land, buildings, machinery, furniture, trucks, patents, and franchise rights. You must capitalize the full cost of the asset, including freight and installation charges.

If you produce certain property for use in your trade or business, capitalize the production costs. See section 1.263A of the Income Tax Regulations for information on the uniform capitalization rules.

Improvements

The cost of making improvements to a business asset are capital expenses, if the improvements add to the value of the asset, appreciably lengthen the time you can use it, or adapt it to a different use. Ordinarily, you add the cost of the improvement to the basis of the improved property.

Improvements **include** such items as new electric wiring, a new roof, a new floor, new plumbing, bricking up windows to strengthen a wall, and lighting improvements.

Restoration plan. Capitalize the cost of reconditioning, improving, or altering your property as part of a general restoration plan to make it suitable for your business. This applies even if some of the work would by itself be classified as repairs.

Replacements. Like the cost of improvements, you cannot deduct the cost of a replacement that stops deterioration and adds to the life of your property. Capitalize and depreciate it.

Treat amounts paid to replace parts of a machine that only keep it in a normal operating condition like repairs. Deduct them as business expenses. However, if your equipment has a major overhaul, capitalize and depreciate the expense.

Capital or Deductible Expenses

To help you distinguish between capital and deductible expenses, several different items are discussed below.

Business motor vehicles. You usually capitalize the cost of a motor vehicle you buy to use in your business. You can recover its cost through annual deductions for depreciation.

There are dollar limits on the depreciation you may claim each year on passenger automobiles used in your business. See Publication 917.

Repairs you make to your business vehicle are deductible expenses. However, amounts you pay to recondition and overhaul a business vehicle are capital expenses.

Roads and driveways. The cost of building a private road on your business property and the cost of replacing a gravel driveway with a concrete one are capital expenses you may be able to depreciate. The cost of maintaining a private road on your business property is a deductible expense.

Tools. Unless the uniform capitalization rules apply, amounts spent for tools used in your business are deductible expenses if the tools have a life expectancy of less than one year.

Machinery. Unless the uniform capitalization rules apply, the cost of replacing short-lived parts of a machine to keep it in good working condition and not to add to its life is a deductible expense. See section 1.263A of the Income Tax Regulations for information on the uniform capitalization rules.

Heating equipment. The cost of changing from one heating system to another is a capital expense and not a deductible expense.

Personal and Business Expenses

If you have an expense for something that is used partly for business and partly for personal purposes, divide the total cost between the business and personal parts. You can deduct as a business expense only the business part.

For example, if you borrow money and use 70% of it in your business and the other 30% for a family vacation, you generally can deduct as a business expense only 70% of the interest you pay on the loan. The remaining 30% is personal interest that is not deductible. See Chapter 8 for information on deducting interest and the allocation rules.

Business use of your home. If you use your home in your business, the rule for dividing expenses between the business and personal parts applies to the expenses of maintaining your home, for example, mortgage interest, insurance, utilities, and repairs.

However, the business use of your home must meet strict requirements before any of these expenses can be taken as business deductions. In general, you can deduct expenses only for the part of your home you use both **regularly** and **exclusively**:

- 1) As a place where you meet with customers or clients,
- 2) As the principal place where you carry on the business, or
- 3) In connection with your trade or business, if you are using a separate structure that is not attached to your house or residence.

If you use your home as a day-care center or to store the products you sell, an exception applies to the requirement that you must use a part of your home exclusively for business. For more information, see Publication 587.

Business use of your car. If you use your personal car in your business, determine how many miles you drove it for business out of the total mileage it was driven during the year. Only your expenses for the miles you drove it for business are deductible as business expenses. These expenses include depreciation on the car, gas and oil, tires, repairs, tune-ups, insurance, and registration fees. Instead of figuring the business part of these expenses, you may be able to use a standard mileage rate to figure your deduction. For 1994, the standard mileage rate is 29 cents a mile.

If you are self-employed, the business part of interest on your car loan, state and local personal property tax on the car, parking fees, and tolls can be deducted in addition to the standard mileage rate. The nonbusiness part of the personal property tax may be used in determining your deduction for taxes on Schedule A (Form 1040) if you itemize your deductions.

For more information on car expenses and the standard mileage rate, see Publication 917.

How Much Can Be Deducted?

You cannot deduct more for a business expense than the amount you actually spend. There is usually no other limit on how much you can deduct if the amount is reasonable. However, if your deductions are large enough to produce a net business loss for the year, the amount of tax loss may be limited.

Recovery of amount deducted. If you are a cash method taxpayer who pays an expense and then recovers part of the amount paid in the same tax year, reduce your expense deduction by the amount of the recovery. If you have a recovery in a later year, include the recovered amount in income. However, if part of the deduction for the expense did not reduce your tax, you do not have to include all of the recovery in income. Exclude an amount equal to the part that did not reduce your tax.

Limits on losses. If your deductions for an investment or business activity are more than the income it brings in, you have a net loss. There may be limits on how much, if any, of the loss you can use to offset income from other sources.

- 1) **Not-for-profit limits.** If you do not carry on your business activity with the intention of making a profit, you cannot use a loss from it to offset other income. The kinds of deductions you can take for a not-for-profit activity and the amounts you can deduct are limited so that a deductible loss will not result.

- 2) **At-risk limits.** In general, a deductible loss from a business or investment activity is limited to the investment you have “at risk” in the activity. You are “at risk” for any of your own money you invested. You are generally also “at risk” for amounts borrowed for use in the activity, if you are personally liable for repayment of the loan or the loan is secured by property you pledged that is not used in that activity.

- 3) **Passive activities.** Your deductions from passive activities can generally only be used to offset your income from passive activities. Any excess deductions may not be deducted against your other income. In addition, any allowable credits from passive activities can only be used to offset your tax liability allocable to your passive activities. However, any excess passive activity deductions or credits can be carried over to later years. In general, a passive activity is any activity that involves the conduct of any trade or business in which you do not materially participate. A rental activity is a passive activity even if you materially participate in the activity.

For more information on the at-risk rules and passive activities, see Publication 925. The not-for-profit rules are discussed later in this chapter.

If your deductions are more than your income for the year, you may have a “net operating loss.” A net operating loss can be used to lower your taxes in other years. See Publication 536 for more information.

Payments in kind. If you provide services to pay a business expense, the amount you can deduct is limited to the amount you must spend to provide the services. It is not what you would have paid in cash.

Similarly, if you pay a business expense in goods or other property, you can deduct only the amount the property costs you. If these costs are already figured into the cost of goods sold, you cannot also deduct them as a business expense.

When Can an Expense Be Deducted?

Under the cash method of accounting, you deduct business expenses in the tax year you actually paid them, even if you incur them in an earlier year. Under an accrual method of accounting, you deduct business expenses when you become liable for them, whether or not you pay them in the same year. All events that set the amount of the liability must have happened, and you must be able to figure the amount of the expense with reasonable accuracy.

Economic performance rule. Under an accrual method, you generally do not deduct business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property

by you, economic performance occurs as the property or services are provided, or as the property is used. If your expense is for property or services you provide to others, economic performance occurs as you provide the property or service.

Example. Your tax year is the calendar year. In December 1994, the Field Plumbing Company did some repair work at your place of business and sent you a bill for \$150. You paid it by check in January 1995. If you use an accrual method of accounting, deduct the \$150 on your tax return for 1994 because all events that set the amount of liability and economic performance occurred in that year. If you use the cash method of accounting, take the deduction on your 1995 return.

For more information on accounting methods, see Publication 538.

Prepayment. You cannot deduct expenses in advance, even if you pay them in advance.

Example. In 1994, you sign a 10-year lease and immediately pay your rent for the first three years. Even though you paid the rent for 1994, 1995, and 1996, you can deduct only the rent for 1994 on your current tax return. You can deduct on your 1995 and 1996 tax returns the rent for those years.

Application. This rule applies to both the cash and accrual methods. It applies to prepaid interest, prepaid insurance premiums, and any other expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

Contested liabilities. Under the cash method, you deduct a disputed expense just as you would any other expense, only in the year you pay it.

However, a special rule applies under an accrual method if you contest your liability for an expense. Do not deduct the expense in the year it is incurred. Rather, deduct it in the earlier of the following 2 years:

- 1) The year the dispute is settled and you are found to be liable, or
- 2) The year you pay the expense or transfer funds to pay it, for example, to an escrow account not under your control.

If later, after the dispute is settled, any of your payment is returned to you, report it as income. However, if any part of the deduction did not reduce your tax, you can subtract that amount from the returned payment before reporting it as income.

See *Contested Liabilities* in Publication 538 for more information.

Related parties. Under an accrual method of accounting, you generally deduct expenses when you incur them, even if you have not paid them. However, if you and the person you owe are “related parties” and the person you owe uses the cash method of accounting, you are allowed a deduction only when you pay the expense. Thus, the deduction by an accrual method payer is allowed no earlier than when

the corresponding amount is includible in income by the related cash method payee. See *Related taxpayers under Unpaid Salaries* in Chapter 2 of this publication.

Not-for-Profit Activities

If your business activity or the activity you invest in is not carried on to make a profit, the deductions you can take for it are limited and no loss is allowed to offset other income. Activities you do as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

In determining whether an activity is carried on for profit, all the facts in regard to the activity are taken into account. No one factor alone is decisive. Among the factors to be considered are:

- 1) Whether you carry on the activity in a businesslike manner.
- 2) Whether the time and effort you put into the activity indicate you intend to make it profitable.
- 3) Whether you are depending on income from the activity for your livelihood.
- 4) Whether your losses from the activity are due to circumstances beyond your control (or are normal in the start-up phase of your type of business).
- 5) Whether you change your methods of operation in an attempt to improve the profitability of the activity.
- 6) Whether you, or your advisors, have the knowledge needed to carry on the activity as a successful business.
- 7) Whether you were successful in making a profit in similar activities in the past.
- 8) Whether the activity makes a profit in some years, and how much profit it makes.
- 9) Whether you can expect to make a future profit from the appreciation of the assets used in the activity.

Limit on Deductions and Losses

If your activity is not carried on for profit, take deductions only in the following order, only to the extent stated in the three categories, and only if you itemize them on Schedule A (Form 1040).

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. All nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses belong in this category. Deduct them on the appropriate lines of Schedule A (Form 1040). Casualty losses are deductible as personal casualty losses to the

extent each loss exceeds \$100. Total personal casualty losses (over \$100 each) are deductible in full to the extent of personal casualty gains and any remaining loss is deductible to the extent it exceeds 10% of your adjusted gross income. See Publication 547.

For the limits that apply to mortgage interest, see Publication 936.

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) for it under the first category. Most business deductions, such as those for advertising, insurance premiums, interest, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) for it under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss not deductible in category (1) belong in this category. Where more than one asset is involved, divide depreciation and these other deductions proportionally among those assets.

Additional limit. Claim the amounts in categories (2) and (3) as miscellaneous deductions on Schedule A (Form 1040). They are subject to the 2% of adjusted gross income limit. See Publication 529 for information on this limit.

Example. You are engaged in a not-for-profit activity. The income and expenses of the activity are as follows:

Gross income		\$3,200
Less expenses:		
Real estate taxes	\$700	
Home mortgage interest	900	
Insurance	400	
Utilities	700	
Maintenance	200	
Depreciation on automobile	600	
Depreciation on a machine	200	
		3,700
Loss		\$ 500

The real estate taxes and home mortgage interest are deductible in full. Your deductions are limited to \$3,200, the gross income you earned from the activity. The limit is reached in category (3), as follows:

Limit on deduction		\$3,200
Category 1, Taxes and interest ...	\$1,600	
Category 2, Insurance, utilities, and maintenance	1,300	2,900
Available for Category 3		\$ 300

The \$300 for depreciation is divided between the automobile and machine, as follows:

$$\frac{\$600}{\$800} \times \$300 = \$225 \text{ depreciation for the automobile}$$

$$\frac{\$200}{\$800} \times \$300 = \$75 \text{ depreciation for the machine}$$

The basis of each asset is reduced accordingly.

The \$1,600 for category (1) is deductible in full on the appropriate lines for taxes and interest on Schedule A (Form 1040). The remaining \$1,600 (the total of categories (2) and (3)) is added to your other miscellaneous deductions on Schedule A (Form 1040) that are subject to the 2% of adjusted gross income limit.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual stockholder's or partner's distributive shares.

More than one activity. A single business or investment activity may consist of more than one undertaking, if the undertakings are similar or serve the same business purpose and are organizationally connected, or different undertakings may be considered different activities. If you are carrying on two or more different activities, keep the deductions and income from each one separate. Figure separately whether each is a not-for-profit activity. Then figure the limit on deductions and losses separately for each activity that is not-for-profit.

Presumption of Profit

An activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least 2 of the last 7 tax years including the current year. You have a profit when the gross income from an activity is more than the deductions for it.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the period ends on the date of the taxpayer's death.

If your business or investment activity passes this 3- (or 2-) years-of-profit test, presume it is carried on for profit. This means it will not come under these limits. You can take all your business deductions from the activity, even for the years that you have a loss. You can rely on this presumption in every case, unless the IRS shows it is not valid.

Using the presumption later. If you are starting an activity and do not have 3 years (or 2 years) showing a profit, you may want to take advantage of this presumption at a later time, after you have the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing Form 5213. Filing this form postpones any determination your activity is not carried on for profit until 5 (or 7) years have passed since you started the activity. Form 5213 must generally be filed within 3 years of the due date of your return for the year in which you first carried on the activity.

The benefit gained by making this choice is that the IRS will not immediately question whether your activity is engaged in for profit. Accordingly, it will not restrict your deductions. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the activity. If you show 3 (or 2) years of profit at the end of this period, your deductions are not limited under these rules. If you do not have 3 years (or 2 years) of profit, the limit can be applied retroactively to any year in the 5-year (or 7-year) period with a loss.

Filing Form 5213 automatically extends the statute of limitations on any year in the 5-year (or 7-year) period to 2 years after the due date of the return for the last year of the period. The statute is extended only for deductions of the activity and any related deductions that might be affected.

2. Employees' Pay

Topics

This chapter discusses:

- Deductibility of pay
- Cash payments
- Noncash payments

Useful Items

You may want to see:

Publication

- 15** (Circular E) Employer's Tax Guide
- 521** Moving Expenses
- 534** Depreciation
- 551** Basis of Assets

Form (and Instructions)

- W-2** Wage and Tax Statement
- 3800** General Business Credit
- 4782** Employee Moving Expense Information

This chapter explains the deductibility of salaries, wages, and other forms of pay you make to your employees. It discusses common cash and noncash payments. For each type of payment, it discusses what you can deduct and how to claim it on your tax return. It also discusses whether the payment is included in your employees' income as wages and if it is subject to employment and income tax withholding.

You may also pay your employees indirectly through employee benefit programs. For example, you can deduct group term life insurance premiums you pay or incur on a policy covering an employee if you are not the direct or indirect beneficiary of the policy. You can

deduct the cost of providing \$50,000 coverage for an employee as an employee benefit. You must include the cost of providing coverage over \$50,000 in the employee's income and you can deduct it as wages. For more information on employee benefit programs, see Chapter 5.

Deductibility of Pay

You can generally deduct salaries, wages, and other forms of pay you make to employees for personal services as a business expense. However, you must reduce the deduction by any current tax year employment credits. For more information on these credits, see Form 3800 and the related employment credit forms.

Commissions. Generally, you can deduct a commission you pay to a salesperson or another person if, before the service is performed, you and that person agree on the service to be performed and the amount to be paid.

Employee-stockholder. A salary to an employee who is also a stockholder must meet the same tests for deductibility as the salary of any other executive or employee. See *Tests for Deductibility*, discussed later.

You cannot deduct a payment to an employee-stockholder that is not for services performed. The payment may be a distribution of dividends on stock. This is most likely to occur in a corporation with few shareholders, practically all of whom draw salaries. A salary paid to an employee-stockholder that is more than the salary ordinarily paid for similar services and that bears a close relationship to the stock holdings of the employee is probably not paid wholly for services performed. This salary may include a distribution of earnings on the stock.

However, if the payment to an employee-stockholder of a **closely held corporation** is reasonable and for services performed, the payment will not be denied as a deduction merely because the corporation has a poor history of paying dividends on its outstanding stock.

If your corporation uses an accrual method of accounting and the salary is unpaid at the end of the tax year, see *Unpaid Salaries*, later, for special rules.

Relatives. You can deduct the salary or wage paid to a relative who is an employee, including your minor child, if the four tests for deductibility, discussed later, are met. However, also see *Unpaid Salaries*, discussed later.

Payment to beneficiary of deceased employee. You can deduct a payment you make to an employee's beneficiary because of the employee's death if the payment is reasonable in relation to past services performed by the employee. The payment must also meet the tests for deductibility, discussed later.

Cost of goods sold. Generally, you must capitalize or include in inventory the wages

and salaries you pay employees to produce real or tangible personal property or to acquire property for resale. If the property is inventory, add the wages to inventory. Capitalize the costs for any other property. Personal property acquired for resale is not subject to this rule if your average annual gross receipts for the 3 preceding tax years are \$10,000,000 or less. You can deduct these wages as a current business expense. For more information, see Publication 551.

You cannot deduct salaries and other wages incurred for constructing capital assets. You must include them in the basis of the asset constructed and recover your cost through depreciation deductions. See Publication 534 for information on depreciation.

Tests for Deductibility

To be deductible, salaries or wages you pay your employees must meet all of the following tests.

- **Ordinary and necessary**
- **Reasonable**
- **For services performed**
- **Paid or incurred**

Test 1 — Ordinary and necessary. You must be able to show that the salary, wage, or other payment for services an employee renders is an ordinary and necessary expense and directly connected with your trade or business. See *What Can Be Deducted?* in Chapter 1.

The fact that you pay your employee for a legitimate business purpose is not sufficient, by itself, for you to deduct the amount as a business expense. You can deduct a payment for the services of your employee only if the payment is ordinary and necessary to carry on your trade or business.

Expenses (including salaries and other payments for services) incurred to complete a merger, recapitalization, consolidation, or other reorganization are not expenses of carrying on a business; they are capital expenditures. You cannot deduct them as ordinary and necessary business expenses. However, if you later abandon your plan to reorganize, etc., you can deduct the expenses for the plan in the tax year you abandon it.

Test 2 — Reasonable. The reasonableness of pay is determined by the facts. Generally, reasonable pay is the amount that would ordinarily be paid for the services by like enterprises under similar circumstances.

You must be able to prove the pay is reasonable. This test is based on the circumstances that exist at the time you contract for the services, not those existing when the reasonableness is questioned. If the pay is excessive, you can deduct only the part that is reasonable.

Factors to be considered. To determine if pay is reasonable, consider the following items and any other pertinent data.

- 1) The duties performed by the employee.
- 2) The volume of business handled.

- 3) The character and amount of responsibility.
- 4) The complexities of your business.
- 5) The amount of time required.
- 6) The general cost of living in the locality.
- 7) The ability and achievements of the individual employee performing the service.
- 8) The pay compared with the amount of gross and net income of the business, as well as with distributions to shareholders, if the business is a corporation.
- 9) Your policy regarding pay for all of your employees.
- 10) The history of pay for each employee.

Individual salaries. You must base the test of whether or not a salary is reasonable on each individual's salary and the service performed, not on the total salaries paid to all officers or all employees. For example, even if the total amount of salaries you pay to your officers is reasonable, you still cannot deduct an individual officer's salary if it is not reasonable based on the items listed above.

Test 3 — For services performed. You must be able to prove the payment was made for services actually performed.

Test 4 — Paid or incurred. You must have actually made the payment or incurred the expense during the tax year.

If you use the cash method of accounting, deduct your expense for the salary or wage paid to an employee in the year it is paid to the employee.

If you use an accrual method of accounting, deduct your expense for the salary or wage when you establish your obligation to make the payment and when economic performance occurs. Economic performance generally occurs as an employee performs the services for you. The economic performance rule is discussed in *When Can an Expense Be Deducted?* in Chapter 1. Your payment need not be made in the year the obligation exists. It can be deferred to a later date, but special rules apply. See *Unpaid Salaries*, later.

Cash Payments

Some of the ways you may provide compensation that involves cash to your employees are discussed next.

Bonuses and Awards

You can deduct bonuses and awards to your employees if they meet certain conditions.

Bonuses. You can deduct a bonus paid to an employee if you intended the bonus as additional pay for services, not as a gift, and you paid the bonus for services actually performed. However, to deduct the amount as wages the total bonuses, salaries, and other

pay must be reasonable for the services performed. The bonus is included in an employee's income. You can pay a bonus in cash, property, or a combination of both.

Gifts of nominal value. If, in order to promote employee goodwill, you distribute turkeys, hams, or other merchandise of nominal value to your employees at holidays, the value of these items is not salary or wages. You can deduct the cost of these items as a business expense.

If you distribute cash, gift certificates, or similar items readily convertible to cash, the value of these items is considered additional wages or salaries, regardless of the amount or value.

Employee achievement awards. You can deduct the cost of an employee achievement award, subject to certain limits. An employee achievement award is **tangible personal property** that is:

- 1) Given for length of service or safety achievement,
- 2) Awarded as part of a meaningful presentation, and
- 3) Awarded under conditions and circumstances that do not create a significant likelihood of disguised compensation.

Length-of-service award. An award will not qualify as a length-of-service award if:

- 1) The employee receives the award during his or her first 5 years of employment, or
- 2) The employee received a length-of-service award (other than one of very small value) during that year or in any of the prior 4 years.

Safety achievement award. An award will not qualify as a safety achievement award if it is:

- 1) Awarded to a manager, administrator, clerical employee, or other professional employee, or
- 2) Given to more than 10% of your employees during the year, excluding those listed in (1).

Qualified or nonqualified plan awards. A qualified plan award must be given as part of an established written plan that does not discriminate in favor of highly compensated employees as to eligibility or benefits. See *Exclusion of Fringe Benefits* in Chapter 4 for the definition of a highly compensated employee.

An award will not be considered a qualified plan award if the average cost of all the employee achievement awards given during the tax year (that would be qualified plan awards except for this limitation) exceeds \$400. To determine this average cost, do not take into account awards of very small value.

Limits on deductible awards. Deductible nonqualified plan awards made to any employee cannot be more than \$400 during the tax year. The total deductible awards, including both qualified and nonqualified plan

awards, made to any one employee cannot be more than \$1,600 during the tax year.

If the employee achievement awards do not exceed the deductible limits, they can be excluded from the employee's income and you can deduct them on the "Other deductions" line of your tax return or business schedule.

If the award costs more than the amount you can deduct, include in the employee's income the **larger** of:

- 1) The part of the cost of the award you cannot deduct (up to the award's fair market value), or
- 2) The amount by which the fair market value of the award is more than the amount you are allowed to deduct.

Do not include the remaining value of the award in the employee's income.

Loans or Advances

You can generally deduct as wages a loan or advance you make to an employee that you do not expect the employee to repay if it is for personal services actually performed. The total must be reasonable when the loan or advance is added to the employee's other compensation, and it must meet the tests for deductibility, discussed earlier. However, if services are not performed, the amount you advanced to the employee is treated as a loan and it cannot be deducted as compensation.

Below-market interest rate loans. On certain loans you make to an employee or stockholder, you may be considered to have received interest income and to have paid compensation or dividends equal to that interest. See *Below-Market Interest Rate Loans* in Chapter 8 for more information.

Vacation Pay

Vacation pay is an amount you pay or will pay to an employee while the employee is on vacation. It includes an amount you pay an employee even if the employee chooses not to take a vacation. Vacation pay does not include any amount for sick pay or holiday pay.

Cash basis taxpayer. If you are a cash basis taxpayer, you can deduct vacation pay as wages when you pay an employee.

Accrual basis taxpayer. If you are an accrual basis taxpayer, you can deduct vacation pay earned by an employee as wages in the year earned only if you pay it:

- 1) By the close of your tax year, or
- 2) If the amount is vested, within 2½ months after the close of the tax year.

You deduct the vacation pay in the year actually paid if you pay it later than this.

Unpaid Salaries

If you have a definite, fixed, and unconditional agreement to pay an employee a certain salary for the year, but you defer paying part of it

until the next tax year, your deduction for the salary is based on the following factors.

- 1) If you use an accrual method of accounting, you can deduct the entire salary in the first year if economic performance has occurred (the employee performed the services in that year).
- 2) If you use the cash method of accounting, only the amount actually paid each year can be deducted that year.

If no definite prior arrangement was made, only the amount paid in the first year can be deducted that year because no fixed obligation exists to make the later payments. This is the same for the cash method and an accrual method of accounting.

Special rule for accrual method payer. If you use an accrual method of accounting, you cannot deduct salaries, wages, and other expenses owed to a related person (defined next) until:

- 1) The tax year you make the payment, and
- 2) The amount is includible in the gross income of the person paid.

This rule applies even if you and that person cease to be related taxpayers prior to the time the amount is includible in the that person's gross income.

Related taxpayers. For purposes of this special rule, related taxpayers include:

- 1) Members of a family, but only:
 - a) Brothers and sisters (either whole- or half-blood).
 - b) Spouses.
 - c) Ancestors (parents, grandparents, etc.).
 - d) Lineal descendants (children, grandchildren, etc.).
- 2) An individual and a corporation in which more than 50% of the value of the outstanding stock is owned directly or indirectly by or for that individual.

Indirect ownership of stock. To determine if a person indirectly owns any of the outstanding stock of a corporation, the following rules apply.

- 1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.
- 2) Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. See *Related taxpayers*, earlier, for persons considered members of a family.
- 3) Stock in a corporation owned by an individual (other than because of rule (2) above) is considered owned by or for the individual's partner.
- 4) Stock considered owned by a person because of rule (1) is treated, for applying rules (1), (2), or (3), as actually owned by

that person. But stock considered owned by an individual because of rules (2) or (3) is not treated as owned by that individual for applying either rule (2) or (3) again to consider another the owner of that stock.

Example 1. Tom Green runs a retail store as a sole proprietor. He uses the calendar year and an accrual method of accounting. Tom's brother Bob works for him and he pays Bob \$1,000 a month. Bob uses the calendar year and the cash method of accounting. At the end of December 1994, Tom accrues Bob's December salary of \$1,000.

Because of a temporary cash shortage, Tom pays Bob \$600 on January 13, 1995, and the \$400 balance on April 1, 1995. Tom cannot deduct the \$1,000 until 1995, the year Bob must include the amount in his income.

Example 2. The Lomar Corporation uses the calendar year and an accrual method of accounting. Frank Wilson, an officer in the corporation, uses the calendar year and the cash method of accounting. At the close of calendar year 1994, Frank owns 50% of the outstanding stock of the corporation. On March 3, 1995, he acquires additional shares that bring his holdings to 51%. The corporation accrues salary of \$1,000 payable to Frank at the end of December 1994.

The Lomar Corporation pays Frank \$600 on January 30, 1995, and the balance by March 14, 1995. The corporation can deduct the salary of \$1,000 in 1994. Frank and the Lomar Corporation are not related taxpayers at the close of Lomar's 1994 tax year.

Guaranteed Annual Wage

If you guarantee to pay certain employees full pay during the year (determined by the number of hours in the normal work year) under terms of a collective bargaining agreement, you can deduct the pay as wages. You must include the payments in the employees' income and they are subject to FICA and FUTA taxes and income tax withholding.

Compensation for Sickness and Injury

You can deduct amounts you pay to your employees for sickness and injury, including lump-sum amounts, as compensation. However, your deduction is limited to amounts not compensated by insurance or other means.

Meals and Lodging

You can usually deduct the cost of furnishing meals and lodging to your employees if the expense is an ordinary and necessary business expense. The cost is not deducted as employees' pay, but as an expense of operating your business. For example, if you own a restaurant or operate a cafeteria for your employees, include the cost of food your employees eat in the cost of goods sold. Similarly, if you rent or purchase a house for an employee, you deduct the cost of insurance, utilities, rent, and/or depreciation in each of those categories on your return.

Whether you must include the value of meals or lodging in an employee's income depends on whether you furnished them on your premises for your convenience, or, in the case of lodging, whether you required it as a condition of employment. See Chapter 3 for more information.

Reimbursement of Employee Expenses

There are generally two different ways you can deduct the amount you reimburse employees for business expenses they incur on your behalf for items such as travel and entertainment.

- 1) You deduct the reimbursement of expenses under an accountable plan in the category of the expense reimbursed. For example, if you reimburse an employee under an accountable plan for travel expenses incurred on your behalf, deduct this reimbursement as a travel expense on your return. See the instructions for the form you file for information on which lines to use.
- 2) Include the reimbursement of expenses under a nonaccountable plan in the compensation you pay your employees and deduct it as wages on your return.

See *Travel, Meals, and Entertainment* in Chapter 16 for more information on reimbursing employees and an explanation of accountable and nonaccountable plans.

Noncash Payments

You may pay your employees in property other than cash, such as property used in your business or shares of your company stock. You may also pay expenses for your employees, such as tuition for non-job-related courses or the cost of moving to another location. These items are discussed next.

Other benefits you provide for your employees are also a form of pay. These include life and medical insurance, dependent care assistance, and educational assistance. You generally deduct them as an employee benefit and they are discussed in Chapter 5.

Education Expenses

If you pay or reimburse education expenses for an employee enrolled in a course not required for the job or not otherwise job-related, deduct the payment as wages. You must include the payment in the employee's income and it is subject to FICA and FUTA taxes and income tax withholding. However, if the payment is part of a qualified educational assistance program, these rules may not apply. See Chapter 5.

If you pay or reimburse education expenses for an employee enrolled in a job-related course, you can deduct the payment as a noncompensatory business expense. Since this expense would be deductible if paid by the employee, it is called a working condition

fringe benefit. Do not include a working condition fringe benefit in an employee's income. Working condition fringe benefits are discussed in more detail in Chapter 4.

Moving Expenses

Deduct as a qualified fringe benefit amounts you reimburse employees or pay on their behalf for qualified moving expenses incurred after 1993. Qualified moving expenses are those the employee could deduct if he or she paid or incurred them directly. They include only the reasonable expenses of:

- 1) Moving household goods and personal effects from the former home to the new home, and
- 2) Travel (including lodging) from the former home to the new home.

Qualified moving expenses do not include any expenses for meals.

Deduct as wages any payment you make as an allowance or reimbursement for a non-qualified moving expense (i.e., an expense the employee cannot deduct). You must include the payment in the employee's income. The payment is wages for income tax withholding and FICA and FUTA taxes. For example, if you reimburse an employee for a loss on the sale of a home, you must treat the amount as wages and subject it to income tax withholding and FICA and FUTA taxes. You treat the reimbursement to the employee as payment for services. You can deduct the amount if it meets the deductibility tests discussed earlier.

Statement to employee. You must give the employee a statement describing the payments made to the employee, or on his or her behalf, for moving expenses. The statement must contain sufficient information so the employee can properly figure the allowable moving expense deduction.

You may use Form 4782 for this purpose. You must give this information to your employee by January 31 of the year following the year in which you make the payments.

Form W-2. You must also show any reimbursement for moving expenses on the employee's Form W-2. However, any amount considered a qualified fringe benefit is reported in box 13, not box 1, *Wages, tips, other compensation*.

More information. For more information on moving expenses, see Publication 521.

Capital Assets

If you transfer a capital asset or an asset used in your business to one of your employees as payment for services, you can deduct as wages its fair market value on the date of the transfer. You treat the deductible amount as received in exchange for the asset, and you must recognize any gain or loss realized on the transfer. You figure gain or loss on the difference between the fair market value of the

asset and its adjusted basis on the date of transfer.

Payment in Restricted Property

In general, restricted property is property subject to a condition that significantly affects its value.

If you transfer property, including stock in your company, as payment for services and the property is considered substantially vested in the recipient, you generally have a deductible ordinary and necessary business expense.

"Substantially vested" means the recipient can transfer the property and is not subject to risk of forfeiture; that is, the recipient is not likely to have to give up his or her rights in the property in the future.

The amount and the year in which you can deduct the payment will vary, depending in part on the kind of property interest you transfer. The amount you can deduct depends on the amount includible in the recipient's income. However, if the recipient is an employee, you must withhold federal income tax in order to take the deduction.

3.

Meals and Lodging for Employer Convenience

Topics

This chapter discusses:

- Deductibility of meals and lodging
- Exclusion from employees' income

Useful Items

You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 525** Taxable and Nontaxable Income

This chapter discusses the deductibility of meals and lodging you furnish to your employees and how to claim the deduction on your business tax return. The chapter also describes special rules that must be met to exclude the value of meals and lodging from your employees' income and provides examples for applying those rules.

Deductibility of Meals and Lodging

You can usually deduct the cost of furnishing meals and lodging to your employees if the expense is an ordinary and necessary expense to your business. For information on the requirements that all business expenses must meet, see Chapter 1. If the value of the meals and lodging is included in an employee's income, that value when added to all other compensation paid to that employee must meet all of the tests described under *Tests for Deductibility* in Chapter 2.

50% limit on meals. Your allowable deduction for the expense of providing meals to your employees is limited to 50% of the costs unless one of the following exceptions applies to you.

- 1) The value of the meals is includible in your employees' income. The value of the meals is generally includible in your employees' income unless:
 - a) The meals are furnished to your employees on your premises and for your convenience as discussed later under *Exclusion From Employees' Income*, or
 - b) The meals qualify as a de minimis fringe benefit discussed later in Chapter 4.
- 2) You operate a restaurant or catering service and you furnish the meals to your employees at the work site.
- 3) You furnish the meals to your employees as part of the expense of providing recreational or social activities, such as a company picnic.
- 4) You are required to furnish meals to crew members of a commercial vessel under a federal law. This includes crew members of commercial vessels operating on any U.S. inland waterway if meals would be required under federal law had the vessel been operated at sea. This does not include meals furnished on vessels primarily providing luxury water transportation.
- 5) You provide the meals on an oil or gas platform or drilling rig located offshore or in Alaska. This exception also applies to meals provided at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

How To Claim the Deduction

The deductible costs of providing meals and lodging to your employees are shown on your return in whatever category the expense falls. For example, if you operate a restaurant, the cost of the meals provided to your employees would be deducted as part of the cost of goods sold. If you operate a nursing home, motel, or rental property and require a manager or director to live on the premises, the costs of providing lodging to that person would be deducted as expenses for utilities, linen service, salaries, depreciation, etc.

If the value of the meals and lodging must be included in your employees' income, do not again deduct that value as wages.

Exclusion From Employees' Income

The value of meals and lodging furnished to your employees is not included in their income if the meals and lodging meet certain requirements. These requirements are discussed next under *Rules for Exclusion*. In addition, there are examples at the end of the discussion to help clarify the requirements.

If the value of the meals and lodging is not included in income, it is not subject to social security, Medicare, FUTA, or income tax withholding.

Rules for Exclusion

Meals and lodging you furnish to your employees must meet the following rules before you can exclude their value from the employees' income.

Rule 1. The meals or lodging must be furnished on **your business premises**.

Rule 2. The meals or lodging must be furnished for **your convenience**.

Rule 3. In the case of lodging (but not meals), the employees must be required to accept the lodging as a **condition of their employment**. This means they must accept the lodging to allow them to properly perform their duties.

If the employees have a choice of either receiving additional pay or meals or lodging, treat the value of the meals or lodging as income to your employees.

Business Premises of Employer

This generally means the place of employment. For example, meals and lodging furnished to a domestic worker in an employer's private home are furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding cattle on land leased or owned by an employer are furnished on the employer's business premises.

Convenience of Employer

Whether or not meals or lodging are furnished for your convenience as an employer must be determined from all the facts and circumstances. Treat meals or lodging as furnished for your convenience, if you, as an employer, have a substantial business reason other than providing the employee additional pay. A statement that you did not intend the meals or lodging as pay is not sufficient to prove either item is furnished for your convenience. See *Substantial nonpay reasons* next for situations that are considered substantial nonpay business reasons.

If you have a substantial nonpay business reason for furnishing meals or lodging, and

you furnish these items on your business premises (and, in the case of lodging, *Rule 3* is also met), you do not include the value in your employees' income. This is true even though you may also intend the meals and lodging to be pay. Thus, you exclude the value of meals or lodging from your employees' income even if a law or an employment contract provides that they are furnished as pay.

However, if you furnish meals or lodging to provide additional pay, and do not have a substantial nonpay business reason for furnishing them, you must include the value as additional income to the employee. For example, meals furnished to employees to promote goodwill, to boost morale, or to attract prospective employees are considered additional pay and must be included as income to your employees.

Substantial nonpay reasons. In the following situations, meals furnished without charge are regarded as furnished for a substantial nonpay business reason:

- 1) Meals you furnish during working hours so your employee will be available for emergency calls during the meal period. However, you must be able to show that emergencies have occurred or can reasonably be expected to occur.
- 2) Meals you furnish during working hours because the nature of your business restricts your employee to a short meal period (such as 30 or 45 minutes), and the employee cannot be expected to eat elsewhere in such a short time. For example, meals can qualify if there are insufficient eating facilities near the place of employment, or if the peak workload occurs during the normal lunch hour. But if the reason for the short meal period is to allow the employee to leave earlier in the day, the meal will not qualify.
- 3) Meals you furnish to restaurant or other food service employees, for each meal period in which they work, if you furnish the meals during, immediately before, or immediately after work hours. For example, if a waitress works through the breakfast and lunch periods, you can exclude from her income the value of the breakfast and lunch you furnish in your restaurant for each day she works.
- 4) Meals you furnish immediately after working hours that you would have furnished during working hours for a substantial nonpay business reason, but because of the work duties were not eaten during working hours.
- 5) Meals you furnish to all employees at your place of business if substantially all of your employees are furnished meals for a substantial nonpay business reason.

Meals furnished on nonworkdays or with lodging. The value of meals you furnish on any nonworkday is normally income to your employees. But, if your employees must occupy living quarters on your business premises as a condition of employment, as defined

in *Rule 3*, do not treat the **value of any** meal you furnish without charge on the business premises as income.

Meals with a charge. Meals furnished with a charge must meet Rules 1 and 2 discussed earlier. The fact that a charge is made for the meals and the fact that the employee may accept or decline the meals, shall not be taken into account in determining whether meals are furnished for the convenience of the employer.

If you furnish meals for which the employees are charged a flat amount, do not include the flat amount charged in your employees' income. This does not depend on the employees' acceptance of the meals. You may have to include the **actual value of the meals** in your employees' income if Rule 1 and Rule 2 are not met.

If there is a flat charge for meals and you have to include the value in your employees' gross income, include the value whether it is more or less than the amount charged. If there is no evidence to indicate otherwise, the value of the meals is the amount charged for them.

Lodging Required by Employer

In addition to meeting the business premises and convenience of employer rules, in order for the value of lodging to be excluded from your employees' income, you must require your employees to accept the lodging as a condition of their employment. This means that your employees need to live on your business premises to be able to properly perform their duties. Examples include employees who must be available at all times and employees who could not perform their required duties without being furnished the lodging.

Thus, if the lodging is furnished as a condition of employment, the value is excluded from your employees' pay even if you are required to provide the lodging as pay under the terms of an employment contract, or a law fixing the terms of employment.

The lodging may be furnished to the employees with or without a charge. If you charge a flat amount for lodging whether or not the employee accepts it, the flat charge is not includible in the employee's gross income. Whether the value of such lodging is income depends on whether Rules 1, 2, and 3 are all met. If any one of these rules is not met, you must include the value of the lodging in your employees' income whether it is more or less than the amount charged. If no evidence indicates otherwise, treat the value of the lodging as the amount charged for it.

Examples

These examples will help you determine whether to include the value of meals or lodging you furnish to your employees in their income.

Example 1 (Meals). You operate a restaurant business and furnish your employee, Carol, who is a waitress, two meals per workday without charge during her 7 a.m. to 4 p.m. workday. You encourage but do not require Carol to have her breakfast on the business

premises before starting work. She must have her lunch on the premises. Since Carol is a food service employee and works during the normal breakfast and lunch periods, you do not treat the value of her breakfast and lunch **as income** to her.

Example 2 (Meals on nonworkdays). You also allow Carol to have meals on your business premises without charge on her days off. You must include the value of these meals **as income** to Carol.

Example 3 (Meals). A bank furnishes Frank, a bank teller who works from 9 a.m. to 5 p.m., his lunch without charge in a cafeteria the bank maintains on its premises. The bank furnishes these meals to Frank to limit his lunch period to 30 minutes, since the bank's peak workload occurs during the normal lunch period. If Frank got his lunch elsewhere, it would take him much longer than 30 minutes, and the bank strictly enforces the time limit. The value of these meals **is not income**.

Example 4 (Meals). A hospital maintains a cafeteria on its premises where all of its 230 employees may get meals at no charge during their working hours. The hospital furnishes meals to have 210 employees available for emergencies, and it is shown that each of these employees is at times called upon to perform services during the meal period. Although the hospital does not require these employees to remain on the premises, they rarely leave the hospital during their meal period. Since the hospital furnishes meals to most of its employees to have each of them available for emergency call during their meal periods, the value of the meals **is not income** to any of the employees who eat in the hospital cafeteria.

Example 5 (Lodging). A hospital gives Joan, an employee of the hospital, the choice of living at the hospital free of charge or living elsewhere and receiving a cash allowance in addition to her regular salary. If Joan chooses to live at the hospital, her employer must include the value of the lodging **in income** to her because her residence at the hospital is not required to properly perform the duties of her employment.

4.

Fringe Benefits

Topics

This chapter discusses:

- The definition of fringe benefits
- The general valuation rule
- Special valuation rules
- Exclusion of fringe benefits from employee income

Useful Items

You may want to see:

Publication

- **521** Moving Expenses
- **534** Depreciation
- **937** Employment Taxes

This chapter gives general information on fringe benefits and fringe benefit valuation rules. However, it does not cover all the exceptions to these rules, or the rules that apply to the use of an aircraft. See section 1.61-21 of the Income Tax Regulations.

Definition

A fringe benefit is a form of compensation provided to any person for the performance of services by that person. For these rules, treat a person who agrees not to perform services (such as under a covenant not to compete) as performing services.

The compensation may include any property or services provided by the employer, such as:

- 1) An automobile,
- 2) A flight on an employer-provided aircraft,
- 3) A free or discounted commercial airline flight,
- 4) A vacation,
- 5) A discount on property or services,
- 6) A membership in a country club or other social club, and
- 7) A ticket to an entertainment or sporting event.

Provider. You are the provider of a fringe benefit if you are the person for whom the services are performed, even if you do not actually provide the benefit. You do not have to be the recipient's employer. You may be, for example, a client or customer of an independent contractor.

Recipient. The recipient of a fringe benefit is the person performing the services for which the fringe benefit is provided. It is not necessary for that person to actually receive the benefit.

The recipient does not have to be your employee. For example, the recipient may be a partner, director, or independent contractor. In this chapter, "employee" includes any recipient of a fringe benefit unless otherwise specified.

Including benefits in pay. You must include in your employees' pay the value of fringe benefits you provide for their performing services for you unless the benefits are specifically excluded from income by law or the employee pays for them. The value of includible fringe benefits you provide is generally subject to social security and Medicare tax (FICA), federal

unemployment tax (FUTA), and federal income tax withholding.

If you include the value of a **noncash fringe benefit** in an employee's gross income, you cannot deduct the value as compensation. But you can deduct the costs you incurred to provide the benefit. You may be able to take a depreciation deduction. Publication 534 has more information on depreciation. If the noncash fringe benefit is property leased by you, you may be able to deduct the rent as an ordinary and necessary business expense.

Withholding periods. You can elect, for employment tax and withholding purposes, to treat taxable noncash fringe benefits you provide to your employees as if they were paid on a pay period, quarterly, semi-annually, annually, or any other time period you choose. However, you must treat them as paid no less than once a year. You do not have to use the same time period for all employees.

You can change your election as often as you want as long as you treat all benefits provided in a calendar year as paid no later than December 31 of that year. However, see *Special accounting period rule* under *Special Valuation Rules*, later. This election does not apply to a fringe benefit involving the transfer of property normally held for investment.

You can treat the value of a single noncash fringe benefit as if it were paid on one or more dates in the same calendar year, even if the employee receives the entire benefit at one time. For example, if you provide your employee with a fringe benefit on March 31 that is valued at \$1,000, you can treat the \$1,000 as though it had been provided equally over 4 quarters and paid on March 31, June 30, September 30, and December 31.

Accounting period. You must determine the value of the noncash fringe benefit you provided to your employees in a calendar year by January 31 of the following year. This is called the **general income tax and reporting rule**. However, you can use the **special accounting period rule**, under *Special Valuation Rules*, later, to determine the value of fringe benefits, rather than using the general income tax and reporting rule.

More information. For more information on withholding from and reporting of taxable noncash fringe benefits, see *Withholding and Reporting Taxable Noncash Fringe Benefits* in Publication 937.

General Valuation Rule

Include in an employee's gross income the amount by which the **fair market value (FMV)** of the fringe benefit is more than the sum of:

- 1) The amount the employee paid for the benefit, plus
- 2) The amount specifically excluded by law from gross income.

Therefore, no amount is included in an employee's gross income if he or she pays FMV for the fringe benefit.

Fair market value (FMV). You determine FMV based on all the facts and circumstances. Specifically, the FMV of a fringe benefit is the amount a person would pay a third party to purchase or lease the fringe benefit. Disregard any special relationship between you and the employee.

Neither the amount the employee considers to be the value of the fringe benefit nor the cost you incur to provide the benefit determines its FMV. Special rules used to value certain fringe benefits are discussed later.

If the law excludes a **fringe benefit cost** from income, the recipient does not include in gross income the difference between the FMV and the excludable cost of that fringe benefit. If the law excludes a limited amount of the cost, however, the FMV of the fringe benefit due to any excess cost may be includible.

Employer-provided vehicle. If you do not use the special valuation rules for a vehicle, discussed next, determine the FMV of the availability of an employer-provided vehicle under the general valuation rule. The value is generally what the cost would be to a person leasing from a third party the same or comparable vehicle on the same or comparable terms in the same geographic area.

Also, unless the employee can prove that the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability of the vehicle cannot be determined using a cents-per-mile rate.

Special Valuation Rules

You can use special valuation rules to value certain fringe benefits. These special valuation rules are the:

- 1) Automobile lease valuation rule,
- 2) Vehicle cents-per-mile valuation rule,
- 3) Commuting valuation rule, and
- 4) Employer-operated-eating-facility meal valuation rule.

When reporting fringe benefits, you can elect to use one of the special valuation rules listed above. However, neither you nor your employee may use the special valuation rule to value any benefit, unless one of the following conditions is satisfied:

- 1) You treat the value of the benefit as wages for reporting purposes by the due date of the return (including extensions) for the tax year you provide the benefit,
- 2) Your employee includes the value of the benefit in income by the due date of the return for the year the benefit is received,
- 3) Your employee is not a control employee as defined later under *Commuting Valuation Rule*, or

- 4) You demonstrate a good faith effort to treat the benefit correctly for reporting purposes.

Neither you nor your employee must notify the IRS of the election.

Using the special valuation rules. All of the following apply when you use the special valuation rules.

- 1) If you use one of the special rules to value a benefit you provide to your employee, the employee must use the same special rule unless you do not treat the value of the benefit as wages for reporting purposes by the due date of the return (including extensions) and one of the conditions just listed in items 2 through 4 is met.
- 2) If you and your employee properly use a special rule, your employee must include in gross income the value you determine under the rule, minus any reimbursement he or she paid you and any amount excluded by law from gross income. You and your employee can use the special valuation rules to determine the reimbursement the employee owes you.
- 3) If you provide vehicles to more than one employee, you do not have to use the same special valuation rule for each employee. If you provide a vehicle for use by more than one employee (for example, an employer-sponsored van pool), you can use any special valuation rule. However, you must use that rule for all employees who share use of the vehicle.
- 4) You can use the formulas in the special valuation rules only with those rules. When you properly apply a special valuation rule to a fringe benefit, the IRS will accept the value you calculated as the FMV of that fringe benefit. However, if you do not properly apply a special valuation rule, or if you use a special valuation rule but are not entitled to do so, determine the FMV of the fringe benefit under the general valuation rule.

Special accounting period rule. Instead of using the general income tax and reporting rule to report employee benefits on a calendar year basis, you can use a special accounting period rule.

You cannot use the special accounting period rule for a fringe benefit that is a transfer of personal property normally held for investment. Nor can you use it for a transfer of real property.

Under the special accounting period rule, you can treat the value of benefits provided in the last 2 months of the calendar year, or any shorter period, as though you paid them in the next year. To do this, add the value of the benefits provided in the last 2 months of a calendar year (or shorter period) to the value of benefits provided in the first 10 months (or longer period) of the next year.

Not all benefits treated as provided during the last 2 months of a calendar year can be deferred until the next year. Only the value of the benefit you actually provided during the last 2 months of the calendar year can be treated this way. For example, if you treat a fringe benefit as provided equally over the year, as discussed earlier under *Withholding periods*, you can defer only the value of the benefit provided during the last 2 months.

Use of special rule is optional. You can use the rule for some fringe benefits and not for others. The period of use need not be the same for each fringe benefit. However, if you use the special accounting period rule for a particular benefit, use it for all employees who receive that fringe benefit.

If you use the special accounting period rule, your employee must use it for the same period. However, your employee can use it only if you use it.

Automobile Lease Valuation Rule

If you provide an employee with an automobile for an entire calendar year, you can use the automobile's **annual lease value** to value the benefit. If you provide an employee with an automobile for less than an entire calendar year, the value of the benefit provided is either a **prorated annual lease value** or the **daily lease value** (discussed later). The applicable lease value is included in the employee's gross income unless excluded by law.

For this rule, **automobile** means any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways.

If your employee uses the automobile for business, he or she may qualify to exclude part of the lease value as a working condition fringe benefit. Reduce the amount of the applicable lease value to be included in your employee's gross income by any working condition fringe benefit. See *Working Condition Fringe* under *Exclusion of Fringe Benefits*, later in this chapter.

Excludable vehicles. These valuation rules do not apply to fringe benefits of certain vehicles specifically excluded from income. See *Qualified Nonpersonal Use Vehicles* under *Working Condition Fringe*, later.

Annual lease value. Generally, you figure the annual lease value of an automobile as follows:

- 1) Determine the FMV of the automobile (discussed later) on the first date the automobile is available to any employee for personal use.
- 2) Using the following Annual Lease Value Table, read down column 1 until you come to the dollar range within which the FMV of the automobile falls. Then read across to column 2 to find the annual lease value.

Annual Lease Value Table

Automobile fair market value	Annual Lease Value
(1)	(2)
\$0 to 999	\$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

For vehicles with an FMV of more than \$59,999, the annual lease value equals: (0.25 × the FMV of the automobile) + \$500.

Fair market value. To determine the annual lease value of an automobile using the table, the FMV of an automobile is the amount a person would pay a third party in the area in which the vehicle is purchased or leased to purchase the particular automobile provided. That amount includes sales tax and title fees.

If you have 20 or more automobiles, see section 1.61-21(d)(5)(v) of the Income Tax Regulations.

You do not have to include the FMV of a telephone or any specialized equipment added to, or carried in, the automobile if the equipment is necessary for your business. However, include the value of specialized equipment in the FMV if the employee to whom the automobile is available uses the

specialized equipment in a trade or business other than yours.

Your cost for either purchasing or leasing the automobile does not determine the FMV of the automobile. However, see *Safe-harbor value*, next.

Safe-harbor value. To figure the annual lease value of an automobile under the automobile lease valuation rule, you can use the safe-harbor value as the FMV. For an automobile you own, the safe-harbor value is your cost, including tax, title, and other purchase expenses, if you purchased the automobile at arm's length. You cannot have been the manufacturer of the vehicle.

For an automobile you lease, the safe-harbor value is:

- 1) The manufacturer's invoice price (including options) plus 4%,
- 2) The manufacturer's suggested retail price less 8% (including sales tax, title, and other expenses of purchase), or
- 3) The retail value of the automobile reported by a nationally recognized pricing source.

Items included in annual lease value table.

The annual lease values in the table include the FMV of maintenance and insurance for the automobile. Neither you nor your employee can reduce this value by the FMV of any service included in the amount if it is not provided by you. For example, you cannot reduce the annual lease value by the FMV of a maintenance service contract or insurance not provided by you. However, you can take into account such services actually provided for the automobile by valuing the availability of the automobile under the general valuation rule. If you have 20 or more automobiles, see section 1.61-21(d)(5)(v) of the Income Tax Regulations.

The annual lease values do not include the FMV of fuel you provide to employees for personal use, regardless of whether you provide it, reimburse its cost, or have it charged to you. You can value fuel you provided at FMV or at 5.5 cents per mile for all miles driven by the employee. However, you cannot value at 5.5 cents per mile fuel you provide for miles driven outside the United States (including its possessions and territories), Canada, and Mexico.

If you reimburse an employee for the cost of fuel, or have it charged to you, you generally value the fuel at the amount of reimbursement, or the amount charged to you if it was purchased at arm's length.

Add the FMV of any service (other than maintenance and insurance for an automobile) provided to the annual lease value of the automobile in determining the FMV of the benefit provided.

Consistency rules. If you adopt the automobile lease valuation rule:

- 1) You must adopt it by the first day you make the automobile available to one of

your employees for personal use. However, if you adopt the commuting valuation rule (discussed later) when you first make the automobile available to your employee for personal use, you can change to the automobile lease valuation rule on the first day for which you do not use the commuting valuation rule.

- 2) You must use the rule for all later years in which you make the automobile available to any employee, except that for any year during which use of the automobile qualifies, you can use the commuting valuation rule.
- 3) You must continue to use the rule if you provide a replacement automobile to your employee and your primary reason for the replacement is to reduce federal taxes.

4-year lease term. The annual lease values figured under this rule are based on a 4-year lease term. The annual lease values figured using the table will generally stay the same for the period that begins with the first date you use the rule for the automobile and ends on December 31 of the 4th full calendar year following that date.

Figure the annual lease value for each later 4-year period by determining the FMV of the automobile on January 1 of the first year of the later 4-year period and selecting the amount in column 2 of the table that corresponds to the appropriate dollar range in column 1.

Using the special accounting period rule. If you use the special rule, discussed earlier under *Special accounting period rule*, you can calculate the annual lease value for each later 4-year period at the beginning of the special accounting period that starts immediately before the January 1 date described in the previous paragraph.

For example, assume that you use the special accounting period rule and that beginning on November 1, 1993, the special accounting period is November 1 to October 31. You elect to use the automobile lease valuation rule as of January 1, 1994. You can recalculate the annual lease value on November 1, 1997, rather than on January 1, 1998.

Transferring an automobile from one employee to another. Unless the primary purpose of the transfer is to reduce federal taxes, you can refigure the annual lease value based on the FMV of the automobile on January 1 of the calendar year of transfer.

However, if you use the special accounting period rule, you can recalculate the annual lease value (based on the FMV of the automobile) at the beginning of the special accounting period in which the transfer occurs. If you do not refigure the annual lease value, your employee cannot refigure it.

Prorated annual lease value. If you provide an automobile to your employee for continuous periods of 30 or more days but less than an entire calendar year, you can prorate the annual lease value. Figure the prorated annual lease value by multiplying the applicable

annual lease value by a fraction, using the number of days of availability as the numerator and 365 as the denominator.

If you provide an automobile continuously for at least 30 days, but the period covers 2 calendar years (or 2 special accounting periods if you are using the *Special accounting period rule*, discussed earlier), you can use the prorated annual lease value or the daily lease value.

If an automobile is unavailable to the employee because of his or her personal reasons (for example, if the employee is on vacation), you cannot take into account the periods of unavailability when you use a prorated annual lease value.

You cannot use a prorated annual lease value if the reduction of federal tax is the main reason the automobile is unavailable.

Daily lease value. If you provide an automobile for continuous periods of one or more but less than 30 days, use the daily lease value to figure its value. Figure the daily lease value by multiplying the applicable annual lease value by a fraction, using four times the number of days of availability as the numerator and 365 as the denominator.

However, you can apply a prorated annual lease value for a period of continuous availability of less than 30 days by treating the automobile as if it had been available for 30 days. Use a prorated annual lease value if it would result in a lower valuation than applying the daily lease value to the shorter period of availability.

Vehicle Cents-Per-Mile Valuation Rule

If you provide an employee with a vehicle that you reasonably expect will be regularly used in your trade or business throughout the calendar year (or for a shorter period during which you own or lease it) or that satisfies the *Mileage rule* requirements discussed later, you value the benefit using the standard mileage rate (applied prospectively) multiplied by the total miles the employee drives the vehicle for personal purposes. For 1994, this rate is 29 cents per mile.

Whether a vehicle is regularly used in an employer's trade or business is determined based on all the facts and circumstances. A vehicle is considered regularly used in a trade or business if it meets one of the following conditions.

- 1) At least 50% of the vehicle's total annual mileage is for that trade or business, or
- 2) The vehicle is generally used each workday to drive at least 3 employees to and from work in an employer-sponsored commuting pool.

Infrequent business use of the vehicle, such as for occasional trips to the airport or between your multiple business premises, does not constitute regular use of the vehicle in your trade or business.

You apply the standard mileage rate only to personal miles. You disregard business

miles. For example, if your employee drives 20,000 personal miles and 35,000 business miles in 1994, the personal use value of the vehicle is \$5,800 (20,000 × 0.29).

Personal use is any use of the vehicle other than use in your trade or business.

For the vehicle cents-per-mile valuation rule, a **vehicle** is any motorized wheeled vehicle, including an automobile, manufactured primarily for use on public streets, roads, and highways.

Mileage rule. If you provide an employee with a vehicle you do not expect the employee to use regularly in your trade or business but that meets the mileage rule, you can use the cents-per-mile method to value the benefit provided. A vehicle meets the mileage rule for a calendar year if:

- 1) It is actually driven at least 10,000 miles in that year, and
- 2) It is used during the year primarily by employees.

Consider the vehicle used primarily by employees if they use it consistently for commuting. For example, if only one employee uses a vehicle during the year and that employee drives the vehicle at least 10,000 miles in that calendar year, the vehicle meets the mileage rule even if all miles driven by the employee are personal.

Less than a full year. If you own or lease the vehicle only part of the year, reduce the 10,000 mile requirement proportionately. Do not treat use of the vehicle by an individual (other than the employee) whose use would be taxed to the employee as use by the employee.

Items included in cents-per-mile rate. The cents-per-mile rate includes the FMV of maintenance and insurance for the vehicle. Do not reduce the rate by the FMV of any service included in the rate that you have not provided. However, you can take into account the services provided for the automobile by valuing the automobile under the general valuation rule.

For miles driven in the United States, its territories and possessions, Canada, and Mexico, the cents-per-mile rate includes the FMV of fuel you provide. If you do not provide fuel, you can reduce the rate by no more than 5.5 cents.

For miles driven outside the United States, Canada, and Mexico, the FMV of fuel you provide is not reflected in the cents-per-mile rate. Accordingly, you can reduce the cents-per-mile rate, but by no more than 5.5 cents.

If you provide the fuel, value it based on all the facts and circumstances. If you reimburse the employee for the cost of fuel, the FMV of the fuel is generally the reimbursement if the fuel was purchased at arm's length. If you allow the employee to charge it to you, the FMV is the amount charged if the fuel was purchased at arm's length.

When you can use the cents-per-mile rule. You can only use the cents-per-mile valuation

rule to value the miles driven for personal purposes. To figure how much to include in an employee's income, multiply the number of personal miles driven by the employee by the appropriate cents-per-mile rate. Remember, you cannot include in income 100% (all business and personal miles) of the value of the use of the vehicle if you use the cents-per-mile valuation rule.

Consistency rules. You must adopt the cents-per-mile rule by the first day the vehicle is used by an employee for personal use. If you adopt the commuting valuation rule (discussed later) when the vehicle is first used by an employee for personal purposes, you can use the cents-per-mile rule on the first day you do not use the commuting valuation rule.

Once you adopt the cents-per-mile rule for a vehicle, use it for all later periods in which the vehicle qualifies. However, you can use the commuting valuation rule for any period during which the vehicle qualifies for that rate.

If the vehicle does not qualify for the cents-per-mile rule during a later period, you can adopt any other special valuation rule for which the vehicle then qualifies. The first day on which an automobile, for which you had been using the cents-per-mile rule, no longer qualifies for that rule may be considered to be the first day on which the automobile is available to your employee for personal use.

Continue to use the cents-per-mile rule if:

- 1) You provide a replacement vehicle (that qualifies for the rule) to your employee, and
- 2) Your primary reason for the replacement is to reduce federal taxes.

When you cannot use the cents-per-mile rule. You cannot determine the value of the use of an automobile under the vehicle cents-per-mile valuation rule if the FMV of the automobile is more than \$14,700 in 1994.

Commuting Valuation Rule

Under this rule, the commuting use of a vehicle you provide is valued at \$1.50 per one-way commute (that is, from home to work or from work to home) for each employee who commutes in the vehicle.

The term **vehicle** means any motorized wheeled vehicle, including an automobile, manufactured primarily for use on public streets, roads, and highways.

You can use this special rule to figure commuting value if you and your employee meet all of the following requirements.

- 1) You own or lease the vehicle and provide it to one or more employees for use in your trade or business.
- 2) For bona fide noncompensatory business reasons, you require the employee to commute to and/or from work in the vehicle.

- 3) You establish a written policy under which the employee is not allowed to use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home).
- 4) Except for de minimis personal use, the employee does not use the vehicle for personal purpose other than commuting.
- 5) The employee required to use it for commuting is not a **control employee** (defined later).

Personal use of a vehicle is all use that is not for your trade or business. An employer-provided vehicle generally used to carry at least three employees to and from work in an employer-sponsored commuting pool meets requirements (1) and (2) above.

If the vehicle is a chauffeur-driven vehicle, you cannot use the commuting valuation rule for any passenger. However, you can use it to value the commuting use of the chauffeur.

If the employee required to use the vehicle for commuting is a control employee and the vehicle is not an automobile, you can still use the commuting valuation rule.

Control employees. A control employee of a **nongovernment employer** is any employee who:

- 1) Is a board- or shareholder-appointed, confirmed, or elected officer of the employer and whose compensation is \$66,000 or more,
- 2) Is a director of the employer,
- 3) Receives compensation of \$132,000 or more from the employer, or
- 4) Owns a 1% or more equity, capital, or profits interest in the employer.

Any individual who owns (or is considered to own under section 318(a) of the Internal Revenue Code or principles similar to section 318(a) for entities other than corporations) 1% or more of the FMV of an entity (the "owned entity") is considered a 1% owner of all other entities grouped with the owned entity under the rules of section 414(b), (c), (m), or (o). An employee who is an officer or director of an employer is considered an officer or director of all entities treated as a single employer under section 414(b), (c), (m), or (o).

A control employee of a **government employer** is any:

- 1) Elected official, or
- 2) Employee whose compensation is at least as much as that paid to a federal government employee at Executive Level V. For 1994, this amount is \$108,200.

For the commuting valuation rule, the term "government" includes any federal, state, or local governmental unit and any of their agencies or instrumentalities.

Commuting because of unsafe conditions. The value of the commuting use of employer-

provided transportation is \$1.50 for a one-way commute if:

- 1) The employee is a qualified employee of the employer,
- 2) The employee does not use the transportation for personal purposes other than commuting because of unsafe conditions,
- 3) The employer provides transportation solely because of unsafe conditions to an employee who would ordinarily walk or use public transportation for commuting, and
- 4) The employer established a written policy under which the transportation is not provided for the employee's personal purposes other than for commuting because of unsafe conditions and the employer's practice follows the established policy.

Unsafe conditions. Unsafe conditions exist if, under the facts and circumstances, a reasonable person would consider it unsafe for the employee to walk or use public transportation at the time of day the employee must commute. One factor indicating whether it is unsafe is the history of crime in the geographic area surrounding the employee's workplace or home at the time of day the employee commutes.

Employer-provided transportation. Employer-provided transportation is local transportation by a vehicle bought by the employer from an unrelated person to transport a qualified employee to or from work. It includes transportation by a vehicle bought by the employee and reimbursed by the employer. Employer reimbursements to an employee under a bona fide reimbursement arrangement to cover the cost of purchasing transportation, such as hiring a cab, are employer-provided transportation.

Qualified employee. A qualified employee is one who:

- 1) Performs services during the current year,
- 2) Is paid on an hourly basis,
- 3) Is not claimed under section 213(a)(1) of the Fair Labor Standards Act of 1938 (as amended) to be exempt from the minimum wage and maximum hour provisions,
- 4) Is within a classification for which the employer actually pays, or has specified in writing it will pay, compensation for overtime equal to or exceeding one and one-half times the regular rate provided in section 207 of the 1938 Act, and
- 5) Does not receive compensation of more than \$66,000 from the employer in 1994.

Trip-by-trip determination. This special valuation rule applies on a trip-by-trip basis. If you and your employee fail to meet the requirements for any trip, the amount included in the employee's income is determined by the FMV of the transportation. Otherwise, the value is \$1.50 for each one-way trip.

Valuation of Meals Provided at an Employer-Operated Eating Facility

If the value of meals is includible in an employee's gross income, determine the amount to include under the general valuation rule. If the meals are provided at an employer-operated eating facility, figure the amount to include from the total meal value, discussed later. For situations where an employee does not have to include the value of meals in gross income, see the discussion under *De Minimis (Minimal) Fringe*, later.

Employer-operated eating facility. An employer-operated eating facility for employees is a facility that meets all of the following conditions.

- 1) You own or lease the facility.
- 2) You operate the facility.
- 3) The facility is on or near your business premises.
- 4) The meals furnished at the facility are provided during, or immediately before or after, your employee's workday.

You are considered to operate the eating facility if you have a contract with another to operate it. **Meals** means food, beverages, and related services provided at the facility.

Total meal value rule. To figure the value of an employee's meal provided at an employer-operated eating facility, first determine the total meal value. The total meal value is 150% of the *direct operating costs* of the eating facility. This total meal value is considered the value of all meals provided at that facility for employees during the calendar year.

Direct operating costs. The direct operating costs of an eating facility are the costs of food and beverages and the cost of labor for personnel performing services relating to the facility primarily on the eating facility premises. For example, the labor costs for cooks, waiters, and waitresses are included in direct operating costs.

However, the labor cost for a manager of an eating facility whose services are not primarily performed on the eating facility premises is not included in direct operating costs.

Determining the taxable value. After you determine the total meal value, you can figure the taxable value of these meals in either of two ways. You can figure the *individual meal subsidy* or allocate the *total meal subsidy*. However, you can use the individual meal subsidy only if there is a charge for each meal, and the price charged each employee is the same for any given meal.

Individual meal subsidy. Determine the individual meal subsidy by multiplying the price charged for a particular meal by a fraction, using the total meal value as the numerator and the gross receipts of the eating facility for the calendar year as the denominator.

Then subtract the amount paid by the employee for the meal. The taxable value of meals provided to a particular employee during a calendar year is the total of the individual meal subsidies you provide to that employee during the year.

Total meal subsidy. Instead of using the individual meal subsidy method, you can allocate the total meal subsidy (total meal value less the gross receipts of the facility) among employees in any manner reasonable under the circumstances. It is presumed reasonable for you to allocate the total meal subsidy on a per-employee basis if you can show that each employee was provided approximately the same number of meals at the facility.

Exclusion of Fringe Benefits

You can exclude certain fringe benefits you provide an employee from the employee's gross income. The fringe benefits excludable from gross income include:

- 1) A no-additional-cost service,
- 2) A qualified employee discount,
- 3) A working condition fringe,
- 4) A de minimis (minimal) fringe,
- 5) A qualified transportation fringe,
- 6) A qualified moving expense reimbursement, and
- 7) Certain athletic facilities.

Nondiscrimination rules. Highly compensated employees cannot exclude from their gross income a no-additional-cost service, a qualified employee discount, or a meal provided at an employer-operated eating facility unless the benefit is available on the same terms to:

- 1) All your employees, or
- 2) A group of your employees defined under a reasonable classification you set up that does not discriminate in favor of highly compensated employees.

Meals provided at an employer-operated eating facility are discussed under *De Minimis (Minimal) Fringe*.

If any benefit is discriminatory, include the total cost of the benefit, not only the discriminatory part, in the income of your highly compensated employees.

Highly compensated employee. A highly compensated employee is an employee who during the current or preceding year:

- 1) Was a 5% owner of the employer,
- 2) Received more than \$99,000 in compensation from the employer,
- 3) Received more than \$66,000 in compensation from the employer and was in the top 20% of all employees when ranked by pay, or
- 4) Was at any time an officer of the employer and received more than \$59,400 in compensation.

No-Additional-Cost Service

If you provide an employee with the same service you offer to customers in the ordinary course of the line of business in which the employee works and certain nondiscrimination rules are met as discussed above under *Non-discrimination rules*, this service is a no-additional-cost service. You do not include the cost in the employee's income if you do not have any substantial additional costs to provide the service to the employee. To determine additional costs include lost revenue, but do not reduce the costs you incur by any amount the employees paid for this service.

Examples of these services are: excess capacity airline, bus, or train tickets; hotel rooms; or telephone services provided free or at a reduced price to employees working in those lines of business.

Generally, an employer's **line of business** is determined by the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget.

Reciprocal agreements. Your employees can exclude the value of no-additional-cost services provided by an unrelated employer if all of the following apply.

- 1) The service is the same type of service generally provided to customers by both the line of business in which your employee works and the line of business in which the service is provided.
- 2) You and the employer providing the service have a written reciprocal agreement under which a group of employees of each employer, all of whom perform substantial services in the same line of business, may receive no-additional-cost services from the other employer.
- 3) Neither you nor the other employer incurs any substantial additional cost (including lost revenue) either in providing the service or because of the written agreement.

Employee. For this fringe benefit, "employee" includes any:

- 1) Individual currently employed by you,
- 2) Individual who stopped working for you because of retirement or disability,
- 3) Surviving spouse of an individual who died while working for you or who stopped working for you because of retirement or disability, or
- 4) Partner who performs services for a partnership.

Treat services provided the spouse or **dependent child** of an employee as provided the employee.

Treat any use of air transportation by the parent of an employee as use by the employee. This rule does not apply to use by the parent of a person considered an employee because of item (3) above.

Dependent child. For this fringe benefit, "dependent child" means any son, stepson,

daughter, or stepdaughter who is a dependent of the employee, or both of whose parents have died and who is not age 25. Treat a child of divorced parents as a dependent of both parents.

Qualified Employee Discount

Gross income does not include the value of a qualified employee discount. A qualified employee discount is a price reduction you give employees on certain property or services you offer to customers in the ordinary course of the line of business in which the employees perform services.

A discount on real property (such as a building or land) or on personal property of a kind commonly held for investment (such as stocks or bonds) is not a qualified employee discount. A qualified employee discount also does not include any amount that is more than the amount determined for the following:

- 1) For property, your **gross profit percent** times the price you charge customers for the property, and
- 2) For services, 20% of the price you charge customers for the service.

Determine the **gross profit percent** based on all property offered to customers (including employee customers) in the ordinary course of your line of business and your experience during the tax year immediately before the tax year in which the discount is available. To figure the gross profit percent, subtract the total cost of the property from the total sales price of the property and divide the result by the total sales price of the property.

The term "employee" includes the same individuals listed earlier under *No-Additional-Cost Service*. Treat an employee who works for a leased section of a department store as an employee of the department store. Treat an employee of the department store as an employee of the leased section.

Working Condition Fringe

You can exclude from your employee's gross income (as working condition fringe benefits) the value of property or services you provide if the employee could deduct them as a trade or business, or depreciation expense if he or she paid for them.

For this fringe benefit, "employee" includes any:

- 1) Individual currently employed by you,
- 2) Partner who performs services for the partnership,
- 3) Director of your company, and
- 4) Independent contractor who performs services for you.

However, an independent contractor who performs services for you cannot exclude from income the value of parking or consumer goods that you provide for use in a product testing program. Also, a director cannot exclude from income the value of consumer

goods you provide for use in a product testing program.

Vehicle-allocation rules. Generally, for an employer-provided vehicle, the amount that can be excluded as a working condition fringe is the amount that would be allowable as a qualified business expense if paid by your employee. That is, if your employee uses the car for business, as well as for personal use, the value of the working condition fringe would be the portion determined to be for business use of the vehicle. See *Business use of your car* in Chapter 1.

However, instead of excluding the value of the working condition fringe related to the qualified car expense, you may include the entire annual lease value in your employee's gross income. Any allowable business car expense may then be claimed on the employee's personal income tax return.

The total inclusion option is only allowed if you use the automobile lease valuation rule to value the fringe benefit for a vehicle you furnish to your employee, discussed earlier.

Educational assistance. To the extent educational assistance does not meet the requirements discussed in Chapter 5 to be excluded from your employee's income under an educational assistance program, it may qualify as a working condition fringe.

To qualify as a working condition fringe, the cost of the education must be a job-related deductible expense by your employee. See Publication 508, *Educational Expenses*, for more information on deductible education expenses.

Note: The exclusion from employees' income for educational assistance does not apply to tax years beginning after December 31, 1994. See Chapter 5.

Outplacement services. You can exclude the value of outplacement services provided to an employee on the basis of need if you get a substantial business benefit from the services distinct from the benefit you get from the payment of additional wages. Substantial benefits include promoting a positive business image, maintaining the remaining employees' morale, avoiding wrongful termination suits, and fostering a positive work atmosphere.

You cannot exclude the value of services that do not qualify as a working condition fringe because the employee can choose to receive cash or taxable benefits in place of the services. For example, if you maintain a severance plan and permit employees to get reduced severance pay with outplacement services, you include in an employee's gross income the difference between the unreduced severance and the reduced severance payments. This amount also constitutes wages for FICA, FUTA, and income tax withholding.

Demonstrator cars. You can exclude the value of the use of a demonstrator car by your

full-time auto salesperson if the use is primarily to facilitate the salesperson's services provided for you and there are substantial restrictions on personal use. See section 1.132-5 of the Income Tax Regulations for the definition of full-time auto salesperson.

Qualified Nonpersonal Use Vehicles

All your employee's use of a qualified nonpersonal use vehicle qualifies as a working condition fringe. Therefore, you can exclude the value of that use from your employee's income. A qualified nonpersonal use vehicle is any vehicle the employee is not likely to use more than minimally for personal purposes because of its design. Qualified nonpersonal use vehicles include:

- 1) Clearly marked police and fire vehicles,
- 2) Unmarked vehicles used by law enforcement officers (explained later) if the use is officially authorized,
- 3) An ambulance or hearse used for its specific purpose,
- 4) Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds,
- 5) Delivery trucks with seating for the driver only, or driver plus a folding jump seat,
- 6) A passenger bus with a capacity of at least 20 passengers used for its specific purpose,
- 7) School buses, and
- 8) Tractors and other special purpose farm vehicles.

Clearly marked police or fire vehicles. A police or fire vehicle is a vehicle, owned or leased by a governmental unit (or any of its agencies or instrumentalities), that a police officer or fire fighter who is on call at all times must use for commuting. The governmental unit must prohibit any personal use (other than commuting) of the vehicle outside the limit of the police officer's arrest powers or the fire fighter's obligation to respond to an emergency. A police or fire vehicle is clearly marked if, through a painted symbol or words, it is easy to see the vehicle is a police or fire vehicle. A marking on a license plate is not a clear marking for this purpose.

Unmarked law enforcement vehicles. The governmental agency or department that owns or leases the vehicle and employs the officer must authorize any personal use of an unmarked law enforcement vehicle. The personal use must be necessary to help enforce the law, such as being able to report directly from home to a stakeout site or to an emergency. Use for vacation or recreation trips is not an authorized use.

Law enforcement officer. A law enforcement officer is a full-time employee of a governmental unit responsible for preventing or investigating crimes involving injury to persons or property (including catching or detaining persons for such crimes). The law allows these officers to:

- Carry firearms,
- Execute search warrants, and
- Make arrests (other than citizen's arrest).

These officers regularly carry firearms except when working undercover. A law enforcement officer includes an arson investigator if the investigator meets these requirements.

Trucks and vans. A pickup truck or van is not a qualified nonpersonal use vehicle unless specially modified so it is not likely to be used more than minimally for personal purposes. The following are guidelines that a pickup truck or van can meet to be a qualified nonpersonal use vehicle. Even if these guidelines are not met, the vehicle may still qualify, based upon the facts. In that case, contact your local IRS for further guidance.

Pickup truck. A pickup truck with a loaded gross vehicle weight not over 14,000 pounds qualifies if clearly marked with permanently affixed decals, special painting, or other advertising associated with your trade, business, or function. It must be either:

- 1) Equipped with at least one of the following:
 - a) Hydraulic lift gate,
 - b) Permanent tanks or drums,
 - c) Permanent side boards or panels that materially raise the level of the sides of the truck bed, or
 - d) Other heavy equipment (such as an electric generator, welder, boom, or crane used to tow automobiles and other vehicles), or
- 2) Used primarily for transporting a particular type of load (other than over the public highways) in a construction, manufacturing, processing, farming, mining, drilling, timbering, or other similar operation for which it was specially designed or significantly modified.

Van. A van with a loaded gross vehicle weight not over 14,000 pounds qualifies if clearly marked with permanently affixed decals, special painting, or other advertising associated with your trade, business, or function. It must have a seat for the driver only or the driver and one other person, and either:

- 1) Permanent shelving that fills most of the cargo area, or
- 2) The cargo area is open and the van at all times carries merchandise, material, or equipment used in your trade, business, or function.

Items Not Excludable

The following are some items you cannot exclude from your employee's income as working condition fringe benefits.

- 1) A service or property offered through a flexible spending account. A flexible spending account is an agreement that makes available to employees over a

time period a certain amount of unspecified noncash benefits with a predetermined cash value.

- 2) Any item for which the employee does not have the necessary substantiation to deduct it as a trade, business, or depreciation expense.
- 3) Expenses the employee can deduct under sections of the Internal Revenue Code other than for trade or business expenses or depreciation.
- 4) A physical examination program, whether mandatory to some or all employees.
- 5) A cash payment you made to your employee unless you require your employee to do all of the following:
 - a) Use the money for expenses that are deductible in a specific or prearranged activity as trade, business, or depreciation expenses,
 - b) Verify the money is used for such expenses, and
 - c) Return any unused money to you.

De Minimis (Minimal) Fringe

Gross income does not include the value of a de minimis fringe benefit. A de minimis fringe is any property or service you provide to an employee that has so small a value (taking into account how frequently you provide similar fringe benefits to your employees) that accounting for it would be unreasonable or administratively impracticable. Cash, no matter how little, is never excludable as a de minimis fringe, except as discussed next. Employee means any recipient of a fringe benefit.

Examples of de minimis fringes include:

- Typing of a personal letter by a company secretary,
- Occasional personal use of a company copying machine,
- Occasional parties or picnics for employees and their guests,
- Occasional meal money or local transportation fare for employees working overtime not based on hours worked and, for meals, provided to enable the employee to work overtime,
- Holiday gifts, other than cash, with a low FMV,
- Occasional tickets for entertainment events,
- Coffee, doughnuts, or soft drinks furnished to employees, and
- Group term life insurance payable on the death of an employee's spouse or dependent if it is not more than \$2,000.

The value of meals you provide to your employees at an eating facility operated by you is a de minimis fringe only if the annual revenue from the facility equals or exceeds the direct operating costs of the facility. The meals must be available on substantially the same terms to each member of a group of employees (see *Nondiscrimination rules*, the first discussion under *Exclusion of Fringe Benefits*, earlier).

For more information, including definitions of an employer-operated eating facility and direct operating costs, see *Valuation of Meals Provided at an Employer-Operated Eating Facility*, earlier.

Qualified Transportation Fringe

You can exclude qualified transportation fringe benefits from the gross income of employees, up to certain limits. The following benefits, which you can provide in any combination at the same time to an employee, are qualified transportation fringes:

- 1) Transportation in a commuter highway vehicle if the transportation is between the employee's home and work place,
- 2) A transit pass, and
- 3) Qualified parking.

Cash reimbursements you make to an employee for these expenses under a bona fide reimbursement arrangement are also excludable. Cash reimbursements for transit passes qualify only if a voucher or a similar item that may be exchanged only for a transit pass is not readily available for direct distribution by you to your employee.

Benefit taxable if in lieu of pay. You cannot exclude from an employee's income any qualified transportation fringe benefit that you provide in place of compensation that would have been payable to the employee. This rule applies even if state or local law requires you to offer employees the choice of receiving the benefit or higher pay.

Relation to other fringe benefits. You cannot exclude a qualified transportation fringe benefit under the *de minimis* or *working condition* fringe rules. However, if you provide a local transportation benefit other than by transit pass or commuter highway vehicle, or to a person other than an employee as defined later, you may be able to exclude all or part of the benefit under other fringe benefit rules (*de minimis*, *working condition*, etc.).

Benefits and Employees Defined

The following discussions define each of the three qualified transportation fringe benefits and the employees who can receive these excludable benefits.

Commuter highway vehicle. A commuter highway vehicle is any highway vehicle that seats at least 6 adults (not including the driver). In addition, you must reasonably expect that at least 80% of the vehicle mileage will be for transporting employees between their homes and work place, with at least one-half of the vehicle seats (not including the driver's) being occupied by your employees.

Transit pass. A transit pass is any pass, token, farecard, voucher, or similar item entitling a person, free of charge or at a reduced rate, to ride:

- Mass transit, or
- In a vehicle that seats at least 6 adults (not including the driver), if it is operated by a person in the business of transporting persons for compensation or hire.

Mass transit may be publicly- or privately-operated and includes bus, rail, or ferry.

Qualified parking. Qualified parking is parking provided to your employees on or near your business premises. It also includes parking provided on or near the location from which your employees commute to work using mass transit, commuter highway vehicles, or carpools. It does not include parking on or near your employee's residence.

Employee. Qualified transportation fringes may be provided only by employers to employees. The definition of employee includes common-law employees and other statutory employees, such as officers of corporations. Self-employed individuals, including partners, 2 percent shareholders in S corporations, sole proprietors, and other independent contractors are not employees for purposes of this fringe benefit.

Exclusion Limits

You may exclude from the gross income of each employee up to:

- 1) \$60 per month for combined commuter highway vehicle transportation and transit passes, and
- 2) \$160 per month for qualified parking.

The dollar limits are subject to an increase for inflation each year.

Excess benefits taxable. If for any month, the fair market value of a benefit is more than its limit, only the amount in excess of the limit, minus any amount paid for the benefit by or for the employee, is includible in gross income.

Example 1. Each month, the Stephan Company provides a transit pass valued at \$70 to its employee, Tom Travis. Tom does not pay his employer for any part of the pass. Because the value of the monthly transit pass exceeds the limit by \$10 (for each month this pass is provided), \$10 must be included in Tom's wages for income and employment tax purposes.

Example 2. Each month, the Tommy Company provides qualified parking valued at \$175 to Travis Ramon. Travis does not pay his employer for any part of the parking. Because the fair market value of the parking exceeds the limit by \$20 (for each month this parking is provided), \$20 must be included in Travis's wages for income and employment tax purposes.

Example 3. The Thomas Company provides qualified parking with a fair market value of \$200 per month to its employees, but charges the employees \$45 per month. Because the value of the parking exceeds the limit by \$45 and that excess benefit minus the amount paid (\$45) by the employees is zero,

no amount is includible in the employees' gross income.

Taxable Benefits – Withholding and Reporting

Treat taxable fringe benefits as wages subject to employment taxes. When and how you withhold on and report the value of qualified transportation fringe benefits that you must include in an employee's pay depends on whether the benefits are noncash benefits or cash reimbursements.

Noncash benefits. For information on when and how to withhold on and report taxable noncash fringe benefits, see *Including benefits in pay* and *Withholding periods* under *Definition* at the beginning of this chapter.

Cash reimbursements. For employment tax purposes, treat taxable cash reimbursements as paid when actually paid. You must deposit and report amounts withheld in addition to depositing and reporting your FUTA tax and your part of the FICA taxes.

More Information

For more information on qualified transportation fringe benefits, including van pools, and how to determine the value of parking, see Notice 94-3 found in 1994-3 Internal Revenue Bulletin 14.

Moving Expense Reimbursements

You can exclude from your employee's gross income any reimbursements or payments you make for qualified moving expenses incurred after 1993.

Qualified Moving Expense Reimbursements

Qualified moving expense reimbursements include any amount your employee receives from you, directly or indirectly, as a payment for, or a reimbursement of, expenses that would be deductible as moving expenses if paid or incurred by your employee. The reimbursements should be made under rules similar to those for an accountable plan described under *Travel, Meals, and Entertainment* in Chapter 16.

Deductible moving expenses. Deductible moving expenses include only the reasonable expenses (other than meals) of:

- 1) Moving household goods and personal effects from the former home to the new home, and
- 2) Traveling (including lodging) from the former home to the new home.

Deductible moving expenses *do not include* any expenses for meals, househunting trips, temporary living quarters, and the sale, purchase, or lease, of a qualified residence. For information on deductible and nondeductible moving expenses, see Publication 521.

Nonqualified reimbursements. Any reimbursements for moving expenses that are not qualified moving expense reimbursements are to be included in your employee's gross income as payment for services. Reimbursements that do not qualify include any payment for, or reimbursements of, expenses your employee may have deducted in a prior year.

Where to report reimbursements. Any reimbursements you make in 1994 that qualify as an excludable fringe benefit are reported in box 13 of the 1994 Form W-2. Use Code "P" to identify the nontaxable reimbursements reported in box 13.

Any moving expense reimbursements, that do not qualify as an excludable fringe benefit are to be included in your employee's wages and reported in box 1 of Form W-2.

Athletic Facilities

You can exclude from your employees' gross income the value of an on-premises gym or other athletic facility you provide and operate if substantially all use during the calendar year is by your employees, their spouses, and their dependent children.

The exclusion does not apply to any athletic facility if access to the facility is made available to the general public through the sale of memberships, the rental of the facility, or a similar arrangement. The exclusion does not apply to any athletic facility that is for residential use. For example, a resort with athletic facilities would not qualify.

5.

Employee Benefit Programs

Topics

This chapter discusses:

- Life insurance
- Medical insurance
- Educational assistance
- Dependent care assistance
- Supplemental unemployment benefits
- Cafeteria plans

Useful Items

You may want to see:

Publication

- 15** (Circular E) Employer's Tax Guide
- 525** Taxable and Nontaxable Income

Form (and Instructions)

- W-2** Wage and Tax Statement
- 5500** Annual Return/Report of Employee Benefit Plan

Employers may provide forms of pay other than cash to their employees. These include life insurance, health or accident insurance, educational assistance, and other benefit programs. This chapter explains what costs you can and cannot deduct, whether the amount is includible or excludable from an employee's income, if it is subject to employment and income tax withholding, and how to claim a deduction for it on your business tax return.

Life Insurance

Generally, you can deduct premiums (cost of insurance) you pay or incur on life insurance policies covering the lives of your officers and employees if you are not the beneficiary under the contract and can show that the premiums represent current pay. However, the total of the premiums paid combined with other pay must be reasonable as discussed in Chapter 2.

Deductible premiums. For premiums *excludable* from an employee's income, deduct them on the "employee benefit programs" line of the tax schedule or return for your business. For premiums *includible* in an employee's income, deduct them as wages subject to certain employment taxes, as explained next.

Employment taxes. The cost of group term life insurance (discussed later) that is income to the employee is not subject to income tax withholding and is exempt from FUTA tax. However, the cost is subject to social security and Medicare tax withholding.

Former employee. The cost of group term life insurance that is income to employees who quit or retire is subject to social security and Medicare tax withholding. The former employee is liable for the employee's share of the tax and you must provide (on Form W-2) the amount for the employee to include on line 53, Form 1040.

Form W-2. You must report on Form W-2 the cost includible in the employee's income. For information on Form W-2, see Publication 15.

Nondeductible premiums. You cannot deduct premiums on a life insurance policy covering yourself, an employee, or any person financially interested in your business if you are directly or indirectly a beneficiary of the policy. This is true whether the policy insures you, your employee, or a person who has a financial interest in your business. A person has a financial interest in your business if the person is an owner or part owner of the business or has lent money to the business.

Partners. If you are a partner in a partnership, you are considered a beneficiary if you take out an insurance policy on your own life and name your partners as beneficiaries to induce them to retain their investments in the partnership.

Security for loan. If you take out a policy on your life or on the life of another person financially interested in your business to get or protect a business loan, you cannot deduct

the premiums as business expenses. Nor can you deduct the premiums as interest on business loans or as an expense of financing loans. In the event of death, the proceeds of the policy are not taxed as income even if they are used to liquidate the debt.

Group Term Life Insurance

You can deduct group term life insurance premiums paid or incurred by you on policies covering the lives of your officers and employees if you are not directly or indirectly the beneficiary under the contract.

Cost taxable to employee. Generally, an employee must include in income the cost of group term life insurance coverage on his or her life to the extent that the cost is more than the total of:

- 1) The cost of \$50,000 of this insurance, **plus**
- 2) Any amount paid by the employee toward the purchase of the insurance.

The \$50,000 relates to insurance protection the employee receives during any part of the tax year.

The cost of the group term life insurance that you must include in your employees' income is not the actual cost of the extra coverage, but an amount figured using monthly costs listed later. See *Monthly cost includible in employee's income*.

However, if your plan is discriminatory, you may also have to include in certain key employees' income the cost of the first \$50,000 of this insurance. See *Discriminatory Group Term Life Insurance Plans*, later.

If the insurance includes **permanent benefits**, you must include in the employees' income:

- 1) The cost of the permanent benefits, **minus**
- 2) The amount paid by the employee for the permanent benefits.

Permanent benefits are economic values provided under a life insurance policy that extend beyond one policy year, such as paid-up or cash surrender value.

Cost for employees' spouse or children. The cost of group term life insurance you pay on the life of an employee's spouse or children is generally included in the employee's income. However, no amount is included in income if the insurance payable on the death of a spouse or a child does not exceed \$2,000. The cost of higher amounts of coverage may also be excluded from income if it is a de minimis fringe benefit. In determining whether the coverage is a de minimis fringe, only the excess of the cost of the insurance over the amount paid by the employee is considered. For more information on de minimis fringe benefits, see *De Minimis (Minimal) Fringe* in Chapter 4.

Group term life insurance defined. Group term life insurance is term life insurance provided to a group of employees under a policy carried directly or indirectly by the employer and provides:

- 1) A general death benefit that is excluded from gross income, and
- 2) An amount of insurance to each employee based on a formula using factors such as age, years of service, compensation, or position that prevents individual selection of insurance coverage.

Permanent benefits included in insurance. Life insurance that includes permanent benefits is not group term life insurance unless both of the following conditions are met.

- 1) The policy or the employer must specify in writing which part of the death benefit provided for each employee is group term life insurance.
- 2) The part of the death benefit specified as group term life insurance for any policy year cannot be less than the difference between the total death benefit provided by the policy and the employee's deemed death benefit at the end of the policy year. See Income Tax Regulation 1.79-1(d)(3) for information about how to determine a deemed death benefit.

Note: Travel insurance or accident and health policies that include death benefits but do not provide general death benefits are not group term life insurance.

Group requirements. Generally, life insurance qualifies for treatment as group term life insurance only if it is provided to at least 10 full-time employees at some time during the calendar year. However, your insurance can also qualify as group term if you meet all of the following conditions.

- 1) You provide the insurance to all of your full-time employees or, if evidence of insurability affects eligibility, to all full-time employees who provide evidence of insurability satisfactory to the insurer.
- 2) You figure the insurance coverage based on a uniform percentage of pay or based on the insurer's coverage brackets.
- 3) Evidence of insurability is limited to a medical questionnaire completed by the employee that does not require a physical exam.

For purposes of these conditions, you do not have to provide insurance to any of the following:

- 1) Employees 65 or older,
- 2) Employees working 20 hours or less a week or 5 months or less in any calendar year, or
- 3) Employees who have not been employed for the waiting period specified in the policy. The waiting period cannot be more than 6 months.

Insurance is considered to be provided to employees who choose not to receive the insurance unless they are required to contribute to the cost of benefits other than the group term life insurance. For example, if an employee could receive group term life insurance by contributing to the cost, that employee is counted in determining whether the group term life insurance is provided to 10 or more employees, even if that employee chooses not to receive the insurance.

However, if an employee must contribute to the cost of permanent benefits to get group term life insurance, you do not count that employee when determining if you provide the group term life insurance to 10 or more employees unless the group term life insurance is actually provided to that employee.

Employee. An employee is:

- 1) A person who performs services for an employer and whose legal relationship to the employer is that of an employee,
- 2) A full-time life insurance salesperson, or
- 3) A person who was formerly an employee.

However, certain former employees are exempt from including the cost of this insurance that is more than \$50,000 in their income. For more information, see *Retired employees under Group Life Insurance Premiums* in Publication 525.

Monthly cost includible in employee's income. Determine the amount to include in your employee's income by figuring the cost of the part of the insurance that is more than \$50,000 during each month. Do this by multiplying the number of thousands of dollars in excess of the \$50,000 (figured to the nearest 10th) by the appropriate cost per thousand per month from the following table. Multiply that result by the number of months during the year the employee's insurance exceeded \$50,000 by that number of thousands. From that amount, subtract any amount the employee paid toward the purchase of the insurance. Determine your employee's age on the last day of the tax year. If you provide group term life insurance for a period of coverage of less than 1 month, prorate the monthly cost over that period. The monthly cost of each \$1,000 of group term life insurance protection is as follows:

Age	Cost
Under 30	\$.08
30 - 34	\$.09
35 - 39	\$.11
40 - 44	\$.17
45 - 49	\$.29
50 - 54	\$.48
55 - 59	\$.75
60 - 64	\$1.17
65 - 69	\$2.10
70 and over	\$3.76

Example. Your company provides group term life insurance to all of its employees. The company plan requires your employees to pay 5 cents per thousand dollars of coverage per month toward the premiums. Your company

pays the balance. Dave, one of your employees, has \$65,000 of coverage payable in a lump sum upon his death to his wife. Dave is age 52 at the end of the year. The annual premium on Dave's policy is \$325. Of that, Dave paid \$39.

To figure the amount to include in Dave's income, subtract \$50,000 from his \$65,000 of insurance coverage. Multiply the number of thousands of dollars in excess of the \$50,000 (.15) by the monthly cost in the above table (.48) for Dave's age bracket. The result is \$7.20. Multiply that amount by the number of months during the year the insurance coverage was \$15,000 over the \$50,000. In this case, it is 12 months times \$7.20, or a total of \$86.40. From the \$86.40 subtract the \$39 in premiums paid by Dave. The difference, \$47.40, must be included in Dave's income. Your company's deduction for life insurance premiums paid on Dave's policy is \$286 (\$325-\$39).

Discriminatory Group Term Life Insurance Plans

Generally, you cannot exclude any part of the employer-provided cost of group term life insurance from a key employee's income if the plan discriminates in favor of key employees. The term "key employee" is defined later in *Key employees*. If the plan is nondiscriminatory or a church plan, treat your key employees like other employees and you exclude from their income the cost of up to \$50,000 of this insurance.

Cost to include in key employee's income. The cost that you must include in a key employee's income, if the plan is discriminatory, is the **larger of:**

- 1) The actual cost of the coverage, or
- 2) The cost of the coverage using the monthly cost table, shown earlier.

Discriminatory plan defined. A discriminatory group term life insurance plan is any plan of an employer that provides group term life insurance that favors key employees as to eligibility to participate or the type and amount of life insurance benefits provided under the plan. The participation and benefits tests are to be applied separately to active and former employees.

Eligibility to participate. A plan generally does not discriminate if:

- 1) The plan benefits at least 70% of all employees,
- 2) At least 85% of all participating employees are not key employees (defined later in *Key employees*),
- 3) The plan benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees, or
- 4) The eligibility rules for cafeteria plans are satisfied, if the plan is part of a cafeteria plan (discussed later).

You can exclude certain employees from consideration when applying the eligibility-to-participate test. These are employees who:

- 1) Have not completed 3 years of service with the employer,
- 2) Are part-time or seasonal employees,
- 3) Are nonresident aliens who receive no U.S.-source income from the employer, or
- 4) Are not included in the plan but are included in a unit of employees covered by a collective bargaining agreement, if the benefits provided under the plan were the subject of good faith bargaining between the employer and employee representatives.

Type and amount of benefits. A group term life insurance plan may meet the eligibility-to-participate test and still be a discriminatory plan if it discriminates in terms of the type of life insurance benefits. All benefits available to participating key employees must also be available to all other participating employees. However, group term life insurance benefits will not be considered to discriminate merely because the amount of life insurance provided to employees bears a uniform relationship to employees' pay.

Key employees. A key employee is any employee or former employee who during the year, or any of the 4 preceding years, was:

- 1) An officer of the employer having, for any year listed below, annual compensation of more than —
 - a) 1990 — \$51,291
 - b) 1991 — \$54,482
 - c) 1992 — \$56,111
 - d) 1993 — \$57,821
 - e) 1994 — \$59,400
- 2) One of 10 employees having annual compensation of more than \$30,000 and owning (or considered to own under the related-party rules) the largest interests in the employer,
- 3) A 5% owner of the employer, or
- 4) A 1% owner of the employer with annual compensation of more than \$150,000.

Key employees also include any former employee who was a key employee upon retirement or separation from service.

Related parties. A related party includes members of the employee's immediate family (including spouse, children, grandchildren, and parents). These rules also apply to certain relationships between individuals, corporations, partnerships, estates, and trusts. Related parties are treated as if each owned both his or her own interest and also the other party's interest.

Medical Insurance

Generally, you can deduct the premiums you pay or incur for health or accident insurance plans and the payments you make under self-insured medical reimbursement plans. This includes payments you make under plans that reimburse premiums paid by employees on personal health insurance policies, including supplemental medical insurance.

These amounts are deducted on the line titled *Employee benefit programs* on your business return and are generally not includible in your employee's income.

Group Health Plans

You can deduct the contributions you make to provide coverage under a group health plan for your employees.

A group health plan is any plan that provides medical care to your employees, former employees, or their families. Care may be provided directly or through insurance, reimbursement, or otherwise.

Excise tax on certain health plans. If your group health plan does not cover the working aged, active disabled, or those with end stage renal disease, you will be subject to an excise tax. The tax is 25% of the expenses incurred for each of the group health plans to which you contribute.

Continuation of Coverage

Your group health plan must provide for continuation of coverage. If your plan fails to provide continuation coverage to qualified beneficiaries discussed later in *Continuation coverage requirement*, you will be subject to an excise tax. The excise tax generally is \$100 per day during the **noncompliance period** for each beneficiary. For beneficiaries in the same family, \$200 per day is the maximum tax that can be imposed.

The **noncompliance period** for each failure begins on the day the failure first occurs and ends on the earlier of:

- 1) The day the failure is corrected, or
- 2) 6 months after the last day in the period for which the employer could have been required to provide continuation coverage (see *Period of coverage*, later).

The excise tax generally does not apply to:

- 1) Any group health plan if all employers maintaining the plan normally employed fewer than 20 employees on a typical business day in the preceding calendar year,
- 2) Any governmental plan, or
- 3) Any church plan.

The tax does not apply for any period during which the failure was not known to exist and would not have been discovered using reasonable care. The tax also does not apply if the failure is due to reasonable cause, not willful neglect, and is corrected within a 30-day period beginning when the failure is found, or

would have been found if reasonable care were used. However, these exceptions do not apply (and the tax does) if the failure is not corrected before the IRS sends you a notice of examination for a period during which the failure occurred or continued.

Continuation coverage requirement. To meet the continuation coverage requirement, your group health plan must provide qualified beneficiaries the choice of continuing to be covered by the plan if any of the following events occurs.

- 1) Covered employee's death.
- 2) Covered employee's termination (other than for gross misconduct) or reduction in hours of employment.
- 3) Covered employee's divorce or legal separation from a spouse.
- 4) Covered employee's entitlement to Medicare benefits.
- 5) A dependent child ceases to be a dependent, which ends the child's eligibility for coverage under the plan guidelines.
- 6) Bankruptcy proceeding (which began after June 30, 1986) under Title 11, United States Code, of the employer of a retired covered employee.

If any of these events occurs, the plan must provide an election period of at least 60 days to qualified beneficiaries to choose to continue coverage under the plan.

In general, this coverage must be **identical** to that received by beneficiaries who have not experienced any of these events.

Qualified beneficiaries. An employee's spouse and dependent children, if covered under the plan, are qualified beneficiaries. The covered employee is also a qualified beneficiary if the event is a termination or reduction of hours or a bankruptcy proceeding.

Period of coverage. Coverage generally must extend for at least 36 months from the day the event occurs. If there is a termination or reduction of hours, the coverage period must be at least 18 months.

In the case of a bankruptcy proceeding, coverage must extend until the death of the covered employee or qualified beneficiary or, for the surviving spouse or dependent children of the employee, 36 months after the death of the employee.

Certain situations may shorten the period of coverage. For example, the coverage period can end earlier if the employer terminates all of its group health plans, if the beneficiary does not pay the premiums on time, or if the beneficiary becomes entitled to Medicare.

Required notice of continuation coverage election rights. Employees and their spouses must be given written notice of their continuation coverage election rights when their coverage under a plan begins.

Employers generally must notify the plan administrator within 30 days of the death, termination or reduction in hours, or Medicare entitlement of any covered employee, or of their own Title 11 bankruptcy proceeding.

Employees or their qualified beneficiaries are responsible for notifying the plan administrator if there is a divorce or legal separation, or if a child's eligibility under the plan ends. This notification generally must be made within 60 days after the date of the event.

Also, within 14 days of their notification, plan administrators generally must inform qualified beneficiaries of their right to choose continuation coverage.

Self-Insured Medical Reimbursement Plans

You can generally deduct amounts paid under a self-insured medical reimbursement plan to reimburse your employees for medical expenses. You do not include these amounts in your employees' gross income nor do you withhold FICA, FUTA, or income taxes.

A self-insured medical reimbursement plan reimburses employees for medical expenses not reimbursed by an accident or health insurance policy. The medical expenses can be for the employees, their spouses, or their dependents.

Discriminatory plan. If a plan discriminates in favor of highly compensated individuals, you must include all or part of the amounts paid to these individuals in their gross income. Generally, this rule also applies if a highly compensated employee is enrolled in a Health Maintenance Organization (HMO) as an alternative to the self-insured plan.

A highly compensated individual (for these purposes) is:

- 1) One of the five highest paid officers,
- 2) A shareholder who owns more than 10% in value of the employer's stock, or
- 3) Among the highest paid 25% of all employees, other than nonparticipants who can be excluded from participation in the plan.

Educational Assistance

You can exclude from an employee's income up to \$5,250 of your payments or expenses incurred for the employee during the calendar year under a **qualified** educational assistance plan. (The requirements for a qualified educational assistance program are discussed later.) If the total cost under a qualified plan exceeds \$5,250, the excess is treated in one of two ways, as discussed next. You cannot exclude costs under a **nonqualified** plan. These costs must be included in the employee's income.

Payments over \$5,250 limit. If your total educational assistance cost for an employee under a qualified plan exceeds the \$5,250 limit, the excess may qualify as a working condition fringe benefit, discussed in Chapter 4 of Publication 535. If the excess qualifies as a working condition fringe benefit, you can exclude the excess from the employee's income.

You must include in the employee's income any excess cost that does not qualify as a working condition fringe benefit.

Business tax return. Deduct up to \$5,250 of the qualified educational costs for an employee on the *Employee benefit programs* line of your business tax return. Any excess educational costs that qualify as a working condition fringe benefit are deducted on that line, also. The excess educational costs not excluded from income are deducted on the *Wages* line of your business return.

W-2. Educational costs not excluded as qualified educational expenses or working condition fringe benefits are wages subject to income, social security, and Medicare taxes. They are reported to the employee in the *Wages, tips, other compensation* box on Form W-2.

Qualifying Requirements

To be a qualified plan, your plan must be in writing and for the exclusive benefit of your employees. Also, your plan must:

- 1) Be set up under a classification that IRS finds does not discriminate in favor of highly compensated employees or their dependents.
- 2) Not pay more than 5% of its benefits during a year for shareholders or owners (or their spouses or dependents). A shareholder or owner is anyone, who on any day of the year, owns more than 5% of the stock or of the capital or profits interest in your business.
- 3) Not provide eligible employees a choice between receiving the educational assistance or other remuneration includible in gross income.
- 4) Provide reasonable notification of the availability and terms of the program to eligible employees.

Note: For purposes of (1) above, you can exclude employees who are covered by a collective bargaining agreement if there is evidence that educational assistance was the subject of good faith bargaining.

Educational assistance defined. Educational assistance means amounts you pay for your employees and includes amounts for tuition, fees, books, equipment, and supplies. However, it does not include costs for equipment, tools, or supplies (other than textbooks) if your employee may keep these items at the end of the course. Nor does it include meals, lodging, or transportation.

The income exclusion for employer-provided educational assistance does not apply to tax years beginning after December 31, 1994.

Dependent Care Assistance

How you deduct the expenses for providing dependent care assistance to your employees depends on how you provide the care. If you provide the care in-kind (operate a dependent care facility for your employees), deduct the costs of operating the care facility in the appropriate categories (depreciation, utilities, salaries, etc.) on your return. If you contract with a third party to provide the care, or if you reimburse your employees directly for the dependent care expenses they incur, deduct your costs on the *Employee benefit programs* line of your return.

If you have a dependent care assistance program that meets the requirements discussed later under *Qualifying Requirements*, you can exclude each year up to \$5,000 of assistance for each employee. Include the entire amount paid to your employee or paid on your employee's behalf in Box 10 of your employee's 1994 Form W-2. If you furnished the care in-kind, use the fair market value of the dependent care provided to that employee, less any amount the employee may have paid you for the care. The fair market value of the care provided is a reasonable estimate of what the employee would pay for care of the type and quality you furnished. Any amount above the \$5,000 is also included in the employee's income in Box 1 of the W-2. This excess is subject to federal income tax withholding and FICA and FUTA taxes.

Qualifying Requirements

To apply the exclusion of income for a dependent care assistance program to all of your employees (both highly and nonhighly compensated employees), your plan must meet the following requirements:

- 1) It must be a separate written plan for the exclusive benefit of your employees to provide them with dependent care assistance.
- 2) It must not discriminate in favor of highly compensated employees or their dependents.
- 3) It must not pay more than 25% of its benefits during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of the employer.
- 4) It must provide reasonable notification of the availability and terms of the program to eligible employees.
- 5) It must furnish to each employee by January 31, a Form W-2 showing the amount you spent to provide dependent care assistance for the employee during the previous calendar year.
- 6) It must meet the 55% benefits test (discussed later).

If your plan does not meet these requirements to qualify as a dependent care assistance program, your plan will still qualify as a dependent care assistance program for applying the exclusion of income to your employees who are not highly compensated.

A highly compensated employee is defined in Chapter 4 under *Exclusion of Fringe Benefits*.

55% benefits test. For your plan to meet this test, your average benefit under all your plans provided to your employees who are not highly compensated must be at least 55% of the average benefits under all plans provided to your highly compensated employees.

Note: For purposes of the 55% benefits test, if you provide benefits through a salary reduction arrangement, your plan may exclude employees with compensation of less than \$25,000.

To determine both the eligibility test and the 55% benefits test for your plan, you can exclude the following persons from consideration:

- 1) Employees who have not attained age 21 and completed 1 year of service, and
- 2) Employees not included in a dependent care assistance program who are covered by a collective bargaining agreement, if there is evidence that dependent care benefits were a subject of good faith bargaining.

Supplemental Unemployment Benefits

You can deduct costs you pay to a **welfare benefit fund** which provides supplemental unemployment benefits for your employees if the costs are ordinary and necessary business expenses. Your deduction cannot be more than the fund's **qualified cost** for the tax year.

These amounts are deducted on the line titled *Employee benefit programs* on your business tax return.

Welfare benefit fund defined. A welfare benefit fund is any fund which is part of an employer's plan through which you provide welfare benefits to employees or their beneficiaries.

Qualified cost. The qualified cost is the sum of the **qualified direct cost** for the year, and any addition to a **qualified asset account** for the year. You reduce the qualified cost by any after-tax income of the fund for the year.

Qualified direct cost. Qualified direct cost is the total amount (including administrative expenses) which would have been allowable as a deduction if:

- 1) You provided the benefits directly, and
- 2) You used the cash method of accounting.

Qualified asset account. A qualified asset account is any account consisting of assets set aside to provide supplemental unemployment benefits. You cannot deduct an addition to a qualified asset account to the extent the addition will cause the amount in the account to be more than the **account limit**. The account limit is the amount estimated to be actuarially necessary to fund:

- 1) Claims incurred but not paid, and
- 2) Administrative costs for such claims.

Cafeteria Plans

You can deduct your contributions to a cafeteria plan on the *Employee benefit programs* line of your tax return.

Cafeteria plans, including flexible spending arrangements, are written plans that allow your employees to choose among two or more benefits consisting of cash and qualified benefits.

Generally, a plan that provides for deferred compensation is not a cafeteria plan. However, certain profit sharing or stock bonus plans, and certain life insurance plans maintained by educational institutions can be offered through a cafeteria plan even though they provide for deferred compensation.

Unless actually elected, the fact that cash or certain taxable benefits are available under the plan does not cause an employee to be treated as having received the cash or taxable benefit.

Qualified benefits. A cafeteria plan may offer any qualified benefit other than scholarships and fellowship grants, educational assistance, and, generally, the fringe benefits discussed in Chapter 4. Qualified benefits include any other benefits your employees are allowed to exclude from their income because of specific provisions of the law including those discussed in this chapter. Generally, qualified benefits include accident or health plans, dependent care assistance benefits and group term life insurance. The cost of group term life insurance in excess of \$50,000, and employer-provided dependent group term life insurance are includible in gross income.

Nondiscrimination rules. If, in any plan year, your cafeteria plan discriminates in favor of highly compensated individuals as to eligibility to participate in the plan or as to plan contributions or benefits, highly compensated participants are taxed on the amount of the taxable benefits that could have been elected.

Highly compensated individual or participant. An individual or participant is highly compensated if he or she is:

- 1) An officer,
- 2) A shareholder owning more than 5% of the voting power or value of all classes of the employer's stock,
- 3) Highly compensated, or
- 4) A spouse or dependent of a person described in (1), (2), or (3).

Nontaxable benefits to key employees.

If your plan provides nontaxable benefits to **key employees** that are more than 25% of the total of the nontaxable benefits provided for all employees under the plan, key employees must include in income the value of the benefits that could have been elected. A key employee is defined earlier under *Group Term Life Insurance*.

Collective bargaining agreement. If your plan is maintained under a collective bargaining agreement, it is not treated as discriminatory.

Reporting requirements. If you, as an employer, maintain a cafeteria plan, you are required to keep complete records showing:

- 1) The number of your employees,
- 2) The number of your employees eligible to participate in your plan,
- 3) The number of your employees participating in the plan,
- 4) The total cost of your plan for the tax year,
- 5) Your name, address, and taxpayer identifying number (TIN), and
- 6) The type of business you are engaged in.

Also, an employer maintaining a cafeteria plan must file a Form 5500 after the plan year.

Generally, benefits excludable from gross income under a cafeteria plan are not subject to FICA or FUTA withholding.

6.

Retirement Plans

Important Change

New compensation limit. Compensation of a participant that can be taken into account for computing contributions to a Keogh or SEP plan is generally limited to \$150,000 for plan years beginning on or after January 1, 1994. See *Deduction Limits* under *Keogh Plans* for more information.

Topics

This chapter discusses:

- Qualified plans
- Kinds of qualified plans
- Plans for the self-employed
- Keogh plans
- Simplified employee pensions (SEPs)
- Salary reduction arrangements
- Nonqualified plans
- Individual retirement arrangements (IRAs)

Useful Items

You may want to see:

Publication

- 533** Self-Employment Tax
- 560** Retirement Plans for the Self-Employed
- 590** Individual Retirement Arrangements (IRAs)
- 937** Employment Taxes

Form (and Instructions)

- W-2** Wage and Tax Statement
- 5305-SEP** Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- 5305A-SEP** Salary Reduction and Other Elective Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- 5500-EZ** Annual Return of One-Participant (Owners and Their Spouses) Pension Benefit Plan

Retirement plans are savings plans that offer you tax advantages to set aside money for your own and your employees' retirement.

In general, **a sole proprietor or a partner is considered an employee** for purposes of participating in a retirement plan.

Funding the plan. A retirement plan can be funded entirely by employer contributions or by a mix of employer and employee contributions. Employee contributions may not satisfy the minimum funding requirements for your plan. Employee contributions can be mandatory or voluntary. For example, a retirement plan can require after-tax employee contributions that, by themselves, do not meet the minimum funding requirements.

Although they are considered **employer contributions**, a plan can allow your employees to make **elective deferrals**. This allows employees to elect to have you contribute part of their current compensation (pay) to a retirement plan. Only the remaining portion of their pay is currently taxable. The income tax on the contributed pay (and earnings on it) is **deferred**.

Employer contributions to an employer-sponsored retirement plan are generally deductible as discussed later under *Deduction Limits*.

Employer contributions that must be capitalized. You cannot currently deduct employer contributions to a retirement plan, or any other expenses, that you are required to capitalize (include in the basis of certain property or in inventory costs). See chapter 1.

Kinds of plans. Employer retirement plans are either:

- Qualified plans (includes retirement plans for the self-employed, such as H.R. 10 (Keogh) plans and simplified employee pensions (SEPs)), or
- Nonqualified plans.

Also, in general, individuals who work can set up and contribute to individual retirement arrangements (IRAs).

Qualified Plans

A qualified retirement plan is a written plan that you can establish for the exclusive benefit of your employees and their beneficiaries.

Contributions to the plan may be made by you, or by both you and your employees. If your plan meets the qualification requirements, you can generally deduct your contributions to the plan when you make them, except for any amount capitalized. For more information, get Publication 560.

Your employees generally are not taxed on your contributions or increases in the plan's assets until they are distributed to them. However, certain loans made from qualified employer plans are treated as taxable distributions. For more information, get Publication 575.

Qualification rules. To be a qualified plan, the plan must meet many requirements. Among these are rules concerning:

- Who must be covered by the plan,
- How contributions to the plan are to be invested,
- How contributions to the plan and benefits under the plan are to be determined, and
- How much of an employee's interest in the plan must be guaranteed (vested).

For more information, get Publication 560.

Nondiscrimination rules. To prevent discrimination in a plan caused by using separate businesses (and separate plans), all employees of certain related employers are treated as if employed by a single employer. For example, employees of commonly controlled businesses or affiliated service groups are treated as working for a single employer.

Kinds of Qualified Plans

There are two basic kinds of qualified retirement plans: defined contribution plans and defined benefit plans.

Defined Contribution Plans

These are plans that provide for a separate account for each person covered by the plan. Benefits are based only on amounts contributed to or allocated to each account.

There are **three types** of defined contribution plans: profit-sharing plans, stock bonus plans, and money purchase pension plans.

Profit-sharing plan. This is a plan that lets your employees or their beneficiaries share in the profits of your business. The plan must have a definite formula for allocating the contributions to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This plan is similar to a profit-sharing plan, but it can be set up only by

Table 6-1. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution	Time Limit to Begin Distributions ¹		
IRA	Due date of income tax return (NOT including extensions)	Smaller of \$2,000 or taxable compensation	April 1 of year after year you reach age 70½		
SEP-IRA	Due date of employer's return (Plus extensions)	Smaller of \$30,000 or 15% ² of participant's taxable compensation ³	April 1 of year after year you reach age 70½		
Keogh	Due date of employer's return (plus extensions). (To make contributions for a year to a new plan, the plan must be set up by the last day of the employer's tax year.)	<p style="text-align: center;">Defined Contribution Plans</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"> <p>Employee</p> <p>Money Purchase—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p>Profit-Sharing— Smaller of \$30,000 or 15% of employee's taxable compensation</p> </td> <td style="width: 50%; vertical-align: top;"> <p>Self-Employed Individual</p> <p>Money Purchase—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁴</p> <p>Profit-Sharing— Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁴</p> </td> </tr> </table> <p style="text-align: center;">Defined Benefit Plans</p> <p>Amount needed to provide an annual retirement benefit no larger than the smaller of \$118,800 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years</p>	<p>Employee</p> <p>Money Purchase—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p>Profit-Sharing— Smaller of \$30,000 or 15% of employee's taxable compensation</p>	<p>Self-Employed Individual</p> <p>Money Purchase—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁴</p> <p>Profit-Sharing— Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁴</p>	April 1 of year after year you reach age 70½ (unless the participant reached age 70½ before 1988, in which case the distributions must begin by the year he or she retires)
<p>Employee</p> <p>Money Purchase—Smaller of \$30,000 or 25% of employee's taxable compensation</p> <p>Profit-Sharing— Smaller of \$30,000 or 15% of employee's taxable compensation</p>	<p>Self-Employed Individual</p> <p>Money Purchase—Smaller of \$30,000 or 20% of self-employed participant's taxable compensation⁴</p> <p>Profit-Sharing— Smaller of \$30,000 or 13.0435% of self-employed participant's taxable compensation⁴</p>				

¹ Distributions of at least the required minimum amount must be made each year if the entire balance is not distributed.

² 13.0435% of the self-employed participant's taxable compensation before adjustment for this contribution.

³ Contributions are made to each participant's IRA (SEP-IRA) including that of any self-employed participant.

⁴ Compensation is before adjustment for this contribution.

a corporation. Benefits are payable in the form of the company's stock.

Money purchase pension plan. Under this plan, your contributions are a stated amount, or are based on a stated formula that is not subject to your discretion. For example, your formula could be 10% of each participating employee's compensation. Your contributions to the plan are not based on your profits.

Defined Benefit Plans

These are any plans that are not defined contribution plans. In general, a qualified defined benefit plan must provide for set benefits. Your contributions to the plan are based on actuarial assumptions. You may need continuing professional help to have a defined benefit plan.

Plan Approval

The Internal Revenue Service (IRS) will issue a determination or opinion letter regarding a plan's qualification. The determination or opinion of the IRS will be based on how the plan is written, not on how it operates.

You are not required to request a determination or opinion letter to get all the tax benefits of a plan. But, if your plan does not have a determination letter, you may want to request

one to ensure that your plan meets the requirements for tax benefits.

Because requesting a determination, opinion, or ruling letter can be complex, you may need professional help. Also, the IRS charges a fee for issuing these letters. For more information, get Publication 1380, *User Fees*.

Master and prototype plans. It may be easier for you to adopt an existing IRS-approved master or prototype retirement plan than to set up your own original plan. Master and prototype plans can be provided by the following sponsoring organizations:

- Trade or professional organizations,
- Banks (including some savings and loan associations and federally insured credit unions),
- Insurance companies, or
- Mutual funds.

Adoption of a master or prototype plan does not mean that your plan is automatically qualified. It must still meet all of the qualification requirements stated in the tax law.

Retirement Plans for the Self-Employed

If you are a self-employed person, you can set up certain qualified retirement plans. See *Qualified Plans*, earlier. These plans are generally called Keogh or HR-10 plans. You can also set up a less complicated tax-advantaged retirement plan. See *Simplified Employee Pension (SEP)*, later.

Keogh Plans

Only a sole proprietor or a partnership (but not a partner) can set up a Keogh plan. For plan purposes, a self-employed person is both an employer and an employee. It is not necessary to have employees besides yourself to set up a Keogh plan. The plan must be for the exclusive benefit of employees or their beneficiaries. You can generally deduct contributions to the plan. Contributions are not taxed to your employees until plan benefits are distributed to them.

Deduction Limits

The limits differ depending on the kind of Keogh plan you have. If your plan is a defined contribution plan, the limit for each employee generally is the lesser of \$30,000 or

- 15% of the employee's taxable compensation, if your plan is a profit-sharing plan, or
- 25% of the employee's taxable compensation if your plan is a money purchase pension plan.

The maximum compensation that can be taken into account for these limits is generally \$150,000 for plan years beginning in 1994.

Note: For employees in a collective bargaining unit covered by a plan for which the \$150,000 limit is not effective for the plan year beginning in 1994, the compensation limit is \$242,280.

The deduction limit for contributions to a defined benefit plan may be greater than the defined contribution plan limits just described, but actuarial calculations are needed to determine the amount. For more information, see *Kinds of Plans* in Publication 560.

Deduction of contributions for yourself. To take a deduction for employer contributions made for your benefit to a plan, you must have **net earnings** from the trade or business for which the plan was established.

Limit on deduction. If the Keogh plan is a **profit-sharing plan**, your deduction of employer contributions for yourself is limited to the smaller of \$30,000 or 13.0435% (15% reduced as discussed below) of your net earnings from the trade or business that has the plan. If the plan is a **money purchase pension plan**, the deduction is limited to the smaller of \$30,000 or 20% (25% reduced as discussed below) of your net earnings.

Net earnings. Your net earnings must be from self-employment in a trade or business where your personal services are a material income-producing factor. Therefore, if you are a partner who only contributed capital, and who did not perform personal services, you cannot participate in the partnership's plan. Your net earnings do not take into account tax-exempt income (or deductions related to that income) other than foreign earned income and foreign housing cost amounts.

Your net earnings is your business gross income minus allowable deductions from that business. Allowable deductions include contributions to the plan for your common-law employees along with your other business expenses. If you are a partner, other than a limited partner, your net earnings include your distributive share of the partnership income or loss (other than separately computed items such as capital gains and losses) and any guaranteed payments you receive from the partnership. If you are a limited partner, your net earnings include only guaranteed payments you receive for services rendered to or for the partnership. For more information, see *Partners* under *Self-Employment Income*, in Publication 533.

Adjustments. You must reduce your net earnings by the income tax deduction you are allowed for one-half of the self-employment tax. Also, net earnings must be reduced by the deduction for employer contributions made for

your benefit. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. To reduce net earnings by the employer deduction for contributions for yourself presents a problem. This is because the deduction and the net earnings depend on each other. You can make this adjustment to your net earnings indirectly by, in figuring your maximum deduction, reducing the contribution rate called for in the plan.

Figuring your deduction. Use the following worksheet to find the reduced contribution rate. Make no reduction to the contribution rate for any common-law employees.

Self-Employed Person's Rate Worksheet

- 1) Plan contribution rate as a decimal (for example, 10½% would be 0.105) _____
- 2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105) _____
- 3) Self-employed rate as a decimal (divide line 1 by line 2) _____

Now that you have your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps:

Self-Employed Person's Deduction Worksheet

- Step 1**
Enter the contribution rate shown in line 3 above _____
- Step 2**
Enter your net earnings from line 3, Schedule C-EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K-1 (Form 1065) \$ _____
- Step 3**
Enter your deduction for self-employment tax from line 25, Form 1040 \$ _____
- Step 4**
Subtract Step 3 from Step 2 and enter the result \$ _____
- Step 5**
Multiply Step 4 by Step 1 and enter the result \$ _____
- Step 6**
Multiply \$150,000 by your plan contribution rate. Enter the result but not more than \$30,000 \$ _____
- Step 7**
Enter the smaller of Step 5 or Step 6. This is your **maximum deductible contribution**. Enter your deduction on Line 27, Form 1040. \$ _____

Example. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, and 10½% of your common-law employees' compensation. Your net earnings from Line 31, Schedule C (Form 1040) is \$200,000. In figuring this amount, you deducted your common-law employees' pay of

\$100,000 and contributions for them of \$10,500 (10½% x \$100,000). You figure your self-employed rate and maximum deduction for employer contributions for your benefit as follows:

Self-Employed Person's Rate Worksheet

- 1) Plan contribution rate as a decimal (for example, 10½% would be 0.105) _____ 0.105
- 2) Rate in line 1 plus one, (for example, 0.105 plus one would be 1.105) _____ 1.105
- 3) Self-employed rate as a decimal (divide line 1 by line 2) _____ 0.0950

Self-Employed Person's Deduction Worksheet

Step 1

Enter the contribution rate shown in line 3 above 0.0950

Step 2

Enter your net earnings from line 3, Schedule C-EZ (Form 1040), line 31, Schedule C (Form 1040), or line 36, Schedule F (Form 1040), or line 15a, Schedule K-1 (Form 1065) \$200,000

Step 3

Enter your deduction for self-employment tax from line 25, Form 1040 \$ 6,435

Step 4

Subtract Step 3 from Step 2 and enter the result \$193,565

Step 5

Multiply Step 4 by Step 1 and enter the result \$ 18,389

Step 6

Multiply \$150,000 by your plan contribution rate. Enter the result but not more than \$30,000 \$ 15,750

Step 7

Enter the smaller of Step 5 or Step 6. This is your **maximum deductible contribution**. Enter your deduction on Line 27, Form 1040. \$ 15,750

When to make contributions. To take a deduction for contributions for a particular year, you must make the contributions not later than the due date (plus extensions) of your return for that year.

Additional information on retirement plans for the self-employed and on the reporting forms that must be filed for these plans can be found in Publication 560.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make deductible contributions toward your own and your employees' retirement, without getting involved in more complex retirement plans. A corporation also can have a SEP and make deductible

contributions toward its employees' retirement. But some advantages available to Keogh and other qualified plans, such as the special averaging treatment that may apply to lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to an individual retirement arrangement (called a SEP-IRA in this chapter), which is owned by you or your common-law employee.

SEP-IRAs are set up for, at a minimum, each **qualifying employee**. A SEP-IRA may have to be set up for a **leased employee**, but need not be set up for an **excludable employee**. For more information, get Publication 560.

You may be able to use **Form 5305-SEP** in setting up your SEP. See the Form 5305-SEP sample at Table 6-2.

Employer contributions. You can contribute each year to each employee's SEP-IRA up to the smaller of \$30,000 or 15% of the employee's **compensation** (determined without regard to your contributions to the employee's SEP-IRA). If you are self-employed, SEP contributions you make to **your SEP-IRA**, because a special computation is required, are limited to 13.0435% of your compensation. See *Figuring your deduction under Retirement Plans for the Self-Employed*, earlier. Make no reduction to the contribution rate for any common-law employees.

Your contributions are not included in a participant's income when contributed.

Your employees cannot take a deduction for your SEP contribution.

SEP and profit-sharing plans. If you also contributed to a qualified profit-sharing plan, you must reduce the 15% deductible limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in the profit-sharing plan.

SEP and other qualified plans. If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing plan for purposes of applying the overall 25% deduction limit described in section 404(h) of the Internal Revenue Code.

Employee contributions. Participants can also make contributions of up to \$2,000 to their SEP-IRAs independent of your SEP contributions. The portion of the contributions that is deductible may be reduced or eliminated because the participant is covered by an employer retirement plan (the SEP plan). See Publication 590 for details.

Salary Reduction Arrangement

A SEP can include a salary reduction (elective deferral) arrangement. Under the arrangement, employees can elect to have you contribute part of their pay to their SEP-IRAs. The tax on the part contributed is deferred. This choice is called an elective deferral. This election is available only if:

- At least 50% of your employees eligible to participate choose the salary reduction arrangement,

- You had no more than 25 employees who were eligible to participate in the SEP (or would have been eligible to participate if you had maintained a SEP) at any time during the preceding year, and
- The deferral each year by each eligible **highly compensated employee** (as defined in Publication 560) as a percentage of pay (deferral percentage) is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate (the **ADP test**). For plan years beginning in 1994, you generally cannot consider compensation of an employee in excess of \$150,000 in figuring an employee's deferral percentage.

Note. For employees in a collective bargaining unit covered by a SEP for which the \$150,000 limit is not effective, the compensation limit is \$242,280.

Limits on deferrals. In general, the total income an employee can defer under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1994 is limited to \$9,240. This limit applies only to the amounts that represent a reduction from the employee's pay, not to any contributions from employer funds.

Employment taxes. Elective deferrals, not exceeding the ADP test, are not subject to income tax in the year of deferral, but are included in wages for social security, Medicare, and unemployment (FUTA) tax purposes.

Reporting SEP contributions on Form W-2

Your SEP contributions are excluded from your employees' income. Therefore, unless there are contributions in excess of the applicable limit, or unless there are contributions under a salary reduction arrangement, do not include these contributions in your employees' wages on Form W-2, for income, social security, or Medicare tax purposes. Your SEP contributions **under a salary reduction arrangement** are included in your employees' Form W-2 wages for social security and Medicare tax purposes only.

Example. In 1994, Jim chooses to have \$4,500 taken out of his pay to fund employer contributions to his SEP-IRA. His compensation for the year is \$30,000. On Jim's Form W-2, his employer will show total wages of \$25,500 (\$30,000 minus \$4,500) for income tax and \$30,000 for social security and Medicare wages. Jim will report \$25,500 as wages on his tax return.

For more information on employer withholding requirements, get Publication 937.

For more information on SEPs, get Publication 560.

Nonqualified Plans

You can deduct contributions made to a non-exempt trust or premiums paid under a non-qualified annuity plan. Your employees generally must include the contributions or premiums in their gross income.

Deduct your contributions to the plan in the tax year in which any of your employees must include an amount attributable to the contributions in their gross income. You can deduct contributions only if you maintain separate accounts for each participating employee.

Transferable interest. When an employee's interest in your contributions or premiums for that employee is transferable, the employee must include those amounts in gross income for the tax year in which you make them. This rule also applies if the employee's interest is not subject to a substantial risk of forfeiture (that is, there is not much of a risk that the employee will lose his or her interest) when you make contributions or pay premiums for that employee.

Nontransferable interest. If, when you make the contributions, the employee's interest in the trust or in the value of the annuity contract is not transferable and is subject to a substantial risk of forfeiture, the employee does not include that interest in gross income until the tax year in which the interest becomes transferable or is no longer subject to a substantial risk of forfeiture.

Individual Retirement Arrangements (IRAs)

You can set up and make contributions to an individual retirement arrangement (IRA) if you received taxable **compensation** during the year and have not reached age 70½ by the end of the year. You can have an IRA whether or not you are covered by any other retirement plan. However, you may not be able to deduct any or some of your contributions if you or your spouse is covered by an employer's retirement plan.

Compensation. Compensation includes taxable wages, salaries, commissions, bonuses, tips, professional fees, self-employment income (subject to certain adjustments, discussed below, and providing your personal services are a material income-producing factor), other amounts received for personal services, and taxable alimony and separate maintenance payments.

If you are an employee, compensation includes any amount properly shown in Box 1 (wages, tips, other compensation) of Form W-2, provided that amount is reduced by any amount shown in Box 11 (nonqualified plans).

If you are self-employed (a sole proprietor or partner), compensation is the net earnings of your trade or business (self-employment income) reduced by the deduction for contributions on your behalf to retirement

plans and the deduction allowed for one-half of your self-employment tax.

Compensation does not include:

- Income received from property, such as rental, interest, or dividend income, or
- Any amounts received as a pension or annuity, or as deferred compensation.

Foreign income. Foreign earned income and other amounts that are excluded from gross income are **not** compensation for IRA purposes.

Contributions. The most you can contribute for any year to your IRA is the **smaller** of:

- \$2,000, or
- Your taxable compensation.

Deductible and nondeductible contributions. Generally, you can take a deduction for the contributions you are allowed to make to your IRA. However, if you or your spouse is covered by an employer retirement plan at any time during the year, your IRA deduction may be reduced or eliminated, depending on your filing status and the amount of your income. Whether or not your allowable contributions are deductible, you can choose to make nondeductible contributions to your IRA. For details on these and other rules, as well as general information on IRAs, get Publication 590.

7. Rent Expense

Topics

This chapter discusses:

- The definition of rent
- Taxes on leased property
- The cost of acquiring a lease
- Improvements by the lessee
- Capitalizing rent expenses

Useful Items

You may want to see:

Publication

- 334** Tax Guide for Small Business
- 534** Depreciation
- 538** Accounting Periods and Methods
- 946** How To Begin Depreciating Your Property

If you lease property for use in your business, you generally can deduct the rent you pay. You can also deduct certain other expenses as rent. If you lease a car for use in

your business, see *Leasing a Car* in Publication 917. If you lease business property and incur a casualty loss on the leased property, see Chapter 26 in Publication 334.

Rent

Rent is any amount you pay for the use of property that you do not own. In general, you can deduct rent as an expense only if the rent is for property that you use in your trade or business. If you have or will receive equity in or title to the property, the rent is not deductible.

Unreasonable rent. You cannot take a rental deduction for rents that are unreasonable. Ordinarily, the issue of reasonableness of the rent will not arise unless you and the lessor are related. Rent paid to a related party is reasonable if it is the same amount that would be paid to a stranger for use of the same property. A percentage rental is reasonable if the rental paid is reasonable. For a definition of related taxpayers, see Chapter 2.

Rent on a personal residence. If you rent rather than own a home and use part of your home as your place of business, you may be able to deduct the rent you pay for that part, if you meet the requirements for business use of your home. For more information, see *Use Tests* in Publication 587.

Rent paid in advance. Generally, rent paid in connection with your trade or business is deductible in the year paid or accrued. If you pay rent in advance, you can deduct only the amount that applies to your use of the rented property during the tax year. The balance of your payment can be deducted only over the period to which it applies.

Example 1. In May 1994, you leased a building for 5 years beginning July 1, 1994, and ending June 30, 1999. According to the terms of the lease, your rent is \$12,000 per year. You paid the first year's rent (\$12,000) on June 30, 1994. On your income tax return for calendar year 1994, you can deduct only \$6,000 ($6/12 \times \$12,000$) for the rent applicable to 1994.

Example 2. In January 1994, you leased property for 3 years for \$6,000 a year. You paid the full \$18,000 ($3 \times \$6,000$) during the first year of the lease. For 1994, you can deduct only \$6,000, the part of the rent that applies to 1994. You can deduct the balance (\$12,000) over the remaining 2-year term of the lease at \$6,000 each year.

Lease or purchase. There may be instances where it is necessary to determine whether your payments are for rent or for the purchase of the property. You must first determine whether your agreement is a lease or a conditional sales contract. If, under the agreement, you acquired or will acquire title to or equity in the property, the agreement should be treated as a conditional sales contract. Payments made under a conditional sales contract are not deductible as rent expense.

Whether the agreement is a conditional sales contract depends upon the **intent of the parties**. Intent is determined based upon the facts and circumstances existing at the time the agreement is made.

Determining the intent. In general, an agreement is considered a conditional sales contract rather than a lease if any of the following is true:

- 1) The agreement applies part of each payment toward an equity interest that you will receive.
- 2) You get title to the property upon the payment of a stated amount required under the contract.
- 3) The amount you pay to use the property for a short period of time is a large part of the amount you would pay to get title to the property.
- 4) You pay much more than the current fair rental value for the property.
- 5) You have an option to buy the property at a nominal price compared to the value of the property at the time you may take advantage of the option. Determine this value at the time of the agreement.
- 6) You have an option to buy the property at a nominal price compared to the total amount you are required to pay under the lease.
- 7) The lease designates some part of the payments as interest, or part of the payments are easy to recognize as interest.

Leveraged leases. These transactions may be considered leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually the lease covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender.

If you plan to take part in what appears to be a leveraged lease, you may want to get an advance ruling. The following Revenue Procedures contain the guidelines to determine whether a leveraged lease is a lease for federal income tax purposes.

Revenue Procedure 75-21, 1975-1 C.B. 715

Revenue Procedure 75-28, 1975-1 C.B. 752

Revenue Procedure 76-30, 1976-2 C.B. 647

Revenue Procedure 79-48, 1979-2 C.B. 529

In general, the Revenue Procedures provide that, for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction to be a valid lease if all of the following apply:

- 1) The lessor must risk a minimum unconditional investment in the property (at least 20%) during the entire lease;
- 2) The lessee may not have a contractual right to buy the property from the lessor at

less than fair market value at the time the right is exercised;

- 3) The lessee may not invest in the property, except as provided by Revenue Procedure 79-48;
- 4) The lessee may not lend any money to the lessor to buy the property; and
- 5) The lessor must have a profit motive apart from the tax deductions, allowances, credits, and other tax attributes.

The IRS will charge you a **user fee** for issuing a tax ruling. See Publication 1380 for more information.

Leveraged leases of limited-use property. The IRS will not issue advance rulings on leveraged leases of so-called limited-use property. Limited-use property is property not expected to be either useful to or usable by a lessor at the end of the lease term except for continued leasing or transfer to a member of the lessee group. See Revenue Procedure 76-30 for examples of limited-use property and property that is not limited-use property.

Leases over \$250,000. Special rules are provided for certain leases of tangible property. The rules apply if the lease calls for total payments of more than \$250,000, and:

- 1) Rents are payable after the close of the calendar year following the year the use occurs, or
- 2) Rents are either increasing or decreasing during the lease.

Generally, if these conditions are met, you must accrue rents and impute interest on any unpaid rents for prior tax years. The accrual must be stated in the lease terms. Any rent that is to be paid after the end of the lease is valued using the present value concept. For certain tax avoidance transactions, rents are valued based on a constant rental accrual. See IRC section 467 for more information.

Taxes on Leased Property

If you lease business property, you can deduct as additional rent any taxes that you have to pay to or for the lessor. When you can deduct these taxes as additional rent depends on your accounting method.

Cash method. If you use the cash method of accounting, you can only deduct the taxes as additional rent for the tax year in which you pay them.

Accrual method. If you use an accrual method of accounting, you can deduct taxes as additional rent for the tax year in which you can determine:

- 1) That you have a liability for taxes on the leased property,
- 2) How much the liability is, and
- 3) That economic performance occurred.

The liability and amount of taxes are determined by state or local law and also by the lease agreement. Economic performance occurs as you use the property.

Example. Oak Corporation is a calendar year taxpayer that uses an accrual method of accounting. Oak leases land for use in its business. Under local law, owners of real property become liable (incur a lien on the property) for real estate taxes for the year on January 1 of that year, but do not have to pay these taxes until July 1 of the next year (18 months later). This means that property owners become liable for 1994 real estate taxes on January 1, 1994, but do not have to pay them until July 1, 1995.

Under the terms of the lease, Oak becomes liable for the real estate taxes when the tax bills are issued on July 1, 1995. Oak cannot deduct the real estate taxes for 1994 as additional rent until July 1, 1995. This is when Oak's liability under the lease becomes fixed.

If, according to the terms of the lease, Oak is liable for the real estate taxes when the owner of the property becomes liable for them, on January 1, 1994, but does not have to pay them until July 1, 1995, Oak will deduct the lessor's real estate taxes as additional rent on its 1994 tax return. This is the year in which Oak's liability under the lease becomes fixed.

Cost of Acquiring a Lease

You may either enter into a new lease with the lessor of the property or acquire an existing lease from another lessee. Very often when you acquire an existing lease from another lessee, in addition to paying the rent on the lease, you must pay the previous lessee a sum of money to acquire that lease.

If you acquire an existing lease on property or equipment for your business, you must amortize any amount you pay to acquire that lease over the remaining term of the lease. For example, if you pay \$10,000 to acquire an existing lease on a machine and there are 10 years remaining on the lease with no option to renew, you can deduct \$1,000 each year.

The cost of acquiring a lease is not subject to the amortization rules on section 197 intangibles, discussed in Chapter 12.

Option to renew. The term of the lease for amortization will include all renewal options (as well as any period for which the lessee and lessor reasonably expect the lease to be renewed), if less than 75% of the cost is attributable to the term remaining on the purchase date. In determining the term of the lease remaining on the purchase date, you do not include any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee. Generally, allocation of the lease cost to the original term and any option term is based on the facts and circumstances. This allocation can be made using a present value computation. For more information, see section 1.178-1(b)(5) of the Income Tax Regulations.

Example 1. You paid \$10,000 to acquire a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, \$7,000 was paid for the original lease and \$3,000 was applied to the renewal options. Since \$7,000 is less than 75% of the total cost of the lease of \$10,000, you must amortize the \$10,000 over 30 years, the remaining life of your present lease plus the periods for renewal.

Example 2. If in Example 1, the amount applicable to the original lease had been \$8,000, then you would have been allowed to amortize the entire \$10,000 over the 20-year remaining life of the original lease because the \$8,000 cost of acquiring the original lease was not less than 75% of the total cost of the lease.

Cost of a modification agreement. If you have to pay an additional "rent" amount over part of the lease period in order to change certain provisions in your lease, you must capitalize these payments and amortize them over the remaining period of the lease. You cannot deduct the payments as additional rent, even if they are described as rent in the agreement.

Example. You are a calendar year taxpayer and sign a 20-year lease to rent part of a building starting on January 1. However, before you occupy it, you decide that you really need less space. The lessor agrees to reduce your rent from \$7,000 to \$6,000 per year and to release the excess space from the original lease. In exchange, you agree to pay an additional rent amount of \$3,000, payable in 60 monthly installments of \$50 each.

You must capitalize the \$3,000 and amortize it over the 20-year term of the lease. Your amortization deduction each year will be \$150 ($\$3,000 \div 20$). You cannot deduct the \$600 that you will actually pay during each of the first 5 years as rent.

Commissions, bonuses, and fees. Commissions, bonuses, fees, and other amounts that you pay to obtain a lease on property you use in your business are capital costs. You must amortize these costs over the term of the lease.

Loss on merchandise and fixtures. If you sell at a loss merchandise and fixtures that you bought solely to acquire a lease, the loss is a cost of acquiring the lease. You must capitalize the loss and amortize it over the remaining term of the lease.

Improvements by Lessee

If you add buildings or make other permanent improvements to leased property, you depreciate the cost of the improvements using the modified accelerated cost recovery system (MACRS). The property is depreciated over its appropriate recovery period. You are not allowed to amortize the cost over the remaining term of the lease.

If you do not keep the improvements when the lease is terminated, your gain or loss is

based on your adjusted basis of the improvements at that time.

For more information, see the discussion of MACRS in Publication 946.

Assignment of a lease. If a long-term lessee makes permanent improvements to leased land and later assigns all lease rights to you for money, and you pay the rent required by the lease, the amount you pay for the assignment is a capital investment. If the rental value of the leased land increased since the lease began, part of your capital investment is for that increase in the rental value, and the balance is for your investment in the permanent improvements.

The part that is for the increased rental value of the leased land is a cost of acquiring a lease and you amortize it over the remaining term of the lease. You can depreciate the part that is for your investment in the improvements as discussed earlier.

Capitalizing Rent Expenses

Under the uniform capitalization rules, you are required to capitalize direct costs and an allocable part of most indirect costs that benefit or are incurred because of production or resale activities.

You are subject to the uniform capitalization rules if you:

- 1) Produce real or tangible personal property for use in a trade or business or an activity engaged in for profit,
- 2) Produce real or tangible personal property for sale to customers, or
- 3) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts are not more than \$10 million.

Indirect costs include amounts incurred for rent of equipment, facilities, or land.

Example 1. You rent construction equipment to build a storage facility. The rent you paid for the equipment must be capitalized as part of the cost of the building. You recover your cost by claiming a deduction for depreciation on the building.

Example 2. You rent space in a facility to conduct your business of manufacturing tools. The rent you paid to occupy the facility must be included in the cost of the tools you produce.

More information. For more information, see *Uniform Capitalization Rules* in Publication 538.

8.

Interest

Important Change for 1994

Refunds of interest shown on Form 1098. Form 1098, *Mortgage Interest Statement*, has been revised for 1994. Box 3 of the form will show any refunds for overpayment(s) of interest you made in a prior year or years. See *Mortgages*, later in this chapter.

Topics

This chapter discusses:

- Allocation of interest
- Interest you can deduct
- Interest you cannot deduct
- Interest capitalization
- When to deduct interest
- Below-market interest rate loans

Useful Items

You may want to see:

Publication

- 537** Installment Sales
- 538** Accounting Periods and Methods
- 550** Investment Income and Expenses
- 936** Home Mortgage Interest Deduction

Form (and Instructions)

- Sch A (Form 1040)** Itemized Deductions
- Sch E** Supplemental Income and Loss
- Sch K-1 (Form 1065)** Partner's Share of Income, Credits, Deductions, etc.
- Sch K-1 (Form 1120S)** Shareholder's Share of Income, Credits, Deductions, etc.
- 1098** Mortgage Interest Statement
- 3115** Application for Change in Accounting Method
- 4952** Investment Interest Expense Deduction
- 8582** Passive Activity Loss Limitations

Interest is the amount you pay for the use of borrowed money. You can generally deduct all interest you pay or accrue during the tax year on debts related to your trade or business. (However, see *Interest Capitalization*, discussed later.) Special rules apply if you have a loan on which the interest rate is less than the applicable federal rate. See *Below-Market Interest Rate Loans*, later.

To deduct the interest paid, you must be liable for its payment. For example, you cannot deduct on your individual return interest paid on a corporation's debt.

Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), allocate the interest on the loan to each use. However, qualified home mortgage interest is fully deductible regardless of how the funds are used. For more information on home mortgage interest, see Publication 936.

The best way to allocate interest is to keep the proceeds of a particular loan separate from any other funds. You can treat an expenditure made from any account (or in cash) within 30 days before or after the debt proceeds are deposited (or received in cash) as being made from such debt proceeds.

In general, the interest on a loan is allocated in the same way as the loan itself is allocated. This is true even if the funds are paid directly to a third party. You allocate loans by tracing disbursements to specific uses. If you must allocate your interest expense, use the following categories:

- 1) Trade or business interest.
- 2) Passive activity interest.
- 3) Investment interest.
- 4) Personal interest.
- 5) Portfolio expenditure interest.

Allocation based on use of loan's proceeds. You allocate interest on a loan the same way as the loan is allocated. Loan proceeds and the related interest are allocated by the use of the proceeds. The allocation is not affected by the use of property that secures the loan.

Example. You secure a loan with property used in your business. You use the loan proceeds to buy an automobile for personal use. You must allocate interest expense on the loan to personal use (purchase of the automobile) even though the loan is secured by business property.

Allocation period. The period a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the date the loan is:

- 1) Repaid, or
- 2) Reallocated to another use.

Proceeds not disbursed to borrower. Even if the lender pays the loan proceeds to a third party, the allocation of the loan is still based on the use of the funds. This applies if you pay for property, services, or anything else by incurring a loan, or if you take property subject to a debt.

Proceeds deposited in borrower's account. Loan proceeds deposited in an account are treated as property held for investment. It does not matter whether or not the account pays interest. Any interest you pay on the loan is investment interest expense. If the proceeds of the loan are withdrawn, the loan must be reallocated based on the use of the funds.

Example. Connie, a calendar-year taxpayer, borrows \$100,000 on January 4 and immediately uses the proceeds to open a checking account that pays no interest. No other amounts are deposited in the account during the year, and no part of the loan principal is repaid during the year. On April 1, Connie uses \$20,000 from the checking account for a passive activity expenditure. On September 1, Connie uses an additional \$40,000 from the account for a personal expenditure.

Under the interest allocation rules, the entire \$100,000 loan is allocated to an investment expenditure for the period of January 4 through March 31. From April 1 through August 31, Connie must allocate \$20,000 of the loan to the passive activity expenditure, and \$80,000 of the loan to the investment expenditure. From September 1 through December 31, she must allocate \$40,000 of the loan to the personal expenditure, \$20,000 to the passive activity expenditure, and \$40,000 to the investment expenditure.

Order of funds spent. Generally, loan proceeds deposited in an account are treated as used (spent) **before**:

- 1) Any unborrowed amounts held in the same account, and
- 2) Any amounts deposited after these loan proceeds.

Example. On January 11, Edith opened a checking account, depositing \$500 of the proceeds of Loan A and \$1,000 of unborrowed funds. The following table shows the transactions in her account during the tax year.

Date	Transaction
January 11	\$500 proceeds of Loan A and \$1,000 unborrowed funds deposited
January 13	\$500 proceeds of Loan B deposited
February 18	\$800 used for personal expenditure
February 26	\$700 used for passive activity
June 22	\$1,000 proceeds of Loan C deposited
November 23	\$800 used for an investment
December 21	\$600 used for personal expenditure

Edith treats the \$800 used for a personal reason as made from the \$500 proceeds of Loan A and \$300 of the proceeds of Loan B. She treats the \$700 used for a passive activity as made from the remaining \$200 proceeds of Loan B and \$500 of unborrowed funds. She treats the \$800 used for an investment as made entirely from the proceeds of Loan C.

Edith treats the \$600 used for a personal expenditure as made from the remaining \$200 proceeds of Loan C and \$400 of unborrowed funds. Note that for the periods during which loan proceeds are held in the account, the loan is allocated to an investment expenditure.

Expenditures paid from checking accounts. Generally, an expense paid from a checking or similar account is treated as made at the time the check is written. The check must be mailed to the payee within a reasonable period. You can treat checks written on the same day as written in any order.

Expenses paid within 30 days. You can allocate loan proceeds to expenses paid from

any account (or from cash) as long as the expenses were paid within 30 days before or after the loan proceeds are deposited. This rule applies regardless of the allocation rules mentioned earlier. It does not matter that you do not use the actual proceeds of the loan to pay the expense.

Optional method for determining date of reallocation. You can use the following method to determine the date loan proceeds are reallocated to another use. You can treat all expenses paid from loan proceeds in the account during any month as taking place on the **later of**:

- 1) The first day of that month, or
- 2) The date the loan proceeds are deposited in the account.

However, you can use this optional method only if you treat all expenses paid from the account during the same calendar month in the same way.

Interest on a separate account. If you have an account that contains only loan proceeds and interest earned on the account, you can treat any expense paid from that account as being paid first from the interest. When the interest earned is used up, then apply the expense to the loan proceeds.

Example. In April you borrowed \$20,000 and used the proceeds of this loan to open a new savings account. The account earned interest of \$867 during the year. Interest paid on the loan proceeds is investment interest.

If you withdraw \$20,000 from the savings account for personal purposes, you can treat the \$20,000 as coming first from the interest, \$867, and then from the loan proceeds, \$19,133 (\$20,000 – \$867). Interest paid on the \$19,133 would be allocated to personal interest. Interest paid on the balance in the account, \$867, would be allocated to investment interest.

Loan proceeds received in cash. If you receive the proceeds of a loan in cash, you can treat any expenditure, up to the amount of the loan, as being paid from the loan's proceeds. This only applies to an expenditure you make within **30 days** before or after you receive the proceeds of the loan. The expenditure can be made from any account or from cash. Also, you can treat the expenditure as made on the date you received the cash. Otherwise, loan proceeds you receive in cash are treated as personal loans.

Example. Frank gets a loan of \$1,000 on August 4 and receives the proceeds in cash. Frank deposits \$1,500 in an account on August 17 and on August 27 writes a check on the account for a passive activity expense. Also, Frank deposits his paycheck, deposits other loan proceeds, and pays his bills during the same period. Regardless of these other transactions, Frank may treat \$1,000 of the deposit he made on August 17 as being paid from the loan proceeds on August 4. In addition, Frank may treat the passive activity expense he paid on August 27 as made from the \$1,000 loan proceeds treated as deposited in the account.

Loan repayments. When any part of a loan allocated to more than one use is repaid, the loan is treated as being repaid in the following order:

- 1) Amounts allocated to personal use.
- 2) Amounts allocated to investments and passive activities (other than those included in (3) below).
- 3) Amounts allocated to passive activities in connection with a rental real estate activity in which you actively participate.
- 4) Amounts allocated to former passive activities.
- 5) Amounts allocated to trade or business use and to expenses for certain low-income housing projects.

Continuous borrowings. If you have a line of credit or similar arrangement that allows you to borrow funds periodically under a single loan agreement, the following rules apply:

- 1) All borrowings on which interest accrues at the same fixed or variable rate are treated as a single loan, and
- 2) Borrowings or parts of borrowings on which interest accrues at different fixed or variable rates are treated as different loans. These loans are treated as repaid in the order in which they are treated as repaid under the loan agreement.

Loan refinancing. The replacement loan is allocated to the same expenses as the repaid loan. This is true only to the extent the proceeds of the new loan are used to repay any part of the original loan.

Partnerships and S Corporations

Special rules apply to the allocation of interest expense in connection with debt-financed acquisitions of, and distributions from, partnerships and S corporations. These rules do not apply if the partnership or S corporation is formed or used for the principal purpose of avoiding the interest allocation rules.

Debt-financed acquisitions. This is the use of loan proceeds to purchase an interest in an entity or to make a contribution to the capital of the entity. If you purchase an interest in an entity, allocate the loan proceeds and the interest expense among all the assets of the entity. The allocation can be based on the fair market value, book value, or adjusted basis of the assets, reduced by any debts allocated to the assets.

If you contribute to the capital of an entity, make the allocation based on the assets or by tracing the loan proceeds to the entity's expenditures. A purchase of an interest in an entity is treated as a contribution to capital to the extent the entity receives any proceeds of the purchases.

Example. You purchase an interest in a partnership for \$20,000 using borrowed funds. The partnership's only assets include machinery used in its business valued at \$60,000 and

stocks valued at \$15,000. You allocate the loan proceeds based on the value of the assets. Therefore, \$16,000 of the loan proceeds (\$60,000/\$75,000 × \$20,000) and the interest expense on that part are allocated to trade or business use. \$4,000 (\$15,000/\$75,000 × \$20,000) and the interest on that part are allocated to investment use.

Reallocation. If you allocate the loan proceeds among the assets, you must make a reallocation if the assets or the use of the assets change.

How to report. Individuals should report the interest expense either on Schedule A or Schedule E of Form 1040 depending on the type of asset (or expenditure if the allocation is based on the tracing of loan proceeds) to which the interest expense is allocated.

For interest allocated to trade or business assets (or expenditures), report the interest in Part II, Schedule E (Form 1040). On a separate line, put "business interest" and the name of the entity in column (a) and the amount in column (i).

For passive activity use, enter the interest on Form 8582 as a deduction from the passive activity of the entity. Show any deductible amount in Part II, Schedule E (Form 1040). On a separate line, put "passive interest" and the name of the entity in column (a) and the amount in column (g).

For investment use, enter the interest on Form 4952. Carry any deductible amount attributable to royalties to Part II, Schedule E (Form 1040). On a separate line enter "investment interest" and the name of the entity in column (a) and the amount in column (i). Carry the balance to line 13, Schedule A (Form 1040).

Any interest allocated to a personal expenditure is treated as personal interest which is not deductible. Personal interest is all interest other than:

- 1) Interest on a trade or business debt,
- 2) Investment interest,
- 3) Passive activity interest,
- 4) Qualified residence interest, or
- 5) Interest on certain deferred estate tax payments.

A personal expenditure is an expenditure that is not incurred in connection with your trade or business, passive activity, or investment activity.

Debt-financed distributions. Generally, if the entity borrows funds the general allocation rules discussed earlier in this section apply. If those funds are allocated to distributions made to partners or shareholders, the distributed loan proceeds and related interest expense must be reported to the partners and shareholders separately. This is because the loan proceeds and the interest expense must be allocated depending on how the partner or shareholder uses the proceeds. For example, if a shareholder uses distributed loan proceeds to invest in a passive activity, that shareholder's portion of the entity's interest

expense on the loan proceeds is allocated to a passive activity use.

Optional method. The entity may choose to allocate the distributed loan proceeds to other expenditures it makes during the tax year of the distribution. This allocation is limited to the amount of the other expenditures less any loan proceeds already allocated to them. For any distributed loan proceeds that are more than the amount allocated to the other expenditures, the rules in the previous paragraph apply.

How to report. If the entity does not use the optional method, it reports the interest expense on the loan proceeds on the line on Schedule K-1 (Form 1065 or Form 1120S) for "Other deductions." The expense is identified on an attached schedule as "Interest expense allocated to debt-financed distributions." The partner or shareholder claims the interest expense depending on how the distribution was used.

If the entity uses the optional method, it reports the interest expense on the loan proceeds allocated to other expenditures on the appropriate line or lines of Schedule K-1. For example, if the entity chooses to allocate the loan proceeds and related interest to a rental activity expenditure, the entity will take the interest into account in figuring the net rental income or loss reported on Schedule K-1.

More information. For more information on allocating and reporting these interest expenses, see Notice 88-37, 1988-1 C.B. 522, and Notice 89-35, 1989-1 C.B. 675, which are available at most IRS offices.

Interest You Can Deduct

Generally, the amount agreed upon by the lender and the borrower as interest can be deducted when paid or accrued, unless the interest must be capitalized, or if personal, is subject to certain limits. Both parties must intend that the loan will be repaid.

Insurance contracts. If you borrow on your life insurance, endowment, or annuity contract and use the proceeds for business purposes, you can take a business interest deduction. (However, you cannot deduct the interest if you are required to capitalize it.) If you use the proceeds for a nonbusiness purpose, you cannot deduct the interest. Personal interest is not deductible.

For loans under life insurance policies purchased after June 20, 1986, no interest deduction is allowed to the extent total loans on policies covering an officer, employee, or individual financially interested in your trade or business are more than \$50,000.

Mortgages. Monthly mortgage payments are usually made up of principal and interest. You can deduct only the interest unless you are required to capitalize it. If you paid mortgage interest of \$600 or more during the year on any one mortgage to a mortgage holder (including

a financial institution, a governmental unit, or a cooperative housing corporation) in the course of that holder's trade or business, you will receive Form 1098 or a similar statement.

In addition, if you receive a refund of interest you overpaid in an earlier year, this amount will be reported on box 3 of Form 1098. You **cannot deduct** this amount. For information on how to report this refund, see *Refunds of interest*, later in this chapter.

Prepayment penalty. If you pay off your mortgage early and pay the lender a penalty for doing this, you can deduct the penalty as interest.

Points. The term "points" is often used to describe some of the charges paid by a borrower when the borrower takes out a loan or a mortgage. These charges are also called **loan origination fees**, maximum loan charges, or premium charges. If any of these charges is solely for the use of money, it is interest.

These points are interest paid in advance and you cannot deduct it all in one tax year. Instead, you deduct part of the interest each tax year during the period of the loan, unless the interest must be capitalized.

To figure how much to deduct each year, divide the part of the loan period falling within your tax year by the total loan period. Then multiply this answer by the amount of prepaid interest. For example, if you take out a 10-year loan on October 1, 1994, 3 months of the loan period fall in your 1994 tax year. You can deduct 3/120 of the payment you made for the points on your 1994 tax return. You can deduct 12/120 of the prepaid interest on your 1995 tax return.

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. If the property mortgaged is business or income-producing property, you can amortize the costs over the life of the mortgage.

Partial liability. If you are liable for part of a business debt, you can deduct only your share of the total interest paid or accrued.

Example. You and your brother borrow money. You are liable for 50% of the note. You use your half of the loan in your business, and you make one-half of the loan payments. You can deduct your half of the total interest payments as a business deduction.

Partial payments on a nontax debt. If you make partial payments on a debt (other than a debt owed IRS), the payments, in the absence of an agreement between you and the lender, are applied first to interest and any remainder to principal. You can deduct only the interest.

Unstated interest. If you make payments on an installment purchase on which no interest or low interest is charged, part of the payment is considered unstated interest. Both the buyer and the seller must treat a part of each installment sale payment as interest. For the most part, this interest will be stated in the sales

agreement. For more information on unstated interest, see Publication 537.

The holder of any debt instrument having original issue discount (OID) that is issued after July 1, 1982, must generally include in gross income (as interest) an amount equal to the sum of the daily portions of the OID for each day during the tax year in which the holder held the debt instrument. This rule does not apply to:

- 1) Any holder who purchased the debt instrument at a premium,
- 2) A life insurance company,
- 3) Tax-exempt obligations,
- 4) United States savings bonds,
- 5) Short-term obligations,
- 6) Obligations issued by natural persons before March 2, 1984, and
- 7) Certain loans between natural persons if the amount is not over \$10,000.

For more information, see Publication 1212.

Interest You Cannot Deduct

Some interest payments cannot be deducted. In addition, certain other expenses that may seem to be interest are not and are not deductible as interest.

Payment by cash or equivalent. A cash method taxpayer cannot deduct interest unless it is paid in cash or its equivalent. If you are a cash method taxpayer, you cannot deduct interest you pay with borrowed funds you get from the original lender through a second loan, an advance, or any other arrangement similar to a loan. You may deduct the interest expense once you start making payments on the new loan. When you make partial payments on loans, you first apply the payment to interest and then to the principal. This rule will not apply if both you and the lender intend for a different allocation to be made. All amounts you apply to the interest on the first loan are deductible, along with any interest you pay on the second loan, subject to any applicable limits.

Capitalized interest. In addition to the interest capitalization rules, discussed later, there are certain interest expenses you must capitalize rather than deduct.

If you buy property and pay interest owed by the seller (for example, by assuming the debt and any interest accrued on the property), you cannot deduct the interest. You add to the basis of the property the interest you paid that the seller owed.

Commitment fees or standby charges. Fees you incur to have business funds available on a standby basis, but not for the actual use of the funds, are not deductible as interest payments. They may be deductible as business expenses.

If the funds are for inventory or certain property used in your business, the fees are indirect costs and must be capitalized under the uniform capitalization rules. See section 1.263A of the Income Tax Regulations on uniform capitalization rules for more information.

If you pay or incur commitment fees or standby charges on a loan to have money made available when needed, you may be able to deduct the expense. The commitment fees are a cost of getting your loan and you can generally deduct part of the fees each year during the period of the loan. To figure your deduction for each year, divide the part of the loan period falling within the tax year by the total loan period. Then multiply this answer by the total amount of the fees. If you do not take out a loan, you can take a loss deduction for these fees in the year your right to borrow the funds expires.

Income tax owed. Interest paid or accrued on income tax assessed on your individual income tax return is not a business deduction even though the tax due is related to income from your trade or business. This interest is treated as a business deduction only in figuring a net operating loss deduction.

Penalties. Penalties on deficiencies and underestimated tax are not interest and cannot be deducted. Fines and penalties are generally not deductible.

Interest related to tax-exempt income. Generally, interest related to tax-exempt income is not deductible. No deduction is allowed for:

- 1) Interest on a debt incurred to buy or carry tax-exempt securities.
- 2) Amounts paid or incurred in connection with personal property used in a short sale.
- 3) Amounts paid or incurred by others for the use of any collateral used in connection with a short sale.

If you deposit cash as collateral in a sale and the cash does not earn a material return during the period of sale, item (2) above does not apply. For more information on short sales, see *Short Sales* in Publication 550.

Limit on investment interest. Your deduction for investment interest expense is limited to the amount of your net investment income. This rule applies only if:

- 1) You are a noncorporate taxpayer (including shareholders and partners of S corporations and partnerships), and
- 2) You paid or accrued interest on money you borrowed to buy or carry property held for investment (including amounts allowable as a deduction in connection with personal property used in a short sale).

For more information about the limit on the investment interest expense deduction, see Publication 550.

Interest Capitalization

Under the uniform capitalization rules, you must generally capitalize interest on debt used to finance the production of real or tangible personal property. The property must be produced by you for use in your trade or business or produced by you for sale to customers. Interest on a debt on property acquired and held for resale does not have to be capitalized. Interest you paid or incurred during the production period (defined later) must be capitalized if the property produced is **qualified property**. Qualified property is:

- 1) Real property,
- 2) Personal property with a class life of 20 years or more,
- 3) Personal property with an estimated production period of more than 2 years, or
- 4) Personal property with an estimated production period of more than one year if the estimated cost of production is more than \$1 million.

Under this rule, you are considered to have produced property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property.

Production period. For real property, the production period begins when physical activity is first performed on the property. This includes grading or clearing of land and excavation of foundations or utility lines. For all other property, the production period begins on the date the total production costs incurred (including planning and design costs) equal or exceed 5% of the total estimated production costs (including planning and design costs) allocable to the property.

The production period ends when the property is ready to be placed in service or held for sale.

Capitalized interest. Capitalized interest is treated as a cost of the property produced. You recover the interest when you sell or use the property, or dispose of it under the rules that apply to such transactions. You recover capitalized interest through cost of goods sold, an adjustment to basis, depreciation, amortization, or other method.

The capitalization rules of Internal Revenue Code Sections 263A and 460 apply to interest you pay or incur on any debt allocable to the costs of producing qualified property. For example, these costs include planning and design activities which are generally incurred before the production period begins, as well as the costs of raw land and materials acquired before the production period begins. Also, they include any costs you may incur under a contract for property produced by a third party.

Allocating interest. To determine the amount of interest to be capitalized on qualified property, first capitalize the interest on debt directly allocable to the property's costs of production (traced debt). Then assign any

other debt to any remaining costs of production. The interest on that debt is capitalized to the extent the interest could have been reduced if the production costs had not been incurred (avoided cost debt).

Do not reduce the interest expense capitalized by any interest income you may earn on unspent debt proceeds you invest in temporarily.

Traced debt. Generally, allocate traced debt to a particular cost by tracing payments made from the debt's proceeds to that cost. In this case, a **traced debt** includes only:

- 1) Eligible debt (defined later) equal to or less than the qualified property's accumulated production costs, and
- 2) Debt directly attributable to the production of qualified property.

See *Election to avoid tracing requirement*, later.

Eligible debt. This includes all of your debt, **except** for any debt with:

- 1) Permanently nondeductible interest (such as tax-exempt interest),
- 2) Personal interest,
- 3) Qualified home mortgage interest,
- 4) Interest incurred by a tax-exempt organization (unless directly connected to that organization's unrelated trade or business), and
- 5) Interest attributable to a debt between you and certain related parties (or between the parties themselves), if the rate of interest is less than the applicable federal interest rate on the date issued. See *Related taxpayers* in Chapter 2 for information about related parties.

Avoided cost debt. Assign any excess eligible debt to the amount of the production costs over the traced debt. Then capitalize the interest on that debt. Do this only if the production costs for the property exceed your traced debt.

Next figure the interest to be capitalized under the **avoided cost method**. That is, base the debt to be allocated to excess production costs on the interest expense that would have been avoided if production costs had not been made and such costs were used to repay your debt.

The avoided cost method assumes that such repayment of debt occurs, regardless of your intentions or the facts and circumstances surrounding your operations. You can apply this method regardless of whether you actually would have used the amounts otherwise spent for production to repay the debt.

Example. Assume you are engaged in the production of qualified property. Your production costs are \$1,000,000. You have a \$400,000 loan traced to these production costs. You have another loan of \$1,200,000 which is an eligible debt, bearing interest at a 10% annual rate.

You must capitalize the interest incurred on the traced debt during the production period of the property. You must also capitalize interest

incurred on the avoided cost debt during that period (\$600,000 of the \$1,200,000 obligation at a 10% annual interest rate). Treat this \$600,000 portion of the loan as avoided cost debt regardless of the particular financial or regulatory accounting treatment of the debt, regardless of the purpose for which you got the loan, or regardless of when you incurred the loan.

Interest rate on avoided cost debt. The interest rate on avoided cost debt is generally a weighted average of the interest rates on your eligible debt outstanding during the production period. It does not include debt specifically traced to the production activity.

Advance payments. If you contract out your production activity and agree to make progress or advance payments to the contractor, you must capitalize the interest on the debt incurred during production that is allocable to the payments.

The contractor who produces the property for you must also capitalize interest costs related to that property to the extent the production costs incurred by the contractor exceed your total payments for the property.

Property used in production. If you incur interest on a debt to finance any asset used in the production of property (for example, manufacturing equipment and facilities), you must also capitalize the interest to the extent it is paid or incurred during the production of the property. If an asset is used in the production of property and for other purposes, capitalize only the part of the interest allocated to the production activity.

Calculation methods. When figuring the amounts of traced or avoided cost debt, the interest on debt, and the amount of accumulated production costs for which interest must be capitalized, you can use any reasonable method you apply consistently. For example, you can use methods that involve the computation of daily, weekly, or monthly average debt balances, interest rates, or production costs. You cannot, however, use a method that involves computations made less frequently than monthly, unless you can demonstrate that no significant difference occurs between the method you choose and a method based on monthly computations.

Election to avoid tracing requirement. Instead of determining and accounting for the amount of all traced debt under the rules described earlier, you can elect to treat all of your traced debt as debt under the avoided cost method, regardless of the actual disbursement of debt proceeds to specific costs. The way you figure your interest under the election may vary from year to year depending on your situation for that year.

Accumulated production costs more than eligible debt. If your accumulated production costs exceed your total eligible debt, add all of your otherwise traced debt to your other eligible debt. Then treat the total as avoided cost debt to figure the interest you must capitalize.

Eligible debt more than accumulated production costs. If your total eligible debt

exceeds your accumulated production costs, first allocate all of the trade or business debt to your production costs and capitalize the interest. You must capitalize the interest as you would with an avoided cost debt. If your eligible trade or business debt exceeds the production costs, capitalize a pro rata portion of the interest on this debt as you would with an avoided cost debt. **Trade or business debt** is eligible debt as described earlier, except it does not include debt subject to the investment interest or passive activity limitations.

If your total production costs exceed your trade or business debt, you must also allocate your remaining eligible debt that is not trade or business debt to these production costs on a pro rata basis. But only do this to the extent of the excess. In this case, you are not required to use the allocation rules and will thereby avoid the tracing requirements for any of your trade or business debt.

Election requirements. If you were previously subject to the interest capitalization rules and elect to avoid the tracing requirements, you must obtain permission from the Commissioner of the Internal Revenue Service to make a change in accounting method. Use Form 3115 and indicate you are requesting this change under Section VII of Notice 88-99, 1988-2 CB 422.

Partnerships and S corporations. The interest capitalization rules, described above, are applied first at the level of the partnership or S corporation, and then at the level of the partners or shareholders. These rules are applied to the extent the partnership or S corporation has insufficient debt to support the production or construction costs.

If you are a shareholder in an S corporation, you may have to capitalize interest you incur during the tax year for the production costs of the S corporation. You may also have to capitalize interest incurred by the S corporation for your own production costs. See Internal Revenue Service Notice 88-99, 1988-2 CB 422. You must provide the required information in an attachment to the Schedule K-1 to properly capitalize interest for this purpose.

If you are a partner in a partnership, you may have to capitalize interest you incur during the tax year with respect to the production costs of the partnership. Similarly, you may have to capitalize interest incurred by the partnership with respect to your own production costs. See Internal Revenue Service Notice 88-99. You must provide the required information in an attachment to the Schedule K-1 to properly capitalize this interest.

Related parties. Under the avoided cost method, interest capitalization also applies to the extent a party related to the taxpayer produces qualified property.

For more information on the uniform capitalization rules, see section 1.263A of the Income Tax Regulations and Internal Revenue Notice 88-99, 1988-2 C.B. 422, (as amended by Announcement 89-72) available at most IRS offices.

When To Deduct Interest

If interest capitalization (discussed earlier) does not apply to you, deduct interest as follows.

Cash method. You can deduct only payments of interest you actually made during the tax year. A promissory note you give as payment of interest is not deductible because it is a promise to pay and not an actual payment.

Prepaid interest. Under the cash method, you cannot generally deduct any interest paid before the year it is due. Interest you pay that is properly allocable to a later tax year must be charged to a capital account. Treat an advance payment as paid in the period covered by the prepaid interest.

Discounted loans. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you cannot deduct it when you get the loan. A cash-method taxpayer must prorate this discount over the loan period and can deduct interest only when payments are made on the loan.

Refunds of interest. If you pay interest and then receive a refund of any part of the interest later in the same tax year, reduce your interest deduction by the amount of the refund. If you receive the refund in a later tax year, include the refund in income if the deduction for the interest reduced your tax. You should include in income only the amount of the interest deduction that reduced your tax.

Accrual method. You can deduct only interest that has accrued during the tax year.

Prepaid interest. If you pay interest in advance, deduct it as it accrues over the period of the debt. This rule also applies to the amount subtracted on a **discounted loan**.

Payments unlikely to be made. If it is unlikely you will make the interest payments because of financial difficulty, you can still take a deduction for accrued interest.

Tax deficiency. If a corporation contests a federal income tax deficiency, interest does not accrue until the tax year final determination of liability is made. If the corporation does not contest the deficiency, then the interest accrues in the year the tax was asserted and agreed to. Interest is deducted in the year it accrues.

However, if a corporation contests but pays the proposed tax deficiency and interest, and the corporation does not designate the payment as a cash bond, then the interest is deductible in the year it is paid.

Related taxpayer. If you use the accrual method, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. The relationship is determined as of the end of the tax year for which the interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ceases to exist

before the interest is includible in the gross income of that person. See *Related taxpayers* in Chapter 2 under *Unpaid Salaries*.

However, you can deduct the amount if you pay it within 2½ months after the end of your tax year, and if the amount is paid:

- 1) On debt incurred on or before September 29, 1983, or
- 2) Under a contract binding on September 29, 1983, and thereafter before the amount is paid or incurred.

Below-Market Interest Rate Loans

A **below-market loan** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which you, the borrower, are treated as having received:

- 1) A loan in exchange for a note that requires the payment of interest at the applicable federal rate, and
- 2) An additional payment.

The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on whether the loan is a gift loan, term loan, or a gift term loan. These loans are discussed later.

For these rules to apply to a below-market loan, two transactions are assumed to have taken place:

- 1) A transfer of forgone interest from the lender to the borrower, and
- 2) A retransfer of the forgone interest from the borrower to the lender.

Forgone interest. Forgone interest is the excess of the interest payable if it was figured at the applicable federal rate (and was payable annually on December 31) over the actual interest payable on the loan for that period. The applicable federal rate is figured and published by the Internal Revenue Service each month in a revenue ruling. You may contact an Internal Revenue Service office for these rates.

How you treat the forgone interest depends on the type of loan you have. The various loans and types of treatment of forgone interest are discussed next.

Gift and demand loans. If you receive a below-market gift loan or other demand loan, you are treated as receiving an additional payment (as a gift, dividend, etc.) equal to the forgone interest on the loan. A **gift loan** is one where the forgone interest is treated as a gift. A **demand loan** is one payable in full at any time upon the lender's demand.

You are treated as transferring the forgone interest to the lender. You may be entitled to deduct that amount as an interest expense, if it qualifies. The lender must report this amount as interest income. These transfers are deemed to occur annually, generally on December 31.

Term loans. If you receive a below-market term loan (any loan that is not a demand loan), you are treated as receiving an additional lump-sum cash payment (as a gift, dividend, etc.) on the date the loan is made. The amount of this payment is the excess of the loan amount over the present value of all payments due under the loan. This excess is treated as original issue discount and the original issue discount rules apply. See *Original Issue Discount (OID)* in Publication 550.

If you receive a **gift term loan**, you are treated as receiving an additional amount as determined using the rules for term loans, discussed earlier. The forgone interest treated as transferred by you to the lender as interest income, however, is determined using the rules for demand loans, discussed earlier.

Loans subject to the rules. The rules for below-market loans apply to:

- 1) Gift loans.
- 2) Compensation-related loans.
- 3) Corporation-shareholder loans.
- 4) Tax avoidance loans.
- 5) Other below-market loans.
- 6) Loans to qualified continuing care facilities (made after October 11, 1985).

Exceptions. The rules for below-market loans do not apply to:

- 1) Gift loans between individuals if:
 - a) The total outstanding amount of loans between such individuals is \$10,000 or less, and
 - b) The loan is for any purpose other than the purchase or carrying of income-producing assets.
- 2) Compensation-related loans or corporation-shareholder loans if:
 - a) The total outstanding amount of loans between you and the lender is \$10,000 or less, and
 - b) The avoidance of federal tax is not a main purpose of the loan.

Special rule for certain gift loans. Forgone interest on a gift loan between individuals that does not exceed \$100,000 may be treated as being transferred from you (the borrower) to the lender. The amount considered transferred is limited to your net investment income for the year. Forgone interest on a gift loan **will be** treated as transferred from you to the lender only if your net investment income is over \$1,000 for the year. If your net investment income does not exceed \$1,000, no transfer of interest is deemed to have occurred.

Loans not subject to the rules. Some loans are specifically excluded from the rules for below-market loans, such as:

- 1) Loans made available by lenders to the general public on the same terms and conditions.
- 2) Accounts or withdrawable shares with a bank, building and loan or other savings

9. Taxes

Topics

This chapter discusses:

- Real estate taxes
- State and local income taxes
- Employment taxes
- Other taxes

Useful Items

You may want to see:

Publication

- 378** Fuel Tax Credits and Refunds
- 533** Self-Employment Tax
- 551** Basis of Assets
- 937** Employment Taxes

Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- Sch SE (Form 1040)** Self-Employment Tax
- 3115** Application for Change in Accounting Method

You can deduct various taxes imposed by federal, state (including certain Indian tribal governments), local, and foreign governments if you incur them in the ordinary course of your trade or business and if they are directly attributable to that trade or business.

If you use the cash method of accounting, you can deduct taxes only in the year paid. If you use an accrual method, you can deduct them only in the year they are properly accrued.

Uniform capitalization rules apply to certain taxpayers who produce real or tangible personal property for use in a trade or business, or for sale to customers, or acquire property for resale. Under these rules, certain expenses that are allocable to the property, including taxes, may have to be included in inventory costs or capitalized. In some cases, you may elect to capitalize taxes. For more information, see Publication 551.

Federal income, estate and gift taxes, and state inheritance, legacy, and succession taxes are not deductible.

Refunds of taxes. If you use the cash method of accounting and you receive a refund for any taxes you deducted in an earlier year, include the refund in income. However, if part of the deduction did not reduce your income subject to tax, you do not have to include all of the refund in income. Exclude an amount equal to the part that did not reduce your income subject to tax.

institution, or credit union made in the ordinary course of business.

- 3) Acquisitions of publicly traded debt obligations for an amount equal to the public trading price at the time of acquisition.
- 4) Loans made by a life insurance company to an insured, under a loan right contained in a life insurance policy, secured by cash surrender values.
- 5) Loans subsidized by the federal, state (including the District of Columbia), or municipal government (or any agency or instrumentality), and made available under a program of general application to the public.
- 6) Certain employee-relocation loans.
- 7) Tax-exempt obligations.
- 8) U.S. government obligations.
- 9) Gift loans to a charitable organization.
- 10) Loans made by a private or charitable foundation for certain nonprofit purposes.
- 11) Certain loans to or from a foreign person, unless the interest income would be effectively connected with the conduct of a U.S. trade or business and not exempt from U.S. tax under an income tax treaty.
- 12) Any loan if the taxpayer can show the interest arrangement has no significant effect on the federal tax liability of the lender or the borrower.
- 13) Loans to the extent excepted from Internal Revenue Code section 482 income and expense reallocation rules for the interest-free period referred to in regulations 1.482-2(a)(1) relating to certain debts arising in the ordinary course of business out of sales, leases, and services.
- 14) Certain commodities, futures and options margin accounts.
- 15) Other loans described in revenue rulings or procedures issued by IRS.

Certain loans to qualified continuing care facilities. The below-market interest rules do not apply to loans made by a lender age 65 or older to a qualified continuing care facility pursuant to a continuing care contract. These loans are exempt only if:

- 1) The principal amount of the loan, when added to the total outstanding amount of all loans from the lender (or lender's spouse) do not exceed \$121,100 for 1994.
- 2) The lender (or lender's spouse) is age 65 or older, beginning with the calendar year in which the lender (or lender's spouse) reaches age 65.

A continuing care facility is one or more facilities that are designed to provide services under continuing care contracts and where substantially all of the residents living there have entered into continuing care contracts. In addition, substantially all of the facilities used

to provide services required under the continuing care contract must be owned or operated by the loan borrower.

A written contract between an individual and a qualified continuing care facility must meet the following conditions:

- 1) The individual and/or the individual's spouse must be entitled to use the facility for the remainder of their life or lives.
- 2) The residential use must begin in a separate, independent living unit provided by the continuing care facility and continue until such individual (or individual's spouse) is capable of living independently. The facility is required to provide various "personal care" services to the resident such as maintenance of the residential unit, meals, and daily aid and supervision relating to routine medical needs.
- 3) The facility must also be obligated to provide long-term nursing care if the resident is no longer capable of living independently.
- 4) The contract must require the facility to provide the "personal services" and "long-term nursing care" without substantial additional cost to the individual.

Tax avoidance loans. If one of the principal purposes of structuring a transaction as an exempted loan is the avoidance of federal tax, the loan will be considered a tax avoidance loan and will be subject to the rules for below-market loans.

Significant effect on federal tax liability. Whether an interest arrangement has a significant effect on the federal tax liability (item 12) of the lender or the borrower will be determined by all the facts and circumstances. Factors to be considered include:

- 1) Whether items of income and deduction generated by the loan offset each other.
- 2) The amount of such items.
- 3) The cost of complying with the below-market loan provisions if they applied.
- 4) Any reasons, other than taxes, for structuring the transaction as a below-market loan.

Effective dates. Except as provided above, these rules apply to term loans made after June 6, 1984, and to demand loans outstanding after that date.

For more information, see section 7872 of the Internal Revenue Code and 1.7872-5T of the regulations.

Sale or exchange of property. Different rules generally apply to a loan connected with the sale or exchange of property. If the loan does not provide adequate stated interest, part of the principal payment may be considered interest. However, there are exceptions that may require you to apply the below-market interest rate rules to these loans. See the *Unstated Interest* discussion in Publication 537.

You must include any interest paid on state or local tax refunds in income.

Real Estate Taxes

Real estate (real property) taxes are the taxes you pay on real property that you own. Ordinarily, you can deduct them, but sometimes you may elect to capitalize expenses for taxes as part of the cost of property. See Chapter 10. Sometimes you **must** capitalize expenses for real property taxes under the uniform capitalization rules. See Publication 551.

Assessments. Assessments for **local** benefits that tend to increase the value of your property, such as assessments for construction of streets, sidewalks, and water and sewerage systems, or to provide public parking facilities, generally are not deductible. If the local benefit increases the value of your property, you must capitalize the assessment.

Local assessments for maintenance, repairs, or interest charges for benefits such as streets, sidewalks, and water and sewerage systems are deductible. If only part of the assessment is for maintenance, repairs, or interest, you must be able to show the amount allocated to the different purposes. If you cannot show what part of the assessment is for maintenance, repairs, or interest, none of it is deductible.

Water bills, sewerage, and other service charges assessed against your business property are deductible as business expenses.

Example. City X, to improve downtown commercial business, converted a downtown business area street already improved by lights, sidewalks, sewers, etc., into an enclosed pedestrian mall. The full cost of construction, financed with 10-year bonds, was assessed against the affected properties. The property owners are required to make payments of principal and interest annually for 10 years, which is also the period of expected business advantage.

The assessments incurred by the property owners are not deductible as taxes or as business expenses, but are depreciable capital expenses. The part of the payments that is to pay the interest charges on the bonds is deductible as taxes.

Real estate sales. If real estate is sold, the deduction for real estate taxes must be divided between the buyer and the seller according to the number of days in the **real property tax year** (the period to which the tax imposed relates) that each held the property. The taxes are apportioned to the seller up to but not including the date of sale, and to the buyer beginning with the date of sale, regardless of the accrual or lien dates under local law.

If you use the cash method and the buyer of your property is personally liable for the tax, you are considered to have paid the part of the tax imposed for the part of the year up to the time of the sale. This permits you to deduct the part of the tax to the date of sale even though you do not actually pay it.

If you use an accrual method and have not elected to ratably accrue real property taxes, the taxes apportioned to you (but not deductible for any year under your accounting method) accrue on the date you sell the property.

Example. Al Green, a calendar year accrual method taxpayer, owns real property in X County but has not elected to ratably accrue property taxes. November 30 of each year is the assessment and lien date. He sold the property on June 30, 1994, and under his accounting method would not be able to claim a deduction for the taxes because the sale occurred before November 30. The part of the 1994 tax apportioned to him, 180/365 (January 1–June 29), is treated as having accrued on June 30, and is deductible for 1994.

Election to ratably accrue. An accrual method taxpayer may elect to accrue real property tax that is related to a definite period of time ratably over that period of time.

Example. John Smith is a calendar year taxpayer who is on an accrual method. His real property taxes applicable to the fiscal year July 1, 1994, to June 30, 1995, amount to \$1,200. The assessment and lien date is July 1.

If for 1994 John makes the election to ratably accrue the taxes, \$600 of the taxes will accrue in 1994 ($\$1,200 \times 6/12$, July 1–December 31) and the balance will accrue in 1995.

Separate elections. An election may be made for each separate trade or business and for nonbusiness activities if accounted for separately. The election to ratably accrue real property taxes is binding unless the consent of the IRS is obtained to change the method of deducting real property taxes.

Any real property taxes that normally are deductible for the tax year, and that apply to periods prior to the year of the election, are deductible for the tax year in which you make the election.

Making the election. If you make your election for the first year in which real property taxes are incurred, the election may be made in a statement attached to your income tax return for that year. The return must be filed by the regular due date (including extensions). The statement should indicate:

- 1) The trades or businesses to which the election applies and the accounting method or methods used,
- 2) The period of time to which the taxes relate, and
- 3) The computation of the real property tax deduction for the first year of election.

Under an automatic procedure rule, you generally may elect, or revoke an election, to ratably accrue real estate taxes by attaching a statement to your timely filed return (including extensions) for your first tax year after 1992. See Revenue Procedure 94–32 for more information.

In other cases, you must secure consent of the IRS to make the election for the change. To request the consent, complete Form 3115

and file it with the IRS. Generally, this form should be filed within 180 days from the beginning of the tax year for which the election is to be effective, and you may have to pay a user fee. See the *Instructions for Form 3115* for more information.

Limitation on accrual of taxes. A taxing jurisdiction can require the use of an earlier date for accruing taxes than that which it previously required. However, the accrual date for federal income tax purposes is the date on which the tax would have accrued had no action been taken.

State and Local Income Taxes

State income taxes imposed on a corporation or partnership are deductible by the corporation or partnership. However, state income taxes imposed on an individual are not deductible by the individual as expenses of the business, but can be deducted in computing the individual's income tax liability if deductions are itemized.

A state tax on gross income (as distinguished from net income) directly attributable to a trade or business carried on by an individual or a partnership is deductible as an expense of the business.

Accrual of additional state income taxes. If an accrual method is used and liability is contested, any increase in deductible business taxes for an earlier year will accrue and be deductible in the year the amount is finally determined.

Filing a state tax return is not considered contesting a liability for additional state income taxes assessed against taxpayers for prior years. Without some objective act of protest or evidence of denial of liability by an accrual-method taxpayer, any additional state taxes assessed for a prior year are deductible for the prior year rather than in the year the amount is finally determined.

However, a taxpayer who uses a consistent method of accounting to deduct additional prior year state taxes (including uncontested ones) in the year they are finally determined may continue to use that accounting method and deduct the additional taxes in the year finally determined. If that taxpayer deducts the additional taxes against income of the prior year, a credit or refund will be allowed only if the taxpayer received permission from the IRS to change the accounting method.

Employment Taxes

As an employer, you are responsible for withholding and paying certain taxes in connection with the salaries, wages, tips, certain fringe benefits, and other compensation of your employees. The most common are the social security and Medicare taxes under the Federal

Insurance Contributions Act (FICA), the unemployment tax under the Federal Unemployment Tax Act (FUTA), and the federal income tax.

You should deduct as salary the gross amount you pay an employee, which includes the taxes withheld by you. For example, if you pay an employee \$18,000 a year in gross salary but the employee actually receives \$14,500 net after withholding for the various taxes, you deduct the entire \$18,000 as salary. The social security, Medicare, and federal unemployment taxes that you pay as an employer are deductible business expenses.

It is important to remember that you, as the employer, are liable for payment to the government of the various taxes withheld from your employees' compensation and you are subject to penalties for nonpayment. However, members of a partnership are not employees of the partnership, and payments made on behalf of the partners are not deductible by the partnership as amounts paid on behalf of persons who are employees of the partnership.

For more information on employment taxes, see Publication 937.

Other Taxes

The following are other taxes that you can deduct if they are incurred in the ordinary course of your trade or business.

Personal property tax. You can deduct any tax imposed by a state or local government on personal property used in your trade or business.

Sales tax. An individual cannot deduct state and local sales tax as an itemized deduction. However, if you pay or accrue sales tax on the purchase of property, the tax is treated as part of the cost of the property. Thus, if you acquire depreciable property for use in a business, any sales tax paid or accrued on the purchase is added to the basis of the property and treated as part of the property's cost for depreciation purposes. If you buy a nondepreciable item that is deductible as a business expense, the sales tax on the purchase is also deductible as a business expense. If you pay sales tax on the purchase of merchandise for resale, the sales tax is treated as part of the merchandise cost.

Sales tax imposed on sales of property or services at retail and measured by gross sales price or gross receipts may be deductible. Rentals qualify as sales if so treated under local law.

Sales taxes collected and paid over to the state are not deductible if you have not included them in gross receipts. If you have, you may take a deduction for them when you pay them over to the state. Because the various states and local jurisdictions have different requirements for collection of sales taxes, you should contact the taxing authorities in your area for sales tax regulations.

Sales tax imposed on the seller or retailer. If state law imposes the sales tax on the seller or retailer and allows the seller or retailer

to state it separately or pass it on to the consumer, that consumer may deduct as a business expense the sales tax paid in purchasing property used in a trade or business, provided that the property is not a capital item (generally, a depreciable asset) or an inventory item. If the property is a capital item or an inventory item, the consumer (business person) must treat the sales tax as part of the cost of the item.

Use tax. A compensating use tax is treated as a general sales tax. This tax is imposed on the use, storage, or consumption of an item brought in from another taxing jurisdiction. It is often imposed at the same rate as the general sales tax and is often complementary to a general sales tax on retail sales of similar items in the taxing jurisdiction.

Self-employment tax. You can deduct half of your self-employment tax when figuring your income tax. After you figure your self-employment tax on Schedule SE, deduct half of the tax on line 25 of your 1994 Form 1040. For more information, see Publication 533.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that you use in your business usually are included as part of the cost of the fuel itself and are not deducted as a separate item.

Also, you may be entitled to a credit for tax paid on fuels used for certain purposes. For more information, see Publication 378.

Unemployment fund taxes. As an employer, you may be required to make payments to a state unemployment compensation fund or to a state disability benefit fund. These payments are deductible as taxes.

Franchise taxes. Corporate franchise taxes are deductible as a business expense. If you are a cash-basis taxpayer, you deduct the franchise tax in the year paid. If you are an accrual-basis taxpayer, you take a deduction in the year you become legally liable to pay the tax regardless of the year the tax is based on. Thus, if your state imposes a franchise tax for 1994 that is based on your corporate net income for 1993, you deduct the tax in 1994 if you are on the accrual basis because that is the year you became legally liable for the tax.

Excise taxes. All excise taxes you pay or incur as ordinary and necessary expenses of carrying on your trade or business can be deducted as operating expenses.

10.

Insurance

Important Change for 1994

Health insurance costs for self-employed persons. The deduction for 25% of health insurance premiums paid for self-employed persons and their spouses and dependents expired for tax years beginning after December 31, 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend this provision. For information on late legislative changes, see Publication 553, *Highlights of 1994 Tax Changes*.

Topics

This chapter discusses:

- When to deduct premiums
- Deductible premiums
- Nondeductible premiums
- Life insurance policies

Useful Items

You may want to see:

Publication

- 551 Basis of Assets

You can deduct the cost of insurance for your business or profession as a business expense if the insurance is an ordinary and necessary expense in carrying on your trade or business. However, you cannot deduct the cost of certain life insurance. See *Life Insurance Policies*, later.

Under the uniform capitalization rules, you must capitalize or include in your inventory certain insurance costs that would otherwise be deductible. These rules apply if you:

- 1) Produce real or tangible personal property for use in a trade or business or an activity engaged in for profit,
- 2) Produce real or tangible personal property for sale to customers, or
- 3) Acquire property for resale. However, the rules do not apply to personal property if your average annual gross receipts for the 3 preceding tax years are not more than \$10,000,000.

You must capitalize or include in inventory the insurance costs on the item being produced or acquired, and insurance on your plant, machinery, equipment, off-site storage facilities, and vehicles used for handling inventory. For more information on the uniform capitalization rules, see Publication 551 and section 1.263A of the Income Tax Regulations.

When to Deduct

You usually deduct premiums in the tax year to which they apply.

Cash method. If you use the cash method of accounting and you pay a premium for insurance that covers an earlier tax year, you can deduct the payment only in the tax year it is paid.

If you make an advance payment of a premium for an insurance policy that covers more than one tax year, you cannot deduct the entire premium in the year you make the payment, even if you are a cash basis taxpayer. You can deduct only the part of the premium that applies to the current tax year. In each later tax year you deduct the part that applies to that tax year.

Example. You operate a business and file your returns on a calendar-year basis. You bought a fire insurance policy on your building effective October 1, 1994, and paid in advance a premium of \$1,200 for 2 years. On your 1994 return, you can deduct only the part of the total premium that applies to the 3 months of coverage in 1994. The part of the premium that applies to 1995 and 1996 can be deducted in those years. Since the total policy premium is \$1,200 for 2 years, the yearly rate is \$600 and the monthly rate is \$50. For the 3-month period in 1994, you can deduct \$150; for 1995, you can deduct \$600; and for the 9-month period in 1996, you can deduct \$450.

If you use the cash method of accounting and you do not pay the \$1,200 premium until January 1995, you cannot deduct on your return for 1994 the \$150 for that year. However, you can deduct \$750 (the \$150 that applies to 1994 plus the \$600 that applies to 1995) on your return for 1995.

Accrual method. If you use an accrual method of accounting, your insurance expense deduction depends on when economic performance occurs. If you have a liability to make premium payments, economic performance generally occurs as the insurance protection is provided to you. See the example in the discussion of the economic performance rule under *When Can an Expense Be Deducted?* in Chapter 1.

Dividends received. If you receive dividends from business insurance and you deducted the premiums in prior years, part of the dividends are income. However, see *Recovery of amount deducted* in Chapter 1.

Deductible Premiums

You can generally deduct the following kinds of insurance premiums related to your business.

- 1) Fire, theft, flood, or other casualty insurance.
- 2) Merchandise and inventory insurance.

- 3) Credit insurance to cover losses from unpaid debts. Report any proceeds from this insurance as ordinary income.
- 4) Group hospitalization and medical insurance costs paid for employees.
- 5) A partnership can deduct the cost of accident and health insurance premiums as guaranteed payments for partners.
- 6) An S corporation can deduct the cost of accident and health insurance premiums paid for its shareholders. (However, the cost of the premiums paid for a more-than-2% shareholder is included in the shareholder's income.)
- 7) Employers' liability insurance.
- 8) Malpractice insurance that covers your professional personal liability for negligence resulting in injury or damage to patients or clients.
- 9) Liability insurance that covers your liability for bodily injuries suffered by persons who are not your employees and for property damage to others.
- 10) Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault. A partnership can deduct workers' compensation premiums paid on behalf of partners.
- 11) Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered taxes under state law.
- 12) Use and occupancy and business interruption insurance. This insurance pays you for lost profits if your business is shut down due to a fire or other cause. Report the proceeds as ordinary income.
- 13) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness. Report the proceeds as ordinary income.
- 14) Car and other vehicle insurance. This insurance covers liability, damages, and other losses from accidents involving vehicles used in your business. If you operate a vehicle partly for personal use, you can deduct only the part of your insurance premiums that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums.

Nondeductible Premiums

You may incur expenses for insurance policies that cannot be deducted. The following are examples of some nondeductible premiums.

Cost of goods sold. Manufacturers, processors, and others who include a part of their business insurance premiums in cost of goods sold cannot deduct that part as a current business expense.

Self-insurance reserve funds. You cannot deduct amounts credited to a reserve you set up for self-insurance. This applies even if you cannot get business insurance coverage for certain business risks. However, your actual losses are deductible.

Loss of earnings. You cannot deduct premiums for a policy that pays for your lost earnings due to sickness or disability. However, see the earlier discussion on overhead insurance under *Deductible Premiums*.

Life Insurance Policies

You cannot deduct premiums on a life insurance policy covering yourself, an employee, or any person financially interested in your business if you are directly or indirectly a beneficiary of the policy. This is true whether the policy insures you, your employee, or a person who has a financial interest in your business. For example, a person has a financial interest in your business if the person is an owner or part owner of the business or has lent money to the business.

You can deduct the premiums if you are not a beneficiary and can show they represent current pay. However, the total of the premiums paid plus other pay must be reasonable as discussed in Chapter 2.

See Chapter 5, *Employee Benefit Programs*, for discussions of split-dollar life insurance plans and group term life insurance.

The following discussions illustrate some instances in which expenses for life insurance associated with your trade or business may or may not be deductible as a business expense.

Partners. If you are a partner in a partnership, you are considered a beneficiary if you take out an insurance policy on your own life and name your partners as beneficiaries to induce them to retain their investments in the partnership. You cannot deduct the premiums as business expenses.

Security for loan. If you take out a policy on your life or on the life of another person financially interested in your business to get or protect a business loan, you cannot deduct the premiums as business expenses. Nor can you deduct the premiums as interest on business loans or as an expense of financing loans. In the event of death, the proceeds of the policy are not taxed as income even if they are used to liquidate the debt.

11.

Costs You Can Deduct or Capitalize

Topics

This chapter discusses:

- Carrying charges
- Research and experimental costs
- Drilling and development costs
- Exploration costs
- Circulation costs
- Costs of removing barriers to the disabled and the elderly

Useful Items

You may want to see:

Publication

- 334** Tax Guide for Small Business
- 534** Depreciation
- 538** Accounting Periods and Methods
- 544** Sales and Other Dispositions of Assets

Form (and Instructions)

- 3115** Application for Change in Accounting Method
- 3468** Investment Credit
- 6251** Alternative Minimum Tax—Individuals
- 6765** Credit for Increasing Research Activities (or for claiming the orphan drug credit)

There are certain costs that you can choose either to deduct or to capitalize. The choice you make depends on when it is best for you to recover your costs.

If you deduct a cost as an expense, you “recover” it in full by subtracting it from your income.

If you capitalize a cost, you may be able to recover the cost through a section 179 deduction, a deduction for clean-fuel vehicles or certain refueling property, or periodic deductions for depreciation, amortization, or depletion. (See Publication 534, for information on the section 179 deduction and depreciation; Chapter 12 for information on amortization; Chapter 13 for information on depletion; and Chapter 15 for information on the deduction for clean-fuel vehicles and certain refueling property. Or you may recover the cost when you sell the asset you bought and figure your gain or loss.

See *Interest Capitalization* in Chapter 8 for a discussion on the capitalization of interest expense.

The costs that you can choose to deduct or to capitalize include:

- Certain carrying charges on property,
- Research and experimental costs,
- “Intangible” drilling and development costs for oil, gas, and geothermal wells,
- Exploration costs for new mineral deposits,
- Mine development costs for a new mineral deposit,
- Costs of increasing the circulation of a newspaper or other periodical, and
- Costs of removing architectural and transportation barriers to people with disabilities and the elderly.

The decision to capitalize or to deduct costs belongs to the business entity, that is — the sole proprietor, partnership, corporation, estate, or trust. Individual partners, shareholders, and beneficiaries do not make the choice themselves (except for exploration costs for a new mineral deposit).

Note. For individuals, partners, beneficiaries, and S corporation shareholders, all the costs listed above, except carrying charges and costs of removing architectural and transportation barriers to the disabled and the elderly, are adjustments or items of tax preference. These items are subject to the alternative minimum tax if they are deducted on your tax return.

If you decide to deduct these items over an optional write-off period, they are not treated as adjustments or tax preference items. For more information, see *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

Carrying Charges

Carrying charges are the taxes and interest you pay to carry or develop real property or to carry, or transport, or install personal property. Certain carrying charges must be capitalized under the uniform capitalization rules. (For more information, see Chapter 8.) In addition, you can choose to capitalize carrying charges not subject to the uniform capitalization rules, but only if they are otherwise deductible.

You can make a separate choice to capitalize carrying charges for each project you have and for each type of carrying charge. For unimproved and unproductive real property, your choice is good for only one year. You must make a new choice each year the property remains unimproved and unproductive. For other property, your choice to capitalize carrying charges remains in effect until construction, development, or installation is completed (or, for personal property, the date you first use it, if later).

How to make the choice. To make the choice to capitalize a carrying charge, write a statement saying which charges you choose to capitalize. Attach it to your original tax return for the year the choice is to be effective.

You may be eligible for an extension of time to make the choice, see Revenue Procedure 92-85 for more information.

Research and Experimental Costs

The costs of research and experimentation are generally capital expenses. However, you can choose to deduct these costs as current business expenses.

This choice applies to the reasonable costs of research and development arising from laboratory or experimental procedures. It includes the cost of developing or improving a product, a formula, an invention, a plant process, an experimental or pilot model, or something similar. It also includes the cost of any research or experimental work carried on for you by someone else (such as a research institute, foundation, engineering company, or similar contractor). It does not apply to market research, management surveys, or normal product testing. It also does not apply to the costs of acquiring or improving land or depreciable property.

The choice you make applies to all your research and experimental costs. You cannot choose to deduct some of these expenses and capitalize others.

However, if you do not choose to deduct your research and experimental costs currently, you have other choices. You can choose to treat them as deferred expenses and amortize them over a period of at least 60 months, beginning with the month that you first receive an economic benefit from the research. See *Research and Experimental Costs* in Chapter 12. You can also choose to deduct them over the 10-year period beginning with the tax year they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251 and Internal Revenue Code section 59(e).

Research and experimental costs defined. For tax years beginning after October 3, 1994, research and development costs are reasonable costs you incur in your trade or business that are the experimental or laboratory portion of research and development costs. This includes all costs incident to the development or improvement of a product. (See *Product*, later.) It also includes the costs of obtaining a patent (i.e., attorney’s fees in making and perfecting a patent application).

Costs qualify as research or experimental costs depending on the nature of the activity the costs relates to, rather than the nature of the product or the improvement being developed or the level of technological advancement represented.

Costs are the experimental or laboratory portion of research and development costs if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to you does not establish the capability or method for developing or improving

the product or the appropriate design of the product.

Research and experimental costs do not include expenses for:

- 1) Quality control testing,
- 2) Efficiency surveys,
- 3) Management surveys,
- 4) Consumer surveys,
- 5) Advertising or promotions,
- 6) The acquisition of another's patent, model, production or process, or
- 7) Research in connection with literary, historical, or similar projects.

Product. For tax years beginning after October 3, 1994, the term "product" includes:

- 1) Any pilot model,
- 2) Process,
- 3) Formula,
- 4) Invention,
- 5) Technique,
- 6) Patent, or
- 7) Similar property.

It also includes products used by you in your trade or business or held for sale, lease, or license.

How to make the choice. To choose to deduct research and experimental costs currently, claim them as an expense deduction on your income tax return for the year in which you first have them.

If you want to make this choice after the first year, you must get the permission of the Internal Revenue Service (IRS). File Form 3115.

Research credit. You may qualify for a credit on some or all of your research and experimental costs no matter how you treat them. You must reduce the amount you deduct or capitalize by the amount of the credit, unless you choose to take a reduced credit. See the instructions for Form 6765.

Drilling and Development Costs

The costs of developing *oil, gas, or geothermal wells* are ordinarily capital expenses. They can usually be recovered through depreciation or depletion. However, you can choose to deduct as current business expenses certain drilling and development costs for wells located in the United States in which you hold an operating or working interest. To be deductible, the costs must be for drilling or preparing a well for the production of oil, gas, geothermal steam, or geothermal hot water.

You can choose to deduct only costs for items that, in themselves, do not have a salvage value. These include wages, fuel, repairs, hauling, and supplies. These costs are known as intangible drilling and development costs because they are not directly for the

purchase of tangible, depreciable business assets.

The cost to you of any drilling or development work, exclusive of depreciable items, done by contractors under any form of contract is also an intangible drilling and development cost.

The choice to deduct intangible drilling and development cost applies to the cost of drilling bore holes to determine the location and delineation of offshore hydrocarbon deposits, if the shaft is capable of conducting hydrocarbons to the surface on completion. It does not matter whether there is any intent to produce hydrocarbons.

If you do not choose to deduct your intangible drilling and development costs currently you can choose to deduct them over the 60-month period beginning with the month they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

How to make the choice. To choose to deduct intangible drilling and development costs currently, take the deduction on your income tax return for the first tax year in which you have eligible expenses. No formal statement is required. If you file Form 1040 (Schedule C), 1065, or 1120S enter these costs under "Other Expenses." If you file Form 1120 allocate the costs among the expenses that make up the costs.

Energy credit. If you capitalize the drilling and development costs of geothermal wells that you place in service, you may be able to claim a business energy credit. See Form 3468 for more information.

Nonproductive wells. If you capitalize your intangible drilling and development costs for a nonproductive well, an additional option is available to you. You can deduct these costs as an ordinary loss if you indicate your choice on your tax return for the first year in which the well is completed. Once made, the choice for oil and gas wells is binding for all later years. But you can revoke your choice for a geothermal well by filing an amended return that does not claim the loss.

Intangible drilling and development costs incurred outside the United States. You can not currently deduct the intangible drilling and development costs paid or incurred for an oil, gas, or geothermal well located outside the United States. However, you can choose to include the costs in the adjusted basis for purposes of computing cost depletion. If you do not make this choice, you can deduct the costs over the 10-year period beginning with the tax year in which you paid or incurred them. These rules do not apply to a nonproductive well.

Exploration Costs

If the costs of determining the existence, location, extent, or quality of any mineral deposit lead to the development of a mine, they ordinarily are capital expenses. You can recover

these costs through depletion as the mineral is removed from the ground. However, you can choose to deduct the costs of exploration in the United States (except those for oil, gas, and geothermal wells) if you paid or incurred them before the development stage began.

If you do not choose to deduct your exploration costs currently, you can choose to deduct them over the 10-year period beginning with the tax year they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

Partnerships. Each partner, not the partnership, chooses whether to capitalize or to deduct that partner's share of exploration costs.

How to make the choice. To deduct your exploration costs currently, take the deduction on your income tax return or an amended income tax return. Your return must adequately describe and identify each property or mine, and clearly state how much is being deducted for each one. The choice applies to all the domestic exploration costs you have during the tax year that you make this choice and all following tax years.

Reduced deduction for corporations. A corporation (other than an S corporation) can deduct only 70% of its domestic exploration costs. It must capitalize the remaining 30% and amortize them over the 60-month period starting with the month the exploration costs are paid or incurred. The 30% the corporation capitalizes cannot be added to its basis in the property for purposes of figuring cost depletion. However, the amount amortized is treated as additional depreciation and is recaptured as ordinary income on a disposition of the property. See *Depreciation Recapture on Real Property* in Chapter 4 of Publication 544.

These rules also apply to the deduction of **development costs for corporations.** See *Development Costs*, later.

Recapture of exploration expenses. When your mine reaches the producing stage, you must recapture any exploration costs you chose to deduct for it. Use either of the following methods.

Method 1—Include the amount of your deducted costs in your gross income for the tax year the mine reaches the producing stage. Your choice of this recapture method must be made by the due date (including extensions) of your return and must be clearly indicated on the return. Increase your adjusted basis in the mine by the amount included in income.

Method 2—If you do not choose method 1, reduce the depletion deduction you would otherwise take for the tax year the mine reaches the producing stage and following tax years, until your deducted costs have been recaptured.

You must also recapture deducted exploration costs if you receive a bonus or royalty from

leased mine property before it reaches the producing stage. Reduce the depletion deduction you would otherwise take for the tax year you receive the bonus or royalty and following tax years, until you have recaptured your deducted costs.

If you dispose of the mine before your deducted exploration costs have been fully recaptured, recapture the remainder by treating all or part of your gain as ordinary income.

Foreign exploration. If you pay or incur exploration costs for a mine or other natural deposit located outside the United States, you cannot deduct all of the costs in the current year. You can choose to include the costs (other than for an oil, gas, or geothermal well) in the adjusted basis for purposes of computing cost depletion. If you do not make this choice, you must deduct the costs over the 10-year period beginning with the tax year in which you pay or incur them.

These rules also apply to **foreign development** costs. (See the following discussion.)

Development Costs

You can deduct costs paid or incurred during the tax year for developing a **mine or any other natural deposit** (other than an oil or gas well) located in the United States if the costs are paid or incurred after the discovery of ores or minerals in commercially marketable quantities. Development costs include those incurred by a contractor on your behalf. They do not include costs for depreciable improvements.

You can choose to treat development costs as deferred expenses and deduct them on a ratable basis when you sell the units of produced ores or minerals benefited by the expenses. This choice applies each tax year to expenses paid or incurred in that tax year. Once made, the choice is binding for that tax year and cannot be revoked for any reason.

You can also choose to deduct your development costs over the 10-year period, beginning with the tax year they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

How to make the choice. The choice to deduct development costs on a ratable basis when the ores or minerals are sold must be made for each mine or other natural deposit by a clear indication on your return, or by a statement filed with the IRS office where you filed your return. You must make the choice not later than the due date of the return (including extensions).

Foreign development. The same rules discussed earlier for foreign exploration costs apply to foreign development costs.

Reduced deduction for corporations. The treatment of corporate deductions for exploration costs, discussed earlier, also applies to corporate deductions for development costs.

Circulation Costs

The costs of increasing the circulation of a newspaper, magazine, or other periodical are deductible business expenses. For example, you can deduct the cost of hiring extra employees for a limited time to get new subscribers through telephone calls. These costs are deductible even if they result in an asset (i.e., a subscriber list) having a useful life of more than one year. However, a publisher can choose to capitalize the costs of increasing circulation.

A publisher can also choose to deduct circulation costs over the 3-year period beginning with the tax year they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

Purchases of land or depreciable property and purchases of any part of the business of another publisher do not come under these rules. These costs **must** be capitalized.

How to make the choice. To show you are choosing to capitalize circulation costs, attach a statement to your return for the first tax year the choice applies. The choice is binding for the year it is made and for all later years, unless you get the permission of the IRS to revoke your choice.

Costs of Removing Barriers to the Disabled and the Elderly

The cost of an improvement to a business asset is normally a capital expense. However, you can choose to deduct your expenses for making a facility or public transportation vehicle, owned or leased for use in connection with your trade or business, more accessible to and usable by those who are disabled or elderly. For this purpose, a facility is all or any part of buildings, structures, equipment, roads, walks, parking lots, or similar real or personal property. A public transportation vehicle is a vehicle, such as a bus or railroad car, that provides transportation service to the public (including service for your customers, if you are not in the business of providing transportation services). You cannot deduct any costs that you had in completely renovating or building a new facility or public transportation vehicle, or in normally replacing depreciable property.

Amount of deduction. The most you can deduct in 1994 is \$15,000. However, any amounts in excess of this limit can be added to the basis of the property subject to depreciation.

Partners and partnerships. The \$15,000 limit applies to a partnership and also to each partner in the partnership. A partner can divide the \$15,000 in any manner among the partner's individually incurred costs and the partner's distributive share of partnership costs. If this division results in the partner not being

able to deduct all of the share of partnership costs, the partnership can add back any costs not deducted to the basis of the improved property.

A partnership must be able to show that any amount added back to basis was not deducted by the partners and that it was the amount that was over a partner's \$15,000 limit (as determined by the partner). If the partnership cannot show this, it is presumed that all the partners were able to deduct their distributive shares of the partnership's costs in full.

Example. In 1994, John Duke's distributive share of the ABC partnership's deductible expenses for the removal of architectural barriers was \$15,000. John also had \$10,000 of similar expenses in the operation of his sole proprietorship, which he chose to deduct in 1994. John allocated \$10,000 of his \$15,000 limit to his distributive share of the ABC partnership's expenses and \$5,000 to his own expenses. John may add to the basis of his own property his excess \$5,000. Also, if ABC can show that John could not deduct \$5,000 of his distributive share of the partnership's expenses, the partnership may add that amount to the basis of its property.

Qualification standards. For your costs to be deductible as a current expense, the following specific standards for improved access for the disabled or the elderly must be met:

Grading. The grading of ground must reach the level of a normal entrance to make a facility accessible to people with physical disabilities.

Walks.

- 1) A public walk must be at least 48 inches wide and must not slope more than 5%. A walk of maximum or near maximum steepness that is fairly long must have level areas at regular intervals. A walk or driveway must have a nonslip surface.
- 2) The walk must have a continuing common surface and must not have steps or sudden changes in level.
- 3) Where a walk crosses another walk, a driveway, or a parking lot, they must blend to a common level. However, this does not require the removal of curbs which are a safety feature for those with disabilities, especially blindness.
- 4) A sloping walk must have a level platform at the top and at the bottom. If a door swings out onto the platform at the top or bottom of the walk, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform, the platform must be at least 3 feet deep and 5 feet wide. A platform must extend at least 1 foot past the opening side of any doorway.

Parking lots.

- 1) At least one parking space that is near a facility must be set aside and marked for use by persons with disabilities.

- 2) The parking space must be open on one side to allow room for people in wheelchairs or on braces or crutches to get in and out of a car onto a level surface.
- 3) A designated parking space that is placed between two regular diagonal or head-on parking spaces must be at least 12 feet wide.
- 4) The parking space must be located so that people in wheelchairs or on braces or crutches do not have to go behind parked cars.

Ramps.

- 1) A ramp must not rise more than 1 inch for each foot of length.
- 2) The ramp must have at least one handrail that is 32 inches high, measured from the surface of the ramp. The handrail must be smooth, and must extend at least 1 foot past the top and bottom of the ramp. However, this does not require a handrail extension, which is itself a hazard.
- 3) The ramp must have a nonslip surface.
- 4) The ramp must have a level platform at the top and at the bottom. If a door swings out onto the platform, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform, the platform must be at least 3 feet deep and 5 feet wide. The platform must extend at least 1 foot past the opening side of any doorway.
- 5) The ramp must have level platforms no farther than 30 feet apart and at any turn.
- 6) A curb ramp must be provided at an intersection. The curb ramp must not be less than 4 feet wide and must not slope more than 1 inch for each foot of length. The two surfaces must blend smoothly. A curb ramp must have a nonslip surface.

Entrances. A building must have at least one main entrance that is usable by people in wheelchairs. The entrance must be on a level accessible to an elevator.

Doors and doorways.

- 1) A door must have a clear opening at least 32 inches wide and must be operable by a single effort.
- 2) The floor on the inside and outside of a doorway must be level for at least 5 feet from the door in the direction that the door swings and must extend at least 1 foot past the opening side of the doorway.
- 3) There must not be any sharp slopes or sudden changes in level at a doorway. The threshold must be flush with the floor. A door closer must be selected, placed, and set so as not to impair the use of the door by persons with disabilities.

Stairs.

- 1) Stairsteps must have round nosing of between 1 and 1½ inch radius.
- 2) Stairs must have a handrail 32 inches high as measured from the front of the tread.

- 3) Stairs must have at least one handrail that extends at least 18 inches past the top step and the bottom step. But this does not require a handrail extension which is itself a hazard.
- 4) Each step must not be more than 7 inches high.

Floors.

- 1) Floors must have a nonslip surface.
- 2) Floors on each story of a building must be on the same level or must be connected by a ramp, as discussed previously.

Toilet rooms.

- 1) A toilet room must have enough space for people in wheelchairs.
- 2) The toilet room must have at least one toilet stall that—
 - a) Is at least 36 inches wide,
 - b) Is at least 56 inches deep,
 - c) Has a door, if any, that is at least 32 inches wide and swings out,
 - d) Has handrails on each side that are 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches away from the wall, and fastened securely at the ends and center, and
 - e) Has a toilet with a seat 19 to 20 inches from the floor.
- 3) The toilet room must have, in addition to or instead of a toilet stall described in (2), at least one toilet stall that:
 - a) Is at least 66 inches wide,
 - b) Is at least 60 inches deep,
 - c) Has a door, if any, that is at least 32 inches wide and swings out,
 - d) Has a handrail on one side, 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches away from the wall, and fastened securely at the ends and center, and
 - e) Has a toilet with a seat 19 to 20 inches from the floor with a centerline located 18 inches from the side wall on which the handrail is located.
- 4) The toilet room must have sinks with narrow aprons. Drain pipes and hot water pipes under a sink must be covered or insulated.
- 5) A mirror and a shelf above a sink must not be higher than 40 inches above the floor, measured from the top of the shelf and the bottom of the mirror.
- 6) A toilet room for men must have wall-mounted urinals with the opening of the basin 15 to 19 inches from the floor or floor-mounted urinals that are level with the main floor.
- 7) Towel racks, towel dispensers, and other dispensers and disposal units must not be mounted higher than 40 inches from the floor.

Water fountains.

- 1) A water fountain or cooler must have up-front spouts and controls.
- 2) The water fountain or cooler must be hand-operated or hand-and-foot-operated.
- 3) A water fountain mounted on the side of a floor-mounted cooler must not be more than 30 inches above the floor.
- 4) A wall-mounted, hand-operated water cooler must be mounted with the basin 36 inches from the floor.
- 5) The water fountain must not be fully recessed and must not be set into an alcove unless the alcove is at least 36 inches wide.

Public telephones.

- 1) A public telephone must be placed so that the dial and the headset can be reached by people in wheelchairs.
- 2) The public telephone must be equipped for those who are hearing impaired and be so identified with instructions for use.
- 3) Coin slots of public telephones must not be more than 48 inches from the floor.

Elevators.

- 1) An elevator must be accessible to, and usable by, persons with disabilities and the elderly on the levels they use to enter the building and all levels and areas normally used.
- 2) Cab size must allow for turning a wheelchair. It must measure at least 54 by 68 inches.
- 3) Door clear opening width must be at least 32 inches.
- 4) All controls needed must be within 48 to 54 inches from the cab floor. These controls must be usable by those who are visually impaired and must be identifiable by touch.

Controls. Switches and controls for light, heat, ventilation, windows, draperies, fire alarms, and all similar controls that are needed or used often must be placed within the reach of people in wheelchairs. These switches and controls must not be higher than 48 inches from the floor.

Markings.

- 1) Raised letters or numbers must be used to mark rooms and offices. These markings must be placed on the wall to the right or left of the door at a height of 54 to 66 inches from the floor.
- 2) A door that might prove dangerous if a person who is blind were to use it, such as a door leading to a loading platform, boiler room, stage, or fire escape, must be identifiable by touch.

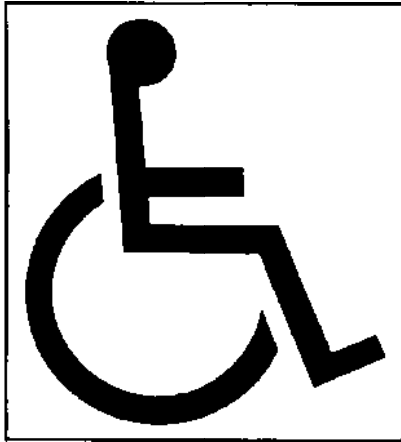
Warning signals.

- 1) An audible warning signal must be accompanied by a simultaneous visual signal for the benefit of those who are hearing impaired.

- 2) A visual warning signal must be accompanied by a simultaneous audible signal for the benefit of persons who are blind.

Hazards. Hanging signs, ceiling lights, and similar objects and fixtures must be at least 7 feet from the floor.

International accessibility symbol. The international accessibility symbol (see illustration) must be displayed on routes to and at wheelchair-accessible entrances to facilities and public transportation vehicles.



Rail facilities.

- 1) A rail facility must have at least one entrance with a clear opening at least 36 inches wide.
- 2) A boarding platform edge bordering a drop-off or other dangerous condition must be marked with a strip of floor material that is different in color and texture from the rest of the floor surface. The gap between boarding platform and vehicle doorway must be as small as possible.

Buses.

- 1) A bus must have a mechanism such as a lift or ramp to enable a wheelchair user to enter the bus and enough clearance to let a wheelchair user reach a secure location.
- 2) The bus must have a wheelchair-securing device. However, this does not require a wheelchair-securing device that is itself a barrier or hazard.
- 3) The vertical distance from a curb or from street level to the first front doorstep must not be more than 8 inches; each front doorstep after the first step up from the curb or street level must also not be more than 8 inches high; and the steps at the front and rear doors must be at least 12 inches deep.
- 4) The bus must have clear signs that indicate that seats in the front of the bus are priority seats for persons who have disabilities or are elderly. The signs must encourage other passengers to make these seats available to those who have priority.

- 5) Handrails and stanchions must be provided in the entrance to the bus so that passengers who have disabilities or are elderly can grasp them from outside the bus and use them while boarding and paying the fare. This system must include a rail across the front of the bus interior for passengers to lean against while paying fares. Overhead handrails must be continuous except for a gap at the rear doorway.
- 6) Floors and steps must have nonslip surfaces. Step edges must have a band of bright contrasting color running the full width of the step.
- 7) A stepwell next to the driver must have, when the door is open, at least 2 foot-candles of light measured on the step tread. Other stepwells must have, at all times, at least 2 foot-candles of light measured on the step tread.
- 8) The doorways of the bus must have outside lighting that provides at least 1 foot-candle of light on the street surface for a distance of 3 feet from the bottom step edge. This lighting must be below window level and must be shielded from the eyes of entering and exiting passengers.
- 9) The fare box must be located as far forward as practical and must not block traffic in the vestibule.

Rapid and light rail vehicles.

- 1) Passenger doorways on the vehicle sides must have clear openings at least 32 inches wide.
- 2) Audible or visual warning signals must be provided to alert passengers of closing doors.
- 3) Handrails and stanchions must permit safe boarding, moving around, sitting, standing, and getting off by persons who have disabilities or are elderly. On a level-entry vehicle, handrails, stanchions, and seats must be located to allow a wheelchair user to enter the vehicle and position the wheelchair in a location that does not block the movement of other passengers. On a vehicle with steps, handrails and stanchions must be provided in the entrance so that persons who have disabilities or are elderly can grasp them and use them from outside the vehicle while boarding.
- 4) Floors must have nonslip surfaces. Step edges on a light rail vehicle must have a band of bright contrasting color running the full width of the step.
- 5) A stepwell next to the driver must have, when the door is open, at least 2 foot-candles of light measured on the step tread. Other stepwells must have, at all times, at least 2 foot-candles of light measured on the step tread.
- 6) Doorways on a light rail vehicle must have outside lighting that provides at least 1 foot-candle of light on the street surface

for a distance of 3 feet from the bottom step edge. This lighting must be below window level and must be shielded from the eyes of entering and exiting passengers.

Other barrier removals. To be deductible, expenses of removing any barrier not covered by the above standards must meet three tests.

- 1) The removed barrier must be a substantial barrier to access or use of a facility or public transportation vehicle by persons who have disabilities or are elderly,
- 2) The removed barrier must have been a barrier for at least one major group of these persons (such as people who are blind, deaf, or physically disabled), and
- 3) The barrier must be removed without creating any new barrier that significantly impairs access to or use of the facility or vehicle by these persons.

How to make the choice. If you choose to deduct your costs for removing barriers to the disabled or the elderly, claim the deduction on your income tax return (partnership return for partnerships) for the tax year the expenses were paid or incurred. Identify the deduction as a separate item. For your choice to be valid, you must file your return no later than its due date, including extensions. Your choice is irrevocable after the due date of your return. The choice applies to all the qualifying costs you have during the year, up to the \$15,000 limit. If you make this choice, you must maintain adequate records to support your deduction.

Disabled access credit. If you make your business accessible to people with disabilities and your business is an eligible small business, you may be able to take the disabled access credit. If you make this choice you must reduce the amount you deduct or capitalize by the amount of the credit.

For more information, see Chapter 32 in Publication 334.

12.

Amortization

Important Reminder

Amortization of certain intangibles. You may have to amortize, over 15 years, certain intangibles that you acquired in connection with a trade or business.

For more information, see *Amortization of Certain Intangibles*, later.

Topics

This chapter discusses:

- Amortization of certain intangibles
- Going into business expenses
- Reforestation expenses
- Pollution control facilities
- Construction period interest and taxes
- Research and experimental costs
- Bond premium
- The cost of acquiring a lease

Useful Items

You may want to see:

Publication

- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses
- 551** Basis of Assets

Form (and Instructions)

- 3468** Investment Credit
- 4562** Depreciation and Amortization
- 6251** Alternative Minimum Tax—Individuals

You may be able to deduct each year, as amortization, a part of certain capital expenses. Amortization lets you recover these expenses in a way that is like straight line depreciation. Only certain specified expenses may be amortized for federal income tax purposes.

Since amortization sometimes allows a write-off of expenses that are not ordinarily deductible, you may want to elect to recover your eligible expenses by taking amortization deductions.

If you want to amortize your expenses, you usually must make an election to do so. The election is made by reporting the deduction on Form 4562. See the discussion under each type of amortization for more information.

Report your amortization deduction for tax years after your election on Form 4562 only if you are otherwise required to file the form. You must file Form 4562 if:

- 1) You are beginning to claim amortization this tax year,
- 2) You are claiming depreciation on property placed in service this year,
- 3) You are claiming a section 179 deduction,
- 4) You are claiming a deduction for any vehicle reported on a form other than Schedule C (Form 1040) or Schedule C-EZ (Form 1040),
- 5) You are claiming depreciation on any listed property, or
- 6) You are claiming depreciation on a return for a corporation (other than an S corporation).

If you do not have to file Form 4562, claim amortization directly on the “Other Expenses”

or “Other Deductions” line of either Schedule C (Form 1040), Form 1065, or Form 1120.

Optional write-off of tax preferences. This chapter does not discuss the optional write-off periods for:

- Intangible drilling and development costs,
- Circulation costs, or
- Mining exploration and development costs.

See the instructions for Form 6251.

Amortization of Certain Intangibles

You must amortize the capitalized costs of certain intangibles that you acquire after August 10, 1993 over 15 years. These intangibles are called “amortizable section 197 intangibles” and are defined later. They must be held in connection with your trade or business or in an activity engaged in for the production of income. The amount of your deduction is the adjusted basis (for purposes of determining gain) of the intangible amortized over a 15-year period beginning with the month acquired. No other depreciation or amortization deduction is allowed for section 197 intangibles.

Effective date elections. While this amortization provision generally applies only to property acquired after August 10, 1993, under **two elections**, you may choose to have it apply differently.

First, you can choose to apply this amortization provision to section 197 intangibles acquired after July 25, 1991, and before August 11, 1993. Once made, the election applies to all section 197 intangibles acquired during that period and it can only be revoked with the consent of the IRS.

Second, you can choose **not** to apply this amortization provision to section 197 intangibles acquired after August 10, 1993, if they were acquired under a binding written contract in effect on that date and at all times thereafter until the property was acquired. Once made, the choice applies to all property acquired under that contract, and the choice can only be revoked with the consent of the IRS. This election may not be made if you have chosen to apply the new amortization provision to all section 197 intangibles acquired after July 25, 1991, as discussed in the preceding paragraph.

Special rules prevent you from converting goodwill, going concern value, or any other section 197 intangible from property this amortization provision would not apply to into property that would qualify for the amortization. See *Anti-churning rules*, later.

Section 197 Intangibles

The following assets are section 197 intangibles:

- 1) Goodwill,
- 2) Going concern value,

- 3) Workforce in place including its composition, terms, and conditions (contractual or otherwise) of employment,
- 4) Business books and records, operating systems, and any other information base including lists, or other information with respect to current or future customers,
- 5) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item,
- 6) A customer-based intangible,
- 7) A supplier-based intangible,
- 8) A license, permit, or other right granted by a governmental unit or agency (including renewals),
- 9) A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business, and
- 10) A franchise, trademark, or trade name (including renewals).

You cannot amortize any of the intangibles listed in items 1) through 7) that you created, unless you created it in connection with the acquisition of a substantial portion of a business.

Goodwill. Goodwill is the value of a trade or business that is attributable to expected continued customer patronage, due to either the name or the reputation of a trade or business or to any other factor.

Going concern value. Going concern value is the additional value of a trade or business that attaches to property because it is an integral part of a going concern. It includes the value attributable to the ability of a business to continue to function and generate income even though there is a change in ownership.

Workforce in place. This includes the composition of a workforce (for example, its experience, education, or training), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Therefore, the part of a purchase price of a trade or business attributable to the existence of a highly-skilled workforce, or the cost of acquiring an existing employment contract or relationship with employees or consultants as part of the acquisition of a trade or business are examples of workforce in place.

Business books and records, etc. This includes any part of the purchase price of a trade or business attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems. Business books and records also include the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio, or television advertisers.

Patents, copyrights, etc. Package designs, computer software, and any interest in a film, sound recording, videotape, book, or other similar property, except as discussed later

under *Intangibles that are not section 197 intangibles* are included as part of this category.

Customer-based intangible. A customer-based intangible is the composition of market, market share, and any other value resulting from the future provisions of goods and services because of relationships with customers in the ordinary course of business. It includes that part of the purchase price of a trade or business that is attributable to a customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services.

Customer-based intangibles do not include that part of the purchase price of a trade or business that is attributable to accounts receivable or other similar rights to income for goods or services that have been provided to customers before the acquisition of that trade or business.

Supplier-based intangible. A supplier-based intangible is the value resulting from the future acquisition of goods or services because of relationships in the ordinary course of business with suppliers of goods or services to be used or sold by the business. Examples include that part of the purchase price of a trade or business that is attributable to the existence of a favorable relationship with distributors (such as favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts.

License, permit, etc. granted by government. Any license, permit, or other right granted by a governmental unit or agency is a section 197 intangible. For example, this includes the capitalized costs of acquiring (including issuing or renewing) from any person, a liquor license, a taxi-cab medallion or license, or a television or radio broadcasting license.

Covenant not to compete. A covenant not to compete (or similar arrangement) entered into in connection with the acquisition of an interest in a trade or business is a section 197 intangible. An interest in a trade or business includes holding stock in a corporation engaged in a trade or business and having an interest in a partnership engaged in a trade or business.

Any amount paid or incurred under a covenant not to compete (or similar arrangement) after the tax year in which the covenant was entered into, is amortized over the remaining months in the 15-year amortization period.

Amounts paid under a covenant not to compete (or similar arrangement) that actually represent additional consideration for the purchase of stock in a corporation are not eligible for amortization. They must be added to the basis of the acquired stock.

Franchise, trademark, or trade name. A franchise, trademark, or trade name is a section 197 intangible. A current deduction is allowed for amounts paid or incurred on the

transfer of a franchise, trademark, or trade name if:

- 1) The payments are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name,
- 2) The payments are part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and
- 3) The payments are substantially equal in amount or payable under a fixed formula.

Any other amount, whether fixed or contingent, that is paid or incurred on the acquisition is not a section 197 intangible. Instead, it is a capitalized cost of a section 197 intangible.

Intangibles that are not section 197 intangibles. The following assets are not section 197 intangibles:

- 1) Any interest in a corporation, partnership, trust or estate, futures contract, foreign currency contract, notional principal contract, or similar financial contract,
- 2) Any interest in land,
- 3) Most computer software (see *Computer software*, later),
- 4) Any of the following **not** acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business:
 - a) An interest in a film, sound recording, videotape, book, or similar property,
 - b) A right to receive tangible property or services under a contract or granted by a governmental agency,
 - c) An interest in a patent or copyright,
 - d) A right under a contract (or a right granted by a governmental agency) if the right has a fixed life of less than 15 years or is of a fixed amount that except for the section 197 intangible provisions, would be recoverable under a method similar to the unit-of-production method of cost recovery.
- 5) An interest under an existing lease or sublease of tangible property,
- 6) An interest under an indebtedness that was in existence when the interest was acquired,
- 7) Sports franchises,
- 8) A right to service residential mortgages unless the right is acquired in the acquisition of a trade or business or a substantial part of a trade or business, and
- 9) Certain transaction costs under a corporate organization or reorganization in which any part of a gain or loss is not recognized.

Computer software. Section 197 intangibles do not include computer software that is:

- 1) Readily available for purchase by the general public,
- 2) Subject to a nonexclusive license, and

- 3) Not substantially changed.

Also, computer software not acquired in the acquisition of a substantial part of a business is not section 197 property.

If depreciation is allowed for any computer software that is not a section 197 intangible, use the straight line method with a useful life of 36 months.

For more information on depreciation of computer software, see Publication 534.

Computer software defined. Computer software includes all programs designed to cause a computer to perform a desired function. It also includes any data base or similar item that is in the public domain and is incidental to the operation of qualifying software.

Additional costs associated with nonsection 197 intangibles. Additional costs that are taken into account in determining the basis of property that is not a section 197 intangible are not themselves section 197 intangibles. For example, none of the cost of acquiring real property held for the production of rental income (including goodwill, going concern value, etc.) is an amortizable section 197 intangible. These costs are instead, added to the basis of the real property.

Dispositions. A section 197 intangible is treated as depreciable property used in your trade or business. Therefore, if you dispose of a section 197 intangible that you held for more than 1 year, the property qualifies as section 1231 property. Any gain on the disposition is treated as ordinary income to the extent of the allowable amortization. The gain or loss on the sale of property held for 1 year or less is reported as an ordinary gain or loss. See Chapter 2 in Publication 544, *Sales and Other Dispositions of Assets*, for more information.

If you acquire more than one section 197 intangible in a transaction (or series of related transactions) and later dispose of one of them or if one of them becomes worthless, you cannot recognize any loss on it. Increase the adjusted basis of each remaining amortizable section 197 intangible that you did not dispose of by:

The amount of the loss not recognized on the disposition

MULTIPLIED BY

A fraction:

- The numerator of which is the adjusted basis of that remaining intangible as of the date of its disposition, and
- The denominator of which is the total adjusted basis of all retained amortizable section 197 intangibles as of the date of the disposition.

Covenant not to compete. A covenant not to compete or similar arrangement is not considered disposed of or worthless before the disposition of your entire interest in the trade or business for which the covenant was entered into.

Nonrecognition transfers. If you dispose of one section 197 intangible and acquire another section 197 intangible in a nonrecognition transfer, the part of the adjusted basis of the acquired intangible that does not exceed the adjusted basis of the transferred intangible will be treated as the transferred section 197 intangible. Nonrecognition transfers include, but are not limited to, incorporation transfers, partnership contributions and distributions, like-kind exchanges, and involuntary conversions.

Example. You own a section 197 intangible that you have amortized for 4 full years and that has a remaining unamortized basis of \$30,000. You exchange the asset plus \$10,000 for a like-kind section 197 intangible. The nonrecognition provisions of like-kind exchanges apply. Therefore, \$30,000 of the basis of the acquired section 197 intangible will be amortized over the 11 years remaining in the original 15-year amortization period for the transferred asset. The other \$10,000 of adjusted basis will be amortized over 15 years.

Anti-Churning Rules

You cannot convert existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable before August 10, 1993, to amortizable property. Under the anti-churning rules any intangible for which an amortization deduction is only allowable under section 197 cannot be treated as an amortizable section 197 intangible if it was acquired after August 10, 1993, and:

- 1) You or a related person (defined later) held or used the intangible at any time from July 25, 1991, through August 10, 1993, or
- 2) You acquired the intangible from a person who held the intangible at any time from July 25, 1991, through August 10, 1993, and as part of the transaction, the user does not change, or
- 3) You grant the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the period from July 25, 1991, through August 10, 1993.

The anti-churning rules do not apply to an intangible you acquired from a decedent if the property's basis is stepped up to fair market value.

For more information on the basis of property acquired from a decedent see *Basis—Property Acquired from a Decedent*, in Publication 448, *Federal Estate and Gift Taxes*.

Related person. For purposes of the anti-churning rules related persons are:

- 1) Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) An individual and a corporation when the individual owns, directly or indirectly,

more than 20% in value of the outstanding stock of the corporation.

- 3) Two corporations that are members of the same controlled group as defined in section 1563(a), except that "more than 20%" is substituted for "at least 80%" in that definition.
- 4) A trust fiduciary and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 20% in value of the outstanding stock of the corporation.
- 5) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- 6) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 7) A tax-exempt educational or charitable organization and a person (or if the person is an individual, a member of that person's family) who, directly or indirectly, controls such an organization.
- 8) A corporation and a partnership if the same persons own more than 20% in value of the outstanding stock of the corporation and more than 20% of the capital interest, or the profits interest, in the partnership.
- 9) Two S corporations if the same persons own more than 20% in value of the outstanding stock of each corporation.
- 10) Two corporations, one of which is an S corporation, if the same persons own more than 20% in value of the outstanding stock of each corporation.
- 11) Two partnerships if the same persons own, directly or indirectly, more than 20% of the capital interests or the profits interests.
- 12) A person and a partnership when the person owns, directly or indirectly, more than 20% of the capital interest or profits interests in the partnership.

These persons will be treated as related to you if the relationship exists immediately before or immediately after your acquisition of the intangible.

Ownership of stock. In determining whether an individual owns, directly or indirectly, any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning (other than by applying rule 2) any stock in a corporation is considered to own the stock owned, directly or indirectly, by or for his or her partner.

Rule 4. For purposes of applying rules 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rules 2 or 3 is not treated as owned by the individual for reapplying either rule 2 or 3 to make another person the constructive owner of the stock.

Related person exception. An exception to the anti-churning rules applies to an intangible you acquired from a person with a relationship to you that is more than 20% but not more than 50% under the following conditions:

- 1) The seller recognizes gain on the disposition of the intangible, and
- 2) The seller pays tax on the gain which when added to any other federal income tax imposed on the gain, equals tax on the gain at the highest tax rate, or
- 3) The excess of the seller's total tax liability for the year over what the seller's tax liability would have been if the sale of the intangible had been excluded from the tax computation equals or exceeds the tax on the gain on the sale of the intangible at the maximum tax rate.

If this exception applies, the anti-churning rules apply to the intangible only to the extent that your adjusted basis in the intangible exceeds the gain recognized in 1) above.

Note. The additional tax the seller pays under this exception is reported on line 39 of the seller's Form 1040. On the dotted line next to line 39, the seller should also write "197."

Anti-abuse rule. A section 197 intangible may not be amortized under these rules if you acquired the intangible in a transaction one of the principal purposes of which is to:

- 1) Avoid the requirement that the intangible be acquired after August 10, 1993, or
- 2) Avoid any of the anti-churning rules.

Recapture of Amortization

Amortization you claim on section 197 property is subject to the recapture rules of section 1245 of the Internal revenue Code. For more information on the recapture rules of section 1245 property, see Chapter 4 in Publication 544.

Going Into Business

When you go into business, all the costs you have to get your business started are treated as capital expenses and are a part of your basis in the business. Any costs that are for particular assets can generally be recovered through depreciation deductions. Other costs generally cannot be recovered until you sell or otherwise go out of business. (See *Capital Expenses* in Chapter 1 for a discussion of how to treat these costs if you do not go into business.)

However, you can elect to amortize certain costs that you have in setting up your business. These costs are deducted in equal amounts over 60 months or more. To be amortizable, costs must qualify in one of the following three areas:

- 1) Business start-up costs,
- 2) Organizational costs for a corporation, or
- 3) Organizational costs for a partnership.

The sections that follow discuss which costs qualify in each of these three areas.

Business start-up costs. Start-up costs are those you have in setting up an active trade or business or investigating the possibility of creating or acquiring an active trade or business. Start-up costs include any amounts paid or incurred in an activity engaged in for profit and the production of income in anticipation of the activity becoming an active trade or business.

To be amortizable, your start-up cost must meet the following tests.

- 1) It must be a cost that you could deduct if it were paid or incurred to operate an existing trade or business.
- 2) You must pay or incur the cost before you actually begin your business operations.

Start-up costs **include** what you pay for both investigating a prospective business and getting the business started. For example, they may include costs for the following items:

- A survey of potential markets,
- An analysis of available facilities, labor, supplies, etc.,
- Advertisements for the opening of the business,
- Salaries and wages for employees who are being trained, and their instructors,
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers, and
- Salaries and fees for executives and consultants, or for other professional services.

Start-up costs **do not include** deductible interest, taxes, and research and experimental costs. See *Research and Experimental Costs*, later.

Business sold. If you completely dispose of your business before the end of the amortization period selected, any deferred start-up costs for the business that you have not deducted can be deducted to the extent they qualify as a loss from a business.

Organizational costs for a corporation. Corporate organizational costs are those used directly for the creation of the corporation. They include the cost of temporary directors, organizational meetings, state incorporation fees, and accounting services for setting up the organization. They also include the cost of legal services, such as drafting the charter, by-laws, terms of the original stock certificates, and minutes of organizational meetings.

However, you cannot amortize costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs, because they are not organizational costs. Costs for the transfer of assets to the corporation also cannot be amortized. They are capitalized.

To qualify for amortization, your organizational cost must meet all three of the following tests.

- 1) It must be incident to the creation of the corporation. You must have incurred the cost before the end of the first tax year in which the corporation is in business. A corporation using the cash method of accounting may amortize organizational expenses incurred within the first tax year, even if it does not pay them in that year.
- 2) It must be chargeable to a capital account.
- 3) It must be a cost that could be amortized over the life of the corporation, if the corporation had a fixed life.

Organizational costs for a partnership. Partnership organizational costs are those costs for the creation of the partnership. To be amortizable, your organizational cost must be chargeable to a capital account; and it must be one that you could amortize over the life of the partnership, if the partnership had a fixed life.

The expenses must be for the creation of the partnership and not for starting or operating the partnership trade or business. Organizational expenses include legal and accounting fees that are for services incident to the organization of a partnership, such as the negotiation and preparation of a partnership agreement, and filing fees.

Partnership organizational costs do not include syndication fees. That is, they do not include costs for issuing and marketing interests in the partnership, such as commissions, professional fees, and printing costs. These costs are capitalized. You cannot depreciate or amortize these costs.

How to amortize. You deduct start-up and organizational costs in equal amounts over a period of not less than 60 months. You can elect a period for start-up costs that is different from the period you elect for organizational costs, as long as both are 60 months or more. Once you elect an amortization period, you cannot change it.

To figure your deductions, you divide your total start-up or organizational costs by the months in the amortization period. The result is the amount you can deduct each month.

However, partnerships on the cash method of accounting are not allowed a deduction for an expense that has not been paid by the end of the tax year. Any expense that your partnership could have deducted as an organizational expense in an earlier tax year if it had paid it, can be deducted in the tax year of payment.

The amortization period starts with the month you begin business operations. You can amortize only if you actually go into business. For the amortization of organizational

costs, a partnership or corporation is considered to begin business operations when it starts the activities for which it is organized. This can happen either before or after the corporate charter is granted or a partnership agreement is signed. A partnership or corporation is considered to begin business when its activities have reached the point where the nature of its business operations is established. For example, if it acquires the assets it needs to operate its business, this may constitute the beginning of business activities.

Making the election. To amortize your costs, you must complete Part VI of Form 4562 and attach it to your income tax return. You must also attach to your return a statement showing the information listed below. If you have both start-up and organizational costs, attach a separate statement to your return for each type of cost. Each statement should:

- 1) Show the total start-up or organizational costs you will amortize,
- 2) Describe what each is for,
- 3) Give the date each was incurred,
- 4) State the month your business began operations (or the month you acquired the business), and
- 5) Specify the number of months in your amortization period (not less than 60).

Attach Form 4562 and accompanying statements to your return for the first tax year you are in business. The return must be filed by the due date for the return (including any extensions).

Partnerships and corporations. If your business is organized as a partnership or corporation, only your partnership or corporation can elect to amortize its start-up or organizational costs. A partner or shareholder cannot make this election.

If you as a partner or shareholder incur costs in setting up your partnership or corporation, you cannot amortize them. If the partnership or corporation does not reimburse you for these costs, it cannot amortize them. These costs then become part of the basis of your interest in the business. You can recover them only when you sell your interest in the partnership or corporation.

However, you as an individual can elect to amortize the costs you incur to investigate an interest in an existing partnership. These costs qualify as business start-up costs if you succeed in acquiring your interest.

Reforestation Expenses

You can elect to amortize a limited amount of your reforestation expenses for qualified timber property.

Reforestation expenses are the direct costs you incur in planting or seeding for reforestation or reforestation. **Qualifying expenses include** amounts spent for site preparation, seeds or seedlings, labor, tools, and depreciation on equipment used in planting or

seeding. The qualified costs include only those costs that you must capitalize and include in the adjusted basis of the property. Costs you can deduct currently do not qualify.

If the government reimburses you for expenses under a cost-sharing program, you cannot amortize these expenses unless you include the reimbursement in your income.

Qualified timber property. Your qualified timber property must be located in the United States. You must hold it for the growing and cutting of timber that will either be used by you or sold by you, for use in the commercial production of timber products. Your property may be a woodlot or other site, but it must consist of at least one acre that is planted with tree seedlings in a manner normally used in forestation or reforestation. You do not have to own the property. You can elect to amortize qualifying reforestation expenses you incur on qualified leased property. Qualified timber property does not include property on which you have planted shelter belts or ornamental trees, such as Christmas trees.

Yearly limit. Each year, you can elect to amortize up to \$10,000 of qualified expenses that you incur during the tax year. The yearly limit is \$5,000 if you are a married individual filing a separate return. You cannot carry over or carry back qualifying expenses that are over the yearly limit. The yearly limit applies to expenses you pay or incur during a tax year on all of your qualified timber property. If you incur more than \$10,000 in expenses for more than one piece of timber property, you can allocate the yearly limit among the properties.

For example, if you incur \$10,000 of qualifying expenses on each of four qualified timber properties in 1994, you can elect to amortize \$2,500 of the amount spent on each property, or you can elect to amortize \$10,000 spent on any one property.

Partnerships and S corporations. Similar rules apply to partnerships and S corporations.

A partnership or S corporation makes the election to amortize its qualified expenses. The yearly limit on expenses that can be amortized applies to the partnership or S corporation, as well as to each partner or shareholder. The yearly limit for a partnership or S corporation is \$10,000. The amortizable expenses are allocated among the partners or shareholders.

A partner or shareholder is again subject to a yearly limit of \$10,000 (\$5,000, if married and filing a separate return) in the aggregate. For example, if a married individual is a partner in two or more partnerships that elect to amortize qualified expenses, the individual's total share of partnership amortizable basis acquired during the year cannot be more than \$10,000 on a joint return, or \$5,000 on a separate return. **Amortizable basis** is the part of the basis of qualified property that is from reforestation expenses.

Estates. Estates can elect to amortize up to \$10,000 of qualified reforestation expenses incurred in each tax year. Any amortizable basis acquired by an estate is apportioned between

the estate and the income beneficiary on the basis of the income of the estate allocable to each. The amount of amortizable basis apportioned from an estate to a beneficiary is taken into account in determining the beneficiary's yearly limit.

Life tenant and remainderman. If property is held by one person for life with the remainder to another person, the life tenant is entitled to the full amortization (up to the yearly limit) for reforestation expenses made by the life tenant. The remainder interest is ignored for amortization.

Amortization period. Qualified reforestation expenses can be amortized over a period of 84 months. The 84-month period starts on the first day of the seventh month of the tax year you incur the expenses. You can claim amortization deductions for only 6 months of the first and eighth tax years of the period.

Example. John Jones incurred qualified reforestation expenses of \$8,400 in 1994. First he figures his monthly deduction by dividing \$8,400 by 84 months to arrive at \$100 per month. Since 1994 is the first year of the 84-month period, he can deduct only \$600 (\$100 a month for 6 months).

Recapture. If you sell or otherwise dispose of qualified timber property within 10 years after the tax year you elect to amortize reforestation expenses for it, you must report any gain as ordinary income to the extent of the amortization taken.

Investment credit. Reforestation expenses that are eligible to be amortized qualify for an investment credit, whether or not they are amortized. See the instructions for Form 3468 for information.

Election to amortize. To make this election, attach Form 4562 to your income tax return and enter the deduction in Part VI of that form. Also, attach a statement to Form 4562 that describes the expenses and provides the dates they were incurred. Show the type of timber being grown and the purpose for which it is grown. Attach a separate statement for each property for which you amortize reforestation expenses. You can make the election only on a timely filed return (including extensions) for the tax year in which the expenses were made.

Revocation. You must get consent to revoke an election to amortize reforestation expenses. Your application to revoke must set forth your name, address, the years for which your election was in effect, and your reason for revoking it. You must sign the application and file it at least 90 days before the time prescribed (without extensions) for filing your income tax return for the first tax year for which your election is to terminate. Send the application to the:

Commissioner of Internal Revenue,
Washington, DC 20224.

Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility over a period of 60 months. The facility must be used for a plant (or other property) that was in operation before 1976.

Certified pollution control facility. A certified pollution control facility is a new identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. It must be appropriately certified by state and federal certifying authorities.

The facility must not significantly increase the output or capacity, extend the useful life, or reduce the total operating costs of the plant or other property. It also must not significantly change the nature of the manufacturing or production process or facility.

If it appears that all or a part of the cost of a facility will be recovered from its operation, such as through sales of recovered wastes, the federal certifying authority will certify to that effect, describing the nature of the potential cost recovery. The amortizable cost of the facility must be reduced accordingly.

New identifiable treatment facility. A new identifiable treatment facility is tangible depreciable property. A building and its structural components is not included unless the entire building is a treatment facility.

For more information, see section 169 of the Internal Revenue Code and the Income Tax Regulations thereunder.

Alternative minimum tax. Individuals, estates, and trusts who elect amortization may be liable for alternative minimum tax. Individuals see Form 6251 and its instructions. Estates and trusts see Form 1041.

Construction Period Interest and Taxes

You must capitalize the cost of constructing or improving property used in a trade or business or an activity engaged in for profit. These capitalized costs, including construction period interest and taxes incurred after 1986, generally are recovered through depreciation. See Publication 551 for more information on costs that must be capitalized.

However, construction period interest and taxes incurred before 1987 on real property (other than low-income housing) expected to be used for a trade or business or in an activity conducted for profit generally could not be depreciated. Instead, the amounts usually had to be amortized.

Amortization deduction. A fixed percentage of the interest and taxes incurred before 1987 was deductible in the tax year paid or accrued

and in each following amortization year, as shown in the table below.

If the amount is paid or accrued in a tax year starting in:

Nonresidential property	Residential property	Percentage each year
—	1983	11½
1982–1986	1984–1986	10
after 1986	after 1986	–0–

Amortization year. The amortization year means the tax year in which the amount was paid or accrued, and each tax year thereafter starting with the later of:

- 1) The tax year after the tax year in which the amount was paid or accrued, or
- 2) The tax year in which the real property was ready to be placed in service or held for sale, until the full amount has been allowed as a deduction (or until the property is sold or exchanged).

Reporting amortization. Deduct your amortization on the appropriate line of your tax return or in Part VI of Form 4562 if you are otherwise required to file that form.

Research and Experimental Costs

Your research and experimental costs can be either amortized or deducted as current business costs. See Chapter 11 for a discussion of the choice to deduct the costs currently. If you choose to amortize the costs, you can deduct them in equal amounts over a period of not less than 60 months, beginning with the month in which you first receive an economic benefit from the research.

You also have the option of deducting research and experimental costs ratably over a 10-year period beginning with the tax year in which the costs are incurred.

The amortization deduction is an election that applies to those costs that are chargeable to a capital account and that:

You paid or incurred in your trade or business, and

You are not deducting currently.

For more information, see sections 174 and 59(e) of the Internal Revenue Code and the Income Tax Regulations.

Election to amortize. To make this election, attach Form 4562 to your income tax return and enter the deduction in Part VI of that form.

Bond Premium

Bond premium is generally the amount you pay for a bond that is greater than the amount the bond issuer will pay upon maturity of the bond. For taxable bonds, bond premium is determined by the amount the issuer will pay

upon an earlier call date if it results in a smaller amortizable bond premium for the period ending on the call date. Bond premium does not include any amount for the conversion features of a bond.

You must amortize the premium on tax-exempt bonds, but you cannot deduct the amortizable premium in figuring your taxable income. Each year reduce your basis in the bond by the amount of the premium amortized for the year.

You can elect to amortize the premium on taxable bonds. If you do not elect to amortize the premium, it is treated as part of your basis of the bond.

If you are required or elect to amortize the premium, you decrease the basis of the bond by the amortizable bond premium. This gives the adjusted basis you use to figure gain or loss on the sale or redemption of the bond.

A **dealer in taxable bonds** (or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business and who would properly include bonds on hand in inventory at the close of the tax year) cannot claim a deduction for amortizable bond premium. Instead, the premium is part of the cost of the bonds.

See section 75 of the Internal Revenue Code to determine your gross income if you are a dealer in tax-exempt bonds.

For more information and a discussion of how to report bond premium, see Publication 550.

Cost of Acquiring a Lease

If you acquire a lease for business property, you recover the cost by amortizing it over the term of the lease. The term of the lease for amortization includes all renewal options (and any other period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost is for the term of the lease remaining on the acquisition date. The remaining term of the lease on the acquisition date does not include any period for which the lease may be subsequently renewed, extended, or continued under an option exercisable by the lessee.

Enter your deduction in Part VI of Form 4562, if you are required to file that form, or on the appropriate line of your tax return. Enter “178” as the code section under which you are amortizing these costs.

Example. A lessee paid \$5,000 to acquire a lease for a building to be used in the lessee's business. The lease runs for 20 years with an option to renew for an additional 10-year period. The cost for the initial 20-year period is \$4,500. Since more than 75% of the total cost of \$5,000 (\$3,750) is for the initial 20-year period of the lease, the \$5,000 cost is amortized over 20 years.

13.

Depletion

Topics

This chapter discusses:

- Mineral property
- Oil and gas wells
- Natural and geothermal deposits
- The lessor's gross income
- Timber

Useful Items

You may want to see:

Publication

- 533** Self-Employment Tax
- 542** Tax Information on Corporations
- 544** Sales and Other Dispositions of Assets

Form (and Instructions)

- T** Forest Industries Schedules
- Sch E (Form 1040)** Supplemental Income and Loss
- Sch SE (Form 1040)** Self-Employment Tax
- 6198** At-Risk Limitations
- 6251** Alternative Minimum Tax—Individuals
- 8582** Passive Activity Loss Limitations

If you own mineral property or standing timber, you can take a deduction for depletion. Mineral property includes oil and gas wells, mines, and other natural deposits (including geothermal deposits).

The depletion deduction is available to you as an owner and operator only if you have an economic interest in mineral deposits or standing timber.

You have an economic interest if you have a legal interest in minerals in place or standing timber and you have the right to income from the extraction and sale of the mineral or the cutting of the timber to which you must look for a return of your capital investment. More than one party may have an economic interest in a mineral deposit or timber if each qualifies. If you have no legally enforceable right to share in the mineral deposit or timber, you do not have an economic interest.

Depletion is figured separately for each mineral property. A mineral property is each separate interest you own in each mineral deposit in each separate tract or parcel of land. (Various special rules let you group separate mineral properties or treat such properties as separate. See section 614 of the Internal Revenue Code.) A timber property is your economic interest in standing timber in each tract

or block representing a separate timber account.

Alternative minimum tax. Individuals, corporations, estates, and trusts who claim depletion deductions may be liable for alternative minimum tax.

For more information on individual alternative minimum tax, see the instructions for Form 6251. For more information on corporate alternative minimum tax, see Publication 542. For more information on estate and trust alternative tax, see Form 1041 and its instructions.

Mineral Property

There are two ways of figuring depletion on mineral property: cost depletion and percentage depletion. However, percentage depletion does not apply to oil and gas wells except for certain ones exempt from this rule. See *Oil and Gas Wells*, later.

If you can use percentage depletion but it is less than cost depletion for any year, you must use cost depletion.

Cost depletion. Figure cost depletion by dividing the adjusted basis of the mineral property by the total recoverable units in the property's natural deposit. Then multiply the resulting rate per unit by:

- 1) The units sold for which you receive payment during your tax year, if you use the cash method of accounting, or
- 2) The units sold, if you use the accrual method of accounting.

The adjusted basis of your mineral property is your original cost or other basis plus any capitalized costs, minus all the depletion allowed or allowable on the property. The basis for depletion would therefore be the same adjusted basis you would use in determining gain on the sale or other disposition of property but not including:

- 1) The amounts recoverable—
 - a) Through depreciation deductions,
 - b) Through deferred expenses, (including deferred exploration and development costs) and
 - c) Through deductions other than depletion.
- 2) The residual value of land and improvements at the end of operations, and
- 3) The cost or value of land acquired for purposes other than mineral production.

The adjusted basis does not include the cost of nonmineral property, such as nonmineral lands or manufacturing assets or land used for purposes other than mineral production. In the case of timber property, it does not include the land. Depletion allowed or allowable each year is the greater of percentage depletion or cost depletion. However, the adjusted basis may never be less than zero.

The total recoverable units is the number of units of mineral remaining at the end of the

year (including units recovered but not sold) plus the number of units sold during the tax year.

The recoverable units in place in a natural deposit are mainly an engineering problem. It is your responsibility to prove, by using accepted methods, the number of recoverable units.

Percentage depletion. Figure percentage depletion by multiplying a certain percentage, specified for each mineral, by your gross income from the property during the tax year. The depletion deduction under this method cannot be more than **50%** (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction.

When figuring your percentage depletion and the taxable income limit, exclude from your gross income from the property an amount equal to any rents and royalties (which are depletable income to the payee) you pay or incur for the property.

Also, reduce your gross income from the property by the allocable part of any bonus you paid for a mineral lease or an oil and gas lease on the property. Figure that part of the bonus by multiplying the total bonus you paid by a fraction. The numerator (top number) of the fraction is the number of units you sold in that tax year and the denominator (bottom number) is the total estimated recoverable units from the property.

In figuring the taxable income limit, do not deduct a net operating loss deduction from the gross income from the property.

Charitable contributions are not deducted from gross income from the property by a corporation in figuring the limit.

Also reduce mining expenses by any gain you must report as ordinary income that is allocable to the property and results from the disposition of section 1245 property.

Limit for certain oil and gas wells. If you are a qualified independent producer or royalty owner of oil and gas (see *Small Producers Exemption*, discussed later, under *Oil and Gas Wells*), your deduction for percentage depletion cannot be more than the smaller of:

- 1) Your taxable income from the property figured without the deduction for depletion (as explained above), or
- 2) 65% of your taxable income from all sources figured without the depletion allowance, any net operating loss carryback, and any capital loss carryback.

Any amount that cannot be deducted because of the 65% limit can be carried over and added to your depletion allowance (before applying any limits) for the following year.

Oil and Gas Wells

Generally, percentage depletion is not allowed for any oil or gas well. However, an exemption from this rule applies to certain gas and oil producers.

The use of percentage depletion for oil and gas is usually allowed only for domestic gas

and oil production of small producers. The percentage depletion allowance is 15% of the gross income from the qualifying production from oil and gas property.

Small Producers Exemption

Independent producers and royalty owners (small producers) qualify for a 15% rate for an average daily production of up to 1,000 barrels. (6,000 cubic feet of natural gas is the equivalent of a barrel of oil.) This is the small-producer exemption.

If you have a part interest in property, you have production from that property in proportion to your interest.

Share of production for part interest.

You have a part interest in property, for example, if you have a net profits interest. To figure the share of production for your net profit interest, you must determine your percentage participation (as measured by the net profits) in the gross revenue from the property. To figure this percentage, you divide the income you receive for your net profits interest by the gross revenue from the property.

Example. John Oak owns oil property in which Paul Elm owns a 20% net profits interest. In 1994, the property produced 10,000 barrels of oil. John sold the oil produced for \$200,000 gross revenue. John had expenses of \$90,000 attributable to the property. Therefore, the property generated a net profit of \$110,000. Paul received income of \$22,000 for his net profits interest.

Paul determined his percentage participation to be 11% by dividing \$22,000 (the income he received) by \$200,000 (the gross revenue from the property). Paul determined his share of the oil production to be 1,100 barrels (10,000 barrels \times 11% percentage participation).

Refiners. You do not qualify for the small-producer exemption if you or a related person refine crude oil and your refinery runs exceed 50,000 barrels on any day during the tax year.

Retailers. You also do not qualify for this exemption if you, directly or through a related person, sell oil or natural gas (excluding bulk sales to commercial or industrial users), or their by-products (excluding bulk sales of aviation fuels to the Department of Defense):

- 1) Through a retail outlet, or
- 2) To any person who markets the oil, gas, or by-products using a trademark or trade name owned by you or a related person, or
- 3) To any person given authority to occupy any retail outlet of yours or a person related to you.

However, you qualify for the exemption if the combined gross receipts of all retail outlets from the sale of oil or natural gas or their by-products is not more than \$5 million for the tax year. Do not include sales you make outside the United States if none of your domestic production or that of a related person is exported during the tax year or the preceding tax year.

For purposes of the small producer's exemption, you are not considered to be selling oil or natural gas through a related retailer if:

- 1) You do not own a significant ownership interest in the retailer,
- 2) You sell your production to persons unrelated to you and unrelated to the retailer,
- 3) The retailer does not purchase oil or natural gas from your customers or persons related to your customers,
- 4) There are no arrangements for the retailer to acquire for resale oil or natural gas you produced or made available for purchase by the retailer, and
- 5) Neither you nor the retailer has knowledge or control over the final disposition of the oil or natural gas you sold or the original source of the petroleum products the retailer acquired for resale.

For more information, see Revenue Ruling 92-72 in Internal Revenue Bulletin 1992-37, page 5.

Transferees. You do not qualify for the small-producer exemption if you received your interest in a proven oil or gas property by transfer after 1974 and before October 12, 1990. However, the term "transfer" usually does not include:

- Transfers at death,
- Certain transfers to controlled corporations,
- Certain changes of beneficiaries of a trust,
- Transfers between businesses under common control,
- Transfers between members of the same family,
- Transfers between a trust and related persons in the same family, and
- Certain transfers by individuals to corporations solely in exchange for stock.

An election by a corporation to become an S corporation is treated as a transfer of all its properties on the day on which the election first takes effect. If an S corporation ceases to be an S corporation and becomes a regular corporation, each shareholder is treated as transferring to the corporation the shareholder's pro rata share of all the S corporation's assets.

Allocation of exemption. If your average daily production for the calendar year is more than 1,000 barrels (or 6 million cubic feet of gas), allocate the small-producer exemption among all of the properties in which you have an interest in proportion to their respective production.

Allocation of the exemption also must be made among corporations that are members of the same controlled group (the common control test is 50%); among corporations, trusts, and estates if 50% of the beneficial interest is owned by the same or related persons (considering only persons that own at least 5% of the beneficial interest); and among the producer or royalty owner and his or her spouse and minor children.

Gross income from oil and gas property.

For purposes of percentage depletion, gross income from oil and gas property is the amount you receive from the sale of the oil or gas in the immediate vicinity of the well. If you do not sell the oil or gas on the property, but manufacture or convert it into a refined product before sale or transport it before sale, the gross income from the property is the representative market or field price (RMFP) of the oil or gas, before conversion or transportation.

If gas is sold after it is removed from the premises, for a price that is lower than the RMFP, gross income from the property for percentage depletion purposes is determined without regard to the RMFP.

Gross income from the property does not include lease bonuses, advance royalties, or other amounts payable without regard to production from the property.

Partnership oil and gas properties.

For partnership property, the depletion allowance, whether cost or percentage, is figured separately by each partner and not by the partnership. Each partner must decide whether to use cost or percentage depletion. If a partner uses percentage depletion, the 65% of taxable income limit, as discussed earlier under *Percentage depletion* is applied to the partner's taxable income from all sources, and not just to taxable income from the property. In addition, as discussed next, only the partner can determine that partner's share of adjusted basis of oil and gas properties used to figure cost depletion or any gain or loss if the property is disposed of by the partnership.

The partnership must allocate to each partner that partner's proportionate share of the adjusted basis of each partnership domestic oil or gas property. This allocation is made as of the date the partnership acquires the oil or gas property. The partner's share of the adjusted basis of the oil or gas property is figured by that partner's interest in partnership capital or income, or as determined by a partnership agreement.

The partner's share of the adjusted basis of the oil and gas property is adjusted by the partnership for any capital expenditures made for the property and for any change in partnership interests.

Each partner, after receiving the information from the partnership, must keep this information separately. Later, in those separate records, the partner must reduce the share of the adjusted basis of each property by the depletion taken on the property each year by that partner, and use that reduced adjusted basis to figure any cost depletion or the partner's gain or loss if the partnership disposes of the property.

Reporting the deduction. Deduct oil and gas depletion for a partnership interest on Schedule E (Form 1040). If you have a current year loss or a prior year unallowed loss, the loss may be limited by the at-risk rules and the passive activity loss rules described under *How Much Can Be Deducted* in Chapter 1. See the Schedule E (Form 1040) instructions for Part II to determine whether you first need to use Form 6198 to figure the deductible loss.

Further, if the loss is from a passive activity, you generally need to complete Form 8582 to figure the allowable loss to enter in Part II, column (g) of Schedule E, for that activity.

If you do not have a loss, enter your net income or loss from the partnership, before depletion, in either the passive or nonpassive section of Part II on the same lettered line for which you enter the name of the partnership, the employer identification number and other partnership information. On the next lettered line of that section's loss column, enter the depletion deduction. If you are entitled to a depletion deduction from more than one oil and gas partnership, make this computation for each partnership.

You may also have to complete Schedule SE (Form 1040) if your partnership net income is considered net earnings from self-employment. See Publication 533 for more information on self-employment income.

S corporation oil and gas properties. The depletion allowance is figured separately by each shareholder of an S corporation in the same way as a partner in a partnership.

For an S corporation shareholder to figure cost depletion, the S corporation must allocate to each shareholder that shareholder's adjusted basis of each oil or gas property held by the S corporation. The allocation is made as of the date the corporation acquires the property. The shareholder's share of the adjusted basis of the oil and gas property is adjusted by the S corporation for any capital expenditures made for the property.

Each shareholder must separately keep records of the shareholder's pro rata share of the adjusted basis in each oil and gas property of the S corporation. Thereafter, the shareholder must reduce the share of the adjusted basis by the depletion taken on the property by the shareholder and use that reduced adjusted basis to figure cost depletion or the shareholder's gain or loss on the disposition of the property by the S corporation.

For any distribution of the oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property is the total of all the shareholders' adjusted bases in the property.

Depletion of certain natural gas wells. Percentage depletion is allowed for regulated natural gas and for natural gas sold under a fixed contract or produced from geopressured brine, regardless of whether you qualify for the small-producer exemption.

Fixed contract. Income from natural gas sold under a fixed contract qualifies for percentage depletion at 22%.

Natural gas sold under a fixed contract is domestic gas sold by the producer under a contract in effect on February 1, 1975, and at all times thereafter before the sale. The price must not be adjusted to reflect the increase in the liability of the seller for tax because of the change in the law regarding percentage depletion for gas. Price increases after February 1, 1975, are presumed to take the liability into account unless the taxpayer can demonstrate to the contrary by clear and convincing evidence.

Natural gas from geopressured brine.

Qualified natural gas from geopressured brine is eligible for percentage depletion at the rate of 10% if it is produced from a well you began to drill after September 1978 and before 1984.

Natural and Geothermal Deposits

Mines, wells, and other natural deposits, including geothermal deposits, qualify for percentage depletion.

Mines and other natural deposits. The percentage of your gross income from a natural deposit that you can deduct as depletion is based on the type of deposit.

Some of the depletion percentages for the more common minerals follow:

DEPOSITS	PERCENT
Sulphur, uranium, and, if from deposits in the United States, asbestos, lead, zinc, nickel, and mica,	22
Gold, silver, copper, iron ore, and certain oil shale, if from deposits in the United States	15
Coal, lignite, and sodium chloride	10
Clay and shale used in making sewer pipe or bricks or used as sintered or burned lightweight aggregates	7½
Clay (used or sold for use in making drainage and roofing tile, flower pots, and kindred products), gravel, sand, and stone (other than stone used or sold by a mine owner or operator as dimension or ornamental stone)	5
Most other minerals, including carbon dioxide produced from a well, and metallic ores	14

Reduction of percentage depletion for corporations. The percentage depletion deduction of a corporation for iron ore and coal (including lignite) is reduced by 20% of the excess of:

- 1) The percentage depletion deduction for the tax year (determined without regard to this reduction), over
- 2) The adjusted basis of the property at the close of the tax year (determined without the depletion deduction for the tax year).

Gross income from mining. Gross income from a mining property, other than a geothermal deposit, is the gross income from extracting ores or minerals from the ground, applying treatment processes, and transporting them not more than 50 miles from the point of extraction to the plant or mill in which a recognized mining treatment process is applied. Treatment processes that are included as mining depend on the ore or mineral mined, and usually include those processes needed to make the mineral first suitable for sale or consumption. This usually means processing to a shipping grade and form. However, in certain cases, additional processes specified in the law are included as mining. To qualify as mining, the treatment processes must be applied by the mine owner or operator.

Gross income from mining property also includes the separately stated excise tax received by a mine operator from the sale of coal to compensate the operator for excise tax the mine operator must pay to finance black lung benefits.

Transportation of more than 50 miles. If the Internal Revenue Service finds that the physical and other requirements are such that the ore or mineral must be transported more than 50 miles to plants or mills to be treated, the entire transportation is included in the computation of gross income from mining. If you wish to include transportation of more than 50 miles in the computation of gross income from mining, file an application in duplicate, setting forth the facts concerning the physical and other requirements which prevented the construction and operation of the plant within 50 miles from the point of extraction. Send this application to:

Internal Revenue Service
 Washington DC 20224
 Attention: Assistant Chief Counsel, Pass-throughs and Special Industries.

Disposal of coal or iron ore. If you dispose of coal (including lignite) or iron ore mined in the United States, held for more than 1 year, with a retained economic interest and the gain is a capital gain, you cannot take a depletion deduction.

Geothermal deposits. Geothermal deposits located in the United States or its possessions qualify for percentage depletion at the rate of 15%. A geothermal deposit is a geothermal reservoir of natural heat stored in rocks or in a watery liquid or vapor. It is not considered a gas well.

Gross income from a geothermal steam well is figured in the same way as for oil and gas wells. See *Gross income from oil and gas property*, earlier, under *Oil and Gas Wells*.

Lessor's Gross Income

A lessor's gross income from the **lease of gas, oil, or mineral property** for percentage depletion usually is the total of the royalties received from the lease, excluding rentals that are not payment for units of mineral produced or to be produced.

Bonus and advanced royalties. Bonuses and advanced royalties are payments a lessee makes to a lessor for the lease or for minerals, gas, or oil to be extracted from leased property. Both types of payments are made in advance of production. If you are the lessor, your income from bonuses and advanced royalties is subject to an allowance for depletion.

If you can use percentage depletion, figure the depletion allowance using both the cost and percentage depletion methods. Then select the method that gives you the larger deduction to figure the depletion allowance for your tax return.

To figure cost depletion on a bonus, multiply your adjusted basis in the property by a

fraction, the numerator (top number) of which is the bonus and the denominator (bottom number) of which is the total bonus and royalties expected to be received. To figure cost depletion on advanced royalties, use the computation explained earlier under *Cost depletion*, treating the units for which the advanced royalty is received as the units sold.

When you figure percentage depletion (for other than gas, oil, or geothermal property), the bonus or advanced royalty payments are part of your gross income from the property.

Terminating the lease. For a bonus on a lease terminated before any income was derived from the extraction of mineral or cutting of timber, include in income the depletion deduction you took. Also increase your adjusted basis in the property to restore the depletion deduction you previously subtracted.

For advanced royalties, include in income the depletion claimed on minerals for which the advanced royalties were paid if the minerals were not produced prior to termination. Increase your adjusted basis in the property by the amount you include in income.

Delay rentals. These are payments for deferring development of the property. These rentals can be avoided by abandoning the lease, by beginning development operations, or by obtaining production. Since delay rentals are ordinary rent, these amounts received by a lessor are ordinary income that is not subject to depletion.

Timber

You can figure timber depletion only by the cost method. Percentage depletion does not apply to timber. Your depletion is based on your cost or other basis in the timber. Your cost does not include the cost of land.

Figuring the deduction. Depletion takes place when standing timber is cut. However, you can figure your depletion deduction when the quantity of cut timber is first accurately measured in the process of exploitation.

Figure your depletion allowance by multiplying the number of timber units cut by your depletion unit.

Figure your depletion unit as follows:

- 1) Determine your cost or adjusted basis of the timber on hand at the beginning of the year.
- 2) Add to the amount determined in 1) the cost of any units acquired during the year and any additions to capital.
- 3) Figure the number of units to take into account by adding the number of units acquired during the year to the number of units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the number of units remaining in the account.
- 4) Divide the result of 2) by the result of 3). This is your depletion unit.

Example. You bought a timber tract for \$160,000 and the land was worth as much as the timber. Your basis for the timber is therefore \$80,000. Based on an estimated one million board feet (1,000 MBF) of standing timber, you figure your depletion unit to be \$80 per MBF. If you cut 500 MBF of timber, your depletion allowance would be \$40,000 (500 MBF at \$80 per MBF).

When to claim depletion. Claim your depletion allowance as a deduction in the year of sale or other disposition of the products cut from the timber, unless you elect to treat the cutting of timber as a sale or exchange. Allowable depletion for timber products not sold during the tax year the timber is cut is included as an item of cost in the closing inventory of timber products for the year. The inventory amount is your basis for determining gain or loss in the tax year that you sell the timber products.

Example. In the example under *Figuring the deduction*, if you sold half of the timber products in the cutting year, you would deduct \$20,000 of the \$40,000 depletion that year and add the remaining \$20,000 depletion to your closing inventory of timber products.

Electing to treat the cutting of timber as a sale or exchange. You can elect, under certain circumstances, to treat the cutting of timber as a sale or exchange. If you make this election, subtract the adjusted basis for depletion from the fair market value of the timber at the beginning of the tax year in which it is cut to figure the gain to report on the cutting. You generally report the gain as long-term capital gain. The fair market value then becomes your basis for figuring your ordinary gain or loss on the sale or other disposition of the products cut from the timber. See Publication 544.

Form T. Attach Form T to your income tax return if you are claiming a deduction for timber depletion.

- 536** Net Operating Losses
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

Form (and Instructions)

- Sch C** (Form 1040) Profit or Loss From Business
- Sch F** (Form 1040) Profit or Loss From Farming
- 1065** U.S. Partnership Return of Income
- 1120** U.S. Corporation Income Tax Return
- 1120-A** U.S. Corporation Short-Form Income Tax Return
- 1120S** U.S. Income Tax Return for an S Corporation

If someone owes you money you cannot collect, you have a bad debt. You may generally deduct the amount of the bad debt owed you when you figure your income for tax purposes. You can deduct a debt only in the year it becomes worthless.

A bad debt may be either totally or partly worthless. If you can collect part, but not all, of the amount owed you, you have a partly worthless debt. If you cannot collect any of the amount owed you, even if you collected some of it in the past, you have a totally worthless debt.

This chapter explains:

- Which business bad debts you may deduct,
- When you may claim a deduction, and
- How you claim the deduction on your tax return.

For information on nonbusiness bad debts, see Publication 550.

A business deducts its bad debts from gross income when figuring its taxable income. Unlike nonbusiness bad debts, you do not deduct business bad debts as short-term capital losses.

A business bad debt is a loss from a debt created or acquired in your trade or business.

Any other worthless debt is a business bad debt if there is a very close relationship between the debt and your trade or business when the debt becomes worthless.

A debt has a very close relationship to your trade or business if your dominant motive for incurring the debt is for a business reason.

The bad debts of a corporation are always business bad debts.

Example. John Smith, an advertising agent, made loans to certain clients to retain their business. His main reason for making these loans was his business. One of these clients later went bankrupt and could not repay him. Since John's business was the main reason for making the loan, the debt was a business debt and he can take a business bad debt deduction.

Credit transactions. Business bad debts are mainly the result of credit sales to customers. They can also be loans to suppliers, clients, employees, or distributors. Goods and services customers have not paid for are shown in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. Accounts or notes receivable valued at fair market value at the time of the transaction are deductible only at fair market value, even though that value may be less than face value.

You can take a bad debt deduction for your accounts and notes receivable only if you included the amount owed you in your gross income. This applies to amounts owed you from all sources of taxable income, such as sales, services, rents, and interest.

If you meet certain requirements, you can use the nonaccrual-experience method, discussed later. This method allows you to estimate uncollectible amounts. Do not include them in gross income.

Accrual method taxpayers. Accrual method taxpayers normally report income as they earned it. Therefore, they can take a bad debt deduction when they cannot collect what is owed them, if they have included that amount in income.

Cash method taxpayers. Cash method taxpayers normally do not report income until they receive payment. Therefore, they cannot take a bad debt deduction for payments they have not received or cannot collect.

Former business. If you sell your business but keep its accounts receivable, these debts are business debts since they arose in your trade or business. If an account becomes worthless, the loss is a business bad debt. These accounts would also be business debts if sold to the new owner of the business.

If you sell your business to one person and sell your accounts receivable to someone else, the character of the debts as business or nonbusiness is based on the activities of the holder of these debts. If the new holder engages in a trade or business, a loss from these accounts is a business bad debt. If the new holder does not engage in a trade or business, a loss from these accounts is a nonbusiness bad debt.

Debt acquired from a decedent. Determine the character of a loss from a business acquired from a decedent in the same way as a debt sold by a business. If you are in a trade or business, the loss is a business bad debt. If you are not in a trade or business, the loss is a nonbusiness bad debt.

Liquidation. If you liquidate your business and some of your accounts receivable become worthless, they are business bad debts.

Debts owed by political parties. If a political party (or other organization that accepts contributions or spends money to influence elections) owes you money and the debt becomes worthless, you cannot take a bad debt deduction unless you use an accrual method of accounting and meet all the following tests:

14.

Business Bad Debts

Topics

This chapter discusses:

- Methods of treating bad debts
- The specific charge-off method
- The nonaccrual-experience accounting method

Useful Items

You may want to see:

Publication

- 525** Taxable and Nontaxable Income

- 1) The debt was from the sale of goods and services in the ordinary course of your trade or business,
- 2) More than 30% of all your receivables in the year of the sale were from sales made to political parties, and
- 3) You made substantial continuing efforts to collect on the debt.

Loans or capital contributions. You cannot take a bad debt deduction for loans you made to a corporation if the loans are actually capital contributions.

Insolvency of partner. If your business partnership breaks up and one of your former partners cannot pay any of the partnership's debts, you may have to pay more than your share of the partnership's debts. When you pay any part of the insolvent partner's share of the debts, you can take a bad debt deduction.

Business loan guarantees. If you guarantee a debt that becomes worthless and can show your reason for guaranteeing it was closely related to your trade or business, then the debt can qualify as a business bad debt. Consider any guarantees you make to protect or improve your job as closely related to your trade or business as an employee.

Example. Bob Zayne owns the Zayne Dress Company. He guaranteed payment of a \$20,000 note for Elegant Fashions, a dress outlet. Elegant Fashions is one of Zayne's largest clients. Elegant Fashions later files for bankruptcy and defaults on the loan. Mr. Zayne makes full payment to the bank. He can take a business bad debt deduction, since his guarantee was closely related to his trade or business. He was motivated by the desire to retain one of his better clients and keep a sales outlet.

Deductible in the year paid. A payment you make on a loan you guaranteed is deductible in the year of payment unless you have rights against the borrower.

Rights against a borrower. When you make payment on a loan you guaranteed, you may have the right to take the place of the lender. The debt is then owed to you. If you have this right, or some other right to demand payment from the borrower, you cannot take a bad debt deduction until these rights become partly or totally worthless.

Reporting business bad debts. Use the following guide to find where to report your business bad debt deductions.

Individuals. Deduct a bad debt from operating a trade or business on line 9 of Schedule C (Form 1040). Deduct a bad debt from operating a farm business on line 34 of Schedule F (Form 1040).

Corporations. Corporations deduct bad debts on line 15 of Form 1120, line 15 of Form 1120-A, or line 10 of Form 1120S.

Partnerships. Partnerships deduct business bad debts on line 12 of Form 1065.

Methods of Treating Bad Debts

There are two ways to treat uncollectible amounts: the specific charge-off and nonaccrual-experience methods. All taxpayers, except certain financial institutions, must generally use the specific charge-off method. You can use the nonaccrual-experience method if you meet the requirements, discussed later.

Specific Charge-Off Method

If you use the specific charge-off method, you can deduct specific business bad debts that become either partly or totally worthless during the tax year.

Partly worthless debts. You can deduct specific bad debts that are partly uncollectible. But limit your deduction to the amount you charge off on your books during the tax year. You do not have to annually charge off and deduct your partly worthless debts. Instead you may delay the charge-off until a later year. You may wait until more of the debt becomes worthless, or you collect all you can and it is totally worthless. You cannot, however, deduct any part of a debt after the year it becomes totally worthless.

Deduction disallowed. Usually, you can take a partial bad debt deduction only in the year you make the charge-off on your books. However, the Internal Revenue Service (IRS) may not allow your deduction. If the debt becomes partly worthless in a later tax year, you can deduct the amount you charge off in that year, plus the amount charged off in the earlier year. The charge-off in the earlier year, unless reversed on your books, fulfills the charge-off requirement for the later year.

Totally worthless debts. Deduct a totally worthless debt only in the tax year it becomes totally worthless. The deduction for the debt must not include any amount deducted in an earlier tax year when the debt was only partly worthless.

You do not have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. However, you may want to do so. If a debt you claim to be totally worthless is not charged off on your books and IRS later rules the debt is only partly worthless, you will not be allowed any deduction. A deduction of a partly worthless bad debt is limited to the amount actually charged off.

Recovery of bad debt. If you deduct a bad debt and later recover (collect) all or part of it, you may have to include the amount you recover in gross income. However, you can exclude from gross income the amount recovered up to the amount of the deduction that did not reduce your tax in the year deducted.

Example. In 1993, the Willow Corporation had gross income of \$158,000, a bad debt deduction of \$3,500, and other allowable deductions of \$49,437. The corporation reported on the accrual method of accounting and used the specific charge-off method for bad debts. In

1994, the corporation recovers part of the \$3,500 deducted in 1993. It must include the part recovered in income for 1994. The entire bad debt deduction reduced the tax on the 1993 corporate return. For 1994, Willow reports the recovery as "Other Income" on its corporate return.

See *Recoveries* in Publication 525 for more information on recovered amounts.

Property received for debt. If you receive property in partial settlement of a debt, reduce the debt by the fair market value of the property received. The remaining debt is deductible as a bad debt in the year you determine it to be worthless and charge it off.

If you later sell the property received, include any gain from the sale in gross income. The gain is not a recovery of a bad debt previously deducted without tax benefit.

For information on the sale of an asset, see Publication 544.

Bankruptcy claim. You may only deduct the difference between the amount owed to you by a bankrupt entity and the amount you received from the distribution of its assets as a bad debt.

Sale of mortgaged property. If you sell mortgaged or pledged property for less than the debt, the unpaid balance of the debt after the sale is a bad debt. If the debt represents capital or an amount you previously included in income, you can deduct it as a bad debt in the year it becomes totally worthless or in the year you charged it off as partially worthless.

Net operating loss. A bad debt deduction may produce or increase a net operating loss. If you have a net operating loss one year, you can carry it back or forward to other tax years and deduct it from income you earned in those years. As a result, a bad debt deduction that contributes to a net operating loss helps lower taxes in the year to which you carry the net operating loss.

See Publication 536 for more information.

Nonaccrual-Experience Method

If you use an accrual method of accounting and qualify under the rules explained in this section, you can use the nonaccrual-experience method of accounting for bad debts. Under this method, you do not have to accrue income you do not expect to collect.

The nonaccrual-experience method applies only to amounts you will receive (accounts receivable) for performing services. You cannot use it if you charge interest or penalties on late payments. If you determine, based on your experience, you will not collect your accounts receivable, do not include it in your gross income for the tax year.

Performing services. You can use the nonaccrual-experience method only for amounts earned by performing services that you would otherwise include in income. You cannot use this method for amounts owed to

you from activities such as lending money, selling goods, or acquiring receivables or other rights to receive payments.

Interest cannot be charged on amounts due. Generally, you cannot use the nonaccrual-experience method for amounts due on which you charge interest or a late payment penalty. However, do not treat offering of a discount for early payment as charging interest or a late payment penalty if:

- 1) You accrue the full amount due as gross income at the time you provide the services, and
- 2) You treat the discount allowed for early payment as an adjustment to gross income in the year of payment.

You can apply the nonaccrual-experience method under either a separate receivable system or a periodic system. Under the **separate receivable system**, apply the nonaccrual-experience method separately to each account receivable. Under the **periodic system**, apply the nonaccrual-experience method to total qualified accounts receivable at the end of your tax year.

Treat each system as a separate method of accounting. You generally cannot change from one system to the other without IRS consent.

Generally, you also need IRS consent to change to either system under the nonaccrual-experience method from a different accounting method.

For more information on the separate receivable system, see section 1.448-2T of the Income Tax Regulations. For more information on the periodic system, see Notice 88-51, 1988-1, C.B. 535.

15.

Electric and Clean-Fuel Vehicles

Topics

This chapter discusses:

- The deduction for clean-fuel vehicle property
- The deduction for clean-fuel vehicle refueling property
- Recapture of the deductions
- The electric vehicle credit
- Recapture of the credit

Useful Items

You may want to see:

Publication

- 534** Depreciation
- 544** Sales and Other Dispositions of Assets

- 917** Business Use of a Car
- 946** How To Begin Depreciating Your Property

Form (and Instructions)

- 8834** Qualified Electric Vehicle Credit

You are allowed deductions for the cost of clean-fuel vehicle property and clean-fuel vehicle refueling property placed in service after June 30, 1993, subject to certain limitations. You can take these deductions only in the tax year the qualifying properties are placed in service.

A new electric vehicle tax credit is available for qualified electric vehicles placed in service after June 30, 1993. The amount of the credit is the smaller of \$4,000 or 10% of the cost of the vehicle. For more information, see *Electric Vehicle Credit*, later.

Deductions for Clean-Fuel Vehicles and Refueling Property

You are allowed limited deductions for the cost of qualifying clean-fuel vehicle property and clean-fuel vehicle refueling property placed in service after June 30, 1993. These deductions are allowed only in the tax year you place the qualifying property in service.

You cannot deduct the part of any property's cost that you claim as an expense deduction under section 179 of the Internal Revenue Code (the "section 179 deduction"). You also cannot claim the deduction for property:

- 1) Used predominantly outside the United States,
- 2) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
- 3) Used by certain tax-exempt organizations, or
- 4) Used by governmental units or foreign persons or entities.

Clean-burning fuels. Clean-burning fuels include natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, and any other fuel that has a combined content of at least 85% methanol, ethanol, any other alcohol, or ether.

Deduction for Clean-Fuel Vehicle Property

You are allowed a limited deduction from gross income for the cost of qualifying clean-fuel vehicle property that you place in service after June 30, 1993. The deduction for qualifying clean-fuel vehicle property is available to all taxpayers regardless of whether the property is used in a trade or business.

Where you claim this deduction on your tax return is determined by whether its use by you

is business or nonbusiness. See *How To Claim the Deductions*, later.

Clean-fuel vehicle property defined. Clean-fuel vehicle property is made up of two kinds of property.

- 1) Motor vehicles produced by an original equipment manufacturer and designed so that they can be propelled by a clean-burning fuel. The only part of a vehicle's basis that qualifies for the deduction is the part that is attributable to:
 - a) An engine that can use a clean-burning fuel,
 - b) The property used to store or deliver the fuel to the engine, or
 - c) The property used to exhaust gases from the combustion of the fuel.
- 2) Any property installed (including installation costs) on a motor vehicle propelled by a fuel that is not a clean-burning fuel to enable it to be propelled by such a fuel if:
 - a) The property is an engine (or modification of an engine) that can use a clean-burning fuel, or
 - b) The property is used to store or deliver such fuel to the engine or to exhaust gases from the combustion of such fuel.

For vehicles propelled by both a clean-burning fuel and any other fuel, you are allowed a deduction for the incremental cost of permitting the use of the clean-burning fuel.

Note: Clean-fuel vehicle property does not include an electric vehicle that qualifies for the 10% electric vehicle credit discussed later under *Electric Vehicle Credit*.

Motor vehicle defined. A motor vehicle is defined as any vehicle that has four or more wheels and is manufactured primarily for use on public streets, roads, and highways. It does not include a vehicle operated exclusively on a rail or rails.

Qualifying requirements. For your property to qualify for the deduction:

- 1) It must be acquired for your own use (not for resale),
- 2) Its original use must begin with you,
- 3) If it is a motor vehicle, it must satisfy any federal or state emissions standards that apply to each fuel for which it is designed to be propelled, and
- 4) If it is installed on a retrofitted vehicle, it must satisfy any applicable federal and state emissions certification, testing, and warranty requirements.

Deduction limit. Your deduction for clean-fuel vehicle property is limited to:

- 1) \$50,000 for trucks or vans with a gross vehicle weight rating of more than 26,000 pounds and buses with a seating capacity of at least 20 adults (not including the driver),

- 2) \$5,000 for trucks or vans with a gross vehicle weight rating of more than 10,000 pounds but not more than 26,000 pounds, and
- 3) \$2,000 for other vehicles not included in (1) or (2).

These dollar amounts are reduced for property put into service after the year 2001.

Deduction for Clean-Fuel Vehicle Refueling Property

You are allowed a limited deduction from gross income for the cost of qualifying clean-fuel vehicle refueling property that you place in service after June 30, 1993. The deduction for this property is available only for qualifying depreciable property, the original use of which began with you and that is used in a trade or business or for the production of income.

Clean-fuel vehicle refueling property defined. Clean-fuel vehicle refueling property includes any property (other than a building or its structural components) used to:

- 1) Store or dispense a clean-burning fuel into the fuel tank of a motor vehicle propelled by the fuel, but only if the storage and dispensing is at the point where the fuel is delivered into the tank, or
- 2) Recharge motor vehicles propelled by electricity, but only if the property is located at the point where the vehicles are recharged.

Recharging property. This property includes any equipment used to provide electricity to the battery of a vehicle propelled by electricity. It includes low-voltage and high-voltage (quick) charging equipment and ancillary connection equipment, such as inductive charging equipment. It does not include property used to generate electricity, such as solar panels or windmills, and does not include the battery used in the vehicle.

Deduction limit. The total cost you can deduct for clean-fuel vehicle refueling property placed in service at one location is limited to \$100,000. To figure your maximum deduction for any tax year, subtract from \$100,000, the total amount you (or any related person or predecessor) claimed with respect to property placed in service at that location for all earlier years.

Note: If this limit applies, you must specify on your tax return the property items (and portions of the property's cost) that you are using as a basis for a deduction in that tax year.

Related person. For this purpose, a related person includes:

- 1) An individual and his or her brothers and sisters, spouse, ancestors, and lineal descendants.
- 2) An individual and a corporation in which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for such individual.

- 3) Two corporations that are members of the same controlled group.
- 4) A grantor and fiduciary of the same trust.
- 5) Fiduciaries of two separate trusts if the same person is a grantor of both trusts.
- 6) A fiduciary and a beneficiary of the same trust.
- 7) A fiduciary and a beneficiary of two separate trusts if the same person is a grantor of both trusts.
- 8) A fiduciary of a trust and a corporation in which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or a grantor of the trust.
- 9) A person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by such person or by members of the family of such person.
- 10) A corporation and a partnership if the same person owns more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
- 11) Two S corporations or an S corporation and a regular corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 12) A partnership and a person owning, directly or indirectly, more than 50% of the capital or profits interest in the partnership.
- 13) Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interest.

For the indirect stock ownership rules, see *Indirect ownership of stock*, under *Unpaid Salaries*, in Chapter 2.

How To Claim the Deductions

How you claim the deductions for clean-fuel vehicles and refueling property depends on the use of the property and the income tax return you file.

Nonbusiness use of clean-fuel vehicle property by individuals. Individuals can claim the deduction for the nonbusiness use of clean-fuel vehicle property by including the amount of the deduction in the total on line 30 of Form 1040. Also enter the amount of your deduction and "Clean-Fuel" on the dotted line next to line 30. If you use the vehicle partly for business, see the discussions that follow.

Business use by employees. Employees who use clean-fuel vehicle property for business or partly for business and partly for nonbusiness purposes should enter the entire deduction in the total on line 30 of Form 1040. Also enter the amount of your deduction and "Clean-Fuel" on the dotted line next to line 30.

Business use by sole proprietors. Individuals who operate a business as a sole proprietor can claim their deduction for the business

use of clean-fuel vehicles and clean-fuel vehicle refueling property on the *Other expenses* line of either Schedule C (Form 1040) or Schedule F (Form 1040), whichever applies. If clean-fuel vehicle property is used partly for nonbusiness purposes, claim the nonbusiness part of the deduction as explained earlier under *Nonbusiness use of clean-fuel vehicle property by individuals* and the balance as stated here.

Partnerships. Partnerships should claim the deduction for the business use of clean-fuel vehicles and clean-fuel vehicle refueling property on line 20 of Form 1065.

Corporations. Corporations, other than S corporations, should claim the deduction for the business use of clean-fuel vehicles and clean-fuel vehicle refueling property on line 26 of Form 1120 (line 22 of Form 1120-A). S corporations should use line 19 of Form 1120S.

Recapture of the Deductions

The benefit of any deduction allowable for a clean-fuel vehicle or clean-fuel vehicle refueling property is subject to recapture if the property ceases to qualify. The benefit is recaptured by including the deduction, or a part of the deduction, in your income in the year recapture occurs.

Clean-Fuel Vehicle Property

Your clean-fuel vehicle property ceases to qualify if, within 3 years after you place the property in service, the vehicle is:

- 1) Modified so that it can no longer be propelled by a clean-burning fuel,
- 2) Used predominantly outside the United States,
- 3) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
- 4) Used by certain tax-exempt organizations, or
- 5) Used by governmental units or foreign persons or entities.

Recapture amount for clean-fuel vehicle property. Determine the benefit that you must recapture by multiplying the amount of the deduction you claimed by a recapture percentage. The recapture percentage is based on the number of years you held the property after it was placed in service and before it ceased to qualify. The percentages are as follows:

- 1) 100% if the property ceases to qualify within the first year after it was placed in service.
- 2) 66% if the property ceases to qualify within the second year after it was placed in service.
- 3) 33% if the property ceases to qualify within the third year after it was placed in service.

There is no recapture if the property continued to qualify for the deduction through the first 3 years of service.

Sales or dispositions. No recapture is required when you sell or otherwise dispose of a clean-fuel vehicle (including a disposition by reason of an accident or other casualty). However, if the vehicle was subject to depreciation, the clean-fuel vehicle deduction (minus any amount of the deduction recaptured) is considered depreciation for purposes of treating part of any gain as ordinary income upon its disposition. See Publication 544 for more information on dispositions of depreciable property.

Clean-Fuel Vehicle Refueling Property

Your clean-fuel vehicle refueling property ceases to qualify if, at any time before the end of its depreciation recovery period, the property is no longer used predominantly in your trade or business to:

- 1) Dispense clean-burning fuel into the fuel tanks of motor vehicles propelled by the fuel, or
- 2) Recharge motor vehicles propelled by electricity.

Clean-fuel vehicle refueling property also ceases to qualify if it is used predominantly outside of the United States, used predominantly to furnish lodging or in connection with the furnishing of lodging, used by certain tax-exempt organizations, or used by governmental units or foreign persons or entities.

Recapture amount for clean-fuel vehicle refueling property. For the recapture provisions, the clean-fuel vehicle refueling property deduction is spread over the property's depreciation recovery period. Therefore, the amount that you must recapture (include in income) is the ratable part of the deduction for the property's remaining recovery period (including the year of recapture) at the time the property ceases to qualify.

Basis Adjustment

You must reduce the basis of your clean-fuel vehicle or clean-fuel vehicle refueling property by the amount of the deduction claimed. If, in a subsequent year, you are required to recapture part or all of the deduction, increase the basis of the property by the amount recaptured.

If the property for which you have recaptured part of the deduction is depreciable property, you can recover the additional basis over the remaining recovery period for the property beginning with the tax year of recapture. If you were using the percentage tables to figure your depreciation on the property, you will not be able to continue to do so. See Publication 534 for information on figuring your depreciation without the tables.

Electric Vehicle Credit

You may be allowed a 10% tax credit if you place a qualified electric vehicle in service after June 30, 1993. This discussion explains what property qualifies for the credit, the credit limit, how to claim the credit on your tax return, and the rules for recapturing the credit.

Electric Vehicle

An electric vehicle is a vehicle that:

- 1) Has at least four wheels and is manufactured for use on public streets, roads, and highways,
- 2) Is powered *primarily* by an electric motor that draws its power from rechargeable batteries, fuel cells, or other portable sources of electrical current,
- 3) Is originally used by you, and
- 4) Is acquired for your own use, not for resale.

You cannot take the credit for property:

- 1) Used predominantly outside the United States,
- 2) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
- 3) Used by certain tax-exempt organizations, or
- 4) Used by governmental units or foreign persons or entities.

Amount of the Credit

The credit is equal to 10% of the cost of each vehicle you place in service after June 30, 1993. If your vehicle is a depreciable business asset, you must reduce the cost of the vehicle by any section 179 deduction before figuring the 10% credit. If you need information on the section 179 deduction, get Publication 917 or Publication 946.

Credit limits. The credit is limited to \$4,000 for each vehicle. The total credit is then limited to your regular tax liability as reduced by the child and dependent care credit, credit for the elderly or the disabled, mortgage interest credit, foreign tax credit, orphan drug credit, credit for fuel from a nonconventional source, and any tentative minimum tax. To figure the maximum amount of credit you can take, complete Form 8834 and attach it to your tax return.

The credit begins to be phased out in the year 2002, and is totally eliminated by 2005.

How To Claim the Credit

To claim the electric vehicle credit, you must complete and attach Form 8834 to your tax return. The amount of your credit is then entered on your tax return as discussed next.

Individuals. Individuals claim the credit by entering the amount from line 19 of Form 8834

on line 44 of Form 1040. Check box "d" and specify Form 8834.

Partnerships. The amount of credit for partnerships is claimed by entering the amount from line 19 of Form 8834 on line 14 of Schedule K (Form 1065) and is allocated to the partners on line 14 of Schedule K-1 (Form 1065). See the instructions for Form 1065.

S corporations. The amount of credit for S corporations is claimed by entering the amount from line 19 of Form 8834 on line 13 of Schedule K (Form 1120S) and is allocated to the shareholders on line 13 of Schedule K-1 (Form 1120S). See the instructions for Form 1120S.

Corporations other than S corporations. The amount of credit for corporations other than S corporations is claimed by entering the amount from line 19 of Form 8834 in the total for line 4d of Schedule J (Form 1120) and checking the Form 8834 box to the left of the entry. See the instructions for Form 1120.

Recapture of the Credit

The electric vehicle credit is subject to recapture if, within 3 years after the date you place the vehicle in service, it ceases to qualify for the electric vehicle credit. The credit is recaptured by including the unallowed credit on line 49 of Form 1040 in that later year. Write "QEV" to the left of line 49. The vehicle ceases to qualify if it is:

- 1) Modified so that it is no longer primarily powered by an electric motor drawing its power from rechargeable batteries, etc.,
- 2) Used predominantly outside the United States,
- 3) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
- 4) Used by certain tax-exempt organizations, or
- 5) Used by governmental units or foreign persons or entities.

Recapture amount. Determine the amount of the credit that you must recapture by multiplying the credit you claimed by a recapture percentage. The recapture percentage is based on the number of years you held the vehicle after it was placed in service and before it ceased to qualify. The percentages are as follows:

- 1) 100% if the vehicle ceases to qualify within one year after it was placed in service.
- 2) 66% if the vehicle ceases to qualify within the second year after it was placed in service.
- 3) 33% if the vehicle ceases to qualify within the third year after it was placed in service.

There is no recapture if the vehicle continued to qualify for the credit through the first 3 years of service.

Sales or dispositions. No recapture is necessary when you sell or otherwise dispose of an electric vehicle (including a disposition by reason of an accident or other casualty). However, if the vehicle was subject to depreciation, the electric vehicle credit is considered depreciation for purposes of treating part of any gain as ordinary income upon its disposition. See Publication 544 for more information on dispositions of depreciable property.

Basis Adjustment

Reduce the basis of your qualified electric vehicle by the amount of credit allowed for the vehicle. If, in a subsequent year, you are required to recapture part or all of the credit, increase the basis of your property by the amount recaptured.

If the qualified electric vehicle is depreciable property, you can recover the additional basis over the vehicle's remaining depreciable recovery period beginning with the tax year of recapture. If you were using the percentage tables to figure your depreciation on the vehicle, you will not be able to continue to do so. See Publication 534 for information on figuring your depreciation without the tables.

16.

Other Expenses

Important Changes for 1994

Business meals and entertainment. Beginning in 1994, you can deduct only 50% of the cost of your business meal and entertainment expenses. See *Travel, Meals, and Entertainment*.

Club dues. You are not allowed any deduction for dues paid or incurred after 1993 for membership in any club organized for business, pleasure, recreation, or other social purpose. See *Dues and subscriptions*.

Environmental clean up costs. You may be able to deduct the costs of cleaning up land and treating groundwater contaminated with hazardous waste resulting from your business operations. See *Environmental clean up costs*.

Lobbying expenses. Beginning in 1994, you cannot take a business expense deduction for certain lobbying and political expenses. See *Lobbying expenses*.

Standard mileage rate. The standard mileage rate for 1994 is 29 cents a mile for all business miles put on a car or light truck.

Important Reminder for 1994

Franchise, trademark, or trade name. If any amount you pay or incur for a franchise, trademark, or trade name acquired after August 10, 1993, does not qualify to be deducted as a business expense, you must capitalize the amount. You may be able to deduct the amount ratably over a 15-year period. See *Amortization of Certain Intangibles* in Chapter 12.

Topics

This chapter discusses:

- Travel, meals, and entertainment
- Bribes and kickbacks
- Charitable contributions
- Education expenses
- Outplacement services
- Penalties and fines
- Repayments, claim of right

Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, and Gift Expenses
- 529** Miscellaneous Deductions
- 534** Depreciation
- 538** Accounting Periods and Methods
- 542** Tax Information on Corporations
- 917** Business Use of a Car
- 946** How To Begin Depreciating Your Property
- 1542** Per Diem Rates

Form (and Instructions)

- Sch A** (Form 1040) Itemized Deductions
- 1099-MISC** Miscellaneous Income
- 6069** Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction

This chapter covers some expenses you as a business owner may have that are not explained earlier.

You can find more information about some of the expenses in the publications listed earlier. The publication number is given near the end of the discussion of the expense.

If you use an accrual method of accounting, your deduction for the following expenses depends on when economic performance occurs. The economic performance rule is discussed under *When Can an Expense Be Deducted?* in Chapter 1.

You generally must capitalize or include in inventory the costs you incur to produce real or tangible personal property or to acquire property for resale. Property acquired for resale is

not subject to this rule if your annual gross receipts are \$10,000,000 or less. For more information on the uniform capitalization rules, see section 1.263A of the Income Tax Regulations.

Travel, Meals, and Entertainment

To be deductible, the expense for travel, meals, and entertainment must be an ordinary and necessary expense of carrying on your trade or business. Also, you must be able to prove the expense was incurred.

You must show that travel, meals, and entertainment expenses are directly related to, or associated with, the conduct of your trade or business.

The following discussion explains how you deduct any reimbursements or allowances you make for these expenses incurred by your employees. If you are self-employed and incur these expenses yourself, see Publication 463 for information on how you can deduct them.

Reimbursements

How you deduct a reimbursement or allowance (including per diem allowances, discussed later) for travel, meals, and entertainment expenses incurred by your employees depends on whether you have an accountable plan or a nonaccountable plan.

If you reimburse these expenses under an accountable plan, deduct them as travel, meal, and entertainment expenses. If you reimburse these expenses under a nonaccountable plan, you must report the reimbursements as wages on Form W-2 and deduct them as wages, as explained next.

How to deduct. You can take a deduction for travel, meals, and entertainment if you reimburse your employees for these expenses under an accountable plan. The amount you reimburse for meals and entertainment, however, may be subject to a 50% deduction limit, discussed later. If you are sole proprietor, deduct the reimbursement on line 24 of Schedule C (Form 1040). If you file a corporation income tax return, include the reimbursement in the amount claimed on the "Other deductions" line of Form 1120 or Form 1120-A. If you file any other income tax return, such as a partnership or S Corporation return, deduct the reimbursement on the appropriate line of the return, as provided in the instructions for that return.

Nonaccountable plan. For employee travel, meals, and entertainment expenses reimbursed, or treated as reimbursed, under a nonaccountable plan, you must report the reimbursement as wages on Form W-2. That reimbursement is subject to income tax withholding, social security, Medicare, and federal unemployment taxes. You can deduct the reimbursement as compensation or wages only to the extent it meets the deductibility tests for employees' pay in Chapter 2. Deduct the allowable amount as compensation or wages on

the appropriate line of your income tax return, as provided in its instructions.

Accountable Plans

To be an accountable plan, your reimbursement or allowance arrangement must meet the *Qualifying requirements*, explained later. A reimbursement or allowance arrangement is a system by which you substantiate and pay the advances, reimbursements, and charges for your employees' business expenses. If you make a single payment to your employees and it includes both wages and an expense reimbursement, you must specify the amount of the reimbursement.

You can deduct as travel, meals, and entertainment expenses, reimbursements to your employees for these expenses under an accountable plan. The reimbursements are not wages.

If you pay for your employees' meals and entertainment expenses under an accountable plan, you may be subject to the 50% deduction limit, discussed later.

Qualifying requirements. To qualify as an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all of the following rules:

- 1) They must have paid or incurred deductible expenses while performing services as your employees,
- 2) They must adequately account to you for these expenses within a reasonable period of time, and
- 3) They must return any excess reimbursement or allowance within a reasonable period of time.

Amounts treated as paid under nonaccountable plans. If any expenses reimbursed under this arrangement are not substantiated, or are an excess reimbursement that is not returned within a reasonable period of time by an employee, you cannot treat these expenses as reimbursed under an accountable plan. Instead, treat the reimbursed expenses as paid under a nonaccountable plan, discussed later.

A reasonable period of time depends on the facts and circumstances. Generally, it is considered reasonable if your employees adequately account for the expenses within 60 days after they were paid or incurred and return any excess reimbursement within 120 days after the expense was paid or incurred. Also, it is considered reasonable if you give your employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days.

Per Diem or Other Fixed Allowance

You may reimburse your employees by travel days, miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you if the payments do not exceed rates established by the federal government. For 1994, the **standard mileage**

rate is 29 cents a mile for auto expenses. However, see Revenue Procedure 93-51 in IRB 1993-42, for information on using a fixed and variable rate (FAVR) allowance. You can read the text of Revenue Procedure 93-51 at most IRS offices and at many public libraries. The federal per diem rates for meals and lodging within the continental U.S. are listed in Publication 1542, *Per Diem Rates*. Other than the amount of these expenses, your employee's business expenses (for example, the business purpose of the travel or the number of business miles driven) must be substantiated.

If the per diem or allowance paid exceeds the federal rates, you must report the excess amount as wages, as explained next.

How to report and deduct per diem allowances. If you reimburse your employee with a per diem allowance (daily amount) under an accountable plan, two facts affect how you report and deduct the reimbursement.

- 1) The federal rate for the area where the employee traveled, and
- 2) Whether the allowance is more than the federal rate.

For this purpose, the **federal rate** can be figured by using any of three methods:

- 1) The regular federal per diem rate (discussed later),
- 2) The high-low method (discussed later), or
- 3) The standard meal allowance (see Chapter 1 in Publication 463).

Per diem allowance LESS than or EQUAL to the federal rate. If your per diem allowance for the employee is less than or equal to the federal rate, that allowance is not part of the employee's pay. Deduct the allowance as travel expenses (including meals that may be subject to the 50% limit, discussed later). See *How to deduct*, discussed earlier.

Per diem allowance MORE than the federal rate. If your employee's per diem allowance is more than the federal rate, you must include the allowance amount up to the federal rate in box 13 (code L) of the employee's Form W-2. This amount is treated as substantiated. Deduct it as travel expenses (as explained in the preceding paragraph). For the per diem allowance in excess of the federal rate, however, you must include the excess amount in box 1 (and in boxes 3 and 5 if applicable) of the employee's Form W-2. You must report this part of the allowance as wages subject to income tax withholding, social security, Medicare, and federal unemployment taxes, because this part is treated as reimbursed under a nonaccountable plan. Deduct that part as compensation or wages, as explained earlier under *How to deduct* and its discussion, *Nonaccountable plan*.

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a

particular area. The rates are different for different locations. Publication 1542 lists the rates in the continental U.S.

The federal rates for meal and incidental expenses are the same as those rates discussed under *Standard Meal Allowance* in Chapter 1 in Publication 463.

High-low method. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States. For more information, see Chapter 6 in Publication 463.

Meals and Entertainment

Under an accountable plan, you can generally deduct only 50% of any business-related meal and entertainment expenses that you reimburse your employees. The deduction limit applies even if you reimburse them for 100% of the expenses.

Applying the limit. The 50% limit on your deduction for meal and entertainment expenses reimbursed to your employees under an accountable plan applies if the expense is otherwise deductible. The limit applies to trade or business expenses and to expenses incurred for the production of income including rental or royalty income.

The 50% deduction limit applies to reimbursements you make to your employees for expenses they incur while traveling away from home on business and for entertaining business customers at your place of business or a restaurant. It applies to attending a business convention or reception, business meeting, or business luncheon at a club. The deduction limit may also apply to meals you furnish on your premises to your employees (discussed in Chapter 3). The limit also applies to the meal or entertainment activity's related expenses (taxes, tips, cover charges, etc.), explained later. It does not, however, apply to other services, such as transportation to and from the activity, or to lodging.

Allocation of per diem allowances. If you provide your employees with a per diem allowance (discussed earlier), your deduction for that allowance may include expenses for other services (such as lodging or transportation), which are not subject to the 50% limit. To accurately figure your deduction, you must make a reasonable allocation between the meals and entertainment expenses and those expenses for other services. For example, you must make an allocation if a hotel includes one or more meals in its room charge, or you provide your employee with one per diem amount to cover both lodging and meal expenses.

Taxes and tips. Taxes and tips relating to expenses for a meal or entertainment activity that you reimburse to your employee under an accountable plan are included in the amount that is subject to the 50% limit. Reimbursements you make for expenses, such as cover charges for admission to a night club, rent paid for a room to hold a dinner or cocktail party, or the amount you pay for parking at a sports

arena, are all subject to the 50% limit. However, the cost of transportation to and from a business meal or entertainment activity that is otherwise allowable is not subject to the 50% limit.

On-site meals. The 50% limit does not apply to the food or beverages an employer provides on an oil or gas platform or drilling rig located offshore or in Alaska. This exception also applies to meals provided by an employer at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

De minimis (minimal) fringe benefit. The 50% limit does not apply to an expense for food or beverage that is excluded from the gross income of an employee because it is a de minimis fringe benefit. A de minimis benefit is one you provide your employees that is so small in value it would be unreasonable or impractical for you to account for it. You must also consider the frequency with which you provide similar fringes to your employees in determining if the value is minimal. Although certain entertainment expenses, such as occasional tickets to the theater or sporting events, may qualify as a de minimis fringe benefit, this exception to the 50% limit does not apply to entertainment expenses.

Example. You operate an employee cafeteria for all your employees. The cafeteria is on your business premises and the prices you charge your employees cover the direct operating costs of the cafeteria. The cafeteria is considered a de minimis fringe benefit and you are not subject to the 50% limit for these expenses.

Company cafeteria or executive dining room. You can deduct the cost of food and beverages you provide primarily to your employees on your business premises. This includes the cost of maintaining the facilities for providing the food and beverages. These expenses are subject to the 50% limit unless they qualify as de minimis fringe benefits, discussed earlier.

Employee activities. You can deduct the expense of providing recreational, social, or similar activities. You can also deduct for the use of a facility that is primarily for the benefit of your employees who are not highly compensated employees, defined in Chapter 4 under *Exclusion of Fringe Benefits*. These expenses are not subject to the 50% limit. For example, the expenses for food, beverages, and entertainment for a company-wide picnic are not subject to the 50% limit.

Nonaccountable Plans

A nonaccountable plan is an arrangement that does not meet the requirements for an accountable plan. All amounts paid, or treated as paid, under a nonaccountable plan are reported as wages on Form W-2. The payments are subject to income tax withholding, social security, Medicare, and federal unemployment taxes. You can deduct them as wages as explained under *How to deduct*, earlier.

Other Reimbursed Expenses

You may provide other meals and entertainment expenses to individuals other than your employees. These expenses may or may not be subject to the 50% limit, depending on the circumstances.

Nonemployee. If you provide a person who is not your employee with meals, goods, services, or the use of a facility and the item you provide is considered entertainment, you can deduct these expenses only to the extent they are included in the gross income of the recipient as compensation for services or as a prize or award. You must file the necessary information return (Form 1099-MISC) to claim the deduction. These expenses are not subject to the 50% limit.

Director, stockholder, or employee meetings. You can deduct entertainment expenses directly related to business meetings of your employees, partners, stockholders, agents, or directors. You can provide some minor social activities, but the main purpose of the meeting must be your company's business. These expenses are subject to the 50% limit.

Trade association meetings. You can deduct expenses directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, trade and professional associations and must be related to your active trade or business. These expenses are subject to the 50% limit.

Sale of meals or entertainment. You can deduct the cost of providing meals, entertainment, goods and services, or use of facilities that you actually sell to the public. For example, if you run a nightclub, your expense for the entertainment you furnish to your customers, such as a floor show, is a business expense. These expenses are not subject to the 50% limit.

Advertising to promote goodwill. You can deduct the cost of providing meals, entertainment, or recreational facilities to the general public as a means of advertising or promoting goodwill in the community. For example, the expense of sponsoring a television or radio show is deductible. You can also deduct the expense of distributing free food and beverages to the general public. Expenses under this exception are not subject to the 50% limit.

Charitable sports event. The 50% limit does not apply to the expenses covered by a package deal that includes a ticket to a charitable sports event. See *Entertainment tickets* in Publication 463 for a list of the conditions a charitable sports event must meet before you can deduct 100% of the cost of the package deal.

Miscellaneous Expenses

In addition to travel, meal, and entertainment expenses, there are other expenses that you as an employer may deduct. This section briefly covers some of these expenses (listed in alphabetical order).

Advertising expenses. You can deduct reasonable advertising expenses if they relate to your business activities. Generally, you cannot deduct the cost of advertising to influence legislation. See *Lobbying expenses* later in this chapter.

You can usually deduct as a business expense the cost of public service advertising to keep your name before the public if it relates to business you reasonably expect to gain in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross, to buy U.S. Saving Bonds, or to participate in similar causes is usually deductible.

Foreign expenses. You cannot deduct the costs of advertising on foreign radio and television (including cable) where the advertising is primarily for a market in the United States. However, this rule only applies to advertising expenses in countries that deny a deduction for advertising on a United States broadcast primarily for that country's market.

Anticipated liabilities. Anticipated liabilities or reserves for anticipated liabilities are not deductible. For example, assume you sold one-year TV service contracts this year totaling \$50,000. From past experience, you know you will have expenses of about \$15,000 in the coming year for these contracts.

You cannot deduct any of the \$15,000 this year by charging expenses to a reserve or liability account. You can deduct your expenses only when you actually pay or accrue them, depending on your accounting method.

Black lung benefit trust contributions. If you, as a coal mine operator, make a contribution to a qualified black lung benefit trust, you may be able to deduct your contribution. To be deductible, you must make your contribution during the tax year or pay it to the trust no later than the due date for filing your federal income tax return (including extensions). You must make the contribution in cash or in property the trust is permitted to hold. If you contribute property, treat the transaction as a sale or exchange of the property. Do not treat a transfer to the trust of a note or other evidence of your indebtedness as a contribution to the trust.

Figure your allowable deduction for contributions to a black lung benefit trust on Schedule A of Form 6069.

Bribes and kickbacks. You cannot deduct bribes, kickbacks, or similar payments if they are either of the following:

- 1) Payments directly or indirectly to an official or employee of any government or an

agency or instrumentality of any government in violation of the law. If the government is a foreign government, the payments are not deductible if they are unlawful under the Foreign Corrupt Practices Act of 1977.

- 2) Payments directly or indirectly to a person in violation of any federal or state law (but only if that state law is generally enforced) that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

Meaning of “generally enforced.” A state law is considered generally enforced unless it is never enforced or enforced only for infamous persons or persons whose violations are extraordinarily flagrant. For example, a state law is generally enforced unless proper reporting of a violation of the law results in enforcement only under unusual circumstances.

Kickbacks. A kickback includes a payment for referring a client, patient, or customer. The common kickback situation occurs when money or property is given to someone as payment for influencing a third party to purchase from, use the services of, or otherwise deal with the person who pays the kickback. In many cases, the person whose business is being sought or enjoyed by the person who pays the kickback does not know of the payment.

Example 1. Mr. Green, an insurance broker, pays part of the insurance commissions he earns to car dealers who refer insurance customers to him. The car dealers are not licensed to sell insurance. If these payments are made in violation of any federal or state law, as explained in (2) above, Mr. Green cannot deduct them.

Example 2. The Yard Corporation is in the business of repairing ships. It returns 10% of the repair bills as kickbacks to the captains and chief officers of vessels it repairs. It considers kickbacks necessary to get business. The owners of the ships do not know of these payments.

In the state where the corporation operates, it is unlawful to attempt to influence the actions of any employee, private agent, or fiduciary in relation to the principal's or employer's affairs by giving or offering anything of value without the knowledge and consent of the principal or employer. The state generally enforces the law. Therefore, the kickbacks paid by the Yard Corporation are not deductible.

Medicare or Medicaid. Kickbacks, bribes, and rebates paid in Medicare or Medicaid programs are not deductible.

Form 1099-MISC. If you pay kickbacks during your tax year, whether or not they are deductible on your return, file an information return, Form 1099-MISC, for every person to whom you pay \$600 or more during the year.

Car and truck expenses. You can deduct the cost of operating a car, truck, or other vehicle in your business. Only the expenses for business use are deductible. Traveling between your home and your place of business is not business use. You can deduct all costs of operating the vehicle for business. These costs

include gas, oil, repairs, license tags, insurance, and depreciation.

Under certain conditions, you can use the standard mileage rate instead of deducting your expenses for your vehicle. The standard mileage rate for 1994 is 29 cents a mile for all business miles put on a car, van, pick-up, or panel truck. For more information on how to figure your deduction, see Publication 917.

Recordkeeping. You must prove your deductions for operating a vehicle by adequate records or by sufficient evidence that corroborates your own statement.

To support each element of an expense, you should keep an account book, diary, statement of expenses, or similar record supported by adequate documentation.

Charitable contributions. Cash payments to charitable, religious, educational, scientific, or similar organizations may be deductible as business expenses if the payments are not charitable contributions or gifts. If the payments are charitable contributions or gifts, you cannot deduct them as business expenses. However, corporations can deduct charitable contributions on their income tax returns. See *Charitable Contributions* in Publication 542 for more information. Individuals, partners in a partnership, or shareholders in an S corporation may be able to deduct charitable contributions made by their business on their individual income tax returns.

Example. You paid \$15 to a local church for a half-page ad in a program for a concert it is sponsoring. Since your payment is not a contribution, you cannot deduct it as such. However, you can deduct it as an advertising expense.

Inventory. You can take a charitable contribution deduction for inventory items donated to a qualified charitable organization. Your deduction is limited to the fair market value of the property on the date of the contribution less any gain you would have realized if you had sold the property at its fair market value. You must remove from opening inventory for the year you make the contribution any costs for the donated property included from prior years. These costs are not part of the cost of goods sold for determining gross income for the year of the contribution. Use them in figuring the basis of the donated property. However, you can include (as part of the cost of goods sold) costs in the year of the contribution if you treat them as part of the cost of goods sold under your accounting method. Do not use these costs to increase the basis of the donated property.

Example 1. You own an auto repair shop and in 1994 you donated auto parts to your local school for its auto repair class. The fair market value of the parts at the time of the contribution was \$600 and you had included \$400 for the parts in your opening inventory for 1994. Your charitable contribution is \$400, determined as follows:

Fair market value	\$600
Minus: Gain if sold (\$600 - 400 basis)	200
Charitable contribution	<u>\$400</u>

You reduce your opening inventory by the \$400 for the donated property.

Example 2. Assume the same facts as Example 1, except you purchased the auto parts in 1994 for \$400 (not part of the opening inventory). The \$400 is included as part of the cost of goods sold for 1994 but not in figuring the basis of the property. Your charitable contribution is \$0, determined as follows:

Fair market value	\$600
Minus: Gain if sold (\$600 - 0 basis)	600
Charitable contribution	<u>\$ 0</u>

Demolition expenses or losses. You cannot deduct any amount paid or incurred to demolish a structure, or any loss for the undepreciated basis of a demolished structure. Add these costs to the basis of the land where the demolished structure was located.

Depreciation. If property you buy to use in your business has a useful life longer than one year, you generally cannot deduct the entire cost as a business expense in the year you buy it. You must spread the cost over more than one tax year and deduct part of it each year. This method of deducting the cost of business property is called depreciation.

There is an exception to this requirement to depreciate long-lived business property. You can choose to deduct a limited amount of the cost of certain depreciable property in the year you purchase it for use in your business. The deduction is referred to as a “section 179 deduction.”

For information on the deduction limit and how to figure it, see Chapter 2 of Publication 534 or use the Section 179 Worksheet in Publication 534.

Dues and subscriptions. You cannot deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes business, social, athletic, luncheon, sporting, airline, and hotel clubs.

You can deduct donations to other business organizations as business expenses if they relate directly to your trade or business and you reasonably expect a financial return in line with your donation. For example, a contribution you make to a committee organized by the Chamber of Commerce to bring a national convention to your city may be deductible.

You can deduct as a business expense subscriptions to professional, technical, and trade journals that deal with your business field.

Education expenses. You can deduct two kinds of expenses for education. One is the ordinary and necessary expenses you pay for the education and training of your employees. See Chapter 5.

The other is for amounts you spend for your own education in your trade, business, or profession, along with certain related travel. You must be able to show the education maintains or improves skills required in your trade, business, or profession, or it is required by law

or regulations for keeping your pay, status, or job.

You **cannot** deduct education expenses you incur to meet the minimum requirements of your present trade, business, or profession, or those that qualify you for a new trade, business, or profession, even if the education maintains or improves skills presently required in your business.

Example 1. Dr. Carter, who is a psychiatrist, begins a program of study at an accredited psychoanalytic institute to qualify as a psychoanalyst. She can deduct the cost of the program because the study maintains or improves skills required in her profession and does not qualify her for a new one.

Example 2. Herb Jones owns a repair shop for electronic equipment. The bulk of the business is television repairs, but occasionally he fixes tape decks and disc players. To keep up with the latest technical changes, he takes a special course to learn how to repair disc players. Since the course maintains and improves skills required in his trade, he can deduct its cost.

Example 3. You have your own accounting and tax practice. You take several courses in taxation and tax accounting. Since these courses improve skills required in your trade or business and are not part of a program qualifying you for a new trade or business, you can deduct them.

Example 4. Peter Green, an architect in business in New York, decided to take a special 2-week course on the latest building techniques. He went to Los Angeles, devoted 2 weeks to the course in building techniques, spent 8 weeks on personal activities, and returned to New York.

Absent a substantial nonpersonal reason for taking the course in Los Angeles, the time he spent on personal activities indicates his main reason for going to Los Angeles was to take a vacation, even though he took the course to improve skills required in his business. His trip is mainly personal because 80% of his time is personal and his reasons for taking the course in Los Angeles were personal. He can deduct his education expenses and meals and lodging for the 2 weeks spent on the course. He cannot deduct his round trip transportation expense to Los Angeles or any of the expenses for the 8 weeks spent on personal activities.

Environmental clean up costs. You can deduct certain costs to clean up land and to treat groundwater that you contaminated with hazardous waste from your business operations. You can deduct the costs you incur to restore your land and groundwater to the same physical condition that existed prior to contamination. You cannot deduct costs attributable to the construction of groundwater treatment facilities. You must capitalize those costs and you can recover them through depreciation.

Franchise, trademark, trade name. A franchise includes an agreement that gives one of the parties to the agreement the right to

distribute, sell, or provide goods, services, or facilities within a specified area.

If you buy a franchise, trademark, or trade name under a contract entered into after October 2, 1989, you can deduct the amount you pay or incur as a business expense only if the payments are part of a series of payments that are:

- 1) Contingent on productivity, use, or disposition of the item,
- 2) Payable at least annually for the entire term of the transfer agreement, and
- 3) Substantially equal in amount (or payable under a fixed formula).

Contracts entered into before October 3, 1989. For contracts to buy a franchise, trademark, or trade name entered into before October 3, 1989, you can deduct payments contingent on productivity, use, or disposition. Items (2) and (3) above do not apply.

Property acquired before August 11, 1993. For a transfer not treated as a sale or exchange of a capital asset, you can deduct a lump-sum payment of an agreed upon principal amount ratably over the shorter of 10 years or the life of the agreement. However, for transfers after October 2, 1989, this 10-year period does not apply if the principal sum is over \$100,000.

For a transfer not treated as a sale or exchange of a capital asset, you can deduct, in the year made, a payment that is one of a series of approximately equal payments payable over:

- The period of the transfer agreement, or
- A period of more than 10 years, regardless of the life of the agreement.

Charge any payment not deductible because of these rules to a capital account. However, you can deduct the payments charged to a capital account over the life of the asset if you can determine the useful life of the asset. Otherwise, you can amortize the payment over a 25-year period beginning with the tax year the transfer occurs.

Property acquired after August 10, 1993. Any amounts you pay or incur for the transfer (after August 10, 1993) of a franchise, trademark, or trade name (if the payments are not described in (1) through (3) above) must be charged to a capital account. See Chapter 12 for more information on how to recover these costs.

You can also elect to apply this same treatment to any franchise, trademark, or trade name acquired after July 25, 1991. This election is binding and cannot be revoked without consent from the IRS.

Renewals. The term of the transfer agreement includes all renewal options, and any other period the parties reasonably expect the agreement to be renewed.

Recapture. You must recapture the payments as ordinary income if you transfer, sell, or otherwise dispose of a franchise, trademark, or trade name for which payments were deducted as:

- 1) A lump-sum or serial payment of a principal amount not treated as a sale or exchange of an asset, or
- 2) An amortized payment deducted over 25 years.

For more information on the amortization of intangibles, see Chapter 12.

Interview expense allowances. Reimbursements you make to job candidates for transportation or other expenses related to interviews for possible employment are not wages. They are not subject to social security and Medicare taxes (FICA), federal unemployment taxes (FUTA), or the withholding of income tax. However, you can deduct the allowances as a business expense.

Legal and professional fees. Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses of operating your business and directly related to your business, are deductible as business expenses. However, you usually cannot deduct legal fees you pay to acquire business assets. Add them to the basis of the property.

If the fees include payments for work of a personal nature (such as making a will), you take a business deduction only for the part of the fee related to your business. The personal portion of legal fees for producing or collecting taxable income, doing or keeping your job, or for tax advice may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529.

Tax preparation fees. You can deduct as a trade or business expense on Schedule C (Form 1040) the cost of preparing that part of your tax return relating to your business as a sole proprietor. The remaining cost is deductible on Schedule A (Form 1040) if you itemize your deductions.

You can also take a business deduction on Schedule C for the amount you pay or incur in resolving asserted tax deficiencies for your business as a sole proprietor.

Licenses and regulatory fees. Licenses and regulatory fees for your trade or business paid each year to state or local governments are deductible. See Chapter 12 for when these expenses must be amortized.

Lobbying expenses. Generally, you cannot take a deduction for lobbying expenses for any amounts you pay or incur after December 31, 1993. This includes amounts paid or incurred for:

- Influencing legislation;
- Participating, or intervening, in any political campaign for, or against, any candidate for public office;
- Attempting to influence the general public, or segments of the public, about elections, legislative matters, or referendums; or

- Communicating directly with covered executive branch officials in any attempt to influence the official actions or positions of such officials.

Lobbying expenses you cannot deduct also include amounts paid or incurred for research, preparation, planning, or coordination of any activity described in the preceding list.

Covered executive branch official. A covered executive branch official in the last item of preceding list includes:

- 1) The President,
- 2) The Vice President,
- 3) Any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in the Executive Office,
- 4) Any individual serving in a position in Level I of the Executive Schedule under Section 5312 of Title 5, United States Code, any other individual designated by the President as having Cabinet-level status, and
- 5) Any immediate deputy of an individual listed in item (4) above.

Exceptions to denial of deduction. The general denial of the deduction does not apply to:

- 1) Expenses for attempting to influence the legislation of any local council or similar governing body (**local legislation**). An Indian tribal government shall be treated as a local council or similar governing body.
- 2) Any in-house expenses for influencing legislation or communicating directly with a covered executive branch official if such expenses for the tax year do not exceed \$2,000 (excluding overhead expenses).
- 3) Expenses incurred by taxpayers engaged in the trade or business of lobbying (**professional lobbyists**) on behalf of another person (but does apply to payments by the other person to the lobbyist for lobbying activities).

Disallowance of charitable deduction.

You cannot take a charitable deduction for amounts paid to an organization described in IRC 170(c) if that organization conducts lobbying activities on matters of direct financial interest to your business and if a principle purpose of your contribution is to avoid federal income tax.

If a tax-exempt organization provides you with a notice on the portion of dues that are allocable to nondeductible lobbying and political expenses, you cannot deduct that portion of the dues.

Losses recovered. If you are compensated during the tax year for unrecovered losses, you may be able to take a special deduction. The deduction applies only to damages included in gross income and recovered from

patent infringement, breach of contract or fiduciary duty, or antitrust injury. The deduction is the smaller of:

- 1) The amount you received or accrued for damages in the tax year reduced by the amount you paid or incurred in the year to recover that amount, or
- 2) Your losses from the injury you have not deducted.

The deduction applies only to amounts recovered for actual injury, not any additional amount.

Medical expenses. If you are disabled, you can deduct expenses necessary for you to be able to work (impairment-related expenses) as a business expense, rather than as a medical expense.

You are disabled if you have:

- 1) A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed, or
- 2) A physical or mental impairment that substantially limits one or more of your major life activities.

You can deduct the expenses as a business expense if:

- 1) Your work clearly requires the expense for you to satisfactorily perform the work,
- 2) The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities, and
- 3) Their treatment is not specifically provided for under other tax law provisions.

Example. You are blind. You must use a reader to do your work, both at and away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as a business expense.

Moving machinery. The cost of moving your machinery from one city to another is a deductible expense. So is the cost of moving machinery from one plant to another, or from one part of your plant to another. You can deduct the cost of installing the machinery in the new location. However, capitalize the costs of installing or moving newly purchased machinery.

Outplacement services. You can deduct the costs of outplacement services you provide to your employees to help them find new employment (such as career counseling, resume assistance, skills assessment, etc.).

The costs of outplacement services may cover more than one deduction category. For example, deduct as a utilities expense the cost of telephone calls made under this service, and deduct as rental expense the cost of renting machinery and equipment for this service.

Penalties and fines. Penalties you pay for late performance or nonperformance of a contract are generally deductible. For instance, if you contracted to construct a building by a certain date and had to pay an amount for each

day the building was not finished after that date, you can deduct the amounts paid or incurred.

On the other hand, you cannot deduct penalties or fines you pay to any government agency or instrumentality because of a violation of any law. These fines or penalties include amounts:

- 1) Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.
- 2) Paid as a penalty imposed by federal, state, or local law in a civil action, including certain additions to tax and additional amounts and assessable penalties imposed by the Internal Revenue Code.
- 3) Paid in settlement of actual or possible liability for fine or penalty, whether civil or criminal.
- 4) Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Examples of nondeductible penalties and fines include:

- 1) Fines for violating city housing codes.
- 2) Fines paid by truckers for violating state maximum highway weight laws and air quality laws.
- 3) Civil penalties for violating federal laws regarding mining safety standards and discharges into navigable waters.

A fine or penalty does not include:

- 1) Legal fees and related expenses to defend yourself in a prosecution or civil action for a violation of the law imposing the fine or civil penalty.
- 2) Court costs or stenographic and printing charges.
- 3) Compensatory damages paid to a government.

Nonconformance penalty. You can deduct a nonconformance penalty assessed by the Environmental Protection Agency for failing to meet certain emission standards.

Political contributions. You cannot deduct contributions or gifts to political parties or candidates as business expenses. In addition, you cannot deduct expenses you pay or incur to take part in any political campaign of a candidate for public office.

Indirect political contributions. You also cannot deduct indirect political contributions and costs of taking part in political activities as business expenses. Examples of nondeductible expenses include:

- 1) Advertising in a convention program of a political party, or in any other publication if any of the proceeds from the publication are for, or intended for, the use of a political party or candidate.
- 2) Admission to a dinner or program (including, but not limited to, galas, dances, film presentations, parties, and sporting events) if any of the proceeds from the

function are for, or intended for, the use of a political party or candidate.

- 3) Admission to an inaugural ball, gala, parade, concert, or similar event if identified with a political party or candidate.

Repairs. The cost of repairing or improving property used in your trade or business is either a deductible or capital expense. You can deduct expenses to keep your property in a normal efficient operating condition. But you must capitalize expenses that add to the value of your property or significantly increase its life. Although you cannot deduct capital expenditures as current expenses, you can usually deduct them over a period of time as depreciation.

Repairs neither add to the value or usefulness of property nor appreciably lengthen its life. They merely maintain the property in a normal efficient operating condition. Deductible repairs include the cost of labor, supplies, and certain other items. However, you **cannot** deduct the value of your own labor.

Examples of repairs include:

Patching and repairing floors.

Repainting the inside and outside of a building.

Repairing roofs and gutters.

Mending leaks.

You cannot deduct repairs allocable to the **cost of goods sold** again as business expenses.

Repayments (claim of right). If you included an amount in income because you thought you had an unrestricted right to it, and in a later year you have to repay all or part of it, a special rule may apply. Usually, you can deduct the repayment in the year in which you make it. If the income item gave rise to a deduction in the year you included it in income, any deduction for the repayment is limited to the net amount you included in income in the earlier year.

The character of the deduction in the year of repayment depends on the character of the

income included in the earlier year. For instance, if you repay an amount previously reported as a long-term capital gain, the repayment is a long-term capital loss.

Example. You use the cash method of accounting. In 1993, you were involved in a lawsuit resulting from a contract dispute with Doe Corporation. The dispute was over the amount owed to you. The court decided in your favor for \$2,000. Although Doe Corporation said it would appeal the judgment, it was ordered by the court to pay you immediately without restriction. As promised, Doe Corporation appealed the case and won. The appellate court reversed the lower court's judgment in June 1994. In 1994, you repaid the \$2,000 you received in 1993.

You included the \$2,000 in your income for 1993 because you had an unrestricted right to it. No deduction arose from the inclusion. In 1994, you can deduct the \$2,000 repayment.

Repayment over \$3,000. If the amount you repaid is more than \$3,000, your tax is the lesser of:

- 1) Your tax for this year figured with a deduction for the amount repaid, or
- 2) Your tax for this year:
 - a) Figured without deducting the repaid amount, and
 - b) Reduced by the amount your tax for the earlier year increased because you included the amount repaid in income.

If your tax is the amount figured under (2), you cannot deduct the amount repaid in figuring a net operating loss for this year. However, take the amount into account in figuring the decrease in tax for the earlier tax year.

This discussion does not apply if your deduction results from any of the following:

- 1) Sales of inventory items to customers in the ordinary course of trade or business.
- 2) Sales returns and allowances and similar items.

- 3) Bad debts.

- 4) Legal and other expenses of contesting the repayment.

Accounting for repayments. If you use the cash method of accounting, you can claim the deduction only in the year the income item is repaid. If you included the amount in income because of the rule of constructive receipt, but never received it, you can deduct the amount in the tax year you must give up your right to receive it. If you use any other accounting method, you can deduct the repayment only in the proper tax year under that accounting method.

Supplies and materials. You can deduct the cost of incidental supplies and materials, such as office supplies and wrapping paper, used in your business during the tax year. However, if you make unusually large purchases of these items, you may not be allowed to deduct the entire cost in the year you buy them.

You can also deduct the cost of books, professional instruments, equipment, etc., if you normally use them up in less than a year.

Utilities. Your business expenses for heat, lights, power, and telephone are deductible. However, any part due to personal use is not deductible.

Telephone. If you have an office in your home, even though you are in business, you cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home.

Cellular telephone. Any cellular telephone or similar telecommunications equipment placed in service in tax years beginning after 1989 is listed property. If listed property is not used more than 50% for qualified business use during any tax year, the section 179 deduction is not allowed and the depreciation deductions are limited. See *Predominant Use Test* in Chapter 4 of Publication 534.

Table 6-2. Form 5305-SEP

<p>Form 5305-SEP (Rev. March 1994)</p> <p>Department of the Treasury Internal Revenue Service</p>	<p>Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement (Under section 408(k) of the Internal Revenue Code)</p>	<p>OMB No. 1545-0499 Expires 2-29-97</p> <p>DO NOT File with the Internal Revenue Service</p>
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_____ makes the following agreement under section 408(k) of the Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see Specific Instructions.)
The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least _____ years old (not to exceed 21 years old) and have performed services for the employer in at least _____ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) includes does not include employees covered under a collective bargaining agreement, includes does not include certain nonresident aliens, and includes does not include employees whose total compensation during the year is less than \$396*.

Article II—SEP Requirements (See Specific Instructions.)
The employer agrees that contributions made on behalf of each eligible employee will be:

A. Based only on the first \$150,000 of compensation.
B. Made in an amount that is the same percentage of total compensation for every employee.
C. Limited annually to the smaller of \$30,000* or 15% of compensation.
D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

_____ Employer's signature and date	_____ Name and title
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Paperwork Reduction Act Notice
The time needed to complete this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 7 min.
Learning about the law or the form 26 min.
Preparing the form 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the Internal Revenue Service, Attention: Reports Clearance Officer, PC:FP, Washington, DC 20224; and the Office of Management and Budget, Paperwork Reduction Project (1545-0499), Washington, DC 20503. **DO NOT** send this form to either of these addresses. Instead, keep it for your records.

A Change To Note
For years beginning after December 31, 1993, the Revenue Reconciliation Act of 1993 (the Act) reduced to \$150,000 the annual compensation of each employee to be taken into account in making contributions to a SEP. The \$150,000 amount will be indexed for inflation after 1994 in increments of \$10,000 that will be rounded to the next lowest multiple of \$10,000. See Act section 13212 for different effective dates and the transition rules that apply to governmental plans and plans under a collective bargaining agreement.

General Instructions
Section references are to the Internal Revenue Code unless otherwise noted.
Purpose of Form.—Form 5305-SEP (Model SEP) is used by an employer to make an agreement to provide benefits to all eligible employees under a SEP described in section 408(k). Do not file this form with the IRS. See Pub. 580, Retirement Plans for the Self-Employed, and Pub. 580, Individual Retirement Arrangements (IRAs).

Specific Instructions
Instructions to the Employer
Simplified Employee Pension.—A SEP is a written arrangement (a plan) that provides you with a simplified way to make contributions toward your employees' retirement income. Under a SEP, you can contribute to an employee's individual retirement account or annuity (IRA). You make contributions directly to an IRA set up by or for each employee with a bank, insurance company, or other qualified financial institution. When using Form 5305-SEP to establish a SEP, the IRA must be a Model IRA established on an IRS form or a master or prototype IRA for which the IRS has issued a favorable opinion letter. Making the agreement on Form 5305-SEP does not establish an employer IRA described in section 408(c).
When Not To Use Form 5305-SEP.—Do not use this form if you:

1. Currently maintain any other qualified retirement plan. This does not prevent you from also maintaining a Model Elective SEP (Form 5305A-SEP) or other SEP to which either elective or nonelective contributions are made.
2. Previously maintained a defined benefit plan that is now terminated.
3. Have any eligible employees for whom IRAs have not been established.
4. Use the services of leased employees (described in section 414(n)).
5. Are a member of an affiliated service group (described in section 414(m)), a controlled group of corporations (described in section 414(b)), or trades or businesses under common control (described in sections 414(c) and 414(o)), unless all eligible employees of all the members of such groups, trades, or businesses, participate in the SEP.
6. Will not pay the cost of the SEP contributions. Do not use Form 5305-SEP for a SEP that provides for elective employee contributions even if the contributions are made under a salary reduction agreement.

Use Form 5305A-SEP, or a nonmodel SEP if you permit elective deferrals to a SEP.
Eligible Employees.—All eligible employees must be allowed to participate in the SEP. An eligible employee is any employee who: (1) is at least 21 years old, and (2) has performed "service" for you in at least 3 of the immediately preceding 5 years. *Note:* You can establish less restrictive eligibility requirements, but not more restrictive ones.
Service is any work performed for you for any period of time, however short. If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, service includes any work performed for any period of time for any other member of such group, trades, or businesses.
Excludable Employees.—The following employees do not have to be covered by the SEP: (1) employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by you and their union, (2) nonresident alien employees who did not earn U.S. source income from you, and (3) employees who received less than \$396* in compensation during the year.
Contribution Limits.—The SEP rules permit you to make an annual contribution of up to 15% of the employee's total compensation or \$30,000*, whichever is less. Compensation, for this purpose, does not include employer contributions to the SEP or the employee's compensation in excess of \$150,000. If you also maintain a Model Elective SEP or any other SEP that permits employees to make elective deferrals, contributions to the two SEPs together may not exceed the smaller of \$30,000* or 15% of compensation for any employee.
Contributions cannot discriminate in favor of highly compensated employees. You are not required to make contributions every year. But you must contribute to the SEP-IRAs of all of the eligible employees who actually performed services during the year of the contribution. This includes eligible employees who die or quit working before the contribution is made.

*This amount reflects the cost-of-living increase under section 408(b)(9), effective January 1, 1994. The amount is adjusted annually. Each January, the IRS announces the increase, if any, in a news release and in the Internal Revenue Bulletin.

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