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Business Expenses

For use in preparing 2006 Returns

Contents

Introduction .......................................................... 1
What’s New for 2006 ........................................... 2
What’s New for 2007 ........................................... 2
Reminders ............................................................... 2
1. Deducting Business Expenses .......................... 2
2. Employees’ Pay ............................................... 6
3. Rent Expense ................................................ 8
4. Interest .......................................................... 10
5. Taxes ............................................................. 15
6. Insurance ......................................................... 17
7. Costs You Can Deduct or Capitalize ............. 20
8. Amortization .................................................... 25
9. Depletion ........................................................ 25
10. Business Bad Debts ........................................ 37
11. Other Expenses ............................................. 39
12. How To Get Tax Help ...................................... 45
Index .................................................................. 47

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 cover specific expenses and list other publications and forms you may need.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions. You can write to us at the following address:

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one of the three addresses shown under How To Get Tax Help in the back of this publication.

What's New for 2006

The following items highlight some changes in the tax law for 2006. More information on these and other changes can be found in Publication 553, Highlights of 2006 Tax Changes.

- Retirement plans. The information is available in Publication 560, Retirement Plans for Small Business (SEP, Simple, and Qualified Plans).
- Electric and clean-fuel vehicles. The clean-fuel vehicle and refueling property deduction expired for vehicles placed in service after December 31, 2005. For information on the recapture of this deduction, see Regulations section 1-179A-1. For information on the electric vehicle credit, see Form 8834, Qualified Electric Vehicle Credit. You may be able to claim a credit if you placed an energy-efficient vehicle or alternative fuel vehicle refueling property in service in 2006. See Form 8910, Alternative Motor Vehicle Credit, and Form 8911, Alternative Fuel Vehicle Refueling Property Credit, for more information.

Capital gains treatment for certain self-created musical. Capital gains treatment for certain self-created musical works has been made permanent.

Partial expensing for advanced mine safety equipment. For costs paid or incurred for any qualified advanced mine safety equipment property after December 20, 2006, an election can be made to treat 50% of the cost as a currently deductible expense if the property is placed in service during the tax year. See chapter 7 for more information.

Tax rates and maximum net earnings. The maximum net self-employment earnings subject to the social security portion (12.4%) of the self-employment tax increased to $89,600 for 2006. There is no maximum limit on earnings subject to the Medicare portion (2.9%). See Schedule SE (Form 1040), Self Employment Tax.

Meal expense deduction subject to "hours of service" limits. For 2006, this deduction is 75% of the reimbursed meals you employees consumed while they were subject to the Department of Transportation’s "hours of service" limits. See chapter 11.

Elective deferrals. For 2007, the maximum amount of elective deferrals under a salary reduction agreement that could be contributed to a qualified plan increased to $15,500 ($20,500 if you are age 50 or older). For SIMPLE plans, the amount increased to $10,000 ($12,500 if you were age 50 or older).

Compensation limit. The maximum compensation used for figuring contributions and benefits for a retirement plan has increased from $20,500 to $22,000 for 2006.

Traditional and Roth IRA contributions limit. The maximum contribution you can make to a traditional or Roth IRA in 2007 is $4,000, but $500 if your income is below a specified level.

Qualified employer-sponsored retirement plans. The exclusion for amounts contributed to a qualified employer-sponsored retirement plan increased to $15,000 ($20,000 if income tax package.

For 2006, the maximum amount of elective deferrals under a salary reduction agreement that could be contributed to a qualified plan increased to $15,000 ($20,000 if you were age 50 or older). For SIMPLE plans, the amount increased to $10,000 ($12,500 if you were age 50 or older).

Compensation limit. The maximum compensation used for figuring contributions and benefits for a retirement plan has increased from $210,000 to $220,000 for 2006.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2007 is 48.5 cents a mile for all business miles.

What’s New for 2007

The following items highlight some changes in the tax law for 2007.

Domestic production activities deduction. The deduction rate for 2007 will be increased to 6%. See Form 8903, Domestic Production Activities Deduction, for more information.

Meal expense deduction subject to "hours of service" limits. For 2007, this deduction is unchanged at 75% of the reimbursed meals you employees consumed while they were subject to the Department of Transportation’s "hours of service" limits. See chapter 11.

Elective deferrals. For 2007, the maximum amount of elective deferrals under a salary reduction agreement that can be contributed to a qualified plan increases to $15,500 ($20,500 if you are age 50 or older). However, for SIMPLE plans, the amount is $10,500 ($13,000 if you are age 50 or older).

Compensation limit. The maximum compensation used for figuring contributions and benefits for a retirement plan will increase from $220,000 to $225,000 for 2007.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2007 is 48.5 cents a mile for all business miles.

Reminders

IRS e-file (Electronic Filing)

You can file your tax returns electronically using an IRS e-file. The benefits of IRS e-file include faster refunds, increased accuracy, and acknowledgment of IRS receipt of your return. You can use one of the following IRS e-file options.

- Use an authorized IRS e-file provider.
- Use a personal computer.
- Visit a Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE) site.

For details on these fast filing methods, see your income tax package.

Qualifed environmental cleanup (remedia- tion) costs. The deduction for qualified envi- ronmental cleanup (remediation) costs include costs you pay or incur before 2006. See chapter 7.

Marginal production of oil and gas. The suspension of the taxable income limit on per- centage depletion from the marginal production of oil and natural gas has been extended to tax years beginning before 2006. For more information on marginal production, see section 613A(c) of the Internal Revenue Code.

Photographs of missing children. The Intern- al Revenue Service is a proud partner with the National Center for Missing and Exploited Chil- dren. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-6787) if you recognize a child.

1. Deducting Business Expenses

Introduction

This chapter covers the general rules for deducting business expenses. Business expenses are the costs of carrying on a trade or business and they are usually deductible if the business is operated to make a profit.

Topics

This chapter discusses:

- What you can deduct
- How much you can deduct
- When you can deduct
- Not-for-profit activities

Useful Items

You may want to see:

Publication

- 334 Tax Guide for Small Business
- 463 Travel, Entertainment, Gift, and Car Expenses
- 525 Taxable and Nontaxable Income
- 529 Miscellaneous Deductions
- 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 538 Accounting Periods and Methods
What Can I Deduct?

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

It is important to distinguish business expenses from:

- The expenses used to figure cost of goods sold,
- Capital expenses, and
- Personal expenses.

Cost of Goods Sold

If your business manufactures products or purchases them for resale, you generally must value inventory at the beginning and end of each tax year to determine your cost of goods sold. Some of your business expenses may be included in figuring cost of goods sold. Cost of goods sold is deducted from your gross receipts to figure your gross profit for the year. If you include an expense in the cost of goods sold, you cannot deduct it again as a business expense.

The following are types of expenses that go into figuring cost of goods sold:

- The cost of products or raw materials, including freight.
- Storage.
- Direct labor (including contributions to pension or annuity plans) for workers who produce the products.
- Factory overhead.

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for certain production or resale activities. Indirect costs include rent, interest, taxes, storage, purchasing, processing, repackaging, handling, and administrative costs.

This rule does not apply to personal property you acquire for resale if your average annual gross receipts (or those of your predecessor) for the preceding 3 tax years are not more than $10 million.

For more information, see the following sources:
- Cost of goods sold — chapter 6 of Publication 334.
- Inventories — Publication 538.
- Uniform capitalization rules — Publication 538 and section 263A of the Internal Revenue Code and the related regulations.

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." Capital expenses are considered as sets in your business. There are, in general, three types of costs you capitalize:

- Business start-up costs (See Tip below).
- Business assets.
- Improvements.

Cost recovery. Although you generally cannot take a current deduction for a capital expense, you may be able to recover the amount you spend through depreciation, amortization, or depletion. These recovery methods allow you to deduct part of your cost each year. In this way, you are able to recover your capital expense. See Amortization (chapter 8) and Depletion (chapter 9) in this publication. You may also be allowed a section 179 deduction. For information on the section 179 deduction and depletion, see Publication 946.

Business Assets

There are many different kinds of business assets; for example, land, buildings, machinery, furniture, trucks, patents, and franchise rights. You must fully capitalize the cost of these assets, including freight and installation charges. Certain property you produce for use in your trade or business must be capitalized under the uniform capitalization rules. See Regulations section 1.263A-2 for information on these rules.

Improvements

The costs 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. Improvements are generally major expenditures. Some examples are: new electric wiring, a new roof, a new floor, new plumbing, brickking up windows to strengthen a wall, and lighting improvements.

However, you can currently deduct repairs that keep your property in a normal efficient operating condition as a business expense. Treat as repairs amounts paid to replace parts of a machine that only keep it in a normal operating condition.

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.

Capital versus Deductible Expenses

To help you distinguish between capital and deductible expenses, different examples are given below.

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

There are dollar limits on the depreciation you can claim each year on passenger automobiles used in your business. See Publication 463.

Generally, repairs you make to your business vehicle are currently deductible. However, amounts you pay to recondition and overhaul a business vehicle are capital expenses and are recovered through depreciation.

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 1 year or their cost is minor.

Machinery parts. Unless the uniform capitalization rules apply, the cost of replacing short-lived parts of a machine to keep it in good working condition, but not add to its life, is a deductible expense.

Heating equipment. The cost of changing from one heating system to another is a capital expense.

Personal versus Business Expenses

Generally, you cannot deduct personal, living, or family expenses. However, 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 the business part.

For example, if you borrow money and use 70% of it for business and the other 30% for a family vacation, you generally can deduct 70% of the interest as a business expense. The remaining 30% is personal interest and generally is not deductible. See chapter 4 for information on deducting interest and the allocation rules.

Business use of your home. If you use part of your home for business, you may be able to deduct expenses for the business use of your home. These expenses may include mortgage
Deducting Business Expenses

Interest, insurance, utilities, repairs, and depreciation.

To qualify to claim expenses for the business use of your home, you must meet both of the following tests.

1. The business part of your home must be used exclusively and regularly for your trade or business.
2. The business part of your home must be:
   a. Your principal place of business, or
   b. A place where you meet or deal with patients, clients, or customers in the normal course of your trade or business, or
c. A separate structure (not attached to your home) used in connection with your trade or business.

You generally do not have to meet the exclusive use test for the part of your home that you regularly use either for the storage of inventory or product samples, or as a daycare facility.

Your home office qualifies as your principal place of business if you meet the following requirements.

• You use the office exclusively and regularly for administrative or management activities of your trade or business.
• You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

If you have more than one business location, determine your principal place of business based on the following factors.

• The relative importance of the activities performed at each location.
• If the relative importance factor does not determine your principal place of business, consider the time spent at each location.

For more information, see Publication 587.

Business Use of Your Car.

If you use your car exclusively in your business, you can deduct car expenses. If you use your car for both business and personal purposes, you must divide your expenses based on actual mileage.

You can deduct actual car expenses, which include depreciation (or lease payments), gas and oil, tires, repairs, tune-ups, insurance, and registration fees. Or, instead of figuring the business part of these actual expenses, you may be able to use the standard mileage rate to figure your deduction. For 2006, the standard mileage rate is 44.5 cents a mile for all business miles.

If you are self-employed, you can also deduct the business part of interest on your car loan, state and local personal property tax on the car, parking fees, and tolls, whether or not you claim the standard mileage rate.

For more information on car expenses and the rules for using the standard mileage rate, see Publication 463.

How Much Can I Deduct?

You can deduct the cost of a business expense if it meets the criteria of ordinary and necessary and it is not a capital expense.

Recovery of amount deducted (tax benefit rule).

If you recover part of an expense in the same year in which you would have claimed a deduction, reduce your current year expense by the amount of the recovery. If you have a recovery in a later year, include the recovered amount in income in that year. However, if part of the deduction for the expense did not reduce your tax, you do not have to include that part of the recovered amount in income.

For more information on recoveries and the tax benefit rule, see Publication 525.

Payments in kind.

If you provide services to pass favored persons, the amount you can deduct is limited to your out-of-pocket costs. You cannot deduct the cost of your own labor.

Generally, if you pay a business expense in goods or other property, you can deduct only what the property costs you. If these costs are included in the cost of goods sold, do not deduct them as a business expense.

Limits on losses.

If your deductions for an investment or business activity are more than the income it brings in, you have a loss. There may be limits on how much of the loss you can deduct.

Not-for-profit limits.

If you carry on your business activity without the intention of making a profit, you cannot use a loss from it to offset other income. See Not-for-Profit Activities, later.

At-risk limits.

Generally, a deductible loss from a trade or business or other income-producing activity is limited to the investment you have “at risk” in the activity. You are at risk in any activity for the following.

1. The money and adjusted basis of property you contribute to the activity.
2. Amounts you borrow for use in the activity if:
   a. You are personally liable for repayment, or
   b. You pledge property (other than property used in the activity) as security for the loan.

For more information, see Publication 925.

Passive activities.

Generally, you are in a passive activity if you have a trade or business activity in which you do not materially participate, or a rental activity. In general, deductions for losses from passive activities only offset income from passive activities. You cannot use any excess deductions to offset other income. In addition, you cannot deduct the tax on net passive income. Any excess loss or credits are carried over to later years. Suspended passive losses are fully deductible in the year you completely dispose of the activity.

For more information, see Publication 925.

Net operating loss.

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

See Publication 542 for information about net operating losses of corporations.

When Can I Deduct an Expense?

When you can deduct an expense depends on your accounting method. An accounting method is a set of rules used to determine when and how income and expenses are reported. The two basic methods are the cash method and the accrual method. Whichever method you choose must clearly reflect income.

For more information on accounting methods, see Publication 538.

Cash method.

Under the cash method of accounting, you generally deduct business expenses in the tax year you pay them.

Accrual method.

Under an accrual method of accounting, you generally deduct business expenses when both of the following apply.

1. The all-events test has been met. The test is met when:
   a. All events have occurred that fix the fact of liability, and
   b. The liability can be determined with reasonable accuracy.
2. Economic performance has occurred.

Economic performance. You generally cannot deduct or capitalize a business expense until economic performance occurs. If your expense is for property or services provided to you, or for your use of property, economic performance occurs as the property or services are provided, or 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 services.

Example. Your tax year is the calendar year. In December 2006, the Field Plumbing Company did some repair work at your place of business and sent you a bill for $600. You paid it by check in January 2007. If you use the accrual method of accounting, deduct the $600 on your tax return for 2006 because all events have occurred to “fix” the fact of liability (in this case the work was completed), the liability can be determined, and economic performance occurred in that year.

If you use the cash method of accounting, deduct the expense on your 2007 return.

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

Example. In 2006, you sign a 10-year lease and immediately pay your rent for the first 3
years. Even though you paid the rent for 2006, 2007, and 2008, you can only deduct the rent for 2008 on your 2008 tax return. You can deduct the rent for 2007 and 2008 on your tax returns for those years.

Contested liability. Under the cash method, you can deduct a contested liability only in the year you pay the liability. Under the accrual method, you can deduct contested liabilities such as taxes (except foreign or U.S. possession income, war profits, and excess profits taxes) either in the tax year you pay the liability (or transfer money or other property to satisfy the obligation) or in the tax year you settle the contest. However, to take the deduction in the year of payment or transfer, you must meet certain conditions. See Contested Liability in Publication 538 for more information.

Related person. Under an accrual method of accounting, you generally deduct expenses when you incur them, even if you have not yet paid them. However, if you and the person you owe are related and that person uses the cash method of accounting, you must pay the expense before you can deduct it. Your deduction is allowed when the amount is includible in income by the related cash method payee. See Related Persons in Publication 538.

Not-for-Profit Activities
If you do not carry on your business or investment activity to make a profit, you cannot use a loss from the activity to offset other income. Activities you do as a hobby, or mainly for sport or recreation, are often not entered into for profit.

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 you are carrying on an activity for profit, several factors are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- You carry on the activity in a businesslike manner,
- The time and effort you put into the activity indicates it is intended to make it profitable,
- You depend on the income for your livelihood,
- Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type of business),
- You change your methods of operation in an attempt to improve profitability,
- You (or your advisors) have the knowledge needed to carry on the activity as a successful business,
- You were successful in making a profit in similar activities in the past,
- The activity makes a profit in some years, and
- You can expect to make a future profit from the appreciation of the assets used in the activity.

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. The activity must be substantially the same for each year within this period. You have a profit when the gross income from an activity exceeds the deductions.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the "test" 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, the IRS will presume it is carried on for profit. This means the limits discussed here will not apply. 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 unless the IRS later shows it to be invalid.

Using the presumption later. If you are starting an activity and do not have 3 (or 2) years showing a profit, you can elect to have the presumption made after you have the 5 (or 7) years of experience allowed by the test.

You may file Form 5213 to elect to do this by filing Form 5213. Filing this form postpones any determination that your activity is not carried on for profit until 5 (or 7) years have passed since you started the activity.

The benefit gained by making this election is that the IRS will not immediately operation 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 the required number of years. 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 (or 2) years of profit, the limit can be applied retroactively to any year with a loss in the 5-year (or 7-year) period.

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

You must file Form 5213 within 3 years after the due date of your return (determined without extensions) for the year in which you first carried on the activity, or, if earlier, within 60 days after receiving written notice from the Internal Revenue Service proposing to disallow deductions attributable to the activity.

Limit on Deductions
If your activity is not carried on for profit, take deductions in the following order and to the extent stated in the three categories. If you are an individual, these deductions may be taken only if you itemize. These deductions may be taken on Schedule A (Form 1040).

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. For individuals, 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). You can deduct a casualty loss on property you own for personal use only to the extent it is more than $100 and exceeds 10% of your adjusted gross income. See Publication 547 for more information on casualty losses. 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 your deductions under the first category. Most business deductions, such as those for advertising, insurance premiums, interest, utilities, and wages, 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 exceeds the deductions you take under the first two categories. Deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category (1) belong in this category. Where more than one asset is involved, allocate depreciation and these other deductions proportionally.

Individuals must 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. Ida is engaged in a not-for-profit activity. The income and expenses of the activity are as follows.

Gross income .................................. $3,200
Subtract: Real estate taxes ................. $700
Home mortgage interest ................ $900
Insurance ................................... 400
Utilities ....................................... 700
Maintenance .................................. 200
Depreciation on an automobile .......... 600
Depreciation on a machine .............. 200 3,700

Loss ........................................... $(500)

Ida must limit her deductions to $3,200, the gross income she 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 $800 of depreciation is allocated between the automobile and machine as follows.

$600 x $300 = $225 depreciation for the automobile

$200 x $300 = $75 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). Ida deducts the
You can generally deduct amounts you pay to Employees’ Pay for the services they perform. To determine the reasonableness of pay by the amount of any employment credits you claim, for more information about these credits, see Publication 954, Tax Incentives for DISTRESSED Communities, or Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

More than one activity. If you have several undertakings, each may be a separate activity or several undertakings may be combined. The following are the most significant facts and circumstances in making this determination.

- The degree of organizational and economic interrelationship of various undertakings.
- The business purpose that is (or might be) served by carrying on the various undertakings separately or together in a business or investment setting.
- The similarity of the undertakings.

The IRS will generally accept your characterization if it is supported by facts and circumstances.

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 on Schedule A (Form 1040) subject to the 2%-of-adjusted-gross-income limit.

2. Employees’ Pay

Introduction
You can generally deduct the pay you give your employees for the services they perform. The pay may be in cash, property, or services. It may include wages, or salaries, or other compensation such as: vacation allowances, bonuses, commissions, and fringe benefits. For information about deducting employment taxes, see chapter 5.

You can claim the following employment credits if you hire individuals who meet certain requirements.

- Empowerment zone and renewal community employment credit.
- Indian employment credit.
- Welfare-to-work credit.
- Work opportunity credit.
- Credits for employers affected by Hurricane Katrina, Rita, or Wilma.

Reduce your deduction for employee wages by the amount of any employment credits you claim. For more information about these credits, see Publication 954, Tax Incentives for Distressed Communities, or Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

Topics
This chapter discusses:
- Tests for deducting pay
- Kinds of pay

Useful Items
You may want to see:
Publication
- 15 (Circular E), Employer’s Tax Guide
- 15-A Employer’s Supplemental Tax Guide

See chapter 12 for information about getting publications and forms.

Tests for Deducting Pay
To be deductible, your employees’ pay must be an ordinary and necessary expense and you must pay or incur it. These and other requirements that apply to all business expenses are explained in chapter 1.

In addition, the pay must meet both of the following tests.
- Test 1. It must be reasonable.
- Test 2. It must be for services performed.

The form or method of figuring the pay does not affect its deductibility. For example, bonuses and commissions based on sales or earnings, and paid under an agreement made before the services were performed, are both deductible.

Test 1—Reasonableness
Determine the reasonableness of pay by the facts and circumstances. Generally, reasonable pay is the amount that like enterprises pay for the same, or similar, services.

You must be able to prove that the pay is reasonable. Base this determination on the circumstances that exist when you contract for the services, not those that existed when the reasonableness is questioned. If the pay is excessive, the excess is disallowed.

Factors to consider. To determine if pay is reasonable, consider the following items and any other pertinent facts.
- The duties performed by the employee.
- The volume of business handled.
- The character and amount of responsibility.

- The complexities of your business.
- The amount of time required.
- The cost of living in the locality.
- The ability and achievements of the individual employee performing the service.
- The pay compared with the gross and net income of the business, as well as with distributions to shareholders if the business is a corporation.
- Your policy regarding pay for all your employees.
- The history of pay for each employee.

Test 2—For Services Performed
You must be able to prove the payment was made for services actually performed.

Employee-shareholder salaries. If a corporation pays an employee who is also a shareholder a salary that is unreasonably high considering the services actually performed, the excessive part of the salary may be treated as a constructive distribution to the employee-shareholder. For more information on corporate distributions to shareholders, see Publication 542, Corporations.

Kinds of Pay
Some of the ways you may provide pay to your employees in addition to regular wages or salaries are discussed next. For specialized and detailed information on employees’ pay and the employment tax treatment of employees’ pay, see Pub. 15, Pub. 15-A, and Pub. 15-B.

Awards
You can generally deduct amounts you pay to your employees as awards, whether paid in cash or property. If you give property to an employee as an employee achievement award, your deduction may be limited.

Achievement awards. An achievement award is an item of tangible personal property that meets all the following requirements.
- It is given to an employee for length of service or safety achievement.
- It is awarded as part of a meaningful presentation.
- It is awarded under conditions and circumstances that do not create a significant likelihood of disguised pay.

Length-of-service award. An award will qualify as a length-of-service award only if either of the following applies.
- The employee receives the award after his or her first 5 years of employment.
- The employee did not receive another length-of-service award (other than one of very small value) during the same year or in any of the prior 4 years.
Safety achievement award. An award for safety achievement will qualify as an achievement award unless one of the following applies.

1. It is given to a manager, administrator, clerical employee, or other professional employee.
2. During the tax year, more than 10% of your employees, excluding those listed in (1), have already received a safety achievement award (other than one of very small value).

Deduction limit. Your deduction for the cost of employee achievement awards given to any one employee during the tax year is limited to the following:

- $400 for awards that are not qualified plan awards.
- $1,600 for all awards, whether or not qualified plan awards.

A qualified plan award is an achievement award that is part of an established written plan or program that does not favor highly compensated employees as to eligibility or benefits.

A highly compensated employee for 2006 is an employee who meets either of the following tests.

1. The employee was a 5% owner at any time during the year or the preceding year.
2. The employee received more than $100,000 in pay for the preceding year.

You may be able to exclude all or part of the value of some fringe benefits from your employees' pay. You also may not owe employment taxes on the value of the fringe benefits. See Table 2-1 in Publication 15-B for details.

Fringe Benefits

A fringe benefit is a form of pay for the performance of services. You can generally deduct the cost of fringe benefits.

You can usually deduct the cost of furnishing meals and lodging to your employees. Deduct the cost in whatever category the expense falls. For example, if you operate a restaurant, deduct the cost of the meals you furnish to employees as part of the cost of goods sold. If you operate a nursing home, motel, or rental property, you can deduct the cost of furnishing lodging to an employee as expenses for utilities, linen service, salaries, depreciation, etc.

Deduction limit on meals. You can generally deduct only 50% of the cost of furnishing meals to your employees. However, you can deduct the full cost of the following meals:

- Meals whose value you include in an employee's wages.
- Meals that qualify as a de minimus fringe benefit as discussed in section 2 of Publication 15-B. This generally includes meals you furnish to employees at your place of business if more than half of these employees are provided the meals for your convenience.
- Meals you furnish to your employees at the work site when you operate a restaurant or catering service.
- Meals you furnish to your employees as part of the expense of providing recreational or social activities, such as a company picnic.
- Meals you are required by federal law to furnish to crew members of certain commercial vessels (or would be required to furnish if the vessels were operated at sea). This does not include meals you furnish on vessels primarily providing luxury water transportation.
- Meals you furnish on an oil or gas platform or drilling rig located offshore or in Alaska.

This includes meals you furnish at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

Employee benefit programs. Employee benefit programs include the following.

- Accident and health plans.
- Adoption assistance.
- Cafeteria plans.
- Dependent care assistance.
- Educational assistance.
- Life insurance coverage.
- Welfare benefit funds.

You can generally deduct amounts you spend on employee benefit programs on the applicable line of your tax return. For example, if you provide dependent care by operating a dependent care facility for your employees, deduct your cost under the category for dependent care in your tax return. For more information, see Regulations section 1.267A-1 for more information.

Welfare benefit funds. A welfare benefit fund is a funded plan (or a funded arrangement having the effect of a plan) that provides welfare benefits to your employees, independent contractors, or their beneficiaries. Welfare benefits are any benefits other than deferred compensation or transfers of restricted property.

The contributions for a welfare benefit fund are limited to the fund's qualified cost for the tax year. If your contributions to the fund are more than its qualified cost, carry the excess over to the next tax year.

Generally, the fund's "qualified cost" is the total of the following amounts, reduced by the after-tax income of the fund:

- The cost you would have been able to deduct using the cash method of accounting if you had paid for the benefits directly.
- The contributions added to a reserve account that are needed to fund claims incurred but not paid as of the end of the year. These claims can be for supplemental unemployment benefits, severance pay, or disability, medical, or life insurance benefits.

For more information, see sections 419(c) and 419A of the Internal Revenue Code and the related regulations.

Education Expenses

If you pay or reimburse education expenses for an employee, you can deduct the payments if they are part of a qualified educational assistance program. Deduct them on the "Employee benefit programs" line or other appropriate line of your tax return. For information on educational assistance programs, see Educational Assistance in section 2 of Publication 15-B.

Bonuses

You can generally deduct a bonus paid to an employee if you intended the bonus as additional pay for services, not as a gift, and the services were performed. However, the total bonuses, salaries, and other pay must be reasonable for the services performed. If the bonus is paid in property, see Property, later.

Gifts of nominal value. If, to promote employee goodwill, you distribute food, or merchandise of nominal value to your employees at holidays, you can deduct the cost of these items as a nonwage business expense. Your deduction for de minimus gifts of food or drink are not subject to the 50% deduction limit that generally applies to meals. For more information on this deduction limit, see Meals and lodging, later.
4. A grantor and a fiduciary of any trust/services, you can generally deduct it as wages.

Example 1. You pay a lump-sum amount, as wages. However, 1. An individual and his or her brothers and sisters are considered related persons. You can deduct vacation pay only in the tax year in which the employee actually receives it. This rule applies regardless of whether you use the cash or accrual method of accounting.

3. Related persons. For this purpose, the following are considered related persons:
   1. An individual and his or her brothers and sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grand-children, etc.).
   2. An individual and a corporation if the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
   3. Two corporations that are members of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
   4. A grantor and a beneficiary of any 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 corporation and a trust or a corporation if the trust or a grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
   9. A person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by that person or by members of the family of that person.
   10. A corporation and a partnership if the same persons own 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. An executor of an estate and a beneficiary of the estate unless the sale or exchange is in satisfaction of a pecuniary bequest.

To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, see Related Persons in Publication 542, Corporations. For rules that apply to transactions between partners and partnerships, see Publication 541, Partnerships.

Rent on your home. If you rent your home and use part of it as your place of business, you may be able to deduct the rent you pay for that part. You must meet the requirements for business use of your home. For more information, see Business use of your home in chapter 1.

Rent paid in advance. Generally, rent paid in 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 rental property during the tax year. You can deduct the rest of your payment only over the period to which it applies.

Example 1. You are a calendar year tax payer and you leased a building for 5 years beginning July 1. Your rent is $12,000 per year. You paid the first year’s rent ($12,000) on June 30. You can deduct only $6,000 ($12,000 × 12/12) for the rent that applies to the first year.

Example 2. You are a calendar year tax payer. Last January you leased property for 3 years for $6,000 a year. You paid the full
$18,000 (3 × $6,000) during the first year of the lease. Each year you can deduct only $6,000, the part of the lease that applies to that year.

**Canceling a lease.** You generally can deduct as rent an amount you pay to cancel a business lease.

**Lease or purchase.** There may be instances in which you must 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. Payments made under a conditional sales contract are not deductible as rent expense.

**Conditional sales contract.** Whether an agreement is a conditional sales contract depends on the intent of the parties. Determine intent based on the following points of the agreement and the facts and circumstances that exist when you make the agreement. No single test, or specific combination of tests, always applies. However, in general, an agreement may be considered a conditional sales contract rather than a lease if any of the following is true:

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after you make a stated amount of required payments.
- The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property.
- You pay much more than the current fair rental value of the property.
- You have an option to buy the property at a nominal price compared to the value of the property when you may exercise the option. Determine this value when you make the agreement.
- You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement.
- The agreement designates part of the payments as interest, or that part is easy to recognize as interest.

**Leveraged leases.** Leveraged lease transactions may not be considered leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually the lease term 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. Revenue Procedure 2001-28 on page 1156 of Internal Revenue Bulletin 2001-19 contains the guidelines the IRS will use to determine if a leveraged lease is a lease for federal income tax purposes. Revenue Procedure 2001-29 on page 1160 of the same Internal Revenue Bulletin provides the information required to be furnished in a request for an advance ruling on a leveraged lease transaction. Internal Revenue Bulletin 2001-19 is available at www.irs.gov/pub/irs-ibrs/ib01-19.pdf

In general, Revenue Procedure 2001-28 provides 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 the factors in the revenue procedure are met, including the following:

- The lessor must maintain a minimum unconditional “at risk” equity investment in the property (at least 20% of the cost of the property) during the entire lease term.
- The lessee may not have a contractual right to buy the property from the lessor at less than fair market value when the right is exercised.
- The lessee may not invest in the property, except as provided by Revenue Procedure 2001-28.
- The lessee may not lend any money to the lessor to buy the property or guarantee the loan used by the lessor to buy the property.
- The lessor must show that it expects to receive a profit apart from the tax deductions, allowances, credits, and other tax attributes.

The IRS may charge you a user fee for issuing a tax ruling. For more information, see Revenue Procedure 2007-1, on page 1 of Internal Revenue Bulletin No. 2007-1. Internal Revenue Bulletin 2007-1 is available at www.irs.gov/pub/irs-ibs/ib07-01.pdf.

**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 lessee. See Revenue Procedure 2001-28 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 any of the following apply:

- Rents increase during the lease.
- Rents decrease during the lease.
- Rents are prepaid (rent is payable after the end of the calendar year following the calendar year in which the use occurs and the rent is allocated).
- Rents are prepaid (rent is payable before the end of the calendar year preceding the calendar year in which the use occurs and the rent is allocated).

These rules do not apply if your lease specifies equal amounts of rent for each month in the lease term and all rent payments are due in the calendar year to which the rent relates (or in the preceding or following calendar year).

Generally, if the special rules apply, you must use an accrual method of accounting (and time value of money principles) for your rental expenses, regardless of your overall method of accounting. In addition, in certain cases in which the IRS has determined that a lease was designed to achieve tax avoidance, you must take rent and stated or imputed interest into account under a constant rental accrual method in which the rent is treated as accruing ratably over the entire lease term. For details, see section 467 of the Internal Revenue Code.

**Taxes on Leased Property**

If you lease business property, you can deduct as additional rental any taxes you have to pay for 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 deduct the taxes as additional rent only 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 all the following:

- That you have a liability for taxes on the leased property.
- How much the liability is.
- That economic performance occurred.

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

**Example 1.** Oak Corporation is a calendar year taxpayer that uses an accrual method of accounting. Oak leases land for use in its business. Under state 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. However, they do not have to pay these taxes until July 1 of the next year (18 months later) when tax bills are issued. Under the terms of the lease, Oak becomes liable for the real estate taxes in the later year when the tax bills are issued. If the lease ends before the tax bill for a year is issued, Oak is not liable for the taxes for that year.

Oak cannot deduct the real estate taxes as rent until the tax bill is issued. This is when Oak’s liability under the lease becomes fixed.

**Example 2.** The facts are the same as in Example 1 except that, according to the terms of the lease, Oak becomes liable for the real estate taxes when the owner of the property becomes liable for them. As a result, Oak will deduct the real estate taxes as rent on its tax return for the earlier year. This is the year in which Oak’s liability under the lease becomes fixed.

**Cost of Getting a Lease**

You may either enter into a new lease with the lessor of the property or get an existing lease from another lessee. Very often when you get an existing lease from another lessee, you must...
Commissions, bonuses, and fees. Commis-
sions, bonuses, fees, and other amounts you
pay to get 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 get a lease, the loss is a cost of
getting 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, depreciate
the cost of the improvements using the modified
accelerated cost recovery system (MACRS).
Depreciate the property over its appropriate re-
covery period. You cannot amortize the cost
over the remaining term of the lease.

If you do not keep the improvements when
you end the lease, figure your gain or loss based
on your adjusted basis in the improvements at
that time.

For more information, see the discussion
of MACRS in Publication 946, How To Depreciate
Property.

Assignment of a lease. If a long-term lessee
who makes permanent improvements to land,
later assigns all lease rights to you for money,
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. The rest is for your investment in
the permanent improvements.

The part that is for the increased rental value
of the land is a cost of getting a lease, and you
must amortize it over the remaining term of the
lease. You can depreciate the part that is for your
investment in the improvements over the recov-
ery period of the property as discussed earlier,
without regard to the lease term.

Capitalizing Rent Expenses
Under the uniform capitalization rules, you must
capitalize the direct costs and part of the indirect
costs for certain production or resale activities.
Include these costs in the basis of property you
produce or acquire for resale, rather than claim-
ing them as a current deduction. You recover the
costs through depreciation, amortization, or cost
of goods sold when you use, sell, or otherwise
dispose of the property.

Indirect costs include amounts incurred for
renting or leasing equipment, facilities, or land.

Uniform capitalization rules. You may be
subject to the uniform capitalization rules if you
do any of the following, unless the property is
produced for your use other than in a business or
an activity carried on for profit.

1. Produce real property or tangible personal
property. For this purpose, tangible per-
sonal property includes a film, sound re-
cording, video tape, book, or similar
property.

2. Acquire property for resale.
However, these rules do not apply to the follow-
ing property.

1. Personal property you acquire for resale if
your average annual gross receipts are
$10 million or less for the 3 prior tax years.

2. Property you produce if you meet either of
the following conditions.
   a. Your indirect costs of producing the
property are $200,000 or less.
   b. You use the cash method of accounting
and do not account for inventories.

Example 1. You rent construction equip-
ment to build a storage facility. If you are subject
to the uniform capitalization rules, you must cap-
italize as part of the cost of the building the rent
you paid for the equipment. 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.
If you are subject to the uniform capitalization
rules, you must include the rent you paid to
occupy the facility in the cost of the tools you
produce.

More information. For more information on
these rules, see Uniform Capitalization Rules in
Publication 538 and the regulations under Inter-
nal Revenue Code section 263A.

4. Interest

Introduction
This chapter discusses the tax treatment of busi-
ness interest expense. Business interest ex-
pense is an amount charged for the use of
money you borrowed for business activities.

Topics
This chapter discusses:

- Allocation of interest
- Interest you can deduct
- Interest you cannot deduct
- Capitalization of interest
- When to deduct interest
- Below-market loans
Allocating Interest

The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, or investment activities. If you use the proceeds of a loan for more than one type of expense, you must make an allocation to determine the interest for each use of the loan’s proceeds.

Allocate your interest expense to the following categories:

- Nonpassive trade or business activity interest
- Passive trade or business activity interest
- Investment interest
- Portfolio interest
- Personal interest

In general, you allocate interest on a loan the same way you allocate the loan proceeds. You allocate loan proceeds by tracing disbursements to specific uses.

The easiest way to trace disbursements to specific uses is to keep the proceeds of a particular loan separate from any other funds.

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.

If the property that secures the loan is your home, you generally do not allocate the loan proceeds or the related interest. The interest is usually deductible qualified home mortgage interest, regardless of how the loan proceeds are used. See Publication 936.

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

- The date the loan is repaid.
- The date the loan is reallocated to another use.

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

Proceeds deposited in borrower’s account. Treat loan proceeds deposited in an account as property held for investment. It does not matter whether the account pays interest.

Example. Connie, a calendar-year taxpayer, borrows $100,000 on January 4 and immediately uses the proceeds to open a checking account. 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 personal purposes.

Under the interest allocation rules, the entire $100,000 loan is treated as property held for investment for the period from January 4 through March 31. From April 1 through August 31, Connie must treat $20,000 of the loan as used in the passive activity and $80,000 of the loan as property held for investment. From September 1 through December 31, she must treat $40,000 of the loan as used for personal purposes, $20,000 as used in the passive activity, and $40,000 as property held for investment.

Order of funds spent. Generally, you treat loan proceeds deposited in an account as used (spent) before either of the following amounts:

- Any unborrowed amounts held in the same account.
- Any amounts deposited after these proceeds.

Example. On January 9, 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.

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 9</td>
<td>$500 proceeds of Loan A and $1,000 unborrowed funds deposited</td>
</tr>
<tr>
<td>January 13</td>
<td>$500 proceeds of Loan B deposited</td>
</tr>
<tr>
<td>February 18</td>
<td>$800 used for personal purposes</td>
</tr>
<tr>
<td>February 27</td>
<td>$700 used for passive activity</td>
</tr>
<tr>
<td>June 19</td>
<td>$1,000 proceeds of Loan C deposited</td>
</tr>
<tr>
<td>November 20</td>
<td>$800 used for an investment</td>
</tr>
<tr>
<td>December 18</td>
<td>$600 used for personal purposes</td>
</tr>
</tbody>
</table>

Edith treats the $800 used for personal purposes 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. She treats the $600 used for personal purposes as made from the remaining $200 proceeds of Loan C and $400 of unborrowed funds.

For the periods during which loan proceeds are held in the account, Edith treats them as property held for investment.

Payments from checking accounts. Generally, you treat a payment from a checking or similar account as made at the time the check is written if you mail or deliver it to the payee within a reasonable period after you write it. You can treat checks written on the same day as written in any order.

Amounts paid within 30 days. If you receive loan proceeds in cash or if the loan proceeds are deposited in an account, you can treat any payment (up to the amount of the proceeds) made from any account you own, or from cash, as made from those proceeds. This applies to any payment made within 30 days before or after the proceeds are received in cash or deposited in your account.

If the loan proceeds are deposited in an account, you can apply this rule even if the rules stated earlier under Order of funds spent would otherwise require you to treat the proceeds as used for other purposes. If you apply this rule to any payments, disregard those payments and (the proceeds from which they are made) when applying the rules stated under Order of funds spent.

If you received the loan proceeds in cash, you can treat the payment as made on the date you received the cash instead of the date you actually made the payment.

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 18 and on August 28 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 transac-
tions, Frank can treat $1,000 of the deposit he
account on August 4 as being paid on August 4
from the loan proceeds. In addition, Frank can
treat the passive activity expense he paid on
August 28 as made from the $1,000 loan pro-
cceeds treated as deposited in the account.

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
payments from loan proceeds in the account
during any month as taking place on the later of
the following dates:
• The first day of that month.
• The date the loan proceeds are deposited
in the account.

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

Interest on a segregated account. If you have
an account that contains only loan pro-
cceeds and interest earned on the account, you
can treat any payment from that account as being
made first from the interest. When the
interest earned is used up, any remaining pay-
ments are from loan proceeds.

Example. You borrowed $20,000 and used
the proceeds of this loan to open a new savings
account. When the account had earned interest
of $867, you withdrew $20,000 for personal pur-
poses. You can treat the withdrawal as coming
first from the interest earned on the account,
$867, and then from the loan proceeds, $19,133
($20,000 – $867). All the interest charged on
the loan from the time it was deposited in the ac-
count until the time of the withdrawal is invest-
ment interest expense. The interest charged on
the part of the proceeds used for personal pur-
poses ($19,133) from the time you withdrew it
until you either repay it or reallocate it to another
use is personal interest expense. The interest
charged on the loan proceeds you left in the
account ($867) from the time it was deposited to
the amount in column (f). If the proceeds
were used in an investment activity, enter the
interest on Form 4952. If the proceeds are used
for personal purposes, the interest is generally
not deductible.

Loan repayment. When you repay any part of
a loan allocated to more than one use, treat it as
being repaid in the following order.
1. Personal use.
2. Investments and passive activities (other
than those included in (3)).
3. Passive activities in connection with a
rental real estate activity in which you ac-
tively participate.
4. Former passive activities.
5. Trade or business use and expenses for
certain low-income housing projects.

Line of credit (continuous borrowings). The
following rules apply if you have a line of
credit or similar arrangement:
1. Treat all borrowed funds on which interest
accrues at the same fixed or variable rate as a single loan.
2. Treat borrowed funds or parts of borrowed
funds on which interest accrues at different
fixed or variable rates as different loans.

Treat these loans as repaid in the order
shown on the loan agreement.

Loan refinancing. Allocate the replacement
loan to the same uses to which the repaid loan
was allocated. Make the allocation only to the
extent you use the proceeds of the new loan to
repay any part of the original loan.

Debt-financed distribution. A debt-financed
distribution occurs when a partnership or S cor-
poration borrows funds and allocates those
funds to distributions made to partners or share-
holders. The manner in which you report the
interest expense associated with the distributed
debt proceeds depends on your use of those
proceeds.

How to report. If the proceeds were used
in a nonpassive trade or business activity, report
the interest on Schedule E (Form 1040), line 28;
enter “interest expense” and the name of the part-
nership or S corporation in column (a) and
the amount in column (h). If the proceeds were
used in a passive activity, follow the instructions
for Form 8582, Passive Activity Loss Limita-
tions, to determine the amount of interest ex-
 pense that can be reported on Schedule E
(Form 1040), line 28; enter “interest expense” and
the name of the partnership in column (a) and
the amount in column (f). If the proceeds
were used in an investment activity, enter the
interest on Form 4952. If the proceeds are used
for personal purposes, the interest is generally
not deductible.

Interest You Can Deduct

You can generally deduct as a business ex-
 pense all interest you pay or accrue during the
tax year on debts related to your trade or busi-
ness. Interest relates to your trade or business if
you use the proceeds of the loan for a trade or business expense. It does not matter what type
of property secures the loan. You can deduct
interest on a debt only if you meet all the follow-

requirements.
• You are legally liable for that debt.
• Both you and the lender intend that the
debt be repaid.
• You and the lender have a true
debtor-creditor relationship.

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 pay-
ments as a business deduction.

Mortgage. Generally, mortgage interest paid
or accrued on real estate you own legally or
equitably is deductible. However, rather than
deducting the interest currently, you may have
to add it to the cost basis of the property as ex-
plained later under Capitalization of Interest.

Statement. If you paid $600 or more of
mortgage interest (including certain points) dur-
ing the year on any one mortgage, you generally
will receive a Form 1098 or a similar statement.
You will receive the statement if you pay interest
to a person (including a financial institution or a
cooperative housing corporation) in the course
of that person’s trade or business. A govern-
mental unit is a person for purposes of furnishing
the statement.

If you receive a refund of interest you over-
paid in an earlier year, this amount will be re-
ported in 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.

Expenses paid to obtain a mortgage. Certain
expenses you pay to obtain a mortgage
cannot be deducted as interest. These ex-
penses, 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.

Prepayment penalty. If you pay off your
mortgage early and pay the lender a penalty for
doing this, you can deduct the penalty as inter-
est.

Interest on employment tax deficiency. In-
terest charged on employment taxes assessed
on your business is deductible.

Original issue discount (OID). OID is a form
of interest. A loan (mortgage or other debt) gen-
erally has OID when its proceeds are less than
its principal amount. The OID is the difference
between the stated redemption price at maturity
and the issue price of the loan.

A loan’s stated redemption price at maturity
is the sum of all amounts (principal and interest)
payable on it other than qualified stated interest.
Qualified stated interest is stated interest that is
unconditionally payable in cash or property (other
than another loan of the issuer) at least annually
over the term of the loan at a single
fixed rate.

You generally deduct OID over the term of
the loan. Figure OID using the constant-yield method, unless the OID on the
loan is de minimis.

De minimis OID. The OID is de minimis if it
is less than one-fourth of 1% (.0025) of the
stated redemption price of the loan at maturity
multiplied by the number of full years from the
date of original issue to maturity (the term of
the loan).

If the OID is de minimis, you can choose one of
the following ways to figure the amount you
can deduct each year.
• On a constant-yield basis over the term of
the loan.
• On a straight-line basis over the term of
the loan.
• In proportion to stated interest payments.
• In its entirety at maturity of the loan.

You make this choice by deducting the OID in a
manner consistent with the method chosen on
Interest on income tax. Interest charged 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. Treat this interest as a business deduction only in figuring a net operating loss deduction.

Penalties. Penalties on underpaid deficiencies and underpaid estimated tax are not interest. You cannot deduct them. Generally, you cannot deduct any fines or penalties.

Interest on loans with respect to life insurance policies. You generally cannot deduct interest on a debt incurred with respect to any life insurance, annuity, or endowment contract if a key person is a covered individual. However, the deduction for any month cannot be more than the interest figured using Moody's Composite Yield on Sea- sioned Corporate Bonds (formerly known as Moody's Corporate Bond Yield Average-Monthly Average Corporates) (Moody's rate) for that month.

Who is a key person? A key person is an officer or 20% owner. However, the number of individuals you can treat as key persons is limited to the greater of the following.

• Five individuals.
• The lesser of 5% of the total officers and employees of the company or 20 individuals.

Exceptions for pre-June 1997 contracts. You can generally deduct the interest if the contract was issued before June 9, 1997, and the covered individual is someone other than an employee, officer, or someone financially inter- ested in your business. If the contract was pur- chased before June 21, 1986, you can generally deduct the interest no matter who is covered by the contract.

Interest allocated to unborrowed policy cash value. Corporations and partnerships generally cannot deduct any interest expense allocable to unborrowed cash values of life in- surance, annuity, or endowment contracts. This rule applies to contracts issued after June 8, 1997, that cover someone other than an officer, director, employee, or 20% owner. For more information, see section 264(l) of the Internal Revenue Code.
Capitalization of Interest

Under the uniform capitalization rules, you generally capitalize interest on your expenditures to produce real property or certain tangible personal property. The property must be produced by you for use in your trade or business or for sale to customers. You cannot capitalize interest related to property that you acquire in any other manner.

Interest you pay or incurred during the production period must be capitalized if the property produced is designated property. Designated property is any of the following.

- Real property.
- Tangible personal property with a class life of 20 years or more.
- Tangible personal property with an estimated production period of more than 2 years.
- Tangible personal property with an estimated production period of more than 1 year if the estimated cost of production is more than $1 million.

Property you produce. You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow it. Treat property produced for you under a contract as produced by you up to the amount you pay or incur for the property.

Carrying charges. Carrying charges include taxes you pay to carry or develop real estate or to carry, transport, or install personal property. You can choose to capitalize carrying charges not subject to the uniform capitalization rules if they are otherwise deductible. For more information, see chapter 7.

Capitalized interest. Treat capitalized interest as a cost of the property produced. You recover your interest when you sell or use the property. If the property is inventory, recover capitalized interest through an adjustment to basis, depreciation, amortization, or other method.

Partnerships and S corporations. The interest capitalization rules are applied first at the partnership or S corporation level. The rules are then applied at the partners' or shareholders' level to the extent the partnership or S corporation has insufficient debt to support the production or construction costs.

If you are a partner or a shareholder, you may have to capitalize interest you incur during the tax year for the production costs of the partnership or S corporation. You may also have to capitalize interest incurred by the partnership or S corporation for your own production costs. To properly capitalize interest under these rules, you must be given the required information in an attachment to the Schedule K-1 you receive from the partnership or S corporation.

Additional information. The procedures for applying the uniform capitalization rules are beyond the scope of this publication. For more information, see sections 1.263A-8 through 1.263A-15 of the regulations and Notice 88-99. Notice 88-99 is in Cumulative Bulletin 1988-2.

When To Deduct Interest

If the uniform capitalization rules, discussed under Capitalization of Interest, earlier, do not apply to you, deduct interest as follows.

Cash method. Under the cash method, you can generally deduct only the interest you actually paid during the tax year. You cannot deduct a promissory note you gave as payment because it is a promise to pay and not an actual payment.

Prepaid interest. You generally cannot deduct any interest paid before the year it is due. Interest paid in advance can be deducted only in the tax year in which it is due.

Discounted loan. 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. For more information, see Original issue discount (OID) under Interest You Can Deduct, earlier.

Refunds of interest. If you pay interest and then receive a refund in the same tax year of any part of the interest, reduce your interest deduction by the refund. If you receive the refund in a later tax year, include the refund in your income to the extent the deduction for the interest reduced your tax.

Accrual method. Under an accrual method, you can deduct only interest that has accrued during the tax year.

Prepaid interest. See Prepaid interest, above.

Discounted loan. See Discounted loan, above.

Tax deficiency. If you contest a federal income tax deficiency, interest does not accrue until the tax year the final determination of liability is made. If you do not contest the deficiency, then the interest accrues in the year the tax was asserted and agreed to by you.

If you contest but pay the proposed tax deficiency and interest, you do not designate the payment as a cash bond, then the interest is deductible in the year paid.

Related person. If you use an accrual method, you cannot deduct interest owed to a related person who uses the cash method unless 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. See Related Persons in Publication 538.

Below-Market Loans

If you receive a below-market gift or demand loan and use the proceeds in your trade or business, you may be able to deduct the forgone interest. See Treatment of gift and demand loans later in this discussion.

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 gift or demand loan that is a below-market loan generally is considered an arm's-length transaction in which you, the borrower, are considered as having received both the following.

- A loan in exchange for a note that requires the payment of interest at the applicable federal rate.
- An additional payment in an amount equal to the forgone interest.

The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

For any period, forgone interest is:

1. The interest that would have been payable for that period if interest accrued on the loan at the applicable federal rate, that was payable annually on December 31, minus
2. Any interest actually payable on the loan for the period.

Loans subject to the rules. The rules for below-market loans apply to the following.

Gift loans (below-market loans where the forgone interest is in the nature of a gift).

Compensation-related loans (below-market loans where the compensation is cash payment in lieu of services you provide or an employee or between an independent contractor and a person for whom the contractor provides services).

Corporation-shareholder loans.

Tax avoidance loans (below-market loans where the avoidance of federal tax is one of the main purposes of the interest arrangement).

Loans to qualified continuing care facilities under a continuing care contract (made after October 11, 1985).

Except as noted in (5) above, these rules apply to demand loans (loans payable in full at any time upon the lender's demand) outstanding after June 6, 1984, and to capital loans (loans that are not demand loans) made after that date.

Treatement of gift and demand loans. If you receive a below-market gift loan or demand loan, you are treated as receiving an additional payment (as a gift, dividend, etc.) equal to the forgone interest on the loan. You are then treated as transferring this amount back to the lender as interest. These transfers are considered to occur annually, generally on December 31. If you use the loan proceeds in your trade or business, you can deduct the forgone interest.
each year as a business interest expense. The lender must report it as interest income.

**Limit on forgone interest for gift loans of $100,000 or less.** For gift loans between indi-
viduals, forgone interest treated as transferred back to the lender is limited to the borrower’s net investment income for the year. This limit applies if the outstanding loans between the lender and borrower total $100,000 or less. If the bor-
rower’s net investment income is $1,000 or less, it is treated as zero. This limit does not apply to a loan if the avoidance of any federal tax is one of the main purposes of the interest arrangement.

**Treatment of term loans.** If you receive a below-market term loan other than a gift or de-
mand loan, you are treated as receiving an addi-
tional cash payment (as a dividend, etc.) on the date the loan is made. This payment is equal to the loan amount minus the present value, at the applicable federal rate, of all payments due under the loan. The same amount is treated as original issue discount on the loan. See Original issue discount (OID) under Interest You Can Deduct, earlier.

**Exceptions for loans of $10,000 or less.** The rules for below-market loans do not apply to any day on which the total outstanding loans be-
tween the borrower and lender is $10,000 or less. This exception applies only to the follow-
ing.

1. Gift loans between individuals if the loan is not directly used to buy or carry in-
come-producing assets.

2. Compensation-related loans or corpora-
tion-shareholder loans if the avoidance of any federal tax is not a principal purpose of the interest arrangement.

This exception does not apply to a term loan described in (2) above that was previously sub-
ject to the below-market loan rules. Those rules will continue to apply even if the outstanding balance is reduced to $10,000 or less.

**Exceptions for loans without significant tax effect.** The following loans are specifically ex-
empted from the rules for below-market loans because their interest arrangements do not have a significant effect on the federal tax liability of the borrower or the lender.

1. Loans made available by lenders to the general public on the same terms and con-
ditions that are consistent with the lender’s customary business practices.

2. Loans subsidized by a federal, state, or municipal government that are made avail-
able under a program of general applica-
tion to the public.

3. Certain employee-relocation loans.

4. Certain loans to or from a foreign person, unless the interest income would be effec-
tively connected with the conduct of a U.S. trade or business and not exempt from U.S. tax under an income tax treaty.

5. Any other loan if the taxpayer can show that the interest arrangement has no signif-
ificant effect on the federal tax liability of the lender or the borrower will be determined by all the facts and circumstances. Consider all the follow-
ing factors.

a. Whether items of income and deduction generated by the loan offset each other.

b. The amount of the items.

c. The cost of complying with the be-
low-market loan provisions if they were to apply.

da. Any reasons, other than taxes, for structuring the transaction as a be-
low-market loan.

**Exception for certain loans to a qualified continuing care facility.** The below-market interest rules do not apply to a loan made by a lender to a qualified continuing care facility under a continuing care contract if the lender (or lender’s spouse) is age 65 or older by the end of the calendar year. For 2006, this exception applies only to the part of the total outstanding loans from the lender (or lender’s spouse) that does not exceed $163,300.

A qualified continuing care facility is one or more facilities that are designed to provide serv-
es under continuing care contracts and where substantially all the residents have entered into continuing care contracts. In addition, substan-
tially all the facilities used to provide services required under the continuing care contract must be owned or operated by the loan bor-
rower.

A continuing care contract is a written con-
tract between an individual and a qualified con-
tinuing care facility that meets all the following conditions.

1. The individual and/or the individual’s spouse must be entitled to use the facility for the rest of their life or lives.

2. The residential use must begin in a sepa-
rate, independent living unit provided by the continuing care facility and continue until the individual (or individual’s spouse) is incapable of living independently. The facility must 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 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 substan-
tial additional cost to the individual.

**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 Unstated Interest and Origi-
nal Issue Discount (OID) in Publication 537.

**More information.** For more information on below-market loans, see section 7872 of the Internal Revenue Code and section 1.7872-5T of the regulations.

## 5. Taxes

### Introduction

You can deduct various federal, state, local, and foreign taxes directly attributable to your trade or business as business expenses. You cannot deduct federal income taxes, estate and gift taxes, or state inheritance, legacy, and succession taxes.

**Topics**

- When to deduct taxes
- Real estate taxes
- Income taxes
- Employment taxes
- Other taxes

### Useful Items

**You may want to see:**

**Publication**

- 15 (Circular E), Employer’s Tax Guide
- 334 Tax Guide for Small Business
- 510 Excise Taxes for 2007
- 538 Accounting Periods and Methods
- 551 Basis of Assets

**Form (and Instructions)**

- Sch A (Form 1040) Itemized Deductions
- Sch SE (Form 1040) Self-Employment Tax
- 3115 Application for Change in Accounting Method

See chapter 12 for information about getting publications and forms.

### When To Deduct Taxes

Generally, you can only deduct taxes in the year you pay them. This applies whether you use the cash method or an accrual method of account-
ing. Under an accrual method, you can deduct a tax before you pay it if you meet the exception for recurring items discussed under Economic
Uniform capitalization rules. Uniform capitalization rules apply to certain taxpayers who produce real property or tangible personal property for use in a trade or business or for sale to customers. They also apply to certain taxpayers who acquire property for resale. Under these rules, you either include certain costs in inventory or capitalize certain expenses related to the property, such as taxes. For more information, see chapter 1.

Carrying charges. Carrying charges include taxes you pay to carry or develop real estate or to carry, transport, or install personal property. You can elect to capitalize carrying charges not subject to the uniform capitalization rules if they are otherwise deductible. For more information, see chapter 7.

Refunds of taxes. If you receive a refund for any taxes you deducted in an earlier year, include in income the amount of the refund that reduces your federal income tax in the earlier year. For more information, see Recover of amount deducted (tax benefit rule) in chapter 1.

You must include in income any interest you receive on tax refunds.

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real estate levied for the general public welfare. The taxing authority must base the taxes on the assessed value of the real estate and charge them uniformly against the property. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. See Taxes for local benefits, later.

If you use an accrual method, you generally cannot accrue real estate taxes until you pay them to the government authority. However, you can elect to ratably accrue the taxes during the year. See Electing to ratably accrue, later.

ELECTING TO RATABLY ACCRUE. If you use an accrual method, you can elect to ratably accrue real estate taxes related to a definite period ratably over that period.

Example. John Smith is a calendar year taxpayer who uses an accrual method. His real estate taxes for the real property tax year, July 1, 2006, to June 30, 2007, are $1,200. July 1 is the assessment and lien date.

If John elects to ratably accrue the taxes, he must include in income the amount of the tax for the first year in which the tax is accrued and the remaining amount in the later year. See Form 3115.

Making the election. You can elect to ratably accrue the taxes for the first year in which you incur real estate taxes, attach a statement to your income tax return for that year. The statement should show all the following items:

- The trades or businesses to which the election applies and the accounting method or methods used.
- The period to which the taxes relate.
- The computation of the real estate tax deduction for that first year.

Generally, you must file your return by the due date of the original return (including extensions). However, if you timely filed your return for the year without electing to ratably accrue, you can still make the election by filing an amended return within 6 months after the due date of the return (excluding extensions). Attach the statement to the amended return and write “Filed pursuant to section 301.9100-2” on the statement. File the amended return at the same address where you filed the original return.

Form 3115. If you elect to ratably accrue for a year after the first year in which you incur real estate taxes or if you want to revoke your election to ratably accrue real estate taxes, file Form 3115. For more information, including applicable time frames for filing, see the instructions for Form 3115.

Income Taxes

This section discusses federal, state, local, and foreign income taxes.

Federal income taxes. You cannot deduct federal income taxes.

State and local income taxes. A corporation or partnership can deduct state and local income taxes imposed on the corporation or partnership as business expenses. An individual can deduct state and local income taxes only as an itemized deduction on Schedule A (Form 1040).

However, an individual can deduct a state tax on gross income (as distinguished from net income) directly attributable to a trade or business as a business expense.
Accrual of contested income taxes. If you use an accrual method, can deduct taxes before you pay them, and contest a state or local in-
come tax liability, a special rule applies. Under this special rule, you must accrue and deduct any contested amounts in the tax year in which the
liability is finally determined.
If additional state or local income taxes for a 

prior year are assessed in a later year, you 
can deduct the taxes in the year in which the 

liability is finally contested. You cannot deduct them in the 

year in which the liability is finally deter-
mined.

The filing of an income tax return is not consi-
idered a contest and, in the ab-
sence of an overt act of protest, you 
can deduct the tax in the prior year. Also, you can 
deduct any additional taxes in the prior year 

if you do not show some affirmative evidence of 
denial of the liability.

However, if you consistently deduct addi-
tional assessments in the year they are paid or 

finally determined (including those for which there is no protest), you must continue to do 

so. You cannot take a deduction in the earlier 

year unless you receive permission to change your method of accounting. For more informa-

tion on accounting methods, see When Can I 

Deduct an Expense? in chapter 1.

Foreign income taxes. Generally, you can 
take either a deduction or a credit for income 
taxes imposed on you by a foreign country or a 

U.S. possession. However, an individual cannot 
take a deduction or credit for foreign income 
taxes paid on income that is exempt from U.S. 
tax under the foreign earned income exclusion or the foreign housing exclusion. For information 

on these exclusions, see Publication 54, Tax 

Guide for U.S. Citizens and Resident Aliens 

Abroad. For information on the foreign tax credit, 

see Publication 514, Foreign Tax Credit for Indi-

viduals.

Insurance

Introduction
You generally can deduct the ordinary and nec-

essary cost of insurance as a business expense 

if it is for your trade, business, or profession. 

However, you may have to capitalize certain 

insurance costs under the uniform capitalization 

rules. For more information, see Capitalized 

Premiums, later.

Topics
This chapter discusses:

• Deductible premiums
• Nondeductible premiums
• Capitalized premiums
• When to deduct premiums

Useful Items
You may want to see:

Publication

15-B Employer’s Tax Guide to Fringe 

Benefits

525 Taxable and Nontaxable Income 

538 Accounting Periods and Methods 

547 Casualties, Disasters, and Thefts 

Form (and Instructions)

1040 U.S. Individual Income Tax Return 

See chapter 12 for information about getting 

publications and forms.

Deductible Premiums
You generally can deduct premiums you pay for 

the following kinds of insurance related to your 

trade or business.

1. Insurance that covers fire, storm, theft, acci-

cident, or similar losses.

2. Credit insurance that covers losses from 

business bad debts.

3. Group hospitalization and medical insur-

ance for employees, including long-term 

care insurance.

a. If a partnership pays accident and 

health insurance premiums for its part-

ners, it generally can deduct them as 
guaranteed payments to partners.

b. If an S corporation pays accident and 

health insurance premiums for its 2% 

shareholder-employees, it generally can 
deduct them, but must also include 

Unemployment Fund Taxes. As an employer, you 
may have to make payments to a state 

unemployment compensation fund or to a state 

disability benefit fund. Deduct these payments as 
taxes.

Other Taxes
The following are other taxes you can deduct if 
you incur them in the ordinary course of your 

trade or business.

Excise taxes. You can deduct as a business 

expense all excise taxes that are ordinary and 
necessary expenses of carrying on your trade or business. However, see Fuel taxes, later.

Franchise taxes. You can deduct corporate 

franchise taxes as a business expense.

Fuel taxes. Taxes on gasoline, diesel fuel, 

and other motor fuels that you use in your busi-

ness are usually included as part of the cost of 

the fuel. Do not deduct these taxes as a sepa-

rate item.

You may be entitled to a credit or refund for 

federal excise tax you paid on fuels used for 
certain purposes. For more information, see 

Publication 510.

Occupational taxes. You can deduct as a busi-

ness expense an occupational tax charged 
at a flat rate by a locality for the privilege of 

working or conducting a business in the locality.

Personal property tax. You can deduct any 
tax imposed by a state or local government on 

personal property used in your trade or busi-

ness.

Sales tax. Treat any sales tax you pay on a 

service or on the purchase or use of property as 

part of the cost of the service or property. If the 

service or the cost or use of the property is a 
deductible business expense, you can deduct 

the tax as part of that service or cost. If the 

property is merchandise bought for resale, the 
sales tax is part of the cost of the merchandise. If 

the property is depreciable, add the sales tax to 

the basis for depreciation. For more information 

on basis, see Publication 551.

Do not deduct state and local sales 

taxes imposed on the buyer that you 
must collect and pay over to the state 
or local government. Also, do not include these 
taxes in gross receipts or sales.

Self-employment tax. You can deduct one-half of your self-employment tax as a busi-

ness expense in figuring your adjusted gross 

income. This deduction only affects your incom-

taxes, your employee receives $14,500. You 

must pay an additional $1,500 in employment 

taxes. You also pay an additional $1,500 in 

employment taxes. You should deduct the full $18,000 as wages. You can deduct the tax as part of that service or cost. If the 

property is depreciable, add the sales tax to 

the basis for depreciation. For more information 

on basis, see Publication 551.

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employment taxes. You should deduct the full $18,000 as wages. You can deduct the tax as part of that service or cost. If the 

property is depreciable, add the sales tax to 

the basis for depreciation. For more information 

on basis, see Publication 551.

Do not deduct state and local sales 

taxes imposed on the buyer that you 
must collect and pay over to the state 
or local government. Also, do not include these 
taxes in gross receipts or sales.
them in the shareholder’s wages subject to federal income tax withholding. See Publication 15-B.

4. Liability insurance.

5. Malpractice insurance that covers your personal liability for professional negligence resulting in injury or damage to patients or clients.

6. 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. If a partnership pays workers’ compensation premiums for its partners, it generally can deduct them as guaranteed payments to partners.

b. If an S corporation pays workers’ compensation premiums for its 2% shareholder-employees, it generally can deduct them, but must also include them in the shareholder’s wages.

7. Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.

8. Overhead insurance that pays for business overhead expenses you have during long periods of disability caused by your injury or sickness.

9. Car and other vehicle insurance that covers vehicles used in your business for liability, damages, and other losses. If you operate a vehicle partly for personal use, deduct only the part of the insurance premium 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.

10. Life insurance covering your officers and employees if you are not directly or indirectly a beneficiary under the contract.

11. Business interruption insurance that pays for lost profits if your business is shut down due to a fire or other cause.

Self-Employed Health Insurance Deduction

You may be able to deduct premiums paid for medical and dental insurance and qualified long-term care insurance for you, your spouse, and your dependents if you are one of the following:

a. A self-employed individual with a net profit reported on Schedule C (Form 1040), Profit or Loss From Business, Schedule C-EZ (Form 1040), Net Profit From Business, or Schedule F (Form 1040), Profit or Loss From Farming.

b. A partner with net earnings from self-employment reported on Schedule K-1 (Form 1065), Partner’s Share of Income, Deductions, Credits, etc., box 14, code A.

c. A shareholder owning more than 2% of the outstanding stock of an S corporation with wages from the corporation reported on Form W-2, Wage and Tax Statement.

The insurance plan must be established under your business. Partners and more-than-2% S corporation shareholders can claim the self-employed health insurance deduction only if the policy is in the name of the partnership or S corporation. For sole proprietors, the policy does not have to be in the name of the business if it is in the name of the sole proprietor.

You may be allowed this deduction whether you paid the premiums yourself or your partnership or S corporation paid them and you included the premium amount in your gross income. Take the deduction on Form 1040, line 29.

Qualified long-term care insurance. You can include premiums paid on a qualified long-term care insurance contract for you, your spouse, or your dependents when figuring your deduction. But, for each person covered, you can include only the smaller of the following amounts:

1. The amount paid for that person.
2. The amount shown below. Use the person’s age at the end of the year.
   a. Age 40 or younger—$280
   b. Age 41 to 50—$530
   c. Age 51 to 60—$1,060
   d. Age 61 to 70—$2,830
   e. Age 71 or older—$3,530

Qualified long-term care insurance contract. A qualified long-term care insurance contract is an insurance contract that only provides coverage of qualified long-term care services. The contract must meet all the following requirements:

1. It must be guaranteed renewable.
2. It must provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits.
3. It must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed.
4. It generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

Qualified long-term care services. Qualified long-term care services are:

1. Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and
2. Maintenance or personal care services.
3. The services must be required by a chronically ill individual and prescribed by a licensed health care provider.

Chronically ill individual. A chronically ill individual is a person who has been certified as one of the following:

1. An individual who has been unable, due to loss of functional capacity for at least 90 days, to perform at least two activities of daily living without substantial assistance from another individual. Activities of daily living are eating, toileting, transferring (general mobility), bathing, dressing, and continence.
2. An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

The certification must have been made by a licensed health care practitioner within the previous 12 months.

Benefits received. For information on excluding benefits you receive from a long-term care contract from gross income, see Publication 525.

Other coverage. You cannot take the deduction for any month you were eligible to participate in any employer (including your spouse’s) subsidized health plan at any time during that month. This rule is applied separately to plans that provide long-term care insurance and plans that do not provide long-term care insurance. However, any medical insurance payments not deductible on Form 1040, line 29, can be included as medical expenses on Schedule A (Form 1040), Itemized Deductions, if you itemize deductions.

Effect on itemized deductions. Subtract the health insurance deduction from your medical insurance deduction when figuring medical expenses on Schedule A (Form 1040) if you itemize deductions.

Effect on self-employment tax. Do not subtract the health insurance deduction when figuring net earnings for your self-employment tax.

How to figure the deduction. Generally, you can use the worksheet in the Form 1040 instructions to figure your deduction. However, if any of the following apply, you must use Worksheet 6-A in this chapter.

1. You had more than one source of income subject to self-employment tax.
2. You file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.
3. You are using amounts paid for qualified long-term care insurance to figure the deduction.

If you are claiming the health coverage tax credit, complete Form 8885, Health Coverage Tax Credit, before you figure this deduction.

Health coverage tax credit. You may be able to take this credit only if you were an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, or Pension Benefit Guaranty Corporation pension recipient. Use Form 8885 to figure the amount, if any, of this credit.
Worksheet 6-A. Self-Employed Health Insurance Deduction Worksheet

1. Enter total payments made during the year for health insurance coverage established under your business for you, your spouse, and your dependents. Do not include payments for any month you were eligible to participate in a health plan subsidized by your or your spouse’s employer or:
   - Any amounts you included on Form 8886, line 4.
   - Any qualified health insurance premiums you paid to “U.S. Treasury-HCTC.”
   - Any health coverage tax credit advance payments shown in box 1 of Form 1099-H.
   - Also, do not include payments for qualified long-term care insurance.

2. For coverage under a qualified long-term care insurance contract, enter for each person the smaller of the following amounts:
   a) Total payments made for that person during the year.
   b) The amount shown below. Use the person’s age at the end of the year.

3. Add the total of lines 1 and 2.

4. Enter your net profit* and any other earned income** from the trade or business under which the insurance plan is established. If the business is an S corporation, skip to line 11.

5. Enter the total of all net profits* from Schedule C (Form 1040), line 31; Schedule C-EZ (Form 1040), line 3; Schedule F (Form 1040), line 36; or Schedule K-1 (Form 1065), box 14, code A; plus any other income allocable to the profitable businesses. See the instructions for Schedule SE (Form 1040), Do not include any net losses shown on these schedules.

6. Divide line 4 by line 5.

7. Multiply Form 1040, line 27, by the percentage on line 6.

8. Subtract line 7 from line 4.

9. Enter the amount, if any, from Form 1040, line 28, attributable to the same trade or business in which the insurance plan is established.

10. Subtract line 9 from line 8.

11. Enter your wages from an S corporation in which you are a more-than-2% shareholder and which the insurance plan is established.

12. Enter the amount from Form 2555, line 45, attributable to the amount entered on line 4 or 11 above, or the amount from Form 2555-EZ, line 18, attributable to the amount entered on line 11 above.

13. Subtract line 12 from line 10 or 11, whichever applies.

14. Compare the amounts on lines 3 and 13 above. Enter the smaller of the two amounts here and on Form 1040, line 29. Do not include this amount when figuring a medical expense deduction on Schedule A (Form 1040).

* If you used either optional method to figure your net earnings from self-employment from any business, do not enter your net profit from the business. Instead, enter the amount attributable to that business from Schedule SE (Form 1040), line 4b.

** Earned income includes net earnings and gains from the sale, transfer, or licensing of property you created. It does not include capital gain income.

When figuring the amount to enter on line 1 of Worksheet 6-A, do not include the following:
- Any amounts you included on Form 8886, line 4.
- Any qualified health insurance premiums you paid to “U.S. Treasury-HCTC.”
- Any health coverage tax credit advance payments shown in box 1 of Form 1099-H, Health Coverage Tax Credit (HCTC) Advance Payments.
- More than one health plan and business.

If you have more than one health plan during the year and each plan is established under a different business, you must use separate worksheets (Worksheet 6-B) to figure each plan’s net earnings limit. Include the premium you paid under each plan on line 1 or line 2 of that separate worksheet and your net profit (or wages) from that business on line 4 (or line 11). For a plan that provides long-term care insurance, the total of the amounts entered for each person on line 2 of all worksheets cannot be more than the appropriate limit shown on line 2 for that person.

Non-deductible Premiums

You cannot deduct premiums on the following kinds of insurance.

1. Self-insurance reserve funds. You cannot deduct amounts credited to a reserve set up for self-insurance. This applies even if you cannot get business insurance coverage for certain business risks. However, your actual losses may be deductible. See Publication 547.

2. Loss of earnings. You cannot deduct premiums for a policy that pays for lost earnings due to sickness or disability. However, see the discussion on overhead insurance, Item (8), under Deductible Premiums, earlier.

3. Certain life insurance and annuities.
   a. For contracts issued before June 9, 1997, you cannot deduct the premiums on a life insurance policy covering you, an employee, or any person with a financial interest in your business if you are directly or indirectly a beneficiary of the policy. You are included among possible beneficiaries of the policy if the policy owner is obligated to repay a loan from you using the proceeds of the policy. 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.
   b. For contracts issued after June 8, 1997, you generally cannot deduct the premiums on any life insurance policy, endorsement contract, or annuity contract if you are directly or indirectly a beneficiary. The disallowance applies without regard to whom the policy covers.
   c. Partners. If, as a partner in a partnership, 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 are considered a beneficiary. You cannot deduct the insurance premiums.

4. Insurance to secure a loan. If you take out a policy on your life or on the life of another person with a financial interest in your business to get or protect a business loan, you cannot deduct the premiums as a business expense. Nor can you deduct the premiums as interest on business investments.
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.

**Capitalized Premiums**

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for certain production or resale activities. Include these costs in the basis of property you produce or acquire for resale, rather than claiming them as a current deduction. You recover the costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property. Indirect costs include premiums for insurance on your plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

Uniform capitalization rules. You may be subject to the uniform capitalization rules if you do any of the following, unless the property is produced for your use other than in a business or an activity carried on for profit:

1. Produce real property or tangible personal property. For this purpose, tangible personal property includes a film, sound recording, video tape, book, or similar property.

2. Acquire property for resale. However, these rules do not apply to the following property:

   1. Personal property you acquire for resale if your average annual gross receipts are $10 million or less for the 3 prior tax years.
   2. Property you produce if you meet either of the following conditions:
      a. Your indirect costs of producing the property are $200,000 or less.
      b. You use the cash method of accounting and do not account for inventories.

More information. For more information on these rules, see Uniform Capitalization Rules in Publication 538 and the regulations under Internal Revenue Code section 263A.

**When To Deduct Premiums**

You can usually deduct insurance premiums in the tax year to which they apply. **Cash method.** If you use the cash method of accounting, you generally deduct insurance premiums before the tax year in which you actually pay them (unless the exception for recurring items applies). For more information about the accrual method of accounting, see chapter 1. For information about the exception for recurring items, see Publication 538.

**Prepayment.** You cannot deduct expenses in advance, even if you pay them in advance. This rule applies to any 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.

Expenses such as insurance are generally allocable to a period of time. You can deduct your insurance expenses for the year to which they apply. **Example.** In 2006, you signed a 3-year insurance contract. Even though you paid the premiums for 2006, 2007, and 2008 when you signed the contract, you can only deduct the premium for 2006 on your 2006 tax return. You can deduct in 2007 and 2008 the premium allocable to those years.

**Dividends received.** If you receive dividends from business insurance and you deducted the premiums in prior years, at least part of the dividends generally are income. For more information, see Recovery of amount deducted (tax benefit rule) in chapter 1 under How Much Can I Deduct?

**7. Costs You Can Deduct or Capitalize**

**Introduction**

This chapter discusses costs you can elect to deduct or capitalize. You generally deduct a cost as a current business expense by subtracting it from your income in either the year you incur it or the year you pay it.

If you capitalize a cost, you may be able to recover it over a period of years through periodic deductions for amortization, depletion, or depreciation. When you capitalize a cost, you add it to the basis of property to which it relates.

A partnership, corporation, estate, or trust makes the election to deduct or capitalize the costs discussed in this chapter except for exploration costs for mineral deposits. Each individual partner, shareholder, or beneficiary elects whether to deduct or capitalize exploration costs.

You may be subject to the alternative minimum tax (AMT) if you deduct research and experimental, intangible drilling, exploration, development, circulation, and business organizational costs. For more information on the alternative minimum tax, see the instructions for one of the following forms:

- Form 6251, Alternative Minimum Tax—Individuals.
- Form 4562, Alternative Minimum Tax—Corporations.

**Topics**

This chapter discusses:

- Carrying charges
- Research and experimental costs
- Intangible drilling costs
- Exploration costs
- Development costs
- Circulation costs
- Environmental cleanup costs
- Business start-up and organizational costs
- Reforestation costs
- Retired asset removal costs
- Barrier removal costs
- Film and television production costs

**Useful Items**

You may want to see:

- Publication [544 Sales and Other Dispositions of Assets](#)
- Form (and Instructions) [3468 Investment Credit](#)
- [8826 Disabled Access Credit](#)

See chapter 12 for information about getting publications and forms.

**Carrying Charges**

Carrying charges include the taxes and interest you pay to carry or develop real property or to carry, transport, or install personal property. Certain carrying charges must be capitalized under the uniform capitalization rules. (For information on capitalization of interest, see chapter 4.) You can elect to capitalize carrying charges not subject to the uniform capitalization rules, but only if they are otherwise deductible.

You can elect to capitalize carrying charges separately for each project you have and for each type of carrying charge. For unimproved and unproductive real property, your election is good for only 1 year. You must decide whether to capitalize carrying charges each year the property remains unimproved and unproductive.

For other real property, your election to capitalize carrying charges remains in effect until construction or development is completed. For personal property, your election is effective until the date you install or first use it, whichever is later.
How to make the election. To make the election to capitalize a carrying charge, write a statement saying which charges you elect to capitalize. Attach it to your original tax return for the year the election is to be effective. However, if you timely file your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the statement to the amended return and write “Filed pursuant to section 301.9100-2” on the statement. File the amended return at the same address you filed the original return.

Research and Experimental Costs

The costs of research and experimentation are generally capital expenses. However, you can elect to deduct these costs as a current business expense. Your election to deduct these costs is binding for the year it is made and for all later years unless you get IRS approval to make a change.

If you meet certain requirements, you may elect to defer and amortize research and experimental costs. For information on electing to defer and amortize these costs, see Research and Experimental Costs in chapter 8.

Research and experimental costs defined. Research and experimental costs are reasonable costs you incur in your trade or business for activities intended to provide information that would eliminate uncertainty about the development or improvement of a product. Uncertainty exists if the information available to you does not establish how to develop or improve a product or the appropriate design of a product. Whether costs qualify as research and experimental costs depends on the nature of the activity to which the costs relate rather than on the nature of the product or improvement being developed or the level of technological advancement.

The costs of obtaining a patent, including attorneys’ fees paid or incurred in making and perfecting a patent application, are research and experimental costs. However, costs paid or incurred to obtain another’s patent are not research and experimental costs.

Product. The term “product” includes any of the following items.
- Formula.
- Invention.
- Patent.
- Pilot model.
- Process.
- Technique.
- Property similar to the items listed above.

It also includes products used by you in your trade or business or held for sale, lease, or license.

Costs not included. Research and experimental costs do not include expenses for any of the following activities.
- Advertising or promotions.
- Consumer surveys.
- Efficiency surveys.

If you... THEN...
Elect to deduct research and experimental costs as a current business expense Deduct all research and experimental costs in the first year you pay or incur the costs and all later years.

Do not deduct research and experimental costs as a current business expense If you meet the requirements, amortize them over at least 60 months, starting with the month you first receive an economic benefit from the research. See Research and Experimental Costs in chapter 8.

Intangible Drilling Costs

The costs of developing oil, gas, or geothermal wells are ordinarily capital expenditures. You can usually recover them through depreciation or depletion. However, you can elect to deduct intangible drilling costs (IDCs) as a current business expense. These costs are certain drilling and development costs for wells in the United States in which you hold an operating or working interest. You can deduct only costs for drilling or preparing a well for the production of oil, gas, or geothermal steam or hot water.

You can elect to deduct only the costs of items with no salvage value. These include wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production. Your cost for any drilling or development work done by contractors under any form of contract is also an IDC. However, see Amounts paid to contractor that must be capitalized, later.

You can also elect to deduct the cost of drilling exploratory 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 elect to deduct your IDCs as a current business expense, you can elect to deduct them over the 60-month period beginning with the month they were paid or incurred.

Amounts paid to contractor that must be capitalized. Amounts paid to a contractor must be capitalized if they are either:
- Management studies.
- Quark done by contractors.
- Research in connection with literary, historical, or similar projects.
- The acquisition of another’s patent, model, production, or process.
- Amounts properly allocable to the cost of depreciable property, or
- Amounts paid only out of production or proceeds from production if these amounts are depletible income to the recipient.

When and how to elect. You make the election to deduct research and experimental costs by deducting them on your tax return for the year in which you first pay or incur research and experimental costs. If you do not make the election to deduct research and experimental costs in the first year in which you pay or incur the costs, you can deduct the costs in a later year only with approval from the IRS.

Research credit. If you pay or incur qualified research expenses, you may be able to take the research credit. For more information about the research credit, see the instructions to Form 6865, Credit for Increasing Research Activities.

How to make the election. You elect to deduct IDCs as a current business expense by taking the deduction on your income tax return for the first tax year you have eligible costs. No formal statement is required. If you file Schedule C (Form 1040), enter these costs under “Other expenses.”

For oil and gas wells, your election is binding for the year it is made and for all later years. For geothermal wells, your election can be revoked by the filing of an amended return on which you do not take the deduction. You can file the amended return for the year up to the normal time of expiration for filing a claim for credit or refund, generally, within 3 years after the date you filed the original return or within 2 years after the date you paid the tax, whichever is later.

Energy credit for costs of geothermal wells. If you capitalize the drilling and development costs of geothermal wells that you place in service during the tax year, you may be able to claim a business energy credit. See the instructions for Form 3468 for more information.

Nonproductive well. If you capitalize your IDCs, you have another option if the well is nonproductive. You can deduct the IDCs of the nonproductive well as an ordinary loss. You must indicate and clearly state your election on your tax return for the year the well is completed. Once made, the election for oil and gas wells is binding for all later years. You can revoke your election for a geothermal well by filing an amended return that does not claim the loss.

Costs incurred outside the United States. You cannot deduct as a current business expense all the IDCs paid or incurred for an oil, gas, or geothermal well located outside the United States. However, you can elect to include the costs in the adjusted basis of the well to figure depletion or depreciation. If you do not make this election, 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

The costs of determining the existence, location, extent, or quality of any mineral deposit are ordinarily capital expenditures if the costs lead to the development of a mine. You recover these...
costs through depletion as the mineral is re-
moved from the ground. However, you can elect
to deduct domestic exploration costs paid or
incurred before the beginning of the develop-
ment stage of the mine (except those for oil, gas,
and geothermal wells).

How to make the election. You elect to de-
duct exploration costs by taking the deduction on
your amended income tax return, or on an amended
income tax return, for the first tax year for
which you wish to deduct the costs paid or incurred
during that tax year. The return must clearly state how
much is being deducted for all or part of your gain as ordinary income. velopment costs.

Recapture of exploration expenses. If you dis-
pose of the mine before the tax year you receive
the bonus or royalty and during the tax year.

Partnerships. Each partner, not the part-
nership, elects whether to capitalize or to deduct
that partner’s share of exploration costs.

Reduced corporate deductions for explora-
tion costs. A corporation (other than an S corpo-
ration) can deduct only 70% of its domes-
tic exploration costs. It must capitalize the re-
maining 30% of costs and amortize them over
the 60-month period starting with the month the
exploration costs are paid or incurred. A corpo-
racion may also elect to capitalize and amortize
mining exploration costs over a 10-year period.

Development Costs

Method 1—Include the deducted costs in
gross income for the tax year the mine
reaches the producing stage. Your election
must be clearly indicated on the return. In-
cluding the costs in gross income for the
tax year in which you pay or incur the
amount included in income generally, you must elect this recapitulation method by the
date (including extensions) of your re-
turn. However, if you timely filed your return
for the year without making the election,
you can still make the election by filing an
amended return within 6 months of the due
date of the return (excluding extensions).

Make the election on your amended return
and write “Filed pursuant to section
301.9100-2” on the form where you are in-
cluding the income. File the amended re-
turn at the same address you filed the
original return.

Method 2—Do not claim any depletion de-
duction for the tax year the mine reaches the
producing stage and any later tax years
until the depletion you would have deducted
equals the exploration costs you deducted.

You also must recapitulate deducted explo-
ration costs if you receive a bonus or royalty from
mine property before it reaches the producing
stage. Do not claim any depletion deduction for
the tax year you receive the bonus or royalty and
any later tax years, until the depletion you would
have deducted equals the exploration costs you
deducted.

Generally, if you dispose of the mine before
you have fully recapitulated the exploration costs
you deducted, you must charge the balance of the
total year (including extensions) of the return.

Under these circumstances, you generally treat
as ordinary income all of your gain if it is
less than your adjusted exploration costs with
respect to the mine. If your gain is more than
your adjusted exploration costs, treat as ordi-
nary income only a part of your gain, up to
the amount of your adjusted exploration costs.

Foreign exploration costs. If you pay or incur
exploration costs for a mine or other natural
deposit located outside the United States, you
cannot deduct all the costs in the current year
You can elect to include the costs (other than for
an oil, gas, or geothermal well) in the adjusted
basis of the mineral property to figure cost de-
pletion. (Cost depletion is discussed in chapter
9.) If you do not make this election, you must
deduct the costs over the 10-year period begin-
ning with the tax year in which you pay or incur
them. These rules also apply to foreign develop-
ment costs.

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 outside the United States. These costs
can be paid or incurred after the discovery of ores or
minerals in commercially marketable quantities.

Development costs include those incurred for
the acquisition of circulation through the
purchase of any part of the business of
another publisher of a newspaper, maga-
zeine, or other periodical, including the
purchase of another publisher’s list of sub-
scribers.

Other treatment of circulation costs. If you
do not want to deduct circulation costs as a
current business expense, you can elect one of
the following ways to recover these costs.

• Capitalize all circulation costs that are
  generally chargeable to a capital account.
• Amortize circulation costs over the 3-year
  period beginning with the tax year they
  were paid or incurred.

How to make the election. You elect to capi-
talize circulation costs by attaching a statement
to your return for the first tax year the election
applies. You are eligible for the binding for the year it is made and for all later years, unless you get IRS
approval to revoke it.

Environmental Cleanup Costs

Environmental cleanup (remediation) costs are
generally capital expenditures. However, you
can elect to deduct these costs as a current
business expense if certain requirements (dis-
cussed later) are met. This special tax treatment
is generally available for qualified environmental
cleanup costs you pay or incur before January 1, 2008.
Qualified environmental cleanup costs. Qualified environmental cleanup costs are general capital expenditures or incur to abate or control hazardous substances at a qualified contaminated site.

- Hazardous substance. Hazardous substances are defined in section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 and certain substances are designated as hazardous in section 102 of the Act. For costs paid or incurred after December 31, 2005 (after August 28, 2005, if for a Gulf Opportunity (GO) Zone site), petroleum products are treated as hazardous substances. Substances are not hazardous if a removal or remedial action is prohibited under sections 104 and 104(a)(3) of the Act.

- Recapture. Generally costs you pay or incur to abate or control hazardous substances are recaptured as ordinary income under section 198 if you had not elected to deduct the expenses. However, you can elect to deduct up to $5,000 of any remaining costs must be amortized. For more information about the GO Zone, see Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

Qualified contaminated site. A qualified contaminated site is any area that meets both of the following requirements:

1. You hold it for use in a trade or business, for the production of income, or as inventory.
2. There has been a release, threat of release, or disposal of any hazardous substance at or on the site.

You must get a statement from the designated state environmental agency that the site meets the requirement (2).

A site is not eligible if it is on, or proposed for, the national priorities list under section 105(a)(8)(B) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. To find out if a site is on the national priorities list, contact the U.S. Environmental Protection Agency.

- Expenditures for depreciable property. You cannot deduct the cost of acquiring depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site. However, the part of the depreciation for such property that is otherwise allocated to the qualified contaminated site shall be treated as a qualified environmental cleanup cost.

Business Start-Up and Organizational Costs

Business start-up and organizational costs are generally capital expenditures. However, you can deduct up to $5,000 of any remaining costs must be amortized. For more information about the GO Zone, see Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

- Start-up costs include any amounts paid or incurred in connection with creating an active trade or business or investigating the creation or acquisition of an active trade or business. Organizational costs include the costs of creating a corporation. For more information on start-up and organizational costs, see chapter 8.

How to make the election. You elect to deduct the start-up or organizational costs by taking the deduction on your amended return and write "Filed pursuant to section 301.9100-2" if the amended return at the same address you filed the original return. The election applies when computing taxable income for the current tax year and all subsequent years.

Reforestation Costs

Reforestation costs are generally capital expenditures. However, you can elect to deduct up to $10,000 ($5,000 if married filing separately; $0 for a trust) of qualifying reforestation costs paid or incurred after October 22, 2004, for each qualified timber property. This limit is increased for small timber producers with qualified timber property located in low-income areas located by Hurricanes Katrina, Rita, and Wilma. For more information, see Publication 4492. The remaining costs can be amortized over an 84-month period. For information about amortizing reforestation costs, see chapter 8.

Qualifying reforestation costs are the direct costs of planting or seedling for forestation or reforestation. Qualified timber property is property that contains trees in significant commercial quantities. For more information on qualifying reforestation costs and qualified timber property.

How to make the election. You elect to deduct qualifying reforestation costs by claiming the deduction on your timely filed income tax return (including extensions) for the tax year the expenses were paid or incurred. Form T (Timber), Forest Activities Schedule, is required, complete Part IV of Form T. If Form T is not required, attach a statement containing the following information for each qualified timber property for which an election is being made:

- The unique stand identification numbers.
- The total number of acres forested during the tax year.
- The nature of the reforestation treatments.
- The total amounts of qualified reforestation expenditures eligible to be amortized or deducted.

How to make the election. You elect to deduct the start-up or organizational costs by taking the deduction on your amended return and write "Filed pursuant to section 301.9100-2" if the amended return at the same address you filed the original return. The election applies when computing taxable income for the current tax year and all subsequent years.

How to make the election. You elect to deduct qualifying reforestation costs on a federal income tax return filed before June 15, 2006, but did not include the above information, complete Part IV of Form T or the required statement and attach it to the first federal income tax return you file after June 14, 2006. If you have not elected to deduct qualified timber costs in a prior year you may be able to do so by filing Form 3115, Application for Change in Accounting Method. For more information, see Notice 2006-47 on page 892 of Internal Revenue Bulletin 2006-20. Internal Revenue Bulletin 2006-20

For additional information on reforestation costs, see chapter 8.

Recapture. This deduction may have to be recaptured as ordinary income under section 1245 when you sell or otherwise dispose of the property that would have received an addition to basis if you had not elected to deduct the expenditure. For more information on recapturing the deduction, see Depreciation and amortization under Gain-Treated as Ordinary Income in Publication 544.

Retired Asset Removal Costs

If you retire and remove a depreciable asset in connection with the installation or production of a replacement asset, you can deduct the costs of removing the retired asset. However, if you replace a component (part) of a depreciable asset, capitalize the removal costs if the replacement is an improvement and deduct the costs if the replacement is a repair.

Barrier Removal Costs

The cost of an improvement to a business asset is normally a capital expense. However, you can elect to deduct the costs of making a facility or public transportation vehicle more accessible to and usable by those who are disabled or elderly. You must own or lease the facility or vehicle for use in connection with your trade or business.

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, even if you are not in the business of providing transportation services).

You cannot deduct any costs that you paid or incurred to completely renovate or build a facility or public transportation vehicle or to replace depreciable property in the normal course of business.

Deduction limit. The most you can deduct as a cost of removing barriers to the disabled and the elderly for any tax year is $15,000. However, you can add any costs over this limit to the basis of the property and depreciate these excess costs.

Partners and partnerships. The $15,000 limit applies to a partnership and also to each partner in the partnership. A partner can allocate the $15,000 limit in any manner among the partner’s individually incurred costs and the partner’s distributive share of partnership costs. If the partner cannot deduct the entire share of partnership costs, the partnership can add any costs not deducted to the basis of the improved property.

A partnership must be able to show that any amount added to basis was not deducted by the partner and that it was over a partner’s $15,000 limit (as determined by the partner). If the partnership cannot show this, it is presumed that the partner was able to deduct the distributive share of the partnership’s costs in full.

Example. John Duke’s distributive share of ABC partnership’s deductible expenses for the removal of architectural barriers was $14,000. John had $12,000 of similar expenses in his sole proprietorship. He elected to deduct $7,000 of them. John allocated the remaining $8,000 of the $15,000 limit to his share of ABC’s expenses. John can add the excess $5,000 of his own expenses to the basis of the property used in his business. Also, if ABC can show that John could not deduct $6,000 ($14,000 – $8,000) of his share of the partnership’s expenses because of how John applied the limit, ABC can add $6,000 to the basis of its property.

Qualification standards. You can deduct your costs as a current expense only if the barrier removal meets the guidelines and requirements issued by the Architectural and Transportation Barriers Compliance Board under the Americans with Disabilities Act (ADA) of 1990. You can view the Americans with Disabilities Act at www.usdoj.gov/crt/ada/pubs/ada.txt.

The following is a list of some architectural barrier removal costs that can be deducted:

- Ground and floor surfaces.
- Walks.
- Parking lots.
- Ramps.
- Entrances.
- Doors and doorways.
- Stairs.
- Floors.
- Toilet rooms.
- Water fountains.
- Telephones.
- Elevators.
- Controls.
- Signage.
- Alarms.
- Protuding objects.
- Symbols of accessibility.

You can find the ADA guidelines and requirements for architectural barrier removal at www.usdoj.gov/crt/ada/reg3a.html.

The following is a list of some deductible transportation barrier removal costs:

- Rail facilities.
- Buses.
- Rapid and light rail vehicles.

You can find the guidelines and requirements for transportation barrier removal at www.fta.dot.gov/14534_5608_ENG_HTML.html.

Also, you can access the ADA website at www.ada.gov for additional information.

Other barrier removals. To be deductible, expenses of removing any barrier not covered by the above standards must meet all three of the following 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 a disability or are elderly.

2. The removed barrier must have been a barrier for at least one major group of persons who have a disability or are elderly (such as people who are blind, deaf, or wheelchair users).

3. The barrier must be removed without creating any new barrier that significantly impairs access to or use of the facility or vehicle by a major group of persons who have a disability or are elderly.

How to make the election. If you elect to deduct your costs for removing barriers to the disabled or elderly, the election 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. The election applies to all qualifying costs you have during the year, up to the $15,000 limit. If you make this election, you must maintain adequate records to support your deduction.

For your election to be valid, you generally must file your return by its due date, including extensions. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the election on your amended return and write “Filed pursuant to section 101.9100-2.” File the amended return at the same address you filed the original return. Your election is irrevocable after the due date, including extensions, of your return.

Disabled access credit. If you make your business accessible to persons with disabilities and your business is an eligible small business, you may be able to claim the disabled access credit. If you choose to claim the credit, you must reduce the amount you deduct or capitalize by the amount of the credit.

For more information about the disabled access credit, see Form 8828.

Film and Television Production Costs

Film and television production costs are generally capital expenses. However, you can elect to deduct costs paid or incurred for certain productions that begin after October 22, 2004. For more information, see section 181 of the Internal Revenue Code. For guidance on electing to deduct these costs, see Notice 2006-47 on page 892 of Internal Revenue Bulletin 2006-20. Internal Revenue Bulletin 2006-20 is available at www.irs.gov/pub/irs-irsb/n06-20.pdf.
8. Amortization

Introduction
Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation.

The various amortizable costs covered in this chapter are included in the list below. However, this chapter does not discuss amortization of bond premium. For information on that topic, see chapter 3 of Publication 550.

Topics
This chapter discusses:

- Deducting amortization
- Amortizing costs of starting a business
- Amortizing costs of getting a lease
- Amortizing costs of section 197 intangibles
- Amortizing reforestation costs
- Amortizing costs of geological and geophysical costs
- Amortizing costs of pollution control facilities
- Amortizing costs of research and experimentation
- Amortizing costs of certain tax preferences

Useful Items
You may want to see:

- Publication
  - 544 Sales and Other Dispositions of Assets
  - 550 Investment Income and Expenses
  - 946 How To Depreciate Property
- Form (and Instructions)
  - 3468 Investment Credit
  - 4562 Depreciation and Amortization
  - 4626 Alternative Minimum Tax — Corporations
  - 6251 Alternative Minimum Tax — Individuals

See chapter 12 for information about getting publications and forms.

How To Deduct Amortization
To deduct amortization that begins during the current tax year, complete Part VI of Form 4562 and attach it to your income tax return.

To report amortization from previous years, in addition to amortization that begins in the current year, list on Form 4562 each item separately. For example, in 2005 you began to amortize a lease. In 2006, you began to amortize a second lease. Report amortization from the new lease on line 42 of your 2006 Form 4562. Report amortization from the 2005 lease on line 43 of your 2006 Form 4562.

If you do not have any new amortizable expenses for the current year, you are not required to complete Form 4562 (unless you are claiming depreciation). Report the current year’s deduction for amortization that began in a prior year directly on the “Other deduction” or “Other expense line” of your return.

Starting a Business
When you start a business, treat all eligible costs you incur before you begin operating the business as capital expenditures which are part of your basis in the business. Generally, you recover costs for particular assets through depreciation deductions. Generally, you cannot recover other costs until you sell the business or otherwise go out of business.

However, you can elect to amortize certain costs for setting up and organizing your business. For costs paid or incurred before October 23, 2004, you can elect an amortization period of 60 months or more. For costs paid or incurred after October 22, 2004, you can elect to deduct a limited amount of start-up and organizational costs (see chapter 7). The costs that are not deducted currently can be amortized ratably over a 180-month period. The amortization period starts with the month you begin operating your active trade or business. See Code section 195(b) for limitations.

The cost must qualify as one of the following:

- A business start-up cost.
- An organizational cost for a corporation.
- An organizational cost for a partnership.

Business Start-Up Costs
Start-up costs are amounts paid or incurred for:
- (a) creating an active trade or business; or
- (b) investigating the creation or acquisition of an active trade or business. Start-up costs include amounts paid or incurred in connection with an existing activity engaged in for profit, and for the production of income in anticipation of the activity becoming an active trade or business.

Qualifying costs. A start-up cost is amortizable if it meets both the following tests.

- It is a cost you could deduct if you paid or incurred it to operate an existing active trade or business (in the same field as the one you entered into).
- It is a cost you pay or incur before the day your active trade or business begins.

Start-up costs include amounts paid for the following:

- An analysis or survey of potential markets, products, labor supply, transportation facilities, 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.
- Salaries and fees for executives and consultants, or for similar professional services.

Nonqualifying costs. Start-up costs do not include deductible interest, taxes, or research and experimental costs. See Research and Experimental Costs, later.

Purchasing an active trade or business. Amortizable start-up costs for purchasing an active trade or business include only investigatory costs incurred in the course of a general search for or preliminary investigation of the business. These are costs that help you decide whether to purchase a business.

Example. On June 1st, you hired an accounting firm and a law firm to assist you in the potential purchase of XYZ, Inc. They researched XYZ’s industry and analyzed the financial projections of XYZ, Inc. In September, the law firm prepared and submitted a letter of intent to XYZ, Inc. The letter stated that a binding commitment would result only after a purchase agreement was signed. The law firm and accounting firm continued to provide services including a review of XYZ’s books and records and the preparation of a purchase agreement. On October 22nd, you signed a purchase agreement with XYZ, Inc.

All amounts paid or incurred to investigate the business before October 22nd are amortizable investigative costs. Amounts paid on or after that date relate to the attempt to purchase the business and therefore must be capitalized.

Disposition of business. If you completely dispose of your business before the end of the amortization period, you can deduct any remaining deferred start-up costs. However, you can deduct these deferred start-up costs only to the extent they qualify as a loss from a business.

Organizational Costs
Amounts paid to organize a corporation are the direct costs of creating the corporation.

Qualifying costs. To qualify as an organizational cost it must be:

- For the creation of the corporation,
- Chargeable to a capital account,
- Amortized over the life of the corporation if the corporation had a fixed life, and,
- Incurred before the end of the first tax year in which the corporation is in business.

A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

Examples of organizational costs include:


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The costs to organize a partnership are the direct costs of creating the partnership. Qualifying costs. You can amortize an organizational cost only if it meets all the following tests.

- It is for the creation of the partnership and not for starting or operating the partnership trade or business.
- It is chargeable to a capital account.
- It could be amortized over the life of the partnership if the partnership had a fixed life.
- It is incurred by the due date of the partnership return (excluding extensions) for the first tax year in which the partnership is in business. However, if the partnership uses the cash method of accounting and pays the cost after the end of its first tax year, see Cash method partnership under How To Amortize, later.
- It is for a type of item normally expected to benefit the partnership throughout its entire life.

Organizational costs include the following fees.

- Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement.
- Accounting fees for services incident to the organization of the partnership.
- Filing fees.

Nonqualifying costs. The following costs cannot be amortized.

- The cost of acquiring assets for the partnership or transferring assets to the partnership.
- The cost of admitting or removing partners, other than at the time the partnership is first organized.
- The cost of making a contract concerning the operation of the partnership trade or business including a contract between a partner and the partnership.
- The costs for issuing and marketing interests in the partnership such as brokerage, registration, and legal fees and printing costs. These “syndication fees” are capital expenses that cannot be depreciated or amortized.

How To Make the Election

To elect to amortize start-up or organizational costs, you must complete and attach Form 4562 and an accompanying statement (explained later) to your return for the first tax year you are in business. If you have both start-up and organizational costs, attach a separate statement to your return for each type of cost.

Generally, you must file the return by the due date (including any extensions). However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). For more information, see the instructions for Part VI of Form 4562.

Once you make the election to amortize start-up or organizational costs, you cannot revoke it. If your business is organized as a corporation or partnership, only the corporation or partnership can elect to amortize its start-up or organizational costs. A shareholder or partner cannot make this election. You, as a shareholder or partner, cannot amortize any costs you incur in setting up your corporation or partnership. Only the corporation or partnership can amortize these costs.

However, you, as an individual, can elect to amortize costs you incur to investigate an interest in an existing partnership. These costs qualify as business start-up costs if you acquire the partnership interest.

Start-up costs election statement. If you elect to amortize your start-up costs, attach a separate statement that contains the following information.

- A description of the business to which the start-up costs relate.
- A description of each start-up cost incurred.
- The month your active business began (or was acquired).
- The number of months in your amortization period which is generally 180 months.

Filing the statement early. You can elect to amortize your start-up costs by filing the statement with a return for any tax year before the year your active business begins. If you file the statement early, the election becomes effective in the month of the tax year your active business begins.

Revised statement. You can file a revised statement to include any start-up costs not included in your original statement. However, you cannot include on the revised statement any cost you previously treated on your return as a cost other than a start-up cost. You can file the revised statement with a return filed after the return on which you elected to amortize your start-up costs.

Organizational costs election statement. If you elect to amortize your corporation’s or partnership’s organizational costs, attach a separate statement that contains the following information.

- A description of each cost.
- The amount of each cost.
- The date each cost was incurred.
- The month your corporation or partnership began active business (or acquired the business).
- The number of months in your amortization period which is generally 180 months.

Partnerships. The statement prepared for a cash basis partnership must also indicate the amount paid before the end of the year for each cost.

You do not need to separately list any partnership organizational cost that is less than $10. Instead, you can list the total amount of these costs with the dates the first and last costs were incurred.

After a partnership makes the election to amortize organizational costs, it can later file an amended return to include additional organizational costs not included in the partnership’s original return and statement.

Getting a Lease

If you get 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 purposes generally includes all renewal options (and any other period for which you and the
Section 197 Intangibles

Generally, you may amortize the capitalized costs of “section 197 intangibles” (defined later) ratably over a 15-year period. You must amortize these costs if you hold the section 197 intangibles in connection with your trade or business or in an activity engaged in for the production of income.

You may not be able to amortize section 197 intangibles acquired in a transaction that did not result in a significant change in ownership or use. See Anti-Churning Rules, later.

Your amortization deduction each year is the applicable part of the intangible’s adjusted basis (for purposes of determining gain), figured by amortizing it ratably over 15 years (180 months). The 15-year period begins with the later of:

- The month the intangible is acquired, or
- The month the trade or business or activity engaged in for the production of income begins.

You cannot deduct amortization for the month you dispose of the intangible.

If you pay or incur an amount that increases the basis of an amortizable section 197 intangible after the 15-year period begins, amortize it over the remainder of the 15-year period beginning with the month the basis increase occurs. You are not allowed any other depreciation or amortization deduction for an amortizable section 197 intangible.

Tax-exempt use property subject to a lease. The amortization period for any section 197 intangible leased under a lease agreement entered into after March 12, 2004, to a tax-exempt organization, governmental unit, or foreign person or entity (other than a partnership), shall not be less than 125 percent of the lease term.

Cost attributable to other property. The rules for section 197 intangibles do not apply to any amount that is included in determining the cost of property that is not a section 197 intangible. For example, if the cost of computer software is not separately stated from the cost of hardware or other tangible property and you consistently treat it as part of the cost of the hardware or other tangible property, these rules do not apply. Similarly, none of the cost of acquiring real property held for the production of rental income is considered the cost of goodwill, going concern value, or any other section 197 intangible.

Section 197 Intangibles Defined

The following assets are section 197 intangibles and must be amortized over 180 months:

- Goodwill
- Going concern value
- Workforce in place
- Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers
- A patent, copyright, formula, process, design, pattern, know-how, format, or similar item
- A customer-based intangible
- A supplier-based intangible
- A license, permit, or other right granted by a governmental unit or agency (including issuances and renewals)
- A covenant not to compete entered into in connection with the acquisition of an interest in a business or a substantial part of a business
- Any franchise, trademark, or trade name

You cannot amortize any of the intangibles listed in items (1) through (8) that you created rather than acquired unless you created them in acquiring assets that make up a trade or business or a substantial part of a trade or business.

Goodwill. This is the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor.

Going concern value. This is the additional value of a trade or business that attaches to property because the property is an integral part of an ongoing business activity. It includes value based on the ability of a business to continue to function and generate income even though there is a change in ownership (but does not include any other section 197 intangible). It also includes value based on the immediate use or availability of an acquired trade or business, such as the use of earnings during any period in which the business would not otherwise be available or operational.

Workforce in place, etc. This includes the composition of a workforce (for example, its experience, education, or training). It also includes the terms and conditions of employment, whether contractual or otherwise, and any other value placed on employees or any of their attributes.

Suppliers and customers. An investment management contract. A covenant not to compete. Section 197 intangibles include a covenant not to compete (or similar arrangement) entered into in connection with the acquisition of an interest in a trade or business, or a substantial portion of a trade or business. An interest in a trade or business includes an interest in a partnership or a corporation engaged in a trade or business.

An arrangement that requires the former owner to perform services (or to provide property or the use of property) is not similar to a covenant not to compete to the extent the amount paid under the arrangement represents accounting or inventory control systems. It also includes the cost of customer lists, subscription lists, insurance expiration, patient or client files, and lists of newspaper, magazine, radio, and television advertisers.

Patents, copyrights, etc. This includes package design, and any interest in a film, sound recording, videodisk, tape, or other similar property, except as discussed later under Assets That Are Not Section 197 Intangibles.

Customer-based intangible. This is the composition of market, market share, and any other value resulting from the future provision of goods or services because of relationships with customers in the ordinary course of business. For example, you must amortize the part of the purchase price of a business that is for the existence of the following intangibles:

- A customer base.
- A circulation base.
- A favorable relationship with customers in connection with the acquisition of a trade or business.

Accounts receivable or other similar rights to income for goods or services provided to customers before the acquisition of a trade or business are not section 197 intangibles.

Supplier-based intangible. This is the value resulting from the future acquisition of goods or services used or sold by the business because of business relationships with suppliers.

For example, you must amortize the part of the purchase price of a business that is for the existence of the following intangibles:

- A favorable relationship with distributors (such as favorable shelf or display space at a retail outlet).
- A favorable credit rating.
- A favorable supply contract.

Government-granted license, permit, etc. This is any right granted by a governmental unit or an agency or instrumentality of a governmental unit. For example, you must amortize the capitalized costs of acquiring (including issuing or renewing) a liquor license, a taxicab mediation license, or a television or radio broadcasting license.

Covenant not to compete. Section 197 intangibles include a covenant not to compete (or similar arrangement) entered into in connection with the acquisition of an interest in a trade or business, or a substantial portion of a trade or business. An interest in a trade or business includes an interest in a partnership or a corporation engaged in a trade or business.

An arrangement that requires the former owner to perform services (or to provide property or the use of property) is not similar to a covenant not to compete to the extent the amount paid under the arrangement represents...
Intangible property that is not amortizable under the rules for section 197 intangibles can be amortized under other methods. The depreciation period is specified in the law and regulations. For example, the depreciation period for computer software that is not a section 197 intangible is generally 36 months. For more information on depreciable intangible property, see Intangible Property under section 197 of the code.

Computer software. Section 197 intangibles do not include the following types of computer software:

1. Software that meets all the following requirements:
   a. It is, or has been, readily available for purchase by the general public.
   b. It is subject to a nonexclusive license.
   c. It has not been substantially modified.

2. Software that is not acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business.

Computer software defined. Computer software includes all programs designed to cause a computer to perform a desired function. It also includes any database or similar item that is in the public domain and is incidental to the operation of qualifying software.

Rights of fixed duration or amount. Section 197 intangibles do not include any right under a contract or from a governmental agency if the right is acquired in the ordinary course of a trade or business (or in an activity engaged in for the production of income) but not as part of a purchase of a trade or business and either:

- Has a fixed life of less than 15 years, or during the period in which any part of a gain or loss is recognized.
- Is of a fixed amount that, except for the rules for section 197 intangibles, would be recovered under a method similar to the unit-of-production method of cost recovery.

However, this does not apply to the following intangibles:

- Goodwill.
- Going concern value.
- A covenant not to compete.
- A franchise, trademark, or trade name.
- A customer-related information base, customer-related intangible, or similar item.

Safe Harbor for Creative Property Costs

If you are engaged in the trade or business of film production, you may be able to amortize the creative property costs for properties not set for production within 3 years of the first capitalized transaction. You may amortize these costs ratably over a 15-year period beginning on the first day of the second half of the tax year in which you properly write off the costs for financial accounting purposes. If, during the 15-year period, you dispose of the creative property rights, you must continue to amortize the costs over the remainder of the 15-year period.

Creative property costs include costs paid or incurred to acquire, develop, or produce films, television programs, video tapes, books, and similar properties for purposes of potential future film development, production, and exploitation.


A change in the treatment of creative property costs is a change in method of accounting.

Anti-Churning Rules

Anti-churning rules prevent you from amortizing most section 197 intangibles if the transaction in which you acquired them did not result in a significant change in ownership or use. These rules apply to goodwill and going concern value, and to any other section 197 intangible that is not otherwise depreciable or amortizable.

Under the anti-churning rules, you cannot use 15-year amortization for the intangible if any of the following conditions apply:

1. You or a related person (defined later) held or used the intangible at any time from July 25, 1991, through August 10, 1993.

2. You acquired the intangible from a person who held it at any time during the period in (1) and, as part of the transaction, the user did not change.

3. You granted the right to use the intangible to a person (or a person related to that person) who held or used it at any time during the period in (1). This applies only if the transaction in which you granted the right and the transaction in which you acquired the intangible are part of a series of related transactions. See Related person, later, for information about the kinds of persons that are related.

Exceptions. The anti-churning rules do not apply in the following situations:

- You acquired the intangible from a de- ceased and its basis was stepped up to its fair market value.
- The intangible was amortizable as a section 197 intangible by the seller or transferor you acquired it from. This exception does not apply if the transaction in which you acquired the intangible and the transaction in which the seller or transferor acquired it are part of a series of related transactions.
- The gain-recognition exception, discussed later, applies.
Related person. For purposes of the anti-churning rules, the following are related persons.

- An individual and his or her brothers, sisters, half-brothers, half-sisters, spouses, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- A corporation and an individual who owns, directly or indirectly, more than 20% of the value of the corporation’s outstanding stock.
- Two corporations that are members of the same controlled group as defined in section 1563(a)(1) of the Internal Revenue Code, except that “more than 20%” is substituted for “at least 80%” in that definition and the determination is made without regard to subsections (a)(4) and (e)(3)(C) of section 1563. (For an exception, see section 1.197-2(h)(6)(iv) of the regulations.)
- A trust fiduciary and a corporation if more than 20% of the value of the corporation’s outstanding stock is owned, directly or indirectly, by or for the trust or grantor of the trust.
- The grantor and fiduciary, and the fiduciaries of two different trusts, and the individual for reapplying Rule 2 or 3 to make early application to ownership of the stock directly or indirectly owned by or for his or her partner.
- The executor and beneficiary of an estate.
- A tax-exempt educational or charitable organization and a person who directly or indirectly controls the organization (or whose family members control it).
- A corporation and a partnership if the same persons own more than 20% of the value of the outstanding stock of the corporation and more than 20% of the capital or profits interest in the partnership.
- Two S corporations, and an S corporation and a regular corporation, if the same persons own more than 25% of the value of the outstanding stock of each corporation.
- Two partnerships if the same persons own, directly or indirectly, more than 20% of the capital or profits interests in both partnerships.
- A partnership and a person who owns, directly or indirectly, more than 20% of the capital or profits interests in the partnership.
- Two persons who are engaged in trades or businesses under common control (as described in section 41(f)(1) of the Internal Revenue Code).

When to determine relationship. Persons are treated as related if the relationship existed at the following time.

- In the case of a single transaction, immediately before or immediately after the transaction in which the intangible was acquired.
- In the case of a series of related transactions (or a series of transactions that comprise a qualified stock purchase transaction, as defined in section 383(d)(3) of the Internal Revenue Code), immediately before the latest transaction or immediately after the last transaction.

Ownership of stock. In determining whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

**Rule 1.** Stock directly or indirectly owned 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 to own the stock directly or indirectly owned by or for this person.Family includes only brothers and sisters, half-brothers and half-sisters, spousal 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 directly or indirectly owned by or for his or her partner.

**Rule 4.** For purposes of applying Rule 1, 2, or 3, treat stock constructively owned by a person under Rule 1 as actually owned by that person. Do not treat stock constructively owned by an individual under Rule 2 or 3 as owned by the individual for reapplying Rule 2 or 3 to make another person the constructive owner of the stock.

Gain-recognition exception. This exception to the anti-churning rules applies if the person you acquired the intangible from (the transferee) meets both of the following requirements.

- That person would not be related to you (as described under Related person, earlier) if the 20% test for ownership of stock and partnership interests were replaced by a 50% test.
- That person chose to recognize gain on the disposition of the intangible and pay income tax on the gain at the highest tax rate. See chapter 2 in Publication 544 for information on making this choice.

If this exception applies, the anti-churning rules apply only to the amount of your adjusted basis in the intangible that is more than the gain recognized by the transferor.

**Notification.** If the person you acquired the intangible from chooses to recognize gain under the rules for this exception, that person must notify you in writing by the due date of the return on which the choice is made.

**Anti-abuse rule.** You cannot amortize any section 197 intangible acquired in a transaction for which the principal purpose was either of the following.

- To avoid the requirement that the intangible be acquired after August 10, 1993.
- To avoid any of the anti-churning rules.

**More information.** For more information about the anti-churning rules, including additional rules for partnerships, see Regulations section 1.197-2(h).

Incorrect Amount of Amortization Deducted

If you later discover that you deducted an incorrect amount for amortization for a section 197 intangible in any year, you may be able to make a correction for that year by filing an amended return. See Amended Return, next. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amortization. See Changing Your Accounting Method, later.

Amended Return

If you deducted an incorrect amount for amortization, you can file an amended return to correct the following.

- A mathematical error made in any year.
- A posting error made in any year.
- An amortization deduction for a section 197 intangible for which you have not adopted a method of accounting.

When to file. If an amended return is allowed, you must file it by the later of the following dates.

- 3 years from the date you filed your original return for the year in which you did not deduct the correct amount. (A return filed early is considered filed on the due date.)
- 2 years from the time you paid your tax for that year.

Changing Your Accounting Method

Generally, you must get IRS approval to change your method of accounting. File Form 3115, Application for Change in Accounting Method, to request a change to a permissible method of accounting for amortization.

The following are examples of a change in method of accounting for amortization.

- A change in the amortization method, period of recovery, or convention of an amortizable asset.
- A change in the accounting for amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa.
- A change in the accounting for amortizable assets from one type of multiple asset account to a different type of multiple asset account.

Changes in amortization that are not a change in method of accounting include the following.

- A change in computing amortization in the tax year in which you use the asset of the asset.
- An adjustment in the useful life of an amortizable asset.
- Generally, the making of a late amortization election or the revocation of a timely valid amortization election.
- Any change in the placed-in-service date of an amortizable asset.
Amortization

Section 197 Intangibles

A section 197 intangible is treated as depreciable property used in your trade or business. If you held the intangible for more than 1 year, any gain on its disposition, up to the amount of allowable amortization, is ordinary income (section 1245 gain). If multiple section 197 intangibles are disposed of in a single transaction or a series of related transactions, treat all of the section 197 intangibles as if they were a single asset for purposes of determining the amount of gain that is ordinary income. Any remaining gain, or any loss, is a section 1231 gain or loss. If you held the intangible 1 year or less, any gain or loss on its disposition is an ordinary gain or loss. For more information on ordinary or capital gain or loss on business property, see chapter 3 in Publication 544.

Nondeductible loss. You cannot deduct any loss on the disposition or worthlessness of a section 197 intangible that you acquired in the same transaction (or series of related transactions) as other section 197 intangibles you still have. Instead, increase the adjusted basis of each remaining amortizable section 197 intangible by a proportionate part of the nondeductible loss. Figure the increase by multiplying the nondeductible loss on the disposition of the intangible by the following fraction:

- The numerator is the adjusted basis of each remaining intangible on the date of the disposition.
- The denominator is the total adjusted basis of all remaining amortizable section 197 intangibles on 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 you dispose of your entire interest in the trade or business for which you entered into the covenant.

Nonrecognition transfers. If you acquire a section 197 intangible in a nonrecognition transfer, you are treated as the transferor with respect to the part of your adjusted basis in the intangible that is not more than the transferor’s adjusted basis. You amortize this part of the adjusted basis over the intangible’s remaining amortization period in the hands of the transferor. Nonrecognition transfers include transfers to a corporation, partnership contributions and distributions, like-kind exchanges, and involuntary conversions.

Reforestation Costs

You can elect to deduct a limited amount of reforestation costs paid or incurred during the tax year. See Reforestation Costs in chapter 7. You can elect to amortize the qualifying costs that are not deducted currently over an 84-month period. There is no limit on the amount of your amortization deduction for reforestation costs paid or incurred during the tax year.

The election to amortize reforestation costs incurred by a partnership, S corporation, or estate must be made by the partnership, corporation, or estate. A partner, shareholder, or beneficiary cannot make that election. A partner’s or shareholder’s share of amortizable costs is figured in the general rules for allocating items of income, loss, deduction, etc., of a partnership or S corporation. The amortizable costs of an estate are divided between the estate and the income beneficiary based on the income of the estate allocable to each.

A trust cannot elect to amortize reforestation costs and share of any amortizable reforestation costs of a partnership, S corporation, or estate.

Qualifying costs. Reforestation costs are the direct costs of planting or seeding for reforestation or reforestation. Qualifying costs include only those costs you must capitalize and include in the adjusted basis of the property. They include costs for the following items:

- Site preparation.
- Seeds or seedlings.
- Labor.
- Tools.
- Depreciation on equipment used in planting and seeding.

Qualifying costs do not include costs for which the government reimburses you under a cost-sharing program, unless you include the reimbursement in your income.

Qualified timber property. Qualified timber property is property that contains trees in significant commercial quantities. It can be a woodlot or other site that you own or lease. The property qualifies only if it meets all of the following requirements:

- It is located in the United States.
- It is held for the growing and cutting of timber you own or have use in, or sell for use in, the commercial production of timber products.
- It consists of at least one acre planted with tree seedlings in the manner normally used in forestation or reforestation.

Qualified timber property does not include property on which you have planted shelter belts or ornamental trees, such as Christmas trees.

Amortization period. The 84-month amortization period starts on the first day of the first month of the second half of the tax year you incur the costs (July 1 for a calendar year tax payer), regardless of the month you actually incur the costs. You can claim amortization deductions for no more than 6 months of the first and last (eighth) tax years of the period.

Life tenant and remainderman. If one person holds the property for life with the remainder going to another person, the life tenant is entitled to the full amortization for qualifying reforestations costs incurred by the tenant. Any remainder interest in the property is ignored for amortization purposes.

Recapture. If you dispose of qualified timber property within 10 years after the tax year you incur qualifying reforestation expenses, report any gain as ordinary income up to the amortization you took. See chapter 3 of Publication 544 for more information.

Investment credit. Amortizable reforestation costs qualify for the investment credit, whether or not they are amortized. See the instructions for Form 3468 for information on the investment credit.

How to make the election. To elect to amortize qualifying reforestation costs, complete Part VI of Form 4562 and attach a statement that contains the following information:

- A description of the costs and the dates you incurred them.
- A description of 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 costs.

Generally, you must make the election on a timely filed return (including extensions) for the tax year in which you incurred the costs. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach Form 4562 and the statement to the amended return and write “Filed pursuant to section 301.9100-2” on Form 4562.
Geological and Geophysical Costs

You can amortize the cost of geological and geophysical expenses paid or incurred in connection with oil and gas exploration or development within the U.S. These costs can be amortized ratably over a 24-month period (a 5-year period for major integrated oil companies for costs paid or incurred after May 12, 2006) beginning on the mid-point of the tax year in which the expenses were paid or incurred.

If you retire or abandon the property during the 24-month amortization period, no amortization deduction is allowed in the year of retirement or abandonment.

Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility over 60 months. However, you can elect an optional 84-month period for major integrated oil companies items over an optional period after April 11, 2005. If acquired, the original use must begin with April 11, 2005. The facility must be used in connection with oil and gas exploration or development.

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. Also, it must not significantly change the nature of the manufacturing or production process or facility.

The federal certifying authority will not certify your property to the extent it appears you will recover (over the property’s useful life) all or part of its cost from the profit based on its operation (such as through sales of recovered wastes). The federal certifying authority will describe the nature of the potential cost recovery. You must then reduce the amortizable basis of the facility by this potential recovery.

New identifiable treatment facility. A new identifiable treatment facility is tangible depreciable property that is identifiable as a treatment facility. It does not include a building and its structural components unless the building is exclusively a treatment facility.

Atmospheric pollution control facilities. Certain atmospheric pollution control facilities can be amortized over 84 months. To qualify, the following must apply.

• The facility must be acquired and placed in service after April 11, 2005. If acquired, the original use must begin with April 11, 2005.
• The facility must be used in connection with an electric generation plant or other property placed in operation after December 31, 1975, that is primarily coal fired.
• If you construct, reconstruct, or erect the facility, only the basis attributable to the construction, reconstruction, or erection completed after April 11, 2005, qualifies.

Basis reduction for corporations. A corporation must reduce the amortizable basis of a pollution control facility by 20% before figuring the amortization deduction.

More information. For more information on the amortization of pollution control facilities, see Code sections 169 and 291(c) and the related regulations.

Research and Experimental Costs

You can elect to amortize your research and experimental costs, deduct them as current business expenses, or write them off. The month you first receive an economic benefit from the costs. For a definition of “research and experimental costs” and information on deducting them as current business expenses, see chapter 7.

Optional write-off method. Rather than amortize these costs or deduct them as a current expense, you have the option of deducting (writing off) research and experimental costs ratably over a 10-year period beginning with the tax year in which you incurred the costs.

Costs you can amortize. You can amortize costs chargeable to a capital account if you meet both the following requirements.

• You paid or incurred the costs in your trade or business.
• You are not deducting the costs currently.

How to make the election. To elect to amortize research and experimental costs, complete Part VI of Form 4562 and attach it to your income tax return. Generally, you must file the return by the due date (including extensions). However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach Form 4562 to the amended return and write “Filed pursuant to section 301.9100-2” on Form 4562. File the amended return at the same address you filed the original return.

Your election is binding for the year it is made. You may make an election for all later years unless you obtain approval from the IRS to change to a different method.

Optional Write-off of Certain Tax Preferences

You can elect to amortize certain tax preference items over an optional period beginning in the tax year in which you incurred the costs. If you make this election there is no AMT adjustment. The applicable costs and the optional recovery periods are as follows:

• Circulation costs — 3 years,
• Intangible drilling and development costs — 60 months,
• Mining exploration and development costs — 10 years, and
• Research and experimental costs — 10 years.

How to make the election. To elect to amortize qualifying costs over the optional recovery period, complete Part VI of Form 4562 and attach a statement containing the following information to your return for the tax year in which the election begins:

• Your name, address, and taxpayer identification number; and
• The type of cost and the specific amount of the cost for which you are making the election.

Generally, the election must be made on a timely filed return (including extensions) for the tax year in which you incurred the costs. However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach Form 4562 to the amended return and write “Filed pursuant to section 301.9100-2” on Form 4562. File the amended return.

Send the application to:
Internal Revenue Service
Associate Chief Counsel
Passthroughs and Special Industries
CC:PSI
1111 Constitution Ave., N.W., IR-5300
Washington, DC 20224
Depletion

Introduction
Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves.

There are two ways of figuring depletion: cost depletion and percentage depletion. For mineral property, you generally must use the method that gives you the larger deduction. For standing timber, you must use cost depletion.

Who Can Claim Depletion?

If you have an economic interest in mineral property or standing timber, you can take a deduction for depletion. More than one person can have an economic interest in the same mineral deposit or timber.

You have an economic interest if both the following apply:

- You have acquired by investment any interest in mineral deposits or standing timber.
- You have a legal right to income from the extraction of the mineral or cutting of the timber to which you must look for a return of your capital investment.

A contractual relationship that allows you an economic interest. A production payment carved out of, or retained on the sale of, mineral property is not an economic interest.

- Individuals, corporations, estates, and trusts who claim depletion deductions may be liable for alternative minimum tax.

Mineral Property

Mineral property includes oil and gas wells, mines, and other natural deposits (including geological deposits). For this purpose, the term "property" means each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat two or more separate interests as one property or as separate properties. See section 614 of the Internal Revenue Code and the related regulations for rules on how to treat separate mineral interests.

There are two ways of figuring depletion on mineral property:

- Cost depletion.
- Percentage depletion.

Generally, you must use the method that gives you the larger deduction. However, unless you are an independent producer or royalty owner, you generally cannot use percentage depletion for oil and gas wells. See Oil and Gas Wells, later.

Cost Depletion

To figure cost depletion you must first determine the following:

- The property's basis for depletion.
- The total recoverable units of mineral in the property's natural deposit.
- The number of units of mineral sold during the tax year.

Basis for depletion. To figure the property's basis for depletion, subtract all the following from the property's adjusted basis.

1. Amounts recoverable through:
   a. Depreciation deductions.
   b. Deferred expenses (including deferred exploration and development costs), and
   c. Deductions other than depletion.

2. The residual value of land and improvements at the end of operations.
3. The cost or value of land acquired for purposes other than mineral production.

Adjusted basis. The adjusted basis of your property is your original cost or other basis, plus certain additions and improvements, and minus certain deductions such as depletion allowed or allowable and casualty losses. Your adjusted basis can never be less than zero. See Publication 551, Basis of Assets, for more information on adjusted basis.

Total recoverable units. The total recoverable units is the sum of the following:

- The number of units of mineral remaining at the end of the year (including units recovered but not sold).
- The number of units of mineral sold during the tax year (determined under your method of accounting, as explained next).

You must estimate or determine recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products using the current industry method and the most accurate and reliable information you can obtain.

Number of units sold. You determine the number of units sold during the tax year based on your method of accounting. Use the following table to make this determination.

<table>
<thead>
<tr>
<th>IF you use …</th>
<th>THEN the units sold during the year are …</th>
</tr>
</thead>
<tbody>
<tr>
<td>The cash method of accounting</td>
<td>The units sold for which you receive payment during the tax year (regardless of the year of sale)</td>
</tr>
<tr>
<td>An accrual method of accounting</td>
<td>The units sold based on your inventories and method of accounting for inventory.</td>
</tr>
</tbody>
</table>

The number of units sold during the tax year does not include any for which depletion deductions were allowed or allowable in earlier years.

Figuring the cost depletion deduction. Once you have figured your property’s basis for depletion, the total recoverable units, and the number of units sold during the tax year, you can figure your cost depletion deduction by taking the following steps.

1. Divide your property’s basis for depletion by total recoverable units. Rate per unit.
2. Multiply the rate per unit by units sold during the tax year. Cost depletion deduction.

Note. You must keep accounts for the depletion of each property and adjust these accounts each year for units sold and depletion claimed.


To make the election, attach a statement to your timely filed (including extensions) original return for the first tax year for which the safe harbor is elected. The statement must indicate that you are electing the safe harbor provided by Revenue Procedure 2004-19. The election, if made, is effective for the tax year in which it is
made and all subsequent years. It cannot be revoked for the tax year in which it is elected, but may be revoked in a later year. Once revoked, it cannot be re-elected for the next 5 years.

**Percentage Depletion**

To figure percentage depletion, you multiply a certain percentage, specified for each mineral, by your gross income from the property during the tax year.

The rates to be used and other conditions and qualifications for oil and gas wells are discussed later under *Independent Producers and Royalty Owners* and under *Natural Gas Wells*. Rates and other rules for percentage depletion of other specific minerals are found later in *Mines and Geothermal Deposits*.

**Gross income.** When figuring your percentage depletion, subtract from your gross income from the property the following amounts:

- Any rents or royalties you paid or incurred for the property.
- The part of any bonus you paid for a lease on the property allocable to the product sold (or that otherwise gives rise to gross income) for the tax year.

A bonus payment includes amounts you paid as a lessee to satisfy a production payment retained by the lessor.

Use the following fraction to figure the part of the bonus you must subtract.

\[
\text{No. of units sold in the tax year} \times \text{Bonus property} \div \text{Payments}
\]

For oil and gas wells and geothermal deposits, gross income from the property is defined later under *Oil and Gas Wells*. For property other than a geothermal deposit or an oil and gas well, gross income from the property is defined later under *Mines and Geothermal Deposits*.

**Taxable income limit.** The percentage depletion deduction generally cannot be more than 50% (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction and the domestic production activities deduction.

Taxable income from the property means gross income from the property minus all allowable deductions (excluding any deduction for depletion or qualified domestic production activities) attributable to mining processes, including mining transportation. These deductible items include the following:

- Operating expenses.
- Certain selling expenses.
- Administrative and financial overhead.
- Depreciation.
- Intangible drilling and development costs.
- Exploration and development expenditures.

The following rules apply when figuring your taxable income from the property for purposes of the taxable income limit.

- Do not deduct any net operating loss deduction from the gross income from the property.
- Corporations do not deduct charitable contributions from the gross income from the property.
- If, during the year, you dispose of an item of section 1246 property that was used in conjunction with mineral property, reduce any allowable deduction for mining expenses by the part of any gain you must report as ordinary income that is allocable to the mineral property. See section 1.613-5(b)(1) of the regulations for information on how to figure the ordinary gain allocable to the property.

**Oil and Gas Wells**

You cannot claim percentage depletion for an oil or gas well unless at least one of the following applies.

- You are either an independent producer or a royalty owner.
- The well produces natural gas that is either sold under a fixed contract or produced from geopressured brine.

If you are an independent producer or royalty owner, see *Independent Producers and Royalty Owners*, next.

For information on the depletion deduction for wells that produce natural gas that is either sold under a fixed contract or produced from geopressured brine, see *Natural Gas Wells*, later.

**Independent Producers and Royalty Owners**

If you are an independent producer or royalty owner, you figure percentage depletion using a rate of 15% of the gross income from the property based on your average daily production of domestic crude oil or domestic natural gas up to your depletable oil or natural gas quantity. However, certain refiners, as explained next, and certain retailers and transferees of proven oil and gas properties, as explained later, cannot claim percentage depletion. For information on figuring the deduction, see *Figuring percentage depletion*, later.

Refiners who cannot claim percentage depletion. You cannot claim percentage depletion if you or a related person refine crude oil and you and the related person refined more than 75,000 barrels on any day during the tax year based on average (rather than actual) daily refinery runs for the tax year. The average daily refinery run is computed by dividing total refinery runs for the tax year by the total number of days in the tax year.

**Related person.** You and another person are related persons if either of you holds a significant ownership interest in the other person. For example, a corporation, partnership, estate, trust, or anyone who holds a significant ownership interest in it are related persons. A partnership and a trust are related persons if one person holds a significant ownership interest in each of them.

For purposes of the related person rules, significant ownership interest means direct or indirect ownership of 5% or more in any one of the following:

- The value of the outstanding stock of a corporation.
- The interest in the profits or capital of a partnership.
- The beneficial interests in an estate or trust.

Any interest owned by or for a corporation, partnership, trust, or estate is considered to be owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries.

Retailers who cannot claim percentage depletion. You cannot claim percentage depletion if both the following apply.

1. You sell oil or natural gas or their by-products directly or through a related person in any of the following situations:
   - Through a retail outlet operated by you or a related person.
   - To any person who is required under an agreement with you or a related person to use a trademark, trade name, or service mark or name owned by you or a related person in marketing or distributing oil, natural gas, or their by-products.
   - To any person given authority under an agreement with you or a related person to occupy any retail outlet owned, leased, or controlled by you or a related person.

2. The combined gross receipts from sales (not counting resales) of oil, natural gas, or their by-products by all retail outlets taken into account in (1) are more than $5 million for the tax year.

For the purpose of determining if this rule applies, do not count the following:

- Bulk sales (sales in very large quantities) of oil or natural gas to commercial or industrial users.
- Bulk sales of aviation fuels to the Department of Defense.
- Sales of oil or natural gas or their by-products outside the United States if none of your domestic production or that of a related person is exported during the tax year or the prior tax year.

**Related person.** To determine if you and another person are related persons, see *Related person under Refiners who cannot claim percentage depletion*, earlier.

**Sales through a related person.** You are considered to be selling through a related person if any sale by the related person produces gross income from which you may benefit because of your direct or indirect ownership interest in the person.
You are not considered to be selling through a related person who is a retailer if all the following apply:

1. You do not have a significant ownership interest in the retailer.
2. You sell your production to persons who are not related to either you or the retailer.
3. The retailer does not buy oil or natural gas from your customers or persons related to your production.
4. There are no arrangements for the retailer to acquire oil or natural gas you produced for resale or made available for purchase by the retailer.
5. Neither you nor the retailer knows of or controls the final disposition of the oil or natural gas you sold or the original source of the petroleum products the retailer acquired for resale.

Transferors who cannot claim percentage depletion. You cannot claim percentage depletion if you received your interest in a proven oil or gas property by transfer after 1974 and before October 12, 1990. For a definition of the term "transfer," see section 1613A-7(n) of the regulations. For a definition of the term "interest in proven oil or gas property," see section 1613A-7(p) of the regulations.

Figuring percentage depletion. Generally, as an independent producer or royalty owner, you figure your percentage depletion by computing your average daily production of domestic oil or gas and comparing it to your depletable oil or gas quantity. If your average daily production does not exceed your depletable oil or gas quantity, you figure your percentage depletion by multiplying the gross income from the oil or gas property (defined later) by 15%. If your average daily production of domestic oil or gas exceeds your depletable oil or gas quantity, you must make an allocation as explained later under Average daily production exceeds depletable quantities.

In addition, there is a limit on the percentage depletion deduction. See Taxable income limit, later.

Average daily production. Figure your average daily production by dividing your total domestic or custodial oil or gas for the tax year by the number of days in your tax year.

Partial interest. If you have a partial interest in the production from a property, figure your share of the production by multiplying total production from the property by your percentage of interest in the revenues from the property.

You have a partial interest in the production from a property if you have a net profits interest in the property. To figure the share of production for your net profits interest, you must first 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. Then multiply the total production from the property by your percentage participation to figure your share of the production.

Example. John Oak owns oil property in which Paul Elm owns a 20% net profits interest. During the year, the property produced 10,000 barrels of oil, which John sold for $200,000. John had expenses of $90,000 attributable to the property. The property generated a net profit of $100,000 ($200,000 - $90,000). Paul received a 20% share in the gross revenue from the property. Paul determined his share of the oil production to be 1,100 barrels (10,000 barrels x 11%).

Depletable oil or natural gas quantity. Generally, your depletable oil quantity is 1,000 barrels. Your depletable natural gas quantity is 6,000 cubic feet multiplied by the number of barrels of your depletable oil quantity that you choose to apply. If you claim depletion on both oil and natural gas, you must reduce your depletable oil quantity (1,000 barrels) by the number of barrels you use to figure your depletable natural gas quantity.

Example. You have both oil and natural gas production. To figure your depletable natural gas quantity, you choose to apply 360 barrels of your 1000-barrel depletable oil quantity. Your depletable natural gas quantity is 2.16 million cubic feet of gas (360 x 6000). You must reduce your depletable oil quantity to 640 barrels (1000 - 360).

If you have production from marginal wells, see section 613A(c)(6) of the Internal Revenue Code to figure your depletable oil or natural gas quantity.

Business entities and family members. You must allocate the depletable oil or gas quantity among the following related persons in proportion to each entity's or family member's production of domestic oil or gas for the year:

1. Corporations, trusts, and estates if 50% or more of the beneficial interest is owned by the same or related persons (considering only persons that own at least 5% of the beneficial interest).
2. You and your spouse and minor children.

A related person is anyone mentioned in the related persons discussion under Non-deductible loss in chapter 2 of Publication 544, except that for purposes of this allocation, item (1) in that discussion includes only an individual, his or her spouse, and minor children.

Controlled group of corporations. Members of the same controlled group of corporations are treated as one taxpayer when figuring the depletable oil or natural gas quantity. They share the depletable quantity. Under these rules, a controlled group of corporations is defined in section 1563(a) of the Internal Revenue Code, except that the stock ownership requirement in that definition is "more than 50%" rather than "at least 80%.

Gross income from the property. For purposes of percentage depletion, gross income from the property (in the case of oil and gas wells) 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.

For oil you sold after you removed it from the premises for a price that is lower than the RMFP, determine gross income from the property for percentage depletion purposes 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.

Average daily production exceeds depletable quantities. If your average daily production for the year is more than your depletable oil or natural gas quantity, figure your allowance for depletion for each domestic oil or natural gas property as follows:

1. Figure your average daily production of oil or natural gas for the year.
2. Figure your depletable oil or natural gas quantity for the year.
3. Figure depletion for all oil or natural gas produced from the property using a percentage depletion rate of 15%.
4. Multiply the result figured in (3) by a fraction, the numerator of which is the result figured in (2) and the denominator of which is the result figured in (1). This is your depletion allowance for that property for the year.

Taxable income limit. If you are an independent producer or royalty owner of oil and gas, your deduction for percentage depletion is limited to the smaller of the following:

1. 100% of your taxable income from all sources, figured without the depletion deduction for depletion and the deduction for domestic production activities under section 199 of the Internal Revenue Code. For a definition of taxable income from the property, see Taxable income limit, earlier, under Mineral Property.
2. 65% of your taxable income from all sources, figured without the depletion allowance, the deduction for domestic production activities, any net operating loss carryback, and any capital loss carryback.

You can carry over to the following year any amount you cannot deduct because of the 65%-of-taxable-income limit. Add it to your depletion allowance (before applying any limits) for the following year.

Note. Depletion on the marginal production of oil or natural gas is not limited to your taxable income from the property figured without the depletion deduction. For information on marginal production, see section 613A(c)(6) of the Internal Revenue Code.

Partnerships and S Corporations

Generally, each partner or shareholder, and not the partnership or S corporation, figures the depletion allowance separately. (However, see
Elected large partnerships must figure depletion whereas, later) Each partner or shareholder must decide whether to use cost or depletion allowance. If a partner or shareholder uses percentage depletion, he or she must apply the 65%-of-taxable-income limit using his or her taxable income from all sources.

Partner’s or shareholder’s adjusted basis. The partnership or S corporation must allocate to each partner or shareholder his or her share of the adjusted basis of each oil or gas property held by the partnership or S corporation. The partnership or S corporation makes the allocation as of the date it acquires the oil or gas property.

Each partner’s share of the adjusted basis of the oil or gas property generally is figured according to the partner’s interest in partnership income. The partnership or S corporation adjusts the partner’s or shareholder’s share of the adjusted basis of the oil or gas property for any capital expenditures made for the property and for any change in partnership or S corporation interests. Each partner or shareholder must separately keep records of his or her share of the adjusted basis in each oil and gas property of the partnership or S corporation. The partner or shareholder must reduce his or her adjusted basis by the depletion allowed or allowable on the property each year. The partner or shareholder must use that reduced adjusted basis to figure cost depletion or his or her gain or loss if the partnership or S corporation disposes of the property.

Reporting the deduction. Information that you, as a partner or shareholder, use to figure your depletion deduction on oil and gas properties is reported by the partnership or S corporation on Schedule K-1 (Form 1065) or on Schedule K-1 (Form 1120S). Deduct oil and gas depletion for your partnership or S corporation interest on Schedule E (Form 1040). The instructions for Schedule E explain where to report this income or loss and whether you need to file either of the following forms.

- Form 6198, At-Risk Limitations.
- Form 8582, Passive Activity Loss Limitations.

Elected large partnerships must figure depletion allowance. An elected large partnership, rather than each partner, generally must figure the depletion allowance. The partnership figures the depletion allowance without taking into account the 65-percent-of-taxable-income limit and the depletable oil or natural gas quantity. Also, the adjusted basis of a partner’s interest in the partnership is not affected by the depletion allowance.

An elected large partnership is one that meets both the following requirements.

- The partnership had 100 or more partners in the preceding year.
- The partnership chooses to be an elected large partnership.

Disqualified persons. An elected large partnership does not figure the depletion allowance of its partners that are disqualified persons. Disqualified persons must figure it themselves, as explained earlier. All the following are disqualified persons.

- Refiners who cannot claim percentage depletion (discussed under Independent Producers and Royalty Owners, earlier).
- Retailers who cannot claim percentage depletion (discussed under Independent Producers and Royalty Owners, earlier).
- Any partner whose average daily production of domestic crude oil and natural gas is more than 500 barrels during the tax year in which the partnership tax year ends. Average daily production is discussed earlier.

Natural Gas Wells

You can use percentage depletion for a well that produces natural gas either sold under a fixed contract or produced from geopressurized brine. Natural gas sold under a fixed contract. Natural gas sold under a fixed contract qualifies for a percentage depletion rate of 22%. This is domestic natural gas sold by the producer under a contract that does not provide for a price increase to reflect any increase in the seller’s tax liability because of the repeal of percentage depletion for gas. The contract must have been in effect from February 1, 1975, until the date of sale of the gas. Price increases after February 1, 1975, are presumed to take the increase in tax liability into account unless demonstrated otherwise by clear and convincing evidence.

Natural gas from geopressurized brine. Qualifed natural gas from geopressurized brine is eligible for a percentage depletion rate of 10%. This is natural gas that is both the following.

- Produced from a well you began to drill after September 1978 and before 1984.
- Determined in accordance with section 503 of the Natural Gas Policy Act of 1978 to be produced from geopressurized brine.

Mines and Geothermal Deposits

Certain minerals, wells, and other natural deposits, including geothermal deposits, qualify for percentage depletion. Mines and other natural deposits. For a natural deposit, the percentage of your gross income from the property that you can deduct as depletion depends on the type of deposit.

The following is a list of the percentage depletion rates for the more common minerals.

<table>
<thead>
<tr>
<th>DEPOSITS</th>
<th>RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>sulphur, uranium, and, if from deposits in the United States, asbestos, lead ore, zinc ore, nickel ore, and mica</td>
<td>22%</td>
</tr>
<tr>
<td>Gold, silver, copper, iron ore, and certain oil shale, if from deposits in the United States</td>
<td>15%</td>
</tr>
<tr>
<td>Borax, granite, limestone, marble, mollusk shells, potash, slate, soapstone, and carbon dioxide produced from a well</td>
<td>14%</td>
</tr>
<tr>
<td>Coal, lignite, and sodium chloride</td>
<td>10%</td>
</tr>
</tbody>
</table>
| Clay and shale used or sold for use in making sewer pipe or bricks or used or sold for use as sintered or burned lightweight aggregates | 71/2%
| Clay used or sold for use in making drainage and roofing tile, flower pots, and kindred products, and gravel, sand, and stone (other than stone used or sold for use by a mine owner or operator as dimension or ornamental stone) | 5%

You can find a complete list of minerals and their percentage depletion rates in section 613(b) of the Internal Revenue Code.

Corporate deduction for iron ore and coal. The percentage depletion deduction of a corporation for iron ore and coal (including lignite) is reduced by 20% of:

- The percentage depletion deduction for the tax year (figured without regard to this reduction), minus
- The adjusted basis of the property at the close of the tax year (figured without the depletion deduction for the tax year).

Gross income from the property. For property other than a geothermal deposit or an oil or gas well, gross income from the property means the gross income from mining. Mining includes all the following.

- Extracting ores or minerals from the ground.
- Applying certain treatment processes.
- Transporting ores or minerals (generally, not more than 50 miles) from the point of extraction to the plants or mills in which the treatment processes are applied.

Excise tax. Gross income from mining includes the separately stated excise tax received by a mine operator from the sale of coal to compensate the operator for the excise tax the mine operator must pay to finance black lung benefits.

Extraction. Extracting ores or minerals from the ground includes extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. This does not apply to extraction from waste or residue of prior mining by the purchaser of the waste or residue or the purchaser of the rights to extract ores or minerals from the waste or residue.

Treatment processes. The processes included as mining depend on the ore or mineral mined. To qualify as mining, the treatment processes must be applied by the mine owner or operator. For a listing of treatment processes considered as mining, see section 613(c)(4) of the Internal Revenue Code and the related regulations.

Transportation of more than 50 miles. If the IRS finds that the ore or mineral must be transported more than 50 miles to plants or mills...
to be treated because of physical and other requirements, the additional authorized trans- portation is considered mining and 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 with the IRS. Include on the application the facts concerning the physical and other requirements which prevented the construction and operation of the plant within 50 miles of the point of extraction. Send this application to:

Internal Revenue Service
Associate Chief Counsel
Passthoughts and Special Industries
CC:PSI:FO
1111 Constitution Ave., N.W., IR-5300
Washington, DC 20224

Disposal of coal or iron ore. You cannot take a depletion deduction for coal (including lignite) or iron ore mined in the United States if both the following apply.

- You disposed of it after holding it for more than 1 year.
- You disposed of it under a contract under which you retain an economic interest in the coal or iron ore.

Treat any gain on the disposition as a capital gain.

Disposal to related person. This rule does not apply if you dispose of the coal or iron ore to one of the following persons.

- A related person (as listed in chapter 2 of this publication).
- A person owned or controlled by the same interests that own or control you.

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. For percentage depletion purposes, a geothermal deposit is not considered a gas well.

Figure gross income from the property for a geothermal steam well in the same way as for oil and gas wells. See Gross income from the property, earlier, under Oil and Gas Wells. Percentage depletion on a geothermal deposit cannot be more than 50% of your taxable income from the property.

**Lessor’s Gross Income**

A lessor’s gross income from the property that qualifies for percentage depletion usually is the total of the royalties received from the lease. However, for oil, gas, or geothermal property, gross income does not include lease bonuses, advanced royalties, or other amounts payable without regard to production from the property.

**Bonuses and advanced royalties.** Bonuses and advanced royalties are payments a lessee makes before production to a lessor for the grant of rights in a lease or for minerals, gas, or oil to be extracted from leased property. If you are the lessor, your income from bonuses and advanced royalties received is subject to an allowance for depletion.

**Figuring cost depletion.** To figure cost depletion on a bonus, multiply your adjusted basis in the property by a fraction, the numerator of which is the bonus and the denominator 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 number of units for which the advanced royalty is received as the number of units sold.

**Figuring percentage depletion.** In the case of mines, wells, and other natural deposits other than gas, oil, or geothermal property, you may use the percentage rates discussed earlier under Mines and Geothermal Deposits. Any bonus or advanced royalty payments are generally a part of the gross income from the property to which the rates are applied in making the calculation. However, in the case of independent produc- ers and royalty owners of oil and gas property, bonuses and advanced royalty payments are not a part of gross income.

**Terminating the lease.** If you receive a bonus on a lease that expires, terminates, or is abandoned before you derive any income from the extraction of mineral, include in income for the year of lease termination, the termination, or abandon- ment, 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 for the year of lease termination, the depletion claimed on minerals for which the advanced royalties were paid if the minerals were not pro- duced before termination. Increase your ad- justed basis in the property by the amount you include in income.

**Delay rentals.** These are payments for defer- ring development of the property. Since delay rentals are ordinary rent, they are ordinary in- come that is not subject to depletion. These rentals can be avoided by either abandoning the lease, beginning development operations, or obtaining production.

**Timber**

You can figure timber depletion only by the cost method. Percentage depletion does not apply to timber. Base your depletion on your cost or other basis in the timber. Your cost does not include the cost of land or any amounts recoverable through depreciation.

Depletion takes place when you cut standing timber. You can figure your depletion deduction when you actually cut timber is first accurately measured in the process of exploitation.

**Figuring cost depletion.** To figure your cost depletion allowance, you multiply the number of timber units cut by your depletion unit.

**Timber units.** When you acquire timber property, you must make an estimate of the quantity of marketable timber that exists on the property. You measure the timber using board foot, log scale, cords, or other units. If you later determine that you have more or less units of timber, you must adjust the original estimate. The term "timber property" means your eco- nomic interest in standing timber in each tract or block representing a separate timber account.

**Depletion unit.** You figure your depletion unit each year by taking the following steps.

1. Determine your cost or adjusted basis of the timber on hand at the beginning of the year. Adjusted basis is defined under Cost Depletion in the discussion on Mineral Property.
2. Add to the amount determined in (1) the cost of any timber units acquired during the year and any additions to capital.
3. Figure the number of timber units to take into account by adding the number of tim- ber units acquired during the year to the number of timber units on hand in the ac- count at the beginning of the year and then subtracting (or subtracting) any correction to the estimate of the number of timber 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 $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 ($80,000 ÷ 1,000). If you cut 500 MBF of timber, your deple- tion allowance would be $40,000 (500 MBF × $80).

When to claim depletion. Claim your deple- tion allowance as a deduction in the year of sale or other disposition of the products cut from the timber, unless you choose to treat the cutting of timber as a sale or exchange (explained below). Include allowable depletion for timber products not sold during the tax year the timber is cut as a cost item in the closing inventory of timber prod- ucts for the year. The inventory is your basis for determining gain or loss in the tax year you sell the timber products.

**Example.** Assume the same facts as in the previous example except that you sold only half of the timber products in the cutting year. You would deduct $20,000 of the $40,000 depletion for that year. You would add the remaining $20,000 depletion to your closing inventory of timber products.

**Eating to treat the cutting of timber as a sale or exchange.** You can elect, under cer- tain circumstances, to treat the cutting of timber held for more than 1 year as a sale or exchange. You must make the election on your income tax return for the tax year to which it applies. If you make this election, subtract the adjusted basis for depletion from the fair market value of the timber on the first day of the tax year in which you cut it to figure the gain or loss on the cutting. You generally report the gain as long-term capi- tal 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. For more information, see Timber in chapter 2 of Publication 544, Sales and Other Dispositions of Assets.
You may revoke an election to treat the cutting of timber as a sale or exchange without IRS’s consent. The prior election (and revocation) is disregarded for purposes of making a subsequent election. See Form T (Timber), Forest Activities Schedule, for more information.

Form T. Complete and attach Form T (Timber) to your income tax return if you claim a deduction for timber depletion, choose to treat the cutting of timber as a sale or exchange, or make an outright sale of timber.

10.

Business Bad Debts

Introduction

If someone owes you money that you are not going to be able to collect, you have a bad debt. There are two kinds of bad debts—business and nonbusiness. This chapter discusses only business bad debts.

Generally, a business bad debt is one that comes from operating your trade or business. You can deduct business bad debts on your business income tax return. All other bad debts are nonbusiness bad debts and are deductible only as short-term capital losses on Schedule D (Form 1040). For more information on nonbusiness bad debts, see Publication 550.

Topics

This chapter discusses:

- Definition of business bad debt
- When a debt becomes worthless
- How to treat business bad debts
- Recovery of a business bad debt

Useful Items

You may want to see:

- Publication
  - 525 Taxable and Nontaxable Income
  - 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
  - 544 Sales and Other Dispositions of Assets
  - 550 Investment Income and Expenses
  - 556 Examination of Returns, Appeal Rights, and Claims for Refund

See chapter 12 for information about getting publications and forms.

Definition of a Business Bad Debt

A business bad debt is a loss from the worthlessness of a debt that is either:

- Created or acquired in your trade or business, or
- Closely related to your trade or business when it became partly or totally worthless.

A debt is closely related to your trade or business if your primary motive for incurring the debt is business related. Bad debts of a corporation are always business bad debts.

Credit sales. Business bad debts are mainly the result of credit sales to customers. Goods that have been sold, but not yet paid for, and services that have been performed, but not yet paid for, are recorded in your books as accounts receivable or notes receivable. After a reasonable period of time, if you have tried to collect the amount due, but are unable to do so, the uncollectible part becomes a business bad debt.

Accounts or notes receivable valued at fair market value (FMV) when received are deductible only at that value, even though the FMV may be less than the face value. If you purchased an account receivable for less than its face value, and the receivable subsequently becomes worthless, the most you are allowed to deduct is the amount you paid to acquire it.

You can claim a bad debt deduction only if the amount owed to you was previously included in gross income. This applies to amounts owed to you from all sources of taxable income, including sales, services, rents, and interest.

Accrual method. If you use the accrual method of accounting, generally, you report income as you earn it. You can only claim a bad debt deduction for an uncollectible receivable if you have previously included the entire uncollectible amount in income.

If you qualify, you can use the nonaccrual-experience method of accounting discussed later. Under this method, you do not have to accrue income that, based on your experience, you do not expect to collect.

Cash method. If you use the cash method of accounting, generally, you report income when you receive payment. You cannot claim a bad debt deduction for amounts owed to you because you never included those amounts in income. For example, a cash basis architect cannot claim a bad debt deduction if a client fails to pay the bill because the architect’s fee was never included in income.

Debts from a former business. If you sell your business but retain its receivables, these debts are business bad debts because they arose out of your trade or business. If any of these receivables subsequently become worthless, the loss is still a business bad debt.

Debt acquired from a decedent. The character of a loss from debts of a business acquired from a decedent is determined in the same way as debts sold by a business. The executor of the decedent’s estate treats any loss from the debts as a business bad debt if the debts were closely related to the decedent’s trade or business when they became worthless. Otherwise, a loss from these debts becomes a nonbusiness bad debt for the decedent’s estate.

Liquidation. If you liquidate your business and some of your receivables become worthless, they become business bad debts.

Types of Business Bad Debts

The following are situations that may result in a business bad debt.

Loans to clients and suppliers. If you loan money to a client, supplier, employee, or distributor for a business reason and subsequently, after making attempts to collect, the loan receivable becomes worthless, you have a business bad debt.

Debts of 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 can claim a bad debt deduction only if you use an accrual method of accounting and meet all the following tests.

1. The debt arose from the sale of goods or services in the ordinary course of your trade or business.
2. More than 30% of your receivables accrued in the year of the sale were from sales to political parties.
3. You made substantial and continuing efforts to collect on the debt.

Loan or capital contribution. You cannot claim a bad debt deduction for a loan you made to a corporation if, based on the facts and circumstances, the loan is actually a contribution to capital.

Debts of an insolvent partner. If your business partnership breaks up and one of your former partners becomes insolvent, you may have to pay more than your pro rata share. If you pay any part of the insolvent partner’s share of the debts, you can claim a bad debt deduction for the amount you paid that is attributable to the insolvent partner’s share.

Business loan guarantee. If you guarantee a debt that subsequently becomes worthless, the business can qualify as a business bad debt if all the following requirements are met.

- You made the guarantee in the course of your trade or business.
- You have a legal duty to pay the debt.
- You made the guarantee before the debt became worthless. You meet this requirement if you reasonably expected you would not have to pay the debt without full reimbursement from the issuer.
- You receive reasonable consideration for making the guarantee. You meet this requirement if you made the guarantee in accord with normal business practice or for a good faith business purpose.
Property in partial settlement of a debt, reduce receipts test if your average annual gross receipts is £5 million. If you receive property for debt, you can deduct the amount of the debt. If you make a payment on a loan you guaranteed, you can deduct it in the year paid, 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 claim a bad debt deduction until these rights become partly or totally worthless.

Joint debtor. If two or more debtors jointly owe you money, your inability to collect from one does not enable you to deduct a proportionate amount as a bad debt.

Sale of mortgaged property. If mortgaged or pledged property is sold for less than the debt, the unpaid, uncollectible balance of the debt is a bad debt.

### When Debt Becomes Worthless

You do not have to wait until a debt is due to determine whether it is worthless. A debt becomes worthless when there is no longer any chance the amount owed will be paid. If you later sell the property, any gain on the sale is due to the appreciation of the property. It is not a recovery of a bad debt. For information on the sale of an asset, see Publication 544.

### How To Claim a Business Bad Debt

There are two methods to claim a business bad debt.

- The specific charge-off method.
- The nonaccrual-experience method. Generally, you must use the specific charge-off method. However, you may use the nonaccrual-experience method if you meet the requirements discussed later under Non accrual-Experience Method.

### 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 become partly uncollectible during the tax year. Your tax deduction is limited to the amount you charge off on your books during the year. You do not have to charge off and deduct your partly worthless debts annually. You can delay the charge off until a later year. However, you cannot deduct any part of a debt after the year it becomes totally worthless.

Significantly modified debt. An exception to the charge-off rule exists for debts that have been significantly modified and on which the holder recognized gain. For more information, see Regulations section 1.166-3(i)3(a)(3).

Deduction disallowed. Generally, you can claim a partial bad debt deduction only in the year you make the charge-off on your books. If, under audit, the IRS does not allow your deduction and the debt becomes partly worthless in a later tax year, you can deduct the amount you charge off in that year plus the disallowed 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. If a debt becomes totally worthless in the current tax year, you can deduct the entire amount, less 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, if you make a claim, the IRS must notify you. You will not be allowed a deduction for the debt in that tax year. A deduction of a partly worthless debt is limited to the amount actually charged off.

Filing a claim for refund. If you did not deduct a bad debt on your original return for the year it became worthless, you can file a claim for a credit or refund. If the bad debt was totally worthless, you must file the claim by the later of the following dates:

- 7 years from the date your original return was due (not including extensions).
- 2 years from the date you paid the tax.

If the claim is for a partly worthless bad debt, you must file the claim by the later of the following dates:

- 3 years from the date you filed your original return.
- 2 years from the date you paid the tax.

You may have longer to file the claim if you were unable to manage your financial affairs due to a physical or mental impairment. Such an impairment requires proof of existence. See Code section 6511(h).

For details and more information about filing a claim, see Publication 556. Use one of the following forms to file a claim.

**Table 11-1. Forms Used To File a Claim**

<table>
<thead>
<tr>
<th>Form Number</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1040X</td>
<td>Sole proprietor or farmer</td>
</tr>
<tr>
<td>1120X</td>
<td>Corporation</td>
</tr>
<tr>
<td>1120S (check box F(5))</td>
<td>S corporation</td>
</tr>
<tr>
<td>1065 (check box G(5))</td>
<td>Partnership</td>
</tr>
</tbody>
</table>

**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 for bad debts. Under this method, you do not accrue service related income you expect to be uncollectible.

Generally, you can use the nonaccrual-experience method for accounts receivable for services you performed only if:

- The services are provided in the fields of accounting, actuarial science, architecture, consulting, engineering, health, law, or the performing arts, or
- You meet the $5 million gross receipts test for all prior years.

**Service related income.** You can use the nonaccrual-experience method only for amounts earned by performing services. 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 payment.

**Gross receipts test.** You meet the gross receipts test if your average annual gross receipts for the 3 prior tax years does not exceed $5,000,000.

**Interest or penalty charged.** 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 a discount offered for early payment as the charging of interest or a penalty if both the following apply:

- You otherwise accrue the full amount due as gross income at the time you provide the services.
- You treat the discount allowed for early payment as an adjustment to gross income in the year of payment.
Recovery of a Bad Debt

If you claim a deduction for a bad debt on your income tax return and later recover (collect) all or part of it, you may have to include all or part of the recovery in gross income. The amount you include is limited to the amount you actually deducted. However, you can exclude the amount deducted that did not reduce your tax. Report the recovery as “Other income” on the appropriate business form or schedule.

See Recoveries in Publication 525 for more information.

Net operating loss (NOL) carryover. If a bad debt deduction increases an NOL carryover that has not expired before the beginning of the tax year in which the recovery takes place, you treat the deduction as having reduced your tax. 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 about net operating losses.

Methods available. You can use any of the following nonaccrual-experience methods.

• 6-year moving average method.
• Actual experience method.
• Modified Black Motor method.
• Modified 6-year moving average method.
• Alternative nonaccrual-experience method.

Apply the nonaccrual-experience method separately to each account receivable.

Generally, you cannot change from one method to another without IRS approval. You may be able to obtain automatic consent to change your method of accounting. See Regulations section 1.448-2 for more information on obtaining consent to change to a nonaccrual-experience method (other than one of the safe harbor methods) or to change from one method to another.

For more information about the nonaccrual-experience method, including the $5 million gross receipts test, see Code section 448(d)(5) and Regulations section 1.448-2.

Introduction

This chapter covers business expenses that may not have been explained to you, as a business owner, in previous chapters of this publication.

Table 11–1. Reporting Reimbursements

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

No reimbursement plan:

| Either adequate accounting or return of excess, or both, not required by plan | The entire amount as wages in box 1. |

Reimbursement of Travel, Meals, and Entertainment

The following discussion explains how to handle any reimbursements or allowances you may provide for travel, meals, and entertainment expenses when incurred by your employees. If you are self-employed and report your income and expenses on Schedule C or C-EZ (Form 1040), see Publication 463.

To be deductible for tax purposes, expenses incurred for travel, meals, and entertainment must be ordinary and necessary expenses incurred while carrying on your trade or business. Generally, you also must show that entertainment expenses (including meals) are directly related to, or associated with, the conduct of your trade or business. For more information on travel, meals, and entertainment, including deductibility, see Publication 463.

Reimbursements

A “reimbursement or allowance arrangement” provides for payment of advances, reimbursements, and charges for travel, meals, and entertainment expenses incurred by your employees.
during the ordinary course of business. Upon satisfying your established substantiation re-
requirements, you can deduct the allowable amount on your tax return. Because of differ-
ences between accounting methods and tax law, these amounts may not be the same. For
example, you may deduct 100% of the cost of meals on your business books and records.
However, for tax purposes, only 50% of these costs are allowed by law as a tax deduction.
A reimbursement or allowance arrangement (including per diem allowances, discussed later)
depends on whether you have: (1) an accountable
- plan or (2) a nonaccountable plan. If you
reimburse these expenses under a accountable
- plan, then you can deduct the amount allow-
able to the extent of the tax law as travel, meal,
and entertainment expenses on your tax return.
If you reimburse these expenses under a nonaccountable plan, then you must report the
reimbursements as wages on Form W-2, Wage
and Tax Statement, and deduct them as wages on the appropriate line of your tax return. If you
make a single payment to your employees and it includes both wages and an expense reim-
bursement, you must specify the amount attribu-
table to reimbursement and report it accordingly.
See Table 11–1, Reporting Reimbursements.

Accountable Plans
An accountable plan, requires your employees to meet all of the following requirements. They
must:

1. Have paid or incurred deductible expenses while performing services as your employ-
   ees.
2. Adequately account to you for these ex-
   penses within a reasonable period of time, and
3. Return any excess reimbursement or al-
   lowance within a reasonable period of time.

An arrangement under which you advance
money to employees is treated as meeting (3) above only if the following requirements are also met:

• The advance is reasonably calculated not to exceed the amount of anticipated ex-
  penses.
• You make the advance within a reasona-
  ble period of time.

If any expenses reimbursed under this ar-
rangement are not substantiated, or an excess reimbursement is not returned within a reasona-
ble period of time by an employee, you are not allowed to deduct these expenses as reim-
ursed under an accountable plan. Instead, treat the reimbursed expenses as paid under a
nonaccountable plan, discussed later.

Adequate accounting. Your employees must adequately account to you for their travel,
meals, and entertainment expenses. They must give you documentary evidence of their travel,
 mileage, and other employee business ex-
penses. This evidence should include items such as receipts, along with either a statement
of expenses, an account book, a day-planner, or similar record in which the employee entered
each expense at or near the time the expense was incurred.

Excess reimbursement or allowance. An
excess reimbursement or allowance is any amount pay to an employee that is more than the business-related expenses for which the employee adequately accounted. The em-
ployee must return any excess reimbursement or allowance to you within a rea-
sonable period of time.

Reasonable period of time. A reasonable
period of time depends on the facts and circum-
stances. Generally, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

1. You give an advance within 30 days of the time the employee has incurred the ex-
   pense.
2. Your employees adequately account for their expenses within 60 days after the ex-
   penses were paid or incurred.
3. Your employees return any excess reim-
   bursement within 120 days after the ex-
   penses were paid or incurred.
4. You give a periodic statement (at least quarterly) to your employees that asks them to either return or adequately ac-
   count for outstanding advances and they comply within 120 days of the date of the statement.

How to deduct. You can claim a deduction for travel, meals, and entertainment expenses if you reimburse your employees for these ex-
penses under an accountable plan. Generally, the amount you can deduct for meals and enter-
tainment, is subject to a 50% limit, discussed later. If you are a sole proprietor, or are filing as a single member Limited Liability Company, de-
duct the reimbursement on line 24b, Schedule C (Form 1040) or line 2, Schedule C-EZ (Form
1040).

If you are filing an income tax return for a corporation, the reimbursement should be in-
cluded with the amount claimed on the Other
deductions line of Form 1120, U.S. Corporation
Income Tax Return, or Form 1120-A, U.S. Cor-
poration Short-Form Income Tax Return. If you are filing any other business 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.

Per Diem and Car Allowances
You may reimburse your employees under an accountable plan based on travel days, miles, or
some other fixed allowance. In these cases, your employee is considered to have accounted to you for the amount of the expense that does not exceed the rates established by the federal government. Your employee must actually sub-
stantiate to you the other elements of the ex-
 pense, such as time, place, and business
purpose.

Federal rate. The federal rate can be figured using any one of the following methods.

1. For per diem amounts:
   a. The regular federal per diem rate.
   b. The standard meal allowance.
   c. The high-low rate.
2. For car expenses:
   a. The standard mileage rate.
   b. A fixed and variable rate (FAVR).

Car allowance. Your employee is considered to have accounted to you for car expenses that do not exceed the standard mileage rate. For 2006, the standard mileage rate for each busi-
ness mile is 44.5 cents per mile for all business miles.

You can choose to reimburse your employ-
ees using a fixed and variable rate (FAVR) al-
lowance. This is an allowance that includes a combination of payments covering fixed and va-
 riable costs, such as a cents-per-mile rate to cover your employees' variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your employees' fixed costs (such as deprecia-
tion, insurance, etc.). For information on using a FAVR allowance, see Revenue Procedure

You can read Revenue Procedure 2006-41 at many public libraries or online at www.irs.gov.

Per diem allowance. If your employee actu-
ally substantiates to you the other elements (dis-
cussed earlier) of the expenses reimbursed using the per diem allowance, how you report
and deduct the allowance depends on whether the allowance is for lodging and meal expenses or for meal expenses only and whether the al-
lowance is more than the federal rate.

Regular federal per diem rate. The regular
federal per diem rate is the highest amount the federal government will pay to its employees while away from home on travel. It has two components:

1. Lodging expense, and
2. Meal and incidental expense (M & IE).

The rates are different for different locations. Publication 1542 lists the rates in the continental United States.

Standard meal allowance. The federal rate for meal and incidental expenses (M & IE) is the standard meal allowance. You may pay only an M & IE allowance to employees who travel away from home if:

• You pay the employee for actual expenses for lodging based on receipts submitted to you.
• You provide for the lodging.
• You pay for the actual expense of the lodging directly to the provider,
• You do not have reasonable belief that lodging expenses were incurred by the employee, or
• The allowance is computed on a basis similar to that used in computing the em-
ployee's wages (that is, number of hours worked or miles traveled).
High-low method. This is a simplified method of computing the federal per diem rate for lodging and meal expenses for traveling 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. Under a high-low method, the per diem amount for travel during 2006 is $226 ($58 for M & IE) for certain high-cost locations. All other areas have a per diem amount of $141 ($45 for M & IE). The high-cost locations eligible for the $226 per diem amount under the high-low method are listed in Publication 1542.

Reports per diem and car allowances. The following discussion explains how to report per diem and car allowances. The manner in which you report them depends on how the allowance compares to the federal rate. See Table 11-1.

Allowance less than or equal to the federal rate. If your allowance for the employee is less than or equal to the appropriate federal rate, that allowance is not included as part of the employee's pay in box 1 of the employee's Form W-2. Deduct the allowance as travel expenses (including meals that may be subject to the 50% limit, discussed later). See How to deduct under Accountable Plans, earlier.

Allowance more than the federal rate. If your employee's allowance is more than the appropriate federal rate, you must report the allowance as two separate items.

Include the allowance amount up to the federal rate in box 12 (code L) of the employee's Form W-2. Deduct it as travel expenses (as explained above). This part of the allowance is treated as reimbursed under an accountable plan.

Include the amount that is more than the federal rate in box 1 (and in boxes 3 and 5 if they apply) of the employee's Form W-2. Deduct it as wages subject to income tax withholding, social security, Medicare, and federal unemployment taxes. This part of the allowance is treated as reimbursed under a nonaccountable plan as explained later under Nonaccountable Plans.

Meals and Entertainment

Under an accountable plan, you can generally deduct only 50% of any otherwise deductible business-related meal and entertainment expenses you reimburse your employees. The deduction limit applies even if you reimburse them for 100% of the expenses.

Application of the 50% limit. The 50% deduction limit applies to reimbursements you make to your employees for expenses they incur for meals while traveling away from home on business and for entertaining business customers at your place of business, a restaurant, or another location. It applies to expenses incurred at 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.

Related expenses. Taxes and tips relating to a meal or entertainment activity you reimburse your employees under an accountable plan are included in the amount subject to the 50% limit. Reimbursements you make for expenses, such as cover charges for admission to a nightclub, 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 an otherwise allowable business meal or a business-related entertainment activity is not subject to the 50% limit.

Amount subject to 50% limit. If you provide your employees with a per diem allowance only for meals and incidental expenses, the amount treated as an expense for food and beverages is the lesser of the following:

- The per diem allowance.
- The federal rate for M & IE.

If you provide your employees with a per diem allowance that covers lodging, meals, and incidental expenses, you must treat an amount equal to the federal M & IE rate for the area of travel as an expense for food and beverages. If the per diem allowance you provide is less than the federal per diem rate for the area of travel, you can treat 40% of the per diem allowance as the amount for food and beverages.

Meal expenses when subject to “hours of service” limits. For tax years beginning in 2006, 75% of the reimbursed meals your employees consume while away from their tax home on business during, or incident to, any period subject to the Department of Transportation’s hours of service limits are deductible.

See Publication 463 for a detailed discussion of individuals subject to the Department of Transportation's hours of service limits.

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. See Publication 15-B for additional information on de minimis fringe benefits.

Company cafeteria or executive dining room. The cost of food and beverages you provide primarily to your employees on your business premises is deductible. 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 a de minimis fringe benefit, discussed in Publication 15-B, or unless they are compensation to your employees and you treat them as provided under a nonaccountable plan.

Employee activities. The expense of providing recreational, social, or similar activities (including the use of a facility) for your employees is deductible. The benefit must be primarily for your employees who are not highly compensated.

For this purpose, a highly compensated employee is an employee who meets either of the following requirements.

1. Owned a 10% or more interest in the business during the year or the preceding year. An employee is treated as owning any interest owned by his or her brother, sister, spouse, ancestors, and lineal descendants.

2. Received more than $100,000 in pay for the preceding year. You may choose to include only employees who were also in the top 20% of employees when ranked by pay for the preceding year.

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 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.

Generally, amounts paid for meals, entertainment, and amusement provided to individuals who are not your employees are not subject to the 50% limit. Such activities must be directly related to the active conduct of your trade or business. Examples include:

- Amounts paid for meals, goods, services, or the use of a facility. You are allowed a deduction only to the extent it is included in the gross income of the recipient as compensation for services or as a prize or award.

- Expenses that exceed $600 and are required to be reported on an information return, for example, Form 1099-MISC. See the General Instructions for Forms 1099-MISC, 1098-T, 5498, and W-2G for more information about reporting requirements.

- The cost of providing meals, entertainment, goods and services, or use of facilities you sell to the public. For example, if you operate a nightclub, your expense for the entertainment you furnish to your customers, such as a floor show, is a business expense that is fully deductible.

- The cost of providing meals, entertainment, or recreational facilities to the general public as a means of advertising or promoting goodwill in the community is fully deductible.
Advertising expenses. You can usually de-
duct as a business expense the cost of institu-
tional or goodwill advertising to keep your name
before the public if it relates to business you
reasonably expect to gain in the future. For ex-
ample, the cost of advertising that encourages people
to contribute to the Red Cross, to buy
U.S. Savings Bonds, or to participate in similar
causes is usually deductible.

Anticipated liabilities. Anticipated liabilities
or reserves for anticipated liabilities are not de-
ductible. For example, assume you sold 1-year
TV service contracts this year totaling $50,000.
From experience, you know you will have ex-
penses 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.

Bribes and kickbacks. Engaging in the pay-
ment of bribes or kickbacks is a serious criminal
matter. Such activity could result in criminal
prosecution. Any payments that appear to have
been made, either directly or indirectly, to an
official or employee of any government or an
agency or instrumentality of any government are
not deductible for tax purposes and are in viola-
tion of the law.

Payments made directly or indirectly to a per-
son in violation of any federal or state law (but
only if that state law is generally enforced, de-
fined below) that subjects you to a criminal penalty
or for the loss of a license or privilege to engage
in a trade or business are also not allowed as a
deduction for tax purposes.

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 ex-
traordinarily flagrant. For example, a state law
is generally enforced unless proper reporting of a
violation of the law results in enforce ment only
under unusual circumstances.

Kickbacks. A kickback is a payment for re-
ferring a client, patient, or customer. The com-
mon kickback situation occurs when money or
property is given to someone as payment for
informing an entertainment activity to purchase from
use of the services of, or otherwise deal with the per-
son who pays the kickback. In many cases, the
person whose business is being sought or en-
joyed by the person who pays the kickback is not aware of the payment.

For example, the Yard Corporation is in the
business of repairing ships. It engages in the prac-
tice of returning 10% of the repair bills as
kickbacks to the captains and chief officers of
the vessels it repairs. Although this practice is
considered an ordinary and necessary expense
of getting business, it is clearly a violation of a
state law that is generally enforced. These ex-
penditures are not deductible for tax purposes,
whether or not the owners of the shipyard are
subsequently prosecuted.

Form 1099-MISC. It does not matter
whether any kickbacks paid during the tax year
are deductible on your income tax returns or
reported to information reporting. See Form
1099-MISC for more information.

Car and truck expenses. The costs of operat-
ing a car, truck, or other vehicle in your business
are deductible. For more information on how to
figure your deduction, see Publication 463.

Charitable contributions. Cash payments to
an organization, charitable or otherwise, may be
deductible as business expenses if the pay-
ments are not charitable contributions or gifts. If
the payments are charitable contributions or
gifts, you cannot deduct them as business ex-
penses. However, corporations (other than S
businesses) may be able to deduct chari-
table contributions made by their business on
Schedule A (Form 1040).

Example. You paid $15 to a local church for
a half-page ad in a program for a concert it is
sponsoring. The purpose of the ad was to en-
courage readers to buy your products. Your pay-
ment is not a charitable contribution. However,
you may deduct it as an advertising expense.

Example. You made a $100,000 donation
to a committee organized by the local Chamber
of Commerce to bring a convention to your city.
intended to increase business activity, including
yours. Your payment is not a charitable contribu-
tion. However, you may deduct it as a business
expense.

See Publication 526 for a discussion of
club dues and membership fees. Generally,
amounts paid or incurred for membership in any
club organized for business, pleasure, recrea-
tion, or other social purpose are not deduct-
ible. Clubs organized for business, pleasure,
recreation, or other social purpose include, but
are not limited to country clubs, golf and athletic
clubs, hotel clubs, sporting clubs, airline clubs,
and clubs operated to provide meals under cir-
cumstances generally considered to be condu-
cible to business discussions.

Exception. The following organizations are not
treated as clubs organized for business, pleasure,
recreation, or other social purpose unless
less one of the main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities:

- Boards of trade.
- Business leagues.
- Chambers of commerce.
- Civic or public service organizations.
- Professional organizations such as bar as-
sociations and medical associations.
- Real estate boards.
- Trade associations.

Credit card convenience fees. Credit card
companies charge a fee to businesses who ac-
cept their cards. This fee when paid or incurred
by the business can be deducted as a business expense.

Damas recovered. Special rules apply to
compensation you receive for damages sus-
tained as a result of patent infringement, breach
of contract or fiduciary duty, or antitrust viola-
tions. You must include this compensation in
your income. However, you may be able to take
a special deduction. The deduction applies only
to amounts recovered for actual injury, not any
additional amount. The deduction is the smaller of
the following:

- The amount you received or accrued for
damages in the tax year reduced by the
amount paid or incurred in the year to
recover that amount.
- Your losses from the injury you have not
deducted.

Demolition expenses or losses. Amounts
paid or incurred to demolish a structure are not
deductible. These amounts are added to the
basis of the land where the demolished structure
was located. Any loss for the remaining un-
depreciated basis of a demolished structure
would not be recognized until the property is
disposed.

Education expenses. Ordinary and neces-
sary expenses paid for the cost of the education
and training of your employees are deductible.
See Education Expenses in chapter 2.

You may also deduct the cost of your own
education (including certain related travel) re-
lated to your trade or business. You must be able
to show the education maintains or im-
proves skills required in your trade or business,
or that it is required by law or regulations,
for keeping your license to practice, status, or job.
For example, an attorney can deduct the cost of
attending Continuing Legal Education (CLE)
classes that are required by the state bar associ-
ation to maintain his or her license to practice
law.

Education expenses you incur to meet the
minimum requirements of your present trade or
business, or those that qualify you for a new
trade or business, are not deductible. This is true
even if the education maintains or improves
skills presently required in your business. For
more information on education expenses, see
Publication 970.

Franchise, trademark, trade name. If you
buy a franchise, trademark, or trade name, you
may deduct the amount you pay or incur as a
business expense only if your 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).

When determining the term of the transfer agreement, include all renewal options and any other period for which you and the transferee reasonably expect the agreement to be renewed.

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.

**Impairment-related expenses.** If you are disabled, you can deduct expenses necessary for you to be able to work (impairment-related expenses), rather than as a medical expense.

You are disabled if you have either of the following.

- A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed.
- A physical or mental impairment that substantially limits one or more of your major life activities.

The expense qualifies as a business expense if all the following apply.

- Your work clearly requires the expense for you to satisfactorily perform that work.
- The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities.
- 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.

**Internet-related expenses.** Generally, you can deduct internet-related expenses including domain registrations fees and webmaster consulting costs. If you are starting a business you may have to amortize these expenses as start-up costs. For more information about amortizing start-up and organizational costs, see chapter 8.

**Interview expense allowances.** Reimbursements you make to job candidates for transportation or other expenses related to interviews for possible employment are not wages. You can deduct the reimbursements as a business expense. However, expenses for food, beverages, and entertainment are subject to the 50% limit discussed earlier under Meals and Entertainment.

**Legal and professional fees.** Fees charged by accountants and attorneys that are ordinary and necessary expenses directly related to operating your business are deductible business expenses. However, usually legal fees you pay to acquire business assets are not deductible. These costs are added to the basis of the property.

- Fees that include payments for work of a personal nature (such as drafting a will, or damages arising from a personal injury), are not allowed as a business deduction on Schedule C or C-EZ. If the invoice includes both business and personal charges, compute the business portion as follows: multiply the total amount of the bill by a fraction, the numerator of which is the amount attributable to business matters, the denominator of which is the total amount paid. The result is the portion of the invoice attributable to business expenses. The portion attributable to personal matters is the difference between the total amount and the business portion (computed above).
- Legal fees relating to personal tax advice may be deductible on Line 22, Schedule A (Form 1040). If you itemize deductions. However, the deduction is subject to the 2% limitation on miscellaneous itemized deductions. See Pub. 529, Miscellaneous Deductions.
- Legal fees relating to personal tax advice may be deductible on Line 22, Schedule A (Form 1040). If you itemize deductions. However, the deduction is subject to the 2% limitation on miscellaneous itemized deductions. See Pub. 529, Miscellaneous Deductions.
- Tax preparation fees. The cost of hiring a tax professional, such as a C.P.A., to prepare that part of your tax return relating to your business as a sole proprietor is deductible on Schedule C or Schedule C-EZ. Any remaining cost may be deductible on Schedule A (Form 1040) if you itemize deductions.
- You can also claim a business deduction for amounts paid or incurred in resolving asserted tax deficiencies for your business operated as a sole proprietor.

**Licenses and regulatory fees.** Licenses and regulatory fees for your trade or business paid annually to state or local governments generally are deductible. Some licenses and fees may have to be amortized. See chapter 8 for more information.

**Lobbying expenses.** Generally, lobbying expenses are not deductible. Lobbying expenses include amounts paid or incurred for any of the following activities.

- Influencing legislation.
- Participating in 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.
- Communicating directly with covered executive branch officials (defined later) in any attempt to influence the official actions or positions of those officials.
- Researching, preparing, planning, or coordinating any of the preceding activities.

Your expenses for influencing legislation and communicating directly with a covered executive branch official include a portion of your labor costs and general and administrative costs of your business. For information on making this allocation, see section 1.162-28 of the regulations.

You cannot claim a charitable or business expense deduction for amounts paid to an organization if both of the following apply.

- The organization conducts lobbying activities on matters of direct financial interest to your business.
- A principal purpose of your contribution is to avoid the rules discussed earlier that prohibit a business deduction for lobbying expenses.

If a tax-exempt organization, other than a section 501(c)(3) organization, provides you with a notice on the part of dues that is allocable to nondeductible lobbying and political expenses, you cannot deduct that part of the dues.

**Covered executive branch official.** For purposes of this discussion, a covered executive branch official is any of the following.

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 who:
   a. Is serving in a position in Level I of the Executive Schedule under section 5312 of title 5, United States Code.
   b. Has been designated by the President as having Cabinet-level status, or
   c. Is an immediate deputy of an individual listed in item (a) or (b).

**Exceptions to denial of deduction.**

The general denial of the deduction does not apply to the following.

- Expenses of appearing before, or communing with, any local council or similar governing body concerning its legislation (local legislation) if the legislation is of direct interest to you or to you and an organization of which you are a member. An Indian tribal government is treated as a local council or similar governing body.
- Any in-house expenses for influencing legislation and communicating directly with a covered executive branch official if those expenses for the tax year do not exceed $2,000 (excluding overhead expenses).
- 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).

**Moving machinery.** Generally, the cost of moving 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, you must capitalize the costs of installing or moving newly purchased machinery.

**Outplacement services.** The costs of outplacement services you provide to your employees to help them find new employment, such as...
career counseling, résumé assistance, skills assessment, etc. are deductible.

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.

For information on whether the value of outplacement services is includable in your employees' income, see Publication 15-B.

Penalties and fines. Penalties paid for late performance or nonperformance of a contract are generally deductible. For instance, you own and operate a construction company. You have been contracted to construct a building by a certain date. Due to construction delays, the building is not completed and ready for occupancy on the date stipulated in the contract. You are now required to pay an additional amount for each day that completion is delayed beyond the completion date stipulated in the contract. These additional costs are deductible business expenses.

On the other hand, penalties or fines paid to any government agency or instrumentality because of a violation of any law are not deductible. These fines or penalties include the following amounts:

- Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.
- 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.
- Paid in settlement of actual or possible liability for a fine or penalty, whether civil or criminal.
- Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Examples of nondeductible penalties and fines include the following:

- Fines for violating city housing codes.
- Fines paid by truckers for violating state and local law in a civil action, including certain additions to tax and additional amounts.
- Repaid as a penalty imposed by federal, state, or local law in a civil action, including certain additions to tax and additional amounts.
- Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Political contributions. Contributions or gifts paid to political parties or candidates are not deductible. In addition, expenses paid or incurred to take part in any political campaign of a candidate for public office are not deductible.

Indirect political contributions. You cannot deduct indirect political contributions and costs of taking part in political activities as business expenses. Examples of nondeductible expenses include the following:

- 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.
- 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.
- Admission to an inaugural ball, gala, parade, concert, or similar event if identified with a political party or candidate.

Reparations. The cost of repairing or improving property used in your trade or business is either a deductible or capital expense. Routine maintenance that keeps your property in a normal efficient operating condition, but that does not materially increase the value or substantially prolong the useful life of the property is deductible in the year that it is incurred. Otherwise, the cost must be depreciated over the useful life of the property. See Form 4562 and its instructions for how to compute and claim the depreciation deduction.

The cost of repairs includes the costs of labor, supplies, and certain other items. The value of your own labor is not deductible. Examples of repairs include:

- Reconditioning floors (but not replacement).
- Repainting the interior and exterior walls of a building.
- Cleaning and repairing roofs and gutters, and
- Fixing plumbing leaks (but not replacement of fixtures).

Repayments. If you had to repay an amount you included in your income in an earlier year, you may be able to deduct the amount repaid for the year in which you repaid it. If, however, the amount you repaid is more than $3,000, you may be able to take a credit against your tax for the year in which you repaid it.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For example, if you repay an amount you previously reported as a capital gain, deduct the repayment as a capital loss on Schedule D (Form 1040). If you reported it as self-employment income, deduct it as a business deduction on Schedule C or Schedule C-EZ (Form 1040) or Schedule F (Form 1040).

If you repaid the amount as wages, unemployment compensation, or other nonbusiness ordinary income, enter it on Schedule A (Form 1040) as a miscellaneous itemized deduction that is subject to the 2% limitation. However, if the repayment is over $3,000 and Method 1 (discussed later) applies, deduct it on Schedule A (Form 1040) as a miscellaneous itemized deduction that is not subject to the 2% limitation.

Repayment—$3,000 or less. If the amount you repaid was $3,000 or less, deduct it from your income in the year you repaid it.

Repayment—over $3,000. If the amount you repaid was more than $3,000, you can deduct the repayment, as described earlier. However, you can instead choose to take a tax credit for the year of repayment if you included the income under a "claim of right." This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and use the method that results in less tax.

Method 1. Figure your tax for 2006 claiming a deduction for the repaid amount.

Method 2. Figure your tax for 2006 claiming a credit for the prepaid amount. Follow these steps.

1. Figure your tax for 2006 without deducting the repaid amount.
2. Refigure your tax from the earlier year without including in income the amount you repaid in 2006.
3. Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the amount of your credit.
4. Subtract the answer in (3) from the tax for 2006 figured without the deduction (step 1).

If Method 1 results in less tax, deduct the amount repaid as discussed earlier under Type of deduction.

If Method 2 results in less tax, claim the credit on line 70 of Form 1040, and write "I.R.C. 1341" next to line 70.

Example. For 2005, you filed a return and reported your income on the cash method. In 2005, you repaid $8,000 included in your 2005 gross income under a claim of right. Your filing status in 2006 and 2005 is single. Your income and tax for both years are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>With Income</th>
<th>Without Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$15,000</td>
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<tr>
<td>Tax</td>
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<td>$1,139</td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td>With Deduction</td>
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<tr>
<td>Taxable Income</td>
<td>$49,950</td>
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<tr>
<td>Tax</td>
<td>$9,051</td>
<td>$7,801</td>
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</table>

Your tax under Method 1 is $7,801. Your tax under Method 2 is $8,301, figured as follows:

- Tax previously determined for 2005: $1,889
- Less: Tax as refunded: $1,139
- Decrease in 2005 tax: $750
- Regular tax liability for 2006: $42,950
- Less: Decrease in 2005 tax: $750
- Refigured tax for 2006: $8,301

For information on whether the value of outplacement services is includable in your employees' income, see Publication 15-B.
Because you pay less tax under Method 1, you should take a deduction for the repayment in 2006.

Repayment does not apply. This discussion does not apply to the following.

• Deductions for bad debts.
• Deductions from sales to customers, such as returns and allowances, and similar items.
• Deductions for legal and other expenses of contesting the repayment.

Year of deduction (or credit). If you use the cash method of accounting, you can take the deduction (or credit, if applicable) for the tax year in which you actually make the repayment. If you use any other accounting method, you can deduct the repayment or claim a credit for it only for the tax year in which it is a proper deduction under the method you actually use. For example, if you use the accrual method, you are entitled to the deduction or credit in the tax year in which the obligation for the repayment accrues.

Subscriptions. Subscriptions to professional, technical, and trade journals that deal with your business field are deductible.

Supplies and materials. Unless you have deducted the cost in any earlier year, you generally can deduct the cost of materials and supplies actually consumed and used during the tax year. If you keep incidental materials and supplies on hand, you can deduct the cost of the incidental materials and supplies you bought during the tax year if all the following requirements are met:

• You do not keep a record of when they are used.
• You do not take an inventory of the amount on hand at the beginning and end of the tax year.
• This method does not distort your income.

You can also deduct the cost of books, professional instruments, equipment, etc., if you normally use them within a year. However, if the usefulness of these items extends substantially beyond the year they are placed in service, you must recover their costs through depreciation. For more information regarding depreciation, see Publication 946, How to Depreciate Property.

Utilities. Business expenses for heat, lights, power, telephone service, and water and sewerage are deductible. However, any part attributable to personal use is not deductible.

Telephone. The cost of basic local telephone service (including any taxes) for the first telephone line you have in your home, even though you have an office in your home is not deductible. However, charges for business long-distance phone calls on that line, as well as the cost of a second line into your home used exclusively for business, are deductible business expenses.
Walk-in. Many products and services are available on a walk-in basis.

- Products. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

- Services. You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you’re more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary, but if you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.

Mail. You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 business days after your request is received.

National Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903

CD for Tax Products. You can order Publication 1796, IRS Tax Products CD, and obtain:

- The CD is released twice so that you have the latest products. The first release ships in January and the final release ships in March.
- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Bonus: Historical Tax Products DVD – Ships with the final release.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions (FAQs).
- Tax Topics from the IRS telephone response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.

Buy the CD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for $25 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD for $25 (plus a $5 handling fee). Price is subject to change.

CD for small businesses. Publication 3207, The Small Business Resource Guide CD for 2006, is a must for every small business owner or any taxpayer about to start a business. This year’s CD includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2006.
- Tax Map: an electronic research tool and finding aid.
- Web links to various government agencies, business associations, and IRS organizations.
- “Rate the Product” survey—your opportunity to suggest changes for future editions.
- A site map of the CD to help you navigate the pages of the CD with ease.
- An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

An updated version of this CD is available each year in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.
Mortgage: (Cont.)

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N

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O

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<td>Depletion</td>
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<tr>
<td>Drilling costs</td>
<td>21</td>
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<tr>
<td>Partnerships</td>
<td>34</td>
</tr>
<tr>
<td>S corporations</td>
<td>34</td>
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</table>

Optional write-off method:

| Circulation costs | 31 |
| Experimental costs | 31 |
| Intangible drilling and development costs | 31 |
| Mining exploration and development costs | 31 |
| Research costs | 31 |

Organization costs:

| Corporate | 25 |
| Partnership | 26 |
| Organizational costs | 23 |
| Original issue discount | 12 |
| Outplacement services | 43 |

P

| Passive activities | 4 |
| Payments in kind | 4 |

Penalties:

| Deductible | 44 |
| Nondeductible | 44 |
| Prepayment | 12 |

Per diem and car allowances:

| High-low rate | 40 |
| Regular rate | 40 |
| Reporting allowance | 40 |
| Standard meal allowance | 40 |
| Standard mileage rate | 40 |
| Percentage depletion | 33 |
| Personal property tax | 17 |
| Points | 13 |
| Political contributions | 44 |
| Pollution control facilities | 31 |
| Prepaid expense | 4 |
| Extends useful life | 20 |
| Interest | 14 |
| Rent | 8 |
| Prepayment penalty | 12 |
| Presumption of profit | 5 |

Publications (See Tax help)

R

| Real estate taxes | 16 |
| Recapture: |  |
| Clean-fuel deductions | 2 |
| Exploration expenses | 22 |
| Timber property | 30 |
| Recovery of amount deducted | 4 |
| Refiners who cannot claim percentage depletion | 33 |
| Reforestation costs | 23, 30 |
| Regulatory fees | 43 |
| Reimbursements for business expenses | 59 |
| Mileage | 40 |
| Nonaccountable plan | 41 |
| Per diem | 40 |
| Related persons: Anti-churning rules | 29 |

Per diem or iron ore | 36 |
Payments to | 5, 14 |
Refiners | 33 |
Rent expense | 8 |
Unreasonable rent | 8 |

Removal:

| Barrier | 24 |
| Retired asset | 24 |
| Rent expense, capitalizing | 10 |
| Repairs | 44 |
| Repayments (claim of right) | 44 |
| Research costs | 21, 31 |

S

| Sales taxes | 17 |
| Section 179 expense deduction (See Cost recovery) |  |
| Self-employed health insurance deduction | 18 |
| Self-employment tax | 17 |
| Tax rates and maximum net earnings | 2 |
| Self-insurance, reserve for | 19 |
| Sick pay | 8 |
| Standard meal allowance | 40 |
| Standard mileage rate | 40 |
| Standby charges | 13 |
| Start-up costs | 23, 25 |
| Subscriptions | 42, 45 |
| Suggestions for publication |  |

T

| Taxes: Carrying charge | 20 |
| Employment | 17 |
| Excise | 17 |
| Franchise | 17 |
| Fuel | 17 |
| Income | 16 |
| Leased property | 9 |
| Personal property | 17 |
| Real estate | 16 |
| Sales | 17 |
| Unemployment fund | 17 |
| Taxpayer Advocate | 45 |
| Telephone | 45 |
| Timber | 30, 36 |
| Tools | 3 |
| Trademark, trade name | 28 |
| Travel | 39 |
| TTY/TDD information | 45 |

U

| Unemployment fund taxes | 17 |
| Unpaid expenses, related person | 14 |
| Utilities | 45 |

V

| Vacation pay | 8 |

W

| Wages: Property | 8 |
| Tests for deducting pay | 6 |
| Welfare benefit funds | 7 |

T
Tax Publications for Business Taxpayers

See How To Get Tax Help for a variety of ways to get publications, including by computer, phone, and mail.

General Guides
1 Your Rights as a Taxpayer
17 Your Federal Income Tax (For Individuals)
334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
509 Tax Calendars for 2007
553 Highlights of 2006 Tax Changes
910 Guide to Free Tax Services

Employer’s Guides
15 (Circular E), Employer’s Tax Guide
15-A Employer’s Supplemental Tax Guide
15-B Employer’s Tax Guide to Fringe Benefits
51 (Circular A), Agricultural Employer’s Tax Guide
80 (Circular SS), Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
926 Household Employer’s Tax Guide

Specialized Publications
225 Farmer’s Tax Guide
378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
505 Tax Withholding and Estimated Tax
510 Excise Taxes for 2007
515 Withholding of Tax on Nonresident Aliens and Foreign Entities
517 Social Security and Other Information for Members of the Clergy and Religious Workers

Commonly Used Tax Forms
See How To Get Tax Help for a variety of ways to get forms, including by computer, phone, and mail.

Form Number and Form Title

W-2 Wage and Tax Statement
W-4 Employee’s Withholding Allowance Certificate
840 Employer’s Annual Federal Unemployment (FUTA) Tax Return
941 Employer’s QUARTERLY Federal Tax Return
944 Employer’s ANNUAL Federal Tax Return
1040 U.S. Individual Income Tax Return
Sch. A & B Itemized Deductions & Interest and Ordinary Dividends
Sch. C Profit or Loss From Business
Sch. C-EZ Net Profit From Business
Sch. D Capital Gains and Losses
Sch. D-1 Continuation Sheet for Schedule D
Sch. E Supplemental Income and Loss
Sch. F Profit or Loss From Farming
Sch. H Household Employment Taxes
Sch. J Income Averaging for Farmers and Fishermen
Sch. R Credit for the Elderly or the Disabled
Sch. SE Self-Employment Tax
1040-ES Estimated Tax for Individuals
1040X Amended U.S. Individual Income Tax Return
1065 U.S. Return of Partnership Income
Sch. D Capital Gains and Losses
Sch. K-1 Partner’s Share of Income, Deductions, Credits, etc.
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
Sch. D Capital Gains and Losses and Built-In Gains

Form Number and Form Title

Sch. K-1 Shareholder’s Share of Income, Deductions, Credits, etc.
2106 Employee Business Expenses
2106-EZ Unreimbursed Employee Business Expenses
2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts
2441 Child and Dependent Care Expenses
2848 Power of Attorney and Declaration of Representative
3800 General Business Credit
3903 Moving Expenses
4562 Depreciation and Amortization
4797 Sales of Business Property
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts
6252 Instalment Sale Income
7004 Application for Automatic 6-Month Extension of Time To File Certain Business Income Tax, Information, and Other Returns
8283 Noncash Charitable Contributions
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business
8582 Passive Activity Loss Limitations
8606 Nondeductible IRAs
8822 Change of Address
8829 Expenses for Business Use Of Your Home

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