Department
of the
Treasury

**Internal
Revenue
Service**

Tax Guide for Small Business

For Businesses

Publication
334 95
Cat. No. 11063P

For use in
preparing

1995

Returns

Department
of the
Treasury

**Internal
Revenue
Service**

Tax Guide for Small Business

Contents

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service (IRS) of:

- Tax laws enacted by Congress,
- Treasury regulations, and
- Court decisions.

However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

The publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the Service.

All taxpayers have appeal rights within the Service and may appeal to the courts when they do not agree with the interpretations taken by the Service. For a discussion on appeal procedures, see *The Examination and Appeals Process* in this publication.

Introduction

This publication contains information about the federal tax laws that apply to businesses. It describes the four major forms of business organization—sole proprietorship, partnership, corporation, and S corporation—and explains the tax responsibilities of each.

The *Tax Guide for Small Business* is divided into eight parts. The first part contains general information on business organization and accounting practices. Part II discusses the tax aspects of accounting for the assets used in a business.

Parts III and IV explain how to figure your business income for tax purposes. They describe the kinds of income you must report and the different types of business deductions you can take.

Part V discusses the rules that apply when you sell or exchange business assets or investment property. It includes chapters on the treatment of capital gains and losses, and on involuntary conversions, such as theft and casualty losses. The chapters in Part VI contain some specific tax considerations for each of the four major forms of business organization.

Part VII looks at some of the credits that can reduce your income tax, and some of the other taxes you may have to pay in addition to income tax. It also discusses the information returns that may have to be filed. The last part, Part VIII, shows how to fill out the main income tax forms businesses use.

The information in this publication applies to many different kinds of businesses. However, the publication does not discuss foreign corporations, insurance companies, collapsible corporations, personal holding companies, banks, regulated investment companies, small business investment companies, real estate investment trusts, foreign sales corporations (FSCs), and integrated oil companies. It also does not discuss bankruptcy or corporate reorganizations and acquisitions.

The special situations related to farming and commercial fishing are covered in two other tax information publications. If you operate a farm or a fishing business, you should obtain a copy of *Farmer's Tax Guide* (Publication 225) or *Tax Guide for Commercial Fisherman* (Publication 595).

For information on the individual income tax, you may want to see the companion volume to this publication, *Your Federal Income Tax* (Publication 17).

In addition to these publications, the Internal Revenue Service has many other tax publications that may be of interest to you. Most of them are concerned with particular areas of tax law, such as depreciation, selling a home, rental property, retirement income, or installment sales. You will find references to many of these publications throughout this publication. They are all available free from the Forms Distribution Center for your area. Use the order blank at the end of this publication.

Other federal agencies also publish publications and pamphlets designed to assist small businesses. For a list of federal publications that are for sale call 1–202–512–1800 or write to:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA. 15250-7954

If you want information from the Small Business Administration (SBA) on setting up a small business, call 1–800–827–5722.

We welcome your suggestions for future editions of this publication. Please send your ideas to:

Internal Revenue Service
Technical Publications Branch (T:FP:P)
1111 Constitution Ave. N.W.
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you include your area code and daytime phone number along with your return address. ■

Important Changes for 1995

The following items highlight a number of administrative and tax law changes for 1995.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would affect capital gains and losses. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments.

Higher earned income credit. The maximum earned income credit has been increased to $3,110 in 1995. To claim the credit for 1995, you must have earned income (including net earnings from self-employment) of less than $26,673, adjusted gross income of less than $26,673, and meet certain other requirements.

For more information, see Publication 596, *Earned Income Credit.*

Standard mileage rate. The standard mileage rate for 1995 is 30 cents a mile for all business miles on a passenger automobile (including vans, pickups, or panel trucks). See chapter 15.

Receipts for business expenses. Beginning October 1, 1995, you must have receipts for amounts that are $75 (rather than $25) or more for certain business expenses. See chapter 15.

Depreciation general asset account. You can elect to place assets subject to MACRS in one or more general asset accounts. After you have established a general asset account, figure depreciation on the entire account by using the applicable depreciation method, recovery period, and convention for the assets in the account. See chapter 12.

Limits on depreciation of business cars. The total section 179 deduction and depreciation you can take on a car that you use in your business and first place in service in 1995 is $3,060. Your depreciation cannot exceed $4,900 for the second year of recovery, $2,950 for the third year of recovery, and $1,775 for each later tax year. See chapters 12 and 15.

Direct deposit of refund. If you are due a refund on your 1995 tax return, you can have it deposited directly into your bank account. Complete Form 8888, *Direct Deposit of Refund,* and attach it to your tax return (except Form 1040EZ). If you did not receive Form 8888 in your tax booklet, see *Ordering publications and forms,* later.

Electronic deposit of taxes. In general, taxpayers whose total deposits of railroad retirement, social security, and Medicare taxes exceeded $47 million during calendar year 1993 or 1994 must deposit these taxes through TAXLINK (an electronic funds transfer (EFT) system) beginning in 1996. The EFT system (TAXLINK) allows taxpayers to make tax deposits without coupons, paper checks, or visits to an authorized depositary.

Taxpayers not required to make deposits by EFT can enroll in the system. For more information, call 1–800–829–5469, or write to:

IRS
Cash Management Site Office
Atlanta Service Center
P.O. Box 47669
Stop 295
Doraville, GA 30362

Tax rates and maximum net earnings for self-employment taxes. In 1995, the maximum amount of net earnings from self-employment subject to the social security part (12.4%) of the self-employment tax is $61,200. There is no maximum limit on the amount subject to the Medicare part (2.9%).

For 1996, the maximum amount subject to the social security part (12.4%) increases to

$62,700. All net earnings from self-employment are subject to the Medicare part of the tax. See chapter 32.

Wage maximums for social security and Medicare taxes. For 1996, the maximum amount of wages subject to the social security tax (6.2%) is $62,700 ($61,200 for 1995). There is no wage base limit for the amount subject to the Medicare part (1.45%). All covered wages are subject to the tax.

Health insurance for self-employed persons. The deduction for health insurance costs for self-employed persons has been permanently extended for tax years beginning after 1993. If you were entitled to claim this deduction in 1994 but did not, file Form 1040X, *Amended U.S. Individual Income Tax Return* to amend your 1994 tax return. Do not use the worksheet in the 1995 Form 1040 instructions to figure your deduction for 1994. Instead, get Publication 535, *Business Expenses,* or use the worksheet in the 1994 Form 1040 instructions.

Also, the deduction is increased to 30% for tax years beginning after 1994. See chapter 17.

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

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would extend the income exclusion for employer-provided educational assistance.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments.

Fuel taxes. Some tax rates and the credit or refund amount you may receive have changed. Get the appropriate form for the current rate.

Luxury tax on passenger vehicles. The base amount used to figure the taxable part of a passenger vehicle's first retail sale or use is $34,000 for 1996.

Distribution of marketable securities to a partner. A distribution of certain marketable securities made to a partner after December 8, 1994, is treated as money in determining whether gain is recognized by the partner on the distribution. See *Distributions From a Partnership* in Publication 541.

Office of Small Business Affairs. In March 1994, the Commissioner of the Internal Revenue Service established the *IRS Office of Small Business Affairs.* This office was established to serve as the national IRS contact with small businesses, to recommend changes to regulations and administrative practices that cause undue burden or inequity, and to address issues that are important to both small businesses and the IRS.

On-line access to the Internal Revenue Service. If you have a personal computer and a modem, you can get many tax forms and publications electronically. If you subscribe to an on-line service, check with the provider of the service to determine if IRS information is available and if so, how to access it.

Tax forms and publications are also provided through IRIS on FedWorld (a government bulletin board).

Also, you can purchase a comprehensive CD-ROM containing all the latest tax forms, instructions, and information publications.

For more information, see *How To Get Forms and Publications,* near the end of this publication.

General business credit. The following general business credits have expired.

Targeted jobs credit. This credit cannot be claimed on any wages paid or incurred to individuals who begin work after December 31, 1994.

Research credit. This credit cannot be claimed for any amount paid or incurred after June 30, 1995.

For more information on the general business credit, see chapter 31. ■

Important Reminders

Publication on employer identification numbers (EINs). Publication 1635, *Understanding Your EIN,* provides general information on employer identification numbers. Topics include how to apply for an EIN and how to complete Form SS–4.

Form W–4 for 1996 You should make new Forms W–4 available to your employees and encourage them to check their income tax withholding for 1996 Those employees who owed a large amount of tax or received a large refund for 1995 may need to file a new Form W–4. See chapter 33.

Payment voucher for Form 1040. To help process tax payments more accurately and efficiently, the IRS is sending ***Form 1040–V,*** *Payment Voucher,* to most 1040 filers. Over the next few years, IRS will expand the use of this preprinted payment voucher to all 1040 filers to process payments more accurately and efficiently.

If you have a balance due on your Form 1040, send the voucher with your payment. Follow the instructions that come with the voucher. There is no penalty for not using the payment voucher, but the IRS strongly encourages you to use it.

Payment voucher for Form 940 or 940–EZ. If you are required to make a payment of federal unemployment tax with Form 940 of Form 940–EZ, use the payment voucher at the bottom of the form. For more information, see the instructions for Form 940 or Form 940–EZ.

Investing in small business stock. Beginning in 1998, investments in certain small business stock held more than 5 years will qualify for a special tax benefit. If you sell or exchange the stock at a gain, only one-half of the gain will be subject to federal income tax. For information on qualifying stock, see chapter 4 of Publication 550, *Investment Income and Expenses.*

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. See chapter 33.

Children employed by parents. Wages you pay to your children age 18 and older for services in your trade or business are subject to social security taxes. See chapter 33.

Employees' tips. All tips reported by an employee are subject to the employer portion of the social security tax. Thus, you must pay the employer social security tax on the total amount of tips and wages up to the social security maximum. See chapter 33.

Business use of your home. If you used part of your home in 1995 for your trade or business and can deduct the expenses on Schedule C (Form 1040), you must figure your deduction on Form 8829, *Expenses for Business Use of Home,* and attach it to Form 1040 with Schedule C. For more information, see Publication 587, *Business Use of Your Home.*

Change of home or business address. If you change your mailing address, you should use Form 8822, *Change of Address,* to notify IRS. Be sure to include your suite, room, or other unit number. Send the form to the Internal Revenue Service Center for your old address.

Estimated tax. If you do business as a sole proprietor, or you are a partner in a partnership, or a shareholder in an S corporation, you may have to make estimated tax payments. Use Form 1040–ES, *Estimated Tax for Individuals.* Also, use the *Checklist* near the end of this publication to determine the due dates for making the payments.

Corporations that have to make estimated tax payments may use Form 1120–W (Worksheet), *Corporation Estimated Tax,* or Form 1120–(FY), *Fiscal Year Corporation Estimated Tax.* A corporation may also use the *Checklist* near the end of this publication to determine its due dates for making the payments. See chapter 29.

Corporate estimated tax rules. A corporation's estimated tax payments must be based on the lesser of:

1) 100% of the tax shown on the corporation's return for the preceding tax year, or
2) 100% of the tax for the current year (the current year tax may be determined on the basis of actual income or annualized income).

See chapter 29.

Corporate estimated tax penalty. Generally, a penalty applies to the underpayment of an installment of estimated tax. The underpayment of any installment is the required payment minus the amount paid by the due date. See chapter 29.

Amortization of goodwill and certain other intangibles. You may have to amortize goodwill and certain other intangible property over a period of 15 years. See chapter 13.

This amortizable property is called section 197 property and, if held for more than one year, it may qualify for capital gain treatment on its sale or other disposition. See chapter 22.

Deductions for clean-fuel vehicles and certain refueling property. Deductions are allowed for clean-fuel vehicles and certain clean-fuel vehicle refueling property placed in service after June 30, 1993. For more information, see chapter 15 in Publication 535.

Credit for qualified electric vehicles. A tax credit is available for qualified electric vehicles placed in service after June 30, 1993. For more information, see chapter 15 in Publication 535.

Form 1099–MISC. If you make total payments of $600 or more during the year to another person, other than an employee or generally a corporation, in the course of your business, you must file information returns to report these payments for the year. See chapter 36.

Penalties. There are various penalties you should be aware of when preparing your return. You may be subject to penalties if you:

1) Do not file your return by the due date. This penalty is 5% for each month or part of a month that your return is late, up to 25%.
2) Do not pay your tax on time. This penalty is ½ of 1% of your unpaid taxes for each month or part of a month after the date the tax is due, up to 25%.
3) Substantially understate your tax. This penalty is 20% of the underpayment that is due to the understatement.
4) File a frivolous tax return. This penalty is $500.
5) Fail to supply your social security number. This penalty is $50 for each failure.

Tax shelter penalties. Tax shelters, their organizers, their sellers, or their investors may be subject to penalties for such actions as:

1) Failure to furnish tax shelter registration number. The penalty for the seller of the tax shelter is $100; the penalty for the investor in the tax shelter is $250.
2) Failure to register a tax shelter. The penalty for the organizer of the tax shelter is the greater of 1% of the amount invested in the tax shelter or $500.
3) Not keeping lists of investors in potentially abusive tax shelters. The penalty for the tax shelter is $50 for each person required to be on the list, up to a maximum of $100,000.

Fraud penalty. The penalty for underpayment of taxes due to fraud is 75% of the part of the underpayment due to fraud.

Criminal penalties. You may be subject to criminal prosecution (brought to trial) for actions such as:

1) Tax evasion,
2) Willful failure to file a return, supply information, or pay any tax due,
3) Fraud and false statements, and
4) Preparing and filing a fraudulent return.

Reminders—Before you file your tax return, be sure to:

Use address label. Transfer the address label from the tax return package you received in the mail to your tax return, and make any necessary corrections.

Claim payments made. Be sure to include on the appropriate lines of your tax return any estimated tax payments and federal tax deposit payments you made during the tax year. Also, you must file a return to claim a refund of any payments you made, even if no tax is due.

Attach all forms. Attach all forms and schedules in sequence number order. The sequence number is just below the year in the upper right corner of the schedule or form. Attach all other statements or attachments last, but in the same order as the forms or schedules they relate to. Do not attach these other statements to the related form or schedule.

Fill out self-employment tax return. Fill out Schedule SE (Form 1040) if you had net earnings from self-employment of $400 or more.

Use correct lines. Enter income, deductions, credits, and tax items on the correct lines.

Sign and date return. Make sure the tax return is signed and dated.

Submit payment. For Forms 1040 and 1120S filers, enclose a check for any tax you owe. If the check accompanies your Form 1040, write your social security number on the check. If the check accompanies Form 1120S, write your employer identification number, the tax period, and the tax form number on the check. Also include the telephone number and area code where you can be reached during the day. For 1120 filers, deposit your tax payment with Form 8109, *Federal Tax Deposit Coupon.*

Free tax help. Publication 910, *Guide to Free Tax Services,* provides information on where to get help in preparing tax returns. It describes the kind of year-round services available in resolving questions on bills, letters, and notices received from Internal Revenue Service Centers, as well as questions on the status of tax refunds. The publication also lists free taxpayer information publications. It gives brief descriptions of their content and a list of related tax forms and schedules discussed in the publication. For information about getting Publication 910, see *Ordering publications and forms,* next.

Ordering publications and forms. To order free publications and forms, call 1–800–TAX–FORM(1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

If you have a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms and Publications* near the end of this publication.

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

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

Written tax questions. You can send written tax questions to your IRS District Director. If you do not have the address, you can get it by calling 1–800–829–1040. The IRS is working to decrease the time it takes to respond to your correspondence. If you write, the IRS can usually reply within about 30 days.

Tele-Tax. The IRS has a telephone service called Tele-Tax. This service provides recorded tax information on approximately 140 topics covering such areas as filing requirements, employment taxes, taxpayer identification numbers, and tax credits. Recorded tax information is available 24 hours a day, 7 days a week, to taxpayers using push-button telephones, and during regular working hours to those using dial telephones. The topics covered and telephone numbers for your area are listed in the Form 1040 instructions.

Unresolved tax problems. IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you have been unable to resolve through normal channels, write to your local IRS District Director or call your local IRS office and ask for Problem Resolution assistance.

Although the Problem Resolution Office cannot change the tax law or technical decisions, it can frequently clear up misunderstandings that resulted from previous contacts. For more information, get Publication 1546, *How to Use the Problem Resolution Program of the IRS.*

Hearing-impaired taxpayers who have access to **TDD** equipment may call 1–800–829–4059 to ask for help from Problem Resolution.

Overdue tax bill. If you receive a bill for overdue taxes, do not ignore the tax bill. If you owe the tax shown on the bill, you should make arrangements to pay it. If you believe it is incorrect, contact the IRS immediately to suspend action until the mistake is corrected. See Publication 594, *Understanding the Collection Process,* for more information.

Small business workshops. Workshops are offered for self-employed or small business owners who want to learn about the tax aspects of running their businesses. For details, call IRS at the number listed in your telephone directory under U.S. Government and ask for the Taxpayer Education Coordinator.

Business codes. You must enter on the appropriate line of your return a code that identifies your principal business or professional activity. It is important to use the correct business code, since this information will identify market segments of the public for IRS Taxpayer Education programs. This information is also used by the U.S. Census Bureau for its economic census. See the sample returns in Part VIII.

Rounding off dollars. You may round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.49 becomes $1 and $2.50 becomes $3.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and only round off the total.

Alternative ways of filing. IRS offers several alternatives to make filing your tax return easier. They are more convenient and accurate and will help us process your return faster.

Electronic filing. You can file your return electronically whether you prepare your own return or use a tax preparer. However, you must use an IRS-approved tax preparer or company to file an electronic return.

If you file a complete and accurate electronic return, your refund will be issued within 21 days. (Some refunds may be delayed as a result of compliance reviews to ensure the accuracy of the returns.) You can also choose the convenience and safety of direct deposit. IRS notifies your electronic return transmitter that your return has been received and accepted. Also, if you owe tax, you can file early and pay by April 15, 1996.

In many states, you can electronically file your state tax return with your federal return. Check with your tax return preparer or transmitter. Also, many companies offer electronic filing as a benefit for their employees. Check with your employer.

TeleFile. Single taxpayers who filed a 1994 Form 1040EZ may receive a TeleFile tax package that will allow them to file their 1995 tax return by phone. TeleFile is fast, easy, and free. It is available 24 hours a day and there is nothing to mail. IRS automatically sends the TeleFile package to persons eligible to use this method of filing, including students.

Other alternatives. If you have a computer, tax software, and a modem, you can file an electronic return with certain on-line services. Check with your on-line service.

More information. Call Tele-Tax and listen to topic 252 for more information. Check your tax package for information about Tele-Tax. ■

Part One.

The Business Organization

This Part discusses some of the things you must consider when setting up a business. The first chapter briefly describes the major forms of business organization and discusses how each is taxed. The other chapters discuss recordkeeping, accounting periods, and accounting methods.

1. Initial Considerations

Introduction

Once you have decided to start a business, you must decide what type of business entity to use. Your decision will depend on tax and legal considerations. The tax element is discussed in this chapter. However, legal considerations are beyond the scope of this publication. Normally, a business is conducted in the form of either a sole proprietorship, partnership, or corporation.

In the case of a sole proprietorship or a partnership, the business itself does not pay any income taxes. The sole proprietor or the partners include the profits or losses of the business on their personal income tax returns. Profits of a corporation are taxed both to the corporation and to the shareholders when the profits are distributed as dividends. Also, losses sustained by the corporation usually are not available to its stockholders. These two corporate rules do not apply to S corporations. (S corporations are discussed in chapter 30.)

The tax considerations related to the costs of getting started in a business are discussed under *Going Into Business* in chapter 4.

Topics

This chapter discusses:

- Sole proprietorships
- Partnerships
- Corporations
- S corporations
- Taxpayer identification numbers

Useful Items

You may want to see:

Publication

- ☐ **1635** Understanding Your EIN

Form (and Instructions)

- ☐ **SS–4** Application for Employer Identification Number
- ☐ **SS–5** Application for a Social Security Card
- ☐ **W–9** Request for Taxpayer Identification Number and Certification
- ☐ **1040** U.S. Individual Income Tax Return
- ☐ **Sch C (Form 1040)** Profit or Loss From Business
- ☐ **Sch C–EZ** Net Profit From Business
- ☐ **1065** U.S. Partnership Return of Income
- ☐ **1120** U.S. Corporation Income Tax Return
- ☐ **1120–A** U.S. Corporation Short-Form Income Tax Return
- ☐ **1120S** U.S. Income Tax Return for an S Corporation

Sole Proprietorships

A sole proprietorship is the simplest form of business organization. This form of business has no existence apart from you, the owner. Its liabilities are your personal liabilities, and your ownership (proprietary) interest ends when you die. You undertake the risks of business to the extent of all your assets, whether used in the business or used personally.

Profit or loss. When you figure your taxable income for the year, you must add in any profit, or subtract any loss, you have from your sole proprietorship. You must report the profit or loss from each of your businesses operated as a sole proprietorship on a separate Schedule C (Form 1040). You can file Schedule C–EZ (Form 1040) only if you had one business as a sole proprietor and you meet the requirements in Part I of the schedule. The amount of this business profit or loss is then entered as an item of profit or loss on your individual income tax return Form 1040.

If you are a sole proprietor, you are probably liable for ***self-employment tax*** (see chapter 32). Also, ordinarily you will have to make estimated tax payments (see chapter 27).

Assets. Each asset in your sole proprietorship is treated separately for tax purposes, rather than as part of one overall ownership interest. For example, a sole proprietor selling an entire business as a going concern figures gain or loss separately on each asset. See chapter 27 for information on the sale of your sole proprietorship.

Rules. Other rules explained in this publication apply to sole proprietorships unless stated otherwise.

Partnerships

A partnership is not a taxable entity. However, it must figure its profit or loss and file a return. A partnership files its return on Form 1065.

A partnership is the relationship existing between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business.

For income tax purposes, the term ''partnership'' includes a syndicate, group, pool, joint venture, or other unincorporated organization that is carrying on a business and is not classified as a trust, estate, or corporation.

A joint undertaking to share expenses is ***not*** a partnership. Mere co-ownership of property maintained and leased or rented is ***not*** a partnership. However, if the co-owners provide services to the tenants, then a partnership exists.

Partnership agreement. The partnership agreement includes the original agreement and any modifications of it agreed to by all the partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications may be oral or written.

The partnership agreement may be modified for a particular tax year after the close of that year, but not later than the date, excluding any extension of time, for filing the partnership return.

Generally, a partner's share of income, gain, loss, deductions, or credits is determined by the partnership agreement.

However, the partnership agreement or any modification of it will be disregarded if the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or of any item in these categories) does not have substantial economic effect.

In any matter on which the partnership agreement, or any modification of it, is silent, the provisions of local law are treated as part of the agreement.

Partnerships excluded. If all the members agree, some partnerships may choose to be completely or partially excluded from being treated as partnerships, for federal income tax purposes. The exclusion applies only to certain unincorporated investing partnerships and operating agreements where business is not actively conducted. It applies to the joint production, extraction, or use of property, but not for selling services or property produced or extracted. The members of such an organization must be able to figure their income without having to figure partnership taxable income.

For more information on partnerships, see chapter 28.

Corporations

Corporate profits normally are taxed to the corporation. When the profits are distributed as dividends, the dividends are taxed to the shareholders.

In figuring its taxable income, a corporation generally takes the same deductions as a sole proprietorship. Corporations also are entitled to special deductions that are discussed in chapter 29.

A corporation, for federal income tax purposes, includes associations, joint stock companies, insurance companies, and trusts and partnerships that actually operate as associations or corporations.

Organizations of professional people. Organizations of doctors, lawyers, and other professional people organized under state professional association acts are generally recognized as corporations for federal income tax purposes. A professional service organization must be both ***organized*** and ***operated*** as a corporation to be classified as one. All of the states and the District of Columbia have professional association acts.

Unincorporated organizations. Organizations that are unincorporated and have certain corporate characteristics are classified as associations and are taxed as corporations. These organizations must have associates and must be organized to carry on business and divide any gains from the business. In addition, the organizations must have a ***majority*** of the following characteristics:

1) Continuity of life,
2) Centralization of management,
3) Limited liability, and
4) Free transferability of interests.

Other factors may also be significant in classifying an organization as an association. An organization will be treated as an association if its characteristics more nearly resemble a corporation than a partnership or trust. The facts in each case determine which characteristics are present.

Income tax return. A corporation must file an income tax return unless it has dissolved. This applies even if it has ceased doing business and has disposed of all of its assets except for a small sum of cash retained to pay state taxes to keep its corporate charter. A corporation may be required to file a return for any year following the year in which it has been dissolved, if it carries on substantial activities such as the collection of assets or the payment of obligations in connection with the termination of its business affairs.

A corporation with no assets is not required to file an income tax return after it stops doing business and dissolves. This is so even if it is treated as a corporation under state law for limited purposes connected with winding up its affairs, such as suing or being sued. Most corporations file Form 1120 or Form 1120–A.

Forming a corporation. Forming a corporation involves a transfer of either money, property, or both, by the prospective shareholders in exchange for capital stock in the corporation.

If money is exchanged for stock, no gain or loss is realized by the shareholder or the corporation. The stock received by the shareholder has a basis equal to the amount of money transferred to the corporation by the shareholder.

If property is exchanged for stock, it may be a nontaxable exchange of property for stock, as discussed in chapter 21. In other cases, the shareholder who transfers the property to the corporation will realize a taxable gain or loss. Under certain circumstances, as explained under *Sales and Exchanges Between Related Parties* in chapter 22, any gain recognized which ordinarily would be a capital gain may have to be treated as an ordinary gain, and any loss may be nondeductible.

The gain or loss on a ***taxable exchange*** is figured by comparing the adjusted basis of the property transferred with its fair market value at the time of the transfer to the corporation. This may be a capital gain or loss. See chapter 22.

For more information on corporations, see chapter 29.

S Corporations

A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders will then include in their income their share of the corporation's separately stated items of income, deduction, loss, and credit and their share of nonseparately stated income or loss. A corporation that makes this choice is an S corporation.

Although it generally will not be liable for federal income tax, an S corporation may have to pay a tax on excess net passive investment income, a tax on capital gains, a tax on built-in gains, or the tax from recomputing a prior year's investment credit. An S corporation files its return on Form 1120S.

To make the election to become an S corporation, a corporation, in addition to other requirements, must not have more than 35 shareholders. Also, each shareholder must consent to the election.

For more information on S corporations, see chapter 30.

Taxpayer Identification Number

You generally use your ***social security number*** as your taxpayer identification number. You must put this number on each of your individual income tax forms, such as Form 1040 and its schedules.

However, every partnership, corporation (including S corporations), and certain sole proprietors must have an ***employer identification number*** (EIN) to use as a taxpayer identification number. Sole proprietors must have EINs if they:

1) Pay wages to one or more employees, or
2) Must file any pension or excise tax returns, including those for alcohol, tobacco, or firearms.

If you are required to have an EIN, include it along with your social security number on your Schedule C (Form 1040). If you are not required to have an EIN, use your social security number as your business taxpayer identification number. Enter it on the appropriate line and leave line D blank.

Application for identification number. To apply for a social security number, you should use ***Form SS–5.*** If you are under 18 years of age, you must furnish evidence, along with this form, of age, identity, and U.S. citizenship. If you are 18 or older, you must appear in person with this evidence at a Social Security office. If you are an alien, you must appear in person and bring your birth certificate and either your alien registration card or your U.S. immigration form.

To apply for an EIN, use Form SS–4. This form is available from IRS and Social Security Administration offices.

Payments to others. If you make payments that require an information return, you must include the payee's taxpayer identification number on the information return. See chapter 36.

To get the payee's number, use ***Form W–9.*** This form is available from the IRS. A payee who does not provide you with an identification number may be subject to backup withholding of 31% on the payments you make.

Penalties. A penalty of up to $50 per return applies for each failure to comply by the required due date with certain specified information reporting requirements, up to a maximum of $100,000 for all such failures. Most of these requirements concern furnishing and including taxpayer identification numbers on returns, statements, and other documents. See chapter 36 for more information on penalties.

New EIN. You may need to get a new EIN if either the form or the ownership of your business changes.

Change in organization. A new EIN is required for the following changes:

1) A sole proprietorship incorporates;
2) A sole proprietorship takes in partners and operates as a partnership;
3) A partnership incorporates;
4) A partnership is taken over by one of the partners and is operated as a sole proprietorship; or
5) A corporation changes to a partnership or to a sole proprietorship.

Note. A corporation converting to an S corporation does not need a new EIN.

Change in ownership. A new EIN is required for the following changes:

1) You purchase or inherit an existing business that you will operate as a sole proprietorship (You cannot use the EIN of the former owner, even if he or she is your spouse.);
2) You represent an estate that operates a business after the owner's death; or
3) You terminate an old partnership and begin a new one.

2.

Books and Records

Topics

This chapter discusses:

- Why you should keep records
- What records to keep
- How long to keep records

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, and Gift Expenses
- ☐ **583** Starting a Business and Keeping Records
- ☐ **917** Business Use of a Car

You must keep records to correctly figure your taxes. This chapter explains why you must keep records, what kinds of records you must keep, and how long you must keep them for federal tax purposes.

If you are starting a new business, get Publication 583. It has more details about setting up a recordkeeping system.

Why Keep Records?

Everyone in business must keep records. Good records will help you do the following.

Monitor the progress of your business. You need good records to monitor the progress of your business. Records can show whether your business is improving, which items are selling, or what changes you need to make. Good records can increase the likelihood of business success.

Prepare your financial statements. You need good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help you in dealing with your bank or creditors.

Identify source of receipts. You will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate business from nonbusiness receipts and taxable from nontaxable income.

Keep track of deductible expenses. You may forget expenses when you prepare your tax return unless you record them when they occur.

Prepare your tax returns. You need good records to prepare your tax return. These records must support the income, expenses, and credits you report. Generally, these are the same records you use to monitor your business and prepare your financial statements.

Support items reported on tax returns. You must keep your business records available at all times for inspection by the IRS. If the IRS examines any of your tax returns, you may be asked to explain the items reported. A complete set of records will speed up the examination.

Kinds of Records To Keep

Except in a few cases, the law does not require any special kind of records. You may choose any system suited to your business that clearly shows your income.

The business you are in affects the type of records you need to keep for federal tax purposes. You should set up your books using an accounting method that clearly shows your income for your tax year. See chapter 3. If you are in more than one business, you should keep a complete and separate set of books for each business.

Your books must show your gross income, as well as your deductions and credits. In addition, you must keep supporting documents. Purchases, sales, payroll, and other transactions you have in your business will generate supporting documents such as invoices and receipts. These documents contain the information you need to record in your books.

It is important to keep these documents because they support the entries in your books and on your tax return. You should keep them in an orderly fashion and in a safe place.

Travel, transportation, entertainment, and gift expenses. Special recordkeeping rules apply to these expenses. For more information, see Publication 463, *Travel, Entertainment, and Gift Expenses* and Publication 917, *Business Use of a Car.*

Employment taxes. The following is a list of the specific employment tax records you must keep. For information on the employment taxes you may have to pay, see chapter 33.

Income tax withholding. The specific records you must keep for income tax withholding are:

1) Each employee's name, address, and social security number.
2) The total amount and date of each wage payment and the period of time the payment covers.
3) For each wage payment, the amount subject to withholding.
4) The amount of withholding tax collected on each payment and the date it was collected.
5) If the taxable amount is less than the total payment, the reason why it is less.
6) Copies of any statements furnished by employees relating to nonresident alien status, residence in Puerto Rico or the Virgin Islands, or residence or physical presence in a foreign country.
7) The fair market value and date of each payment of noncash compensation made to a retail commission salesperson, if no income tax was withheld.
8) For accident or health plans, information about the amount of each payment.
9) The withholding allowance certificates (Form W–4) filed by each employee.
10) Any agreement between you and the employee on Form W-4 for the voluntary withholding of additional amounts of tax.
11) If necessary to figure tax liability, the dates in each calendar quarter on which any employee worked for you, but ***not*** in the course of your trade or business, and the amount paid for that work.
12) Copies of statements given to you by employees reporting tips received in their work, unless the information shown on the statements appears in another item on this list.
13) Requests by employees to have their withheld tax figured on the basis of their individual cumulative wages, and any notice that the request was revoked.
14) The Forms W–5, *Earned Income Credit Advance Payment Certificate,* and the amounts and dates of the advance payments.

An employee's earnings ledger, which you can buy at most office supply stores, normally has space for the information required in items (1) to (4).

Social security and Medicare taxes. You must also maintain the following information in your records on the social security and Medicare taxes of your employees:

1) The amount of each wage payment subject to social security tax.
2) The amount of each wage payment subject to Medicare tax.
3) The amount of social security and Medicare tax collected for each payment and the date collected.
4) If the total wage payment and the taxable amount differ, the reason why they do.

Federal unemployment (FUTA) tax. For FUTA tax purposes, you must maintain records containing the following information:

1) The total amount paid to your employees during the calendar year.
2) The amount of compensation subject to the unemployment tax, and, if it differs

from the total compensation, why it differs.

3) The amount you paid into the state unemployment fund.

4) Any other information required to be shown on Form 940 (or Form 940–EZ).

Assets. Assets are the property, such as machinery and furniture, that you own and use in your business. You must keep records to verify certain information about your business assets. You need records to figure the annual depreciation and the gain or loss when you sell the assets. Your records should show:

- When and how you acquired the asset
- Purchase price
- Cost of any improvements
- Section 179 deduction taken
- Deductions taken for depreciation
- Deductions taken for casualty losses, such as fires or storms
- How you used the asset
- When and how you disposed of the asset
- Selling price
- Expenses of sale

Examples of records that may show this information include:

- Purchase and sales invoices
- Real estate closing statements
- Canceled checks

What if I don't have a canceled check? If you do not have a canceled check, you may be able to prove payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. The following is a list of acceptable account statements.

1) An account statement showing a check clearing is accepted as proof if it shows the:

   a) Check number,

   b) Amount,

   c) Payee's name, and

   d) Date the check amount was posted to the account by the financial institution.

2) An account statement showing an electronic funds transfer is accepted as proof if it shows the:

   a) Amount transferred,

   b) Payee's name, and

   c) Date the transfer was posted to the account by the financial institution.

3) An account statement showing a credit card charge (an increase to the cardholder's loan balance) is accepted as proof if it shows the:

   a) Amount charged,

   b) Payee's name, and

   c) Date charged (transaction date).

These account statements must be highly legible and readable.

Proof of payment of an amount alone does not establish that you are entitled to a tax deduction. You should also keep other documents, such as credit card sales slips and invoices, discussed previously.

Computerized system. There are computer software packages that you can use for recordkeeping. They can be purchased in many retail stores. These packages are very useful and relatively easy to use; they require very little knowledge of bookkeeping and accounting.

If you use a computerized system, you must be able to produce legible records from the system to provide the information needed to determine your correct tax liability.

You must also keep all machine-sensible records and a complete description of the computerized portion of your accounting system. This documentation must be sufficiently detailed to show the following:

1) Applications being performed,

2) Procedures used in each application,

3) Controls used to ensure accurate and reliable processing, and

4) Controls used to prevent the unauthorized addition, alteration, or deletion of retained records.

See Revenue Procedure 91–59, printed in Cumulative Bulletin 1991–2 on page 841 for more information.

Microfilm. Microfilm and microfiche reproductions of general books of accounts, such as cash books, journals, voucher registers, and ledgers, are accepted for recordkeeping purposes if they comply with Revenue Procedure 81–46, printed in Cumulative Bulletin 1981–2 on page 621.

How Long To Keep Records

You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax. The period of time in which you can amend your return to claim a credit or refund is generally the later of:

1) 3 years after the date your return is due or filed, or

2) 2 years after the date the tax is paid.

Returns filed before the due date are treated as filed on the due date.

The IRS has 3 years from the date you file your return to assess any additional tax. If you file a fraudulent return or no returns at all, the IRS has a longer period of time to assess additional tax.

Employment taxes. If you have employees, you must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

Assets. Keep records relating to property until the period of limitations expires for the year in which you dispose of the property in a taxable disposition. You must keep these records to figure any depreciation, amortization, or depletion deduction, and to figure your basis for computing gain or loss when you sell or otherwise dispose of the property.

Generally, if you received property in a nontaxable exchange, your basis in that property is the same as the basis of the property you gave up. You must keep the records on the old property, as well as on the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition.

Tax returns. Keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you later file an amended return.

Records for nontax purposes. When your records are no longer needed for tax purposes, do not discard them until you check to see if you have to keep them longer for other purposes. For example, your insurance company or creditors may require you to keep them longer than the IRS does.

3. Accounting Periods and Methods

Introduction

Every taxpayer (business or individual) must figure taxable income and file a tax return on the basis of an annual accounting period. Your ''tax year'' is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

1) A calendar year, or
2) A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

The due date for individual and partnership returns is the 15th day of the 4th month after the end of the tax year. Individuals include sole proprietors, partners, and S corporation shareholders. The due date for filing returns for corporations and S corporations is the 15th day of the 3rd month after the end of the tax year. If the 15th day of the month falls on a Saturday, Sunday, or legal holiday, the due date is the next day that is not a Saturday, Sunday, or legal holiday.

An accounting method is a set of rules used to determine when and how income and expenses are reported. Your ''accounting method'' includes not only the overall method of accounting you use, but also the accounting treatment you use for any material item.

You choose your accounting method when you file your first tax return. After that, if you want to change your accounting method, you must first get consent from the IRS. See *Change in Accounting Method,* later.

No single accounting method is required of all taxpayers. You must use a system that clearly shows your income and expenses and you must maintain records that will enable you to file a correct return. In addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the same method from year to year. Any accounting method that shows the consistent use of generally accepted accounting principles for your trade or business generally is considered to clearly show income. An accounting method clearly shows income only if all items of gross income and all expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, clearly shows your income.

Topics

This chapter discusses:

- Calendar tax years
- Fiscal tax years
- Short tax years
- Accounting methods
- Cash method
- Accrual method
- Change in accounting method

Useful Items

You may want to see:

Publication

- ☐ **538** Accounting Periods and Methods

Form (and Instructions)

- ☐ **1128** Application To Adopt, Change, or Retain a Tax Year
- ☐ **3115** Application for Change in Accounting Method

Accounting Periods

Your regular accounting period is either a calendar tax year or a fiscal tax year.

Calendar Tax Year

If you adopt the calendar year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

You must adopt the calendar tax year if:

1) You do not keep adequate records,
2) You have no annual accounting period, or
3) Your present tax year does not qualify as a fiscal year.

Fiscal Tax Year

A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52–53 week year is a fiscal tax year that varies from 52 to 53 weeks.

If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

For more information on fiscal years including 52–53 week years, get Publication 538.

Note. Employment taxes are figured on a calendar year basis. You must use the calendar quarter for withheld income tax and social security and Medicare taxes. You must use the calendar year for federal unemployment tax. Employment taxes are discussed in chapter 33.

Short Tax Year

A short tax year is a tax year of less than 12 months. There are two situations that can result in a short tax year. The first occurs when you (as a taxable entity) are not in existence for an entire tax year. The second occurs when you change your accounting period. Each situation results in a different way of figuring tax for the short tax year.

Not in existence entire year. A tax return is required for the short period during which you were in existence. Requirements for filing the return and paying the tax generally are the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year.

Example. Corporation X came into existence on July 1, 1995. It elected the calendar year as its tax year. Corporation X must file its return by March 15, 1996. The return covers the period July 1, 1995, through December 31, 1995.

Change in accounting period. You must, with certain exceptions, get approval from the IRS to change your accounting period. To get this approval, you must file a current Form 1128 and enclose a user fee. This form must be filed by the 15th day of the 2nd calendar month after the close of the short tax year. This short tax year begins on the first day after the end of your present tax year and ends on the day before the first day of your new tax year.

Example. You use a calendar tax year and, in 1996, you want to change to a fiscal year ending October 31. You must file Form 1128 by December 16, 1996.

If you change your accounting period, you figure your tax for the short tax year by placing your taxable income for the short period on an annual basis. This computation, and other rules regarding a change in accounting period are explained in Publication 538.

Individuals

Individuals generally use a calendar tax year. If you filed your first return using the calendar tax year, and you later begin business as a sole proprietor, or become a partner, or become a shareholder in an S corporation, you must continue to use the calendar tax year unless you get permission to change. You must report your income from all sources, including your sole proprietorship, salaries, partnership income, and dividends, using the same tax year.

Partnerships

A partnership must conform its tax year to its partners' tax years, unless the partnership can establish a business purpose for a different period or makes a section 444 election. A partnership is required to conform its tax year to its partners' tax years in the following way:

1) If a majority interest (aggregate interest of more than 50%) in partnership capital and profits is held by one partner, or by more than one partner with the same tax year, the partnership must adopt that tax year.
2) If there are no partners who own a majority interest, or if the majority interest partners do not have the same tax year, the partnership is required to change to the tax year of its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
3) If neither (1) nor (2) applies, the partnership is required to adopt a tax year that results in the least aggregate deferral of income to the partners.

For more information about the required year for partnerships, establishing a business purpose tax year, and a section 444 election, see Publication 538. For general information on partnerships, see chapter 28.

S Corporations

A small business corporation can elect to be an S corporation. All S corporations, regardless of when they became S corporations, must use a calendar tax year, or any other tax year for which the corporation establishes a business purpose or makes a section 444 election. For information on establishing a business purpose tax year or a section 444 election, get Publication 538. For general information on S corporations, see chapter 30.

Corporations

A new corporation establishes its tax year when it files its first income tax return. It can use either a calendar year or a fiscal year as its tax year. However, special rules exist that limit your tax year choice if you are a personal service corporation, S corporation, member of an affiliated group filing a consolidated return, real estate mortgage investment conduit, foreign sales corporation, or domestic international sales corporation.

Personal Service Corporations

Personal service corporations must use a calendar tax year unless they can establish a business purpose for a different period, or make a section 444 election. For this purpose, a personal service corporation generally is a corporation in which the principal activity is the performance of personal services that are substantially performed by employee-owners. For information on establishing a business purpose tax year or a section 444 election, get Publication 538.

Performance of personal services. For this purpose, any activity that involves the performance of services in the fields of health, veterinary services, law, engineering, architecture, accounting, actuarial science, performing arts, or certain consulting services, is considered to be the performance of personal services.

For additional information about a personal service corporation's tax year, see Publication 538.

Accounting Methods

Generally, you may figure your taxable income under any of the following accounting methods:

1) Cash method,
2) Accrual method,
3) Special methods of accounting for certain items of income and expenses, and
4) Combination (hybrid) method using elements of two or more of the above.

The cash and accrual methods of accounting are explained later.

Special methods. There are special methods of accounting for certain items of income or expense such as:

Depreciation, discussed in chapter 12,

Amortization and depletion, discussed in chapter 13,

Deduction for bad debts, discussed in chapter 14, and

Installment sales, discussed in chapter 24.

Combination (hybrid) method. Generally, you may use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently. However, the following restrictions apply:

1) If inventories are necessary to account for your income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expenses. See *Inventories,* in the discussion of expenses under *Accrual Method,* later.
2) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
3) If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Any combination that includes the cash method is treated as the cash method, subject to the limitations applied to that method.

Business and personal items. You may account for business and personal items under different accounting methods. For example, you may figure the income from your business under an accrual method even though you use the cash method to figure personal items.

Two or more businesses. If you operate more than one business, you generally may use a different accounting method for each separate and distinct business if the method you use for each clearly shows your income. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business but you must use an accrual method for the accounting of the manufacturing business' sales and purchases.

No business will be considered separate and distinct if you do not keep a complete and separable set of books and records for that business.

Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. However, if inventories are necessary in accounting for your income, you must use an accrual method for your sales and purchases. If you do not have to keep inventories, you usually will use the cash method. However, see *Limits on Use of Cash Method,* next.

Limits on Use of Cash Method

The cash method, including any combination of methods that includes the cash method, cannot be used by the following entities:

1) Corporations (other than S corporations),
2) Partnerships having a corporation (other than an S corporation) as a partner, and
3) Tax shelters.

Exceptions. An exception allows farming businesses with gross receipts of $25 million or less, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less to use the cash method. However, these exceptions do not apply to tax shelters. For more general information, see Publication 538. For more information on the farming exception, see chapter 3 in Publication 225.

Income

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. You must include property and services you receive in your income at their fair market value.

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent receives it.

Example 1. You have interest credited to your bank account in December 1995. You must include it in your gross income for 1995 and not for 1996 when you withdraw it or enter it in your passbook.

Example 2. You have interest coupons that mature and are payable in 1995, but you do not cash them until 1996. You must include them in income for 1995. You must include this matured interest in your gross income even though you later exchange the coupons for other property instead of cashing them.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying the tax on the income. You must report the income in the year the property is made available to you without restriction.

Expenses

Usually, you must deduct expenses in the tax year in which you actually pay them. However, expenses you pay in advance can be deducted only in the year to which they apply. In addition, if the uniform capitalization rules apply (see chapter 7), you may have to capitalize certain costs.

Example. You are a calendar year taxpayer and you pay $1,000 for a business insurance policy that is effective on July 1, 1995, for a one-year period. You may deduct $500 in 1995 and $500 in 1996.

Accrual Method

Under an accrual method of accounting, income generally is reported in the year earned, and expenses are deducted or capitalized in the year incurred. The purpose of an accrual method of accounting is to match your income and your expenses in the correct year.

Income

Generally, all items of income are included in your gross income when you earn them, even though you may receive payment in another tax year. An income item is includible in your gross income in the tax year in which all events that fix your right to receive the income have happened, and you can figure the amount with reasonable accuracy.

Example. You are a calendar year accrual basis taxpayer. You sold a computer on December 28, 1995. You billed the customer in the first week of January 1996, but you did not receive payment until February 1996. You must include the amount of the sale in your income for 1995 because you earned the income in 1995.

Advance income. Special rules dealing with an accrual method of accounting for advance payments to you are discussed in chapter 6 under *Prepaid Income.*

Estimating income. When you include an amount in gross income on the basis of a reasonable estimate, and you later determine the exact amount, the difference, if any, is taken into account in the tax year in which the determination is made.

Change in payment schedule for services. If you contract to perform services for a basic rate, you must include the basic rate in your income as it accrues. You must accrue the basic rate even if, as a matter of convenience, you agree to receive payments at a lower rate until you complete your services, at which time you will receive the difference between the basic rate and the amount actually paid to you.

Accounts receivable for services. You may not have to accrue all of your accounts receivable if, based on your experience, you will not collect all of these accounts. This is called the *nonaccrual-experience method.* See section 1.448–2T(b) of the Income Tax Regulations.

Expenses

You deduct or capitalize business expenses when you become liable for them, whether or not you pay them in the same year. For this purpose, liability occurs in the tax year in which you meet the all events test and the economic performance rule.

All events test. Before you can deduct or capitalize the expenses, all events must have occurred that fix the fact of the liability and you must be able to figure the amount with reasonable accuracy.

Economic performance rule. Generally, you cannot deduct business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services. An exception allows certain recurring expenses to be treated as incurred during a tax year even though economic performance has not occurred.

Example. You are a calendar year taxpayer and in December 1995 you buy office supplies. You received the supplies and are billed for them in December, but you pay for the supplies in January 1996. You can deduct the expense in 1995 because all events that fix the fact of liability have occurred, the amount of the liability can be reasonably determined, and economic performance occurred in that year.

Your office supplies may qualify as a recurring expense. In that case, you may be able to deduct the expense in 1995 even if economic performance (delivery of the supplies to you) did not occur until 1996. See Publication 538 for more information on the economic performance requirement.

Inventories. Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If inventories are necessary to show income correctly, only an accrual accounting method can be used for purchases and sales. Inventories are discussed in chapter 7.

Special Rules for Related Persons

You cannot deduct business expenses and interest owed to a related cash basis person ***until*** you make the payment and the corresponding amount is includible in the gross income of the related person. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ends before the expenses or interest is includible in the gross income of that person.

Related persons. For the purpose of applying this rule, the following are related persons:

1) Members of the immediate family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants.
2) Two corporations that are members of the same controlled group.
3) The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts if the same person is the grantor of both trusts.
4) Certain educational and charitable organizations and a person (if an individual, including the members of the individual's family) who, directly or indirectly, controls the organization.
5) An individual and a corporation of which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for that individual.
6) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust.
7) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
8) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
9) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
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 interest or profits or profits interest in the partnership.
11) A personal service corporation and any employee-owner, regardless of the amount of stock owned by the employee-owner.

Indirect ownership of stock. To decide whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply:

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family (as defined in item (1) under *Related persons*).
3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner, and
4) Stock constructively owned by a person under rule (1), shall, to apply rule (1), (2), or (3), be treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) will not be treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or to prevent evasion of taxes, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

Gains and losses. Gains and losses on sales or exchanges between ***related parties*** are discussed in chapter 21. For information on losses from sales or exchanges of property between partners and partnerships, see chapter 28.

Change in Accounting Method

When you file your first return, you may, without consent from the IRS, choose any permitted accounting method. The method you choose must be used consistently from year to year and clearly show your income.

After your first return is filed, if you want to change your accounting method, you must first get consent from the IRS.

The IRS will consider the need for consistency in the accounting area against your reason for wanting to change your accounting method when the method from which you are changing clearly shows your income.

If you request a change in accounting method (such as from an improper to a proper method), the absence of IRS consent to the change does not prevent the IRS from imposing any penalty or addition to tax, nor diminish the amount of the penalty or the addition to tax.

A change in your accounting method includes a change not only in your overall system of accounting but also in the treatment of any material item. Some examples of changes that ***require*** consent are:

1) A change from the cash method to an accrual method or vice versa (unless you must change to an accrual method and you make the change automatically),
2) A change in the method or basis used to value inventories, and
3) A change in the method of figuring depreciation (except certain changes to the straight line method as explained in chapter 12).

Automatic change to accrual method. If you are required to change from the cash method to an accrual method, discussed earlier under *Limits on Use of Cash Method,* you are not required to have prior approval from the IRS to make this change.

Form 3115. Although this change to an overall accrual method is considered automatic, you must complete and file Form 3115 by the due date (including extensions) for filing your income tax return. Attach Form 3115 with the applicable user fee to your income tax return. For more information, see Publication 538.

Accounting change information. For information about the procedures to change your accounting method, see Publication 538.

Part Two.

Business Assets

Whether you are starting a new business or are continuing a going one, you probably need to acquire property to use in your business. The cost of this property becomes part of the capital investment in your business. This Part discusses the kinds of costs that must be capitalized and how to figure the basis of your business assets.

4. Capital Expenses

Introduction

You must capitalize (charge an expense to a capital asset account), rather than deduct, some costs. These costs are considered a part of your investment in your business and are called ''capital expenses.'' There are, in general, three types of costs that must be capitalized:

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

These costs are discussed later. This chapter and the next discuss the treatment of capital expenses.

Cost of goods sold. If your business manufactures products or purchases them for resale, some of your costs are for the products you sell. You use these expenses to figure the cost of goods you sold during the year. Deduct these costs from your gross receipts to figure your gross profit for the year. (You must maintain inventories to be able to determine your cost of goods sold.) If you use an expense to figure cost of goods sold, you cannot deduct it again as a business expense. See the chapters in Part 3 for more information on gross profit and the cost of goods sold. See chapter 7 for a discussion of the uniform capitalization rules that apply to property produced for sale or purchased for resale.

Business expenses. Most of the other operating costs of your business can be deducted from gross profit when figuring income or loss for the year. These operating costs are known as business expenses. Some of the business expenses that are deductible are advertising, office supplies, insurance premiums, employee wages, utilities, rent, and property taxes. See the chapters in Part 4 for information on deducting business expenses, including the limits on what can be deducted. Also, see chapter 7 for a discussion of the uniform capitalization rules that apply to property produced for sale or purchased for resale.

Topics

This chapter discusses:

- Kinds of capital expenses
- Business assets
- Going into business
- Costs you can choose to deduct or capitalize

Useful Items

You may want to see:

Publication

- ☐ **946** How To Depreciate Property
- ☐ **535** Business Expenses

Form (and Instructions)

- ☐ **6765** Credit for Increasing Research Activities
- ☐ **3115** Application for Change in Accounting Method

Kinds Of Capital Expenses

Generally, three kinds of costs must be capitalized:

1) ***Business assets.*** What you spend for any asset you will use in your business for more than one year is a capital expense. There are many different kinds of business assets—for example, land, buildings, machinery, trucks, books, furniture, patents, and franchise rights. You must capitalize the full cost of the asset, including freight and installation charges. Business assets are discussed later in this chapter.

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

2) ***Going into business.*** The costs of getting started in business, before you actually begin business operations, are capital expenses. This may include expenses for such things as advertising, travel, utilities, repairs, and employees' wages. These are often the same kind of costs that can be deducted when you have them after you open for business. The costs of going into business are discussed later in this chapter.

3) ***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. However, normal repair costs are deducted as business expenses and are not capitalized. Ordinarily, you add the cost of the improvement to the basis of the improved property. The cost of the improvement is recovered through annual depreciation deductions. See chapter 12.

   Examples of improvements are new electric wiring, a new roof, a new floor, new plumbing, bricking up windows to strengthen a wall, and lighting improvements.

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

Basis. When you make a capital expense, it becomes a part of your ''basis.'' Basis is a way of measuring your investment in an asset for tax purposes. It is used in many ways—to figure gain or loss on a sale, to figure the amount of a casualty loss, to figure depreciation deductions, etc.

Your original basis in an asset is the amount you must spend to acquire it. But even if it does not cost you anything to acquire a business asset—for example, if you inherit it or get it as a gift—you will still have a basis in the asset. While you own the asset, various events may take place that will change your basis in the property. Some events, such as improvements or additions, increase basis. Others, such as casualty losses or depreciation deductions, decrease basis.

For more information on figuring basis, see chapter 5.

Recovery. Although you generally cannot directly deduct a capital expense, you can often ''recover'' your cost (i.e., subtract it from income) one part at a time over a number of years. This is done by deducting a percentage of basis each year under one of the following methods:

1) ***Depreciation.*** Depreciation is used to recover capital expenses for most tangible business assets.

2) ***Amortization.*** Amortization is used to recover only certain kinds of capital expenses, such as some research costs, business start-up costs, and the cost of pollution control facilities.

3) ***Depletion.*** Depletion is used to recover the cost of an economic interest in timber, minerals, and other natural resources.

You can choose to deduct in one tax year a limited amount of what you spend to acquire certain tangible property for use in a trade or business instead of treating this amount as a capital expense. The maximum amount you can deduct is $17,500. See *Section 179 Deduction* in chapter 12.

Depreciation is discussed in chapter 12. Amortization and depletion are covered in chapter 13.

If you do not completely recover a capital expense through depreciation, amortization, or depletion, you can usually recover the balance when you sell or otherwise give up ownership of your business assets. Basis is subtracted from the amount you realize on a sale to figure gain or loss (see chapter 21). Basis is also the starting point for figuring gain or loss if a business asset is stolen or destroyed (see chapter 25). If you abandon the asset, you also use basis to figure your loss. See *Dispositions* in Publication 946.

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

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

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

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

There are dollar limits on the depreciation you may claim each year for passenger automobiles used in your business. See chapter 12.

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

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

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

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

See section 1.263A of the Income Tax Regulations for information on the uniform capitalization rules.

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

Business Assets

A business usually owns property that it uses, directly or indirectly, to earn its income. Property that is used in this way is a business asset. Business assets are classified as tangible or intangible, real or personal.

All the costs of getting a business asset that is ordinarily used for more than one year are capital expenses. This includes the cost of freight, installation, and testing. It also includes the costs of building an asset yourself. See chapter 5.

Tangible and intangible property. A business asset may be tangible property—such as a warehouse, lathe, desk, truck, or tool—or it may be intangible property—such as a trademark, customer list, franchise, promissory note, or goodwill. Tangible property is property that can be felt or touched. Its physical features are what make it useful to you. Intangible property is property that is not tangible. Documents that are merely representations of value (such as stock certificates) or evidence of rights (such as patents) are intangible property.

Real and personal property. Tangible business assets are further classified as either real or personal property. Real property is land and anything fixed to the land—for example, fences, parking lots, buildings, or trees. Everything else is personal property—for example, furniture, office equipment, vehicles, and supplies. Components of buildings—such as air conditioning, plumbing, and furnaces—may be real or personal property, depending on state law.

Going Into Business

When you get ready to go into business, you probably will have a number of different costs. For example, you may:

1) Travel to line up customers and suppliers,
2) Conduct market surveys, or begin to advertise your business,
3) Pay salaries or fees for executives, consultants, and other professional services,
4) Begin to hire and train employees, or
5) Analyze available facilities, labor, supplies, etc.

However, because your business has not yet started active operations, you are not allowed to deduct these kinds of costs as expenses. These costs, start-up costs, must be amortized. To be amortizable, a start-up cost must meet the following tests:

1) It must be a cost that you could deduct if it were paid or incurred to operate an existing trade or business.
2) It must be paid or incurred by you before you actually begin business operations.

If you buy business assets. The costs connected with acquiring a business asset become part of your basis in the asset. For example, a lawyer's fee for negotiating a lease becomes part of your basis in the lease. The cost of a land survey for real estate you plan to buy becomes a part of your basis in the property once you acquire it.

If your attempt to acquire a business asset is not successful, you can deduct, as a capital loss, the costs you had in the attempt. You can take this loss whether or not you eventually go into business.

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

However, you can choose to amortize certain costs you have in setting up your business. These costs are deducted as expenses in equal amounts over a period of 60 months or more. The costs you can amortize include:

1) Business start-up costs,
2) Organizational costs for a corporation,
3) Organizational costs for a partnership, and
4) The cost of acquiring a lease.

See chapter 13 for more information on business start-up costs and organizational costs of a corporation or partnership. See chapter 11 for more information on amortizing the cost of a lease.

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

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

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

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

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

Costs You Can Deduct or Capitalize

There are certain costs that you can choose either to deduct or to capitalize. The choice you make depends on when it is best for you to recover your costs.

If you deduct a cost as an expense, you ''recover'' it in full by subtracting it from your income.

If you capitalize a cost, you may be able to recover the cost through a section 179 deduction, a deduction for clean-fuel vehicles or certain refueling property, or periodic deductions for depreciation, amortization, or depletion.

For a discussion on the section 179 deduction and depreciation, see chapter 12; for a discussion on amortization and depletion, see chapter 13; for a discussion on the deduction for clean-fuel vehicles and certain refueling property, see chapter 15 in Publication 535.

Or you may recover the cost when you sell the asset you bought and figure your gain or loss.

See Publication 551, *Basis of Assets* for a discussion of the uniform capitalization rules that apply to property produced for sale or use in a trade or business.

The costs that you can choose to deduct or to capitalize include:

- Certain carrying charges on property (unless the uniform capitalization rules apply),
- Research and experimental costs,
- ''Intangible'' drilling and development costs for oil, gas, and geothermal wells,
- Exploration costs for new mineral deposits,
- Mine development costs for a new mineral deposit,
- Costs of increasing the circulation of a newspaper or a periodical, and
- Costs of removing architectural and transportation barriers to individuals with disabilities and the elderly.

The decision to capitalize or to deduct costs belongs to the business entity, that is, the sole proprietor, partnership, corporation, estate, or trust. Individual partners, shareholders, and beneficiaries do not make the choice themselves (except for exploration costs for a new mineral deposit).

NOTE. For individuals, partners, beneficiaries, and S corporation shareholders, all the costs listed above, except carrying charges and costs of removing architectural and transportation barriers to disabled and elderly people, are adjustments or tax preference items. These items are subject to the alternative minimum tax if they are deducted on your tax return.

If you decide to deduct these items over an optional write-off period, they are not treated as adjustments or tax preference items. For more information, see *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

Carrying charges. Carrying charges are the taxes and interest you pay to carry or develop real property or to carry, transport, and install personal property. Certain carrying charges must be capitalized under the uniform capitalization rules. (For more information, see chapter 5.) In addition, you can choose to capitalize carrying charges not subject to the uniform capitalization rules, but only if they are otherwise deductible.

You can make a separate choice to capitalize carrying charges for each project you have and for each type of carrying charge. For unimproved and unproductive real property, your choice is good for only one year. You must make a new choice each year the property remains unimproved and unproductive. For other property, your choice to capitalize carrying charges remains in effect until construction, development, or installation is completed (or, for personal property, the date you first use it, if later).

How to make the choice. To make the choice to capitalize a carrying charge, write a statement saying which charges you choose to capitalize. Attach it to your original tax return for the year the choice is to be effective.

Research and experimental costs. The costs of research and experimentation are generally capital expenses. However, you can choose to deduct these costs as current business expenses.

The choice you make applies to all your research and experimental costs. You cannot choose to deduct some of these expenses and capitalize others.

However, if you do not choose to deduct your research and experimental costs currently, you have other choices. You can choose to treat them as deferred expenses and amortize them over a period of at least 60 months, beginning with the month that you first receive an economic benefit from the research. See *Research and Experimental Costs* in chapter 13. You can also choose to deduct them over the 10-year period beginning with the tax year they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251 and Internal Revenue Code Section 59(e).

Research and experimental costs defined. Research and development costs are reasonable costs you incur in your trade or business that are the experimental or laboratory portion of research and development costs. This includes all costs incident to the development or improvement of a product. (See *Product,* later.) It also includes the costs of obtaining a patent (i.e., attorneys' fees in making and perfecting a patent application).

Costs qualify as research or experimental costs depending on the nature of the activity the costs relates to, rather than the nature of the product or the improvement being developed or the level of technological advancement represented.

Costs are the experimental or laboratory portion of research and development costs if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to you does not establish the capability or method for developing or improving the product or the appropriate design of the product.

Research and experimental costs do not include expenses for:

1) Quality control testing,
2) Efficiency surveys,
3) Management studies,
4) Consumer surveys,
5) Advertising or promotions,
6) The acquisition of another's patent, model, production or process, or
7) Research in connection with literary, historical, or similar projects.

Product. The term ''product'' includes:

1) Any pilot model,
2) Process,
3) Formula,
4) Invention,
5) Technique,
6) Patent, or
7) Similar property.

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

How to make the choice. To choose to deduct research and experimental costs currently, claim them as an expense deduction on your income tax return for the year in which you first have them.

If you want to make this choice after the first year, you must get the permission of the Internal Revenue Service (IRS). File Form 3115.

Research credit. You may qualify for a credit on some or all of your research and experimental costs no matter how you treat them. You must reduce the amount you deduct or capitalize by the amount of the credit, unless you choose to take a reduced credit. See the instructions for Form 6765.

The research credit does not apply to amounts paid or incurred after June 30, 1995.

Caution: At the time this publication was being prepared for print, Congress was considering legislation that would extend the research credit. For more information, see Publication 553, *Highlights of 1995 Tax Changes.*

Drilling and development costs. The costs of developing oil, gas, or geothermal wells are ordinarily capital expenses. They can usually be recovered through depreciation or depletion. However, you can choose to deduct as current business expenses certain drilling and development costs for wells located in the United States in which you hold an operating or working interest. For more information, see chapter 11 in Publication 535.

Exploration costs. If the costs of determining the existence, location, extent, or quality of any mineral deposit lead to the development of a mine, they ordinarily are capital expenses. You can recover these costs through depletion as the mineral is removed from the ground. However, you can choose to deduct the costs of exploration in the United States (except those for oil, gas, and geothermal wells) if you paid or incurred them before the development stage began. For more information, see chapter 11 in Publication 535.

If you do not choose to deduct your exploration costs currently, you can choose to deduct them over the 10-year period beginning with the tax year they were paid or incurred. See *Optional Write-Off for Certain Expenditures* in the instructions for Form 6251.

Development costs. You can deduct costs paid or incurred during the tax year for developing a mine or any other natural deposit (other than an oil or gas well) located in the United States if the costs are paid or incurred after the discovery of ores or minerals in commercially marketable quantities. Development costs include those incurred by a contractor on your behalf. They do not include costs for depreciable improvements.

You can also choose to deduct your development costs over the 10-year period, beginning with the tax year they were paid or incurred.

For more information on development costs, see chapter 11 in Publication 535.

Costs of removing barriers to the disabled and the elderly. The cost of an improvement to a business asset is normally a capital expense. However, you can choose to deduct your expenses for making a facility or public transportation vehicle, owned or leased for use in connection with your trade or business, more accessible and useable by those who are disabled or elderly. For more information, see chapter 11 in Publication 535.

5.

Basis of Assets

Introduction

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure gain or loss from the sale or other disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses.

This chapter is divided into three sections:

- Cost Basis,
- Adjusted Basis, and
- Other Basis.

The basis for inventories is discussed in chapter 7.

The basis of property you buy is its cost. If you use the asset in a trade or business or any other activity conducted for profit, capitalize (add to basis) many direct and indirect costs.

Your original basis in property is adjusted (increased or decreased) for certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.

You cannot determine your basis in some assets by cost. This includes property you receive as a gift or inheritance. It also applies to property received in an involuntary exchange and certain other circumstances. If you acquire property by inheritance, receive a gift of property, or have property transferred to you from a spouse or former spouse, see *Other Basis* in Publication 551.

If you sell or exchange your property, figure your gain or loss on the transaction. Compare the amount realized from the sale or exchange to the adjusted basis of the property you transferred. The amount realized is the money you received plus the fair market value of any other property you received. For information on sales and exchanges, see chapter 21.

To figure depreciation, use ''unadjusted basis.'' For information on depreciation, see chapter 12.

As a partner, you must know the basis of your interest in the partnership to figure your allowable deduction for partnership losses. You also must know your basis if you dispose of all or part of your interest in the partnership. For information on partnerships, see chapter 28.

If any of your debts were canceled by a creditor, or were discharged because you became bankrupt, the basis of your assets might be affected. For more information, see Publication 908.

Topics

This chapter discusses:

- Cost basis
- Adjusted basis
- Other basis

Useful Items

You may want to see:

Publication

- ☐ **378** Fuel Tax Credits and Refunds
- ☐ **525** Taxable and Nontaxable Income
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **551** Basis of Assets
- ☐ **908** Tax Information on Bankruptcy
- ☐ **917** Business Use of a Car

Form (and Instructions)

- ☐ **8594** Asset Acquisition Statement

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash or in other property or debt obligations. Your cost includes amounts you pay for:

1) Sales tax charged on the purchase,
2) Freight charges to obtain the property,
3) Installation and testing,
4) Excise taxes,
5) Legal and accounting fees (when they must be capitalized),
6) Revenue stamps,
7) Recording fees, and
8) Real estate taxes (if assumed for the seller).

In addition, the basis of real estate and business assets may include other items.

Loans with low or no interest. If you buy business or investment property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price less the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate. See *Unstated Interest* in chapter 24.

Real Property

If you buy real property, certain fees and other expenses you pay are part of your basis in the property.

Real estate taxes. If you buy real property and agree to pay certain taxes the seller owed on it, treat the taxes you pay as part of your basis. You cannot deduct them as taxes paid.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the basis of the property.

Settlement costs. You can include in the basis of property you purchase the settlement fees and closing costs that are for buying it. You cannot include the fees and costs that are for getting a loan on the property. (A fee is for buying property if you would have had to pay it even if you bought the property for cash.)

Some of the settlement fees or closing costs that you can include in the basis of your property are:

1) Abstract fees (sometimes called abstract of title fees),
2) Charges for installing utility services,
3) Legal fees (including title search and preparing the sales contract and deed),
4) Recording fees,
5) Surveys,
6) Transfer taxes,
7) Title insurance, and
8) Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase.

Settlement costs ***do not include*** amounts placed in escrow for the future payment of items such as taxes and insurance.

Some settlement fees and closing costs you ***cannot*** include in the basis of the property are:

1) Fire insurance premiums.
2) Rent for occupancy of the property before closing.
3) Charges for utilities or other services relating to occupancy of the property before closing.
4) Fees for refinancing a mortgage.
5) Charges connected with getting a loan, such as:
   a) Points (discount points, loan origination fees),
   b) Mortgage insurance premiums,
   c) Loan assumption fees,
   d) Cost of a credit report, and
   e) Fees for an appraisal required by a lender.
6) Fees for refinancing a mortgage.

Points. If you pay points to obtain a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), you generally must capitalize and amortize them ratably over the term of the loan. Do not add the cost to the basis of the related property.

Points on home mortgage. Special rules may apply to the amounts you and the seller pay as points when you obtain a mortgage to purchase your main home. If these amounts meet certain requirements, you can deduct them in full as points for the year in which they are paid. If you deduct seller-paid points, reduce your basis by that amount. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction.*

Assumption of a mortgage. If you buy property and assume an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a building and make a down payment for $20,000 and assume a mortgage of $80,000 on it, your basis is $100,000.

Constructing nonbusiness assets. If you build nonbusiness property (i.e., a home), or have assets built for you, the expenses you pay for this construction are part of your cost basis. Some of these expenses include:

1) Land,
2) Materials and supplies,
3) Architect's fees,
4) Building permits,
5) Payments to contractors,
6) Payments for rental equipment, and
7) Inspection fees.

In addition, if you own a business and use your employees, material, and equipment to construct a nonbusiness asset, your basis would also include:

1) Employee compensation paid for the construction work,
2) Depreciation deductions on equipment you own while it is used in the construction,
3) Operating and maintenance costs for equipment used in the construction, and
4) The cost of business supplies and materials consumed in the construction.

Do not deduct these expenses which you must capitalize (include in the asset's basis). Also, reduce your basis by any jobs credit, Indian employment credit, or empowerment zone employment credit allowable on the wages you pay in (1). Do not include the value of your own labor, or any other labor you did not pay for, in the basis of any property you construct.

Business Assets

If you purchase property to use in your business, your basis usually is its actual cost to you. However, if you construct, build, or otherwise produce property, you may be subject to the uniform capitalization rules (discussed later) to determine the basis of the property.

Example 1. Dale White is an independent contractor. He purchased a building for his business. He used it to store his construction equipment. His basis in the building is its cost to him.

Example 2. Assume the same facts as in Example 1 except, instead of purchasing the building, Dale had his employees construct the building. He must determine his basis in the building under the uniform capitalization rules.

Uniform Capitalization Rules

The uniform capitalization rules specify the costs you add to basis in certain circumstances.

Who must use. You must use the uniform capitalization rules if you:

1) Produce real property or tangible personal property for use in a trade or business or an activity engaged in for profit,
2) Produce real property or tangible personal property for sale to customers, or
3) Acquire property for resale.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Treat property produced for you under a contract as produced by you up to the amount you pay or otherwise incur for the property. Tangible personal property includes films, sound recordings, video tapes, books, art work, or similar property.

Under the uniform capitalization rules, you capitalize direct costs and an allocable part of most indirect costs incurred due to production or resale activities. You must include certain expenses you have during the year in the basis of property you produce or in your inventory costs, rather than deduct them as a current expense. You will recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

Any cost that you could not use to figure your taxable income for any tax year is not subject to the uniform capitalization rules.

Exceptions. The uniform capitalization rules do not apply to certain property. This includes:

1) Property you produce that you do not use in your trade or business, or activity conducted for profit.
2) Costs paid or incurred by an individual (other than as an employee) or a qualified employee-owner of a corporation who is a writer, photographer, or artist.
3) Property you produce under a long-term contract.
4) Research and developmental expenses allowable as a deduction under section 174 of the Internal Revenue Code.
5) Costs for personal property acquired for resale if your (or your predecessor's) average annual gross receipts do not exceed $10 million.

More information. For more information on the uniform capitalization rules, see the regulations under section 263A of the Internal Revenue Code.

Intangible Assets

Intangible assets include goodwill, patents, copyrights, trademarks, trade names, and franchises. The basis of an intangible asset is usually its cost. If you acquire multiple assets, for example a going business for a lump-sum, see *Allocating the Basis,* later, to figure the basis of the individual assets.

Patents. The basis of a patent you get for your invention is the cost of development, such as research and experimental expenditures, drawings, working models, and attorneys' and governmental fees. If you deduct the research and experimental expenditures as current business expenses, you cannot include them in the basis of the patent. The value of your time spent on an invention is not part of the basis.

Copyrights. If you are an author, the basis of the copyright for your work usually will be your cost of getting the copyright, plus copyright fees, attorneys' fees, clerical assistance, and the cost of plates that remain in your possession. Do not include in the basis the value of your time as the author, or any other person's time you did not pay for.

Franchises, trademarks, and trade names. If you buy a franchise, trademark, or trade name, the basis is its cost, unless you can deduct your payments as a business expense.

Allocating the Basis

If you buy multiple assets for a lump sum, allocate the amount you pay to each of the assets you receive. Make this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets. See *Trade or business acquired,* later.

Group of assets acquired. If you buy multiple assets for a lump sum, you and the seller may agree to a specific allocation of the purchase price to each asset in the sales contract. If this allocation is based on the value of each asset, and the sale is an arm's-length transaction, the allocation generally will be accepted. However, see *Trade or business acquired,* next.

Trade or business acquired. If you acquire a group of assets that is a trade or business, allocate the purchase price to the various assets acquired.

Make the allocation among the assets in proportion to (but not in excess of) their fair market value on the purchase date in the following order:

1) Cash, demand deposits, and similar accounts,
2) Certificates of deposit, U.S. Government securities, readily marketable stock or securities, and foreign currency,
3) All other assets except section 197 intangibles, and
4) Section 197 intangibles.

Agreement. If you and the seller agree in writing to allocate the consideration, or the fair market value of any asset, the agreement is binding on both you and the seller unless the IRS determines that the amounts are not appropriate.

Reporting requirement. Both the buyer and seller of a trade or business must report to the IRS the allocation of the sales price among section 197 intangibles and the other business assets. Use Form 8594 to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax returns for the year in which the sale occurred.

Land and buildings. If you buy buildings and the land on which they stand for your business and you pay a lump sum, allocate the basis of the whole property among the land and the buildings so you can figure the depreciation allowable on the building. See chapter 12.

When you allocate the basis between land and buildings or among the lots, the amount used as the basis of each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time you get it. If you are not certain of the fair market values of land and buildings, you can allocate the basis among them based on their assessed values for real estate tax purposes.

Demolition of building. Add demolition costs and other losses incurred for the demolition of any building to the basis of the land on which the demolished building was located. Do not claim it as a current deduction.

Modification of building. A modification of a building will not be treated as a demolition if:

1) 75 percent or more of the existing external walls of the building are retained in place as internal or external walls, and
2) 75 percent or more of the existing internal structural framework of the building is retained in place.

If the building is a ***certified historic structure*** the modification must be part of a certified rehabilitation. If these conditions are met, add the costs of the modifications to the basis of the building.

Subdivided lots. If you buy a tract of land and subdivide it, allocate the basis to the individual lots based on the fair market value of each lot to the total price paid for the tract. This allocation is necessary because you must figure the gain or loss on the sale of each individual lot. As a result, you do not recover your entire cost in the tract until you have sold all of the lots.

Future development costs. Certain procedures explain how to get permission to add to the basis of each lot the estimated future cost of qualified development expenses.

For sales you made after December 31,1992, of lots on which development work is not complete, see Revenue Procedure 92–29. However, if you received explicit consent from the IRS to use Revenue Procedure 75–25 (amplified in Revenue Procedure 78–25), you can continue to use this revenue procedure for sales of lots covered by the consent, including sales occurring after December 31, 1992.

Use of erroneous cost basis. If you made a mistake in figuring the cost basis of subdivided lots that you sold in previous years, you cannot correct the mistake for years for which the statute of limitations has expired. Figure the cost basis of any remaining lots by allocating the original cost basis of the entire tract among the original lots.

Example. You bought a tract of land to which you assigned a cost of $15,000. You subdivided the land into 15 building lots of equal size and equitably divided your basis so that each lot had a basis of $1,000. You treated the sale of each lot as a separate transaction and figured gain or loss separately on each sale.

Several years later you determine that your original basis in the tract was $22,500 and not $15,000. You sold 8 lots using $8,000 of basis in years for which the statute of limitations has expired. You now can take $1,500 of basis into account for figuring gain or loss only on the sale of each of the remaining 7 lots ($22,500 basis divided among all 15 lots). You cannot refigure (to $1,500) the basis of the 8 lots sold in tax years barred by the statute of limitations.

Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property.

Rehabilitation expenses also increase basis. However, you must subtract any rehabilitation credit allowed for those expenses before you add them to your basis. If you have to recapture any of the credit, increase your basis by the amount of the recapture.

If you make additions or improvements to business property, keep separate accounts for them. Also, depreciate the basis of each according to the depreciation rules in effect when you place the addition or improvement in service. For more information, see chapter 12.

Some items added to the basis of property are:

1) The cost of extending utility service lines to the property,
2) Legal fees, such as the cost of defending and perfecting title,
3) Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements,
4) Zoning costs, and
5) The capitalized value of a redeemable ground rent.

Assessments for local improvements. Add assessments for items such as streets and sidewalks, which increase the value of the property assessed, to the basis of the property. Do not deduct them as taxes. However, you can deduct assessments for maintenance or repair or for meeting interest charges on the improvements as taxes.

Decreases to Basis

Some items that reduce the basis of your property are:

1) The section 179 deduction,
2) The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property,
3) Nontaxable corporate distributions,
4) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
5) Exclusion from income of subsidies for energy conservation measures,
6) Credit for qualified electric vehicles,
7) Gain from the sale of your old home on which tax was postponed,
8) Investment credit (part or all of credit) taken,
9) Casualty and theft losses,
10) Certain cancelled debt excluded from income,
11) Rebates received from the manufacturer or seller,
12) Easements,
13) Residential energy credit,
14) Gas-guzzler tax, and
15) Tax credit or refund for buying a diesel-powered highway vehicle.

Table 6-1. **Examples of Increases and Decreases to Basis**

Increases to Basis	Decreases to Basis
Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home	Exclusion from income of subsidies for energy conservation measures Casualty or theft loss Credit for qualified electric vehicles
Assessments for local improvements: Water connections Sidewalks Roads	Gain from the sale of your old home on which tax was postponed Section 179 deduction
Casualty Losses: Restoring damaged property	Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property
Legal fees: Such as the cost of defending and perfecting a title	Depreciation Nontaxable corporate distributions
Zoning costs	

Some of these decreases to basis are discussed next.

Section 179 deduction. If you take the section 179 deduction for all or part of the cost of business property, decrease the basis of the property by the deduction. For more information, see chapter 12.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis for amounts you spend after a casualty to restore the damaged property. For more information, see chapter 25.

Easements. The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis to zero and treat the excess as a recognized gain. See *Easements* in chapter 21.

Diesel-powered vehicle. If you received an income tax credit or refund for buying a diesel-powered highway vehicle, reduce your basis in that vehicle by the credit or refund allowable. For more information about this credit or refund, see Publication 378.

Credit for qualified electric vehicle. If you claim the credit for qualified electric vehicles, you must reduce the basis of the property on which you claimed the credit. For more information on this credit, see chapter 15 in Publication 535.

Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property. If you take either the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, or both, you must decrease the basis of the property by the amount of the deduction. For more information on these deductions, see chapter 15 in Publication 535.

Exclusion from income of subsidies for energy conservation measures. If you received a subsidy from a public utility company for the purchase or installation of any energy conservation measure, you can exclude it from income. Reduce the basis of the property on which you received the subsidy by the excluded amount. For more information on this subsidy, see Publication 525.

Gas-guzzler tax. Decrease the basis in your car by the gas-guzzler (fuel economy) tax if you begin using the car within 1 year of the date of its first sale for ultimate use. This rule also applies to someone who later buys the car and begins using it not more than 1 year after the original sale for ultimate use. If the car is imported, the one-year period begins on the date of entry or withdrawal of the car from the warehouse if that date is later than the date of the first sale for ultimate use.

Depreciation. Decrease the basis of your property by the amount of depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you took less depreciation than you could have under the method you selected, decrease the basis by the amount you could have taken under that method. If you did not take a depreciation deduction, then make adjustments to basis for depreciation you could have taken.

If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by an amount equal to the depreciation you should have deducted as well as by the part of the excess depreciation you deducted that actually reduced your tax liability for any year.

In decreasing your basis for depreciation, take into account the amount deducted on your tax returns as depreciation expense, and any depreciation you must capitalize under the uniform capitalization rules.

Canceled Debt Excluded from Income

If a debt is canceled or forgiven, other than as a gift or bequest, the debtor generally must include the canceled amount in gross income for tax purposes. A debt includes any indebtedness for which the debtor is liable or which attaches to property the debtor holds.

You can exclude your canceled debt from income if the debt is:

1) Canceled in a title 11 bankruptcy case or when you are insolvent,
2) Qualified farm debt, or
3) Qualified real property business indebtedness (provided you are not a C corporation).

If you exclude canceled debt from income, you may have to reduce the basis of your property.

For more information on canceled debt in a bankruptcy case or during insolvency, see Publication 908. For more information on canceled debt that is qualified farm debt, see chapter 4 in Publication 225.

Adjusted Basis Example

In January 1990, you paid $80,000 for real property to be used as a factory. You also paid commissions of $2,000 and title search and legal fees of $600. You allocated the total cost of $82,600 between the land and the building—$10,325 for the land and $72,275 for the building. Immediately, you spent $20,000 in remodeling the building before you placed it in service. You were allowed depreciation of $14,526 for the years 1990 through 1994. In 1993 you had a casualty loss that was not covered by insurance of $5,000 on the building from a fire. This loss was claimed as a deduction. You spent $5,500 to repair the fire damages. The adjusted basis of the building on January 1, 1995, is figured as follows:

		Building
Original cost of building, including fees and commissions		$72,275
Adjustments to basis:		
Add:		
Improvements		20,000
Repair of fire damage		5,500
		$97,775
Subtract:		
Depreciation	$14,526	
Casualty loss	5,000	19,526
Adjusted basis on January 1, 1995		$78,249

The basis of the land, $10,325, remains unchanged. It is not affected by any of the above adjustments, which affect only the basis of the building.

Other Basis

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of certain property may be used.

Fair market value (FMV). FMV is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the same date, may be helpful in figuring the property's FMV.

Property for services. If you receive property for services, include the property's FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on before hand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Restricted property. If you receive property for services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. Property becomes substantially vested when you can transfer it or it is not subject to a substantial risk of forfeiture. For more information on restricted property, see the discussion on *Restricted Property Received for Services* in Publication 525.

Taxable exchanges. A taxable exchange is an exchange on which the gain is taxable or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

Involuntary Exchanges

If you acquire property as a result of an involuntary exchange such as a casualty, theft, or condemnation, you can figure the basis of the replacement property using the basis of the property exchanged. See chapter 25.

Similar or related property. If you receive property that is similar or related in service or use to the property exchanged, the new property's basis is the same as the old property's basis on the date of the exchange with the following adjustments:

1) Decreased by—
   a) Any loss recognized on the exchange, and
   b) Any money received that was not spent on similar property.
2) Increased by—
   a) Any gain recognized on the exchange, and
   b) Any cost of acquiring replacement property.

Not similar or related property. If you receive money or other property that is not similar or related in service or use to the old property, and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property decreased by the amount of gain that is not recognized on the exchange.

Example. The state condemned your property. The property had an adjusted basis of $26,000, and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 − $26,000). You bought new property that is similar in use to the old property for $29,000. You recognize a gain of $2,000 ($31,000 − $29,000), the unspent part of the payment from the state. The basis of the new property is figured as follows:

Cost of new property	$29,000
Minus: Gain not recognized	3,000
Basis of the new property	$26,000

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

Example. If, in the previous example, the state had condemned unimproved real property, and the new property you bought was improved real property with both land and buildings, make an allocation. Take the new property's $26,000 basis and allocate it between land and buildings based on their costs.

See chapter 25 for more information on the involuntary exchange rules.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange.

To qualify as a like-kind exchange, both the property you exchange and the property you receive must be held by you for business or investment purposes. There must be an exchange of like-kind property (depreciable tangible personal property may be like-class property). For other requirements, see *Like-kind exchanges,* in chapter 21.

The basis of the property you receive is the same as the basis of property you gave up.

Example. You exchange real estate (adjusted basis $50,000, FMV $80,000) held for investment for other real estate (FMV $80,000) held for investment. Your basis in the new property is the same as the basis of the old ($50,000).

Exchange expenses. Exchange expenses are generally the closing costs that you pay. They include such items as brokerage commissions, attorney fees, deed preparation fees, etc. Add them to the basis of the like-kind property received.

Property plus cash. If you trade property in a nontaxable exchange and pay money, the basis of the property you receive is the basis of the property you exchanged increased by the money you paid.

Example. You trade in a truck (adjusted basis $3,000) for another truck (FMV $7,500) and pay $4,000. Your basis in the new truck is $7,000 (the $3,000 basis of the old truck plus the $4,000 paid).

Special rules for related persons. If a like-kind exchange is made directly or indirectly between related persons and either party disposes of the property within 2 years after the exchange, the exchange is disqualified from like-kind exchange treatment. Each person must report any gain or loss not recognized on the original exchange. Each person reports it on the tax return filed for the year in which the later disposition occurred. If this special rule applies, the basis in the property received in the original exchange will be its fair market value.

These rules generally do not apply to dispositions due to:

1) The death of either related person,
2) Involuntary conversions, or
3) Exchanges whose main purpose is not the avoidance of federal income tax.

Related persons. Generally, related persons are ancestors, lineal descendants, brothers and sisters (whole or half), and a spouse.

For other "related persons" (i.e., two or more corporations, an individual and a corporation, a grantor and fiduciary, etc.) see the rules relating to losses under *Sales and Exchanges Between Related Parties* in chapter 22.

Exchange of businesses. Exchanging the assets of one business for the assets of another business is a multiple asset exchange. For information on determining basis in a multiple asset exchange, see *Multiple Property Exchanges,* in Publication 544.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the old property with the following adjustments:

1) Decreased by—
   a) Any money you received, and
   b) Any loss recognized on the exchange.
2) Increased by—
   a) Any additional costs incurred, and

b) Any gain recognized on the exchange.

The other party to the transaction who assumes your liabilities (including a nonrecourse obligation), treats them as money transferred to you in the exchange.

Allocate the basis among the properties, other than money, you received in the exchange. In making this allocation, the basis of the unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example 1. You exchange a truck (adjusted basis $6,000) for a new, smaller truck (FMV $5,200) and $1,000. You have a recognized gain of $200 ($6,200 – $6,000). Your basis in the new truck is figured as follows:

Adjusted basis of old truck	$6,000
Minus: Cash you received	1,000
	$5,000
Plus: Gain recognized	200
Basis of new truck	$5,200

Example 2. You had an adjusted basis of $15,000 in real estate you held for investment. You exchange it for other real estate to be held for investment with a fair market value of $12,500, a truck with a FMV of $3,000, and $1,000. You have a gain of $1,500 ($16,500 – $15,000) recognized on the exchange. Your basis in the properties you received is:

Adjusted basis of real estate transferred	$15,000
Minus: Cash received	1,000
	$14,000
Plus: Gain recognized	1,500
Total basis of properties received	$15,500

Allocate the total basis of $15,500 between the truck and the real estate. The basis of the truck is its FMV, $3,000, and the basis of the real estate is the remainder, $12,500.

Trade-in or sale and purchase. If a sale and purchase are a single transaction, you cannot increase the basis of property for depreciation by selling your old property outright to a dealer and then buying new property from the same dealer. If your sale of old property and purchase of new property are dependent on each other, you are considered to have traded in your old property. Treat the transaction as an exchange no matter how it is carried out. You cannot avoid this trade-in rule by using a subsidiary in the transaction.

Partial Business Use of Property

If you have property used partly for business and partly for personal use, and you exchanged it in a nontaxable exchange for property to be used wholly or partly in your business, the basis of the property you receive is figured as if you exchanged two properties. The first is an exchange of like-kind property. The second is personal use property on which gain is recognized and loss is not recognized.

First, figure your adjusted basis in the property you transfer as if you transferred two separate properties. Figure the adjusted basis of each part of the property by taking into account any adjustments to basis. Deduct the depreciation you took or should have taken from the adjusted basis of the business part. Then figure the amount realized for your property and properly allocate it to the business and nonbusiness portions of the property you transferred.

In this case, you exchanged property permitted to be exchanged tax free. Recognize any gain from the transaction on your personal-use property. The basis of the property acquired is the total basis of the properties transferred, adjusted to the date of the exchange, increased by the gain recognized on the other property. You are deemed to have received in exchange for your other property an amount equal to its fair market value on the date of the exchange.

Listed property. Special rules apply to listed property not used 100% in your business. Listed property includes:

Any automobile or other property used for transportation,

Property used for entertainment, such as photographic and video recording equipment,

Cellular telephone or similar equipment, and

Computers and related peripheral equipment not used exclusively at a regular business location.

Under a special rule, when listed property used less than 100% for business is traded for business property, your ***basis for depreciating*** the newly acquired property must be adjusted. First, figure the adjusted basis of the old property. Add to this adjusted basis any additional amount paid for the new property. Finally, subtract from that total any remainder of:

1) The depreciation that would have been allowable if the old property had been used 100% for business or investment purposes, over
2) The depreciation allowed for the old property.

Use this adjusted basis only for depreciating the new property. Do not use it to figure a gain or loss on the sale of the new property.

Property changed to business or rental use. When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation. An example of this would be renting out your former main home.

Basis for depreciation. The basis for depreciation equals the lesser of:

1) The FMV of the property on the date of the change, or
2) Your adjusted basis on the date of the change.

Example. Several years ago you paid $60,000 to have your house built on a lot that cost you $10,000. Before changing the property to rental use last year, you paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction for damage to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you change its use is $78,000 ($60,000 + $20,000 – $2,000). On the date of change, your property has a FMV of $80,000, of which $15,000 is for the land and $65,000 for the house. The basis for depreciation on the house is $65,000, the FMV at the date of the change in use, because it is less than your adjusted basis ($78,000).

Sale of property. If you later sell or dispose of the property, the basis of the property you use will depend on whether you are figuring gain or loss.

Gain. The basis for gain is your adjusted basis when you sell the property.

Example. Assume the same facts as in the previous example, except that after being allowed depreciation deductions of $37,500 you sell the property at a gain. Your adjusted basis in this case would be $160,500 ($178,000+ $20,000 (land) – $37,500).

Loss. Figure the basis for loss using the smaller of your adjusted basis or the FMV at the time of the change.

Example. Assume the same facts as in the previous example, except that after being allowed depreciation deductions of $37,500 you sell the property at a loss. Your adjusted basis in this case would be the FMV ($180,000) because it is less than the adjusted basis ($198,000) on the date of the change. That amount ($180,000) is reduced by the depreciation deduction to arrive at a basis of $142,250 ($180,000– $37,500).

Part Three.

Figuring Gross Profit

This Part discusses the items that go into figuring the gross profit of your business—gross receipts and the cost of goods sold. The method for figuring gross profit is essentially the same whether your business is a sole proprietorship, a partnership, or a corporation.

6. Business Income

Introduction

You must report on your tax return any income you receive from your trade or business or any other source unless it is excluded by law. The income can be in the form of cash, property, or services. Some types of income are:

1) Interest, dividends, rents, royalties.
2) Payment for services, including fees, commissions, fringe benefits, and similar items.
3) Gain from the sale or exchange of property (see chapter 21).
4) Income from the discharge of indebtedness.
5) Distributive shares of partnership gross income (see chapter 28).

Topics

This chapter discusses:

- Kinds of income
- Items that are not income
- Accounting for your income
- Prepaid income

Useful Items

You may want to see:

Publication

- ☐ **225** Farmer's Tax Guide
- ☐ **525** Taxable and Nontaxable Income
- ☐ **550** Investment Income and Expenses
- ☐ **908** Tax Information on Bankruptcy
- ☐ **1212** List of Original Issue Discount Instruments

Kinds of Income

This chapter primarily covers income from a trade or business (business income). Business income is income you receive when you sell your product or services. Interest is business income to a lending company. Fees are business income to a professional person. Rents are business income to a person in the real estate business. Dividends generally are business income to a dealer in securities. All income received by a corporation is business income regardless of its source.

Example. You work full time as a mechanical engineer for an aircraft manufacturer. During your nonworking hours, you are an artist. The income you receive from the sale of your paintings is business income.

Property or Services (Barter)

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Example 1. You perform legal services for a client, a small corporation. In payment for your services, you receive shares of stock in the corporation. You must include the fair market value of the shares in income.

Example 2. Both you and a house painter are members of a barter club, an organization that each year gives its members a directory of members and the services each member provides. Members get in touch with other members directly and bargain for the value of the services to be performed.

In return for accounting services you provided for the house painter's business, the house painter painted your home. The fair market value of the services you received from the house painter must be included in your income, and the fair market value of your accounting services must be included in the house painter's income.

Example 3. You are a member of a barter club that uses credit units to credit or debit members' accounts for goods or services provided or received. As soon as units are credited to a member's account, the member can use them to buy goods or services or sell or transfer the units to other members.

The value of credit units received must be included in your gross income for the tax year in which the units are credited to your account.

The dollar value of units received for services by an employee of the club, who can use the units in the same manner as other members, must be included in the employee's gross income for the tax year in which received and is wages for social security and Medicare taxes (FICA), federal unemployment taxes (FUTA), and income tax withholding. See chapter 33.

Example 4. You are a cash method taxpayer. You join a barter club and agree to provide specific services to any member for a specified number of hours. Each member has access to a directory that lists the members of the club and the services available.

Members contact each other directly and request services to be performed. You are not required to provide services unless requested by another member, but you can use as many of the offered services as you wish without paying a fee.

You must include the fair market value of any services you receive from club members in your income when you receive them even if you have not provided any services to club members.

Rents. If you receive property or services as a payment of rent, you must include the fair market value of the property or services in your income.

Example. You own an apartment building, and you received a work of art created by an artist in return for the artist's rent-free use of an apartment for 6 months. The fair market value of the art work is included in your income, and the fair rental value of the apartment is included in the artist's gross income.

Property as dividend. If you receive property in exchange for a dividend, include the fair market value of the property in income.

Information returns. If you are involved in a bartering transaction you may be required to file information returns. See chapter 36 for more details.

Rental Income

The amount you get from the rental of any property is included in your gross income. For rental property, gross income means gross receipts from rents.

Prepaid rent. Advance payments received under a lease that does not put any restriction on their use or enjoyment are income in the year they are received. This is true no matter what accounting method or period you use.

Lease bonus. A bonus that you receive from a tenant for granting a lease is an addition to the rent and included in your rental income in the year it is received.

Lease cancellation payments. Payments that you receive from your tenant for canceling a lease are reported in gross income in the year received.

Payments to third parties. If your tenant makes payments to someone else under an agreement to pay your debts or obligations, the payments are included in your rental income when the tenant makes the payments. A common example of this kind of income is a tenant's payment of the landlord's property taxes on leased real property.

Settlement payments. Payments received by the landlord in settlement of a tenant's obligation to restore the leased property to its original condition are income in the amount that the payments exceed the adjusted basis of the leasehold improvements destroyed, removed, or disconnected by the tenant.

Interest and Dividend Income

Interest and dividends may be considered business income.

Interest. Interest received on loans is business income if you are in the business of lending money. In any business, interest received on notes receivable that you have accepted in the ordinary course of business is business income.

Discounted loans. If you are in the loan business, any payment you receive on a discounted loan usually includes both principal and interest. If you are a cash basis taxpayer, part of the discount is interest income to you when you receive each payment. If you are an accrual method lender, the discount is includible in income as it accrues over the term of the loan, or it is includible as you receive the payments if you receive the payments before they accrue.

Uncollectible loans. If a loan payable to you becomes uncollectible during the tax year, and you are on an accrual method of accounting, you must include in gross income interest accrued up to the time the loan became uncollectible. If the accrued interest later becomes uncollectible, you may be able to take a bad debt deduction. See chapter 14.

Unstated interest. If little or no interest is charged on an installment sale, unstated interest is considered to be included in the payments received. See *Unstated Interest* in chapter 24.

Bond premium. If a corporation issues bonds and gets more than the face value of the bonds in return, the amount received that is greater than the face value is called bond premium. Bond premium is included in the corporation's income, but not all of it is included in the year the bonds are issued. Part of the premium is included in income in each tax year during the term of the bonds.

To figure how much to include for each tax year, divide the number of months the bonds are outstanding during the year by the number of months from the date of issue to the date of maturity. Then multiply this answer by the total bond premium, less any conversion feature. For purposes of determining premium, other interest-bearing obligations issued by corporations, such as debentures, notes, and certificates, are treated the same way.

Original issue discount (OID). If a bond is issued for a lower price than the amount the issuer will pay when the bond matures, the difference between the two amounts is OID, which is the opposite of bond premium, just explained. You include bond premium in income if you are the issuer of the bond. You include OID in income if you are the purchaser of the bond.

OID must be included in your gross income as ordinary income even though the bond is a capital asset in your hands. However, if the OID is less than one-fourth of 1% of the stated redemption price at maturity times the number of full years from original issue to maturity, the OID is considered to be zero.

OID on a note issued by a municipality is considered tax-exempt interest if the note is not an industrial development bond or arbitrage bond. However, any gain on the sale or redemption of a municipal bond is not tax-exempt interest. See Publication 550.

For corporate bonds issued before May 28, 1969, or for government bonds issued before July 2, 1982, you are not required to include the original issue discount in income until the year the bond (or other evidence of indebtedness) is sold, exchanged, or redeemed.

If you hold a corporate bond or other evidence of indebtedness issued after May 27, 1969, you must include part of the OID in income each tax year you own the bond. The rules for figuring how much discount to include in income for a tax year are different for obligations issued after July 1, 1982, and obligations issued after December 31, 1984.

For information on how much OID to include in income for a tax year, see Publication 1212.

Dividends. Generally, dividends are business income to dealers in securities. They also are business income to partnerships and corporations that have invested their funds in stocks. To most people engaged in business, however, dividends are ***nonbusiness income.*** If an individual holds stock as a personal investment separately from the individual's business activity, the dividends from the stock are nonbusiness income.

Canceled Debt

The following explains the general rule for including canceled debt in income and the exceptions to the general rule.

General Rule

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your gross income for tax purposes. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

Example. You obtained a mortgage loan on your home several years ago at a relatively low rate of interest. This year, in return for your paying off the loan early, the lending institution cancels part of the remaining principal. You must include the amount canceled in gross income.

Exceptions to General Rule

The following discussion covers exceptions to the general rule for canceled debt.

Deductible debt. You do not realize income from debt cancellation to the extent that payment of the debt would have given rise to a deduction.

Example. You own a business and obtain accounting services on credit. Later, when you are having trouble paying your business debts (you are not bankrupt or insolvent), your accountant forgives part of the amount you owe for the accounting services. How you treat the cancellation depends on your method of accounting:

1) Cash method – You do not include the debt cancellation in income because payment for the services would have been deductible as a business expense.
2) An accrual method – Your accountant's cancellation of the debt must be included in income. This is because, under an accrual method of accounting, the expense is deductible when the liability is incurred, not when the debt is paid.

For information on the cash and accrual methods of accounting, see chapter 3.

Price reduced after purchase. If you owe a debt to the seller for property you purchased, and the seller reduces the amount you owe, generally you do not have income from the reduction. The part of the debt reduced is treated as a purchase price adjustment and reduces your basis in the property.

Qualified real property business indebtedness. You can elect to exclude (up to certain limits) the discharge of qualified real property business indebtedness. (A C corporation cannot make this election.) If you make the election, you **must** reduce the basis of your depreciable real property by the amount excluded. Make this reduction at the beginning of your tax year following the tax year in which the discharge occurs. However, if you dispose of the property before that time, you must reduce its basis immediately before the disposition.

Discharge of qualified real property business indebtedness. Qualified real property business indebtedness is indebtedness (other than qualified farm debt):

1) That was incurred or assumed in connection with real property used in a trade or business,
2) That was secured by such real property,
3) That was incurred or assumed:
   a) Before January 1, 1993, or
   b) If incurred or assumed on or after that date, is to acquire, construct, or substantially improve such real property, and
4) To which you elect to apply these rules.

Qualified real property business indebtedness includes refinancing of indebtedness described in (3) above, but only to the extent it does not exceed the indebtedness being refinanced.

The amount excluded cannot exceed either:

1) The excess (if any) of:
   a) The outstanding principal of qualified real property business indebtedness (immediately before the discharge), minus
   b) The fair market value (immediately before the discharge) of the business real property that is security for the debt, reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by this property immediately before the discharge, or
2) The total adjusted bases of depreciable real property held by you immediately before the discharge. These adjusted bases are determined after any basis reduction due to a discharge in bankruptcy, insolvency, or of qualified farm indebtedness. Depreciable real property acquired in contemplation of the discharge is not taken into account.

Election. To make this election, complete Form 982 and attach it to your income tax return for the tax year in which the discharge occurs. If you do not file the election with the original return, you may be able to make the election with an amended return or claim by showing reasonable cause for failure to file it with the original return.

Stockholder canceled debt. If you, as a stockholder, gratuitously cancel a debt owed to you by the corporation, the transaction is generally a contribution to the capital of the corporation in the amount of the canceled principal portion of the debt, so no income is realized by the corporation.

However, a solvent, accrual method corporation may be required to report as income any unpaid interest it previously deducted on its debt to you. In the year the debt is forgiven, the corporation would include in gross income the unpaid interest it had deducted, but only up to the amount of the deductions that had lowered its tax in earlier tax years.

Bankruptcy. You can exclude a canceled debt from gross income if the cancellation takes place in a bankruptcy case under title 11 of the United States Code (the Bankruptcy Code). However, you must reduce your tax attributes (but not below zero) by the amount excluded. See Publication 908 for more information.

Insolvency. You can exclude canceled debt from your gross income but only up to the amount by which you are insolvent. However, you must reduce your tax attributes (but not below zero) by the amount excluded. See Publication 908 for information on insolvency.

Qualified farm debt. You can exclude (up to certain limits) from your gross income a cancellation or discharge of qualified farm debt if the debt is discharged by a qualified person. See *Cancellation of Debt* in chapter 4 of Publication 225 for more information.

Other Income

The following discussion includes other types of business income you may receive.

Restricted property. If you receive restricted stock or other property for services performed, the fair market value of the property in excess of your cost is included in your income when the restriction is lifted. However, you can elect to be taxed in the year you receive the property. For more information on including restricted property in income, see Publication 525.

Capital gains. Gains from the sale or exchange of capital assets are included in your gross income. Under certain conditions, some business assets may be treated as capital assets when they are sold or exchanged. See chapter 22.

Franchises, trademarks, trade names. Amounts you receive or accrue during your tax year that are based on the productivity, use, or disposition of a franchise, trademark, or trade name are generally includible in gross income as ***ordinary income.*** See chapter 22.

Promissory notes. Negotiable promissory notes and other evidences of indebtedness, given to you by a responsible and solvent maker are reported in gross income at their fair market value when they are received, if they are received as a part of your sales price and you use the cash method of accounting.

Discounting notes receivable. The discounting of notes receivable is a common practice in some businesses. Many dealers receive the notes of customers as payment for articles sold. These notes are payable over a fixed period of time. The dealer then sells the notes to a finance company, usually for an amount lower than the face value of the notes.

The dealer and the finance company often agree that a part of the price will be held by the finance company in a ***dealer's reserve*** or similar account until collections are made or the reserve reaches a specified total. Then the finance company pays or credits the amount in the reserve to the dealer. Amounts held in the reserve are considered income to the dealer.

Under an accrual method of accounting, the full amount of the discount price, not reduced by the reserve held by the finance company, is included in income when the notes are sold. This practice of discounting notes receivable is sometimes used by automobile dealers.

Losses on worthless notes. Losses on worthless notes that the finance company can charge against the reserve have no bearing on the fact that taxable income has been received by the dealer.

Damages. You must include in gross income compensation you receive during the tax year as a result of:

1) Patent infringement,
2) Breach of contract or fiduciary duty, or
3) Antitrust injury.

Economic injury. You may be entitled to a deduction against the income if it compensates you for actual economic injury. Your deduction is the smaller of:

1) The amount you receive or accrue for damages in the tax year reduced by the amount you pay or incur in the tax year to recover that amount, or
2) Your loss from the injury that you have not yet deducted.

Punitive damages. You must also include punitive damages in income.

Kickbacks. Any kickbacks that you receive are included in your income. However, do not include them if you properly treat them as a reduction of a related expense item, cost of goods sold, or a capital expenditure.

Recovery of items previously deducted. If you recover a bad debt, prior tax, or any item deducted in a previous year, include the recovery in your income. However, if all or part of the deduction in earlier years did not reduce your tax, you may not have to include all of the recovery. Exclude the part that did not reduce your tax. If you exclude part of the recovery from income, you must include with your return a computation showing how you figured the exclusion.

Example 1. In 1995, the Maple Corporation had gross income of $8,000, a bad debt deduction of $300, and other allowable deductions of $7,700. If, in a later year, the Maple Corporation recovers all or part of the $300 bad debt, it must include the recovery in income in the year of recovery.

Example 2. Joe Smith, a sole proprietor, had the same income and deductions as the Maple Corporation in the preceding example. He also had personal exemptions of $5,000. He would not pay income tax even if he did not deduct the bad debt. Therefore, he will not have to report as income any part of the $300 he may recover in any future year.

Depreciation, depletion, or amortization. Amounts deducted for these items in a previous year are not amounts for which you can claim no tax benefit was received. You must use any net operating loss carryovers and carrybacks and capital loss carryovers (or carrybacks for a corporation) to figure whether the previous deduction or credit actually reduced your tax for any previous year.

Recapture of depreciation. If your business use of listed property falls to 50% or less in a tax year after the tax year you placed the property in service, you may have to include in income part of the depreciation you deducted in previous years. See *Applying the Predominant Use Test* in chapter 4 of Publication 946.

If you take a section 179 deduction for an asset and before the end of the asset's recovery period it is not used predominantly in business, you must recapture part of the section 179 deduction. You do this by including in income part of the deduction you took. See *When To Recapture the Deduction* in chapter 12.

Items That Are Not Income

In some cases the receipt of property or money is not income.

Issuance of stock. Issuing stock does not produce income for a corporation regardless of the amount for which the stock was issued. This also applies to the sale of ***treasury stock.***

Contribution to capital. A contribution to capital by an owner or stockholder of a business is not income to the business. For a corporation, contributions to capital by nonstockholders are not always included in gross income. Contributions to capital or other payments to a corporation by persons who are ***not*** direct beneficiaries of a service rendered or to be rendered by the corporation are not included in the corporation's gross income. However, the basis of property contributed or property purchased with money contributed by nonshareholders must be adjusted.

For example, a contribution made to a corporation by a chamber of commerce or civic organization to induce the corporation to locate in its area is not includible in the gross income of the corporation.

Contributions to capital or other payments to a corporation by persons who ***are*** direct beneficiaries of a service rendered or to be rendered by the corporation are included in the corporation's gross income.

For example, to be entitled to receive service, subscribers to a television transmission service must contribute a specified sum toward the cost of constructing the facility for supplying the television signal. They must also pay a monthly maintenance charge. The initial contribution is neither a gift nor a contribution to capital, but is part of the payments for services.

Loans. Money borrowed through a bona fide loan is not income.

Appreciation. Increases in value of your property are not income until you realize the increases through a sale or other taxable disposition.

Leasehold improvements. If a tenant erects buildings or makes improvements to your property, the increase in the value of the property that is due to the improvements is not income to you. However, if the facts indicate that the improvements are a payment of rent to you, then the increase in value would be income.

Exchange of property for like property. If you exchange your business property or property you hold for investment solely for property of a like kind to be used in your business or to be held for investment, no gain or loss is recognized. A common type of nontaxable exchange is the trade-in of a business automobile for another business automobile. See chapter 21.

Consignments. Consignments of merchandise to others to sell for you are not sales. The title of merchandise remains with you, the consignor, even after the consignee possesses the merchandise. Therefore, if you ship goods on consignment, you have no profit or loss until the merchandise has been sold by the consignee. Merchandise that you have shipped out on consignment is included in your inventory until it is sold.

Merchandise that you receive on consignment is never included in your inventory. Your profit or commission on merchandise consigned to you is included in your income when you sell the merchandise or when you receive your profit or commission, depending upon the method of accounting you use.

Accounting for Your Income

Accounting for your income for income tax purposes differs at times from accounting for financial purposes. This section discusses some of the more common differences that may affect business transactions.

The income from your business is figured on the basis of a tax year (see chapter 3) and according to your regular method of accounting (see chapter 3). If the sale of a product is an income-producing factor in your business, the use of inventories is usually required to clearly show your income. Dealers in real estate are prohibited from using inventories. See chapter 7 for more information on inventories.

Assignment of income. All income you earn is taxable to you. You cannot avoid the tax by having the income paid to a third party.

Example. You rent out your property and the rental agreement directs the tenant to pay the rent to your son. The amount paid to your son is gross income to you.

Cash discounts. These are amounts that the seller permits you to deduct from the invoice price for prompt payment. For income tax purposes you can use either of two methods to account for cash discounts. You can:

1) Deduct the cash discount from purchases (see chapter 7), or
2) Credit the cash discount to a discount income account.

You must use the method you select every year for all your purchase discounts.

If the second method is used, the credit balance in the account at the end of your tax year is business income. Under this method, the cost of goods sold is not reduced by the cash discounts you received. When valuing your closing inventory, you cannot reduce the invoice price of merchandise on hand at the close of the tax year by the average or estimated discounts received on the merchandise.

Trade discounts. These are reductions from list or catalog prices and usually are not written into the invoice or charged to the customer. These discounts are not entered on your books of account. Only the net amount is included for purchases. See *Trade discounts* in chapter 7.

Constructive receipt. Income is constructively received when it is credited to your account or set apart in a way that makes it available to you. You do not need to have physical possession of it. If you use the cash method of accounting, report the income in the year it is constructively received. See chapter 3.

Example. Frances Jones, a service contractor, was entitled to receive a $10,000 payment on a contract in December 1995. She was told in December that her payment was available. At her request, she was not paid until January 1996. She must include this payment in her 1995 income because it was constructively received in 1995.

Checks. A valid check received before the close of the tax year is constructive receipt of income in that year, even though you do not cash or deposit the check until the following year.

Example. Dr. Redd received a check for $500 on December 31, 1995, from a patient.

This check was not deposited in her business account until January 2, 1996. This fee must be included in her income for 1995.

Agents. An agent is someone who engages in business transactions for you. Income is constructively received by you in the year your agent receives it.

Partnerships. If you are a member of a partnership, you are required to include in income your share of the partnership profits whether or not they are distributed to you. For each tax year, include your share of the profits from the partnership's tax year that ends during your tax year or that ends on the same day that your tax year ends.

Debts paid by another person or canceled. If your debts are paid by another person or are canceled by your creditors, you may have to report part or all of this debt relief as income. If you receive income in this way, the income is constructively received by you when the debt is canceled or paid. See *Canceled Debt,* earlier.

Payment placed in escrow. If part or all of the purchase price is placed in escrow by the buyer, you do not include any part of it in gross sales until it is actually or constructively received. However, upon completion of the terms of the contract and the escrow agreement, you will have taxable income, even if you do not accept the money until the next year.

Insurance proceeds. These are discussed in chapters 17 and 25.

Sales returns and allowances. Credits you allow customers for returned merchandise and any other allowances you make on sales are deductions from gross sales in figuring net sales.

Prepaid Income

Prepaid income is generally included in your gross income in the year that it is received. However, the amount received is not income unless it is subject to your free and unrestricted use. Prepaid income must be treated this way whether you use the cash or an accrual method of accounting. But, if you use an accrual method and meet the conditions explained in *Advance Income for Services,* next, you may be able to postpone including these amounts in income until the year you earn them.

If you must repay any part or all of the prepaid income in a later year, you can ordinarily deduct the repayment in the year you make the repayment. See chapter 19.

Advance Income for Services

If you use an accrual method of accounting and, under an agreement, you receive advance payments for services to be performed by the end of the next tax year, you can make an election to postpone including the advance payments in income until you earn them. However, you cannot postpone including them beyond the year after the year you receive them.

Service agreements. You may postpone reporting income from advance payments you receive for service agreements on property you sell, lease, build, install, or construct. This includes agreements providing for incidental replacement of parts or materials. However, this applies only if you offer the property without service agreements in the normal course of business.

Guarantees and warranties. You generally cannot postpone reporting as income amounts that you receive under guarantee or warranty contracts.

Prepaid rent or prepaid interest. You cannot postpone reporting income from prepaid rent or for prepaid interest. Prepaid rent does not include payments for use of rooms or other space when significant services are also provided for the occupant. You provide significant services when you supply space in hotels, boarding houses, tourist homes, motor courts, motels, or apartment houses that furnish hotel services.

Postponement not allowed. Usually you may not postpone including in income advance payments for services if, under the agreement:

1) You are to perform any part of the services after the end of the tax year immediately following the year you receive the advance payments, or

2) You are to perform any part of the services at any unspecified future date that may be after the end of the tax year immediately following the year you receive the advance payment.

Any advance payment that you include in gross receipts on your tax return in the tax year you receive the payment cannot be less than the amount of the payment you include as gross receipts in gross income for your books and records and all your reports (including consolidated financial statements) to shareholders, partners, and other proprietors or beneficiaries, and in reports you prepare for credit purposes.

If you want to change your method of reporting advance payments, you must first get consent from the IRS. See chapter 3 for information on how to apply for a change in your accounting method.

All of the following examples use the calendar year as the tax year and an accrual method of accounting.

Example 1. You manufacture, sell, and service television sets. In 1995, you received payment for a one-year contingent service contract on a television set you sold. You may postpone including the part of the payment you did not earn in 1995 in income if you offer the television sets for sale without the contingent service contracts in the normal course of your business.

Example 2. You are in the television repair business. In 1995, you received payments for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets that were sold by an unrelated party. You can include the payments in gross income as you earn them over the period of the contract.

Example 3. You own a dance studio. On November 2, 1995, you received payment for a one-year contract beginning on that date and providing for 48 one-hour lessons. You gave eight lessons in 1995. Under this method of including advance payments, you must include one-sixth of the payment in income for 1995 and five-sixths of the payment in 1996, even if you cannot give all the lessons by the end of 1996.

Advance Income from Sales

If you use an accrual method of accounting, any advance payments you receive for future sales or other dispositions of goods are included in your income under special rules. Under these rules, advance payments include those you receive under an agreement for future sales of goods you hold primarily for sale to your customers in the ordinary course of your trade or business. They also include payments received under agreements for building, installing, or manufacturing items if you do not complete the agreement in the tax year.

If the advance payments are for contracts involving both sale and service of goods, it may be necessary to treat them as two agreements. An agreement also means a gift certificate that can be redeemed for goods. Amounts that are due and payable are treated as received.

Inclusion in income. You may choose when to report the advance payments in income. You may include them in income in the tax year in which you receive them or under an alternative method.

Alternative method. Under an alternative method, you generally include advance payments in income in the ***earlier*** tax year in which:

1) You include the advance payments in gross receipts under the method of accounting that you use for tax purposes, or

2) You include any part of the advance payments in income for any of your financial reports under the method of accounting used for those reports.

Your financial reports include your reports to shareholders, partners, beneficiaries, other proprietors, for credit purposes, and for consolidated financial statements.

Example 1. You are a retailer who uses an accrual method of accounting under which you account for your sales of goods when you ship the goods. You use this method for both tax and reporting purposes. You must include advance payments you receive in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods. However, see *Exception for inventory goods,* later.

Example 2. You are a calendar year taxpayer who makes household furniture. You use an accrual method of accounting. Under your method of accounting, you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted.

In 1995, you received an advance payment of $8,000 from a customer for an order of furniture to be made for a total price of $20,000. You shipped the furniture to your customer in December 1995, but it was not delivered and accepted until January 1996.

You must include the entire $8,000 advance payment in your gross income for 1995. You include the remaining $12,000 of the contract price in your gross income for 1996.

Exception for inventory goods. If you receive advance payments under an agreement for the sale of goods that are properly included in your inventory or under an agreement, such as a gift certificate, that can be satisfied with goods or a type of goods that cannot be identified in the year of receipt, you may be able to postpone including the advance payments in income in the year of receipt. The postponement period for these advance payments may extend only until the end of the second tax year following the year in which you received substantial advance payments (discussed later) and met the following conditions:

1) You must account for advance payments under the alternative method, as discussed earlier,
2) You must have received substantial advance payments, discussed later, on the agreement, and
3) You must have on hand or available to you, through your normal source of supply in the year of receipt, enough substantially similar goods to satisfy the agreement.

If you meet these conditions at the end of a tax year, all advance payments (not included in income under your accrual accounting method) that you receive by the end of the second tax year following the tax year in which you received substantial payments must be included in income for that second year. Also at the end of this second year you must deduct all actual or estimated costs of goods necessary to satisfy the contract.

Any difference between the estimated and the actual costs in fulfilling the contract must be taken into account when the goods are delivered. After the second tax year, any more advance payments received on this contract are reported in income in the year received because no further deferral is allowable on this contract.

Substantial advance payments. Under an agreement for a future sale, you have substantial advance payments if, by the end of a tax year, the total advance payments received during that year and preceding tax years are equal to or more than the total costs and expenditures reasonably estimated to be includible in inventory because of the agreement.

Example. You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method. In 1992, you entered into a contract for the sale of goods that are properly includible in your inventory. The total contract price is $50,000 and you estimate that your total inventoriable costs for the goods will be $25,000. You receive the following advance payments under the contract:

1992	$17,500
1993	$10,000
1994	$ 7,500
1995	$ 5,000
1996	$ 5,000
1997	5,000
Total contract price	$50,000

Your customer asked you to deliver the goods in 1998. In your 1993 closing inventory, you had enough of the type of goods specified in the contract on hand to satisfy the contract. Since the advance payments you had received by the end of 1993 were more than the inventoriable costs you estimated you would have, the payments are substantial advance payments.

Include all payments you receive by the end of 1995, the second tax year following the tax year in which you receive substantial advance payments in income for 1995. You must include $40,000 in sales for 1995, and you must include in your cost of goods sold the cost of the goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventoriable costs necessary to satisfy the contract.

Because no further deferral is allowable for the contract, you must include in your gross income for each remaining year of the contract the advance payment you receive that year. Any difference between the estimated costs and the costs you actually have in satisfying the contract is taken into account in 1998, when you deliver the goods.

Information schedule. If you use this alternative method of treating advance payments for future sales of goods, you must attach to your income tax return for each tax year a statement that shows:

1) Total advance payments you received in the current tax year,
2) Total advance payments you received in earlier tax years that you have not included in income before the current tax year, and
3) Total payments you received in earlier tax years that you have included in income for the current tax year.

To change to the alternative method, you must first get consent from the IRS. See chapter 3 for more information on changing your accounting method.

7. Cost of Goods Sold

Introduction

If you make or buy goods to sell, you are entitled to deduct the cost of goods sold on your tax return. You deduct these costs from your gross receipts. However, to determine these costs, you must maintain inventories.

Manufacturers, wholesalers, retailers, and every other business that makes, buys, or sells goods to produce income, must determine the value of inventory at the beginning and the end of each tax year. Inventories include goods held for sale in the normal course of business as well as raw materials and supplies that will physically become a part of merchandise intended for sale.

You must take physical inventories at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

The inventory methods described in this chapter apply to sole proprietorships, partnerships, and corporations.

Accrual accounting method required. If you must account for inventories in your business, you must use an accrual method of accounting for your purchases and sales. See chapter 3.

Accrual method not required. Personal service businesses, such as those of doctors, lawyers, carpenters, and painters, usually are not required to use inventories. Their gross business income usually is the same as their gross receipts, and most of them use the cash method of accounting. However, if they also sell or charge for the materials and supplies that are normally used in their businesses or professions, they must use inventories.

Topics

This chapter discusses:

- Figuring cost of goods sold
- Inventories
- Uniform capitalization rules

Useful Items

You may want to see:

Publication

- ☐ **538** Accounting Periods and Methods

Form (and Instructions)

- ☐ **970** Application To Use LIFO Inventory Method

Figuring Cost of Goods Sold

Add to your beginning inventory the cost of inventory items purchased during the year, including all other items entering into the cost of obtaining or producing the inventory. From this total, subtract your inventory at the end of the year. The remainder represents the cost of goods sold during the tax period. It should not include selling expenses or any other expenses that are not required to be included in inventory.

The following computation of the cost of goods sold is keyed by numbers to a discussion below of each item used in the computation.

1. Inventory at beginning of year	$30,700	
Minus: Cost of merchandise contributed to charitable organizations during the year	400	$ 30,300
Add:		
2. Merchandise (or raw materials) purchased during the year	$60,000	
3. Labor	20,000	
4. Materials and supplies	4,000	
5. Other costs	6,000	90,000
6. Cost of goods in inventory		$120,300
Subtract:		
7. Inventory at end of year		35,000
Result:		
8. Cost of goods sold		$ 85,300

1. Inventory at Beginning of Year. For a manufacturer or producer, the beginning inventory includes the total cost of raw materials, work in process, finished goods, and materials and supplies used in manufacturing the goods. For merchants, it consists of merchandise held for sale, discussed in *Inventories* in Publication 538.

Opening inventory usually will be identical with the closing inventory of the year before. Any difference must be explained in a schedule attached to the return.

Donation of inventory. If you donate any inventory item to a charitable organization, the amount of your deductible contribution is the fair market value of the item, less the amount that would be ordinary income if you had sold the item at its fair market value on the date of the gift.

Costs and expenses for the contributed property that were incurred in earlier years must be removed from opening inventory. They are not a part of cost of goods sold for figuring gross income for the year of the contribution. Costs and expenses for the contributed property that were incurred in the year of the contribution are deductible as part of cost of goods sold for that year, if this treatment of costs and expenses is proper under your accounting method. If such a deduction is taken, then those costs and expenses that are incurred in the year of the contribution are not treated as resulting in a basis for the contributed property.

Example 1. You are a calendar year taxpayer who uses an accrual method of accounting. In 1995 you contributed property from inventory to a church. It had a fair market value of $600. The closing inventory at the end of 1994 properly included $400 of costs due to the acquisition of the property, and in 1994, you properly deducted $50 of administrative and other expenses attributable to the property as business expense. The amount of the charitable contribution allowed for 1995 is $400 ($600 – $200). The $200 is the amount that would be ordinary income if the contributed inventory had been sold at fair market value on the date of the gift. The cost of goods sold to be used in determining gross income for 1995 may not include the $400. That amount is removed from opening inventory for that year.

Example 2. If, in Example 1, the contributed property had been acquired in 1995 at a cost of $400, the $400 cost of the property would be included in figuring the cost of goods sold for 1995, and the $50 of administrative and other expenses attributable to the property would be allowed as a deduction for that year. You would not be allowed any further deduction for the contributed property.

2. Merchandise or Raw Materials Purchased. For manufacturers or producers, this includes the cost of all raw materials or parts purchased for manufacture into a finished product. For merchants, it includes all merchandise bought for sale.

Trade discounts. The differences between the stated prices of articles and the actual prices you pay for them are called trade discounts. The prices you pay (not the stated prices) must be used in figuring your cost of purchases. Do not show the discount amount separately as an item in gross income.

A dealer must record the cost of an article in inventory reduced by the amount of a manufacturer's rebate that represents a trade discount.

Cash discounts. Cash discounts are amounts your suppliers let you deduct from your purchase invoices for prompt payments. There are two methods of accounting for cash discounts. You may either credit them to a separate discount account or deduct them from total purchases for the year. Whichever method you use, you must be consistent. If you want to change your method of figuring inventory cost, you must get consent from the IRS. See Publication 538.

If you credit cash discounts to a separate account, you must include this credit balance in your business income at the end of the tax year. If you use this method, do not reduce your cost of goods sold by the cash discounts.

Purchase returns and allowances. All returns and allowances must be deducted from your total purchases during the year.

Merchandise withdrawn from sale. If you withdraw merchandise for your personal or family use, you must exclude this cost from the total amount of merchandise you bought for sale. You do this by crediting the purchases or sales account with the cost of merchandise you withdraw for personal use. The amount should be charged to your drawing account. You should keep a separate account of all goods you withdraw for personal or family use.

3. Labor. Labor costs usually are an element of cost of goods sold only in a manufacturing or mining business. Small merchandising concerns usually do not have labor costs that can properly be charged to cost of goods sold. However, see *Uniform Capitalization Rules,* later. In a manufacturing business, labor costs that are properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, salable product.

Direct labor. Direct labor costs are the wages paid to those employees who spend all their time working directly on the product being manufactured. They also include a part of the wages paid to employees who work directly on the product part time, if that part of their wages can be determined.

Indirect labor. Indirect labor costs are the wages paid to employees who perform a general factory function that does not have any immediate or direct connection with making the salable product, but that is a necessary part of the manufacturing process.

Other labor. Other labor costs that are not properly chargeable to the cost of goods sold may be deducted as selling or administrative expenses. Generally, if the uniform capitalization rules do not apply, the only kinds of labor costs that are properly chargeable to your cost of goods sold are the direct or indirect labor costs, and certain other costs that are treated as overhead expenses properly charged to the manufacturing process, as discussed below under *Other Costs.*

4. Materials and Supplies. Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to cost of goods sold. Those that are not used in the manufacturing process are treated as deferred charges, deductible as a business expense when used. For additional information, see *Business expenses* in chapter 4.

5. Other Costs. Examples of other costs incurred in a manufacturing or mining process that are chargeable to your cost of goods sold are as follows.

Containers. Containers and packages that are an integral part of the product manufactured are a part of your cost of goods sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.

Freight-in. Freight-in, express-in, and cartage-in on raw materials, supplies that are used in production, and merchandise that is purchased for sale are all part of cost of goods sold.

Overhead expenses. Overhead expenses include such expenses as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. The overhead expenses you have as direct and necessary expenses of the manufacturing operation are included in your cost of goods sold.

6. Cost of Goods Available for Sale. The total of items 1 through 5 represents the cost of the goods available for sale during the year.

7. Inventory at End of Year. The value of your closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) is subtracted from the amount in item 6.

8. Cost of Goods Sold. When your closing inventory is subtracted from the cost of goods in inventory, the remainder is your cost of goods sold during the tax year. When you subtract your cost of goods sold from your adjusted gross receipts, the remainder is your gross profit from sales. See the illustration in chapter 8.

Inventories

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor in your business.

The most common kinds of inventories are:

1) Merchandise or stock in trade,
2) Raw materials,
3) Work in process,
4) Finished products, and
5) Supplies that physically become a part of the item intended for sale.

The value of inventories at the beginning and end of each tax year is required to determine taxable income. To determine the value of your inventory, you need a method for ***identifying*** the items in your inventory and a method for ***valuing*** these items.

Inventory valuation rules cannot be the same for all kinds of businesses. The method you use must conform to generally accepted accounting practices used for similar businesses, and it must clearly show income. To clearly show income, you must consistently use the same inventory method from year to year.

The value of your inventory may include certain capitalized costs. These rules are explained later under *Uniform Capitalization Rules.*

The rules discussed here only apply if they do not conflict with the uniform capitalization rules under the Internal Revenue Code section 263A.

Items included in inventory. Inventories include all your finished or partly finished goods and raw materials and supplies that will become a part of the merchandise you intend to sell.

Merchandise. You include merchandise in your inventory only if you have title to it. You include merchandise you purchase in inventory if title to it has passed to you, even though it is in transit or you do not have physical possession of it for some other reason. Your inventory also includes:

1) Goods under contract for sale that you have not yet segregated and applied to the contract,
2) Goods out on consignment (see *Consignments* in chapter 6), and
3) Goods that are in display rooms, merchandise mart rooms, or booths that are located away from your place of business.

In figuring gross income, you may be permitted to account for the sale of your product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method you use for keeping your books. Do not include the goods you have sold in your inventory.

Containers. You include containers in your inventory if title to them has not passed to the buyer of the contents. Containers include such items as kegs, bottles, and cases, whether or not on hand and whether or not returnable. If title has passed to a buyer, you exclude the containers from inventory. Under certain circumstances, some containers may be depreciated. See *Containers* in chapter 12.

C.O.D. mail sales. If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes when payment is made. Include the merchandise in your closing inventory until the buyer pays for it.

Items excluded from inventory. Exclude from your inventory all goods you have sold, but be sure that the title to them has passed to the buyer. Also exclude goods in your possession that are consigned to you and goods you ordered for future delivery if you do not yet have title to them. See *Consignments* in chapter 6.

Other assets. Other assets such as land, buildings, and equipment used in your business, as well as notes and accounts receivable, and similar assets, are not included in your inventory. Also, real estate held for sale by a real estate dealer in the ordinary course of business is not included in inventory.

Cost Identification

There are three methods of identifying items in inventory—specific identification, first-in first-out (FIFO), and last-in first-out (LIFO).

Specific identification method. The specific identification method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition in addition to other allocable costs, such as labor and transportation.

If there is no specific identification of items with their costs, you must make an assumption to decide which items were sold and which remain in inventory. Make this identification by either the FIFO method, or the LIFO method.

FIFO and LIFO methods. The ***FIFO method*** assumes that the items you purchased or produced first are the first items you sold, consumed, or otherwise disposed of.

The items in inventory at the end of the tax year are valued as the items most recently purchased or produced. If there is intermingling of the same type of goods in your inventory so that they cannot be identified with specific invoices, you must use the FIFO method to value these items, unless you elect to use the LIFO method.

The ***LIFO method*** assumes that the items of inventory that you purchased or produced last are sold or removed from inventory first. Items included in your closing inventory are considered to be, first, those from the opening inventory in order of acquisition and, second, those items acquired in the tax year.

The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, LIFO will generally produce a smaller cost of goods sold and may produce a higher closing inventory. Under FIFO the reverse will be true.

Adopting LIFO method. To adopt the LIFO method, you must file Form 970, or a statement that has all the information required in Form 970. You must file the form (or the statement) with your timely filed tax return for the year in which you first use LIFO.

You may qualify for an automatic extension of 12 months to make this election; see Revenue Procedure 92–85 for more information.

There are very complex rules involved in using the LIFO method that are not discussed in this publication. For more information, see the regulations under section 472 of the Internal Revenue Code.

An eligible small business may elect the ***simplified dollar-value LIFO method.*** An eligible small business is one with average annual gross receipts of $5 million or less for the 3 preceding tax years. For information on this method, see section 474 of the Internal Revenue Code.

Valuing Inventory

Since valuing the items in your inventory is a major factor in figuring your taxable income, the method you use to value your inventory is very important. The two common methods to value non-LIFO inventory are the ***cost method*** and the ***lower of cost or market method.***

For a new business not using LIFO, you may select either method to value your inventory. You must use the same method to value your entire inventory, and you may not change to another method without consent from the IRS.

Cost method. To properly value your inventory at cost, you must include all direct and indirect costs that are associated with it. Apply the following rules:

1) For merchandise on hand at the beginning of the tax year, cost means the inventory price of the goods.
2) For merchandise purchased during the year, cost means the invoice price less appropriate discounts plus transportation or other charges you incur in acquiring the goods. In addition, see *Uniform Capitalization Rules,* later, for any additional cost that may have to be included in the inventoriable cost of goods purchased.
3) For merchandise produced during the year, cost means all direct and indirect costs that must be capitalized under the uniform capitalization rules.

Discounts. You must reduce the cost of your inventory by trade discounts for volume purchases. You may choose whether to deduct cash discounts for prompt payment, but you must treat them the same way from year to year. If you do not deduct the cash discounts from your inventory costs, you must include them in your business income.

Lower of cost or market method. Lower of cost or market means that you compare the market value of each item on hand at the inventory date with its cost and use the lower value as its inventory value. If at the end of your tax year you had the following items on hand, the value of your closing inventory would be $600.

Items	Cost	Market	Whichever is lower
R	$300	$500	$300
S	200	100	100
T	450	200	200
Totals	**$950**	**$800**	**$600**

If you use this method, you must value each item in the inventory. You may not value the entire inventory at cost ($950) and at market ($800) and use the lower figure. If you use the cost method, the value of your closing inventory would be $950.

Market value. Under ordinary circumstances and for normal goods, market value means the usual bid price at the date of your inventory. This price is based on the volume of merchandise you usually buy. For example, if you buy items in small lots at $10 an item and a competitor buys identical items in larger lots at $8.50 an item, your usual market price is higher than your competitor's.

The lower of cost or market rule applies to goods purchased and on hand, and to basic elements of cost (direct materials, direct labor, and an allocable share of indirect costs) of goods in process of manufacture and finished goods on hand. It does not apply to goods on hand or in process of manufacture for delivery at fixed prices on a firm sales contract (that is, not legally subject to cancellation by either you or the buyer). These goods must be inventoried at cost.

Lower than market. When, in the regular course of business, you have offered merchandise for sale at prices lower than market, the inventory may be valued at these prices, less the direct costs of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices significantly different from the actual prices determined are not acceptable as reflecting the market.

No market exists. If no market exists, or if quotations are given without reference to actual conditions because of an inactive market, you must use whatever evidence of a fair market price is available, at the dates nearest your inventory date. This evidence could include specific purchases or sales you or others made in reasonable volume and in good faith, or compensation paid for cancellation of contracts for purchase commitments.

Unsalable goods. Unsalable goods are goods in your inventory that you cannot sell at normal prices or in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange. You value these goods at selling prices minus direct costs of disposition, no matter what method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, they are valued on a reasonable basis, considering the usability and condition of the goods. Do not value them for less than scrap value.

Perpetual or book inventories. You may figure the cost of goods on hand by perpetual or book inventories if you use sound accounting practices. Inventory accounts, however, are charged with the actual cost of goods purchased or produced, and credited with the value of goods used, transferred, or sold. Credits are figured on the basis of the actual cost of goods acquired during the year and the inventory value at the beginning of the year.

Physical inventories. You must take physical inventories at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

Practices not approved. The following are some of the inventory practices that are not recognized for tax purposes:

1) Deducting a reserve for price changes or an estimated amount for depreciation in the value of your inventory,
2) Taking work in process or other parts of your inventory at a nominal price or less than its full value,
3) Omitting part of your stock on hand,
4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock,
5) Including stock in transit, shipped either to or by you, the title to which you do not hold,
6) Separating indirect production costs into fixed and variable production cost classifications and then allocating only the variable costs to cost of goods produced while treating fixed costs as period costs that are currently deductible (the direct cost method), or
7) Treating all or almost all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

Gains and losses. If items included in inventory are damaged by a fire or other casualty, or are stolen, a casualty or theft loss may result. You do not claim a loss if the cost of the damaged or lost goods has been included in cost of goods sold. See *Loss of inventory* in chapter 25. Any loss from casualty or theft is reflected in the cost of goods sold.

Sale of entire inventory. You must include the total amount you receive from the sale of your entire inventory on your return as ordinary income. For the sale of your entire inventory, such as when you sell or dispose of your business, see *Sale of a Business* in chapter 27.

Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize direct costs and an allocable portion of most indirect costs that benefit or are incurred because of production or resale activities. This means that certain expenses you have during the year are included in the basis of property you produce or in your inventory costs, rather than claimed as a current deduction. You will recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

You are subject to the uniform capitalization rules if, in the course of a trade or business or an activity carried on for profit, you:

1) Produce real or tangible personal property for use in the business activity,
2) Produce real or tangible personal property for sale to customers, or
3) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts for the preceding 3 tax years are not more than $10 million.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced for you under a contract is treated as produced by you to the extent that you make payments or otherwise incur costs for the property.

Tangible personal property includes films, sound recordings, video tapes, books, artwork, photographs, or similar property. However, free-lance authors, photographers, and artists may be exempt from the uniform capitalization rules. See Publication 538 for more information.

For information about how the capitalization rules apply to certain inventory methods, see section 1.263A of the Income Tax Regulations.

Exceptions. The uniform capitalization rules do not apply to:

1) Resellers of personal property with average annual gross receipts for the 3 prior tax years of not more than $10 million;
2) Property you use for personal or nonbusiness purposes, or for purposes not connected with a trade or business or an activity conducted for profit;
3) Research and experimental expenditures deductible under section 174;
4) Intangible drilling and development costs of oil and gas or geothermal wells, or any amortization deduction allowable under Internal Revenue Code section 59(e) for intangible drilling, development, or mining exploration expenditures;
5) Property you produce under a long-term contract, except for certain home construction contracts described in Internal Revenue Code section 460(e)(1);
6) Timber and certain ornamental trees you raise, harvest, or grow, and the underlying land;
7) Qualified creative expenses you incur as a free-lance writer, photographer, or artist;
8) Costs allocable to natural gas acquired for resale, to the extent these costs would otherwise be allocable to ''cushion gas'' stored underground;
9) Property produced if substantial construction occurred before March 1, 1986;
10) Property provided to customers incident to the provision of services, if it is de minimis in amount and not inventory in the hands of the service provider; and
11) The origination of loans.

De minimis exception. The costs of certain producers using a simplified production method are not subject to the uniform capitalization rules if their total indirect costs are $200,000 or less. See section 1.263A–2(b)(3)(iv) of the Income Tax Regulations for more information.

Special uniform capitalization rules apply to farming businesses. See *Special Rules for Farm Property,* in Publication 225, *Farmer's Tax Guide.*

8.

Gross Profit

Introduction

After you have figured the gross receipts from your business (chapter 6) and the cost of goods sold (chapter 7), you are ready to figure your gross profit. You must determine gross profit before you can take any deductions for business operations. These deductions are discussed in Part 4 of this book.

Topics

This chapter discusses:

- Figuring gross profit
- Testing gross profit accuracy
- Additions to gross profit

Useful Items

You may want to see:

Publication

- ☐ **538** Accounting Periods and Methods

Figuring Gross Profit

To figure your gross profit, first figure your net receipts. Do this by subtracting any ''returns and allowances'' from gross receipts. Returns and allowances include cash or credit refunds you make to customers, rebates, and other allowances off the actual sales price.

Next, subtract the cost of goods sold from net receipts. The result is the gross profit from your business.

You do not have to figure the cost of goods sold if the sale of merchandise is not an income-producing factor for your business. Your gross profit is the same as your net receipts—gross receipts minus any refunds, rebates, or other allowances. Most professions and businesses that sell services rather than products can figure gross profit directly from net receipts in this way.

Illustration. This illustration of the gross profit section of the income statement of a retail business shows how gross profit is figured.

Income Statement
Year Ended December 31, 1995

Gross receipts	$400,000
Minus: Returns and allowances	14,940
Net receipts	$385,060
Minus: Cost of goods sold	288,140
Gross profit	$ 96,920

The cost of goods sold for this business is figured as follows:

Inventory at beginning of year		$ 37,845
Plus: Purchases	$285,900	
Minus: Items withdrawn for personal use	2,650	283,250
Goods available for sale		$321,095
Minus: Inventory at end of year		32,955
Cost of goods sold		$288,140

Points to Check

Consider the following items before figuring your gross profit.

Gross receipts. Even very small businesses find it helpful to use cash registers to keep track of receipts. You should also use a proper invoicing system and keep a separate bank account for your business. At the end of each business day, make sure your records balance with your actual cash and credit receipts for the day.

Sales tax collected. Check to make sure your records show the correct sales tax collected.

Inventory at beginning of year. Compare this figure with last year's ending inventory. The two amounts should be the same.

Purchases. If you take any inventory items for your personal use — use them yourself, provide them to your family, or give them as personal gifts, etc. — be sure to remove them from the cost of goods sold. Subtract the amount from your purchases for the year.

Inventory at end of year. Check to make sure your procedures for taking inventory are adequate. These procedures should provide you with a way of making sure that all items have been included in the inventory and that proper pricing techniques have been used.

Avoid using adding machine tapes as the only evidence for your inventory. Inventory forms are available at office supply stores. These forms have columns for recording the description, quantity, unit price, and value of each inventory item. Each page has space to record who made the physical count, who priced the items, who made the extensions, and who proofread the calculations. These forms will help satisfy you that the total inventory is accurate. They will also provide you with a permanent record to support its validity.

Inventories are discussed in chapter 7.

Testing Gross Profit Accuracy

If you are in a retail or wholesale business, you can check the accuracy of your gross profit figure. First, divide gross profit by net receipts. The resulting percentage measures the average spread between the merchandise cost of goods sold and the selling price.

Next, compare this percentage to your markup policy. Little or no difference between these two percentages shows that your gross profit figure is accurate. A large difference between these percentages may show that sales, purchases, inventory, or other items of cost have not been figured accurately. The reason for the difference should be determined.

Example. Joe Able operates a retail business. On the average, he marks up his merchandise so that he will realize a gross profit of 33⅓% on its sales. The net receipts (gross receipts minus returns and allowances) shown on his income statement for 1995 is $300,000. His cost of goods sold is $200,000. This results in a gross profit of $100,000 ($300,000 − $200,000). To test the accuracy of this year's results, Joe divides gross profit ($100,000) by net receipts ($300,000). The resulting 33⅓% confirms his markup policy of 33⅓%.

Additions to Gross Profit

If your business has income from a source other than its regular business operations, add that income to gross profit. Examples include income from an interest-bearing checking account, income from scrap sales, amounts recovered from bad debts, and other kinds of miscellaneous income from your business.

Part Four.

Figuring Net Income or Loss

This Part discusses business expenses that you can deduct from gross profit to figure the net income or loss of your business. Business expenses are the normal and current costs of operating a business.

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

If you have an expense that is partly for business and partly personal, you must separate the personal part from the business part. Only the business part is deductible.

9.

Employees' Pay

Important Change for 1995

Caution. The income exclusion provision for employer-provided educational assistance does not apply after 1994. However, as the publication was being prepared for print, Congress was considering legislation to extend the provision. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments.

Introduction

Salaries, wages, and other forms of pay you give employees for work they perform in your business are generally deductible business expenses. However, you must reduce your deduction for salaries and wages by any current tax year employment credits. For more information, see the employment credit forms listed in chapter 31.

Topics

This chapter discusses:

- Tests for deductibility
- Cash payments
- Noncash payments
- Other payments
- Employee benefit programs
- Meals and lodging furnished to employees
- Exclusion of fringe benefits

Useful Items

You may want to see:

Publication

☐ **535** Business Expenses

Form (and Instructions)

☐ **W–2** Wage and Tax Statement

☐ **4782** Employee Moving Expense Information

Tests for Deductibility

To be deductible, an employee's pay must meet all of the following tests.

Test 1 — Ordinary and necessary. You must be able to show that a salary, wage, or other payment for services an employee renders is an ordinary and necessary expense and is directly connected with your trade or business.

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

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

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

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

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

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

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

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

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

If you use an accrual method of accounting, deduct your expense for the salary or wage when you establish your obligation to make the payment and when economic performance occurs. Economic performance generally occurs as an employee performs his or her services for you. The economic performance rule is discussed in chapter 3. Your payment need not be made in the year the obligation exists. It can be deferred to a later date, but special rules apply. See *Unpaid Salaries,* later.

Cash Payments

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

Bonuses and Gifts

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

Bonus. You can deduct a bonus paid to an employee if you intended the bonus as additional pay for services, not as a gift, and the bonus is paid for services actually performed. However, to deduct the amount as wages, the total bonuses, salaries, and other pay must be reasonable for the services performed. The bonus is included in an employee's income. You can pay a bonus in cash, property, or a combination of both.

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

If you distribute cash, gift certificates, or similar items of easily convertible cash value, the value of these items is considered additional wages or salary regardless of the amount or value. See *Business Gift Expenses* in chapter 15 for more information on gifts.

For information on achievement, safety, and other awards, see chapter 2 in Publication 535.

Loans or Advances

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

Below-market interest rate loans. On certain loans you make to an employee or stockholder, you may be considered to have received interest income and to have paid compensation or dividends equal to that interest. For more information, see *Below-Market Interest Rate Loans* in chapter 16.

Vacation Pay

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

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

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

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

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

Unpaid Salaries

If you have a definite, fixed, and unconditional agreement to pay an employee a certain salary for the year, but you defer paying part of it until the next tax year, your deduction for the salary is based on the following factors.

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

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

Special rule for accrual method payer. If you use an accrual method of accounting, you cannot deduct salaries, wages, and other expenses owed to a related person (as defined in chapter 3) until:

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

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

Example 1. Tom Green runs a retail store as a sole proprietor. He uses the calendar year and an accrual method of accounting. His brother, Bob, works for him and is paid $1,000 a month. Bob uses the calendar year and the cash method of accounting. At the end of 1995, Tom accrues Bob's December salary.

Because of a temporary cash shortage, Tom pays Bob $600 on January 12, 1996, and the $400 balance on April 1, 1996. Tom cannot deduct the $1,000 until 1996, the year Bob must include the amount in his income.

Example 2. The Lomar Corporation uses the calendar year and an accrual method of accounting. Frank Wilson, an officer of the corporation, uses the calendar year and the cash method of accounting. At the close of calendar year 1995, he owns 50% of the outstanding stock of the corporation. On March 4, 1996, he acquires additional shares that bring his holdings up to 51%. At the end of December 1995, the corporation accrues salary of $1,000 payable to Frank.

The Lomar Corporation pays Frank $600 on January 30, 1996, and the balance by March 14, 1996. The corporation can deduct the salary of $1,000 in 1995. Frank and the Lomar Corporation are not related taxpayers at the close of Lomar's 1995 tax year.

Guaranteed Annual Wage

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

Compensation for Sickness and Injury

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

Noncash Payments

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

Education Expenses

If you pay or reimburse education expenses for an employee enrolled in a course not required for the job or not otherwise job related, deduct the payment as wages. You must include the payment in your employee's income and it is subject to FICA and FUTA taxes and income tax withholding.

Moving Expenses

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

1) Moving household goods and personal effects from the former home to the new home, and

2) Traveling (including lodging) from the former home to the new home.

Qualified moving expenses do not include any expenses for meals.

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

Statement to employee. You must give the employee a statement describing the payments made to the employee, or on his or her behalf, for moving expenses. The statement must contain sufficient information so the employee can properly figure the allowable moving expense deduction. You may use Form 4782 for this purpose. You must give this information to your employee by January 31 of the year following the year in which you make the payments.

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

More information. For more information on moving expenses, see Publication 521. For information on excluding fringe benefits, see chapter 4 in Publication 535.

Capital Assets

If you transfer a capital asset or an asset used in your business to one of your employees as payment for services, you can deduct as wages its fair market value on the date of the transfer less any amount the employee paid for the property. You treat the deductible amount as received in exchange for the asset, and you must recognize any gain or loss realized on the transfer. You figure gain or loss on the difference between the fair market value of the asset and its adjusted basis on the date of the transfer. See chapter 22.

Payment in Restricted Property

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

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

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

The amount and the year in which you can deduct the payment will vary, depending in part on the kind of property interest you transfer. The amount you can deduct depends on the amount included in the recipient's income. For tax years beginning after 1994, you must report the amount on a timely filed Form W–2 or Form 1099–MISC (even if the recipient is a corporation) in order to take the deduction. However, no reporting is required if the transfer:

1) Is exempt from reporting because the payment is less than the $600 reporting requirement for Form 1099–MISC, or
2) Meets any other reporting exception that applies to a recipient other than a corporation.

Other Payments

Construction of capital assets. You cannot deduct salaries and other wages incurred for constructing capital assets. Instead, you include them in the basis of the asset and recover your cost through depreciation deductions. See chapter 12.

Cost of goods sold. Generally, you must capitalize or include in inventory the wages and salaries you pay employees to produce real or tangible personal property or to acquire property for resale. If the property is inventory, add the wages to inventory. Capitalize the costs for any other property. Personal property acquired for resale is not subject to this rule if your average annual gross receipts for the 3 preceding tax years are $10,000,000 or less. You can deduct these wages as a current business expense. For more information on the uniform capitalization rules, see chapter 7.

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

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

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

If your corporation uses an accrual method of accounting and the salary is unpaid at the end of the tax year, see *Unpaid Salaries,* earlier, to determine how to handle the deduction.

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

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

Employee Benefit Programs

You may provide forms of pay other than cash to your employees. These include life, health, or accident insurance, educational assistance, and other benefit programs. Life and health insurance are discussed in chapter 17. The following discussion explains the costs you can and cannot deduct, how to claim a deduction on your tax return, whether it is includible or excludable from your employee's income, and whether it is subject to employment and income tax withholding.

Dependent Care Assistance

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

If you have a dependent care assistance program that meets the requirements, you can exclude from each employee's income up to $5,000 of assistance each year. Include the entire amount paid to your employee or paid on your employee's behalf in box 10 of your employee's 1995 Form W–2. If you furnished the care in-kind, use the fair market value of the dependent care provided to that employee, less any amount the employee paid you for the care. The fair market value of the care provided is a reasonable estimate of the amount the employee would pay for care of the type and quality you furnished. Any amount over the limit is included in the employee's income in box 1 of Form W–2. This excess is subject to income tax withholding and FICA and FUTA taxes.

For information on the requirements for dependent care assistance programs, see chapter 5 in Publication 535.

Supplemental Unemployment Benefits

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

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

Welfare benefit fund. A welfare benefit fund is any fund that is part of your plan through which you provide welfare benefits to employees or their beneficiaries.

More information. For more information and the definition of a fund's qualified cost, see chapter 5 in Publication 535.

Cafeteria Plans

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

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

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

The fact that cash or certain taxable benefits may be chosen under the plan does not cause an employee to be treated as having received the cash or taxable benefit.

Qualified benefits. A cafeteria plan may offer any qualified benefit other than scholarships and fellowship grants, educational assistance, and, generally, the fringe benefits discussed in chapter 4 of Publication 535. Qualified benefits include any other benefits your employees are allowed to exclude from income because of specific provisions of the law. Generally, qualified benefits include accident or health plans, dependent care assistance benefits, and group term life insurance. The costs of group term life insurance in excess of $50,000 and employer-provided dependent group term life insurance are considered qualified benefits.

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

More information. For more information on cafeteria plans and the reporting requirements, see chapter 5 in Publication 535.

Meals and Lodging Furnished to Employees

You can usually deduct the costs of furnishing meals and lodging to your employees if the expense is an ordinary and necessary business expense. You can usually deduct only 50% of the cost of food or beverages you furnish.

If the meals and lodging meet the three rules for exclusion, described next, their value is not included in the income of your employees. However, your deduction may be subject to a limit. See chapter 15.

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

If you have deducted the cost of these items elsewhere on your tax return (for example, as part of the cost of goods sold), you cannot deduct their cost again as pay for employees.

Rules for Exclusion

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

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

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

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

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

For more information, see chapter 3 in Publication 535.

Exclusion of Fringe Benefits

You can exclude certain fringe benefits you provide an employee from the employee's income. If the fringe benefits are excludable, the benefits are not subject to income tax withholding, social security and Medicare taxes (FICA), or federal unemployment tax (FUTA). Excludable fringe benefits include:

1) No-additional-cost service.

2) Qualified employee discount.

3) Working condition fringe.

4) De minimis (minimal) fringe.

5) Qualified transportation fringe.

6) Qualified moving expense reimbursement.

7) Certain athletic facilities.

The value of meals you provide to your employees at an eating facility operated by you on or near your business premises is a de minimis fringe only if the annual revenue from the facility equals or exceeds the direct operating costs of the facility.

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

You can also exclude from your employees' income any reimbursements or payments you make for qualified moving expenses.

Certain nondiscrimination requirements apply to a no-additional-cost service, qualified employee discount, and an employer-operated eating facility.

For more information on fringe benefits, see chapter 4 in Publication 535.

10.

Retirement Plans

Introduction

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

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

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

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

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

Employer contributions that must be capitalized. You cannot currently deduct your employer contributions to a retirement plan, or any other expenses, that you must capitalize (include in the basis of certain property or in inventory costs). See chapters 5 and 7.

Kinds of plans. Retirement plans are either:

- Qualified plans (including retirement plans for the self-employed, such as HR–10 (Keogh) plans and simplified employee pensions (SEPs)), or
- Nonqualified plans.

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

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **533** Self-Employment Tax
- ☐ **560** Retirement Plans for the Self-Employed
- ☐ **590** Individual Retirement Arrangements (IRAs)
- ☐ **15** Employer's Tax Guide (Circular E)

Form (and Instructions)

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

Qualified Plans

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

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

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

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

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

For more information, get Publication 560.

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

More than one job. If you are self-employed and also work for someone else, you can participate in retirement plans for both jobs. Generally, your participation in a retirement plan for one job does not affect your participation in a plan for the other job. However, if you have an IRA, you might not be permitted to deduct some or all of your IRA contributions.

Your deduction for IRA contributions might be limited if you also participate in a SEP-IRA. See Publication 560. In addition, your IRA deduction might be limited because you (or your spouse) are covered by an employer's retirement plan and your income is above a certain amount. See Publication 590.

Kinds of Qualified Plans

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

Defined Contribution Plans

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

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

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

Stock bonus plan. The benefits in this plan are similar to those of a profit-sharing plan. Benefits are payable in the form of the company's stock. Only a corporation can set up a stock bonus plan.

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

Table 10-1. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution		When To Begin Distributions[1]
IRA	Due date of IRA owner's income tax return (NOT including extensions)	Smaller of $2,000 or taxable compensation		April 1 of year after year IRA owner reaches age 70½
SEP–IRA	Due date of employer's return (Plus extensions)	Smaller of $30,000 or 15%[2] of participant's taxable compensation[3]		April 1 of year after year participant reaches age 70½
Keogh	Due date of employer's return (plus extensions).[4]	**Defined Contribution Plans**		Generally, April 1 of year after year participant reaches age 70½[6]
		Employee	**Self-Employed Individual**	
		Money Purchase–Smaller of $30,000 or 25% of employee's taxable compensation	***Money Purchase***–Smaller of $30,000 or 20% of self-employed participant's taxable compensation[5]	
		Profit-Sharing–Smaller of $30,000 or 15% of employee's taxable compensation	***Profit-Sharing***–Smaller of $30,000 or 13.0435% of self-employed participant's taxable compensation[5]	
		Defined Benefit Plans		
		Amount needed to provide an annual retirement benefit no larger than the smaller of $120,000 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years		

[1] Distributions of at least the required minimum amount must be made each year if the entire balance is not distributed.
[2] 13.0435% of the self-employed participant's taxable compensation before adjustment for this contribution.
[3] Contributions are made to each participant's IRA (SEP-IRA) including that of any self-employed participant.
[4] The employer must set up the plan by the end of the employer's tax year.
[5] Compensation is before adjustment for this contribution.
[6] If the participant reached age 70½ before 1988, distributions must begin by the year he or she retires.

employee's compensation. Your contributions to the plan are not based on your profits.

Defined Benefit Plans

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

Plan Approval

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

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

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

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

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

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

Retirement Plans for the Self-Employed

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

Keogh Plans

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

Deduction Limits

The limit on your deduction for your contributions to a Keogh plan depends on the kind of plan you have.

Defined contribution plans. The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. Your deduction for contributions to a profit-sharing plan cannot be more than ***15%*** of the compensation from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this 15% limit in figuring the deduction for contributions you make for your own account. See *Deduction of contributions for yourself,* later.

Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is limited to ***25%*** of the compensation from the business paid (or accrued) during the year to participating common-law employees. You must reduce this 25% limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure your deduction limit.

Note. In figuring the deduction for contributions, you cannot take into account any contributions or benefits that exceed the limits discussed under *Limits on Contributions and Benefits* in Publication 560.

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

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

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

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

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

Adjustments. You must reduce your net earnings by the income tax deduction you are allowed for one-half of the self-employment tax. Also, net earnings must be reduced by the deduction for contributions you make for yourself. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. You must reduce your net earnings by the deduction for contributions for yourself. The deduction and the net earnings depend on each other. You can make the adjustment to your net earnings indirectly by reducing the contribution rate called for in the plan and using the reduced rate to figure your maximum deduction for contributions for yourself.

Annual compensation limit. You generally cannot take into account more than $150,000 of your compensation in figuring your contribution to a defined contribution plan.

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

Rate Worksheet for Self-Employed

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

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

Deduction Worksheet for Self-Employed

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

Example. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, and 10½% of your common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) are $200,000. In figuring this amount, you deducted your common-law employees' pay of $100,000 and contributions for them of $10,500 (10½% x $100,000). You figure your self-employed rate and maximum deduction for employer contributions for your benefit as follows:

Rate Worksheet for Self-Employed

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

Deduction Worksheet for Self-employed

Step 1		
Enter the contribution rate shown on line (3), above		0.0950
Step 2		
Enter your net earnings (net profit) from line 3, Schedule C–EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K–1 (Form 1065)	$	200,000
Step 3		
Enter your deduction for self-employment tax from line 25, Form 1040	$	6,473
Step 4		
Subtract step 3 from step 2 and enter the result	$	193,527
Step 5		
Multiply step 4 by step 1 and enter the result	$	18,385
Step 6		
Multiply $150,000 by your plan contribution rate. Enter the result but not more than $30,000	$	15,750
Step 7		
Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 27, Form 1040.	$	15,750

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

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

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make deductible contributions toward your own and your employees' retirement without getting involved in more complex retirement plans. A corporation can also have a SEP and make deductible contributions toward its employees' retirement. But some advantages available to Keogh and other qualified plans, such as the special treatment that may apply to lump-sum distributions, do not apply to SEPs.

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

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

You may be able to use ***Form 5305–SEP*** in setting up your SEP. See the Form 5305–SEP sample shown in this chapter.

Contribution limits. Contributions you make for a year to a common-law employee's SEP-IRA cannot exceed the smaller of 15% of the employee's compensation or $30,000. Compensation, for this purpose, does not include employer contributions to the SEP.

Annual compensation limit. You generally cannot consider the part of compensation of an employee that is over $150,000 when you figure your contributions limit for that employee.

Note. For employees in a collective bargaining unit for which the $150,000 limit is not effective, the compensation limit is $245,000.

More than one plan. If you also contribute to a defined contribution retirement plan, annual additions to an account are limited to the lesser of (1) $30,000 or (2) 25% of the participant's compensation. When you figure these limits, your contributions to more than one such plan must be added. Since a SEP is considered a defined contribution plan for purposes of these limits, your contributions to a SEP must be added to your contributions to defined contribution plans.

Reporting on Form W–2. Do not include SEP contributions on Form W–2, Wage and Tax Statement, unless there are contributions over the limit that applies or there are contributions under a salary reduction arrangement.

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when you figure your maximum deductible contribution. See *Deduction of contributions for yourself,* later.

Deduction limits. The most you can deduct for employer contributions for common-law employees is 15% of the compensation paid to them during the year from the business that has the plan.

Deduction of contributions for yourself. When figuring the deduction for employer contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account:

1) The deduction allowed to you for one-half of the self-employment tax, and

2) The deduction for contributions on behalf of yourself to the plan.

The deduction amount for (2), above, and your compensation (net earnings) are each dependent on the other. For this reason, the deduction amount for (2) is figured indirectly by reducing the contribution rate called for in your plan. This is done by using the *Rate Worksheet for Self-Employed,* shown earlier in the chapter.

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

SEP and other qualified plans. If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing plan for purposes of applying the overall 25% deduction limit described in section 404(h)(3) of the Internal Revenue Code.

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

Salary Reduction Arrangement

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

- At least 50% of your employees eligible to participate choose the salary reduction arrangement,
- You had no more than 25 employees who were eligible to participate in the SEP (or would have been eligible to participate if you had maintained a SEP) at any time during the preceding year, and
- The deferral each year by each eligible ***highly compensated employee*** (as defined in Publication 560) as a percentage of pay (deferral percentage) is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate (the ***ADP test***). You generally cannot consider compensation of an employee in excess of $150,000 in figuring an employee's deferral percentage.

Note. For employees in a collective bargaining unit covered by a SEP for which the $150,000 limit is not effective, the compensation limit is $245,000.

Limits on deferrals. In general, the total income an employee can defer under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1995 is limited to the lesser of 15% of compensation or $9,240. This limit applies only to the amounts that represent a reduction from the employee's pay, not to any contributions from employer funds.

Employment taxes. Elective deferrals, not exceeding the ADP test, are not subject to

Form **5305-SEP**
(Rev. March 1994)
Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499
Expires 2-28-97

DO NOT File with the Internal Revenue Service

______________________________ makes the following agreement under section 408(k) of the
(Name of employer)
Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see **Specific Instructions.**)

The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least ________ years old (not to exceed 21 years old) and have performed services for the employer in at least ________ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) ☐ includes ☐ does not include employees covered under a collective bargaining agreement, ☐ includes ☐ does not include certain nonresident aliens, and ☐ includes ☐ does not include employees whose total compensation during the year is less than $396*.

Article II—SEP Requirements (See **Specific Instructions.**)

The employer agrees that contributions made on behalf of each eligible employee will be:

A. Based only on the first $150,000 of compensation.
B. Made in an amount that is the same percentage of total compensation for every employee.
C. Limited annually to the smaller of $30,000* or 15% of compensation.
D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

______________________________ ______________________________
Employer's signature and date — Name and title

Paperwork Reduction Act Notice

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	7 min.
Learning about the law or the form	28 min.
Preparing the form	20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the **Internal Revenue Service,** Attention: Reports Clearance Officer, PC:FP, Washington, DC 20224; and the **Office of Management and Budget,** Paperwork Reduction Project (1545-0499), Washington, DC 20503. **DO NOT** send this form to either of these addresses. Instead, keep it for your records.

A Change To Note

For years beginning after December 31, 1993, the Revenue Reconciliation Act of 1993 (the Act) reduced to $150,000 the annual compensation of each employee to be taken into account in making contributions to a SEP. The $150,000 amount will be indexed for inflation after 1994 in increments of $10,000 that will be rounded to the next lowest multiple of $10,000. See Act section 13212 for different effective dates and the transition rules that apply to governmental plans and plans under a collective bargaining agreement.

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form.—Form 5305-SEP (Model SEP) is used by an employer to make an agreement to provide benefits to all eligible employees under a SEP described in section 408(k). **Do not** file this form with the IRS. See **Pub. 560,** Retirement Plans for the Self-Employed, and **Pub. 590,** Individual Retirement Arrangements (IRAs).

Specific Instructions

Instructions to the Employer

Simplified Employee Pension.—A SEP is a written arrangement (a plan) that provides you with a simplified way to make contributions toward your employees' retirement income. Under a SEP, you can contribute to an employee's individual retirement account or annuity (IRA). You make contributions directly to an IRA set up by or for each employee with a bank, insurance company, or other qualified financial institution. When using Form 5305-SEP to establish a SEP, the IRA must be a Model IRA established on an IRS form or a master or prototype IRA for which the IRS has issued a favorable opinion letter. Making the agreement on Form 5305-SEP does not establish an employer IRA described in section 408(c).

When Not To Use Form 5305-SEP.—Do not use this form if you:

1. Currently maintain any other qualified retirement plan. This does not prevent you from also maintaining a Model Elective SEP (Form 5305A-SEP) or other SEP to which either elective or nonelective contributions are made.

2. Previously maintained a defined benefit plan that is now terminated.

3. Have any eligible employees for whom IRAs have not been established.

4. Use the services of leased employees (described in section 414(n)).

5. Are a member of an affiliated service group (described in section 414(m)), a controlled group of corporations (described in section 414(b)), or trades or businesses under common control (described in sections 414(c) and 414(o)), unless all eligible employees of all the members of such groups, trades, or businesses, participate in the SEP.

6. Will not pay the cost of the SEP contributions. Do not use Form 5305-SEP for a SEP that provides for elective employee contributions even if the contributions are made under a salary reduction agreement. Use Form 5305A-SEP, or a nonmodel SEP if you permit elective deferrals to a SEP.

Eligible Employees.—All eligible employees must be allowed to participate in the SEP. An eligible employee is any employee who: (1) is at least 21 years old, and (2) has performed "service" for you in at least 3 of the immediately preceding 5 years. **Note:** *You can establish less restrictive eligibility requirements, but not more restrictive ones.*

Service is any work performed for you for any period of time, however short. If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, service includes any work performed for any period of time for any other member of such group, trades, or businesses.

Excludable Employees.—The following employees do not have to be covered by the SEP: (1) employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by you and their union, (2) nonresident alien employees who did not earn U.S. source income from you, and (3) employees who received less than $396* in compensation during the year.

Contribution Limits.—The SEP rules permit you to make an annual contribution of up to 15% of the employee's total compensation or $30,000*, whichever is less. Compensation, for this purpose, does not include employer contributions to the SEP or the employee's compensation in excess of $150,000. If you also maintain a Model Elective SEP or any other SEP that permits employees to make elective deferrals, contributions to the two SEPs together may not exceed the smaller of $30,000* or 15% of compensation for any employee.

Contributions cannot discriminate in favor of highly compensated employees. You are not required to make contributions every year. But you must contribute to the SEP-IRAs of all of the eligible employees who actually performed services during the year of the contribution. This includes eligible employees who die or quit working before the contribution is made.

**This amount reflects the cost-of-living increase under section 408(k)(8), effective January 1, 1994. The amount is adjusted annually. Each January, the IRS announces the increase, if any, in a news release and in the Internal Revenue Bulletin.*

Cat. No. 11825J Form **5305-SEP** (Rev. 3-94) income tax in the year of deferral, but are included in wages for social security, Medicare, and unemployment tax purposes.

Reporting SEP Contributions on Form W–2

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

Example. In 1995 Jim chooses to have $4,500 taken out of his pay to fund employer contributions to his SEP-IRA. His compensation for the year is $30,000. On Jim's Form W–2, his employer will show total wages of $25,500 ($30,000 minus $4,500) for income tax and $30,000 for social security and Medicare wages. Jim will report $25,500 as wages on his tax return.

For more information on employer withholding requirements, get Publication 15.

For more information on SEPs, see Publication 560.

Nonqualified Plans

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

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

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

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

Individual Retirement Arrangements (IRAs)

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

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

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

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

Compensation does ***not*** include:

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

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

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

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

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

11.

Rent Expense

Introduction

If you lease business property, you generally can deduct the rent you pay. You can also deduct certain other expenses as rent. If you lease a car for 30 days or more for use in your business, see *Leasing a Car* in Publication 917. If you lease business property and incur a casualty loss on the leased property, see *Leased Property* in chapter 25.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **538** Accounting Periods and Methods
- ☐ **946** How To Depreciate Property
- ☐ **1375** Procedures For Issuing Rulings

Rent

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

Unreasonable rent. You cannot take a rental deduction for rents that are unreasonable. Ordinarily, the issue of reasonableness of the rent will not arise unless you and the lessor are related. Rent paid to a related person is reasonable if it is the same amount that would be paid to a stranger for use of the same property. A percentage rental is reasonable if the rental paid is reasonable. For a definition of ***related persons,*** see chapter 3.

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

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

Example 1. In May 1995, you leased a building for 5 years, beginning July 1, 1995, and ending June 30, 2000. According to the terms of the lease, your rent is $12,000 per year. You paid the first year's rent ($12,000) on June 30, 1995. On your income tax return for calendar year 1995, you can deduct only $6,000 (6/12 × $12,000) for the rent that applies to 1995.

Example 2. In January 1995, 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. For 1995, you can deduct only $6,000, the part of the rent that applies to 1995. You can deduct the balance ($12,000) over the remaining 2-year term of the lease, at $6,000 each year.

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

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

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

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

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

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

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

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

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

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

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

1) The lessor must maintain a minimum unconditional ''at risk'' investment (at least 20%) in the property during the entire lease;
2) The lessee may not have a contractual right to buy the property from the lessor at less than fair market value at the time the right is exercised;
3) The lessee may not invest in the property, except as provided by Revenue Procedure 79–48;
4) The lessee may not lend any money to the lessor to buy the property or guarantee the loan used to buy the property; and
5) The lessor must have a profit motive apart from tax deductions, allowances, credits, and other tax attributes.

The IRS will charge you a ***user fee*** for issuing a tax ruling. See Publication 1375 for more information.

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

Special rules apply for leases of tangible property over $250,000. See *Leases over $250,000* in chapter 7 of Publication 535 for details.

Taxes on Leased Property

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

Cash method. If you use the cash method of accounting, you can 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:

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

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

Example. Oak Corporation is a calendar year taxpayer that uses an accrual method of accounting. Oak leases land for use in its business. Under local law, owners of real property become liable (incur a lien on the property) for real estate taxes for the year on January 1 of that year, but do not have to pay these taxes until July 1 of the next year (18 months later). This means that property owners become liable for 1995 real estate taxes on January 1, 1995, but do not have to pay them until July 1, 1996.

Under the terms of the lease, Oak becomes liable for the real estate taxes when the tax bills are issued on July 1, 1996. Oak cannot deduct the real estate taxes for 1995 as additional rent until July 1, 1996. This is when Oak's liability under the lease becomes fixed.

If, according to the terms of the lease, Oak is liable for the real estate taxes when the owner of the property becomes liable for them on January 1, 1995, but does not have to pay them until July 1, 1996, Oak will deduct the lessor's real estate taxes as additional rent on its 1995 tax return. This is the year in which Oak's liability under the lease becomes fixed.

Cost of Acquiring a Lease

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

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

The cost of acquiring a lease is not subject to the amortization rules on section 197 intangibles discussed in chapter 13.

Option to renew. The term of the lease for amortization will include all renewal options (as well as any period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost is for the term of the lease remaining on the purchase date. In determining the term of the lease remaining on the purchase date, you do not include any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee.

Generally, allocation of the lease cost to the original term and any option term is based on the facts and circumstances. This allocation can be made using a present value computation. For more information, see section 1.178–1(b)(5) of the Income Tax Regulations.

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

Example 2. Assume the same facts as in Example 1, except that the amount that applies to the original lease was $8,000. You are allowed to amortize the entire $10,000 over the 20-year remaining life of the original lease because the $8,000 cost of acquiring the original lease was not less than 75% of the total cost of the lease.

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

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

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

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

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

Improvements by Lessee

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

If you do not keep the improvements when the lease is terminated, your gain or loss is based on your adjusted basis of the improvements at that time. For more information, see Publication 946.

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

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

Capitalizing Rent Expenses

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

You are subject to the uniform capitalization rules if you:

1) Produce real or tangible personal property for use in a trade or business or an activity engaged in for profit,

2) Produce real or tangible personal property for sale to customers, or
3) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts are not more than $10 million.

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

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

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

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

12. Depreciation

Important Change for 1995

Limits on depreciation for business cars. The total section 179 deduction and depreciation you can take on a car that you use in your business and first place in service in 1995 is $3,060. Your depreciation cannot exceed $4,900 for the second year of recovery, $2,950 for the third year of recovery, and $1,775 for each later tax year. See *Passenger automobiles,* later.

General asset account. You can elect to place assets subject to MACRS in one or more general asset accounts. After you have established a general asset account, figure depreciation on the entire account by using the applicable depreciation method, recovery period, and convention for the assets in the account.

For more information, see *General Asset Account* later.

Introduction

If you buy certain property for use in your trade or business that has a useful life of more than 1 year, you can claim a limited amount of the cost as a section 179 deduction. You must spread the remainder of the cost of this property over more than 1 year and claim depreciation deductions over the recovery period of the property. You can take depreciation deductions only on property that is used in your trade or business or for the production of income.

MACRS is the depreciation system that applies to property placed in service after 1986. If you need information on the depreciation methods for property placed in service before 1987, see Publication 534.

Generally, if you sell, exchange, or involuntarily convert depreciable property, and a gain (profit) is realized, all or part of the gain may be ordinary income. See Chapter 23.

Two other methods for recovering the cost of property, amortization and depletion, permit deductions similar to those allowed by depreciation. ***Amortization*** is a method that permits you to deduct certain capital expenditures in a way similar to depreciation. ***Depletion*** permits the owner of an economic interest in mineral deposits, oil wells, gas wells, geothermal deposits, or standing timber to deduct the cost of the economic interest over the economic life of the property. Depletion and amortization are explained in Chapter 13.

Topics

This chapter discusses:

- Basic information on depreciation
- The section 179 deduction
- The Modified Accelerated Cost Recovery System (MACRS)
- Listed property rules
- Form 4562

Useful Items

You may want to see:

Publication

- ☐ **534** Depreciating Property Placed in Service Before 1987
- ☐ **538** Accounting Periods and Methods
- ☐ **551** Basis of Assets
- ☐ **917** Business Use of a Car
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **4562** Depreciation and Amortization
- ☐ **4797** Sales of Business Property
- ☐ **6251** Alternative Minimum Tax—Individuals

General Information

The first part of the chapter provides you with information on property that can and cannot be depreciated, when depreciation begins and ends, and when to claim depreciation.

What Can Be Depreciated

For property to be depreciable, it must first meet all of the following basic requirements:

1) The property must be used in business or held for the production of income.
2) The property must have a determinable useful life and that life must be longer than one year.
3) The property must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

Depreciable property may be either ***tangible*** or ***intangible.***

Tangible Property

Tangible property is any property that can be seen or touched. Tangible property includes ***real*** and ***personal*** property. Personal property is property such as machinery or equipment that is not real estate. Real property is land and generally anything that is erected on, growing on, or attached to land. However, ***land*** itself is never depreciable.

You can deduct depreciation on tangible property only if it can wear out, decay, lose value from natural causes, be used up, or if it becomes obsolete.

Partial business use. If you use property for business or investment purposes and also for personal purposes, you can deduct only depreciation based on the business use and the use for the production of income. For example, if you use your car both for business and personal transportation, determine what percentage of its use is for business and depreciate only the business percentage part of its cost.

Passenger automobiles. There are dollar limits on the amount of the depreciation deductions you can claim for passenger automobiles. There are also other limits on the depreciation you can claim for passenger automobiles not used more than 50% in a qualified business use. A similar limit applies to lessees of leased cars. See *Listed Property,* later.

Idle property. You must claim a deduction for depreciation on property used in your business that is temporarily idle. For example, if you stop using a piece of machinery because there is a temporary lack of a market for a product made with the machinery, the machinery is still treated as used in your business for federal income tax purposes.

Intangible Property

Intangible property is generally any property that has value and cannot be seen or touched. It and includes property such as a copyright, patent, or franchise.

Generally, if acquired prior to ***August 11, 1993 (or July 26, 1991, if elected),*** intangible property was depreciable only if you could determine a useful life for it. Some examples of these depreciable and nondepreciable intangible properties are discussed next. However, if you acquired an intangible property after ***August 10, 1993 (July 25, 1991, if elected),*** it may qualify for amortization as a section 197 intangible asset. For information on section 197 intangible assets, see chapter 13.

Patents and copyrights. Unless you must amortize the costs of a patent or copyright (as explained in chapter 13), you can recover the costs through depreciation. If you can depreciate the cost of a patent or copyright, use the straight line method over the useful life. The useful life is the life granted by the government for the patent or copyright. If it becomes valueless in any year before its useful life expires, you can deduct in full for that year any remaining cost or other basis you have not yet depreciated.

Patents and copyrights subject to amortization. If you acquired patents and copyrights as part of the acquisition of a substantial portion of a business after August 10, 1993 (after July 25, 1991, if elected), you generally have to amortize the cost as discussed in chapter 13. If the patent or copyright is not acquired as part of an acquisition of a substantial portion of a business, depreciate the cost as discussed above.

Agreement not to compete. An agreement not to compete is an agreement by the seller of a business not to compete with the buyer. The agreement may restrict competition for an agreed upon period of time, within an agreed upon area, or for a combination of both.

Generally, if you bought a business before August 11, 1993, and part of its price is for an agreement not to compete for a fixed number of years, the agreement is depreciable property. However, because goodwill is often confused with an agreement not to compete, and because goodwill is not depreciable, you must establish from the facts and circumstances whether you have purchased goodwill or entered into an agreement not to compete.

If you bought a business after August 10, 1993 (after July 25, 1991, if elected), you must amortize that part of its price that is for an agreement not to compete. If you can amortize the cost of the agreement (as discussed in chapter 13), you cannot depreciate it.

Designs and patterns. Designs and patterns are kinds of intangible property that can be depreciated only if they have a determinable useful life and cannot be amortized (as discussed in chapter 13).

Franchise. A franchise is intangible property that can be depreciated only if it has a determinable useful life and cannot be amortized (as discussed in chapter 13).

Customer or subscription lists, location contracts, and insurance expirations. Generally, you can depreciate these intangible properties only if:

1) Their value can be determined separately from the value of any goodwill that goes with the business,
2) Their useful life can be determined with reasonable accuracy, and
3) They cannot be amortized (as discussed in chapter 13).

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

Software developed before August 11, 1993. If you developed software programs before August 11, 1993 (before July 26, 1991, if elected), you can choose to either treat the development costs as current expenses or capitalize the costs and depreciate them using the straight line method over 5 years (or any shorter life you can clearly establish). You cannot change methods without the approval of the IRS.

Software purchased before August 11, 1993. If you purchased software before August 11, 1993 (before July 26, 1991, if elected), your recovery of costs depends on how you were billed. If the cost of the software was included in the price of computer hardware and the software cost was not separately stated, you treat the entire amount as the cost of the hardware and depreciate it under MACRS as discussed later. If the cost of the software was separately stated, you can depreciate the cost using the straight line method over 5 years (or any shorter life you can establish).

Software acquired after August 10, 1993. If you acquire software after August 10, 1993 (after July 25, 1991, if elected), you can depreciate it over 36 months if it meets all three of the following requirements:

1) It is readily available for purchase by the general public,
2) It is not subject to an exclusive license, and
3) It has not been substantially modified.

Even if the software does not meet the above requirements, you can depreciate it over 36 months if it was not acquired in connection with the acquisition of a substantial portion of a business.

If you acquire software after ***August 10, 1993 (after July 25, 1991, if elected),*** you must amortize it over 15 years (rather than depreciate it) if it does not meet all three of the requirements listed above and it was acquired in connection with the acquisition of a substantial portion of a business. For more information on amortization, see chapter 13.

Software leased. If you lease software, you can treat the rental payments in the same manner that you treat any other rental payments.

Goodwill. Goodwill can never be depreciated because its useful life cannot be determined.

However, if you acquired a business after August 10, 1993 (after July 25, 1991, if elected), and part of the price includes goodwill, you may be able to amortize the cost of the goodwill over 15 years. For more information, see chapter 13.

Trademark and trade name. In general, trademarks and trade names must be capitalized. This means that the full amount cannot be deducted in the current year. For trademarks and trade names acquired before August 11, 1993 (before July 26, 1991, if elected), you can neither depreciate nor amortize these expenses. For trademarks and trade names acquired after August 10, 1993 (after July 25, 1991, if elected), you may be able to amortize their costs over 15 years. For more information, see chapter 13.

What Cannot Be Depreciated

To determine if you are entitled to depreciation, you must know not only what you can depreciate but what you cannot depreciate.

Property placed in service and disposed of in the same year. You cannot deduct depreciation on property placed in service and disposed of in the same taxable year. When property is considered placed in service is explained later.

Inventory. You can never depreciate inventory. Inventory is any property that is held primarily for sale to customers in the ordinary course of business.

In some cases, it is not immediately clear whether property is a business asset or inventory. In these cases, carefully examine all the facts to see if it is depreciable property.

Containers. Containers are generally part of inventory and cannot be depreciated. However, certain durable containers used to ship products can be depreciated if they have a life longer than 1 year, if they qualify as property used in your business, and if title to them does not pass to the buyer. To determine if the above requirements apply and whether your containers can be depreciated, you should consider:

1) Does your sales contract, sales invoice, or acknowledgment of order indicate that you have retained title,
2) Does your invoice treat the containers as separate items, and
3) Do any of your records properly state your basis in the containers.

Manufacturing or processing businesses. If you must include depreciation as part of the cost of goods sold, you cannot deduct this depreciation again as a separate business expense on your return. See chapter 7 for more information on cost of goods sold.

Rented property. Generally, a person who uses depreciable property in a trade or business or holds it for producing income is entitled to the depreciation deduction for the property. This is usually the owner of the property. However, for rented property, this is usually the lessor. An owner or lessor is the person who generally bears the burden of exhaustion of capital investment in the property. This means the person who retains the incidents of ownership for the property. The incidents of ownership include:

1) The legal title,
2) The legal obligation to pay for it,
3) The responsibility to pay its maintenance and operating expenses,
4) The duty to pay any taxes, and
5) The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Land. The cost of land can never be depreciated because land does not wear out or become obsolete and it cannot be used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of land itself. However, you can depreciate some land preparation costs if they are so closely associated with a depreciable asset that it is possible to determine a life for the preparation costs along with the life of the asset with which they are associated.

Demolition of buildings. You cannot deduct costs (paid or incurred) to demolish any building. Nor can you deduct any loss from demolition. Instead, you must add these costs to the basis of the land on which the demolished building stood.

Equipment used to build capital improvements. You cannot deduct depreciation on equipment you are using to build your own capital improvements. You must add depreciation on this equipment during the period of construction to the basis of the improvements. See *Uniform Capitalization Rules* in chapter 5.

Repairs and replacements. If a repair or replacement increases the value of your property, makes it more useful, or lengthens its life, your repair or replacement cost must be capitalized and depreciated. If the repair or replacement does not increase the value of your property, makes it more useful, or lengthen its life, the cost of the repair or replacement is deductible in the same way as any other business expense. See *Additions or improvements to property,* under *Modified Accelerated Cost Recovery System (MACRS),* later.

Professional libraries. If you maintain a library for use in your profession, you can depreciate it. Any technical books, journals, and information services used in your business having a useful life of one year or less are deductible in the same way as any other business expense.

When Depreciation Begins and Ends

You begin to depreciate your property when you place it in service for use in your trade or business or for the production of income. You stop depreciating property either when you have fully recovered its cost or other basis or when you retire it from service. (See *Retired From Service,* later.)

Placed in Service

For depreciation purposes, property is considered placed in service when it is ready and available for a specific use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. Even if the property is not actually being used, it is in service when it is ready and available for its specific use. However, you can begin depreciating property only when it is ready and available for a specific use (placed in service) in a trade or business or for the production of income.

Retired From Service

Property is retired from service when it is permanently withdrawn from use in a trade or business or in the production of income. The period for depreciation ends when property is retired from service.

You can retire property from service by selling or exchanging it, abandoning it, or destroying it.

Correct Depreciation Not Deducted

You cannot deduct unclaimed depreciation in any later tax year. However, you can claim the depreciation on a timely filed amended return for the year for which it should have been claimed. You must file an amended return within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

If you do not claim depreciation you are entitled to deduct, you must still reduce the basis of the property. Reduce the basis by the amount of depreciation you were entitled to deduct. If you deduct more depreciation than you should, you must decrease your basis by any amount deducted from which you received a tax benefit.

Section 179 Deduction

This discussion explains the section 179 deduction. It tells what costs can and cannot be deducted, how to elect the deduction, how to figure the deduction, and when to recapture the deduction.

You can elect to treat all or part of the cost of certain qualifying property as an expense rather than as a capital expenditure. If you make the election, you can deduct a limited amount of the cost of qualifying property you buy for use in your trade or business only in the first year you place your property in service.

Placed in service. For the section 179 deduction, your property is considered placed in service when it is first ready and available for a specific use. Such use can be in a trade or business, the production of income, a tax-exempt activity, or a personal activity. Property placed in service in a use that does not qualify for the section 179 deduction cannot later qualify in another tax year even if its use changes to business.

Example. In 1994, you bought a new car and placed it in service for personal purposes. In 1995, you began to use it for business. The fact that you changed its use to business use does not qualify the cost of your car for a section 179 deduction in 1995. However, you can claim a depreciation deduction for the business use of the car in 1995. To figure this deduction, see *Modified Accelerated Cost Recovery System (MACRS),* later.

What Costs Can and Cannot Be Deducted

You can claim the section 179 deduction only on qualifying property acquired for use in your trade or business. You cannot claim the deduction on property you hold only for the production of income.

Acquired by Purchase

Only the cost of property you acquire for use in your business qualifies for the section 179 deduction. However, the cost of property acquired from a related person or group may not qualify. See *Nonqualifying Property,* later.

Acquired by Trade

If you purchase an asset with cash and a trade-in, part of the basis of the asset you receive is the basis of the trade-in. You cannot claim the section 179 deduction on this part of the basis of the asset. For example, if you buy (for cash and a trade-in) a new truck to use in your business, your cost for the section 179 deduction does not include the adjusted basis of the truck you trade for the new vehicle. See *Adjusted Basis* in chapter 5.

Example. In 1995, Just Sweets, a retail bakery, traded in two ovens with a total adjusted basis of $680 for a new oven costing $1,320. The bakery also traded a used machine with an adjusted basis of $4,500 for a new machine costing $9,000. Both new items were placed in service in 1995. Just Sweets got an $800 trade-in on the old ovens and paid $520 cash for the new oven. The bakery was given $4,800 trade-in and paid $4,200 cash for the machine. The transactions are nontaxable and no gain is recognized on the trade-ins.

The part of the basis of the equipment carried over due to the transactions ($680 for the oven and $4,500 for the machine) is not treated as business cost for the section 179 deduction. However, Just Sweets can elect to deduct $4,720 ($520 and $4,200), the part of the cost of the new property not determined by reference to the property traded.

Qualifying Property

Property qualifying for the section 179 deduction is depreciable property and includes:

1) Tangible personal property,
2) Other tangible property (except most buildings and their structural components) used as:
   a) An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services, or
   b) A research facility in any of the activities in (a), or
   c) A facility in any of the activities in (a) for the bulk storage of fungible commodities,

3) A single purpose agricultural (livestock) or horticultural structure (defined later), and
4) Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

Single purpose structures. A single purpose agricultural structure is any building or enclosure specifically designed, built, and used to:

1) House, raise, and feed a particular type of livestock (including poultry) and its produce, and
2) House the equipment, including any replacements, necessary to house, raise, and feed this livestock.

A ***single purpose horticultural structure*** is:

1) A greenhouse specifically designed, built, and used for the commercial production of plants, or
2) A structure specifically designed, built, and used for the commercial production of mushrooms.

If a structure includes work space, that structure is not a single purpose agricultural or horticultural structure unless the work space is used only for:

1) Stocking, caring for, or collecting livestock or plants or their produce,
2) Maintaining the enclosure or structure, and
3) Maintaining or replacing the equipment or stock enclosed or housed in the structure.

Leased property. Generally, taxpayers other than corporations cannot claim a section 179 deduction based on property they lease to someone else. However, you can claim a section 179 deduction based on:

1) Property you lease to others that you manufactured, or
2) Property you lease to others if the term of the lease is less than half of the property's class life and for the first 12 months the property is transferred to the lessee, the total of the business deductions that you are allowed on the property (except rent and reimbursed amounts) are more than 15% of the rental income from the property.

Nonqualifying Property

You cannot claim the section 179 deduction on:

1) Property held only for the production of income,
2) Real property including buildings and their structural components,
3) Property acquired from certain groups or persons, and
4) Certain property you lease to others (if you are a noncorporate lessor).

For the kind of property you lease on which you can claim the section 179 deduction, see *Leased property,* earlier.

Production of Income

Property is held only for the production of income if it is investment property, rental property (if renting property is not your trade or business), or property that produces royalties. Property you use in the active conduct of a trade or business is not held ***only*** for the production of income.

Acquired From Certain Groups or Persons

Property does not qualify for the section 179 deduction if:

1) The property is acquired by one member of a controlled group from another member of the same group,
2) The property for which the basis is determined in whole or in part by its adjusted basis in the hands of the person from whom you acquired it or is determined under stepped-up basis rules for property acquired from a decedent (see Publication 448), or
3) The property is acquired from a related person.

For this purpose, a list of related persons is available in chapter 2 of Publication 946.

Business and nonbusiness use. When you use property for both business and nonbusiness purposes, you can elect the section 179 deduction only if more than 50% of the property's use in the tax year it is placed in service is for trade or business purposes. You must figure the part of the cost of the property that reflects only the business use of the property. You do this by multiplying the cost of the property by the percentage of business use. This is your business cost and is used to figure your section 179 deduction.

Electing the Deduction

You must make an election to take the section 179 deduction. You can make this election only in the first tax year the property is placed in service. See *Placed in service,* earlier.

How to make the election. You make this election by taking the deduction on Form 4562 with:

1) Your original tax return filed for the tax year the property was placed in service (whether or not you file it timely) or
2) An amended return filed no later than the due date (including extensions) for your return for the tax year the property is placed in service. You cannot make the election for the section 179 deduction on an amended return filed after the due date (including extensions).

Once made, the election can be revoked only with the consent of the Internal Revenue Service (IRS).

How To Figure the Deduction

The total business cost you can elect to deduct under section 179 for a tax year cannot be more than $17,500. This $17,500 maximum dollar limit applies to each taxpayer, not to each business. You do not have to claim the full $17,500. You decide how much of the cost of property you want to deduct under section 179. Any cost you do not deduct under section 179 can be depreciated.

If you acquire and place in service more than one item of qualifying property during the year, you can divide the deduction between the items in any way, as long as the total deduction is not more than the limits. If you have only one item of qualifying property, and it costs less than $17,500, such as $3,200, your deduction is limited to the lesser of:

1) Your taxable income limit or
2) $3,200.

You must figure your section 179 deduction before figuring your depreciation deduction. Taxable income limit is discussed later under *Deduction Limits.*

You must subtract the amount you elect to deduct from the business/investment cost of the qualifying property. This result is called your unadjusted basis and is used to compute your depreciation deduction.

Deduction Limits

Your section 179 deduction cannot be more than the business cost of the qualifying property. In addition, in figuring your section 179 deduction, you must apply the following limits:

1) Maximum dollar limit,
2) Investment limit, and
3) Taxable income limit.

Maximum dollar limit. The total cost you can elect to deduct for a tax year cannot exceed $17,500. This $17,500 maximum applies to each taxpayer and not to each business operated by a taxpayer.

While the maximum dollar amount that can be deducted is $17,500, there are certain rules that can reduce this amount.

Joint returns. A husband and wife who file a joint return are treated as one taxpayer in determining any reduction to the $17,500 maximum dollar limit, regardless of which spouse acquired the property or placed it in service.

Married individuals filing separate returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for purposes of the $17,500 maximum dollar limit and the $200,000 investment limit that applies to the reduction of the maximum dollar limit. Unless they elect otherwise, 50% of the maximum dollar limit (after applying the investment limit) will be allocated to each. If the percentages elected by each spouse do not total 100%, 50 % will be allocated to each spouse. See *Investment limit,* later.

Example 1. Jack Elm is married. He and his wife file separate returns for 1995. Jack bought and placed in service $200,000 of qualified farm machinery in 1995. His wife had her own business and she placed in service $5,000 of qualified business equipment. If Mr. and Mrs. Elm had filed a joint return for 1995, their maximum dollar limit would have been $12,500. This is because their $17,500 maximum dollar limit would have been reduced by $5,000 (the excess over the $200,000 investment limit). They elect to allocate the $12,500 as follows: $9,375 (75%) to Mr. Elm's machinery and $3,125 (25%) to Mrs. Elm's equipment. If they did not make an election to allocate their costs, they would be limited to the $12,500 multiplied by 50% or $6,250 each on their separate returns.

Joint return after filing separate returns. If a husband and wife elect to file a joint return after the due date for filing the return, the maximum dollar limit on the joint return is the lesser of:

1) The maximum dollar limit (after applying the investment limit), or
2) The total cost of section 179 property they elected to expense on their separate returns.

Example 2. Assume Jack Elm and his wife in Example 1 had filed separate returns. On their separate tax returns, Jack elected to expense $4,000 of section 179 property and his wife elected to expense $2,000. If they subsequently file a joint return after the due date for that return, their maximum dollar limit for section 179 is $6,000, the lesser of $12,500 (the maximum dollar limit after applying the investment limit) or $6,000 (the total amount they elected to expense on their separate returns).

Investment limit. For each dollar of business cost over $200,000 of section 179 property placed in service in a tax year, the $17,500 maximum dollar limit is reduced (but not below zero) by one dollar. If your business cost of section 179 property placed in service during a tax year is $217,500 or more, you cannot take a section 179 deduction and you are not allowed to carryover the cost that is more than $217,500.

Example. In 1995, James Smith placed in service machinery with a cost of $207,000. Because the cost of the machinery exceeds $200,000 by $7,000, he must reduce the maximum deduction allowed ($17,500) by $7,000. If his taxable income limit is $10,500 or more, he is entitled to a section 179 deduction for 1995 of $10,500.

Taxable income limit. The total cost that can be deducted in each year is limited to the taxable income from the active conduct of any trade or business during the tax year. Generally, you are considered to actively conduct a trade or business if you meaningfully participate in the management or operations of the trade or business.

Taxable income for this purpose is figured by totaling the net income (or loss) from all trades and businesses you and your spouse (if filing a joint return) actively conducted during the tax year. Items of income derived from a trade or business actively conducted by you include section 1231 gains (or losses) as discussed in chapter 23 of this publication, and interest from working capital of your trade or business. Also include in total taxable income any wages, salaries, tips, or other compensation earned as an employee. When figuring taxable income, do not take into account unreimbursed employee business expenses you may have as an employee.

In addition, taxable income is figured without regard to:

1) The section 179 expense deduction,
2) The self-employment tax deduction, and
3) Any net operating loss carryback or carryforward.

Example. Joyce Jones places in service in 1995 a machine that cost $8,000. The taxable income from her business for 1995 (determined without a section 179 deduction for the cost of the machine and without the self-employment tax deduction) is $6,000. Her section 179 deduction is limited to $6,000. The $2,000 cost that is not allowed as a current section 179 deduction because of the taxable income limit can be carried to 1996.

Carryover of unallowable deduction. The amount you carry over will be taken into account in determining the amount of your section 179 deduction in the next year. In the tax year you place property in service, you can select the properties for which costs will be carried forward and you can allocate the portion of the costs to these properties provided your decisions are shown in your books and records.

See *Carryover of disallowed deduction* in chapter 2 of Publication 946 for more information on figuring the carryover; or to figure the carryover, use the *Section 179 Worksheet* also provided in chapter 2 of Publication 946.

Basis adjustment. Generally, upon a sale or other disposition of section 179 property, or a transfer of section 179 property involving a transaction in which gain or loss is not recognized in whole or in part (including transfers at death), the adjusted basis of the property is increased before the sale or other disposition by the amount of disallowed section 179 deduction.

Neither the old nor the new owner can deduct any of the disallowed amount that is added to the basis of the property.

Passenger automobiles. For passenger automobiles placed in service in 1995, your total section 179 deduction and depreciation cannot be more than $3,060 for 1995. See Publication 917 for more information.

Two different taxable income limits. The section 179 deduction is subject to a taxable income limit. You also may have to figure another deduction that has a limit based on taxable income. The limit for this other deduction may have to be figured taking into account the section 179 deduction. If so, complete the steps discussed next.

Step 1– Figure taxable income without either a section 179 deduction or the other deduction.

Step 2– Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.

Step 3– Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.

Step 4– Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.

Step 5– Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.

Step 6– Now figure your actual section 179 deduction using the taxable income figured in Step 5.

Step 7– Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.

Step 8– Figure your actual other deduction using the taxable income figured in Step 7.

Example. During the tax year, the XYZ corporation purchased and placed in service qualifying section 179 property that cost $10,000. It elects to expense as much as possible under section 179. The XYZ corporation also gave a charitable contribution of $1,000 during the tax year. A corporation's deduction for charitable contributions cannot be more than 10% of its taxable income, figured after subtracting any section 179 deduction. The taxable income limit for the section 179 deduction is figured after subtracting any allowable charitable contributions. XYZ's taxable income figured without taking into account either any section 179 deduction or any deduction for the charitable contributions is $12,000. XYZ figures its section 179 deduction and its deduction for charitable contributions as follows.

Step 1– Taxable income figured without either deduction is $12,000.

Step 2– Using $12,000 as taxable income, a hypothetical section 179 deduction of $10,000 would be allowable.

Step 3– $12,000 (from Step 1) minus $10,000 (from Step 2) equals $2,000.

Step 4– Using $2,000 (from Step 3) as taxable income, a hypothetical charitable contribution (limited to 10% of taxable income) of $200 is figured.

Step 5– $12,000 (from Step 1) minus $200 (from Step 5) equals $11,800.

Step 6– Using $11,800 (from Step 5) as taxable income, the actual section 179 deduction is figured. Because the taxable income is at least $10,000, XYZ can take a $10,000 section 179 deduction.

Step 7– $12,000 (from Step 1) minus $10,000 (from Step 6) equals $2,000.

Step 8– Using $2,000 (from Step 7) as taxable income, the actual charitable contribution (limited to 10% of taxable income) of $200 is figured.

Partnerships and partners. The section 179 deduction limits apply to both the partnership and to each partner. The partnership determines its section 179 deduction subject to the limits. It allocates the deduction among its partners.

Each partner adds the amount allocated from the partnership as shown on Schedule K–1 to his or her other nonpartnership section 179 costs and then applies the maximum dollar limit to this total to determine his or her section 179 deduction. To determine if a partner has passed the $200,000 investment limit, the cost of section 179 property placed in service by the partnership is not attributed to any partner. The total amount of each partner's (partnership and nonpartnership) section 179 deduction is subject to both the taxable income limit and the maximum dollar limit.

For more information about how the section 179 deduction limits apply to partnerships and partners, see Publication 946.

S corporations. The rules that apply to partnerships and its partners also apply to an S corporation and its shareholders. The limits apply to an S corporation and to each shareholder. The corporation allocates the deduction among the shareholders, who then take the deduction subject to the limits.

For more information about how the section 179 deduction limits apply to an S corporation and its shareholders, see Publication 946.

Recordkeeping requirements. You must keep records that show the specific identification of each piece of section 179 property. These records must show how the property was acquired, the person from whom it was acquired, and when it was placed in service. You must stay with your selection of section 179 property for which you claim a deduction when computing taxable income for the tax year the election is made and all later tax years.

When To Recapture the Deduction

If you claim a section 179 deduction for the cost of qualifying property and, in a year after you place it in service, you do not use it predominantly for business, you may have to recapture (include in income) part of the deduction.

You report any recapture of the section 179 deduction on Form 4797.

You figure the amount to include in income by subtracting the depreciation that would have been allowable on the section 179 amount for prior years and the year of recapture from your section 179 deduction.

If you elect the section 179 deduction, the amount deducted is treated as depreciation for purposes of the recapture rules. Any gain you realize from a sale, exchange, or other disposition of property may have to be treated as ordinary income up to the section 179 and depreciation deductions claimed. For more information on dispositions (including installment sales), see chapters 23 and 24.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on August 1, 1993, an item of 3–year property costing $10,000. The property is not listed property. He used the property only for business in 1993 and 1994. He elected a section 179 deduction of $5,000 for this property. During 1995, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

Section 179 Deduction Claimed (1992)		$5,000.00
Allowable Depreciation (Instead of Section 179):		
1993 — $5,000 × 33.33%*	$1,666.50	
1994 — $5,000 × 44.45%*	2,222.50	
1995 — $5,000 × 14.81%* × 40% (Business)	296.20	4,185.20
1995 — Recapture Amount		$ 814.80

*Rates from 200% table, later.

Paul must include $814.80 in income for 1995. This is $5,000 minus $4,185.20 ($1,666.50 + $2,222.50 + $296.20).

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) generally applies to all tangible property placed in service after 1986. MACRS consists of two systems for depreciating property. The main system is called the ***General Depreciation System (GDS)*** and applies to most property. The second system is called the ***Alternative Depreciation System (ADS).*** Unless ADS is specifically required by law or you elect it, GDS is generally used to figure your depreciation deductions.

What Can Be Depreciated Under MACRS

MACRS applies to most tangible depreciable property placed in service after 1986. Property for which you cannot use MACRS is discussed later in *What Cannot Be Depreciated Under MACRS.*

Use of real property changed. All real property acquired before 1987 that was changed from personal use to a business or income-producing use after 1986 must be depreciated under MACRS.

When To Use GDS

Most tangible depreciable property falls within the general rule of MACRS, also called the General Depreciation System (GDS). The major differences between GDS and ADS are the recovery period and method of depreciation you use to figure the deduction. Because GDS permits use of the declining balance method over a shorter recovery period, the deduction is greater in the earlier years.

However, the law requires the use of ADS for certain property as discussed under *When To Use ADS,* next.

Although your property may qualify for GDS, you can elect to use ADS. If you make this election, however, you can never revoke it. How to make this election is discussed in *Election,* under *Depreciation Methods,* later.

When To Use ADS

Under ADS, you determine your deduction by using the straight line method over a recovery period that generally is longer than the recovery period under GDS. This system is required for:

1) Any tangible property used predominantly outside the United States during the year,
2) Any tax-exempt use property,
3) Any tax-exempt bond-financed property,
4) Any imported property covered by an executive order of the President of the United States, and
5) Any property used predominantly in a farming business and placed in service during any tax year in which you make an election not to apply the uniform capitalization rules to certain farming costs.

What Cannot Be Depreciated Under MACRS

You cannot use MACRS for certain property because of special rules that exclude it from MACRS. You can elect to exclude certain property from being depreciated under MACRS.

Property that you cannot depreciate using MACRS includes:

1) Intangible property,
2) Any motion picture film or video tape,
3) Any sound recording,
4) Certain real and personal property placed in service before 1987, and
5) Property you elect to exclude from MACRS that is properly depreciated under a method of depreciation that is not based on a term of years.

Election to exclude certain property. If you properly depreciate any of your property under a method of depreciation that is not based on a term of years, such as the unit-of-production method, you can elect to exclude that property from MACRS. To figure a depreciation deduction under the unit-of-production method, you divide the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the asset. Apply the resulting amount to the units produced in a year to arrive at your depreciation for that year.

You make this election by reporting your depreciation for the property on line 18, of Part III on Form 4562, and attaching a statement as described in the Instructions for Form 4562. You make the election by the tax return due date (including extensions) for the year the property is placed in service.

Use of standard mileage rate. If you use the standard mileage rate for an automobile you buy and use for business after 1980, you are considered to have elected to exclude the automobile from MACRS and ACRS. See chapter 15 of this publication for a discussion of the standard mileage rate.

Property placed in service before 1987. There are special rules that may prevent you from using MACRS for property placed in service by you or anyone (for any purpose) before 1987 (before August 1, 1986, if MACRS was elected). These excluded property rules apply to both personal and real property. However, the rules for personal property are more restrictive.

Note: For these rules, neither real nor personal property is treated as owned before it is placed in service. If you owned property in 1986 but did not place it in service until 1987, it is not treated as owned in 1986.

Personal property. You cannot use MACRS for personal property (section 1245 property) that you acquired after 1986 (after July 31, 1986, if MACRS was elected) if:

1) You or a party related to you owned or used the property in 1986,
2) The property was acquired from a person who owned it in 1986 and, as part of the transaction, the property user does not change,
3) You lease the property to a person (or a person related to this person) who owned or used the property in 1986, or
4) The property was acquired in a transaction in which the property user did not change and the property was not MACRS property in the hands of the person from whom it was so acquired because of 2) or 3).

Real property. For real property placed in service after 1986 (after July 31, 1986, if MACRS was elected), you cannot use MACRS if:

1) You or a party related to you owned the property in 1986,
2) You lease the property back to the person (or a person related to this person) who owned the property in 1986, or
3) You acquired the property in a transaction in which some of your gain or loss was not recognized. MACRS applies only to the part of your basis in the acquired property that represents cash paid or unlike property given up. It does not apply to the substituted portion of the basis.

Note: This rule does not apply to nonresidential real property or residential rental property.

Related parties. For these rules, a party related to you includes members of your immediate family (including your spouse, ancestors, and lineal descendants).

Special rule. The excluded property rules do not apply to any property if the allowable deduction for the property for the first tax year in which the property is placed in service using ACRS is greater than the deduction under MACRS using the half-year convention.

For more information on related parties and other special rules, see chapter 3 of Publication 946.

How To Figure the Deduction Using Percentage Tables

To figure MACRS deduction, you generally must first determine the following information about the property you intend to depreciate.

1) Its basis,
2) Its property class and recovery period,
3) Its date placed in service,
4) Which convention to use, and
5) Which depreciation method to use.

Basis

Basis is a measure of your investment in the property for tax purposes. When you depreciate property, a certain percentage of your basis in it is deducted each year.

For property that you buy, your original basis is usually its cost to you. For property that you acquire in some other way, such as by inheriting it, receiving it as a gift, building it yourself, or getting it in a tax-free exchange, you must figure your original basis in some other way.

Events will often change the basis of a piece of property. This changed basis is called the adjusted basis. Some events, such as improvements, increase basis. Some, such as casualty losses and the section 179 deduction, decrease basis. If basis is adjusted, the depreciation deduction may also have to be changed, depending on the reason for the adjustment and on the method of depreciation you are using.

Chapter 5 explains how to figure basis for property acquired in different ways and how to allocate basis among assets. It also explains what items increase or decrease basis.

Basis of property changed from personal use. If you held property for personal use and later change it to business use or use in the production of income, your basis is the lesser of:

1) The fair market value (FMV) on the date you change it from personal use, or
2) Your original cost or other basis adjusted as follows:
   a) Increased by the cost of any permanent improvements or additions and other costs that must be added to basis, and
   b) Decreased by any tax deductions you claimed for casualty losses and other charges to basis claimed on earlier years' income tax returns.

Property Classes and Recovery Periods

Each item of property depreciated under GDS is assigned to a property class. The property class of an item of property establishes the number of years over which the basis of the property is recovered. This period of time is called a recovery period.

GDS. Under GDS, most types of tangible property fall into one of the following classes:

3–year property. This class includes tractor units for use over the road, any race horse over 2 years old when placed in service, and any other horse over 12 years old when placed in service.

5–year property. This class includes automobiles, buses, trucks, computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), and any property used in research and experimentation.

7–year property. This class includes office furniture and fixtures (desks, files, etc.).

Any property that does not have a class life, and that has not been designated by law as being in any other class and, if placed in service before 1989, any single purpose agricultural or horticultural structure is also 7-year property.

10–year property. This class includes vessels, barges, tugs, and similar water transportation equipment, and, if placed in service after 1988, any single purpose agricultural or horticultural structure, and any tree or vine bearing fruit or nuts.

15–year property. This class includes certain depreciable improvements made directly to land or added to it, such as shrubbery, fences, roads, and bridges.

20–year property. This class includes farm buildings (other than agricultural or horticultural structures) and any municipal sewers.

Nonresidential real property. This class includes any section 1250 real property that is not:

a) Residential rental property, or

b) Property with a class life of less than 27.5 years.

The recovery period for nonresidential real property is:

39 years for property you placed in service ***after*** May 12, 1993, or

31.5 years for property you placed in service ***before*** May 13, 1993.

However, property you placed in service before January 1, 1994, will not be subject to the longer recovery period if you or a ''qualified person'' entered into a binding written contract to purchase or construct the property before May 13, 1993, or you (or a qualified person) began construction of the property before May 13, 1993. A ***qualified person*** is anyone who transfers a contract or property to you so long as the property was not put in service by the transferor. See Publication 946 for the 39–year nonresidential real property table.

Residential rental property. This class includes any real property that is a rental building or structure (including mobile homes) if 80% or more of the property's gross rental income for the tax year is rental income from dwelling units. If you occupy any part of the building or structure, the gross rental income includes the fair rental value of the part you occupy. The recovery period for this property is 27.5 years.

The class lives and recovery periods for most assets are listed in the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

Additions or improvements to property. Additions or improvements you make to any property, including leased property, are treated as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of the date the addition or improvement is placed in service or the date the property to which the addition or improvement is made is placed in service. The recovery period and class of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

Office in the home. If you begin to use part of your home as an office after 1986, that part of your home is depreciated as nonresidential real property over 39 years (31.5 years for property you placed in service ***before*** May 13, 1993) under GDS. See Publication 587 for a discussion of the tests that must be met to claim expenses, including depreciation, for the business use of your home.

Personal residences changed to rental use. If you begin to rent a residence after 1986 that was your personal residence before 1987, you depreciate it as residential rental property over 27.5 years under GDS.

Placed-in-Service Date

As discussed in *Placed in Service* in *When Depreciation Begins and Ends,* earlier, depreciation begins when your property is placed in service in a trade or business or for the production of income. For example, if property is placed in service for personal use, depreciation is not allowable. If the property use changes to a business or income-producing activity, depreciation begins at the time of the change in use.

Example 1. On November 22, 1994, Donald Steep bought a machine for his business. It was delivered on December 7, 1994. However, it was not installed and operational until January 3, 1995. Because it was not operational until 1995, it is considered placed in service in 1995. If the machine had been ready for use when it was delivered in 1994, it would be considered placed in service in 1994 even if it was not actually used until 1995.

Example 2. On April 6, Sue Thorn bought a house to use as residential rental property. She made several repairs and had it ready for rent on July 5. At that time, she began to advertise it for rent in the local newspaper. The house is considered placed in service in July when it was ready and available for rent. She can begin to depreciate it in July.

Conventions

Generally, you use the half-year convention to figure the deduction for property other than residential rental and nonresidential real property. Under a special rule, you may be required to use the mid-quarter convention. For residential rental and nonresidential real property, you use the mid-month convention in all situations.

Half-year convention. Under the half-year convention, treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

Mid-quarter convention. If during any tax year the total depreciable bases of all MACRS property placed in service during the last 3 months of that tax year exceeds 40% of the total depreciable bases of all MACRS property placed in service during that tax year, you must use the mid-quarter convention instead of the half-year convention. In determining the total bases of the properties, do not include the basis of:

Residential rental property,

Nonresidential real property, or

Property placed in service and disposed of in the same tax year.

To determine whether you must use the mid-quarter convention, the depreciable basis of property is your basis multiplied by the percentage of business/investment use and then reduced by:

1) The amount of amortization taken on the property,
2) Any section 179 deduction claimed on the property, and
3) Any deduction claimed for clean-fuel vehicles or for clean-fuel vehicle refueling property.

Under the mid-quarter convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

To figure your MACRS deduction for property subject to the mid-quarter convention, first figure your depreciation for the full tax year. Then multiply this amount by the following percentages for the quarter of the tax year the property is placed in service:

Quarter of tax year	Percentage
First	87.5%
Second	62.5%
Third	37.5%
Fourth	12.5%

For more information including percentage tables based on the mid-quarter convention, see Publication 946.

Mid-month convention. Under the mid-month convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Example. You buy a building for $100,000 that is nonresidential real property. You place it in service in your business on January 7, 1995. You use the calendar year as your tax year. You do not use the tables to compute your depreciation deductions. You figure your MACRS depreciation for the building by dividing 1 by 39 years to get the straight line rate for a full year of 2.564%. The depreciation for a full year is $2,564 (2.564% × $100,000). Under the mid-month convention, January, the month the property is placed in service, is treated as half a month. You would get 11.5 months of depreciation for 1995. Expressed as a percentage, 11.5 months is 95.8% (11.5 ÷ 12). Your 1995 depreciation for the building is $2,456 (95.8% × $2,564).

Depreciation Methods

Under MACRS, there are five ways to depreciate your property.

200% declining balance method. You can use the (200%) declining balance method for nonfarm property in the 3–, 5–, 7–, or 10–year class over a GDS recovery period and apply a half-year or mid-quarter convention (discussed earlier).

150% declining balance method. You use the 150% declining balance method for all property in farming businesses (except real property) and for all other property in the 15- and 20-year property classes.

For these classes of property, you change to the straight line method for the first tax year for which that method, when applied to the adjusted basis at the beginning of such year, will yield a larger deduction. You always use the straight line method for residential rental and nonresidential real property.

Straight line election. Instead of using the declining balance method over the GDS recovery period, you can elect to use the straight line method over the GDS recovery period.

The election to use the straight line method for one item in a property class applies to all property in that class placed in service in the year of the election. Once made,the election to use the straight line method cannot be changed.

The election is made by entering ''S/L'' in column (f) of Part II of Form 4562. The election must be made by the tax return due date (including extensions) for the year the property for which you make the election is placed in service. However, this election can be made each year for each property class.

150% election. Instead of using the 200% declining balance method over the GDS recovery period, you can elect to use the 150% declining balance method over the ADS recovery period for the property. If the property does not have an ADS recovery period assigned to it, the recovery period is 12 years. A half-year or mid-quarter convention is used and there is a change to the straight line method when that method will give a larger deduction.

The election to use the 150% declining balance method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering ''150 DB'' in column (f) of Part II on Form 4562.

ADS method. If you choose, you can use the ADS method. Under this method, depreciation is figured using the straight line method but over ADS recovery periods.

- For residential rental and nonresidential real property, the straight line method is applied to a 40–year recovery period with the mid-month convention.
- For automobiles and light general purpose trucks, the straight line method is applied over a 5–year period with either the half-year or mid-quarter convention.
- For single purpose agricultural and horticultural structures, it is applied over a 15–year period with either the half-year or mid-quarter convention.
- For any tree or vine bearing fruit or nuts, it is applied over a 20–year period with either the half-year or mid-quarter convention.

The ADS recovery periods for many assets can be found in the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

Election of ADS. You make the election to use the ADS method by completing line 16 of Part II of Form 4562. Make the election by the tax return due date (including extensions) for the year the property is placed in service.

The election of the ADS method for one item in a property class generally applies to all property in that class placed in service during the tax year of the election. However, you can make the election on a property-by-property basis for residential rental and nonresidential real property.

Once made, the election to use the ADS method cannot be changed.

Depreciation Methods Chart

To help you determine the proper method for a specific property class, use the following chart. The declining balance method is shown as DB and the straight line method as SL.

Depreciation Methods Chart

Property Class	Method-Recovery Period
3, 5, 7, 10–Year (Nonfarm)	200% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS*
3, 5, 7, 10–Year (Farm)	150% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS*
15, 20–Year (Farm or Nonfarm)	150% DB-GDS SL-GDS* SL-ADS*
Nonresidential Real Property Residential Rental Property Trees or Vines Bearing Fruit or Nuts	SL-GDS SL-ADS*
Tax-Exempt Use Property Tax-Exempt Bond-Financed Property Imported Property Foreign Use Property (Used Outside U.S.)	SL-ADS

*Elective Method

MACRS Deductions

You may determine your MACRS depreciation deduction in one of two ways. You can use the percentage tables discussed next, or you can actually compute the deduction using the applicable depreciation method and convention over the recovery period.

MACRS Percentage tables. The percentage tables are based on the depreciation method, recovery period, and convention. The percentages in the tables are applied to the unadjusted basis of the property each year of the recovery period. ***Unadjusted basis*** is the same amount you would use to compute a gain on a sale but it is figured without taking into account any depreciation taken in earlier years. However, you do reduce your basis by:

1) The amount of amortization taken on the property,
2) Any section 179 deduction claimed, and
3) Any deduction claimed for clean-fuel vehicles and clean-fuel vehicle refueling property.

Also, if the business property is a vehicle, you must reduce the basis by any qualified electric vehicle credit.

However, you cannot continue to use the tables if there are any adjustments to the basis of your property for reasons other than:

1) Depreciation allowed or allowable, or
2) An addition or improvement to that property depreciated as a separate item of property.

For example, if the basis of the property is reduced as a result of a casualty to the property, you cannot continue to use the tables.

For the year of adjustment and the remainder of the recovery period, you must compute your depreciation based on the adjusted basis of the property at the end of the tax year of adjustment and the remaining recovery period. For more information, see *How To Figure the Deduction Without Using the Tables* in chapter 3 of Publication 946.

In addition, you cannot use the tables if you have a short tax year. If this occurs, see *MACRS Deduction in Short Tax Year* in chapter 3 of Publication 946.

200% table. The following table has the percentages for 3–, 5–, and 7–year nonfarm property. The percentages are based on the 200% declining balance method over GDS recovery periods and apply a half-year convention with a change to the straight line method. See Appendix A in Publication 946 for complete MACRS tables, including tables for the mid-quarter convention.

Year	3–Year	5–Year	7–Year
1	33.33%	20%	14.29%
2	44.45%	32%	24.49%
3	14.81%	19.2%	17.49%
4	7.41%	11.52%	12.49%
5		11.52%	8.93%
6		5.76%	8.92%
7			8.93%
8			4.46%

Example. You buy an item of 7–year property for $10,000 and place it in service on August 10, 1994. You do not elect a section 179 deduction. The unadjusted basis of the property is $10,000. You use the percentage tables to figure your deduction.

You multiply $10,000 by 14.29% to get your depreciation for 1994 of $1,429 for this item of 7–year property. For 1995, you multiply $10,000 by 24.49% to get your depreciation deduction of $2,449.

How to figure the deduction without using the tables. Instead of using the percentage tables to figure depreciation, you can actually compute your depreciation deduction each year. You must apply the appropriate convention for the first year.

Note. Figuring MACRS deductions without using the tables will generally result in a slightly different amount than using the tables.

Declining balance method. To figure your MACRS deduction, first determine your declining balance rate. Do this by dividing the specified declining balance percentage (150% or 200%) by the recovery period. For example, for 3–year nonfarm property, you divide 2.00 by 3 to get .6667 or 66.67%. For 15–year property, you divide 1.50 by 15 to get .10 or 10%.

You multiply the unadjusted basis of the property by the declining balance rate and apply the half-year convention to figure your depreciation for the first year. In the second year, first reduce your basis for the amount of depreciation allowable for the first year. Then multiply this adjusted basis by the same rate used in the first year.

Declining balance rates. The following table shows the applicable declining balance rate for each class of property and the first year for which the straight line method will give an equal or greater deduction. For 3–, 5–, 7–, and 10–year nonfarm property, the rate is based on the 200% declining balance method. For farm property and 15– and 20–year property, it is based on the 150% declining balance method.

Class	Declining Balance Rate	Year
3	66.67%	3rd
5	40%	4th
7	28.57%	5th
10	20%	7th
15	10%	7th
20	7.5%	9th

Straight line method. When using the straight line method, you must determine a new depreciation rate for each tax year in the recovery period. For any tax year, the straight line rate is determined by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. The rate is applied to the unrecovered basis of the property. If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight line rate for that tax year is 100%.

For example, the straight line method applied to property with a 5–year recovery period results in a straight line rate of 20% (1 ÷ 5) for a full tax year. After applying the half-year convention, the first year rate is 10%. At the beginning of the second year, the remaining recovery period is 4.5 years as a result of the half-year convention. The straight line rate for the second year is 22.22% (1 ÷ 4.5). This second year rate is applied to the cost or other basis of the property reduced by the depreciation taken in the first year.

General Asset Accounts

You can choose to put certain depreciable property subject to MACRS in one or more general asset accounts. After you have set up a general asset account, you generally figure the depreciation for each general asset account by using the depreciation method, recovery period, and convention that applies to the property in the account. For each general asset account, record the depreciation allowance in a separate depreciation reserve account.

Property you cannot include. You cannot include property in a general asset account if you use it in both a trade or business (or for the production of income) and in a personal activity in the tax year in which you first place it in service.

How To Group Property in General Asset Accounts

Each general asset account must include only property that:

1) Has the same asset class,
2) Has the same recovery period,
3) Has the same depreciation method,
4) Has the same convention, and
5) You placed in service in the same tax year.

The following rules also apply when you establish a general asset account:

1) Property without an asset class, but with the same depreciation method, recovery period, and convention, that you place in service in the same tax year, can be grouped into the same general asset account;
2) Property subject to the mid-quarter convention can only be grouped into a general asset account with property that is placed in service in the same quarter of the tax year;
3) Property subject to the mid-month convention can only be grouped into a general asset account with property that is placed in service in the same month of the taxable year; and
4) Passenger automobiles subject to the limits on passenger automobile depreciation must be grouped into a separate general asset account.

Dispositions and Conversions

When you transfer ownership of property in a general asset account or you permanently withdraw it from use in your trade or business or from the production of income, it is considered disposed of. A disposition also occurs when you transfer property to a supplies, scrap, or similar account. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of property; a disposition ***does not include,*** the retirement of a structural component of real property.

The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected by your disposition of property from the general asset account.

Property you change to personal use must be removed from the general asset account.

Unadjusted depreciable basis. The unadjusted depreciable basis of an item of property in a general asset account is the same amount you would use to figure gain on the sale of the property, but is figured without taking into account any depreciation taken in earlier years.

The unadjusted depreciable basis of a general asset account is the total of the unadjusted depreciable bases of all of the property in the account.

For more information on general asset accounts, see chapter 3 of Publication 946.

Listed Property

There are limits on the depreciation deductions you can claim on listed property. If your listed property is not used more than 50% in business use during any tax year, the section 179 deduction is not allowable and you must depreciate the property using the ADS method. ADS uses the straight line method and is discussed earlier under *When To Use ADS.* Limitations are also imposed on lessees that are similar to those imposed on owners. See chapter 4 of Publication 946.

In addition to the rules for all listed property, there is a special dollar limit on the depreciation and section 179 deduction you can claim each year for passenger automobiles. For ***passenger automobiles*** placed in service in 1995, your total section 179 deduction and depreciation cannot exceed $3,060. For the second year, it cannot exceed $4,900. It cannot exceed $2,950 in the third year and $1,775 each later year. For more information, see Publication 917.

Listed property defined. Listed property is any of the following:

1) Any passenger automobile,
2) Any other transportation vehicle,
3) Any property of a type generally used for entertainment, recreation, or amusement,
4) Any computer and related peripheral equipment ***unless*** it is used only at a regular business establishment and owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit, if, and only if, that portion is used both regularly and exclusively for business as discussed in Publication 587,
5) Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

What Records Must Be Kept

You cannot take any depreciation or section 179 deduction for the use of listed property (including passenger automobiles) unless you can prove business/investment use by adequate records or sufficient evidence to support your own statements.

Adequate Records

To meet the adequate records requirement, you must maintain an account book, diary, log, statement of expense, trip sheet, or similar record or other documentary evidence that, together with the receipt, is sufficient to establish each element of an expenditure or use. It is not necessary to record information in an account book, diary, or similar record if the information is already shown on the receipt. However, your records should back up your receipts in an orderly manner.

For listed property, you must keep records for as long as any excess depreciation can be recaptured (included in income).

For property placed in service after 1986, recapture can occur in any tax year of the ADS recovery period.

For more information, see Publication 946

Alternative minimum tax. If you use accelerated depreciation, you may need to figure alternative minimum tax. For more information about the alternative minimum tax rules applicable to individuals, see Form 6251, *Alternative Minimum Tax–Individuals,* and for the rules applicable to corporations, see Chapter 34 in this publication.

Form 4562

Form 4562 is used by most taxpayers reporting depreciation, amortization, or the section 179 deduction.

File Form 4562 only if:

1) You are claiming depreciation on property placed in service this year,
2) You are claiming a section 179 deduction,
3) You are beginning to claim amortization this tax year,
4) You are claiming depreciation on any listed property,
5) You are claiming a deduction for any vehicle reported on a form other than Schedule C or Schedule C–EZ, or
6) You are filing a corporate tax return (other than Form 1120S).

If you do not have to file Form 4562, claim depreciation on the appropriate line of your tax return. A sample Form 4562 is illustrated in Part 8, *Filled-In Forms* in this publication.

13.

Amortization and Depletion

Important Reminder

Amortization of certain intangibles. You may have to amortize, over 15 years, certain intangibles that you hold in connection with a trade or business or an activity for the production of income.

For more information, see *Amortization of Certain Intangibles,* later.

Introduction

You may be able to deduct each year, as amortization, a part of certain capital expenses. Amortization generally allows a write off of your costs that are not ordinarily deductible. See chapter 12 for information on depreciation.

If you have an exhaustible natural resource or timber, you are allowed a depletion deduction. Depletion is discussed later in this chapter.

Topics

This chapter discusses:

- Amortizing qualified expenses
- Mineral property
- Oil and gas wells
- Natural and geothermal deposits
- Timber

Useful Items

You may want to see:

Publication

- ☐ **533** Self-Employment Tax
- ☐ **535** Business Expenses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses

Form (and Instructions)

- ☐ **T** Forest Industries Schedules
- ☐ **Sch E (Form 1040)** Supplemental Income and Loss
- ☐ **Sch SE (Form 1040)** Self-Employment Tax
- ☐ **4562** Depreciation and Amortization
- ☐ **6251** Alternative Minimum Tax—Individuals

Amortization

Amortization lets you recover certain capital expenses in a way that is like straight line depreciation. Only certain specified expenses can be amortized for federal income tax purposes. The different types of expenses that can be amortized are discussed in this chapter. For a more detailed discussion of amortization, see chapter 12 of Publication 535.

If you want to amortize your expenses, you usually must make an election to do so. The election is made by filing Form 4562 and attaching a required statement to your income tax return. Unless otherwise indicated, you enter your deduction in Part VI, *Amortization,* of Form 4562.

Amortization of Certain Intangibles

You must amortize over 15 years, the capitalized costs of certain intangibles that you acquire after August 10, 1993. These intangibles are called ''amortizable section 197 intangibles'' and are defined later. They must be held in connection with your trade or business or in an activity engaged in for the production of income. The amount of your deduction is the adjusted basis (for purposes of determining gain) of the intangible amortized over a 15-year period beginning with the month acquired. No other depreciation or amortization deduction is allowed for section 197 intangibles.

Effective date elections. While this amortization provision generally applies only to property acquired after August 10, 1993, under ***two elections,*** you may choose to have it apply differently.

First, you can choose to apply this amortization provision to section 197 intangibles acquired after July 25, 1991, and before August 11, 1993. Once made, the election applies to all section 197 intangibles acquired during that period and it can only be revoked with the consent of the IRS.

Second, you can choose not to apply this amortization provision to section 197 intangibles acquired after August 10, 1993, if they were acquired under a binding written contract in effect on that date and at all times thereafter until the property was acquired. Once made, the choice applies to all property acquired under that contract, and the choice can only be revoked with the consent of the IRS. This election may not be made if you have chosen to apply the new amortization provision to all section 197 intangibles acquired after July 25, 1991, as discussed in the preceding paragraph.

Section 197 Intangibles

The following assets are section 197 intangibles:

1) Goodwill,
2) Going concern value,
3) Workforce in place including its composition, and terms and conditions (contractual or otherwise) of its employment,
4) Business books and records, operating systems, and any other information base, including lists, or other information with respect to current or prospective customers,
5) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item,
6) A customer-based intangible,
7) A supplier-based intangible,
8) Any other item similar to those in items 3 through 7.
9) A license, permit, or other right granted by a governmental unit or agency (including renewals),
10) A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business, and
11) A franchise, trademark, or trade name (including renewals).

You cannot amortize any of the intangibles listed in items (1) through (8) that you created, unless you created it in connection with the acquisition of assets constituting a trade or business or substantial portion of a trade or business.

For more information on these section 197 intangibles, see chapter 12 in Publication 535.

Workforce in place. This includes the composition of a workforce (for example, its experience, education, or training), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Therefore, the part of a purchase price of a trade or business attributable to the existence of a highly-skilled workforce, or the cost of acquiring an existing employment contract or relationship with employees or consultants as part of the acquisition of a trade or business are examples of workforce in place.

Customer-based intangible. A customer-based intangible 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. That part of the purchase price of a trade or business that is based on the existence of a customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services must be amortized over 15 years.

Supplier-based intangible. A supplier-based intangible is the value resulting from the future acquisition of goods or services because of relationships in the ordinary course of business with suppliers of goods or services to be used or sold by the business. That part of the purchase price of a trade or business that is based on the existence of a favorable relationship with distributors (such as favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts must be amortized over 15 years.

Other intangibles. The following assets are not section 197 intangibles:

1) Any interest in a corporation, partnership, trust or estate, or under an existing futures contract, foreign currency contract, notional principal contract, or similar financial contract,
2) Any interest in land,
3) Most computer software (see *Computer software,* later),
4) Any of the following ***not*** acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business:
   a) An interest in a film, sound recording, videotape, book, or similar property,
   b) A right to receive tangible property or services under a contract or granted by a governmental agency,
   c) An interest in a patent or copyright,
   d) A right under a contract (or a right granted by a governmental agency) if the right has a fixed life of less than 15 years or is of a fixed amount that except for the section 197 intangible provisions, would be recoverable under a method similar to the unit-of-production method of cost recovery.
5) An interest under an existing lease or sublease of tangible property,
6) An interest under an indebtedness that was in existence when the interest was acquired,
7) Sports franchises,
8) A right to service residential mortgages unless the right is acquired in the acquisition of a trade or business or a substantial part of a trade or business, and
9) Certain transaction costs under a corporate organization or reorganization in which any part of a gain or loss is not recognized.

Computer software. Section 197 intangibles do not include computer software that is:

1) Readily available for purchase by the general public,
2) Subject to a nonexclusive license, and
3) Not substantially changed.

Also, computer software not acquired in the acquisition of a substantial part of a business is not section 197 property.

If depreciation is allowed for any computer software that is not a section 197 intangible, use the straight line method with a useful life of 36 months.

For more information on depreciation of computer software, see Publication 946.

Additional costs associated with nonsection 197 intangibles. Additional costs that are taken into account in determining the basis of property that is not a section 197 intangible are not themselves section 197 intangibles. For example, none of the costs of acquiring real property held for the production of rental income (including goodwill, going concern value, etc.) is an amortizable section 197 intangible. These costs are instead, added to the basis of the real property.

Dispositions

A section 197 intangible is treated as depreciable property used in your trade or business. If you dispose of a section 197 intangible that you held for more than 1 year, the property qualifies as section 1231 property. Any gain on the disposition is treated as ordinary income to the extent of the allowable amortization. The gain or loss on the sale of property held for 1 year or less is reported as an ordinary gain or loss. See chapter 2 in Publication 544, *Sales and Other Dispositions of Assets,* for more information.

If you acquire more than one section 197 intangible in a transaction (or series of related transactions) and later dispose of one of them or if one of them becomes worthless, you cannot recognize any loss on it. Increase the adjusted basis of each remaining amortizable section 197 intangible that you did not dispose of by:

The amount of the loss not recognized on the disposition

MULTIPLIED BY

A fraction:

- The numerator of which is the adjusted basis of that remaining intangible as of the date of its disposition, and
- The denominator of which is the total adjusted basis of all retained amortizable section 197 intangibles as of the date of the disposition.

For more information on dispositions of amortizable section 197 property, see chapter 12 in Publication 535.

Anti-Churning Rules

You cannot convert existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable before August 10, 1993, to amortizable property.

For more information, see chapter 12 in Publication 535.

Anti-abuse rule. A section 197 intangible may not be amortized under these rules if you acquired the intangible in a transaction one of the principal purposes of which is to:

1) Avoid the requirement that the intangible be acquired after August 10, 1993, or
2) Avoid any of the anti-churning rules.

For more information on amortizable section 197 intangibles, see chapter 12 in Publication 535.

Going Into Business

When you go into business, all the costs you have to get your business started are treated as capital expenses and are part of your basis in the business. Any costs that are for particular assets can generally be recovered through depreciation deductions. Other costs generally cannot be recovered until you sell or otherwise go out of business. See *Going Into Business* in chapter 4 for a discussion of how to treat these costs if you do not go into business.

However, you can elect to amortize certain costs that you have in setting up your business. These costs are deducted in equal amounts over a period of 60 months or more. To be amortizable in this way, costs must qualify in one of the following three areas:

1) Business start-up costs,
2) Organizational costs for a corporation, or
3) Organizational costs for a partnership.

The sections below discuss which costs qualify in each of these three areas.

Business Start-Up Costs.

Start-up costs are those that you have in setting up an active trade or business, or investigating the possibility of creating or acquiring an active trade or business.

Start-up costs are amounts you paid or incurred in connection with an activity engaged in for profit and for the production of income in anticipation of that activity becoming an active trade or business.

To be amortizable, a start-up cost must meet the following tests.

1) It must be a cost that would be deductible if it were paid or incurred to operate an existing trade or business.
2) It must be paid or incurred by you before you actually begin business operations.

Start-up costs ***include*** what you pay for both investigating a prospective business and getting the business started. For example, they may include costs of items such as the following:

A survey of potential markets,

An analysis of available facilities, labor, supplies, etc.,

Advertisements for the opening of the business,

- Salaries and wages for employees who are being trained, and their instructors,
- Travel and other necessary expenses for securing prospective distributors, suppliers, or customers, and
- Salaries and fees for executives and consultants, or for other professional services.

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

Disposition of business. If you completely dispose of your business before the end of the amortization period selected, any deferred start-up costs for your business that you have not deducted can be deducted to the extent they qualify as a loss from a trade or business.

Organizational Costs For a Corporation

Corporate organizational costs are those that are incident to the creation of the corporation. They include the cost of temporary directors, organizational meetings, state incorporation fees, and accounting services related to setting up the organization. They also include the cost of legal services, such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings.

However, you cannot amortize costs of issuing and selling stock or securities, such as commissions, professional fees, and printing costs because they are not organizational costs. Costs connected with the transfer of assets to the corporation also cannot be amortized. They must be capitalized.

To qualify for amortization, your organizational cost must meet all three of the following tests:

1) It must be incident to the creation of the corporation. You must have incurred the cost before the end of the first tax year in which the corporation is in business. A corporation using the cash method of accounting may amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.
2) It must be chargeable to a capital account.
3) It must be a cost that could be amortized over the life of the corporation, if the corporation had a fixed life.

Organizational Costs For a Partnership

Partnership organizational costs are those costs that are incident to the creation of the partnership. To be amortizable, your organizational cost must be chargeable to a capital account, and it must be one that you could amortize over the life of the partnership, if your partnership had a fixed life.

Partnership organizational costs do not include syndication fees. That is, they do not include costs connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees, and printing costs. These costs must be capitalized. You cannot depreciate or amortize them.

How To Amortize

You deduct start-up and organizational costs in equal amounts over a period of 60 months or more. You can elect a period for start-up costs that is different from the period you elect for organizational costs, as long as both are 60 months or more. Once you elect an amortization period, you cannot change it.

To figure your deductions, you divide your total start-up or organizational costs by the number of months in the amortization period. The result is the amount you can deduct each month.

The amortization period starts with the month you begin business operations. You can amortize only if you actually go into business. For the amortization of organizational costs, a partnership or corporation is considered to begin business operations when it starts the activities for which it is organized. This can happen either before or after the corporate charter is granted or a partnership agreement is signed. A partnership or corporation will be considered as having begun business if its activities have reached the point where the nature of its business operations can be established. For example, if it acquires the assets it needs to operate its business, this may constitute the beginning of business activities.

Making the election. To amortize your costs, you must complete Part VI of Form 4562 and attach it to your income tax return. You must also attach to your return a statement showing the information listed below. If you have both start-up and organizational costs, attach a separate statement to your return for each type of cost. Each statement should:

1) Show the total start-up or organizational costs that you will amortize,
2) Describe what each is for,
3) Give the date each cost was incurred,
4) State the month your business began operations (or the month you acquired the business), and
5) Specify the number of months in your amortization period (not less than 60).

Attach Form 4562 and accompanying statements to your return for the first tax year you are in business. The return must be filed by the due date for the return (including any extensions).

Partnerships and corporations. If your business is organized as a partnership or corporation, only your partnership or corporation can elect to amortize its start-up or organizational costs. A partner or shareholder cannot make this election.

If you as a partner or shareholder incur costs in setting up your partnership or corporation, you cannot amortize them. If the partnership or corporation does not reimburse you for these costs, it cannot amortize them. These costs then become part of the basis of your interest in the business. You can recover them only when you sell your interest in the partnership or corporation.

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

Construction Period Interest and Taxes

You cannot deduct real property construction period interest or taxes that are paid or accrued in the tax year on property you use in your trade or business or in an activity you conduct for profit. Instead, you must capitalize these amounts. However, you could amortize amounts you paid or incurred before 1987, over a 10-year period.

For more information, see chapter 12 in Publication 535.

Research and Experimental Costs

Research and experimental costs may be amortized or deducted as current business costs. You have the choice to deduct the costs currently as business expenses or to treat them as deferred expenses and amortize them in equal amounts over a period of not less than 60 months. See chapter 4 for a discussion of the choice to deduct the costs currently.

The amortization deduction is an election that applies to those costs that are chargeable to a capital account and that:

1) You paid or incurred in your trade or business, and
2) You are not currently deducting.

For more information, see section 174 of the Internal Revenue Code and the Income Tax Regulations.

Bond Premium

Bond premium generally is the amount you pay for a bond that is more than the amount the bond issuer will pay upon maturity of the bond. For taxable bonds, bond premium is determined by reference to the amount the bond issuer will pay upon an earlier call date if it results in a smaller amortizable bond premium attributable to the period ending on the call date. Bond premium does not include any amount attributable to the conversion features of a bond.

The term ''bond,'' as used in this discussion, means any bond, debenture, note, or certificate or other evidence of debt issued by a corporation or a government or political subdivision of a government and bearing interest. The term does ***not*** include any obligation:

1) That is your stock in trade or business,
2) That would properly be included in your inventory if on hand at the close of the taxable year, or
3) That you held for sale to customers in the ordinary course of your trade or business.

Tax-exempt bonds. You must amortize the premium on tax-exempt bonds, but you cannot deduct the amortizable premium in figuring your taxable income.

Taxable bonds. You can elect to amortize the premium on taxable bonds. However, if you do not elect to amortize the premium, you treat it as part of the basis of your bond.

If you are required or elect to amortize the premium, you decrease the basis of your bond by the amortizable bond premium. This will give you the adjusted basis you will use to figure gain or loss on the sale or redemption of the bond.

A ***dealer in taxable bonds*** (or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business, and who would properly include bonds on hand in inventory at the close of the tax year), cannot claim a deduction for amortizable bond premium. Instead the premium is part of the cost of the bonds.

See section 75 of the Internal Revenue Code for determining your gross income if you are a dealer in tax-exempt bonds.

For more information, see Publication 550.

Reforestation Expenses

You can elect to amortize part of the amounts you spend on forestation or reforestation of property held for commercial timber production. You can amortize your direct costs for planting or seeding, including your costs for site preparation, seeds or seedlings, labor, and tools. Only $10,000 ($5,000 for a married individual filing a separate return) of these costs in each tax year qualify for amortization. Each year's qualifying costs are amortized over an 84–month period. For more information, see *Reforestation Expenses* in chapter 12 of Publication 535.

Pollution Control Facilities

You can elect to amortize the cost of a certified pollution control facility over a period of 60 months. The facility must be used for a plant (or other property) that was in operation before 1976.

Certified pollution control facility. A certified pollution control facility is depreciable property that is a new identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. It must be appropriately certified by state and federal certifying authorities.

If it appears that all or a part of the cost of a facility will be recovered from its operation, such as through sales of recovered wastes, the federal certifying authority will certify to that effect, describing the nature of the potential cost recovery. The amortizable cost of the facility must be reduced accordingly.

For more information on pollution control facilities, see chapter 12 in Publication 535.

Cost of Acquiring a Lease

If you acquire a lease for business purposes, you can recover the cost by amortizing it over the term of the lease. The term of the lease for amortization purposes includes all renewal options (and any other period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost is attributable to the term of the lease remaining on the acquisition date. The remaining term of the lease on the acquisition date does not include any period for which the lease may be subsequently renewed, extended, or continued under an option exercisable by the lessee.

Depletion

If you own mineral property or standing timber, you can take a deduction for depletion. There are two ways of figuring depletion: cost depletion or percentage depletion. You must use cost depletion to figure your deduction on timber property.

The depletion deduction is available to you as an owner and an operator only if you have an economic interest in mineral deposits or standing timber. For more information on depletion, see chapter 13 in Publication 535.

A mineral property is each separate interest you own in each mineral deposit in each separate tract or parcel of land. A timber property is your economic interest in standing timber in each tract or block representing a separate timber account.

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

For more information on individual alternative minimum tax, see Form 6251, *Alternative Minimum Tax–Individuals,* and its instructions. For more information on corporate alternative minimum tax, see Publication 542, *Tax Information on Corporations.* For more information on estate and trust alternative minimum tax, see Form 1041 and its instructions.

Mineral Property

Mineral property includes oil and gas wells, mines, and other natural deposits (including geothermal deposits). There are two ways of figuring depletion on mineral property: cost depletion and percentage depletion. However, percentage depletion does not apply to oil and gas wells, except for certain ones exempt from this rule. See *Oil and Gas Wells,* later.

You must use cost depletion if it is more than percentage depletion for the year.

Cost depletion. Figure cost depletion by dividing the adjusted basis of the mineral property by the total number of recoverable units in the property's natural deposit. You then multiply the resulting rate per unit by:

1) The number of units sold and for which you receive payment during your tax year if you use the cash method of accounting, or
2) The number of units sold if you use the accrual method of accounting.

Percentage depletion. Figure percentage depletion by multiplying a certain percentage, specified for each mineral, by your gross income from the property during the tax year. The deduction for depletion under this method cannot be more than 50% (100% for oil and gas property) of your taxable income from the property figured without the deduction for depletion.

When figuring your percentage depletion and the taxable income limit, exclude from your gross income from the property an amount equal to any rents and royalties (which are depletable income to the payee) you pay or incur for the property.

Also, reduce your gross income from the property by the allocable part of any bonus you paid for a mineral lease or an oil and gas lease on the property.

Limit for certain oil and gas wells. If you are a qualified independent producer or royalty owner of oil and gas (see *Small producers exemption,* later, under *Oil and Gas Wells*), your deduction for percentage depletion is limited to the smaller of:

1) Your taxable income from the property figured without the deduction for depletion, or
2) 65% of your taxable income (figured without certain deductions).

Any amount that cannot be deducted because of the 65% limit can be carried over and added to your depletion allowance (before applying any limits) for the following year.

Oil and Gas Wells

Generally, percentage depletion is not allowed for any oil or gas well. However, an exemption from this rule applies to certain oil and gas producers.

The use of percentage depletion for oil and gas is usually allowed for domestic gas and oil production of small producers.

Small producers exemption. The small producers exemption allows independent producers and royalty owners to qualify for a percentage depletion rate of 15% on an average daily production of up to 1,000 barrels. (6,000 cubic feet of natural gas is the equivalent of a barrel of oil.)

If you have a part interest in property, your production from that property is in proportion to your interest. To figure your share of production for a part interest, such as a net profits interest, see *Share of production for part interest* in chapter 13 of Publication 535.

Gross income from oil and gas property. For purposes of percentage depletion, gross income from oil and gas property is the amount you receive from the sale of the oil or gas in the immediate vicinity of the well. If you do not sell the oil or gas on the property, but manufacture or convert it into a refined product before sale, or transport it before sale, the gross income from the property is the ''representative market or field price'' (RMFP) of the oil or gas before conversion or transportation.

If gas is sold after it is removed from the premises, for a price that is lower than the RMFP, gross income from the property for percentage depletion purposes is determined without regard to the RMFP.

Gross income from the property does not include any lease bonuses, advance royalties, or other amounts payable without regard to production from the property.

Partnership

For partnership oil and gas properties, the depletion allowance, whether cost or percentage, must be figured separately by each partner and not by the partnership. Each partner must decide whether to use cost or percentage depletion.

The partnership must allocate to each partner that partner's proportionate share of the adjusted basis of each partnership domestic oil or gas property.

Each partner, after receiving the information from the partnership, must keep this information separately. Later, in those separate records, the partner must reduce the share of the adjusted basis of each property by the depletion taken on the property each year by that partner, and use that reduced adjusted basis to figure any cost depletion or the partner's gain or loss if the partnership later disposes of the property.

Reporting the deduction. Deduct oil and gas depletion for a partnership interest in Part I of Schedule E (Form 1040).

S Corporation

The depletion allowance is figured separately by each shareholder in the same way as a partner in a partnership.

For an S corporation shareholder to figure depletion, the S corporation must allocate to each shareholder that shareholder's adjusted basis of each oil or gas property held by the S corporation. The allocation is made as of the date the corporation acquires the property. The shareholder's share of the adjusted basis of the oil and gas property is adjusted by the S corporation for any capital expenditures made for the property and for any change in the shareholder's interest.

Each shareholder must separately keep records of the shareholder's pro rata share of the adjusted basis in each oil and gas property of the S corporation. The shareholder must reduce the share of the adjusted basis by the depletion taken on the property by the shareholder, and use that reduced adjusted basis to figure cost depletion or the shareholder's gain or loss on the disposition of the property by the S corporation.

Natural Gas Wells

Percentage depletion is allowed for regulated natural gas and for natural gas sold under a fixed contract or produced from geopressured brine, regardless of whether you qualify for the small-producer exemption.

Fixed contract. Income from natural gas sold under a fixed contract qualifies for percentage depletion at a rate of 22%.

Natural gas sold under a fixed contract is domestic gas that is sold by the producer under a contract in effect on February 1, 1975, and at all times thereafter before the sale. The price must not be adjusted to reflect the increase in the liability of the seller for tax because of the change in the law regarding percentage depletion for gas. Price increases after February 1, 1975, are presumed to take the liability into account unless the taxpayer can demonstrate to the contrary by clear and convincing evidence.

Natural gas from geopressured brine. Qualified natural gas from geopressured brine is eligible for percentage depletion at the rate of 10% if it is produced from a well you began to drill after September 1978, and before 1984.

Natural and Geothermal Deposits

Mine, wells, and other natural deposits and geothermal deposits qualify for percentage depletion.

Mine and other natural deposits. The percentage of your gross income from a natural deposit that you can deduct as depletion is based on the type of deposit.

Some of the depletion percentages of the more common minerals follow:

Deposits	Percent
Sulphur, uranium, and, if from deposits in the United States, asbestos, lead, zinc, nickel, mica, and certain other ores and minerals	22
Gold, silver, copper and iron ore, and certain oil shale if from deposits in the United States	15
Coal, lignite, and sodium chloride	10
Clay and shale used in making sewer pipe or bricks, or used as sintered or burned lightweight aggregates	7½
Clay (used or sold for use in making drainage and roofing tile, flower pots, and kindred products), gravel, sand, and stone (other than stone used or sold by a mine owner or operator as dimension or ornamental stone)	5
Most other minerals, including carbon dioxide produced from a well, and metallic ores	14

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

1) The percentage depletion deduction for the tax year (figured without regard to this reduction), over
2) 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 mining. Gross income from a mining property, other than a geothermal deposit, is the gross income from extracting ores or minerals from the ground, applying treatment processes, and transporting them not more than 50 miles from the point of extraction to the plant or mill in which a recognized mining treatment process is applied.

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

Disposal of coal or iron ore. You cannot take a depletion deduction on coal (including lignite) or iron ore mined in the United States that you held for more than 1 year if:

1) You dispose of it and retain an economic interest, and
2) The gain is a capital gain.

Geothermal deposits. Geothermal deposits located in the United States or its possessions qualify for percentage depletion at the rate of 15%. A geothermal deposit is a geothermal reservoir of natural heat stored in rocks or in a watery liquid or vapor. It is not considered a gas well.

Gross income from a geothermal steam well is figured in the same way as for oil and gas wells. See *Gross income from oil and gas property,* earlier, under *Oil and Gas Wells.*

Lessor's Gross Income

A lessor's gross income from the ***lease of gas, oil, or mineral property*** for percentage depletion purposes usually is the total of the royalties received from the lease, excluding rentals that are not payment for units of mineral produced or to be produced.

Bonuses and advance royalties. Bonuses and advanced royalties are payments that a lessee makes to a lessor as consideration for the lease or for minerals, gas, or oil that are to be extracted from leased property. Both types of payments are made in advance of production. If you are the lessor, your income from bonuses and advanced royalties is subject to an allowance for depletion.

For more information on figuring depletion on bonuses and advance royalties, see chapter 13 in Publication 535.

Timber

You can figure timber depletion only by the cost method. Percentage depletion does not apply to timber. Your depletion is based on your cost or other basis in the timber. Your cost does not include any part of the cost of the land.

Figuring the deduction. Depletion takes place when standing timber is cut, however, you can figure your depletion deduction when the quantity of cut timber is first accurately measured in the process of exploitation. At the end of your tax year include in your closing inventory of products cut from timber as a cost item any allowable depletion on the timber from which the unsold products are cut.

Figure your depletion allowance by multiplying the number of timber units cut by your depletion unit.

Figure your depletion unit as follows:

1) Determine your cost or adjusted basis of the timber on hand at the beginning of the year.

2) Add to the amount determined in 1) the cost of any units acquired during the year and any additions to capital.

3) Figure the number of units to take into account by adding the number of units acquired during the year to the number of units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the number of units remaining in the account.

4) Divide the result of 2) by the result of 3). This is your depletion unit.

Sale or exchange. You can elect, under certain circumstances, to treat the cutting of timber as a sale or exchange. See the discussion under *Timber* in chapter 22.

Form T. Attach Form T to your income tax return if you claim a deduction for depletion of timber.

14. Bad Debts

Introduction

If someone owes you money you cannot collect, you have a bad debt. You can generally deduct the amount of the bad debt owed you when you figure your income for tax purposes. For a bad debt to qualify for the deduction, there must be a true creditor-debtor relationship between you and the person or organization that owes you the money. There must be a legal obligation to pay you a fixed sum of money. You must realize a loss because of your inability to collect the money owed to you.

To take the bad debt deduction, you must show that the debt is worthless and will remain that way. You must have taken reasonable steps to collect the debt. However, it is not necessary to go to court if you can show that a judgment from the court would be uncollectible. Bankruptcy is generally good evidence of the worthlessness of at least part of an unsecured and unpreferred debt.

You can take a bad debt deduction only if you have an actual loss of money, or if you have already reported the amount you were to be paid as income.

Topics

This chapter discusses:

- Nonbusiness bad debts
- Business bad debts
- Reporting a bad debt
- Methods of treating business bad debts

Useful Items

You may want to see:

Publication

- ☐ **525** Taxable and Nontaxable Income
- ☐ **535** Business Expenses
- ☐ **550** Investment Income and Expenses

Form (and Instructions)

- ☐ **Sch C (Form 1040)** Profit or Loss From Business
- ☐ **Sch D (Form 1040)** Capital Gains and Losses
- ☐ **Sch F (Form 1040)** Profit or Loss From Farming

Nonbusiness Bad Debts

There are two kinds of bad debts: business bad debts and nonbusiness bad debts. A business bad debt generally is one that comes from operating your trade or business. All other bad debts are nonbusiness bad debts.

Example. An architect made personal loans to several friends who were not clients. She could not collect on some of these loans. They are deductible only as nonbusiness bad debts, since the architect was not in the business of lending money and the loans do not have any relationship to her business.

Deductible nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness bad debt.

Loan or gift. If you lend money to a relative or friend with the understanding it will be repaid, but later forgive the debt, it is a gift, not a loan. You cannot take a bad debt deduction for a gift. There must be a creditor-debtor relationship between you and the person or organization that owes you the money.

Worthless securities. If you own securities and they become totally worthless, you can take a deduction for a loss, but not for a bad debt. See *Worthless securities* in Publication 550.

Business Bad Debts

A business deducts its bad debts from gross income when figuring its taxable income. Unlike nonbusiness bad debts, you do not deduct business bad debts as short-term capital losses.

To be deductible as a business bad debt, a debt must closely relate to the activity of your business. There must have been a main business reason for you to have entered into the transaction as the creditor.

The bad debts of a corporation are always business bad debts.

A business bad debt can be either totally or partly worthless. If you can collect part, but not all, of the amount owed you, you have a partly worthless bad debt. If you cannot collect any of the amount owed you, even if you collected some of it in the past, you have a totally worthless bad debt.

Example. John Smith, an advertising agent, made loans to certain clients to retain their business. His main reason for making these loans was his business. One of these clients later went bankrupt and could not repay him. Since John's business was the main reason for making the loan, the debt was a business debt and he can take a business bad debt deduction.

Credit transactions. Business bad debts are mainly the result of credit sales to customers. Goods and services customers have not paid for are shown in your books as either ***accounts receivable or notes receivable.***

If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. Accounts or notes receivable valued at fair market value at the time of the transaction are deductible only at fair market value, even though that value may be less than face value.

You can take a bad debt deduction for these accounts and notes receivable only if you included the amount owed you in your gross income. This applies to amounts owed you from all sources of taxable income, such as sales, services, rents, and interest.

If you meet certain requirements, you can use the nonaccrual-experience method, discussed later. This method allows you to estimate uncollectible amounts. Do not include them in your gross income.

Accrual method taxpayers. Accrual method taxpayers normally report income as they earn it. They can take a bad debt deduction for these receivables when they cannot collect what is owed them, if they included that amount in income.

Cash method taxpayers. Cash method taxpayers normally do not report income until they receive payment. They cannot take a bad debt deduction for payments they have not received or cannot collect from these receivables.

Former business. You can deduct a business bad debt that becomes worthless, even if the debt became worthless after you went out of business.

For more information, see *Former business* in chapter 14 in Publication 535.

Insolvency of partner. If your business partnership breaks up and one of your former partners is insolvent and cannot pay any of the partnership's debts, you may have to pay more than your share of the partnership's debts. You can take a bad debt deduction for any part of the insolvent partner's share of the debts that you are required to pay.

Business loan guarantees. If you guarantee payment of another person's debt and then have to pay it off, you may be able to take a bad debt deduction for your loss. It does not matter in what capacity you make the guarantee, whether as guarantor, endorser, or indemnitor. To qualify for a bad debt deduction, a guarantee you enter into must be either entered into with a profit motive or related to your trade or business, or your employment.

Example. Bob Zayne owns the Zayne Dress Company. He guaranteed payment of a $20,000 note for Elegant Fashions, a dress outlet. Elegant Fashions is one of Zayne's largest clients. Elegant Fashions later files for bankruptcy and defaults on the loan. Mr. Zayne makes full payment to the bank. He can take a business bad debt deduction, since his guarantee was closely related to his trade or business. He was motivated by the desire to retain one of his better clients and keep a sales outlet.

Business bad debt. You must be able to show that your reason for guaranteeing the debt was closely related to your trade or business. Consider any guarantees you make to protect or improve your job as being closely related to your trade or business as an employee.

For more information on business bad debts, see chapter 14 in Publication 535.

Nonbusiness bad debt. You must be able to show that your reason for making the guarantee was to protect your investment or that you entered the guarantee transaction with a profit motive. If you make the guarantee as a favor to friends and do not receive any consideration in return, it is a gift. You cannot take a nonbusiness bad debt deduction.

Example. Henry Lloyd, an officer and principal shareholder of the Spruce Corporation, guaranteed payment of a bank loan the corporation received. The corporation defaulted on the loan and Henry made full payment. Because he entered into the guarantee to protect his investment in the corporation, Henry can take a nonbusiness bad debt deduction.

Reporting a Bad Debt

How you report a bad debt depends on whether it is a nonbusiness or business bad debt.

Nonbusiness bad debts. Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040). There are limits on how much of your capital losses you may deduct. For a discussion of these limits, see *Treatment of Capital Losses* in chapter 22.

In Part I, line 1 of Schedule D, enter the name of the debtor, and ''statement attached,'' in column (a), and the amount of the bad debt in column (f). Use a separate line for each bad debt.

If you deduct a nonbusiness bad debt, fully explain it on your tax return. Attach a statement to your return that contains:

1) A description of the debt, including the amount and date it became due,
2) The name of the debtor and any business or family relationship between you and the debtor,
3) The efforts you made to collect the debt, and
4) Why you decided the debt was worthless.

Business bad debts. Use the following guide to find where to report your business bad debt deductions.

Individuals. Deduct a bad debt from operating a trade or business on line 9 of Schedule C (Form 1040). Deduct a bad debt from operating a farm business, on line 34 of Schedule F (Form 1040).

Corporations. Corporations deduct bad debts on line 15 of Form 1120, line 15 of Form 1120–A, or line 10 of Form 1120S.

Partnerships. Partnerships deduct their business bad debts on line 12 of Form 1065.

Methods of Treating Business Bad Debts

There are two ways to treat uncollectible amounts: the specific charge-off and nonaccrual-experience methods. All taxpayers, except certain financial institutions, must generally use the specific charge-off method. You can use the nonaccrual-experience method if you meet the requirements, discussed later.

Specific Charge-Off Method

Using the specific charge-off method, you deduct specific business bad debts that become either partly or totally worthless during the tax year.

Partly worthless debts. You can deduct specific bad debts that are partly uncollectible. But limit your deduction to the amount you charge off on your books during the tax year. You do not have to annually charge off and deduct your partly worthless debts. Instead you can delay the charge-off until a later year. You can wait until more of the debt becomes worthless, or you collect all you can and it is totally worthless. You cannot, however, deduct any part of a debt after the year it becomes totally worthless.

Deduction disallowed. Usually, you can take a partial bad debt deduction only in the year you make the charge-off on your books. However, the Internal Revenue Service may not allow your deduction. If the debt then becomes partly worthless in a later tax year, you can deduct the amount you charge off in that year, plus the amount charged off in the earlier year. The charge-off in the earlier year, unless reversed on your books, fulfills the charge-off requirement for the later year.

Totally worthless debts. Deduct a totally worthless bad debt only in the tax year it becomes totally worthless. The deduction for the debt must not include any amount deducted in an earlier tax year when the debt was only partly worthless.

You do not have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. However, you may want to do so. If a debt you claim to be totally worthless is not charged off on your books and the IRS later rules that the debt is only partly worthless, you will not be allowed a deduction for that debt in that tax year. A deduction of a partly worthless bad debt is limited to the amount actually charged off.

Recovery of a bad debt. If you deduct a bad debt and later recover (collect) all or part of it, you may have to include the amount you recover in gross income. You can exclude from gross income the amount recovered up to the amount of the deduction that did not reduce your tax.

See *Recoveries* in Publication 525 for more information on recovered amounts.

Example. In 1994, the Willow Corporation had gross income of $158,000, a bad debt deduction of $3,500, and other allowable deductions of $49,437. The corporation reported on an accrual method of accounting and used the specific charge-off method for bad debts. In 1995, the corporation recovers part of the $3,500 deducted in 1994. It must include the part recovered in income for 1995. The entire bad debt deduction reduced the tax on the 1994 corporate return. For 1995, Willow reports the recovery as ''Other Income'' on its corporate return.

Net operating loss (NOL) carryover. If the deduction results in the increase of a carryover that has not expired before the beginning of the tax year in which the recovery takes place, then you treat the deduction as having reduced your tax.

Property received for a debt. If you receive property in partial settlement of a debt, reduce the debt by the fair market value of the property received. The remaining debt is deductible as a bad debt in the year you determine it to be worthless and charge it off.

If you later sell the property received, include any gain or loss from the sale in gross income. The gain is not a recovery of a bad debt previously deducted without tax benefit. For information on the sale of an asset, see chapter 21.

Bankruptcy claim. You may only deduct as a bad debt the difference between the amount owed to you by a bankrupt entity and the amount you received from the distribution of its assets.

Net operating loss. A bad debt deduction can produce or increase a net operating loss. If you have a net operating loss one year, you can carry it back or forward to other tax years and deduct it from income you earned in those years. As a result, a bad debt deduction that contributes to a net operating loss may lower taxes in the year to which you carry the net operating loss.

See chapter 20 for information on operating losses.

Nonaccrual-Experience Method

If you use an accrual method of accounting and qualify under certain rules, you can use the nonaccrual-experience method of accounting for bad debts. Under this method, you do not have to accrue income that you expect to be uncollectible.

The nonaccrual-experience method applies only to amounts to be received (accounts receivable) for services you performed. You cannot use it if you charge interest or penalties on late payments. If you determine, based on your experience, that your accounts receivable are uncollectible, do not include them in gross income for the tax year. However, only the methods allowed by the service may be used in determining the uncollectible amounts.

Performing services. You can use the nonaccrual-experience method only for amounts, earned by performing services, that you would otherwise include in income. You cannot use this method for amounts owed to you from activities such as lending money, selling goods, or acquiring receivables or other rights to receive payments.

Interest cannot be charged on amounts due. Generally, you cannot use the nonaccrual-experience method for amounts due on which you charge interest or a late payment penalty. However, do not treat offering a discount for early payment as charging interest or a late payment penalty if:

1) You accrue the full amount due as gross income at the time you provide the services, and

2) You treat the discount allowed for early payment as an adjustment to gross income in the year of payment.

Methods to determine uncollectible amount. You can apply the nonaccrual-experience method under either a separate receivable system or a periodic system. Under the ***separate receivable system,*** apply the nonaccrual-experience method separately to each account receivable. Under the ***periodic system,*** apply the nonaccrual-experience method to the total of the qualified accounts receivable at the end of your tax year.

Treat each system as a separate method of accounting. You generally cannot change from one system to the other without IRS consent.

Generally, you need the consent of the IRS to change to either system under the nonaccrual-experience method from a different accounting method.

For more information on the separate receivable system, see section 1.448-2T of the Income Tax Regulations. For more information on the periodic system, see Notice 88-51, 1988-1 C.B. 535.

15. Travel, Entertainment, and Gift Expenses

Important Changes for 1995

Standard mileage rate. The standard mileage rate for the cost of operating your car in 1995 is 30 cents per mile for all business miles.

Receipts for business expenses. Beginning October 1, 1995, you must have receipts for amounts that are $75 (rather than $25) or more for certain business expenses. See *Recordkeeping.*

Important Reminders

Travel expenses paid for others. You cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel unless the travel satisfies specific requirements. See *Travel expenses for another individual.*

Club dues. Generally, you are not allowed a deduction for dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose. See *Club dues and membership fees.*

Business meals and entertainment. Generally, you can deduct only 50% of your business meals and entertainment expenses.

Introduction

This chapter covers certain expenses of business owners. However, if you reimburse employees for business expenses that they incur on your behalf, this chapter applies to your employees also.

Topics

This chapter discusses:

- Business-related travel away from home
- Entertainment
- Business gifts
- Local business transportation
- Recordkeeping
- Reimbursement of employee business expenses

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, and Gift Expenses
- ☐ **535** Business Expenses
- ☐ **917** Business Use of a Car
- ☐ **1542** Per Diem Rates

Form (and Instructions)

- ☐ **W–2** Wage and Tax Statement
- ☐ **Sch C (Form 1040)** Profit or Loss From Business
- ☐ **Sch C–EZ (Form 1040)** Net Profit From Business
- ☐ **2106** Employee Business Expenses
- ☐ **2106–EZ** Unreimbursed Employee Business Expenses
- ☐ **4562** Depreciation and Amortization

Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section includes the definitions of ''tax home'' and ''temporary'' and a discussion of different types of travel expenses. The section then discusses the rules for travel inside and outside the United States and deductible expenses of attending a convention.

Travel expenses defined. For tax purposes, travel expenses are ordinary and necessary expenses that you pay while traveling away from home for your business or profession. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate to your business. An expense does not have to be indispensable to be considered necessary. However, you cannot deduct expenses to the extent they are lavish or extravagant.

You will find examples of deductible travel expenses in *Table 15–1.*

Traveling away from home. You are traveling away from home if:

1) Your duties require you to be away from the general area of your tax home (defined next) substantially longer than an ordinary day's work, and
2) You need to get sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Tax Home

To deduct travel expenses, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the ***entire city or general area*** in which your business or work is located. If you have more than one regular place of business, your tax home is your main place of business. If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work,* later.

If you do not fit any of these categories, you are considered a transient (an itinerant) and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered away from home.

Main place of business or work. If you have more than one place of work, you should use the following factors to determine your main place of business or work:

1) The total time you ordinarily spend working in each area,
2) The degree of your business activity in each area, and
3) The relative amount of your income from each area.

Example. You live in Cincinnati where you have a seasonal job for 8 months and earn $15,000. You work the remaining 4 months in Miami, also at a seasonal job, and earn $4,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

No main place of business or work. You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live. If you do not have a regular or main place of business or work, use the following three factors to see if you have a tax home.

1) You have part of your business in the area of your main home and use that home for lodging while doing business there.
2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
3) You have not left the area in which both your traditional place of lodging and your main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you meet all three factors above, your tax home is the home where you regularly live, and you may be able to deduct travel expenses. If you meet only two of the factors, you may have a tax home depending on all the facts and circumstances. If you meet only one factor, you are a transient; you do not have a tax home and you cannot deduct travel expenses.

Temporary assignment or job. Although you regularly work or carry on your business activities within the city or general area of your tax home, you may have to work or conduct business at another location. It may not be practical to return home from this other location at the end of each day's work.

If your assignment away from your main place of work is ***temporary,*** your tax home does not change. You are considered to be away from home for the whole period, and your travel expenses are deductible. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment is ***indefinite,*** that location becomes your new tax home and you cannot deduct your travel expenses while there. Your assignment or job is considered indefinite if it is realistically expected to last for more than one year, regardless of whether it actually exceeds one year.

Additional information. See chapter 1 of Publication 463 for more information on tax home.

Table 15-1. **Deductible Travel Expenses**

Expense	Description
Transportation	The cost of travel by airplane, train, or bus between your home and your business destination.
Taxi, commuter bus, and limousine	Fares for these and other types of transportation between the airport or station and your hotel, or between the hotel and your work location away from home.
Baggage and shipping	The cost of sending baggage and sample or display material between your regular and temporary work locations.
Car	The costs of operating and maintaining your car when traveling away from home on business. You may deduct actual expenses or the standard mileage rate, including business-related tolls and parking. If you lease a car while away from home on business, you can deduct business-related expenses only.
Lodging	The cost of lodging if your business trip is overnight or long enough to require you to get substantial sleep or rest to properly perform your duties.
Meals	The cost of meals only if your business trip is overnight or long enough to require you to stop to get substantial sleep or rest. Includes amounts spent for food, beverages, taxes, and related tips.
Cleaning	Cleaning and laundry expenses while away from home overnight.
Telephone	The cost of business calls while on your business trip, including business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Other similar ordinary and necessary expenses related to your business travel such as public stenographer's fees and computer rental fees.

What Are Travel Expenses?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.

Records. When you travel away from home on business, you should keep records of all the expenses you incur. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described later in this chapter under *Recordkeeping.*

Deductible travel expenses. Deductible travel expenses include those ordinary and necessary expenses you incur while traveling away from home on business. The type of expense you can deduct depends on the facts and your circumstances. *Table 15–1* summarizes the expenses you may be able to deduct.

You can use that table as a general guideline. The expenses are explained in more detail in chapter 1 of Publication 463. You may have other deductible travel expenses that are not listed there, depending on the facts and your circumstances.

Travel expenses for another individual. If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses. You can only deduct the travel expenses you pay or incur for such an accompanying individual if that individual:

1) Is your employee,
2) Has a bona fide business purpose for the travel, ***and***
3) Would otherwise be allowed to deduct the travel expenses.

For a bona fide business purpose to exist, you must prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

New business. You cannot deduct amounts you spend for travel to conduct a general search for, or preliminary investigation of, a new business. For more information on how to treat these costs, see *Going Into Business* in chapter 4. If you moved your home in 1995 because you started a new business, you may qualify for a moving expense deduction. For information, see Publication 521, *Moving Expenses.*

Standard Meal Allowance

You generally can deduct a standard amount for your daily meals and incidental expenses while you are traveling away from home on business. Incidental expenses include costs for laundry, cleaning, and tips for services. In this chapter, the term ''standard meal allowance'' refers to meals and incidental expenses.

This method is an alternative to the actual cost method. It allows you to deduct a set amount, depending on where you travel, instead of keeping records of actual meal expenses. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See the recordkeeping rules for travel, explained later under *Recordkeeping.*

Who can use the standard meal allowance. You can use the standard meal allowance whether you are an employee or self-employed.

You can use the standard meal allowance whether or not you are reimbursed for your traveling expenses. If you are not reimbursed or if you are reimbursed under a nonaccountable plan for meal expenses, you can deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount.

Amount of standard meal allowance. The standard meal allowance is ***$26 a day*** for most areas in the United States. Other locations in the United States are designated as high-cost areas, qualifying for higher standard meal allowances.

Table 2 in Publication 463 shows the locations qualifying for rates of $30, $34, or $38 a day for travel on or after January 1, 1995.

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers,* later in this section.

Example. You regularly live and work as an independent contractor in Chicago. You sometimes travel overnight to Des Moines for business. You must keep receipts to prove the amount of your lodging expense. You can claim the standard meal allowance for Des Moines, $30. You are subject to the 50% limit on meal and entertainment expenses.

Standard meal allowance for areas outside the continental United States. The previously mentioned standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The federal per diem rates for these locations are published monthly in the *Maximum Travel Per Diem Allowances for Foreign Areas.*

You can purchase the publication from the:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250–7954

You can also order it by calling the Government Printing Office at (202)512–1800 (not a toll-free number).

The 1995 Foreign Per Diem Rates are also available on the Internet. If you have a computer and a modem, you may access this information via the following addresses:

gopher:
dosfan.lib.uic.edu.port 70
Universal Resource Locator (URL):
gopher://dosfan.lib.uic.edu/
Mosaic or WWW:
http://dosfan.lib.uic.edu/dosfan.html

Once on the Department of State Foreign Affairs Network (DOSFAN), select Travel and Consular Information.

Special rate for transportation workers. You may be able to use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a ***$32 a day*** standard meal allowance ($36 for travel outside the continental United States).

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, however, you must continue to use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

Travel for less than 24 hours. If you are not traveling for the entire 24-hour day, you must prorate the standard meal allowance. You may do so by dividing the day into 6-hour quarters. The 6-hour quarters are:

1) Midnight to 6 a.m.,
2) 6 a.m. to noon,
3) Noon to 6 p.m., and
4) 6 p.m. to midnight.

You can claim one-fourth of the full day standard meal allowance for each 6-hour quarter of the day during any part of which you are traveling away from home.

You may also prorate the standard meal allowance by using any method that is consistently applied and is in accordance with reasonable business practice.

Example. You live and work in your own consulting business in Los Angeles. You go to San Francisco on a temporary assignment. You leave home at 8 a.m. on March 23. Your assignment is completed on March 26. You arrive home at 4 p.m. on that day. You are considered to be traveling for $3\frac{1}{2}$ days (a $\frac{3}{4}$ day on March 23 + 2 full days + a $\frac{3}{4}$ day on March 26). Your standard meal allowance is $133 ($3\frac{1}{2} \times$ $38) while on this assignment.

Travel in the United States

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States.

Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

Example. You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend $630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days and your total cost would have been $580. You can deduct $580 for your trip, including the cost of round-trip transportation to and from New Orleans. The cost of your meals is subject to the 50% limit on meal expenses.

Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules in this section. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States.*

Example. You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. The return trip is all outside the United States, as there are no scheduled stops between Puerto Rico and New York.

Private car. Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

Example. You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

Private plane. If you travel by private plane, any trip, or part of a trip, for which both your takeoff and landing are in the United States is travel in the United States. This is true even if part of your flight is over a foreign country.

Example. You fly nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel in the United States.

Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

See chapter 1 of Publication 463 for information on luxury water travel.

Travel Entirely for Business

If you travel outside the United States and you spend the entire time on business activities, all your travel expenses of getting to and from your business destination are deductible.

In addition, even if you do not spend your entire time on business activities, your trip is considered entirely for business and you can deduct all of your business-related travel expenses if you meet at least one of the following four conditions.

1) You did not have substantial control over arranging the trip. You are not considered to have substantial control merely because you have control over the timing of your trip.

   A self-employed person is generally regarded as having substantial control over arranging business trips.

2) You were outside the United States for a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but count the day you return to the United States.

   Example. You traveled to Paris primarily for business. You left Denver on Tuesday and flew to New York. On Wednesday, you flew from New York to Paris, arriving the next morning. On Thursday and Friday, you had business discussions, and from Saturday until Tuesday, you were sightseeing. You flew back to New York, arriving Wednesday afternoon. On Thursday, you flew back to Denver. Although you were away from your home in Denver for more than a week, you were not outside the United States for more than a week. This is because the day of departure does not count as a day outside the United States. You can deduct your cost of the round-trip flight between Denver and Paris. You can also deduct the cost of your stay in Paris for Thursday and Friday while you conducted business. However, you cannot deduct the cost of your stay in Paris from Saturday through Tuesday because those days were spent on nonbusiness activities.

3) You were outside the United States more than a week, but you spent less than 25% of the total time you were outside the United States on nonbusiness activities. For this purpose, count both the day your trip began and the day it ended.

   Example. You flew from Seattle to Tokyo, where you spent 14 days on business and 5 days on personal matters. You then flew back to Seattle. You spent one day flying in each direction. Because only $^5/_{21}$ (less than 25%) of your total time abroad was for nonbusiness activities, you can deduct as travel expenses what it would have cost you to make the trip if you had not engaged in any nonbusiness activity. The amount you can deduct is the cost of the round-trip plane fare and 16 days of meals (subject to the 50% limit), lodging, and other related expenses.

4) You can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

If you do not meet any of these conditions, you may still be able to deduct some of your expenses. See *Travel Primarily for Business,* next.

Travel Primarily for Business

If you traveled outside the United States primarily for business purposes, but spent 25% or more of your time on nonbusiness activities, your travel expense deductions are limited unless you meet one of the four conditions listed earlier under *Travel Entirely for Business.* If your deductions are limited, you must allocate your travel expenses of getting to and from your destination between your business and nonbusiness activities to determine your deductible amount. These travel allocation rules are discussed in chapter 1 of Publication 463.

Trip Primarily for Vacation

If your travel was primarily for vacation, or for investment purposes, and you spent some time attending brief professional seminars or a continuing education program, the entire cost of the trip is a nondeductible personal expense. You may, however, deduct your registration fees and any other expenses incurred that were directly related to your business.

Example. You are a doctor practicing medicine and are a member of a professional association. The association sponsored a 2-week trip to two foreign countries with three professional seminars in each country. Each seminar was 2 hours long and was held in a different city. You also made an optional side trip to a well-known tourist attraction in each of the countries visited. At the end of the trip you received a Certificate of Continuing Education in Medicine.

You paid the cost of airfare, hotel accommodations, meals, a special escort, transportation to and from hotels, and tips. No part of the cost you paid was specifically stated for the seminars, which were arranged for you by the sponsoring professional association.

Your participation in the professional seminars did not change what was essentially a vacation into a business trip. Your travel expenses were not related primarily to your business. You had no other expenses that were directly for your business. You cannot deduct the cost of your trip as an ordinary and necessary business expense.

Conventions

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family. If the convention is for investment, political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. Nonbusiness expenses, such as social or sightseeing expenses, are personal expenses and are not deductible.

Your appointment or election as a delegate does not, in itself, entitle you to or deprive you of a deduction. Your attendance must be connected to your own trade or business.

Convention agenda. The agenda of the convention does not have to deal specifically with your official duties or the responsibilities of your position or business. It is enough if the agenda is so related to your active trade or business and your responsibilities that attendance for a business purpose is justified.

Foreign conventions. See chapter 1 of Publication 463 for information on conventions held outside the North American area.

Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

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

In addition, the entertainment expense must meet one of two tests:

1) Directly-related test, or
2) Associated test.

You must also meet the requirements discussed later under *Recordkeeping.*

Even if you meet all the requirements for claiming a deduction for entertainment expenses, the amount you can deduct may be limited. Generally, you can deduct only 50% of your unreimbursed entertainment expenses. This limit is discussed later under *50% Limit.*

Club dues and membership fees. You are not allowed a deduction for dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose. This applies to any membership organization if one of its principal purposes is to conduct entertainment activities for members or their guests, or to provide members or their guests with access to entertainment facilities.

The purposes and activities of a club, not its name, will determine whether or not the dues are deductible. You cannot deduct dues paid to country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Entertainment. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. You cannot deduct expenses for entertainment to the extent they are lavish or extravagant. If you buy a ticket to an entertainment event for a client, you generally can only take into account the face value of the ticket even if you paid a higher price.

Entertainment also may include meeting personal, living, or family needs of individuals, such as providing food, a hotel suite, or a car to business customers or their families.

A meal as a form of entertainment. Entertainment includes the cost of a meal you provide to a customer or client whether the meal is a part of other entertainment or by itself. A meal sold in the normal course of your business is not entertainment. Generally, to deduct an entertainment-related meal, you or your employee must be present when the food or beverages are provided.

A meal expense includes the cost of food, beverages, taxes, and tips for the meal.

No double deduction allowed for meals. You cannot claim the cost of your meal as an entertainment expense if you are also claiming the cost of your meal as a travel expense.

Deduction may depend on your type of business. Your kind of business may determine if a particular activity constitutes entertainment. For example, if you are a dress designer and have a fashion show to introduce your new designs to store buyers, the show generally is not considered entertainment because fashion shows are typical in your business. But, if you are an appliance distributor and hold a fashion show for the spouses of your retailers, the show generally is considered entertainment.

Taking turns paying for meals or entertainment. Expenses are ***not*** deductible when a group of business acquaintances take turns picking up each other's meal or entertainment checks without regard to whether any business purposes are served.

Expenses not considered entertainment. Entertainment does not include supper money you give your employees working overtime, a hotel room you keep for your employees while on business travel, or a car used in your business (even if it is used for routine personal purposes, such as commuting to and from work). However, if you provide the use of a hotel suite or a car to your employee who is on vacation, this is entertainment of the employee.

Additional information. For more information on entertainment expenses, including discussions of the directly-related and associated tests, see chapter 2 of Publication 463.

50% Limit

In general, you can deduct only 50% of your business-related meal and entertainment expenses. This limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed.

The 50% limit applies to business meals or entertainment expenses incurred while:

1) Traveling away from home (whether eating alone or with others) on business,
2) Entertaining business customers at your place of business, a restaurant, or other location, or
3) Attending a business convention or reception, business meeting, or business luncheon at a club.

Taxes and tips relating to a business meal or entertainment activity are included in the amount that is subject to the 50% limit. Expenses such as cover charges for admission to a nightclub, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena are subject to the 50% limit. However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

If you pay or incur an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of the other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge, or if you are provided with one per diem amount to cover both your lodging and meal expenses.

Application of 50% limit. The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by one of the exceptions discussed in chapter 3 of Publication 535. The 50% limit also applies to activities that are not a trade or business. It applies to meal and entertainment expenses incurred for the production of income including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

When to apply the 50% limit. You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the rules discussed in this chapter.

If you are self-employed, figure the limit on Schedule C. If you file Schedule C–EZ, enter the total amount of your business expenses on line 2. You can only include 50% of your meal and entertainment expenses in that total.

Example 1. You spend $100 for a business-related meal. If $40 of that amount is not allowable because it is considered lavish and extravagant, the remaining $60 is subject to the 50% limit. Your deduction cannot be more than $30 (.50 × $60).

Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid $150 for the two tickets, which had a face value of $60 each ($120 total). Your deduction cannot be more than $60 (.50 × $120).

Business Gift Expenses

If you give business gifts in the course of your trade or business, you can deduct the cost subject to the limits and rules in this section.

Limit on business gifts. You can deduct no more than $25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

A gift to the spouse of a business customer or client is an indirect gift to the customer or client. However, if you have an independent bona fide business connection with the spouse, the gift generally will not be considered an indirect gift to the other spouse. It will, however, be considered an indirect gift to the other spouse if it is intended for that spouse's eventual use or benefit. These rules also apply to gifts you give to any other family member.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit.

A related cost is considered incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is considered an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not considered an incidental cost of packaging if the basket has a substantial value compared to the value of the fruit.

Exceptions. The following items are not included in the $25 limit for business gifts.

1) An item that costs $4 or less and:
   a) Has your name clearly and permanently imprinted on the gift, and
   b) Is one of a number of identical items you widely distribute.

Examples include pens, desk sets, and plastic bags and cases.

2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Employee achievement awards. Employee achievement awards are not treated as gifts. For information on the requirements you must meet in order to deduct the cost of these awards, see *Bonuses and Awards* in chapter 2 of Publication 535.

Gift or entertainment. Any item that might be considered either a gift or an entertainment expense generally will be considered an entertainment expense. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift expense.

If you give tickets to a theater performance or sporting event to a business customer and you do not go with the customer to the performance or event, you can choose to treat the tickets as either a gift or entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date, but not after the time allowed for the assessment of income tax. In most instances, this assessment period ends 3 years after the due date of your income tax return. But if you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the tickets as a gift expense.

Local Transportation Expenses

This section discusses expenses you can deduct for local business transportation. It also discusses deductions you can take for the business use of your car, whether you use it for business-related local transportation or when traveling away from home overnight on business.

Local transportation expenses include the ordinary and necessary expenses of getting from one workplace to another in the course of your business or profession when you are traveling within your tax home area. Tax home is defined earlier.

The following discussion applies to you if you have a regular or main job away from your residence. If your principal place of business is in your home, see *Office in the home,* later.

Local transportation expenses also include the cost of getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Local business transportation does ***not*** include expenses you have while traveling away from home overnight. Transportation expenses you can deduct while traveling away from home overnight are discussed earlier in this chapter under *Travel Expenses.*

Local business transportation expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

You can deduct your expenses for local business transportation, including the business use of your car, if the expenses are ordinary and necessary. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, or taxi, or driving a car between your home and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

Example. You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip's expenses from commuting to business. You cannot deduct your commuting expenses.

Parking fees. Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

Hauling tools or instruments. If you haul tools or instruments in your vehicle while commuting to and from work, this does not make your commuting costs deductible. However, you can deduct additional costs, such as renting a trailer that you tow with your vehicle for carrying equipment to and from your job.

Advertising display on car. The use of your car to display material that advertises your business does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you cannot deduct your expenses for such uses. Commuting or personal expenses are not deductible.

Office in the home. If you have an office in your home that qualifies as a ***principal place of business,*** you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See Publication 587, *Business Use of Your Home,* for information on determining if your home office qualifies as a principal place of business.)

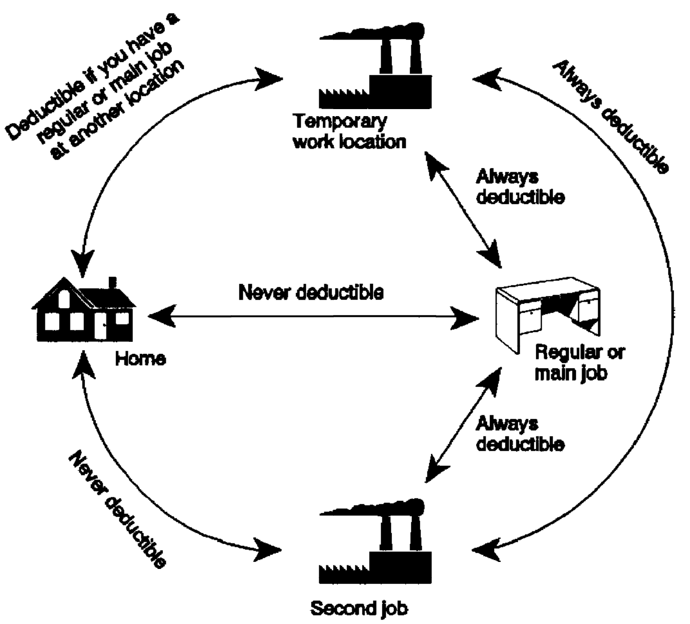
If your home office does not qualify as a principal place of business, follow the general rules explained earlier.

Examples of deductible local transportation. The following examples illustrate when you can deduct local transportation expenses based on the location of your work and your home.

Example 1. Your office is in the same city as your home. You cannot deduct the cost of transportation between your home and your office. This is a personal commuting expense. You can deduct the cost of round-trip transportation between your office and a client's or customer's place of business.

Example 2. You regularly work in an office in the city where you live. You attend a one-week training session at a different office in the same city. You travel directly from

Figure 15-A. When Are Local Transportation Expenses Deductible?
(Do not use this chart if your home is your principal place of business. See *Office in the home.*)



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is irregular or short-term, generally a matter of days or weeks. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary location <u>outside</u> your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. You cannot deduct your transportation costs between your home and a second job on a day off from your main job.

your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

Example 3. Your principal place of business is in your home. (The rules for ''principal place of business'' are discussed in Publication 587, *Business Use of Your Home.*) You can deduct the round-trip business-related local transportation expenses between your qualifying home office and your client's or customer's place of business. You must, however, distinguish between business and personal transportation.

Example 4. You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. In addition, transportation expenses between your last business contact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these trips, you can deduct the costs of going from one client or customer to another.

Illustration of local transportation. *Figure 15–A* illustrates the rules for when you can deduct local transportation expenses when you have a regular or main job away from your residence. You may want to refer to it when deciding whether you can deduct your local business transportation expenses.

Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of two methods to figure your expenses: actual expenses or the standard mileage rate.

Note. You may be entitled to a tax credit for an electric vehicle or a deduction from gross income for a part of the cost of a clean-fuel vehicle that you place in service after June 30, 1993. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see chapter 15 of Publication 535.

Car expense records. Whether you use actual expenses or the standard mileage rate, you must keep records to show when you started using your car for business and the cost or other basis of the car. Your records must also show the business miles and the total miles you drove your car during the year.

Actual expenses. If you deduct actual expenses, you must keep records of the costs of operating the car. If you lease a car, you must also keep records of that cost.

Actual Expenses

If you choose to deduct actual expenses, you can deduct the cost of the following items:

Depreciation	Lease fees	Rental fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use.

Example. You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

Interest on car loans. If you are self-employed and use your car in that business, see chapter 16.

Taxes paid on your car. You cannot deduct luxury or sales taxes, even if you use your car 100% for business. Luxury and sales taxes are part of your car's basis and may be recovered through depreciation. If you are self-employed and use your car in that business, see chapter 18 for more information.

Fines and collateral. Fines and collateral for traffic violations are not deductible.

Leasing a car. If you lease a car that you use in your business, you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for commuting or for any other personal use of the car. You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car even if the payments are called lease payments.

If you lease a car that you use in your business for 30 days or more, you may have to include in your income an amount called an ''inclusion amount.'' For more information, see chapter 3 of Publication 917.

Depreciation and section 179 deductions. If you use your car for business purposes, you may be able to recover its cost by claiming a depreciation or section 179 deduction. The amount you may claim depends on the year you placed the car in service and the amount of your business use.

For more information, see the instructions for Form 4562. Also see chapter 2 of Publication 917 for a detailed discussion of these deductions.

Standard Mileage Rate

Instead of figuring actual expenses, you may be able to use the standard mileage rate to figure the deductible costs of operating your car, van, pickup or panel truck for business purposes. You can use the standard mileage rate only for a car that you own. For 1995, the standard mileage rate is ***30 cents*** a mile for all business miles.

If you choose to take the standard mileage rate, you ***cannot*** deduct actual operating expenses. These include depreciation, maintenance and repairs, gasoline (including gasoline taxes), oil, insurance, and vehicle registration fees.

You generally can use the standard mileage rate regardless of whether you are reimbursed and whether or not any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursement of Employee Expenses,* later.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car, you must choose to use it in the first year you place the car in service in business. Then in later years, you can choose to use the standard mileage rate or actual expenses.

If you choose to use the standard mileage rate, you are considered to have made an election not to use the accelerated cost recovery system (ACRS) or the modified accelerated cost recovery system (MACRS). This is because the standard mileage rate allows for depreciation. You also cannot claim the section 179 deduction. If you change to the actual expenses method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation. For information on how to figure that depreciation, see the exception in *Methods of depreciation* under *Depreciation Deduction* in Publication 917.

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

1) Do not own the car,
2) Use the car for hire (such as a taxi),
3) Operate two or more cars at the same time (as in fleet operations), or
4) Claimed a deduction for the car in an earlier year using:
   a) ACRS or MACRS depreciation, or
   b) A section 179 deduction.

Two or more cars. If you own two or more cars that are used for business at the same time, you cannot take the standard mileage rate for the business use of any car. However, you may be able to deduct a part of the actual expenses for operating each of the cars. See *Actual Car Expenses* in chapter 2 of Publication 917 for information on how to figure your deduction.

You are ***not*** using two or more cars for business at the same time if you alternate using (use at different times) the cars for business.

The following examples illustrate the rules for when you can and cannot use the standard mileage rate for two or more cars.

Example 1. Marcia, a salesperson, owns a car and a van that she alternates using for calling on her customers. She can take the standard mileage rate for the business mileage of the car and the van.

Example 2. Tony uses his own pickup truck in his landscaping business. During 1995, he traded in his old truck for a newer one. Tony can take the standard mileage rate for the business mileage of both the old and the new trucks.

Example 3. Chris owns a repair shop and an insurance business. He uses his pickup truck for the repair shop and his car for the insurance business. No one else uses either the pickup truck or the car for business purposes. Chris can take the standard mileage rate for the business use of the truck and the car.

Example 4. Maureen owns a car and a van that are both used in her housecleaning business. Her employees use the car and she uses the van to travel to the various customers. Maureen cannot take the standard mileage rate for the car or the van. This is because both vehicles are used in Maureen's business at the same time. She must use actual expenses for both vehicles.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

Basis of car. To figure gain or loss on the disposition of a car that you used for business, you must figure its adjusted basis by subtracting from the basis any depreciation (including any section 179 or clean-fuel vehicle deduction) that you claimed. If you used the standard mileage rate for the business use of your car, depreciation was included in that rate. The rate of depreciation that was allowed in the standard mileage rate is shown in the chart that follows. This depreciation reduces the basis of your car (but not below zero) in figuring its adjusted basis when you dispose of it.

Note: These rates do not apply for any year in which the actual expenses method was used.

Year	**Depreciation Rate per Mile**
1994 – 1995	12 cents
1992 – 1993	11½ cents
1989 – 1991	11 cents
1988	10½ cents
1987	10 cents
1986	9 cents
1983 – 1985	8 cents
1982	7½ cents
1980 – 1981	7 cents

For tax years before 1990, the rates applied to the first 15,000 miles. For tax years after 1989, the depreciation rate applies to all business miles.

Example. In 1991, you bought a car for exclusive use in your business. The car cost $14,000. From 1991 through 1995, you used the standard mileage rate to figure your car expense deduction. You drove your car 18,750 miles in 1991, 17,200 miles in 1992, 18,100 miles in 1993, 16,300 miles in 1994, and 17,600 miles in 1995. The depreciation allowed is figured as follows:

Year	Miles × Rate	Depreciation
1991	18,750 × .11	$ 2,063
1992	17,200 × .11½	1,978
1993	18,100 × .11½	2,082
1994	16,300 × .12	1,956
1995	17,600 × .12	2,112
Total depreciation		$10,191

At the end of 1995, your adjusted basis in the car is $3,089 ($14,000 – $10,191).

Recordkeeping

This section discusses the written records you need to keep if you plan to deduct an expense discussed in this chapter. By keeping timely and accurate records, you will have support to show the IRS if your tax return is ever examined. Or, you may require proof of expenses for which you are reimbursing your employees under an accountable plan, as discussed later under *Adequate Accounting.*

If you reimburse employees for business expenses that they incur on your behalf, this section applies to your employees as well as to you, the employer. Your employees must submit the proper records to you, and you must retain these records to support your deductible business expenses. If your employees have questions on what records are needed, you will find the information in this section helpful in answering their questions.

Proof needed. You must be able to prove (substantiate) your deductions for travel, entertainment, business gift, and transportation expenses. You should keep adequate records or have sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

Table 15-2. **Elements To Prove Certain Business Expenses**

Element to be proved (1)	Expense			
	Travel (2)	**Entertainment (3)**	**Gift (4)**	**Transportation (Car) (5)**
Amount	Amount of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories, such as taxis, daily meals for traveler, etc.	Amount of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Cost of gift.	1) Amount of each separate expense including cost of the car, 2) Mileage for each business use of the car, and 3) Total miles for the tax year.
Time	Date you left and returned for each trip, and number of days for business.	Date of entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the business discussion.	Date of gift.	Date of the expense or use.
Place	Name of city or other designation.	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if entertainment is directly before or after a business discussion.	Not applicable.	Name of city or other designation if applicable.
Description	Not applicable.	Not applicable.	Description of gift.	Not applicable.
Business Purpose	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
Business Relationship	Not applicable.	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee was present if entertainment was a business meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	Not applicable.

Timely recordkeeping. You do not need to write down the elements of every expense at the time of the expense. However, a record of the elements of an expense or of a business use made at or near the time of the expense or use, supported by sufficient documentary evidence, has more value than a statement prepared later when generally there is a lack of accurate recall. A log maintained on a weekly basis, which accounts for use during the week, is considered a record made at or near the time of the expense or use.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

Chart that shows proof needed. *Table 15–2* summarizes the factors needed to prove the elements of your expenses for travel, local business transportation, entertainment, and gifts. These factors are discussed in more detail in chapter 5 of Publication 463.

To deduct these expenses, you must be able to prove the elements listed in column 1 of the chart. You prove these elements by having the information and receipts (where needed) for the expenses listed in columns 2, 3, 4, or 5, whichever apply.

Adequate records. You should keep the proof you need for these items in an account book, diary, statement of expense, or similar record, and keep adequate documentary evidence (such as receipts, canceled checks, or bills), that together will support each element of an expense. Documentary evidence is explained in more detail later in this discussion. Written evidence has considerably more value than oral evidence alone.

Separating expenses. Each separate payment usually is considered a separate expense. If you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

Totaling items. You may make one daily entry for reasonable categories such as taxi fares, telephone calls, gas and oil, or other incidental travel costs. Meals should be in a separate category. You should include tips with the costs of the services you received.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

Documentary evidence. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. However, this evidence is ***not*** needed if:

1) You have meal or lodging expenses for travel away from home and you use a per diem allowance method for claiming these expenses,
2) You use the standard mileage rate to claim business car expenses,
3) Your expense, other than lodging, is less than $25 (less than $75 for expenses incurred after September 30, 1995), ***or***
4) You have a transportation expense for which a receipt is not readily available.

Accountable plans and per diem and mileage allowances are discussed later under *Reimbursement of Employee Expenses.*

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has:

1) The name and location of the hotel,
2) The dates you stayed there, and
3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has:

1) The name and location of the restaurant,
2) The number of people served, and
3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

Business purpose. A written statement of the business purpose of an expense is generally needed. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, a written explanation is not needed.

Example. A sales representative who calls on customers on an established sales route does not have to submit a written explanation of the business purpose for traveling that route.

Confidential information. Confidential information relating to an element of a deductible expense, such as the place, business purpose, or business relationship, need not be put in your account book, diary, or other record. However, the information has to be recorded elsewhere at or near the time of the expense and be available to fully prove that element of the expense.

Inadequate records. If you do not have adequate records to prove an element of an expense, then you must prove the element by:

1) Your own statement, whether written or oral, containing specific information about the element, and
2) Other supporting evidence sufficient to establish the element.

Additional information for the IRS. You may have to provide additional information to the IRS to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

How long to keep records and receipts. You must keep proof to support your claim to a deduction as long as your income tax return can be examined. Generally, it will be necessary for you to keep your records for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered as filed on the due date.

Additional information. See chapter 5 of Publication 463 for more information on recordkeeping, including a discussion on how to prove each type of expense discussed in this chapter.

Reimbursement of Employee Expenses

You generally can deduct the amount you reimburse your employees for expenses discussed in this chapter. The amount and manner in which you can deduct these expenses depend in part on whether you reimburse the expenses under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem allowances simplify proving the amount of your expenses, and the tax treatment of these reimbursements and expenses.

Reimbursement, allowance, or advance. A reimbursement or other expense allowance arrangement is a system or plan that you use to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to you by your employees for employee business expenses. It can also be a system used to keep track of amounts you pay through an agent or a third party. Arrangements include per diem and mileage allowances. If a single payment includes both wages and an expense reimbursement, you must specifically identify to the employee the amount of the reimbursement.

You have different options for reimbursing your employees for business-related expenses. These include:

1) Reimbursing them for their actual expenses, as discussed throughout this chapter,
2) Reimbursing them for business use of their cars:
   a) At a fixed amount per mile of business travel,
   b) With a fixed and variable amount determined by a cents-per-mile rate plus a flat amount (based on a standard vehicle and the area) as explained later under *Car or mileage allowances,* or
   c) By any other method that is consistently applied and in accordance with reasonable business practices.
3) Using the meals only allowance (discussed later) to reimburse meals and incidental expenses and reimbursing actual lodging expenses,
4) Using the regular federal per diem rate (discussed later),
5) Using the high-low method (discussed later), or
6) Reimbursing them under any other method that is acceptable to the IRS.

You should tell your employees what method of reimbursement you use and what records they must submit.

No reimbursement. Your employees are not reimbursed or given an allowance for their expenses if you pay them a salary or commission with the understanding that they will pay their own expenses. In this situation, you do not have a reimbursement or allowance arrangement.

Chart that shows how to report. *Table 15-3* explains what you report on Form W–2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

Accountable Plans

To be an accountable plan, your reimbursement or allowance arrangement must require an employee to meet all three of the following rules:

1) The employee's expenses must have a business connection — that is, he or she must have paid or incurred deductible expenses while performing services as your employee,
2) Your employee must adequately account to you for these expenses within a reasonable period of time, and
3) Your employee must return any excess reimbursement or allowance within a reasonable period of time.

''Adequate accounting'' and ''returning excess reimbursements'' are discussed later.

An ***excess reimbursement or allowance*** is any amount you pay that is more than the business-related expenses that your employee adequately accounted for to you. See *Returning Excess Reimbursements,* later, for information on how to handle these excess amounts.

The definition of ***reasonable period of time*** depends on the facts of the situation. The IRS will consider it reasonable for your employee to:

1) Receive an advance within 30 days of the time he or she has an expense,
2) Adequately account for the expense within 60 days after it was paid or incurred, and
3) Return any excess reimbursement to you within 120 days after the expense was paid or incurred.

If you give your employee a periodic statement (at least quarterly) that asks him or her to either return or adequately account for outstanding advances and the employee complies within 120 days of the statement, the IRS will consider the amount adequately accounted for or returned within a reasonable period of time.

Employee meets accountable plan rules. If your employee meets the three rules for accountable plans, do not include any reimbursements in his or her income in box 1 of Form W–2.

Expenses subject to 50% limit. If you reimburse meal or entertainment expenses under an accountable plan, you (the employer) may be subject to the 50% limit. Exceptions to the 50% limit are discussed in chapter 3 of Publication 535.

Keeping records. If you require that your employees account to you and return any excess advances or allowances (and the employees meet these requirements), you must keep the records and supporting documents given to you by your employees to prove the deductions on your return for the allowances and reimbursements you paid them.

Employee does not meet accountable plan rules. You may reimburse an employee under your accountable plan but only part of the employee's expenses may meet all three rules.

If you reimburse expenses under an otherwise accountable plan but your employee does not return, within a reasonable period of time, any reimbursement for which he or she did not adequately account to you, then only the amount for which the employee did adequately account is considered as paid under an accountable plan. The remaining expenses are treated as having been reimbursed under a nonaccountable plan (discussed later).

If you pay your employees an advance or allowance that is higher than the federal per diem or standard mileage rate, see *Returning Excess Reimbursements,* later.

Table 15-3. **Reporting Travel, Entertainment, and Gift Expenses and Reimbursements**

Type of Reimbursement (or Other Expense Allowance) Arrangement	Employer Reports on Form W–2	Employee Shows on Form 2106[1]
Accountable		
Actual expense reimbursement Adequate accounting and excess returned	Not reported	Not shown if expenses do not exceed reimbursement
Actual expense reimbursement Adequate accounting and return of excess both required but excess not returned	Excess reported as wages in box 1. Amount adequately accounted for is reported only in box 13—it is *not* reported in box 1.	All expenses (and reimbursements reported on Form W–2, box 13) ***only*** if some or all of the excess expenses are claimed.[2] Otherwise, form is not filed.
Per diem or mileage allowance (up to federal rate) Adequate accounting and excess returned	Not reported	All expenses and reimbursements ***only*** if excess expenses are claimed.[2] Otherwise, form is not filed.
Per diem or mileage allowance (exceeds federal rate) Adequate accounting up to the federal rate only and excess not returned	Excess reported as wages in box 1. Amount up to the federal rate is reported only in box 13—it is *not* reported in box 1.	All expenses (and reimbursements equal to the federal rate) ***only*** if expenses in excess of the federal rate are claimed.[2] Otherwise, form is not filed.
Nonaccountable		
Either adequate accounting or return of excess, or both, not required by plan	Entire amount is reported as wages in box 1.	All expenses[2]
No reimbursement	Normal reporting of wages, etc.	All expenses[2]

[1] Employees may be able to use Form 2106-EZ. The qualifications are listed on the form.
[2] Any allowable business expense is carried to line 20 of Schedule A (Form 1040) and deducted as a miscellaneous itemized deduction.

Reimbursement of nondeductible expenses. If you reimburse your employees under your accountable plan for expenses related to your business that are not deductible as employee business expenses, the amounts you pay the employee for the nondeductible expenses are treated as paid under a nonaccountable plan.

Example. Your reimbursement arrangement reimburses your employees for travel expenses they incurred while away from home on business, and for meal expenses they paid when working late at the office, even though they are not away from home. The part of the arrangement that reimburses the employees for the nondeductible meals while working late at the office is treated as a second arrangement. The payments under this second arrangement are treated as paid under a nonaccountable plan.

Per diem allowances. If you reimburse employees by a per diem allowance (daily amount) that qualifies as an accountable plan, two facts affect your reporting:

1) The federal rate for the area where your employees traveled, and
2) Whether the allowance or your employees' actual expenses were more than the federal rate.

For this purpose, the ***federal rate*** can be figured by using any one of three methods:

1) The regular federal per diem rate (discussed later),
2) The high-low method (discussed later), or
3) The standard meal allowance (discussed earlier under *What Are Travel Expenses?).*

The following discussions explain how to handle the reimbursements depending upon how the amount of the per diem allowance compares to the federal rate.

Per diem allowance LESS than or EQUAL to the federal rate. If the per diem allowance is less than or equal to the federal rate, you do not include the allowance in box 1 of the employee's Form W–2.

Example. In April you send Jeremy on a 2-day business trip to Boston. The federal rate in Boston is $139 per day. As required by your accountable plan, Jeremy accounts for the time (dates), place, and business purpose of the trip. You reimburse him $139 a day ($278 total) for living expenses.

You do not include any of the reimbursement on his Form W–2.

Per diem allowance MORE than the federal rate. If you pay an amount that is more than the federal rate, you must include the amount of the per diem allowance up to the federal rate in box 13 (code **L**) of your employee's Form W–2. This amount is not taxable. In addition, you must include the amount of the allowance that is more than the federal rate in box 1 of your employee's Form W–2. Your employee must report this part of the allowance as if it were wage income.

Example. Laura lives and works in Austin. You send her to Dallas for 2 days on business. You pay the hotel directly for Laura's lodging and reimburse Laura $40 a day ($80 total) for meals and incidental expenses. The federal rate for Dallas is $34 per day.

You must include the $12 excess over the federal rate [($40 − $34) × 2] in box 1 of Laura's Form W–2. You also show $68 ($34 a day × 2) in box 13 of her Form W–2. This amount is not included in Laura's income.

Car or mileage allowances. The rules governing car or mileage allowances you pay your employees are similar to those governing per diem allowances. You can pay a car or mileage allowance at the standard mileage rate (discussed earlier), pay at another rate per mile, or base the payment on a fixed and variable rate allowance (as described later).

Generally, the amount considered proven by a car or mileage allowance cannot exceed the standard mileage rate. Your employees must prove to you the time (dates), place, and business purpose for using their cars.

Fixed and variable rate allowance (FAVR). You can choose to reimburse your employees for their car expenses by paying them a cents-per-mile rate to cover their variable operating costs (such as gas, oil, etc.) plus a flat amount to cover their fixed costs (such as depreciation, insurance, etc.). This is called a FAVR allowance. See Revenue Procedure 94–73 in Internal Revenue Bulletin 1994–52 for information on using a FAVR allowance.

Employer's plan. You make the decision whether to use an accountable plan or a nonaccountable plan when reimbursing your employees. An employee cannot turn your nonaccountable plan into an accountable plan by voluntarily accounting to you for the expenses and voluntarily returning excess reimbursements to you.

Adequate Accounting

One of the three rules (listed earlier) for a reimbursement or other expense allowance arrangement to qualify as an accountable plan was that employees adequately account to you for their expenses. Employees adequately account by giving you documentary evidence of their mileage, travel, and other employee business expenses, along with a statement of expense, an account book, a diary, or a similar record in which they entered each expense at or near the time they had it. Documentary evidence includes receipts, canceled checks, and bills. See *Table 15–2* for the aspects or elements of each expense that employees must prove.

Employees must account for ***all*** amounts received from you during the year as advances, reimbursements, or allowances for business use of their cars, travel, entertainment, gifts, or any other expenses. This includes amounts that they charged to you by credit card or other method. They must give you the same type of records and supporting information that they would have to give to the IRS if the IRS questioned a deduction on their return. Employees must pay back the amount of any reimbursement or other expense allowance for which they do not adequately account or that exceeds the amount for which they accounted.

Per diem allowance or reimbursement. You can have your employees prove the amount of their travel expenses by using a per diem allowance amount. If you reimburse your employees for lodging, meal, and incidental expenses at a fixed amount per day of business travel, that amount is called a per diem allowance.

The term ''incidental expenses'' includes, but is not limited to, laundry expenses, cleaning and pressing expenses, and fees and tips for persons who provide services, such as food servers and luggage handlers. Incidental expenses do not include taxicab fares or the costs of telegrams or telephone calls.

A per diem allowance satisfies the adequate accounting requirements for the amount in question if:

1) You reasonably limit payments of the travel expenses to those that are ordinary and necessary in the conduct of your trade or business,

2) The allowance is similar in form to and not more than the federal per diem (that is, the allowance varies based on where and how long an employee was traveling),

3) The employee is not related to you (as defined under *Standard Meal Allowance* in chapter 1 of Publication 463), and

4) The time, place, and business purpose of the travel are proved, as explained earlier under *Recordkeeping.*

If the IRS finds that your travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences in different areas, your employees will not be considered to have accounted to you. In this case, they may have to prove their expenses to the IRS.

Allowance for meals. These rules also apply if you reimburse an employee for meal expenses only or give a separate per diem allowance for meals and incidental expenses. Your reimbursement or allowance must not be more than the standard meal allowance. A per diem allowance is paid separately for meals and incidental expenses if you furnish lodging in kind, pay a meal allowance plus the actual cost of lodging, or pay the hotel, motel, etc., directly for employee lodging. A per diem allowance is also paid separately for meals and incidental expenses if you do not have a reasonable belief that an employee incurred lodging expenses, such as when the employee stays with friends or relatives or the employee sleeps in the cab of his or her truck.

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. You must use the rate in effect for the area where your employee stops for sleep or rest. You should have these rates available. You can get Publication 1542, which gives the rates in the continental United States for the current year.

The federal rates for meals and incidental expenses are the same as those rates discussed earlier under *Standard Meal Allowance.*

High-low method. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel during 1995 is $152 for certain locations. All other areas have a per diem amount of $95. The areas eligible for the $152 per diem amount under the high-low method for all of the year or the portion of the year specified in parentheses under the key city name are listed in *Table 6* in chapter 6 of Publication 463.

Returning Excess Reimbursements

Under an accountable plan, you must require your employees to return any excess reimbursement or other expense allowances for business expenses to you. ***Excess reimbursement*** means any amount for which the employee did not adequately account within a reasonable period of time. For example, if an employee received a travel advance and did not spend all the money on business-related expenses, or did not have proof of all his or her expenses, the employee has an excess reimbursement.

Unproven amount. If an employee does not prove that he or she actually traveled on each day for which he or she received a per diem or mileage allowance (proving the elements described in *Table 15–2),* he or she must return this unproven amount of the allowance within a reasonable period of time. If the employee fails to do this, you must report as income in box 1 of the employee's Form W–2 the unproven amount of the allowance as excess reimbursement. This unproven amount is considered paid under a nonaccountable plan (discussed later).

Per diem or mileage allowance MORE than federal rate or standard mileage rate. If your accountable plan pays a per diem or other allowance that is higher than the federal per diem rate, or your mileage allowance is higher than the standard mileage rate, employees do not have to return the difference between the two rates for the period or the miles they can prove business-related expenses. However, you must report this difference between the rates as wages on their Forms W–2. This excess amount is considered paid under a nonaccountable plan (discussed later).

Example. You send Maria on a 5-day business trip to Phoenix. She uses her personal car to make the trip and you reimburse the hotel directly. You give her a $200 ($40 × 5 days) advance to cover her meals and incidental expenses and $192 (600 × 32 cents) for the 600 business miles you expect her to drive. The federal per diem rate for meals and incidental expenses in Phoenix is $34.

Maria's trip only lasts 3 days and she drives only 500 miles. She must return the $80 ($40 × 2 days) advance for the 2 days she did not travel and the $32 (100 miles × 32 cents) for the 100 business miles she did not drive. For the days and miles Maria did travel, she can keep the $18 difference [($40 allowance she received − $34 federal rate for Phoenix) × 3 days] between the per diem rates and the $10 difference [(32 cents-per-mile allowance she received − 30 cents-per-mile standard mileage rate) × 500 miles] between the mileage rates. You must, however, report $28 ($18 + $10) on her Form W–2 as wages.

Nonaccountable Plans

A ***nonaccountable plan*** is a reimbursement or expense allowance arrangement that does not meet the three rules listed earlier under *Accountable Plans.*

In addition, if you reimburse your employees under an accountable plan, the following amounts will be treated as being paid under a nonaccountable plan:

1) Excess reimbursements an employee fails to return, and
2) Reimbursements of nondeductible expenses related to your business. See *Reimbursement of nondeductible expenses* earlier under *Accountable Plans.*

An arrangement that repays an employee by reducing the amount reported as his or her wages, salary, or other compensation will be treated as a nonaccountable plan. This is because the employee is entitled to receive the full amount of his or her compensation regardless of whether or not he or she incurred any business expenses.

You must combine the amount of any reimbursement or other expense allowance paid to your employees under a nonaccountable plan with their wages, salary, or other compensation. Report the total in box 1 of their Forms W–2.

Example 1. You gave Kim $500 a month ($6,000 total for the year) for her business expenses. You do not require Kim to provide any proof of her expenses, and Kim can keep any funds that she does not spend.

You are reimbursing Kim under a nonaccountable plan. You include the $6,000 on Kim's Form W–2 as if it were wages.

Example 2. You pay Kevin $2,000 a month. On days that he travels away from home on business, you designate $50 a day of his salary as paid to reimburse him for his travel expenses. Because you would pay Kevin his $2,000 monthly salary regardless of whether or not he was traveling away from home, the arrangement is a nonaccountable plan. You cannot treat any part of the $50 a day (that you designated as reimbursement) as paid under an accountable plan.

Part of reimbursement paid under accountable plan. If you reimbursed expenses under an otherwise accountable plan but an employee does not return, within a reasonable period of time, any reimbursement for which the employee did not adequately account, that amount is considered paid under a nonaccountable plan. The remainder is treated as having been paid under an accountable plan (as discussed earlier).

Contractors and Clients

This section discusses special rules for independent contractors and clients.

Independent contractor. If you have reimbursed travel, transportation, meal, entertainment, or gift expenses that you incurred on behalf of a client, you should provide an adequate accounting of these expenses to your client. If you do not account to your client for these expenses, you must include any reimbursements or allowances in income. You must keep adequate records of these expenses regardless of whether you account to your client for such expenses.

If you do not separately account for and seek reimbursement for meals and entertainment in connection with providing services for a client, you are subject to the 50% limit on such expenses. See *50% Limit,* earlier.

Report travel and entertainment expenses on line 24 of Part II, Schedule C, or on line 2 of Schedule C–EZ.

Required records for client or customer. If you are a client or customer, you generally do not have to keep records to prove the reimbursements or allowances you give, in the course of your business, to an independent contractor for travel or gift expenses incurred on your behalf. However, you must keep records if:

1) You reimburse the contractor for entertainment expenses incurred on your behalf, ***and***
2) The contractor adequately accounts to you for these expenses.

Contractor adequately accounts. If the contractor does adequately account to you for entertainment expenses, you (the client or customer) must keep records documenting each element of the expense. Use your records as proof for a deduction on your tax return. If entertainment expenses are accounted for separately, you are subject to the 50% limit discussed earlier under *Entertainment Expenses.* You do not, however, have to file an information return to report amounts for which you reimbursed the contractor, as long as he or she adequately accounted to you for these expenses.

Contractor does not adequately account. If the contractor does not adequately account to you for allowances or reimbursements of entertainment expenses, then you (the client or customer) do not have to keep your own separate records of these items incurred by the contractor on your behalf. You are not subject to the 50% limit on entertainment in this case. You can deduct the reimbursements or allowances as compensation if they are ordinary and necessary business expenses. However, you must file Form 1099–MISC, *Miscellaneous Income,* to report amounts paid to the independent contractor if the total of the reimbursements and any other fees is $600 or more during the calendar year.

16.

Interest Expense

Important Reminder for 1995

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

Introduction

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

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

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **537** Installment Sales
- ☐ **538** Accounting Periods and Methods
- ☐ **550** Investment Income and Expenses
- ☐ **551** Basis of Assets
- ☐ **936** Home Mortgage Interest Deduction

Form (and Instructions)

- ☐ **Sch A (Form 1040)** Itemized Deductions
- ☐ **1098** Mortgage Interest Statement
- ☐ **3115** Application for Change in Accounting Method

Allocation of Interest

The rules for deducting interest vary, depending on whether the loan proceeds are used for business, home mortgage, investment, or passive activities. If you use the proceeds of a loan for more than one expense, you must make an ***allocation*** to determine the amount of interest for each use of the loan's proceeds. However, interest on a qualified home mortgage is fully deductible. For more information on home mortgage interest, see Publication 936.

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

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

Expenditure	For More Information
Trade or business	See this chapter
Passive activity	Publication 925
Investment (including portfolio)	Publication 550

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

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

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

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

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

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

Partnerships and S corporations. Special rules apply to the allocation of interest expense in connection with debt-financed acquisitions of, and distributions from, partnerships and S corporations. These rules do not apply if the partnership or S corporation is formed or used for the principal purpose of avoiding the interest allocation rules.

Debt-financed acquisitions. This is the use of loan proceeds to purchase an interest in an entity or to make a contribution to the capital of the entity. If you purchase an interest in an entity, allocate the loan proceeds and the interest expense among all the assets of the entity. The allocation can be based on the fair market value, book value, or adjusted basis of the assets, reduced by any debts allocated to the assets.

If you contribute to the capital of an entity, make the allocation based on the assets or by tracing the loan proceeds to the entity's expenditures. A purchase of an interest in an entity is treated as a contribution to capital to the extent the entity receives any proceeds of the purchases.

Example. You purchase an interest in a partnership for $20,000 using borrowed funds. The partnership's only assets include machinery used in its business valued at $60,000, and stocks valued at $15,000. You allocate the loan proceeds based on the value of the assets. Therefore, $16,000 of the loan proceeds ($60,000 / $75,000 X $20,000) and the interest expense on that part are allocated to trade or business use. The amount allocated to investment use is $4,000 ($15,000 / $75,000 X $20,000) and the interest on that part.

Debt-financed distributions. Generally, if the entity borrows funds, the general allocation rules discussed earlier in this section apply. If those funds are allocated to distributions made to partners or shareholders, the distributed loan proceeds and related interest expense must be reported to the partners and shareholders separately. This is because the loan proceeds and the interest expense must be allocated depending on how the partner or shareholder uses the proceeds. For example, if a shareholder uses distributed loan proceeds to invest in a passive activity, that shareholder's portion of the entity's interest expense on the loan proceeds is allocated to a passive activity use.

For more information on interest allocation, see chapter 8 in Publication 535.

Interest You Can Deduct

Generally, the amount agreed upon by the lender and the borrower as interest can be deducted when paid or accrued, unless it is required to be capitalized. Personal interest is not deductible. The intent of both parties must be to repay the loan.

Insurance contracts. If you borrow on your life insurance, endowment, or annuity contract and use the proceeds for business purposes, you can take a business interest deduction. (However, you cannot deduct the interest if you must capitalize it.) If you use the proceeds for a nonbusiness purpose, you cannot deduct the interest on Schedule A (Form 1040). Personal interest is not deductible. See Publication 17.

For loans on life insurance policies purchased after June 20, 1986, no interest deduction is allowed to the extent that total loans on policies covering an officer, employee, or individual financially interested in your trade or business are more than $50,000.

Mortgages. Monthly mortgage payments are usually made up of principal and interest. You can deduct only the interest, unless you must capitalize it. If you paid mortgage interest of $600 or more during the year on any one mortgage to a mortgage holder (including a financial institution, a governmental unit, or a cooperative housing corporation) in the course of that holder's trade or business, you will receive a Form 1098 or a similar statement.

In addition, if you receive a refund of interest you overpaid in an earlier year, this amount will be reported on box 3 of Form 1098. You ***cannot deduct*** this amount. For information on how to report this refund, see *Refunds of interest,* later in this chapter.

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

Points. The term ''points'' is often used to describe some of the charges paid by a borrower when the borrower takes out a loan or a mortgage. These charges are also called ***loan origination fees,*** maximum loan charges, or premium charges. If any of these charges is solely for the use of money, it is interest.

These points are interest paid in advance and you cannot deduct it all in one tax year. Instead, you can deduct part of the interest in each tax year during the period of the loan, unless it must be capitalized.

To figure how much to deduct in each tax year, divide the part of the loan period falling within your tax year by the total loan period. Then multiply this answer by the prepaid interest. For example, if you take out a 10-year loan on October 1, 1995, 3 months of the loan period fall in your 1995 tax year. For 1995 you deduct $\frac{3}{120}$ of the payments you made for the points. For 1996, you can deduct $\frac{12}{120}$ of the prepaid interest.

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. However, they are not capital expenses that you add to the basis of your property. If the property mortgaged is business or income-producing property, you can amortize the costs over the life of the mortgage.

Partial liability. If you are liable for part of a business debt, you can deduct only your share of the total interest paid or accrued.

Example. You and your brother borrow money. You are liable for 50% of the note. You use your half of the loan in your business, and you make one-half of the loan payments. You can deduct your half of the total interest payments as a business deduction.

Partial payments on a nontax debt. If you make partial payments on a debt (other than a debt owed IRS), the payments, in the absence of any agreement between you and the lender, are applied first to interest and the remainder to principal. You can deduct only the interest.

Installment purchases. If you make an installment purchase of business property, you will pay interest either as part of each payment or separately. If no interest or a low rate of interest is charged under the contract, you may have to determine the unstated interest amount. Generally, this may happen if the seller finances your purchase. Unstated interest reduces your basis in the property and increases your interest expense. For more information on installment sales and unstated interest, see Publication 537.

Interest You Cannot Deduct

Some interest payments cannot be deducted. In addition, certain other expenses that may seem to be interest are not, and are not deductible as interest.

Payment by cash or equivalent. A cash method taxpayer cannot deduct interest unless it is paid in cash or its equivalent. If you are a cash method taxpayer, you cannot deduct interest you pay with borrowed funds you get from the original lender through a second loan, an advance, or any other arrangement similar to a loan. You may deduct the interest expense once you start making payments on the new loan. When you make partial payments on loans, you first apply the payment to interest and then to the principal. This rule does not apply if both you and the lender intend for a different allocation to be made. All amounts you apply to the interest on the first loan are deductible, along with any interest you pay on the second loan, subject to any limits that apply.

Capitalized interest. There are certain interest expenses you must capitalize rather than deduct. These are discussed later under *Interest Capitalization.*

If you buy property and pay interest owed by the seller (for example, by assuming the debt and any interest accrued on the property), you cannot deduct the interest. Add the interest you paid that the seller owed to the basis of the property.

Commitment fees or standby charges. Fees you incur to have business funds available on a standby basis, but not for the actual use of the funds, are not deductible as interest payments. They may be deductible as business expenses.

If the funds are for inventory or certain property used in your business, the fees are indirect costs and must be capitalized under the uniform capitalization rules. See section 1.263A of the Income Tax Regulations on uniform capitalization rules for more information.

If you pay or incur commitment fees or standby charges on a loan to have money made available when needed, you may be able to deduct the expense. The commitment fees are a cost of getting your loan and you can generally deduct part of the fees each year during the period of the loan. To figure your deduction for each year, divide the part of the loan period falling within the tax year by the total loan period. Then multiply this answer by the total amount of the fees. If you do not take out a loan, you can take a loss deduction for these fees in the year your right to borrow the funds expires.

Income tax owed. Interest paid or accrued on income tax assessed on your individual income tax return is not a business deduction even though the tax due is related to income from your trade or business. This interest is treated as a business deduction only in figuring a net operating loss deduction. See chapter 20.

Penalties. Penalties on deficiencies and underestimated tax are not interest and cannot be deducted. Fines and penalties are generally not deductible.

Interest related to tax-exempt income. Generally, interest related to tax-exempt income is not deductible. No deduction is allowed for:

1) Interest on a debt incurred to buy or carry tax-exempt securities,
2) Amounts paid or incurred in connection with personal property used in a short sale, or
3) Amounts paid or incurred by others for the use of any collateral used in connection with a short sale.

If you deposit cash as collateral in a short sale and the cash does not earn a material return during the period of sale, item (2) above does not apply. For more information on short sales, see Publication 550.

Limit on investment interest. Your deduction for investment interest expense is limited to the amount of your net investment income. This rule applies only if:

1) You are a noncorporate taxpayer (including shareholders and partners of S corporations and partnerships), and
2) You paid or accrued interest on money you borrowed to buy or carry property held for investment (including amounts allowable as a deduction in connection with personal property used in a short sale).

For more information about the limit on the investment interest expense deduction, see Publication 550.

Interest Capitalization

Under the uniform capitalization rules, you must generally capitalize interest on debt used to finance the production of real or tangible personal property. The property must be produced by you for use in your trade or business or produced by you for sale to customers. Interest on a debt on property that was acquired and held for resale does not have to be capitalized. Interest you paid or incurred during the production period must be capitalized if the property produced is ***designated property.*** Designated property is:

1) Real property,
2) Personal property with a class life of 20 years or more,
3) Personal property with an estimated production period of more than 2 years, or
4) Personal property with an estimated production period of more than one year if the estimated cost of production is more than $1 million.

Under this rule, you are considered to have produced property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced by you under a contract is treated as produced by you to the extent that you make payments or otherwise incur costs in connection with the property.

Capitalized interest. Capitalized interest is treated as a cost of the property produced. You recover the interest when you sell or use the property, or dispose of it under the rules that apply to such transactions. You recover the capitalized interest through cost of goods sold, an adjustment to basis, depreciation, amortization, or other method.

The capitalization rules of Internal Revenue Code sections 263A and 460 apply to interest you pay or incur on any debt allocable to the costs of producing qualified property. For example, these costs would include planning and design activities that are generally incurred before the production period begins, as well as the costs of raw land and materials acquired before the production period begins. Also, they include any costs you may incur under a contract for property produced by a third party.

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

If you are a shareholder in an S corporation, you may have to capitalize interest you incur during the tax year with respect to the production costs of the S corporation. Similarly, you may have to capitalize interest incurred by the S corporation with respect to your own production costs. See Internal Revenue Service Notice 88–99, 1988-2 C.B. 422. You must provide the required information in an attachment to the Schedule K–1 to properly capitalize interest for this purpose.

If you are a partner in a partnership, you may have to capitalize interest you incur during the tax year with respect to the production costs of the partnership. Similarly, you may have to capitalize interest incurred by the partnership with respect to your own production costs. See Internal Revenue Service Notice 88–99. You must provide the required information to properly capitalize interest for this purpose in an attachment to the Schedule K–1.

For more information on the uniform capitalization rules, see section 1.263A of the Income Tax Regulations and Internal Revenue Notice 88-99, 1988-2 C.B. 422, (as amended by announcement 89-72) available at most IRS offices.

When To Deduct Interest

If interest capitalization (discussed earlier) does not apply to you, deduct interest as follows.

Cash method. You can deduct only payments of interest you actually made during the tax year. For instance, a promissory note you give covering interest owed is not deductible because it is a promise to pay and not an actual payment.

Prepaid interest. Under the cash method, you generally cannot deduct any interest paid before the year it is due. Interest you pay that is properly allocable to a later tax year must be charged to a capital account. Treat an advance payment as paid in the period covered by the prepaid interest.

Discounted loans. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you cannot deduct it when you get the loan. A cash-method taxpayer must spread this discount over the loan period and can deduct interest only when payments are made on the loan.

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

Accrual method. You can deduct only interest that has accrued during the tax year.

Prepaid interest. If you pay interest in advance, deduct it as it accrues over the period of the debt. This rule also applies to the amount subtracted on a ***discounted loan.***

Payments unlikely to be made. If it is unlikely that you will make the interest payments because of your financial difficulty, you can still take a deduction for accrued interest.

Tax deficiency. If a corporation contests a federal income tax deficiency, interest does not accrue until the tax year that final determination of liability is made. If the corporation does not contest the deficiency, then the interest accrues in the year the tax was asserted and agreed to. Interest is deducted in the year it accrues.

However, if a corporation contests but pays the proposed tax deficiency and interest and the corporation does not designate the payment as a cash bond, then the interest is deductible in the year it is paid.

Related taxpayer. If you use an accrual method, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. If a deduction is denied under this rule, the rule will apply even if your relationship with the person ceases to exist before the interest is includible in the gross income of that person. See the definition of related taxpayers in chapter 3.

However, you can deduct the amount if you pay it within $2\frac{1}{2}$ months after the end of your tax year and if the amount is paid:

For debt incurred on or before September 29, 1983, or

Under a contract that was binding on September 29, 1983, and thereafter before the amount is paid or incurred.

Below-Market Interest Rate Loans

A ***below-market loan*** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which you, the borrower, are treated as having received:

1) A loan in exchange for a note that requires the payment of interest at the applicable federal rate, and
2) An additional payment.

The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the purpose of the transaction. You may have to report this payment as additional income depending on its purpose.

For more information, see chapter 8 in Publication 535.

17. Insurance

Important Change for 1995

Self-employed health insurance deduction. The deduction for health insurance costs for self-employed persons has been permanently extended for tax years beginning after 1993. You may be able to file an amended return (Form 1040X) to take the 25% deduction for 1994. The deduction is increased to 30% for tax years beginning after 1994.

Introduction

You can generally deduct the ordinary and necessary cost of insurance for your trade, business, or profession as a business expense. However, you may have to capitalize certain insurance costs under the uniform capitalization rules. For more information, see *Capitalizing Premiums,* later.

Topics

This chapter discusses:

- Deductible premiums
- Nondeductible premiums
- Life insurance
- Capitalizing premiums
- When to deduct premiums

Useful Items

You may want to see:

Publication

- ☐ **535** Business Expenses
- ☐ **538** Accounting Periods and Methods

Form (and Instructions)

- ☐ **1040** U.S. Individual Income Tax Return

Deductible Premiums

You can generally deduct premiums you pay for the following kinds of insurance related to your trade or business. For information on deductible life insurance premiums, see *Life Insurance,* later.

1) Fire, theft, flood, or similar insurance.
2) Credit insurance to cover losses from unpaid debts.
3) Group hospitalization and medical insurance costs paid for employees.
4) A partnership can deduct the cost of accident and health insurance premiums paid for its partners as guaranteed payments made to the partners.
5) An S corporation can deduct the cost of accident and health insurance premiums paid for its shareholders.
6) Employers' liability insurance.
7) Malpractice insurance that covers your professional personal liability for negligence resulting in injury or damage to patients or clients.
8) Liability insurance that covers your liability for bodily injuries suffered by persons who are not your employees and for property damage to others.
9) Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault. A partnership can deduct workers' compensation premiums paid on behalf of partners as guaranteed payments made to the partners. An S corporation can deduct workers' compensation premiums paid on behalf of shareholders.
10) Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered taxes under state law.
11) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness.
12) Car and other vehicle insurance. This insurance covers liability, damages, and other losses from accidents involving vehicles used in your business. If you operate a vehicle partly for personal use, you can deduct only the part of your insurance premiums that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums. See chapter 15 for information on car expenses.

Self-Employed Health Insurance Deduction

You may be able to deduct 30% of the amount paid during the tax year for medical insurance for yourself and your family. To deduct this, you must:

1) Be self-employed,
2) Be a general partner (or a limited partner receiving guaranteed payments) in a partnership, or
3) Be a shareholder owning more than 2% of the outstanding stock of an S corporation.

If you qualify, take this deduction on line 26 of Form 1040. You are allowed this deduction whether you paid the premiums yourself or your partnership or S corporation paid the premiums and you included these amounts in your gross income.

The deduction cannot be more than your net earnings from the trade or business in which the medical insurance plan is established. Also, the deduction cannot be more than your wages from an S corporation, if this is the business in which the insurance plan is established. Do not subtract the amount of this deduction when figuring net earnings for your self-employment tax. However, subtract the amount of this deduction from your medical insurance when figuring your medical expenses on Schedule A (Form 1040) if you itemize your deductions.

You cannot take the deduction for any month if you were eligible to participate in any subsidized health plan maintained by your employer or your spouse's employer at any time during the month. However, any medical insurance payments that are not deductible on line 26 of Form 1040 can be included as part of your medical expenses on Schedule A (Form 1040) if you itemize your deductions. See chapter 10 in Publication 535 for more information.

Note: The 25% deduction for medical insurance costs for self-employed persons, which had expired on December 31, 1993, has been extended retroactively from January 1, 1994, through December 31, 1994.

You may need to file an amended return, Form 1040X, *Amended U.S. Individual Income Tax Return,* for 1994, to claim an additional deduction for insurance costs paid during 1994.

However, you cannot take the deduction for any month in 1994 if you were eligible to participate in any subsidized health plan maintained by your or your spouse's employer at any time during that month. See chapter 10 of Publication 535 for more information on refiguring your 1994 deduction.

Nondeductible Premiums

You cannot deduct the following kinds of insurance premiums. For information on nondeductible life insurance premiums, see *Life Insurance,* later.

1) Self-insurance reserve funds. You cannot deduct amounts credited to a reserve you set up for self-insurance. This applies even if you cannot get business insurance coverage for certain business risks. However, your actual losses may be deductible.
2) Loss of earnings. You cannot deduct premiums for a policy that pays for your lost earnings due to sickness or disability. However, see the earlier discussion on overhead insurance under *Deductible Premiums.*

Life Insurance

Generally, you can deduct premiums (cost of insurance) you pay or incur on life insurance policies covering the lives of your officers and employees if you are not the beneficiary under the contract and can show that the premiums represent current pay. However, the total of the premiums paid combined with other pay must be reasonable as discussed in chapter 9.

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

Where to deduct premiums. Deduct the premiums on the ''employee benefit programs'' line of the tax schedule or return for your business.

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.

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

Group term life insurance. You can generally deduct premiums you pay or incur for group term life insurance covering the lives of your officers and employees. However, you cannot deduct the premiums if you are directly or indirectly the beneficiary under the contract.

Cost taxable to employee. Generally, you must include in an employee's income the cost of group term life insurance coverage you provide on his or her life that exceeds the total of:

1) The cost of $50,000 of this insurance, ***plus***

2) Any amount paid by the employee toward the purchase of the insurance.

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

The cost of group term insurance that you must include in your employees' income is not the actual cost of the excess coverage. Instead, it is the amount figured using monthly costs listed in chapter 5 of Publication 535. Also, you may have to include in certain key employees' income the cost of the first $50,000 of this insurance. See chapter 5 of Publication 535 for more information.

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

1) The cost of the permanent benefits, ***minus***

2) The amount paid by the employee for the permanent benefits.

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

For more information on group term life insurance, see *Group Term Life Insurance* in chapter 5 of Publication 535.

Capitalizing Premiums

Under the uniform capitalization rules, you must capitalize your direct costs and a properly allocable share of your indirect costs to property produced or property acquired for resale. ''Capitalize'' means ''to include in inventory costs'' if the property is inventory and ''to charge to a capital account or basis'' if the property is not inventory. You will recover these costs through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time you use, sell, place in service, or otherwise dispose of the property.

You must use the uniform capitalization rules if, in the course of your trade or business or an activity carried on for profit, you:

1) Produce real property or tangible personal property for use in the business or activity,

2) Produce real property or tangible personal property for sale to customers, or

3) Acquire property for resale. However, this rule does not apply to personal property if your average annual gross receipts are not more than $10,000,000.

Indirect costs include premiums for insurance on your plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

More information. For more information on the uniform capitalization 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 must generally deduct insurance premiums in the tax year in which you actually pay them, even if you incurred them in an earlier year.

Accrual method. If you use an accrual method of accounting, you can generally deduct insurance premiums in the tax year in which you incur a liability for them, whether or not you pay them in the same year.

Cash or accrual method prepayments. You cannot deduct the entire premium for an insurance policy that covers more than one tax year in the year you make the payment or incur a liability for the payment. You can deduct only the part of the premium that applies to the current tax year. In each later tax year you can deduct the part that applies to that tax year.

Example. You operate a business and file your returns on a calendar-year basis. You bought a fire insurance policy on your building effective October 1, 1995, and paid a premium of $1,200 for 2 years of coverage. On your 1995 return, you can deduct only the part of the total premium that applies to the 3 months of coverage in 1995. The part of the premium that applies to 1996 and 1997 can be deducted in those years. Since the total policy premium is $1,200 for 2 years, the yearly rate is $600 and the monthly rate is $50. For the 3-month period in 1995, you can deduct $150; for 1996, you can deduct $600; and for the 9-month period in 1997, you can deduct $450.

If you use the cash method of accounting and you do not pay the $1,200 premium until January 1996, you cannot deduct on your return for 1995 the $150 for that year. However, you can deduct $750 (the $150 that applies to 1995 plus the $600 that applies to 1996) on your return for 1996.

Dividends received. If you receive dividends from business insurance and you deducted the premiums in prior years, part of the dividends are income. For more information, see *Recovery of items previously deducted* in chapter 6.

18.

Taxes

Introduction

You can deduct various taxes imposed by federal, state (including certain Indian tribal governments), local, and foreign governments if you incur them in the ordinary course of your trade or business. Certain other taxes not attributable to your trade or business are deductible only if you itemize deductions on Schedule A (Form 1040).

If you conduct business as a sole proprietor, deduct your business taxes on Schedule C or C–EZ (Form 1040). A partnership deducts its business taxes on Form 1065 and a corporation on Form 1120, Form 1120–A, or Form 1120S.

Federal income, estate, and gift taxes and state inheritance, legacy, and succession taxes are not deductible.

If you use the cash method of accounting, your deduction for taxes can be taken only in the year paid. If you use an accrual method, your deduction can be taken only in the year the taxes are properly accrued.

Uniform capitalization rules apply to certain taxpayers who produce real or tangible personal property for use in a trade or business, or for sale to customers, or acquire property for resale. Under these rules, certain expenses that are allocable to the property, including taxes, may have to be included in inventory costs or capitalized. In some cases, you may elect to capitalize taxes. For more information, see *Uniform Capitalization Rules* in chapter 7.

Deductible taxes. Taxes that are deductible are broken down into broad categories:

1) Real estate taxes;
2) State and local income taxes;
3) Employment taxes (see chapter 33); and
4) Other taxes.

Topics

This chapter discusses:

- Real estate taxes
- State and local income taxes
- Other taxes

Useful Items

You may want to see:

Publication

- ☐ **378** Fuel Tax Credits and Refunds

Form (and Instructions)

- ☐ **Sch A (Form 1040)** Itemized Deductions
- ☐ **Sch C (Form 1040)** Profit or Loss From Business
- ☐ **Sch C–EZ** Net Profit From Business
- ☐ **Sch SE (Form 1040)** Self-Employment Tax
- ☐ **3115** Application for Change in Accounting Method

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority. Deductible real estate taxes generally do not include assessments for local benefits that increase the value of the property. See *Assessments,* later.

If you use the accrual method of accounting, you generally cannot accrue real estate taxes until you pay them to the government authority. You can, however, elect to ratably accrue the taxes during the year. See *Election to ratably accrue,* later.

Assessments. Assessments for ***local*** benefits that tend to increase the value of your property (such as assessments for construction of streets, sidewalks, and water and sewerage systems, or to provide public parking facilities) generally are not deductible. If the local benefit increases the value of your property, you must capitalize the assessment.

Local assessments for maintenance, repairs, or interest charges for benefits such as streets, sidewalks, and water and sewerage systems are deductible. If only part of the assessment is for maintenance, repairs, or interest, you must be able to show the amount allocated to the different purposes. If you cannot show what part of the assessment is for maintenance, repairs, or interest, none of it is deductible.

Example. City X, to improve downtown commercial business, converted a downtown business area street already improved by lights, sidewalks, sewers, etc., into an enclosed pedestrian mall. The full cost of construction, financed with 10-year bonds, was assessed against the affected properties. The property owners have to make payments of principal and interest annually for 10 years, which is also the period of expected business advantage.

The assessments incurred by the property owners are not deductible as taxes, or as business expenses, but are depreciable capital expenses. The part of the payments that is to pay the interest charges on the bonds is deductible as taxes.

Charges for services. Water bills, sewerage, and other service charges assessed against your business property are not real estate taxes, but are deductible as business expenses.

Real estate sales. If real estate is sold, the deduction for real estate taxes must be divided between the buyer and the seller according to the number of days in the ***real property tax year*** (the period to which the tax relates) that each owned the property. The taxes are apportioned to the seller up to but not including the date of sale, and to the buyer beginning with the date of sale, regardless of the accrual or lien dates under local law. This information is usually included on the settlement statement provided at closing.

If you (seller) cannot deduct taxes until they are paid because you use the cash method of accounting and the buyer of your property is personally liable for the tax, you are considered to have paid your part at the time of the sale. This permits you to deduct the part of the tax to the date of sale even though you do not actually pay it.

If you (the seller) use an accrual method and have not elected to ratably accrue real property taxes, the taxes apportioned to you (but not deductible for any year under your accounting method) accrue on the date you sell the property.

Example. Al Green, a calendar year accrual method taxpayer, owns real property in X County but has not elected to ratably accrue property taxes. November 30 of each year is the assessment and lien date. He sold the property on June 30, 1995, and under his accounting method would not be able to claim a deduction for the taxes because the sale occurred before November 30. The part of the 1995 tax apportioned to him, 180/365 (January 1–June 29), is treated as having accrued on June 30, and is deductible for 1995.

Excess deduction. If you sold real property, the deduction you claimed last year for real property taxes may be greater than the taxes apportioned to you, as already discussed. If this occurs, the excess is included in your gross income to the extent provided in *Recovery of items previously deducted* in chapter 6.

Election to ratably accrue. An accrual method taxpayer may elect to accrue ratably real property taxes that are related to a definite period of time over that period of time.

Example. John Smith is a calendar year taxpayer who is on an accrual method. His real property taxes that apply to the fiscal year July 1, 1995, to June 30, 1996, amount to $1,200. The assessment and lien date is July 1.

If for 1995 John makes the election to ratably accrue the taxes, $600 of the taxes will accrue in 1995 and the balance will accrue in 1996.

Separate elections. An election may be made for each separate trade or business and for nonbusiness activities if accounted for separately.

The election to ratably accrue real property taxes is binding unless you get permission from the IRS to change the method of deducting real property taxes.

Any real property taxes that are normally deductible for the tax year, and that apply to periods prior to the year of the election, are deductible for the tax year in which you make the election.

Making the election. If you make your election for the first year in which real property taxes are incurred, attach a statement to your income tax return for that year. File the return by the regular due date (including extensions). The statement should indicate:

1) The trades or businesses to which the election applies, and the accounting method or methods used;

2) The period of time to which the taxes relate; and

3) The computation of the real property tax deduction for the first year of election.

If you make an election for a year that is ***not*** the first year the real property taxes are incurred, file Form 3115, *Application for Change in Accounting Method.* Generally, this form should be filed within 180 days from the beginning of the tax year for which the election is to be effective, and you may have to pay a user fee. See the instructions for Form 3115 for more information.

Changing the election. To change an election to ratably accrue real property taxes, file Form 3115, as discussed above.

Limitation on accrual of taxes. A taxing jurisdiction can require the use of an earlier date for accruing taxes than that which was previously required. However, the accrual date for federal income tax purposes is the date on which the tax would have accrued had no action been taken.

State and Local Income Taxes

State income taxes imposed on a corporation or partnership are deductible by the corporation or partnership. However, state income taxes imposed on an individual are not deductible by the individual as business expenses, but are deductible as an itemized deduction on Schedule A (Form 1040).

A state tax on gross income (as distinguished from net income) directly attributable to a trade or business carried on by an individual or a partnership is deductible as a business expense.

Accrual of additional unpaid state income taxes. If an accrual method of accounting is used and liability is contested, any increase in deductible business taxes for a previous year will accrue and be deductible in the year the amount is finally determined.

Filing a state tax return is not considered contesting a liability for additional state income taxes assessed against taxpayers for prior years. Without some objective act of protest or evidence of denial of liability by an accrual method taxpayer, any additional state taxes assessed for a prior year is deductible for the prior year rather than in the year the amount is finally determined.

However, a taxpayer who uses a consistent method of accounting to deduct additional prior year state taxes (including uncontested ones) in the year they are finally determined may continue to use that accounting method and deduct the additional taxes in the year finally determined. If that taxpayer deducts the additional taxes against income of the prior year, a credit or refund will be allowed only if the taxpayer received permission from the IRS to change the accounting method.

Other Taxes

The following are other taxes that you can deduct if they are incurred in the ordinary course of your trade or business.

Personal property tax. You can deduct any tax imposed by a state or local government on personal property used in your trade or business.

Sales tax. Sales tax you pay on a service or on the purchase or use of property is treated as part of the cost of 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 purchased is merchandise for resale, the sales tax is part of the cost of the merchandise. If the property is depreciable, the sales tax is added to the basis for depreciation. Get Publication 551 for information on the basis of property.

Do not deduct state and local sales taxes imposed on the buyer that you were required to collect and pay over to the state or local government. These taxes are not included in gross receipts or sales.

Self-employment tax deduction. You can deduct half of your self-employment tax when figuring your adjusted gross income. This is an income tax adjustment only. It does not affect your net earnings from self-employment or your self-employment tax.

To deduct the tax, enter on Form 1040, line 25, the amount shown on the ''Deduction for one-half of self-employment tax'' line of the Schedule SE.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that are used in your business are deductible. They usually are included as part of the cost of the fuel itself and are not deducted as a separate item.

Also, you may be entitled to a credit or refund for federal excise tax paid on fuels used for certain purposes. For more information, see Publication 378.

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. These payments are deductible as taxes.

Franchise taxes. Corporate franchise taxes are deductible as a business expense. If you are a cash-basis taxpayer, you deduct the franchise tax in the year paid. If you are an accrual-basis taxpayer, you take a deduction in the year you become legally liable to pay the tax regardless of the year the tax is based on. For example, if your state imposes a franchise tax for 1995 that is based on your corporate net income for 1994, you deduct the tax in 1995 if you are on an accrual basis because that is the year you became legally liable for the tax.

Excise taxes. All excise taxes you pay or incur as ordinary and necessary expenses of carrying on your trade or business can be deducted as operating expenses.

19. Other Business Expenses

Important Change for 1995

Club dues. Generally, you are not allowed any deduction for dues paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose. However, you may be able to deduct dues paid to chambers of commerce and to professional societies. See *Dues and subscriptions.*

Important Reminders for 1995

Environmental clean up costs. You may be able to deduct the costs of cleaning up and treating groundwater contaminated with hazardous waste resulting from your business operations. See *Environmental clean up costs.*

Lobbying expenses. Generally, you cannot take a deduction for lobbying expenses. See *Lobbying expenses.*

Franchise, trademark, or trade name. If any amount you pay or incur for a franchise, trademark, or trade name acquired after August 10, 1993, does not qualify to be deducted as a business expense, you may be able to deduct the amount ratably over a 15–year period. See *Franchise, trademark, trade name* later in this chapter.

Introduction

This chapter briefly covers some expenses that are not explained elsewhere in this publication. So that you may find the different types of expenses more readily, they are in alphabetical order.

You generally must capitalize or include in inventory the costs you incur to produce real or tangible personal property or to acquire property for resale, and apply the uniform capitalization rules. You must include the expenses in the basis of the property you produce or in your inventory costs. These rules do not apply to expenses incurred to acquire personal property 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 on the uniform capitalization rules, see section 1.263A of the Income Tax Regulations.

Topics

This chapter discusses:

- Bribes and kickbacks
- Lobbying expenses
- Loss recovery
- Penalties and fines
- Repayments
- Other miscellaneous expenses

Useful Items

You may want to see:

Publication

- ☐ **529** Miscellaneous Deductions
- ☐ **587** Business Use of Your Home (Including Use by Day-Care Providers)
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **Sch A (Form 1040)** Itemized Deductions
- ☐ **1099-MISC** Miscellaneous Income
- ☐ **6069** Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction

Advertising expenses. You can deduct reasonable advertising expenses if they relate to your business activities. Generally, you cannot deduct the cost of advertising to influence legislation. See *Lobbying expenses* later in this chapter.

You can usually deduct as a business expense the cost of public service advertising to keep your name before the community if it relates to the business you reasonably expect to gain in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross, to buy U.S. Saving Bonds, or to participate in similar causes is usually deductible.

Foreign expenses. You cannot deduct the cost of advertising on foreign radio and television (including cable) where the advertising is primarily for a market in the United States. However, this rule only applies to advertising expenses in countries that deny a deduction for advertising on a United States broadcast primarily for that country's market.

Anticipated liabilities. Anticipated liabilities or reserves for anticipated liabilities are not deductible. For example, assume you sold one-year TV service contracts this year totaling $50,000. From past experience, you know you will have expenses of about $15,000 in the coming year for these contracts.

You cannot deduct any of the $15,000 this year by charging expenses to a reserve or liability account. You can deduct your expenses only when you actually pay or accrue them, depending on your accounting method.

Black lung benefit trust contributions. If you, as a coal mine operator, make a contribution to a qualified black lung benefit trust, you may be able to deduct it. To be deductible, you must make your contribution during the tax year or pay it to the trust by the due date for filing your federal income tax return (including extensions). You must make the contribution in cash or in property the trust is permitted to hold.

Figure your allowable deduction for contributions to a black lung benefit trust on Schedule A of Form 6069.

Bribes and kickbacks. You cannot deduct bribes, kickbacks, or similar payments if they are either of the following:

1) Payments directly or indirectly to an official or employee of any government or an agency or instrumentality of any government in violation of the law. If the government is a foreign government, the payments are not deductible if they are unlawful under the Foreign Corrupt Practices Act of 1977.
2) Payments directly or indirectly to a person in violation of any federal or state law (but only if that state law is generally enforced) that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

Meaning of "generally enforced." A state law is considered generally enforced unless it is never enforced or enforced only for infamous persons or persons whose violations are extraordinarily flagrant. For example, a state law is generally enforced unless proper reporting of a violation of the law results in enforcement only under unusual circumstances.

Kickbacks. A kickback includes a payment for referring a client, patient, or customer. The common kickback situation occurs when money or property is given to someone as payment for influencing a third party to purchase from, use the services of, or otherwise deal with the person who pays the kickback. In many cases, the person whose business is being sought or enjoyed by the person who pays the kickback does not know of the payment.

Example 1. Mr. Green, an insurance broker, pays part of the insurance commissions he earns to car dealers who refer insurance customers to him. The car dealers are not licensed to sell insurance. If these payments are made in violation of any federal or state law, as explained in (2) above, Mr. Green cannot deduct them.

Example 2. The Yard Corporation is in the business of repairing ships. It returns 10% of the repair bills as kickbacks to the captains and chief officers of vessels it repairs. It considers kickbacks necessary to get business. The owners of the ships do not know of these payments.

In the state where the corporation operates, it is unlawful to attempt to influence the actions of any employee, private agent, or fiduciary in relation to the principal's or employer's affairs by giving or offering anything of value without the knowledge and consent of the principal or employer. The state generally enforces the law. Therefore, the kickbacks paid by the Yard Corporation are not deductible.

Medicare or Medicaid. Kickbacks, bribes, and rebates paid in Medicare or Medicaid programs are not deductible.

Form 1099–MISC. If you pay kickbacks during your tax year, whether or not they are deductible on your return, include them when figuring if you must file an information return, Form 1099–MISC. For more information about when to file Form 1099–Misc, see the separate *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Business use of your home. If you use part of your home exclusively and regularly as the principal place of business for your trade or business or as a place where you meet or deal with patients, clients, or customers in your business, you can deduct the expenses for the part of your home used for business. Also, you may be allowed to deduct expenses for use of part of your home as a day-care facility or as a place to store inventory you sell in your business, even if that part of your home is sometimes used for personal purposes. For more information, see Publication 587.

Charitable contributions. Cash payments to charitable, religious, educational, scientific, or similar organizations may be deductible as business expenses if the payments are not charitable contributions or gifts. If the payments are charitable contributions or gifts, you cannot deduct them as business expenses. However, corporations can deduct charitable contributions on their income tax returns. See *Charitable Contributions* in chapter 29. If you are an individual, a partner, or a shareholder in an S corporation, you may be able to deduct charitable contributions made by your business on your individual income tax return.

Example. You paid $15 to a church for a half-page ad in a program for a concert it is sponsoring. Since your payment is not a contribution, you cannot deduct it as such. However, you can deduct it as an advertising expense.

Inventory. You can take a charitable contribution deduction for inventory items donated to a qualified charitable organization. Your deduction is limited to the fair market value of the property on the date of the contribution less any gain you would have realized if you had sold the property at its fair market value. You must remove from opening inventory for the year you make the contribution any costs for the donated property included from prior years. These costs are not part of the cost of goods sold for determining gross income for the year of the contribution. Use them in figuring the basis of the donated property. However, you can include (as part of the cost of goods sold) these costs in the year of the contribution if you treat them as part of the cost of goods sold under your accounting method. Do not use these costs to increase the basis of the donated property.

Demolition expenses or losses. You cannot deduct either any amount paid or incurred to demolish any structure or any loss for the undepreciated basis of a structure. Add these costs to the basis of the land where the demolished structure was located.

Dues and subscriptions. Generally, you cannot deduct amounts you you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes business, social, athletic, luncheon, sporting, airline, and hotel clubs.

Exception. Unless one of its main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities, the following organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose:

1) Boards of trade,
2) Business leagues,
3) Chambers of commerce,
4) Civic or public service organizations,
5) Professional organizations such as bar associations and medical associations,
6) Real estate boards, and
7) Trade associations.

You can deduct as a business expense subscriptions to professional, technical, and trade journals that deal with your business field.

Donations to other organizations. You can deduct donations to other business organizations as business expenses if they relate directly to your trade or business, and you reasonably expect a financial return in line with your donation. For example, a contribution you make to a committee organized by the Chamber of Commerce to bring a national convention to your city may be deductible.

Education expenses. You can deduct two kinds of expenses for education. One is the ordinary and necessary expenses you pay for the education and training of your employees. These expenses are discussed in chapter 9.

The other is for amounts you spend for your own education in your trade, business, or profession, along with certain related travel expenses. For a deduction, you must be able to show that the education maintains or improves skills required in your trade, business, or profession, or it is required by law or regulations for keeping your pay, status, or job.

You ***cannot*** deduct education expenses you incur to meet the minimum requirements of your present trade, business, or profession or those that qualify you for a new trade, business, or profession, even if the education maintains or improves skills presently required in your business.

Environmental clean up costs. You can deduct certain costs to clean up land and to treat groundwater that you contaminated with hazardous waste from your business operations. You can deduct the costs you incur to restore your land and groundwater to the same physical condition that existed prior to contamination. You cannot deduct costs currently for the construction of groundwater treatment facilities. You must capitalize those costs and you can recover them through depreciation deductions.

Franchise, trademark, trade name. A franchise includes an agreement that gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area.

If you buy a franchise, trademark, or trade name under a contract entered into after October 2, 1989, you can deduct the amount you pay or incur as a business expense only if the payments are part of a series of payments that are:

1) Contingent on the productivity, use, or disposition of the item,
2) Payable at least annually for the entire term of the transfer agreement, and
3) Substantially equal in amount (or payable under a fixed formula).

Contracts entered into before October 3, 1989. For contracts to buy a franchise, trademark, or trade name entered into before October 3, 1989, you can deduct payments contingent on productivity, use, or disposition. Items (2) and (3) above do not apply.

Property acquired before August 11, 1993. For a transfer not treated as a sale or exchange of a capital asset, you can deduct a lump-sum payment of an agreed upon principal amount ratably over the shorter of 10 years or the life of the agreement. However, for transfers after October 2, 1989, this 10-year period does not apply if the principal sum is over $100,000.

For a transfer not treated as a sale or exchange of a capital asset, you can deduct, in the year made, a payment that is one of a series of approximately equal payments payable over:

- The period of the transfer agreement, or
- A period of more than 10 years, regardless of the life of the agreement.

Charge any payment not deductible because of these rules to a capital account. However, you can deduct the payments charged to a capital account over the life of the asset if you can determine the useful life of the asset. Otherwise, you can amortize the payment over a 25-year period beginning with the tax year the transfer occurs.

Property acquired after August 10, 1993. Any amounts you pay or incur for the transfer (after August 10, 1993) of a franchise, trademark, or trade name, (if the payments are not described in (1) through (3) above) must be charged to a capital account. See chapter 13 for more information on how to recover these costs.

You can also elect to apply this same treatment to any franchise, trademark, or trade name acquired after July 25, 1991. This election is binding and cannot be revoked without consent from the IRS.

Renewals. The term of the transfer agreement includes all renewal options, and any other period the parties reasonably expect the agreement to be renewed.

Recapture. You must recapture the payments as ordinary income if you transfer, sell, or otherwise dispose of a franchise, trademark, or trade name for which payments were deducted as:

1) A lump-sum or serial payment of a principal amount not treated as a sale or exchange of an asset, or
2) An amortized payment deducted over 25 years.

For more information on the amortization of intangibles, see chapter 13.

Interview expense allowances. Reimbursements you make to job candidates for transportation or other expenses related to interviews are not wages. They are not subject to social security and Medicare taxes (FICA), federal unemployment taxes (FUTA), or income tax withholding. You can deduct the allowance as a business expense.

Legal and professional fees. Legal and professional fees, such as fees charged by accountants that are ordinary and necessary expenses of operating your business and directly related to your business are deductible as business expenses. However, you usually cannot deduct legal fees you pay to acquire business assets. Add them to the basis of the property.

If the fees include payments for work of a personal nature (such as making a will), you can take a business deduction only for the part of the fee directly related to your business. The personal portion of legal fees for producing or collecting taxable income, doing or keeping your job, or for tax advice may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529.

Tax preparation fees. You can deduct as a trade or business expense on Schedule C (Form 1040) the cost of preparing that part of your tax return relating to your business as a sole proprietor. You can deduct the remaining cost on Schedule A (Form 1040) if you itemize your deductions.

You can also take a deduction on Schedule C for the amount you pay or incur in resolving asserted tax deficiencies for your business as a sole proprietor.

Licenses and regulatory fees. Licenses and regulatory fees for your trade or business paid each year to state or local governments are deductible.

Lobbying expenses. Generally, you cannot take a deduction for lobbying expenses. This includes amounts paid or incurred for:

- Influencing legislation,
- Participating, or intervening, in any political campaign for, or against, any candidate for public office,
- Attempting to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
- Communicating directly with covered executive branch officials in any attempt to influence the official actions or positions of such officials.

Lobbying expenses you cannot deduct also include amounts paid or incurred for research, preparation, planning, or coordination of any activity described in the preceding list.

Covered executive branch official. A covered executive branch official in the last item of the preceding list includes:

1) The President,
2) The Vice President,
3) Any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in the Executive Office,
4) Any individual 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, and
   c) Is an immediate deputy of an individual listed in items (a) or (b).

Exceptions to denial of deduction. The general denial of the deduction does not apply to:

1) Expenses for attempting to influence the legislation of any local council or similar governing body ***(local legislation).*** An Indian tribal government is treated as a local council or similar governing body.
2) Any in-house expenses for influencing legislation or communicating directly with a covered executive branch official if such expenses for the tax year do not exceed $2,000 (excluding overhead expenses).
3) Expenses incurred by taxpayers engaged in the trade or business of lobbying ***(professional lobbyists)*** on behalf of another person (but does apply to payments by the other person to the lobbyist for lobbying activities).

Disallowance of charitable deduction. You cannot take a charitable deduction for amounts paid to an organization described in IRC 170(c) if that organization conducts lobbying activities on matters of direct financial interest to your business and if the principal purpose of your contribution is to avoid Federal income tax.

If a tax-exempt organization provides you with a notice on the portion of dues that are allocable to nondeductible lobbying and political expenses, you cannot deduct that portion of the dues.

Losses recovered. If you are compensated during the tax year for unrecovered losses, you may be able to take a special deduction. The deduction applies only to damages included in gross income and recovered from patent infringement, breach of contract or fiduciary duty, or antitrust injury. The deduction is the smaller of:

1) The amount you received or accrued for damages in the tax year reduced by the amount you paid or incurred in the year to recover that amount, or
2) Your losses from the injury you have not deducted.

The deduction applies only to amounts recovered for actual injury, not any additional amount.

Medical expenses. If you are disabled, you can deduct expenses necessary for you to be able to work (impairment-related expenses) as business expenses, rather than as medical expenses. You are disabled if you have:

1) A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed.
2) A physical or mental impairment that substantially limits one or more of your major life activities.

You can deduct the expenses as business expenses if:

1) Your work clearly requires the expenses for you to perform the work satisfactorily,
2) The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities, and
3) Their treatment is not otherwise specified by other tax law provisions.

Moving machinery. The cost of moving your machinery from one city to another is a deductible expense. So is the cost of moving machinery from one plant to another, or from one part of your plant to another part. You can also 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. You can deduct the costs of outplacement services you provide to your employees to help them find new employment (such as career counseling, resumé assistance, skills assessment, etc.).

The costs of outplacement services may cover more than one deduction category. For example, deduct as a utilities expense the cost of telephone calls made under this service, and deduct as rental expense the cost of renting machinery and equipment for this service.

Penalties and fines. Penalties you pay for late performance or nonperformance of a contract are generally deductible. For instance, if you contracted to construct a building by a certain date and had to pay an amount for each day the building was not finished after that date, you can deduct the amounts paid or incurred.

On the other hand, you cannot deduct penalties or fines you pay to any government agency or instrumentality because of a violation of any law. These fines or penalties include amounts:

1) Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.
2) Paid as a penalty imposed by federal, state, or local law in a civil action, including certain additions to tax and assessable penalties imposed by the Internal Revenue Code.
3) Paid in settlement of actual or possible liability for fine or penalty, whether civil or criminal.
4) Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Examples of nondeductible penalties and fines include:

1) Fines for violating city housing codes.
2) Fines paid by truckers for violating state maximum highway weight laws or air quality laws.
3) Civil penalties for violating federal laws regarding mining safety standards and discharges into navigable waters.

A fine or penalty does not include:

1) Legal fees and related expenses to defend yourself in a prosecution or civil action for a violation of the law imposing the fine or civil penalty.
2) Court costs or stenographic and printing charges.
3) Compensatory damages paid to a government.

Nonconformance penalty. You can deduct a nonconformance penalty assessed by the Environmental Protection Agency for failing to meet certain emission standards.

Political contributions. You cannot deduct contributions or gifts to political parties or candidates as business expenses. In addition, you cannot deduct expenses you pay or incur to take part in any political campaign of a candidate for public office.

Indirect political contributions. You also cannot deduct indirect political contributions and costs of taking part in political activities as business expenses. Examples of nondeductible expenses include:

1) Advertising in a convention program of a political party, or in any other publication if any of the proceeds from the publication are for, or intended for, the use of a political party or candidate.
2) Admission to a dinner or program (including, but not limited to, galas, dances, film presentations, parties, and sporting events) if any of the proceeds from the function are for, or intended for, the use of a political party or candidate.
3) Admission to an inaugural ball, gala, parade, concert, or similar event if identified with a political party or candidate.

Repairs. The cost of repairing or improving property used in your trade or business is either a deductible or capital expense. You can deduct expenses to keep your property in a normal and efficient operating condition. But you must capitalize expenses that add to the value of your property or significantly increase its life. Although you cannot deduct capital expenses as current expenses, you can usually deduct them over a period of time as depreciation. See chapter 4.

Repairs neither add to the value or usefulness of property nor appreciably lengthen its life. They merely maintain the property in a normal efficient operating condition. The cost of repairs includes the cost of labor, supplies, and certain other items. You ***cannot*** deduct the value of your own labor.

Examples of repairs include:

1) Patching and repairing floors.
2) Repainting the inside and outside of a building.
3) Repairing roofs and gutters.
4) Mending plumbing leaks.

You cannot deduct the cost of repairs that you added to the ***cost of goods sold,*** discussed in chapter 7, as a separate business expense.

Improvements a lessee makes on rented property are discussed in chapter 11.

Repayments (claim of right). If you included an amount in income because you thought you had an unrestricted right to it, and in a later year you have to repay all or part of it, a special rule may apply. Usually, you can deduct the repayment in the year in which you make it. If the income item gave rise to a deduction in the year you included it in income, any deduction for the repayment is limited to the net amount you included in income in the earlier year.

The character of the deduction in the year of repayment depends on the character of the income included in the earlier year. For instance, if you repay an amount previously reported as a long-term capital gain, the repayment is a long-term capital loss.

Example. You use the cash method of accounting. In 1994, you were involved in a lawsuit resulting from a contract dispute with Doe Corporation. The dispute was over the amount owed to you. The court decided in your favor for $2,000. Although Doe Corporation said it would appeal the judgment, it was ordered by the court to pay you immediately without restriction. As promised, Doe Corporation appealed the case and won. The appellate court reversed the lower court's judgment in June 1995. In 1995, you repaid the $2,000 you received in 1994.

You included the $2,000 in your income for 1994 because you had an unrestricted right to it. No deduction resulted from including it in income. In 1995 you can deduct the $2,000 repayment.

Repayment over $3,000. If the amount you repaid is more than $3,000, your tax is the lesser of:

1) Your tax for this year figured with a deduction for the repayment, or
2) Your tax for this year:
   a) Figured without deducting the repayment, and
   b) Reduced by the amount your tax for the earlier year increased because you included the repayment in income.

If your tax is the amount figured under (2), you cannot deduct the amount repaid in figuring a net operating loss for this year. However, take the amount into account in figuring the decrease in tax for the earlier tax year.

This discussion does not apply if your deduction results from any of the following:

1) Sales of inventory items to customers in the ordinary course of your trade or business.
2) Sales returns and allowances and similar items.
3) Bad debts.
4) Legal and other expenses of contesting the repayment.

Accounting for repayments. If you use the cash method of accounting, you can claim the deduction only in the year the income item is repaid. If you included the amount in income because of the rule of constructive receipt, but never received it, you can deduct the amount in the tax year you must give up your right to receive it. If you use any other accounting method, you can deduct the repayment only in the proper tax year under that accounting method.

Supplies and materials. 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 three of the following requirements are met:

1) You do not keep a record of when they are used,
2) You do not take an inventory of the amount on hand at the beginning and end of the tax year, and
3) This method does not distort your income.

You can also deduct the cost of books, professional instruments, equipment, etc., if you normally use them up in less than a year.

Utilities. Your business expenses for heat, lights, power, and telephone are deductible. However, any part due to personal use is not deductible.

Telephone. If you have an office in your home, even though you are in business, you cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home.

Cellular telephone. Any cellular telephone or similar telecommunications equipment placed in service in tax years beginning after 1989 is listed property. If listed property is not used more than 50% for qualified business use during any tax year, the section 179 deduction is not allowed and the depreciation deductions are limited. See *Predominant Use Test* in chapter 4 of Publication 946.

20. Net Income or Loss

Introduction

After figuring your business income and expenses, you are ready to figure the net income or net loss from your business. You do this by subtracting business expenses from business income. If your expenses are less than your income, the difference is net income. If your expenses are more than your income, the difference is a net loss.

If you have more than one business, you must figure your net income or loss for each business separately.

Sole proprietorship. If you are a sole proprietor, figure the net income or loss from your business on Schedule C (Form 1040). You may be able to use Schedule C–EZ (Form 1040) if you have net income and the other requirements listed on Schedule C–EZ are met. If your business has net income, it generally becomes part of your gross income on Form 1040. If your business has a net loss, it generally can be deducted from other income when figuring your gross income on Form 1040. For more information on sole proprietorships, see chapter 27.

Partnership. A partnership figures its net income or loss on Form 1065. The partnership then allocates its net income or loss among its partners. If the partnership has net income, each partner's share is added into the partner's gross income on the appropriate forms for the partner, depending on whether the partner is an individual, a corporation, or other entity. If the partnership has a net loss, each partner's share is deducted when figuring the partner's gross income. For more information on partnerships, see chapter 28.

Corporation. A corporation figures its net income or loss on Form 1120 or Form 1120–A. The corporation itself must pay tax on its earnings. It figures its taxable income from its net income or loss for the year. For more information on corporations, see chapter 29.

S corporation. An S corporation figures its net income or loss on Form 1120S. It then allocates its net income or loss among its shareholders. If the corporation has net income, each shareholder's share becomes part of his or her gross income on Form 1040. If the corporation has a net loss, each shareholder's share is deducted when figuring gross income on Form 1040. For more information on S corporations, see chapter 30.

Topics

This chapter discusses:

- At-risk limits
- Passive activity limits
- Not-for-profit activities
- Net operating losses (NOLs)
- How to figure an NOL
- When to use an NOL
- How to claim an NOL deduction
- How to figure an NOL carryover
- NOL of a corporation

Useful Items

You may want to see:

Publication

- ☐ **529** Miscellaneous Deductions
- ☐ **535** Business Expenses
- ☐ **536** Net Operating Losses
- ☐ **542** Tax Information on Corporations
- ☐ **547** Nonbusiness Disasters, Casualties, and Thefts
- ☐ **925** Passive Activity and At-Risk Rules
- ☐ **936** Home Mortgage Interest Deduction

Form (and Instructions)

- ☐ **Schedule A (Form 1040)** Itemized Deductions
- ☐ **Schedule C (Form 1040)** Profit or Loss From Business
- ☐ **Schedule C–EZ (Form 1040)** Net Profit From Business
- ☐ **1040X** Amended U.S. Individual Income Tax Return
- ☐ **1045** Application for Tentative Refund
- ☐ **1120X** Amended U.S. Corporation Income Tax Return
- ☐ **1138** Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback
- ☐ **1139** Corporation Application for Tentative Refund
- ☐ **5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit

At-Risk Limits

The at-risk rules limit your losses from most business or income-producing activities to your loss or amount at risk, whichever is less. Any loss that is not allowed in a tax year because of the at-risk limits is treated as a deduction for the activity in the next tax year, where it may again be subject to these rules. The rules apply to individuals and to certain closely held corporations (other than S corporations). These rules must be applied before the passive activity rules discussed later.

Amount at risk. You are considered at risk in an activity to the extent of your cash and the adjusted basis of other property you contribute to the activity. Your amount at risk also includes your share of partnership net income that you do not withdraw and certain amounts borrowed for use in that activity.

You are at risk for amounts borrowed to use in the activity if you are personally liable for repayment or if the amounts borrowed are secured by property other than property used in the activity. However, you are not considered at risk if you borrowed the money from a person having an interest in the activity (other than as a creditor) or from someone related to such a lender. You are also not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or similar arrangements.

For more information, see Publication 925.

Passive Activity Limits

Before you use the passive activity rules, apply the at-risk rules discussed earlier. In general, you are allowed to deduct passive activity losses only from passive activity income. The excess is carried forward to the following year or years until used, or until you dispose of your entire interest in the activity in a fully taxable transaction. Credits are similarly limited. The rules apply to individuals, personal service corporations, and closely held corporations.

Passive activities. There are two kinds of passive activities—trade or business activities in which you do not materially participate during the tax year, and rental activities. A rental activity is a passive activity even if you materially participated in that activity unless you qualify for a special rule for personal services performed in a real property trade or business.

For more information, see Publication 925.

Not-for-Profit Activities

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

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

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

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

Limit on Deductions and Losses

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

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. 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). Casualty losses are deductible as personal casualty losses to the extent each loss exceeds $100. Total personal casualty losses (the part over $100 each) are deductible in full to the extent of personal casualty gains and any remaining loss is deductible if it exceeds 10% of your adjusted gross income. See Publication 547.

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

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

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) for it under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in category (1) belong in this category. Where more than one asset is involved, divide depreciation and these other deductions proportionally among those assets. For an example using the above three categories in figuring the limit on deductions and losses, see chapter 1 in Publication 535.

Additional limit. 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.

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

More than one activity. A single business or investment activity may consist of more than one undertaking, if the undertakings are similar or serve the same business purpose and are organizationally connected, or different undertakings may be considered different activities.

All facts and circumstances must be taken into account in determining your activity or activities. The most significant facts and circumstances in making this determination are:

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

The IRS will generally accept your characterization of several undertakings as one activity, or more than one activity, if 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 and losses separately for each activity that is not-for-profit.

Presumption of Profit

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

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

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

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

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

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

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

Net Operating Losses (NOLs)

The remainder of this chapter discusses NOLs for individuals and corporations. It explains how to figure an NOL, when to use it, how to claim an NOL deduction, and how to figure an NOL carryover.

If your deductions for the year are more than your income for the year, you may have a net operating loss (NOL). You can use an NOL by deducting it from your income in another year or years.

To have an NOL, your loss must be caused by:

1) Deductions from a trade or business,
2) Deductions from your work as an employee, or

3) Deductions for casualty and theft losses.

A loss from operating a business is the most common reason for an NOL.

Partnerships and S corporations generally cannot use an NOL. But partners or shareholders can use their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

NOL Steps

Figure and use your NOL in the following steps:

Step 1. Complete your tax return for the year. You may have an NOL if a negative figure appears on the line below:

Individuals — line 35 of Form 1040.

Corporations — line 30 of Form 1120 or line 26 of Form 1120–A.

If the amount on that line is ***not*** a negative figure, ***stop here —*** you do not have an NOL.

Step 2. Determine whether your have an NOL and its amount. See *How To Figure an NOL,* later. If you do not have an NOL, ***stop here.***

Step 3. Decide whether to carry the NOL back to a past year or to forgo any carryback and instead carry the NOL forward to a future year. See *When To Use an NOL,* later.

Step 4. Deduct the NOL in the carryback or carryforward year. See *How To Claim an NOL Deduction,* later. If your NOL deduction is equal to or smaller than your taxable income without the deduction, ***stop here —*** you have used up your NOL.

Step 5. Determine the amount of your unused NOL. See *How To Figure an NOL Carryover,* later. Carry over the unused NOL to the next carryback or carryforward year and begin again at Step 4.

Note. If your NOL deduction includes more than one NOL amount, apply Step 5 separately to each NOL amount, starting with the earliest.

How To Figure an NOL

If your deductions for the year are more than your income for the year, you have a potential NOL.

There are rules that limit what you can deduct when figuring an NOL. In general, these rules do not allow:

1) Exemptions,
2) Net capital losses,
3) Nonbusiness losses, or
4) Nonbusiness deductions.

Schedule A (Form 1045). You can use Schedule A (Form 1045) to figure an NOL for an individual.

First, complete lines 1–3 of Schedule A, using amounts from your return. If line 3 is a negative amount, you have a net loss and a potential NOL.

Next, complete the rest of Schedule A to figure your NOL. Adjust the amount on line 3 for deductions that are allowed when figuring your taxable income but not when figuring an NOL. The following discussions explain these adjustments.

Adjustment for exemptions (line 4). You cannot deduct your personal exemption or exemptions for dependents. Your adjustment is the total amount you deducted.

Adjustment for nonbusiness deductions (line 12). You can deduct your nonbusiness deductions (line 9) only up to the total of:

1) Your nonbusiness capital gains that are more than your nonbusiness capital losses (line 8), and
2) Your nonbusiness income (line 10).

Your adjustment is your nonbusiness deductions that are more than the total of (1) and (2).

Nonbusiness deductions (line 9). Enter on line 9 as your nonbusiness deductions only those that are unrelated to your trade or business or your employment. For example, enter your deductions for alimony, self-employed health insurance, contributions to an IRA or other retirement plan, medical expenses, and charitable contributions. If you do not itemize deductions, include your standard deduction.

Do ***not*** include your deductions for personal casualty and theft losses or for one-half of self-employment tax. Treat these as business deductions.

Also do not include your deductions for expenses that are ordinary and necessary in carrying on your trade or business or your employment, your deduction for your share of a business loss from a partnership or S corporation, or the following related deductions for:

Moving expenses,

State income tax on business profits,

Interest and litigation expenses on state and federal income taxes related to your business income,

Payments by a federal employee to buy back sick leave used in an earlier year,

Loss on property you rent out,

Loss on the sale or exchange of business real estate or depreciable business property,

Loss on the sale of accounts receivable (if you use an accrual method of accounting),

Loss on the sale or exchange of stock in a small business corporation or a small business investment company, if treated as ordinary loss, and

Unrecovered investment in a pension or annuity claimed on a decedent's final return.

Nonbusiness income (line 10). Enter on line 10 as your nonbusiness income only income that is unrelated to your trade or business or your employment. For example, enter your annuity income, dividends, and interest from investments. Also include your share of nonbusiness income from partnerships and S corporations.

Do ***not*** include the income you receive from your trade or business or your employment. This includes salaries and wages, self-employment income, and your share of business income from partnerships and S corporations. Also, do not include rental income or ordinary gain from the sale or other disposition of business real estate or depreciable business property.

Adjustment for capital losses (line 22). You can deduct your nonbusiness capital losses (line 5) only up to the amount of your nonbusiness capital gains (line 6). If your nonbusiness capital losses are more than your nonbusiness capital gains, you cannot deduct the excess.

You can deduct your business capital losses (line 14) only up to the total of:

1) Your nonbusiness capital gains that are more than the total of your nonbusiness capital losses and excess nonbusiness deductions (line 13), and
2) Your business capital gains (line 15).

Your adjustment is your nondeductible capital losses (line 18) that are more than the nondeductible net capital loss on your return (line 21). (You had a nondeductible net capital loss if your net capital loss was more than your capital loss deduction.)

Adjustment for NOL deduction (line 23). You cannot deduct any NOL carryovers or carrybacks from other years. Your adjustment is the total amount of your NOL deduction for losses from other years.

Schedule A (Form 1045)

The following example illustrates how to figure an NOL. See Publication 536 for filled-in pages 1 and 2 of Form 1040 and Schedule A (Form 1045) for this example.

Example. In 1995, Glenn Johnson started a retail record business. For 1995, he is single and has the following income and deductions on his Form 1040.

INCOME	
Wages from part-time job	$ 1,225
Interest on savings	425
Net long-term capital gain on sale of real estate used in business	2,000
Glenn's total income	$ 3,650

DEDUCTIONS	
Net loss from business (sales of $67,000 minus expenses of $72,000)	$ 5,000
Net short-term capital loss on sale of stock	1,000
Loss on small business stock	700
Loss on small business investment company stock	300
Standard deduction	3,900
Personal exemption	2,500
Glenn's total deductions	$13,400

Glenn's deductions exceed his income by $9,750 ($13,400 – $3,650). However, to figure whether he has an NOL, he must modify certain deductions. He can use Schedule A (Form 1045) to figure his NOL.

Glenn cannot deduct the following:

Personal exemption	$2,500
The excess of his nonbusiness deductions (standard deduction, $3,900) over his nonbusiness income (interest, $425)	3,475
Nonbusiness net short-term capital loss	1,000
Total adjustments to net loss	$6,975

When these items are eliminated, Glenn's net loss is reduced to $2,775 ($9,750 – $6,975). This amount is his NOL for 1995.

When To Use an NOL

Generally, you carry back an NOL to the 3 tax years before the NOL year (the carryback years), and then carry forward any NOL remaining for up to 15 years after the NOL year (the carryforward years). However, see *Forgoing the carryback period,* later. The ''NOL year'' is the year in which the NOL occurred. You cannot deduct any part of the NOL remaining after the 15-year carryforward period.

You must first carry the entire NOL to the earliest carryback year. If your NOL is not used up, you can carry the remainder to the next earliest carryback year, and so on.

If you do not use up the NOL in the 3 carryback years, carry forward what remains of it to the 15 tax years following the NOL year. Start by carrying it to the first tax year after the NOL year. If you do not use it up, carry over the unused part to the next year. Continue to carry over any unused part of the NOL until you complete the 15-year carryforward period.

Example. You started your business in 1995 and had a $42,000 NOL for the year. You begin using your NOL in 1992, the third year before the NOL year, as shown in the following chart.

Year	Carryback or Carryover	Unused Loss
1992	$42,000	$40,000
1993	40,000	37,000
1994	37,000	31,500
1995 (NOL year)		
1996	31,500	22,500
1997	22,500	12,700
1998	12,700	4,000
1999	4,000	–0–

If your loss were larger, you could carry it forward until the year 2010. If you still had an unused 1995 carryforward after the year 2010, you could not deduct it.

Forgoing the carryback period. You can choose not to carry back your NOL. If you make this choice, you use your NOL only in the 15-year carryforward period. To make this choice, attach a statement to your tax return for the NOL year. This statement must show that you are choosing to forgo the carryback period under section 172(b)(3) of the Internal Revenue Code.

You must file this statement by the due date, including extensions, for filing your return for the NOL year. If you do not file it on time, you cannot forgo the carryback period. Once you make this choice, you cannot change it. If you want to forgo the carryback period for more than one NOL, you must make a separate choice for each NOL year.

How To Claim an NOL Deduction

If you have not already carried the NOL to an earlier year, your NOL deduction is the total amount of the NOL. If you carried the NOL to an earlier year, your NOL deduction is the amount of the NOL minus the amount you used in the earlier year or years.

If you carry more than one NOL to the same year, your NOL deduction is the total of these carrybacks and carryovers.

NOL more than taxable income. If your NOL is more than the taxable income of the year you carry it to (figured before deducting the NOL), your income tax for that year is zero. You generally will have an NOL carryover to the next year. See *How To Figure an NOL Carryover,* later, to determine how much NOL you have used and how much you carry to the next year.

Deducting a Carryback

If you carry back your NOL, you can use either Form 1045 or Form 1040X. You can get your refund faster by using Form 1045, but you have a shorter time to file it. A Form 1045 can be used to apply an NOL to all three carryback years. If you use Form 1040X, a separate Form 1040X is required for each carryback year to which the NOL is applied.

Form 1045. You can apply for a quick refund by filing Form 1045. This form results in a tentative adjustment of tax in the carryback year. See Publication 536 for an example that illustrates how to use Form 1045 to claim an NOL deduction in a carryback year. The example includes a filled-in page 1 of Form 1045.

If the IRS refunds or credits an amount to you on the basis of Form 1045 and later determines that the refund or credit is too much, the IRS may assess and collect the excess immediately.

You must file Form 1045 on or after the date you file the return for the NOL year, but not later than one year after the NOL year. For example, if you are a calendar year taxpayer with a carryback from 1995 to 1992, you must file Form 1045 on or after the date you file your tax return for 1995, but no later than December 31, 1996.

The IRS will ordinarily act on Form 1045 within 90 days from the day you file it.

Form 1040X. If you do not file Form 1045, you can file Form 1040X to get a refund of tax because of an NOL carryback. File Form 1040X within 3 years after the due date, including extensions, for filing the return for the NOL year. For example, if you are a calendar year taxpayer and filed your 1992 return by the April 15, 1993, due date, you must file a claim for refund of 1989 tax because of an NOL carryback from 1992 by April 15, 1996.

Attach a computation of your NOL using Schedule A (Form 1045) and, if applicable, your NOL carryover using Schedule B (Form 1045), discussed later.

Refiguring your tax. To refigure your total tax liability for a carryback year, first refigure your adjusted gross income for that year. (On Form 1045, use lines 10 through 12, column (b), (d), or (f).) Use your adjusted gross income after applying the NOL deduction to refigure income or deduction items that are based on, or limited to, a percentage of your adjusted gross income. These are:

1) The special allowance for passive activity losses from rental real estate activities,
2) Taxable social security and tier 1 railroad retirement benefits,
3) IRA deductions, and
4) Excludable savings bond interest.

If more than one of these items apply, refigure them in the order listed above, using your adjusted gross income after applying the NOL deduction and any previous item. (On line 10 of Form 1045, column (b), (d), or (f), enter your adjusted gross income after applying the above refigured items, but without the NOL deduction. Enter your NOL deduction on line 11.)

Next, refigure your taxable income. (On Form 1045, use lines 13 through 16, column (b), (d), or (f).) Use your refigured adjusted gross income (line 12 of Form 1045, column (b), (d), or (f)) to refigure certain deductions and other items that are based on, or limited to, a percentage of your adjusted gross income. These are:

1) The itemized deduction for medical expenses,
2) The itemized deduction for casualty losses,
3) Certain miscellaneous itemized deductions,
4) The overall limitation on itemized deductions, and
5) The phaseout of the deduction for exemptions.

Do not refigure the itemized deduction for charitable contributions.

Finally, use your refigured taxable income (line 16 of Form 1045, column (b), (d), or (f)) to refigure your total tax liability. (On Form 1045, use lines 17 through 26, column (b), (d), or (f).) Refigure your income tax, your alternative minimum tax, and any credits that are based on, or limited to, the amount of tax. Do not refigure self-employment tax.

Deducting a Carryforward

If you carry forward your NOL to a tax year after the NOL year, list your NOL deduction as a negative figure on the ''Other income'' line of Form 1040 (line 21 for 1995).

You must attach a statement that shows all the important facts about the NOL. Your statement should include a computation showing how you figured the NOL deduction. If you deduct more than one NOL in the same year, your statement must cover each of them.

Change in Marital Status

If you and your spouse were not married to each other in all years involved in figuring NOL carrybacks and carryovers, only the spouse who had the loss can take the NOL deduction. If you file a joint return, the NOL deduction is limited to the income of that spouse.

For example, if your marital status changes because of death or divorce, and in a later year you have an NOL, you can carry back that loss only to the part of the income reported on a joint return (filed with your former spouse) that was ***your*** taxable income. After you deduct the NOL in the carryback year, the joint rates apply to the resulting taxable income.

For more information on changes in marital or filing status, see Publication 536.

How To Figure an NOL Carryover

If your NOL is more than your taxable income for the year to which you carry it (figured before deducting the NOL), you may have an NOL carryover. You must make certain modifications to your taxable income to determine how much NOL you will use up in that year and how much you can carry over to the next tax year. Your carryover is the excess of your NOL deduction over your modified taxable income for the carryback or carryforward year. If your NOL deduction includes more than one NOL, apply the NOLs against your modified taxable income in the same order in which you incurred them, starting with the earliest.

Modified taxable income. Your modified taxable income is your taxable income figured with the following changes.

1) You cannot claim an NOL deduction for the NOL whose carryover you are figuring or for any later NOL.
2) You cannot claim a deduction for a net capital loss.
3) You cannot claim your exemptions for yourself or dependents.
4) You must figure any item affected by the amount of your adjusted gross income after making the changes in (1) and (2), above, and certain other changes to your adjusted gross income that result from (1) and (2). This includes income and deduction items used to figure adjusted gross income (for example, IRA deductions), as well as certain itemized deductions. To figure a charitable contribution deduction, the change in (1) is treated as including an NOL deduction for a carryback of an earlier NOL.

Your taxable income as modified cannot be less than zero.

Schedule B (Form 1045). You can use Schedule B (Form 1045) to figure your modified taxable income for carryback years and your carryover from each of those years. Do ***not*** use Schedule B for a carryforward year. See Publication 536 for an example that illustrates how to figure an NOL carryover from a carryback year. The example includes a filled-in Schedule B (Form 1045).

NOL carryover from 1995 to 1996. If you had an NOL deduction that reduced your taxable income on your 1995 return to zero, see Publication 536 for a worksheet that will help you figure the amount of your NOL to carry to 1996.

Corporations

A corporation generally figures and deducts an NOL the same way an individual does. The same carryback and carryforward periods apply, and the same sequence applies when it carries two or more NOLs to the same year. See *When To Use an NOL* and *How To Figure an NOL Carryover,* earlier.

A corporation's NOL generally differs from an individual's in two ways:

1) A corporation can take different deductions when figuring an NOL, and
2) A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried to the next year.

A corporation also uses different forms when claiming an NOL deduction than those used by individuals.

The following discussions explain these differences.

How a Corporation Figures an NOL

A corporation figures an NOL in the same way as its taxable income. It starts with the corporation's gross income and subtracts its deductions. If its deductions are more than its gross income, the corporation has an NOL.

However, there are rules for figuring the NOL that either limit what it can deduct, or permit deductions not ordinarily allowed. These rules are:

1) A corporation cannot deduct any NOL carrybacks or carryovers from other years,
2) A corporation can take the deduction for dividends received, explained later, without limiting it to a percentage of its taxable income, and
3) A corporation can figure the deduction for dividends paid on certain preferred stock of public utilities without limiting it to its taxable income for the year.

Dividends-received deduction. The amount of a corporation's deduction for dividends received from domestic corporations (70% or 80% of the dividends) is generally limited to 70% or 80% of its taxable income. However, if a corporation sustains an NOL for a tax year, the limit on this deduction based on taxable income does not apply. In determining if a corporation has an NOL, the corporation figures the dividends-received deduction without regard to the 70% or 80% of taxable income limit.

See Publication 542 for more information on the dividends-received deduction.

Example. A corporation had $500,000 gross income from business operations and $625,000 of allowable business expenses. It also received $150,000 in dividends from a domestic corporation for which it can take an 80% deduction, ordinarily limited to 80% of its taxable income before the deduction. It figures its NOL as follows:

Income from business	$ 500,000
Dividends	150,000
Gross income	$ 650,000
Deductions (expenses)	(625,000)
Taxable income before special deductions	$ 25,000
Minus: Deduction for dividends received, 80% of $150,000	(120,000)
Net operating loss	($ 95,000)

How a Corporation Claims an NOL Deduction

The form a corporation uses to deduct its NOL depends on whether it carries the NOL back or forward.

For a carryback. If a corporation carries back the NOL, it can use either Form 1120X or Form 1139. A corporation can get a refund faster by using ***Form 1139.*** It cannot file Form 1139 before filing the return for the corporation's NOL year, but it must file Form 1139 no later than one year after the NOL year.

If the corporation does not file Form 1139, it must file Form 1120X within 3 years of the due date, plus extensions, for filing the return for the year in which it has the NOL.

For a carryforward. If a corporation carries forward its NOL, it enters the carryover on Schedule K (Form 1120), line 15. It also enters the deduction for the carryover (but not more than the corporation's taxable income after special deductions) on line 29(a) of Form 1120 or line 25(a) of Form 1120–A.

Carryback expected. If a corporation expects to have an NOL in its current year, it may automatically extend the time for payment of all or part of its income tax for the immediately preceding year. It does this by filing Form 1138. It must explain on the form why it expects the loss.

The extension applies to previously determined unpaid tax required to be paid after filing Form 1138. This amount cannot exceed the tax overpayment in the carryback years due to the NOL carryback.

Period of extension. The extension is in effect until the end of the month in which the return for the NOL year is due, including extensions.

If the corporation files Form 1139 before this date, the extension will continue until the date the IRS notifies the corporation that its Form 1139 is disallowed in whole or in part.

How a Corporation Figures an NOL Carryover

If the NOL available for a carryback or carryforward year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry to the next tax year. Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

Modified taxable income. A corporation figures its modified taxable income in the same way as its taxable income. But it can deduct NOLs only from years before the NOL year whose carryover is being figured. The corporation must figure its deduction for charitable contributions without considering any NOL carrybacks.

Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the next year. It is not used to fill out the corporation's tax return or figure its tax.

Ownership change. A loss corporation that has an ownership change is limited on the amount of taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

See section 382 of the Internal Revenue Code and the related regulations for more information about the limits on corporate NOL carryovers and corporate ownership changes.

Worksheet for figuring a corporation's carryover. See Publication 536 for a worksheet that a corporation can use to figure how much of its NOL is used up in a carryback or carryforward year and how much to carry over to the next year.

Part Five.

Disposing of Business Assets

This Part discusses reporting sales and other dispositions of assets. If you sell a business asset, exchange it for another asset, or dispose of it in some other way, you may have to report a gain or a loss. Gains and losses may be capital or ordinary. If capital, they may be long-term or short-term. However, some kinds of exchanges result in nontaxable gains and nondeductible losses.

The rules for reporting sales and other dispositions of business assets are important in planning future transactions. Several options may be open to you, each producing different tax results.

21. Sales and Exchanges

Introduction

This chapter describes the kinds of transactions that are treated as sales or exchanges and explains how to figure gain or loss.

A ***sale*** is a transfer of property for money or for a mortgage, note, or other promise to pay money. An ***exchange*** is a transfer of property for other property or services. The rules for figuring a taxable gain or a deductible loss apply to both sales and exchanges.

Topics

This chapter discusses:

- Gain or loss from sales and exchanges
- Foreclosures and repossessions
- Nontaxable exchanges

Useful Items

You may want to see:

Publication

- ☐ **504** Divorced or Separated Individuals
- ☐ **544** Sales and Other Dispositions of Assets

Form (and Instructions)

- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **4797** Sales of Business Property
- ☐ **8824** Like-Kind Exchanges

Transactions Treated as Sales or Exchanges

The following discussions describe the kinds of transactions that are treated as sales or exchanges.

Copyrights. Amounts you receive for granting the exclusive use or right to exploit a copyright throughout its life in a particular medium are treated as received from the sale of property. It does not matter if the payment is a fixed amount or a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or an amount based on the number of copies sold, performances given, or exhibitions made. Nor does it matter if it is paid over the same period as that covering the grantee's use of the copyrighted work.

If the property was used in your trade or business and you held it for more than 1 year, the gain or loss is a section 1231 gain or loss. For more information, see *Section 1231 Property* in chapter 23.

Sale or lease. Some agreements that seem to be leases may really be conditional sales contracts. The intention of the parties to the agreement can help you distinguish between a sale or lease.

There is no test or group of tests to prove what the parties intended when they made the agreement. You should consider each agreement based on its own facts and circumstances. For more information on leases, see *Lease or purchase* in chapter 11.

Cancellation of a lease. Payments received by a tenant for the cancellation of a lease are treated as an amount realized from the sale of property. Payments received by a landlord (lessor) for the cancellation of a lease are ordinary income.

Easements. Granting or selling an easement is usually not a sale of property. Instead, the amount received for the easement is subtracted from the basis of the property. If only a part of the entire tract of property is permanently affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received.

Any amount received that is more than the basis to be reduced is a taxable gain. The transaction is reported as a sale of property.

For more information, see chapter 1 in Publication 544.

A transfer of property to satisfy debt. A transfer of property to satisfy a debt is an exchange.

Extended note maturity date. The extension of a note's maturity date is not treated as an exchange of an outstanding note for a new and different note. Nor is it a closed and completed transaction upon which a gain or a loss is figured. This treatment will not apply when changes in the term of the note are so significant as to amount virtually to the issuance of a new security. Also, each case must be determined by its own facts.

Involuntary conversion. An involuntary conversion is the destruction, theft, condemnation, or disposal under the threat of condemnation of your property if you receive other property or money in payment, such as insurance or a condemnation award. See chapter 25 for more information.

Contributions to a partnership. If you contribute property to a partnership and within a short period you receive a distribution of property from that partnership, the transaction may be treated as a sale or exchange on which a gain or loss is recognized. For more information, see chapter 28.

Trade secrets (technical ''know-how''). A transfer of a trade secret is a sale or exchange if the transfer includes all substantial rights to the trade secret. The substantial rights that must be transferred are the right to use the trade secret in perpetuity or until it becomes public knowledge and no longer protectable under laws of the country where the transferee operates, and the exclusive right to prevent further disclosure.

Gain or Loss From Sales and Exchanges

A ***gain*** is the excess of the amount you realize from a sale or exchange over the adjusted basis of the property you transfer. A ***loss*** is the excess of the adjusted basis of the property over the amount you realize.

Basis. Your cost or purchase price of property is usually its basis for figuring gain or loss from its sale or other disposition. However, if you got the property by gift, inheritance, or in some way other than buying it, you must use a basis other than its cost.

Table 21-1. **How to Figure a Gain or Loss**

If:	Then:
Adjusted basis is more than amount realized	You have a loss
Amount realized is more than adjusted basis	You have a gain

Adjusted basis. The adjusted basis of your property is your original cost or other basis plus certain additions, and minus certain deductions such as depreciation and casualty losses.

Chapter 5 discusses basis of assets. In determining gain or loss, the cost of transferring property to a new owner, such as selling expenses, is added to your adjusted basis.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the ***fair market value*** of all property or services you receive. The amount you realize also includes any of your liabilities that were assumed by the buyer and liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

If the liabilities relate to an exchange of multiple properties, see *Exchanges of Multiple Properties,* later.

Fair market value. This is the price at which the property would change hands between a willing buyer and a willing seller when both have reasonable knowledge of all the necessary facts and neither has to buy or sell. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of fair market value (FMV). If there is a stated price for services, this price is treated as their FMV, unless there is contrary evidence.

Example. In your business, you used a building that cost you $70,000. You made certain permanent improvements at a cost of $20,000 and deducted depreciation totaling $10,000. You sold the building for $100,000, plus property having a fair market value of $20,000. The buyer assumed your real estate taxes of $3,000 and a mortgage of $17,000 on the building. The selling expenses were $4,000. Your gain on the sale is figured as follows:

Amount realized:		
Cash	$100,000	
FMV of property received	20,000	
Real estate taxes (assumed by buyer)	3,000	
Mortgage (assumed by buyer)	17,000	
Amount realized		$140,000
Adjusted basis:		
Cost of building	$ 70,000	
Improvements	20,000	
Total	$ 90,000	
Less: Depreciation	10,000	
Adjusted basis	$ 80,000	
Plus: Selling expenses	4,000	84,000
Gain on sale		$ 56,000

Amount recognized. Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses are deductible from gross income. However, there are exceptions to this rule discussed later under *Nontaxable Exchanges.* Also, a loss from the disposition of property held for personal use is not deductible.

Foreclosures and Repossessions

If the borrower (buyer) does not make payments due on a loan secured by property, the lender (mortgagee or creditor) may foreclose on the mortgage or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which the borrower may realize gain or loss (discussed next). This is true even if the property is voluntarily returned to the lender.

Gain or loss on foreclosure or repossession. The borrower's gain or loss from the foreclosure or repossession described previously is generally figured and reported in the same way as gain or loss from sales or exchanges. The gain or loss is the difference between the borrower's adjusted basis of the transferred property and the amount realized. See *Gain or Loss From Sales and Exchanges,* earlier.

For more information about foreclosures and repossessions, see chapter 1 in Publication 544.

Nontaxable Exchanges

Certain exchanges are not taxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even if you realize a gain or loss on the exchange, it will not be recognized until you sell or otherwise dispose of the property you receive.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must:

1) Involve qualifying property, and

2) Involve like property.

These two requirements are discussed later. If the like-kind exchange includes the receipt of money or unlike property, you may have a taxable gain. (See *Partially Nontaxable Exchange,* later.)

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up. See *Deferred Exchanges,* later.

Multiple-party transactions. The like-kind exchange rules also apply to property exchanges that involve ***three- and four-party transactions.*** Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all of the conditions described in this section.

Receipt of title from third party. If you receive property in a like-kind exchange and the other party who transfers the property to you does not give you the title but a third party does, you may still treat this transaction as a like-kind exchange, if it meets all the requirements.

Basis of property received. If you acquire property in a like-kind exchange, the basis of that property is the same as the basis of the property you transferred.

Money paid. If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Example. Bill Smith trades an old cab for a new one. The new cab costs $10,800. He is allowed $2,000 for the old cab, and pays $8,800 cash. He has no taxable gain or deductible loss on the transaction, regardless of the adjusted basis of his old cab. If Bill sold the old cab to a third party for $2,000 and purchased a new one, he would have a recognized gain or loss on the sale of his old cab equal to the difference between the amount realized and the adjusted basis of the old cab.

Sale and purchase. If you sell property and buy similar property in two mutually dependent transactions, you may be required to treat the sale and purchase as a single nontaxable exchange.

Example. You used your car in your business for 2 years. Its adjusted basis is $3,500 and its trade-in value is $4,500. You are interested in a new car that costs $10,500. Ordinarily, you would trade your old car for the new one and pay the dealer $6,000. Your basis for depreciation of the new car will then be $9,500 ($6,000 plus $3,500 basis for the old car).

Because you want your new car to have a larger basis for depreciation, you arrange to sell your old car to the dealer for $4,500. You then buy the new one for $10,500 from the same dealer. However, you are treated as having exchanged your old car for the new one because the sale and purchase are reciprocal and mutually dependent. Your basis for depreciation for the new car is $9,500, the same as if you traded the old car.

Reporting the exchange. Report the exchange of like-kind property on **Form 8824.** The instructions for the form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

If you have any taxable gain because you received money or unlike property, report it on Schedule D (Form 1040) or Form 4797, whichever applies. You may also have to report ordinary income because of depreciation on Form 4797. See *Like-Kind Exchanges and Involuntary Conversions* in chapter 23.

Qualifying Property

The property must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither may be property used for personal purposes, such as your home or family car.

The property must not be property you primarily hold for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for investment or property held for productive use in your trade or business. Machinery, buildings, land, trucks, and rented houses are examples of property that may qualify. Inventories, raw materials, accounts receivable, other current assets, and real estate that dealers hold for sale to customers are examples of property that do not qualify.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether you have engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange. However, see *Exchanges of Multiple Properties,* later.

These rules for like-kind exchanges do not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of debt or interest, or the exchange of partnership interests. However, you may have a nontaxable exchange under another provision, discussed later in this chapter.

Like Property

There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. For example, the trade of an apartment house for a store building that you rent out, or a panel truck for a pickup truck, is a like-kind exchange. An exchange of personal property for real property does not qualify as a like-kind exchange.

Real property. An exchange of city property for farm property, or improved property for unimproved property is a like-kind exchange. The exchange of real estate you own for a real estate lease that runs 30 years or more is a like-kind exchange. However, not all exchanges of interests in real property qualify. For example, the exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

The exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange if the nature and character of the two property interests are the same.

Special rule for foreign real property exchanges. Real property located in the United States and real property located outside the United States are not considered like-kind property under the like-kind exchange rules. If you exchange foreign real property for property located in the United States, any gain on the exchange is taxable. Foreign real property is real property not located in a state or the District of Columbia.

The foreign real property exchange rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like kind under the rules for replacing condemned property to postpone gain on the condemnation. See *Postponement of Gain,* under *Involuntary Conversions,* in chapter 1 of Publication 544.

Personal property. Depreciable tangible personal property can be either ''like kind'' or ''like class'' to qualify for nonrecognition treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class. ***General Asset Classes*** describe the types of property frequently used in many businesses. For more information, see chapter 1 in Publication 544.

Deferred Exchanges

A deferred exchange is one in which you transfer property you use in business or hold for investment and, at a later time, you receive like-kind property you will use in business or hold for investment. (The property you receive is ***replacement property.***) The transaction must be an exchange (that is, property for property) rather than a transfer of property for money that is used to purchase replacement property. The exchange must also meet the identification and receipt requirements (explained next).

For more information, see *Deferred Exchanges* in chapter 1 of Publication 544.

Identification requirement. The property must meet the identification requirement. The property to be received must be identified by the date that is 45 days after the date you transfer the property given in the exchange. Any property received by that day is considered to have been identified. The identification requirement may be met by designating the property to be received in the contract between the parties. See *Identifying replacement property.*

If you transfer more than one property (as part of the same transaction) and the properties are transferred on different dates, the identification period and the receipt period (discussed later) begin on the earliest date of the transfers.

Identifying replacement property. You must identify the replacement property in a signed written document and deliver it to the other person involved in the exchange. You must clearly describe the replacement property in the written document. For example, use the legal description or street address for real property and the make, model, and year for a car. In the same manner, you can revoke an identification of replacement property at any time before the end of the identification period.

For more information on identifying replacement property, including alternative and multiple properties, see *Deferred Exchanges* in chapter 1 of Publication 544.

Receipt requirement. The exchange must meet the receipt transaction requirement. The property must be received by the earlier of:

- The 180th day after the date on which you transfer the property given up in the exchange, or
- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

You must receive substantially the same property that met the identification requirement.

Like-Kind Exchanges Between Related Parties

Special rules apply to like-kind exchanges made between related parties. These rules affect both direct and indirect exchanges. Under these rules, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The 2-year holding period begins on the date of the last transfer of property which was part of the like-kind exchange. The gain or loss on the original exchange must be recognized as of the date of that later disposition.

Related parties. Under these rules, related parties include, for example, you and a member of your family (spouse, brother, sister, parent, child, etc.), you and a corporation in which you have more than 50% ownership, and two partnerships in which you directly or indirectly own more than 50% of the capital interest or profits.

For more information on related parties, see *Nondeductible Loss* under *Sales and Exchanges Between Related Parties* in chapter 2 of Publication 544.

Exceptions to the related party rules. The following kinds of property dispositions are excluded from the related party rules:

1) Dispositions due to the death of either related person,
2) Involuntary conversions, or
3) Dispositions if it is established to the satisfaction of the IRS that neither the exchange nor the disposition had as a main purpose the avoidance of federal income tax.

For more information, see *Like-Kind Exchanges Between Related Parties* under *Nontaxable Exchanges* in chapter 1 of Publication 544.

Partially Nontaxable Exchange

If, in addition to like property, you receive money or unlike property in a like-kind exchange, you have a partially nontaxable exchange. You are taxed on the gain you realize, but only to the extent of the money and the fair market value of the unlike property you receive.

To figure the amount of taxable gain, first determine the fair market value of any unlike property you receive and add it to the amount of any money you receive. The total is the maximum amount of gain that can be taxed. Next, figure the amount of gain on the whole exchange, as discussed earlier under *Gain or Loss From Sales and Exchanges.* Your taxable gain is the lesser of these two amounts. A loss is never deductible in a nontaxable exchange, even if you receive unlike property or cash.

Example. You exchange real estate held for investment, having an adjusted basis of $8,000, for other real estate that you want to hold for investment. The real estate you receive has a fair market value of $10,000. You also receive $1,000 in cash. You paid $500 in exchange expenses. Although the total gain realized on the transaction is $2,500, only $500 ($1,000 cash received minus the $500 exchange expenses) is recognized (included in your income).

Assumption of liabilities. If the other party to a nontaxable exchange assumes any of your liabilities, or you transfer property subject to a liability, you will be treated as if you received cash in the amount of the liability.

Example. The facts are the same as in the preceding example, except the property you give up is subject to a $3,000 mortgage, figure the gain realized and the amount of gain to be taxed as follows:

FMV of like property received	$10,000
Cash	1,000
Mortgage assumed on property given up	3,000
Total consideration received	$14,000
Less: Exchange expenses	(500)
Amount realized	$13,500
Less: Adjusted basis of property you transferred	(8,000)
Realized gain	$ 5,500

The realized gain is taxed only up to $3,500, the sum of the cash received ($1,000 − $500 exchange expenses) and the mortgage ($3,000).

Unlike property given up. If, in addition to like property, you give up unlike property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is equal to the difference between the fair market value of the unlike property and its adjusted basis.

Example. You exchange stock and real estate that you held for investment for real estate that you also intend to hold for investment. The stock you transfer has a fair market value of $1,000 and an adjusted basis of $4,000. The real estate you exchange has a fair market value of $19,000 and an adjusted basis of $15,000. The real estate you receive has a fair market value of $20,000. You do not have a taxable gain on the exchange of the real estate because it qualifies as a nontaxable exchange. However, you must recognize (report on your tax return) a $3,000 loss on the stock because the stock is unlike property.

Exchanges of Multiple Properties

Under the like-kind exchange rules, you must generally make a property-by-property comparison to figure your recognized gain and the basis of the property you receive in the exchange. However, for exchanges of multiple properties, you do not make a property-by-property comparison if you:

Transfer and receive properties in two or more exchange groups, or

Transfer or receive more than one property within a single exchange group.

In this situation, you figure your recognized gain and the basis of the property you receive by comparing the properties within each exchange group. Each exchange group consists of properties transferred and received in the exchange that are of like kind or like class. See *Like Property,* earlier.

For more information, see *Multiple Property Exchanges* in chapter 1 of Publication 544.

Other Nontaxable Exchanges

The following discussions are of other exchanges that may be nontaxable.

Transfers Between Spouses

No gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. This rule does not apply if the recipient-spouse is a nonresident alien. Nor does it apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed and the liabilities on the property.

For more information, see *Property Settlements* in Publication 504.

Corporate Stock

In certain cases, exchanges of corporate stock are nontaxable. The rules for these exchanges follow.

A corporation's own stock. A corporation may dispose of its own stock, including treasury stock, without having a taxable gain or loss.

Stock for stock of the same corporation. You may exchange common stock for common stock in the same corporation, or preferred stock for preferred stock in the same corporation, without having a taxable gain or loss.

Convertible stocks and bonds. If you convert corporate bonds into stock of the same corporation, or preferred stock into common stock of the same corporation, you will not have a taxable gain or loss. The conversion must be made according to the terms of the bond or preferred stock certificate.

Property for stock. If you transfer property to a corporation in exchange for stock or securities in that corporation, and immediately afterwards you are in control of the corporation, the exchange is usually not taxable. This rule applies both to individual investors and to groups of investors who transfer property to a corporation. It does not apply if the corporation is an investment company.

Control of a corporation. To be in control of the corporation, you or your group of investors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

Example. You and Bill Jones transfer property having a basis of $100,000 to a corporation for stock having a fair market value of $300,000. This represents only 75% of each class of stock of that corporation. The other 25% was already issued to someone else. You and Bill recognize a taxable gain of $200,000 on the transaction.

Services rendered. The term ***property*** does not include services rendered or to be rendered to the issuing corporation. Stock received for services is income to the recipient.

Example. You transfer property worth $35,000 and render services valued at $3,000 to a corporation in exchange for stock valued at $38,000. Right after the exchange you own 85% of the outstanding stock. No gain is included in income on the exchange of property. However, you recognize ordinary income of $3,000 as payment for services you rendered.

Property of relatively small value. The term ***property*** does not include property of relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor, if the main purpose of the transfer is to qualify for the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if its fair market value is at least 10% of the fair market value of the stock and securities already owned or to be received for services by the transferor.

Stock received in disproportion to property transferred. If a group of investors exchange property for corporate stock, each investor does not have to receive stock in proportion to his or her interest in the property transferred. If a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock were first received in proportion and then some of it used to make gifts, pay compensation for services, or satisfy the transferor's obligations.

Money or other property. If, in an otherwise nontaxable exchange of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. You are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring gain in this situation generally follow those for a partially nontaxable exchange, discussed earlier under *Like-Kind Exchanges.* If the property you give up includes depreciable property, the taxable gain may have to be reported as ordinary income because of depreciation. See chapter 23. No loss is recognized.

Liabilities. If the corporation assumes your liabilities, or the property is taken subject to a liability, the transfer is not generally treated as if you received money or other property. There are two exceptions to this treatment.

1) If the liabilities the corporation assumes are more than your adjusted basis in the property you exchange, gain is recognized up to the amount of the excess.

   However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.

2) If there is no good business reason for the corporation to assume your liabilities, or if your main purpose in the exchange is to avoid federal income tax, the assumption is treated as if you received money in the amount of the liabilities.

Example. You transfer property to a corporation for stock. You also receive $10,000 in the exchange. Your adjusted basis in the transferred property is $20,000. The stock you receive has a fair market value (FMV) of $16,000. The corporation also assumes a $5,000 mortgage on the property. The gain realized is as follows:

FMV of stock received	$16,000
Cash received	10,000
Liability assumed by corporation	5,000
Total received	$31,000
Less: Adjusted basis of property transferred	20,000
Realized gain	$11,000

The recognized gain is limited to $10,000, the amount of the cash received.

22.

Gains and Losses: Capital or Ordinary

Important Change for 1995

Caution: At the time this publication was being prepared for print, Congress was considering tax law changes to capital gains and losses that would affect your 1995 tax return and 1996 estimated taxes.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronicallly through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Important Reminder

Investing in small business stock. Beginning in 1998, investments in certain small business stock held more than 5 years will qualify for a special tax benefit. If you sell or exchange the stock at a gain, only one-half of the gain will be subject to federal income tax. For information on qualifying stock, see chapter 4 of Publication 550, *Investment Income and Expenses.*

Introduction

You must distinguish gains and losses as ordinary or capital gains or losses (and capital gains or losses as either short-term or long-term gains or losses). These distinctions need to be made to arrive at your net capital gain or loss.

For individuals, a net capital gain may be taxed at a lower tax rate than ordinary income. Your deduction for a net capital loss may be limited. See *Figuring Capital Gains and Losses* later.

Capital gain or loss. Generally, you will have a capital gain or loss if you sell or exchange a capital asset. You may also have a capital gain if you sell or exchange section 1231 property.

Section 1231 property. Generally, this is property held more than 1 year and either used in a trade or business or held for the production of rents or royalties. Section 1231 property also includes any property (including a capital asset used in a trade or business) that is subject to an involuntary conversion. A net gain on the sale of section 1231 property is a capital gain unless the gain is subject to the recapture rule. A net loss on the sale of section 1231 property is an ordinary loss. For more information, see *Section 1231 Property,* in chapter 23.

Sale of a business. If you sell a business that you operate as a ***sole proprietorship,*** see chapter 27. If you sell your interest in a ***partnership,*** see chapter 28. If you sell your interest in a ***corporation,*** see Publication 550.

Topics

This chapter discusses:

- Capital assets
- Noncapital assets
- Sales and exchanges between related parties
- Hedging
- Other Dispositions
- Losses on small business stock (section 1244)
- Figuring capital gains and losses
- Maximum tax rate on capital gains

Useful Items

You may want to see:

Publication

- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses
- ☐ **551** Basis of Assets

Form (and Instructions)

- ☐ **Sch D (Form 1040)** Capital Gains and Losses
- ☐ **4797** Sales of Business Property

Capital Assets

For the most part, everything you own and use for personal purposes or investment is a capital asset. For exceptions to capital assets, see *Noncapital Assets,* next.

Some ***examples of capital assets*** are:

- Stocks and bonds;
- A home owned and occupied by you and your family;
- Timber grown on your home property or investment property, even if casual sales of the timber are made;
- Household furnishings;
- A car used for pleasure or commuting;
- Coin or stamp collections;
- Gems and jewelry; and
- Gold, silver, or any other metal.

Personal use property. Property held for personal use is a capital asset. ***Gain*** from a sale or exchange of a capital asset is a capital gain. A ***loss*** from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty or theft.

Noncapital Assets

This discussion lists and illustrates the six exceptions to capital assets. They are:

1) Property held mainly for sale to customers or property that will physically become part of merchandise for sale to customers,
2) Accounts or notes receivable acquired in the ordinary course of your trade or business, or for services rendered as an employee, or from the sale of any properties described in (1),
3) Depreciable property used in your trade or business (even if fully depreciated),
4) Real property used in your trade or business,
5) A copyright, literary, musical, or artistic composition, a letter or memorandum, or similar property—
   a) Created by your personal efforts, or
   b) Prepared or produced for you (in the case of a letter, memorandum, or similar property), or
   c) Acquired from a person who created the property or for whom the property was prepared, under circumstances (for example, by gift) entitling you to the basis of the person who created the property, or for whom it was prepared or produced, and
6) U.S. Government publications that you got from the government for free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who got the publications for free or for less than normal sales price.

Property held mainly for sale to customers. If you hold property mainly for sale to customers, it is noncapital asset. Whether property is held mainly for sale to customers is a question of fact to be judged in each case. Among the factors to be considered are:

1) The purpose for which the property is acquired,
2) The development of the property between the time it was acquired and sold,
3) The number and frequency of sales, and
4) The time the property is held before it is sold.

Example. You manufacture and sell steel cable, which you deliver on returnable reels that are depreciable property. Customers make deposits on the reels, which you refund if the reels are returned in a year. If they are not returned, you keep each deposit as the agreed-upon sales price. Most reels are returned within the one-year period. You keep adequate records showing depreciation and other charges to the capitalized cost of the reels. Under these conditions, the reels are not property held for sale to customers in the ordinary course of your business. Any gain or loss resulting from their not being returned may be capital or ordinary, depending on your section 1231 transactions.

Letters and memorandums. Letters, memorandums, and similar property (such as drafts of speeches, recordings, transcripts, manuscripts, drawings, or photographs) are not treated as capital assets if your personal efforts created them or they were prepared or produced for you. Nor is this property a capital asset if your basis in it is determined by reference to the person who created it or the person for whom it was prepared. For this purpose, letters and memorandums addressed to you are considered prepared for you. If letters or memorandums are prepared by persons under your administrative control, they are considered prepared for you whether or not you review them.

Sales and Exchanges Between Related Parties

If a gain is recognized on the sale or exchange of property, including a leasehold or a patent application, that is depreciable pro perty in the hands of the party who receives it, the gain may be ordinary income. The gain is ordinary income if the transaction is either directly or indirectly between:

1) A person and the person's controlled entity or entities (discussed below),
2) A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary, unless the beneficiary's interest in the trust is a remote contingent interest; that is, the value of the interest computed actuarially is 5% or less of the value of the trust property, or
3) An employer (and any person related to the employer under rules (1) and (2)) and a welfare benefit fund (within the meaning of section 419(e) of the Internal Revenue Code) that is controlled directly or indirectly by the employer (and any person related to the employer).

A person's controlled entity is:

1) A corporation in which ***more than 50%*** of the value of all outstanding stock, or a partnership in which ***more than 50%*** of the capital interest or profits interest, is owned, directly or indirectly, by or for that person.
2) An entity whose relationship with that person is one of the following:
   a) 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 interest or profits interest in the partnership.
   b) Two corporations that are members of the same controlled group as defined in section 1563(a) of the Internal Revenue Code, except that "more than 50%" is substituted for "at least 80%" in that definition.
   c) Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
   d) Two corporations, one of which is an S corporation, if the same person owns more than 50% in value of the outstanding stock of each corporation.

Controlled partnership transactions. For special rules that apply to sales and exchanges of property between certain persons and partnerships, see in chapter 28.

Determining control. For purposes of the above rules, use the following discussion to determine if you control an entity.

1) Stock or a partnership interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries. (However, for a partnership interest owned by or for a C corporation, this applies only to shareholders who own, directly or indirectly, 5% or more in value of the stock of the corporation.)
2) An individual is treated as owning the stock or a partnership interest owned, directly or indirectly, by or for the individual's family, including only brothers and sisters (either whole or half), spouse, ancestors, and lineal descendants.
3) Stock or a partnership interest ***constructively owned*** by a person under rule (1), for applying rules (1) and (2), is treated as actually owned by that person. But stock or a partnership interest constructively owned by an individual under rule (2) will not be treated as owned by the individual for applying rule (2) to make another person the constructive owner of that stock or partnership interest.

Nondeductible Loss

No deduction is allowable for losses from sales or exchanges of property (other than corporate liquidations) directly or indirectly between the related taxpayers listed under *Related persons* in chapter 3.

Property received from a related party. If, in a purchase or exchange, you received property from a related party who had a loss that was not allowable and you later sell or exchange the property at a gain, you recognize the gain only to the extent that it is more than the loss not allowed to the related party. This rule applies only if you are the original transferee.

Example. Your brother sold stock to you for $7,600. His cost basis was $10,000. His loss of $2,400 was not deductible. You later sell the same stock to an unrelated party for $10,500, realizing a gain of $2,900 ($10,500 − $7,600). Your recognized gain is only $500, the excess gain over the $2,400 loss not allowed to your brother.

Hedging (Commodity Futures)

A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price. The holder of an option on a futures contract has the right (but not the obligation) for a specified period of time to enter into a futures contract to buy or sell at a particular price. A forward contract is generally similar to a futures contract except that the terms are not standardized and the contract is not exchange traded.

Businesses may enter into commodity futures contracts or forward contracts and may acquire options on commodity futures contracts as either:

- Transactions that are entered in the normal course of business primarily to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings, ordinary property, or ordinary obligations (hedging transactions). (Ordinary property or obligations are those that cannot produce capital gain or loss under any circumstances.)
- Transactions that are not hedging transactions.

Futures transactions that are not hedging transactions generally result in capital gain or loss. There is a limit on the amount of capital losses you can deduct each year.

The termination of a contract that is part of a hedge produces ordinary gain or loss. For instance, ordinary gain or loss results from offset or exercise of a futures contract that protects against price changes in a business' inventory. On the other hand, contracts that protect against price changes of noninventory supplies give rise to capital gain or loss. However, if a business sells only a negligible amount of noninventory supply, a transaction to hedge the purchase of that supply is treated as a hedging transaction if it occurred after July 17, 1994. Ordinary gain or loss treatment is also available for certain hedges of the purchase of noninventory supplies that occurred in a tax year that ended before July 18, 1994, and that, as of September 1, 1994, were still open for assessment of tax. See Regulation section 1.1221-2(g)(3) for details.

If you have numerous transactions in the commodity futures market during the year, you must show which transactions are hedging transactions. Clearly identify a hedging transaction on your books and records before the end of the day you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and nonhedging transactions.

The identification must not only be on, and retained as part of, your books and records but must specify both the hedging transaction and the item, items, or aggregate risk that is being hedged. The identification of the hedged item, items, or risk must be made no more than 35 days after entering into the hedging transaction. These rules apply to hedging transactions entered into after 1993, or hedging transactions entered into before 1994 and remaining in existence on March 31, 1994. For exceptions, see Regulation section 1.1221-2(g).

For more information, see chapter 4 in Publication 550.

Other Dispositions

This section discusses some special rules for determining the treatment of gain or loss from various dispositions of property.

Abandonments

Loss from abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. The loss is the amount of the property's adjusted basis when abandoned. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed in chapter 21 under *Foreclosures and Repossessions.* The abandonment loss is taken in the tax year in which the loss is sustained. You may not deduct any loss from abandonment of your personal residence or other property held for personal use.

For more information about abandonments, see chapter 2 in Publication 544.

Dispositions of Intangible Property

Intangible property is any personal property that has value but cannot be seen or touched. It includes such items as patents, copyrights, and the goodwill value of a business.

Gain or loss on the sale or exchange of amortizable or depreciable intangible property held more than 1 year (other than an amount recaptured as ordinary income) is a section 1231 gain or loss. The treatment of section 1231 gain or loss and the recapture of amortization and depreciation as ordinary income are explained in chapter 23. See chapter 13 for information on amortizable intangible property, and chapter 12 for information on depreciable intangible property. Gain or loss on dispositions of other intangible property is ordinary or capital gain or loss depending on whether the property is a capital asset or a noncapital asset.

The following discussions explain special rules that apply to certain dispositions of intangible property.

Section 197 Intangibles

Section 197 intangibles are certain intangibles acquired after August 10, 1993 (after July 25, 1991, if elected), and held in connection with the conduct of a trade or business or an activity entered into for profit, whose costs are amortized over 15 years. Section 197 intangibles are listed in chapter 13 under *Amortization of Certain Intangibles.*

The following special rules apply to dispositions of section 197 intangibles.

Covenant not to compete. A covenant not to compete (or similar arrangement) that is a section 197 intangible cannot be treated as disposed of or worthless before you have disposed of your entire interest in the trade or business for which the covenant was entered into. Members of the same controlled group of corporations and commonly controlled businesses are treated as a single entity in determining whether a member has disposed of its entire interest in a trade or business.

Nondeductible loss. You cannot deduct a loss from the disposition or worthlessness of a section 197 intangible that you acquired in the same transaction (or series of related transactions) as another section 197 intangible you still hold. Instead, you must increase the adjusted basis of your retained section 197 intangible by the amount of nondeductible loss. If you retain more than one section 197 intangible, increase each intangible's adju sted basis. Figure the increase by an amount figured by multiplying the nondeductible loss amount by a fraction, the numerator of which is the intangible's adjusted basis on the date of the loss and the denominator of which is the total adjusted basis of all retained intangibles on the date of the loss.

In applying this rule, members of the same controlled group of corporations and commonly controlled businesses are treated as a single entity. For example, a corporation cannot deduct a loss on the sale of a section 197 intangible if, after the sale, a member of the same controlled group retains other section 197 intangibles that were acquired in the same transaction as the intangible sold.

Patents

Under a special rule, the transfer of a patent by an individual is treated as a sale or exchange of a capital asset held more than one year. This applies even if the payments for the patent are made periodically during the transferee's use or are contingent on the productivity, use, or disposition of the patent. For information on the treatment of capital assets held for more than one year, see *Figuring Capital Gains and Losses* later.

This treatment applies to your transfer of a patent if you meet all of the following conditions:

1) You are the holder of the patent.
2) You transfer the patent other than by gift, inheritance, or devise.
3) You transfer all substantial rights to the patent or an undivided interest in all such rights.
4) You do not transfer the patent to a related person.

Holder. You are the holder of a patent if you are either:

The individual whose effort created the patent property and who qualifies as the original and first inventor or joint inventor, or

The individual who purchased an interest in the patent from the inventor before the invention was tested and operated successfully under operating conditions, and who is neither related to, nor the employer of, the inventor.

Substantial rights. All substantial rights to patent property are all rights that are of value when they are transferred. A security interest (such as a lien), or a reservation calling for forfeiture for nonperformance, is not treated as a substantial right for these rules and may be kept by you as the holder of the patent.

In the following transfers of patent rights, all substantial rights are not transferred, and the holder is not entitled to the special tax treatment:

1) The rights are limited geographically within a country. (But a transfer of rights that are limited to one or more whole countries could be a transfer of all substantial rights.)
2) The rights are limited to a period less than the remaining life of the patent.
3) The rights are limited to fields of use within trades or industries and are less than all the rights that exist and have value at the time of the transfer.
4) The rights are less than all the claims or inventions covered by the patent that exist and have value at the time of the transfer.

Related persons. The special tax treatment does not apply if the transfer is either directly or indirectly between you and a related person as defined under *Related persons,* in chapter 3, with the following changes:

1) Members of your family include your spouse, ancestors, and lineal descendants, but not your brothers, sisters, half-brothers, or half-sisters.

2) Substitute ''25% or more'' ownership for ''more than 50%'' in that listing.

If you fit within the definition of a related person independent of family status, the brother-sister exception in (1), above, does not apply. Thus, a transfer between a brother and a sister (as beneficiary and fiduciary of a trust) is a transfer between related parties. The brother-sister exception does not apply because the trust relationship is independent of the family status.

Contract for Services

A contract for services is not a capital asset. If you assign or sell such a contract, and the assignee or purchaser is only entitled to compensation for services under the terms of the contract for its remaining life, the amount you receive is ordinary income.

Franchise, Trademark, or Trade Name

If you transfer or renew a franchise, trademark, or trade name for a price that is contingent on its productivity, use, or disposition, the amount you receive is generally treated as an amount realized from the sale of a noncapital asset. A franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities within a specified area.

If you keep any significant power, right, or continuing interest in the subject matter of a franchise, trademark, or trade name that you transfer or renew, the amount you receive is ordinary royalty income, rather than an amount realized from a sale or exchange.

Significant power. Significant power, right, or continuing interest in a franchise, trademark, or trade name includes, but is not limited to, the following rights in the transferred interest:

1) A right to disapprove any assignment of the interest, or any part of it.
2) A right to end the agreement at will.
3) A right to set standards of quality for products used or sold, or for services provided, and for the equipment and facilities used to promote such products or services.
4) A right to make the recipient sell or advertise only your products or services.
5) A right to make the recipient buy most supplies and equipment from you.
6) The right to get payments based on the productivity, use, or disposition of the transferred item of interest if such payments are a substantial part of the transfer agreement.

Precious Metals and Stones, Stamps, and Coins

These items are capital assets except when they are held for sale by a dealer. Any gain or loss on their sale or trade generally is a capital gain or loss. If you are a dealer, the sale is ordinary income reportable on Schedule C (Form 1040).

Timber

Standing timber you held as investment property is a capital asset. Gain or loss from its sale is capital gain or loss reported on Schedule D (Form 1040). If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on the sale is ordinary income or loss reported on the gross receipts/sales and cost of goods sold lines of your return. Special rules apply, however, if you owned the timber more than 1 year and you choose to either:

1) Treat timber cutting as a sale or exchange, or
2) Enter into a cutting contract.

Under these rules, discussed below, disposition of the timber is treated as a sale or exchange of section 1231 property. Gain or loss is reported on Form 4797. Depletion on timber is discussed under *Timber* in chapter 13.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old when severed from their roots and sold for ornamental purposes, are included in the term ''timber.'' They qualify for both rules, discussed next.

Timber cutting treated as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until a sale or exchange occurs that gain or loss is realized. But if you owned or had a contractual right to cut timber, you may choose to treat the cutting of timber as a sale or exchange in the year it is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary income or loss. See *Example,* later.

Qualifying for treatment under this rule. For your timber to qualify for this treatment, you must:

1) Own, or hold a contractual right to cut, the timber for a period of more than 1 year before it is cut,
2) Cut the timber for sale or use in your trade or business, and
3) Elect to treat the cutting of timber as a sale or exchange of property used in a trade or business (regardless of whether the timber is includible in inventory or held primarily for sale to customers).

Election. You make the election on your return for the year the cutting takes place by including in income the gain or loss on the cutting, and including a computation of your gain or loss. You do not have to make the election in the first year you cut timber. You may choose to make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect for all later years unless you revoke it. You may revoke an election you made for a tax year beginning after 1986 only if you can show undue hardship and get the consent of the IRS. Thereafter, you may not make any new election unless you have the consent of the IRS.

Special revocation. A special rule for any election you made for a tax year beginning before 1987 allows you to revoke the election for any tax year ending after 1986 without the consent of IRS. You can revoke the election by attaching a statement to your tax return for the year the revocation is to be effective. If you make this special revocation, which can be made only once, you can still make a new election without the consent of the IRS. Any further revocation will require the consent of the IRS.

The statement must provide:

1) Your name, address, and identification number,
2) The year the revocation is effective and timber to which it applies,
3) That the revocation being made is of the election to treat cutting of timber as a sale or exchange under section 631(a) of the Internal Revenue Code,
4) That the revocation is being made under section 311(d) of Public Law 99-514, and
5) That you are entitled to make the revocation under section 311(d) of Public Law 99-514 and temporary Income Tax Regulation section 301.9100–7T.

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut.

Example. In April 1995, you owned 4,000 MBF (1,000 board feet) of standing timber for more than 1 year. It has an adjusted basis for depletion of $40 per MBF. You are a calendar year taxpayer. On January 1, 1995, the timber had a fair market value (FMV) of $120 per MBF. It was cut in April for sale. On your 1995 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report the difference between the FMV and your adjusted basis for depletion as a gain. This amount is reported on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as capital gain or as ordinary gain. You figure your gain as follows:

FMV of timber on January 1, 1995	$480,000
Less: Adjusted basis for depletion	160,000
Section 1231 gain	$320,000

The FMV becomes your basis in the timber cut, and a later sale of the cut timber, including any by-product or tree tops, will result in ordinary income or loss.

Cutting contract. If you own standing timber and dispose of it under a cutting contract, you must treat the disposal as a sale or exchange if you held the timber for more than 1 year before its disposal. You must also retain an economic interest in it.

The difference between the amount realized from the disposal of the timber and it's adjusted basis for depletion is treated as gain or loss on its sale. This amount must be included on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as capital or ordinary gain or loss.

Date of disposal. This is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you may choose to treat the date of payment as the date of disposal. This election is effective only to figure the holding period of the timber. It has no effect on the time for reporting gain or loss. The election is made by a statement attached to the tax return filed by the due date (including extensions) for the year payment is received. The statement identifies the advance payments subject to the election and the contract under which they were made.

Owner. The owner is any person who owns an economic interest in the timber, including a sublessor and the holder of a contract to cut timber.

Economic interest. An economic interest in standing timber means you acquired an interest by investment and get, by any form of legal relationship, income from cutting that timber, for a return of your capital investment.

Tree stumps. Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators after the saleable standing timber was cut and removed from the land are considered by-products. Gain from the sale of stumps in lots or tonnage by such operators is taxed as ordinary income.

Coal and Iron Ore

If you own, for more than 1 year, coal (including lignite) or iron ore mined in the United States and dispose of it under a contract in which you keep an economic interest in the coal or iron ore, the disposition is treated as a sale of section 1231 property. For this rule, the date the coal or iron ore is mined is considered the date of its disposal.

Your gain or loss is the difference between the amount realized from disposal of the coal or iron ore and its adjusted basis for cost depletion (increased by certain expenditures not allowed as deductions for the tax year). This amount is included on Form 4797 along with your other section 1231 gains and losses.

You are considered an ***owner*** if you own or sublet an economic interest in the coal or iron ore in place. If you own only an option to buy the coal in place, you do not qualify as an owner. In addition, this special gain or loss treatment does not apply to income realized by an owner who is a co-adventurer, partner, or principal in the mining of coal or iron ore.

The expenses of making and administering the contract under which the coal or iron ore was disposed of and the expenses of preserving the economic interest kept under the contract are not allowed as deductions in figuring taxable income. Rather, their total along with the adjusted basis is deducted from the amount received to determine the gain. If the total of these expenses plus the adjusted depletion basis is more than the amount received, the result is a loss.

Special rule. The above treatment does not apply if you dispose of the iron ore or coal directly or indirectly to:

1) A related person (defined under *Related persons* in chapter 3), whose relationship to you would result in the disallowance of a loss, or

2) An individual, trust, estate, partnership, association, company, or corporation owned or controlled directly or indirectly by the same interests that own or control your business.

Losses on Small Business Stock (Section 1244)

An individual (not including a trust or estate) can deduct, as an ordinary loss, a loss on the sale, exchange, or worthlessness of small business stock. This ordinary loss is reported on line 11, Part II of Form 4797. If you are reporting a loss on an asset used in a passive activity, use Form 8582, *Passive Activity Loss Limitations,* to see how much of a loss is allowed on Form 4797. The gain on the stock, however, is a capital gain if the stock is a capital asset in your hands. Do not offset the gains against the losses that are within the ordinary loss limits, even if the transactions are in stock of the same corporation. Report the gain on Schedule D (Form 1040).

Ordinary loss. The ordinary loss that you can deduct on this stock is limited to $50,000. On a joint return, the limit is $100,000 even if only one spouse has this type of loss. Thus, if your loss is $110,000 and your spouse has no loss, you may deduct $100,000 on a joint return. The remaining $10,000 is a capital loss.

The stock must be issued to the individual taking the loss. The ordinary loss deduction is available only to the original owner of this stock. To claim a deductible loss on stock issued to your partnership, you must have been a partner when the stock was issued and remain so until the time of the loss. You add your distributive share of the partnership loss to any individual loss you may have on the stock before applying the ordinary loss limits.

Stock distributed by the partnership. If the partnership distributes the stock to the partners, the partners will not be able to treat any later loss on that stock as an ordinary loss.

For more information about the treatment of losses on small business stock, see chapter 4 in Publication 550.

Figuring Capital Gains and Losses

If you have a gain or loss from the disposition of a capital asset, it is a capital gain or loss. Likewise, you may have a capital gain from the disposition of a noncapital asset, if it is section 1231 property (discussed in chapter 23). However, a net section 1231 loss is an ordinary loss, and not a capital loss.

Long and short term. The treatment of a capital gain or loss depends on how long you own the asset before you sell or exchange it. The time you own an asset before disposing of it is the holding period.

If you hold a capital asset 1 year or less, the gain or loss from its disposition is short term. If you hold a capital asset for more than 1 year, the gain or loss from its disposition is long term.

Table 22-1. **Do I Have a Short-Term or Long-Term Gain or Loss?**

If you hold the property:	Then you have a:
One year or less	Short-term capital gain or loss
More than one year	Long-term capital gain or loss

These distinctions are essential to correctly arrive at your net capital gain or loss. Capital losses are allowed in full against capital gains plus up to $3,000 of ordinary income.

Holding period. To figure if you held property more than 1 year, start counting on the day following the day you acquire the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you dispose of the property is part of your holding period.

Table 22-2. **Holding Period for Different Types of Acquisitions**

Type of acquisition:	When your holding period starts:
Stocks and bonds bought on a securities market	Day after trading date you bought security. Ends on trading date you sold security.
U.S. Treasury notes and bonds	If bought at auction, day after notification of bid acceptance. If bought through subscription, day after subscription was submitted.
Nontaxable exchanges	Day after date you acquired old property.
Gift	If your basis is giver's adjusted basis, same day as giver's holding period began. If your basis is FMV, day after date of gift.
Real property bought	Generally, day after date you received title to the property.
Real property repossessed	Day after date you originally received title to the property but does not include time between the original sale and date of repossession.

Example. If you bought an asset on June 18, 1995, you should start counting on June 19, 1995. If you sell the asset on June 18, 1996, your holding period is not more than 1 year, but if you sell it on June 19, 1996, your holding period is more than 1 year.

Inherited property. If you inherit property, you are considered to have held the property for more than 1 year even if you dispose of it within 1 year after the decedent's death.

Installment sale. The gain from an installment sale of a capital asset qualifying for long-term capital gain treatment in the year of sale continues to be long term in later tax years. If it is short term in the year of the sale, it continues to be short term when payments are received in later tax years.

Nontaxable exchanges. If you acquire an asset in exchange for another asset and your basis for the new asset is figured, in whole or in part, by your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Corporate liquidation. The holding period for property you receive in a liquidation generally starts on the day after you receive it if gain or loss is recognized.

Gifts. If you receive a gift of property and your basis in it is figured using the donor's basis, your holding period includes the donor's holding period. See Publication 551.

Real property. To figure how long you held real property, start counting on the day after you received title to it or, if earlier, the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Repossession. If you sell real property but keep a security interest in it and then later repossess it, your holding period for a later sale includes the period you held the property before the original sale, as well as the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

Net Gain or Loss

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

Net short-term capital gain or loss. First, combine your short-term capital gains and losses. Do this by adding up all your short-term capital gains. Then add up all your short-term capital losses. Subtract one total from the other. The result is your net short-term capital gain or loss.

Next, follow the same steps to combine your long-term capital gains and losses. The result is your net long-term capital gain or loss.

Net gain. If the total of your capital gains is more than the total of your capital losses, the excess is taxable. This net gain is generally taxed at the same rate as your ordinary income. However, the part that is not more than your net long-term capital gain is taxed at a rate no higher than 28%. See *Maximum Tax Rate on Capital Gains,* later.

Net loss. If the total of your capital losses is more than the total of your capital gains, the excess is deductible. But there are limits on how much loss you can deduct, and when you can deduct it. See *Treatment of Capital Losses,* next.

Treatment of Capital Losses

If your capital losses are more than your capital gains, you must deduct the excess even if you do not have ordinary income to offset it. The yearly limit on the amount of the capital loss you can deduct is $3,000 ($1,500 if you are married and file a separate return).

Capital loss carryover. Generally, you have a capital loss carryover if either of the following situations applies to you:

1) Your excess capital loss is more than the yearly limit, or
2) The amount shown on line 35, Form 1040 (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you in 1995, complete the *Capital Loss Carryover Worksheet,* provided in the instructions to Schedule D (Form 1040), to figure the amount of your loss that you can carry over to 1996.

In 1996, you will treat the carryover loss as if it occurred in that year. It will be combined with any capital gains and losses you have in 1996, and any excess capital loss will be subject to the limit for that year. Any loss not used in 1996 will be carried over to 1997. When you carry over a loss, it retains its original character as either short term or long term.

Example. Bob and Gloria Sampson sold property in 1995. The sale resulted in a capital loss of $7,000. The Sampsons had no other capital transactions. On their joint 1995 return, the Sampsons deduct $3,000, the yearly limit. They had taxable income of $2,000. The unused part of the loss, $4,000 ($7,000 − $3,000), is carried over to 1996. The allowable $3,000 deduction is considered used in 1995.

If the Sampsons' capital loss had been $2,000, it would not have been more than the yearly limit. They would have no carryover to 1996.

Joint and separate returns. On a joint return, the capital gains and losses of a husband and wife are figured as the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to $1,500. Neither you nor your spouse may deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed jointly and are now filing separately, any capital loss carryover from the joint return can be deducted only on the return of the spouse who actually had the loss.

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The capital loss limit discussed earlier still applies in this situation. Even if the loss is greater than the limit, the decedent's estate cannot deduct the excess or carry it over to following years.

Corporations. A corporation can deduct capital losses only up to its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. It carries the loss to other tax years and deducts it from capital gains occurring in those years. For more information, see Publication 542, *Tax Information on Corporations.*

Maximum Tax Rate on Capital Gains

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to net capital gains. The maximum tax rate on a net capital gain (the smaller of line 17 or 18 of Schedule D, Form 1040) is 28%. Net capital gain is the excess of net long-term capital gain for the year over the net short-term capital loss for the year. To figure the tax on your net capital gain, see the Form 1040 instructions.

Caution: As this publication was being prepared for print, Congress was considering legislation that would affect capital gains and losses. The line numbers on Schedule D (Form 1040) could change for 1995. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through the IRS bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

However, if you elect to include any part of a net capital gain from a disposition of investment property in investment income for figuring your investment interest deduction, you must reduce the net capital gain eligible for the 28% rate by the same amount. You make this election on Form 4952, *Investment Interest Expense Deduction,* line 4e. For information on making this election, see the instructions to Form 4952. For information on the investment interest deduction, see chapter 3 in Publication 550.

23. Dispositions of Depreciable Property

Important Changes

Caution. As this publication was being prepared for print, Congress was considering tax law changes to capital gains and losses that would affect your 1995 tax return and 1996 estimated taxes. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Introduction

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain as ordinary income.

Records. To figure any gain that must be reported as ordinary income, you must keep permanent records of the facts necessary to figure the amount of depreciation or amortization that was allowed or allowable on your property. This includes the date and manner of acquisition, cost or other basis, depreciation or amortization, and all other adjustments that affect basis.

On any property you got in a nontaxable exchange or as a gift, your records must also indicate:

1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property, and
2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Corporate distributions. If the fair market value of depreciated property distributed to shareholders is more than the adjusted basis of that property, the corporation must report ordinary income because of depreciation. This applies even though the distribution, either as a dividend or in liquidation, might otherwise be nontaxable.

Topics

This chapter discusses:

- Section 1231 property
- Depreciation recapture on personal property
- Depreciation recapture on real property
- Other dispositions

Useful Items

You may want to see:

Publication

- ☐ **526** Charitable Contributions
- ☐ **534** Depreciating Property Placed in Service Before 1987
- ☐ **537** Installment Sales
- ☐ **542** Tax Information on Corporations
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **551** Basis of Assets
- ☐ **559** Survivors, Executors, and Administrators
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **4797** Sales of Business Property

Section 1231 Property

Real property and depreciable or amortizable personal property used in a trade or business or held for the production of rents or royalties and held more than 1 year is section 1231 property. Gain or loss recognized on its sale, exchange, or involuntary conversion is subject to section 1231 treatment. Capital assets held in connection with a trade or business or a transaction entered into for profit and subjected to an involuntary conversion are also section 1231 property if held more than 1 year.

Before you apply section 1231 treatment to a gain on a disposition of depreciable section 1231 property, first figure any ordinary gain from the deduction of depreciation. See the rules discussed later under *Depreciation Recapture on Personal Property* or *Depreciation Recapture on Real Property.* Any remaining gain is subject to section 1231 treatment.

Property for sale to customers. Property held mainly for sale to customers or includible in your inventory is not section 1231 property. If you will get back all, or nearly all, of your investment in the property, by selling it rather than by using it up in your business, it is property held mainly for sale to customers. For information about inventory, see Publication 946.

Real property or depreciable personal property. This property must be used in a trade or business or held for the production of rents or royalties, and held for more than 1 year, to qualify as section 1231 property. This includes amortizable section 197 intangibles (described in chapter 13).

Leaseholds. Leaseholds used in a trade or business and held for more than 1 year qualify as section 1231 property.

Timber, coal, and iron ore. Gain or loss from the cutting of timber and the disposal of timber, coal, or domestic iron ore with a retained economic interest, as described in chapter 22 under *Timber* and *Coal and Iron Ore* is subject to section 1231 treatment.

Condemnations. The gain or loss on condemnations (described in chapter 25) is treated as section 1231 gain or loss if the property was held for more than 1 year. This includes business property and capital assets held in connection with a trade or business or transaction entered into for profit, such as investment property. Property held for personal use is not included.

Casualty and theft gains and losses. For casualty and theft gains and losses to receive section 1231 treatment, the property must be held for more than 1 year. These include casualty to or theft of business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance payments or other reimbursement must be taken into account in arriving at the net gain or loss. However, if your casualty or theft losses exceed your casualty or theft gains, neither the gains nor the losses are taken into account in the section 1231 computation.

For more information on casualties and thefts, see chapter 25.

Treatment of gains and losses. Combine all gains and losses from the sale or other disposition of section 1231 property for the tax year. If your section 1231 gains exceed your section 1231 losses, you have a net section 1231 gain. These gains and losses are treated as long-term capital gains or long-term capital losses, unless you have nonrecaptured section 1231 losses. (See the next discussion.) If your section 1231 losses exceed your section 1231 gains, you have a net section 1231 loss. If you have a net section 1231 loss or your section 1231 gains and losses are equal, treat each item as an ordinary gain or loss.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent it does not exceed your nonrecaptured net section 1231 losses taken in prior years. ***Nonrecaptured losses*** are the total of your net section 1231 losses for your five most recent preceding tax years that have not yet been applied (recaptured) against any net section 1231 gains in those years. Your losses are recaptured beginning with the earliest year subject to recapture.

Example. Ashley, Inc., a graphic arts company, is a calendar year corporation. In 1992, it had a net section 1231 loss of $8,000. For tax years 1994 and 1995, the company has net section 1231 gains of $5,250 and $4,600, respectively. In figuring taxable income for 1994, Ashley treated its net section 1231 gain of $5,250 as ordinary income by recapturing $5,250 of its $8,000 net section 1231 loss. In 1995, it applies its remaining net section 1231 loss, $2,750 ($8,000 minus $5,250) against its net section 1231 gain, $4,600. For 1995, the company reports $2,750 as ordinary income and $1,850 ($4,600 minus $2,750) as long-term capital gain.

Depreciation Recapture on Personal Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property. See *Treatment of Gain,* later.

Section 1245 property. This property includes any property that is or has been subject to an allowance for depreciation or amortization and that is:

1) Personal property (either tangible or intangible),
2) Other tangible property (except buildings and their structural components) used as:
   a) An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,
   b) A research facility in any of the activities in (a) above, or
   c) A facility in any of the activities in (a) for the bulk storage of fungible commodities.
3) That part of real property (not included in (2)) having an adjusted basis that was reduced by certain amortization deductions (including those for certified pollution control facilities, removal of architectural and transportation barriers to persons with disabilities and the elderly, reforestation expenditures, or child-care facilities) or a section 179 deduction,
4) Single purpose agricultural (livestock) or horticultural structures, or
5) Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

Buildings and their structural components. Section 1245 property does not include buildings and structural components. Do not include structures that are essentially items of machinery or equipment as buildings and structural components. Also, do not include, as buildings, structures that house property used as an integral part of an activity, if the structures' use is so closely related to the property's use that the structures can be expected to be replaced when the property they initially house is replaced. The fact that the structures are specially designed to withstand the stress and other demands of the property and cannot be economically used for other purposes indicates that they are closely related to the use of the property they house. Thus, structures such as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples are not treated as buildings.

Storage facility. This is a facility used mainly for the bulk storage of fungible commodities. To be fungible, a commodity must be such that any one part may be used in place of another. Bulk storage means the storage of a commodity in a large mass before it is used. Stored materials that vary in composition, size and weight are not fungible. One part cannot be used in place of another part and the materials cannot be estimated and replaced by simple reference to weight, measure, and number. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage. The storage of different grades and forms of aluminum scrap is not bulk storage of fungible commodities.

Treatment of Gain

The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is limited to the ***lower*** of:

1) The depreciation and amortization allowed or allowable on the property (the recomputed basis of the property minus the adjusted basis of the property), or
2) The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

For any other disposition of section 1245 property, ordinary income is the lower of (1) above or the amount by which its fair market value exceeds its adjusted basis. See *Other Dispositions,* later.

Recomputed basis. The recomputed basis of your section 1245 property is the total of its adjusted basis plus depreciation and amortization adjustments (allowed or allowable) reflected in the adjusted basis. These include adjustments:

On property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion, and

Allowed or allowable to a previous owner, if your basis is determined with reference to that person's adjusted basis.

Property received in an exchange or conversion. If you received property in a like-kind exchange or involuntary conversion, the recomputed basis of that property includes a depreciation or amortization adjustment allowed or allowable on the old property you exchanged or converted. This adjustment is reduced by any gain you recognized on the exchange or conversion of the old property.

Depreciation and amortization. Depreciation and amortization that must be recaptured as ordinary income include (but are not limited to) the following items:

1) Ordinary depreciation deductions;
2) Amortization deductions for—
   a) The cost of acquiring a lease,
   b) The cost of lessee improvements,
   c) Pollution control facilities,
   d) Reforestation expenses,
   e) Section 197 intangibles,
   f) Child care facility expenditures made before 1982, and
   g) Franchises, trademarks, and trade names acquired before August 10, 1993;
3) The section 179 expense deduction;
4) Deductions for—
   a) The cost of removing barriers to the disabled and the elderly,
   b) Tertiary injectant expenses, and
   c) Depreciable clean-fuel vehicles and refueling property (less the amount of any recaptured deductions); and
5) The amount of any basis reduction for the investment credit (less the amount of any basis increase for credit recapture).
6) The amount of any basis reduction for the qualified electric vehicle credit (less the amount of any basis increase for credit recapture).

Example. You file your returns on a calendar year basis. In February 1993, you purchased and placed in service for 100% use in your business a light-duty truck (5–year property) with an original basis of $10,000. You used the half-year convention and figure your MACRS deductions for the truck were $2,000 in 1993 and $3,200 in 1994. You did not take the section 179 deduction on the truck. You sold the truck in May 1995 for $7,000. The MACRS deduction in 1995, the year of sale, is $960 (1/2 of $1,920). Your adjusted basis is $3,840 ($10,000 − $6,160). Your recomputed basis is $10,000 ($3,840 + $6,160). The amount you treat as ordinary income is the ***lower*** of the following:

Recomputed basis ($10,000) minus the adjusted basis ($3,840), or $6,160, ***or***

Amount realized ($7,000) minus the adjusted basis ($3,840), or $3,160.

The lower of these two amounts, $3,160, is the amount of gain treated as ordinary income. Figure this amount in Part III, Form 4797.

Depreciation on ''other tangible property''. You must take into account depreciation during periods when the property was not used as an integral part of an activity or did not constitute a research or storage facility, as described earlier under *Section 1245 property*.

For example, if depreciation deductions taken on certain storage facilities amounted to $10,000, of which $6,000 is from the periods before their use in a prescribed business activity, you must use the entire $10,000 in determining ordinary income because of depreciation.

Depreciation allowed or allowable. The greater of the depreciation allowed or allowable is generally the amount to use in figuring the part of gain to report as ordinary income. If, in prior years, you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method.

This treatment applies only when figuring what part of gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

Section 1245 property and other property in the same disposition. A sale or other disposition may involve a combination of section 1245 property and other property. To figure the gain or loss on each item, the total amount realized must be allocated among the section 1245 property and the other property in proportion to each item's fair market value. If a buyer and seller have adverse interests, their arm's-length agreement setting values for the items will establish the allocation. Special allocation rules apply to the sale of a group of assets that can be a trade or business. See *Allocating the Basis* in chapter 5. Losses cannot be used to offset gains to report a combined gain or loss for section 1245 property.

Multiple asset accounts. In figuring ordinary income because of depreciation, you may treat any number of units of section 1245 property in a single depreciation account as one item if the total ordinary income because of depreciation figured by using this method is not less than it would be if depreciation on each unit were figured separately.

Example. In one transaction you sold 50 machines, 25 trucks, and certain other property that was not section 1245 property. All of the depreciation was recorded in a single depreciation account. After dividing the total received among the various assets sold, you figured that each unit of section 1245 property was sold at a gain. You may figure the ordinary income because of depreciation as if the 50 machines and 25 trucks were one item.

However, if 5 of the trucks had been sold at a loss, only the 50 machines and 20 of the trucks could be treated as one item in determining the ordinary income because of depreciation.

Normal retirement. The normal retirement of section 1245 property in multiple asset accounts does not require recognition of gain as ordinary income because of depreciation if your method of accounting for asset retirements does not require recognition of that gain.

Section 1231 gain. Any gain recognized that is more than the part that is ordinary income because of depreciation is a section 1231 gain. See *Treatment of gains and losses,* under *Section 1231 Property* earlier.

Depreciation Recapture on Real Property

A gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. To determine the additional depreciation on section 1250 property, see *Additional Depreciation,* later.

Section 1250 property. Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and has never been section 1245 property or section 1245 recovery property. It includes a leasehold of land or section 1250 property that is subject to an allowance for depreciation.

If, because of a change in its use, section 1250 property becomes section 1245 property in the hands of a taxpayer, it may never again be treated as section 1250 property by that taxpayer.

Generally, the deductions taken under ***ACRS*** on property placed in service before 1987are treated as ordinary income under section 1245, except for deductions taken on the following properties, which are treated as section 1250 property:

1) 15–year, 18–year, or 19–year real property and low-income housing that is residential rental property,
2) 15–year, 18–year, or 19–year real property and low-income housing that is used mostly outside the United States,
3) 15–year, 18–year, or 19–year real property and low-income housing on which the alternate ACRS method of depreciation is taken, and
4) Low-income property.

For more information on ACRS 15–year, 18–year, and 19–year property, get Publication 534.

The ordinary income rules for gains on section 1250 property dispositions ***do not*** apply if:

1) You figured depreciation for the property using the straight line method or any other method that does not result in depreciation that is more than the amount that is figured by the straight line method, and you have held the property more than a year,
2) You realize a loss on the sale, exchange, or involuntary conversion of the property,
3) You dispose of residential low-income rental property that you held for 16⅔ years or more. (For low-income rental housing on which the special 60–month depreciation for rehabilitation expenditures was allowed, the 16⅔ years starts when the rehabilitated property is placed in service.),
4) You chose the alternate ACRS method for the types of 15–, 18–, or 19–year real property covered by the section 1250 rules (discussed earlier), or
5) You dispose of residential rental property or nonresidential real property placed in service after December 31, 1986 (or after July 31, 1986, if the election to use MACRS was made). These properties are depreciated using the straight line method.

Gain Treated as Ordinary Income

To find what part of the gain is treated as ordinary income, follow these steps:

1) In a sale, exchange, or involuntary conversion of the property, figure the excess of the amount realized over the adjusted basis of the property In any other disposition of the property, figure the excess of fair market value over adjusted basis.
2) Figure the additional depreciation for the periods after 1975.
3) Multiply the smaller of (1) or (2) by the applicable percentage (discussed later). Stop here if this is residential rental property, or if (2) is equal to or more than (1). This is the gain that is treated as ordinary income because of additional depreciation.
4) Subtract (2) from (1).
5) Figure the additional depreciation for the periods after 1969 but before 1976.

6) Add the smaller of (4) or (5) to the result in (3). This is the gain that is treated as ordinary income because of additional depreciation.

You use Part III, Form 4797 to figure the ordinary income part of section 1250 gain.

Special rule for corporations. Corporations, other than S corporations, have an additional amount to recognize as ordinary income on the sale or other disposition of section 1250 property. The additional amount treated as ordinary income is 20% of the excess of the amount that would have been ordinary income if the property were section 1245 property over the amount treated as ordinary income under section 1250. Report this additional ordinary income on line 28(f) of Form 4797, Part III.

Additional Depreciation

If you hold section 1250 property longer than 1 year, the additional depreciation is the excess of actual depreciation adjustments over the depreciation figured using the straight line method. For a list of items treated as depreciation adjustments, see *Depreciation and amortization,* under *Depreciation Recapture on Personal Property,* earlier.

Figure straight line depreciation for ACRS real property by using its 15–, 18–, or 19–year recovery period as the property's useful life.

The straight line method is applied without any basis reduction for investment credit.

If you hold section 1250 property for 1 year or less, all of the depreciation is additional depreciation.

You will have additional depreciation if you use the regular ACRS method, the declining balance method, the sum-of-the-years-digits method, the units-of-production method, or any other method of rapid depreciation. You also have additional depreciation if you elect amortization, other than amortization on real property that qualifies as section 1245 property, discussed earlier.

Depreciation taken by other taxpayers or on other property. Additional depreciation includes all depreciation adjustments to the basis of section 1250 property, whether allowed or allowable to you or another person (as for carryover basis property).

Example. Larry Johnson gives his son section 1250 property on which he took $2,000 in depreciation deductions, of which $500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the $500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of $1,000 on the property, of which $200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is $700 ($500 allowed the father plus $200 allowed the son).

Depreciation allowed or allowable. The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) is generally the amount to use in figuring the part of gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the smaller figure will be the depreciation adjustment for figuring additional depreciation.

Retired or demolished property. The adjustments reflected in adjusted basis generally do not include deductions for depreciation on retired or demolished parts of section 1250 property, unless these deductions are reflected in the basis of replacement property that is section 1250 property.

Example. If a wing of a building is totally destroyed by fire, the depreciation adjustments figured in the adjusted basis of the building after the wing is destroyed do not include any deductions for depreciation on the destroyed wing unless it is replaced and the adjustments for depreciation on it are reflected in the basis of the replacement property.

Useful life and salvage value. The useful life and salvage value you use to figure the amount that would have been the depreciation if you had used the straight line method are the same as those you used under the depreciation method you actually used. Salvage value and useful life are not used for either ACRS or MACRS methods of depreciation. If you did not use a useful life under the depreciation method you chose (such as with the units-of-production method), or if you did not take salvage value into account (such as with the declining balance method), the useful life or salvage value for figuring what would have been the straight line depreciation is the useful life and salvage value you would have used under the straight line method.

Property held by lessee. If a lessee makes a leasehold improvement, the lease period for figuring what would have been the straight line depreciation adjustments and for figuring the additional depreciation includes all renewal periods. This cannot extend the period taken into account to a period which exceeds the remaining useful life of the improvement. This same rule applies to the cost of acquiring a lease.

Renewal period. The term ''renewal period'' means any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee. However, the inclusion of renewal periods cannot extend the lease by more than two-thirds of the period that was the basis on which the actual depreciation adjustments were allowed.

Rehabilitation expenditures. A part of the special 60–month depreciation adjustment allowed for rehabilitation expenditures incurred in connection with low-income rental housing is additional depreciation. After 1986, the special 60–month treatment of expenditures is no longer available unless the expenditures were incurred under a binding contract, or if rehabilitation began, before 1987.

If the property is held 1 year or less after the expenses are incurred, the entire special depreciation adjustment is treated as additional depreciation. If the property is held more than 1 year after the expenses are incurred, the additional depreciation is the excess of the special depreciation adjustments from the rehabilitation expenditures over the adjustments that would have resulted if the straight line method, normal useful life, and salvage value had been used.

Applicable Percentage

The applicable percentage used to figure the amount taxable as ordinary income because of additional depreciation depends on whether the real property you disposed of is nonresidential real property, residential rental property, or low-income housing. The applicable percentage for low-income housing is discussed in chapter 4 of Publication 544. The applicable percentages for nonresidential real property and residential rental property are as follows.

Nonresidential real property. For real property, that is not residential rental property, the applicable percentage for periods after 1969 is 100%. For periods before 1970, the applicable percentage is zero. No ordinary income will result on its disposition because of additional depreciation before 1970.

Residential rental property. For residential rental property (80% or more of the gross income is from dwelling units) other than low-income housing, the applicable percentage for periods after 1975 is 100%. For residential rental property, the applicable percentage for periods before 1976 is zero. Therefore, no ordinary income will result from a disposition of residential rental property because of additional depreciation before 1976.

Installment Sales

If you report the sale of property under the installment method, any depreciation recapture under section 1245 or 1250 is taxable as ordinary income in the year of sale, even if no payments are received in that year. If the gain is more than the depreciation recapture income, report the remainder of the gain using the rules of the installment method. For this purpose, add the recapture income to the property's adjusted basis.

If you dispose of ***more than one asset*** in a single transaction, you must separately figure the gain on each asset so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to each asset. Any depreciation recapture income must be reported in the year of sale before using the installment method for any remaining gain.

For more information, see chapter 24.

Other Dispositions

This section discusses the tax treatment of transfers of depreciable property by gift, at death, in like-kind exchanges, and in involuntary conversions. It also explains how to handle a single transaction involving a combination of depreciable property and other property.

Gifts

If you make a ***gift*** of depreciable personal property or real property, you do not have to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property in a disposition that is subject to recapture, the donee must take into account the depreciation you deducted in figuring the gain to be reported as ordinary income.

For low-income housing, the donee must take into account the donor's holding period to figure the applicable percentage. Under *Depreciation Recapture on Real Property,* in chapter 4 of Publication 544, see *Applicable Percentage,* and its discussion on low-income housing.

Disposition part gift and part sale or exchange. If you transfer depreciable personal property or real property for less than its fair market value, the transaction is considered to be partly a gift and partly a sale or exchange and you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain) to recapture depreciation, as discussed earlier in this chapter. If the depreciation (additional depreciation, if section 1250 property) is more than the gain, the balance is carried over to the transferee, to be taken into account on any later disposition of the property. However, see *Bargain sale to charitable organization,* later.

Gift to charitable organization. If you give property to a charitable organization, you figure your deduction for your charitable contribution by reducing the fair market value of the property by the ordinary income and short-term capital gain that would have resulted had you sold the property at its fair market value at the time of the contribution. Thus, your deduction for depreciable real or personal property given to a charitable organization does not include the potential ordinary gain from depreciation.

You also may have to reduce the fair market value of the contributed property by the long-term capital gain (including any section 1231 gain) that would have resulted had the property been sold. For more information, see *Giving Property That Has Increased in Value* in Publication 526, *Charitable Contributions.*

Bargain sale to charitable organization. A bargain sale is a sale or exchange of property to a charitable organization for less than its fair market value. It results in a transaction that is partly a sale or exchange and partly a charitable contribution. A special computation must be made to figure: 1) the gain from the part of the transaction that is a sale, and 2) the amount of any deductible charitable contribution. The adjusted basis of the property must be divided between the part sold and the part given to charity. See *Allocation of basis,* under *Other Dispositions* in chapter 4 of Publication 544.

If a deduction for the contribution is not allowable, the transaction is treated as a regular sale. In that case, any gain is figured (without allocation of basis) in the normal manner (selling price less adjusted basis of entire property).

For more information about charitable contributions, see Publication 526.

Transfers at Death

When a taxpayer dies, no gain is reported on depreciable personal property or real property that is transferred to his or her estate or beneficiary. For information on the tax liability of a decedent, see Publication 559.

However, if the decedent disposed of the property while alive and, because of his or her method of accounting or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported in the same way the decedent would have had to report it if he or she were still alive.

Ordinary income due to depreciation must be reported on a transfer from an executor, administrator, or trustee to an heir, beneficiary, or other individual, if the transfer is a sale or exchange on which gain is realized.

Like-Kind Exchanges and Involuntary Conversions

A like-kind exchange of your depreciable property, or an involuntary conversion of the property into similar or related property will not result in your having to report ordinary income because of depreciation unless money or property other than like-kind, similar, or related property is also received in the transaction. For information on like-kind exchanges, see chapter 21. For information on involuntary conversions, see chapter 25.

Depreciable personal property. If you have a gain from either a like-kind exchange or an involuntary conversion of your depreciable personal property, the amount to be reported as ordinary income because of depreciation, figured under the rules explained earlier (see *Depreciation Recapture on Personal Property*), is limited to the ***sum*** of:

1) The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions, ***plus***
2) The fair market value of the like-kind, similar, or related property other than depreciable personal property acquired in the transaction.

Example. You bought a new machine for $4,300 plus your old machine, for which you were allowed a $1,360 trade-in. The old machine cost you $5,000 two years ago. You took depreciation deductions of $3,950. Even though you deducted depreciation of $3,950, the $310 gain ($1,360 trade-in allowance less $1,050 adjusted basis) is not reported because it is excluded under the rules for like-kind exchanges and you received only depreciable personal property in the exchange.

Depreciable real property. If you have a gain from either a like-kind exchange or an involuntary conversion of your depreciable real property, the amount to be reported as ordinary income because of additional depreciation, figured under the rules explained earlier (see *Depreciation Recapture on Real Property*), is limited to the ***larger*** of:

1) The gain that must be reported under the rules for like-kind exchanges or involuntary conversions, ***plus*** the fair market value of stock bought as replacement property in acquiring control of a corporation, or
2) The gain you would have had to report as ordinary income because of additional depreciation had the transaction been a cash sale, ***less*** the cost (or fair market value in an exchange) of the depreciable real property acquired.

The ordinary income not reported for the year of the disposition is carried over to the depreciable real property acquired in the like-kind exchange or involuntary conversion as additional depreciation from the property disposed of. Further, to figure the applicable percentage of the additional depreciation on low-income housing to be treated as ordinary income, consider the holding period as starting over for the new property.

Example. The state paid you $116,000 when it condemned your depreciable real property for public use. You bought other real property similar in use to the property condemned for $110,000 ($15,000 for depreciable real property and $95,000 for land). You also bought stock for $5,000 to get control of a corporation owning property similar in use to the property condemned. You choose to postpone the tax on the gain. If the transaction had been a sale for cash only, under the rules of this chapter, $20,000 would be reportable as ordinary income because of additional depreciation.

The ordinary income to be reported is $6,000, which is the larger of:

1) The gain that must be reported under the rules for involuntary conversions, $1,000 ($116,000 – $115,000), ***plus*** the fair market value of stock bought as qualified replacement property, $5,000, for a total of $6,000, or
2) The gain you would have had to report as ordinary income because of additional depreciation ($20,000) had this transaction been a cash sale, ***less*** the cost of the depreciable real property bought ($15,000), or $5,000.

Basis of property acquired. If the ordinary income that you have to report because of additional depreciation is limited, the total basis of the property you acquired is its fair market value (its cost, if bought to replace property involuntarily converted into money), minus the gain on which tax is postponed.

If you acquired more than one item of property, allocate the total basis among the properties in proportion to their fair market value (their cost, in an involuntary conversion into money). However, if you acquired both depreciable real property and other property, allocate the total basis as follows:

1) Subtract the ordinary income because of additional depreciation that you do not have to report from the fair market value (or cost) of the depreciable real property acquired.
2) Add the fair market value (or cost) of the other property acquired to the result in (1).
3) Divide the result in (1) by the result in (2).
4) Multiply the total basis by the result in (3). This is the basis of the depreciable real property acquired. If you acquired more than one item of depreciable real property, allocate this basis amount among the properties in proportion to their fair market value (or cost).
5) Subtract the result in (4) from the total basis. This is the basis of the other property acquired. If you acquired more than one item of other property, allocate this basis amount among the properties in proportion to their fair market value (or cost).

Example. John Adams gets a $90,000 fire insurance payment for depreciable real property (office building) with an adjusted basis of $30,000. He uses the whole payment to buy property similar in use, spending $42,000 for depreciable real property and $48,000 for land. He chooses to postpone tax on the $60,000 gain realized on the involuntary conversion. Of this gain, $10,000 is ordinary income because of additional depreciation but is not reported because of the limit for involuntary conversions of depreciable real property. The basis of the property bought is $30,000 ($90,000 – $60,000), allocated as follows:

1) The $42,000 cost of depreciable real property less $10,000 ordinary income that does not have to be reported is $32,000.
2) The $48,000 cost of other property (land) plus $32,000 figured in (1) is $80,000 ($32,000 plus $48,000).
3) The $32,000 figured in (1) divided by the $80,000 figured in (2) is 0.4.
4) The basis of depreciable real property is $12,000. This is the $30,000 total basis multiplied by the 0.4 figured in (3).
5) The basis of the other property (land) is $18,000. This is the $30,000 total basis less the $12,000 figured in (4).

The ordinary income that is not reported ($10,000) is carried over as additional depreciation to the depreciable real property that was bought, and may be taxed as ordinary income on a later disposition.

Depreciable Property and Other Property in One Transaction

If you dispose of both depreciable property and other property in a single transaction and realize a gain, you must allocate the amount realized between the two types of property in proportion to their respective fair market values to figure the part of your gain to be reported as ordinary income because of depreciation. Special rules may apply to the allocation of the amount realized on the sale of a business that includes a group of assets. See *Sale of a Business* in chapter 2 of Publication 544.

In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the depreciable property and other property, any arm's-length agreement between them will establish the allocation.

Like-kind exchanges and involuntary conversions. If you dispose of and acquire both depreciable personal property and other property (other than depreciable real property) in a like-kind exchange or involuntary conversion, the amount realized is allocated in the following way. The amount that is allocated to the depreciable personal property disposed of is treated as consisting of, first, the fair market value of the depreciable personal property acquired and, second (to the extent of any remaining balance), the fair market value of the other property acquired. The amount allocated to the other property disposed of is treated as consisting of the fair market value of all property acquired that has not already been taken into account.

If you dispose of and acquire ***depreciable real property*** and other property in a like-kind exchange or involuntary conversion, the amount realized is allocated in the following way. The amount that is allocated to each of the three types of property (depreciable real property, depreciable personal property, or other property) disposed of is treated as consisting of, first, the fair market value of that type of property acquired and, second (to the extent of any remaining balance), any excess fair market value of the other types of property acquired. (If the excess fair market value is more than the remaining balance of the amount realized and is from both of the other two types of property, you can apply the excess in any manner you choose.)

Example. A fire destroyed your property having a total fair market value of $50,000 and consisting of machinery worth $30,000 and nondepreciable property worth $20,000. You received an insurance payment of $40,000 and immediately used it with $10,000 of your own funds (or a total of $50,000) to buy machinery with a fair market value of $15,000 and nondepreciable property with a fair market value of $35,000. The adjusted basis in the destroyed machinery was $5,000 and your depreciation on it was $35,000. You choose under the rules discussed in chapter 25 to postpone the tax on your gain arising from the involuntary conversion. You must report $9,000 as ordinary income because of depreciation arising from this transaction, figured as follows —

1) The $40,000 insurance payment must be allocated between the machinery and the other property destroyed in proportion to the fair market value of each. Therefore, the amount allocated to the machinery is $30,000/$50,000 of $40,000, or $24,000, and the amount allocated to the other property is $20,000/$50,000 of $40,000, or $16,000. Your gain on the involuntary conversion of the machinery is $24,000 less $5,000 adjusted basis, or $19,000.

2) The $24,000 allocated to the machinery disposed of is treated as consisting of the $15,000 fair market value of the replacement machinery bought and $9,000 of the fair market value of other property bought in the transaction. All of the $16,000 allocated to the other property disposed of is treated as consisting of the fair market value of the other property that was bought.

3) Your potential ordinary income because of depreciation is $19,000, the gain on the machinery, because it is less than the $35,000 depreciation. However, the amount you must report as ordinary income is limited to the $9,000 included in the amount you realized for the machinery that represents the fair market value of property other than the depreciable property you bought.

24. Installment Sales

Important Changes for 1995

Caution. As this publication was being prepared for print, Congress was considering tax law changes that could affect your 1995 tax return. These changes include:

- Capital gains and losses, and
- Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Introduction

Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called ''installment sales.''

The buyer's ''installment obligation'' to make future payments to you might be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's indebtedness to you. The rules discussed in this chapter apply regardless of the form of the installment obligation.

Topics

This chapter discusses:

- Installment method
- Figuring installment sale income
- Installment payments
- Single sale of several assets
- Unstated interest
- Dispositions of installment obligations
- Repossessions

Useful Items

You may want to see:

Publication

- ☐ **523** Selling Your Home
- ☐ **537** Installment Sales

Form (and Instructions)

- ☐ **Sch D (Form 1040)** Capital Gains and Losses
- ☐ **4797** Sales of Business Property
- ☐ **6252** Installment Sale Income

Installment Method

An installment sale is a sale of property where one or more payments are received after the close of the tax year during which the property was sold. If you finance the buyer's purchase of your own property, instead of having the buyer get a loan or mortgage, you probably have an installment sale. It is not an installment sale if the buyer borrows the money from a third party and then pays you the total selling price.

If a sale qualifies as an installment sale, you must report it on the installment method unless you elect to recognize gain on the sale under your regular method of accounting. See *Electing out,* later.

You generally report your gain on an installment sale only as you actually receive the payments. It does not matter whether you use the cash method or an accrual method of accounting. Each payment you receive on an installment sale usually consists of three parts:

1) Return of your investment (basis) in the property sold,
2) Gain on the sale, and
3) Interest.

You are taxed only on the part of each payment that represents interest and your profit on the sale. In this way, the installment method of reporting income relieves you of paying tax on income that you have not yet collected. However, for a sale of depreciable property, you must report in the year of sale any depreciation recapture income up to the amount of the gain. Only the gain in excess of the recapture amount is taken into account under the installment method.

For more information on installment sales than is given in this chapter, see Publication 537.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of sale. You cannot deduct a loss on the sale of property owned for personal use.

If your sale calls for payments in a later year, and there is little or no interest provided for in the contract of sale, you may have to figure unstated interest even though you have a loss. See the discussion of unstated interest, later.

Reporting installment sale income. You must use ***Form 6252*** any time you have a sale of property that you report as an installment sale. Use the form to report the sale in the year it takes place and to report payments received in later years.

Form 6252 will help you determine the gross profit, contract price, gross profit percentage (all discussed later), and how much of each payment received during the tax year on the sale is included in income.

Schedule D. The gain figured on Form 6252 for personal-use property must be carried over and entered on Schedule D (Form 1040), *Capital Gains and Losses.* Each year, you must include on Schedule D the capital gain part of the payments reported on Form 6252.

If your gain from an installment sale qualifies for long-term capital gain treatment in the year of sale, it will continue to qualify in later tax years. Your gain will be long-term if you owned the property for more than one year when you sold it. See chapter 26.

Business property. Taxable gain from payments you receive each year on an installment sale of business property is included with certain other gains and losses from business property. Your gain from the sale of business property you held for more than one year may be reported as capital gain in some years and as ordinary gain in other years. If you sell depreciable or amortizable property, you report depreciation recapture income in the year of sale up to the amount of the gain. See chapter 23.

Stock or securities. If you use the cash basis method of accounting, you cannot use the installment method to report the sale of stock. You must report the sale of stock or securities traded on an established securities market in the year in which the trade date falls.

Dealer sales. Sales of personal property by anyone who regularly sells or otherwise disposes of property of the same type on the installment plan cannot be reported on the installment method for federal income tax purposes. This also applies to real property held for sale to customers in the ordinary course of the trade or business. However, this does not apply to a sale on the installment plan of any property used or produced in the trade or business of farming.

Special rule. Dealers of timeshares and residential lots can report sales using the installment method if they elect to pay a special interest charge. For more information, see section 453(l) of the Internal Revenue Code.

Installment obligations transferred because of death. The transfer of an installment obligation as a result of the death of the seller (or other holder of the obligation), is not a disposition of the obligation. Any unreported gains from the installment obligations are not treated as items of gross income to the decedent. No income is required to be reported on the decedent's return due to this transfer. This means that whoever receives the obligation as a result of the seller's death is taxed on the payments in the same way as the seller would have been if the seller had lived to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferred to the buyer, because of the death of the holder of the obligation, it is a disposition. The estate of the seller must figure gain or loss on the disposition. If the holder and the buyer were related, the fair market value of the installment obligation is considered to be no less than its full face value. See *Dispositions of Installment Obligations,* later.

Electing out. You must report an installment sale using the installment method unless you elect not to use that method. If you make this election, you will generally report the entire gain in the year of sale. Do this even though you will not be paid all of the selling price until later. You then do not have to report any gain from the payments you receive in later years.

How to elect out. To make this election, do not report your sale on Form 6252. Instead, report the full amount of the gain on Schedule D (Form 1040) or Form 4797, whichever is appropriate. See the instructions for Schedule D and Form 4797 for information on reporting your gain.

When to elect out. Make the election not to have the installment method apply by the due date, including extensions, for filing your tax return for the year the sale takes place. Once made, the election generally cannot be changed. However, you can apply to revoke your election not to use the installment method. A revocation of the election will not be permitted when one of its purposes is to avoid federal income tax, or when the tax year in which any payment was received has closed.

You may qualify for an automatic extension of 6 months from the due date of the return, ***excluding extensions,*** to make this election. See Revenue Procedure 92-85 for more information. You can read the full text of this revenue procedure at most IRS offices.

Figuring Installment Sale Income

Each year that you receive payment, you must include in income the interest part of the payment as well as the part of the payment that is your gain. You do not include in income the part of the payment that is the return of your basis in the property.

Interest income. You must report all interest as ordinary income on your income tax return. Interest is generally not included in a down payment. However, you may have to treat part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See *Unstated Interest,* later.

Gain. The rest of each payment is treated as if it were made up of two parts. One part is a return of your investment (basis) in the property you sold. The other part is your gain. The gain is capital gain if the property you sold was a capital asset. However, if you took depreciation deductions on the asset, part of your gain may be treated as ordinary income. For more information, see *Gain reported in year of sale,* later in this chapter.

To determine what part of a payment is gain, multiply the payment by the gross profit percentage.

The following worksheet gives the basic items you must know to figure the gross profit percentage.

1) Selling price		______
2) Minus the sum of:		
Adjusted basis of property sold	______	
Selling expenses	______	
Depreciation recapture	______	______
3) Gross profit (line 1 less line 2)		______
4) Contract price		______
5) Gross profit percentage (line 3 divided by line 4)		______

The following paragraphs discuss the items on the above worksheet.

Selling price. The selling price is the entire cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or to which the property is subject. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. You cannot go back and refigure the gain you reported in earlier years.

Basis and adjusted basis. Basis is a way of measuring your investment in the property you are selling. It is defined and discussed in chapter 5. The way you figure basis depends on how you first acquired the property. The basis of property you bought is usually its cost to you. The basis of property you inherited, got as a gift, built yourself, or received in a tax-free exchange is figured differently. While you own personal use property, various events may change your original basis in the property. Some events, such as additions or permanent improvements, increase basis. Others, such as deductible casualty losses, decrease basis. The result is called adjusted basis.

Installment sale basis. The adjusted basis plus selling expenses and depreciation recapture income is referred to in this chapter as the ***installment sale basis.***

Selling expenses. Selling expenses are those that relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Selling expenses are added to the basis of the sold property.

Gross profit. For an installment sale, gross profit is the amount of gain you report on the installment method.

To figure your gross profit, subtract your installment sale basis from the selling price. If the property you sold was your home, also subtract any gain you can postpone or exclude.

Contract price. The contract price is the total of all principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments,* later.

If the selling price is partly payable in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. This percentage usually remains the same for each payment you receive. It is called the ***gross profit percentage,*** and is figured by dividing your gross profit from the sale by the contract price.

Example. You sell property at a contract price of $2,000, and your gross profit is $500. Your gross profit percentage is 25% ($500 divided by $2,000). After subtracting interest, 25% of each payment, including the down payment, is reported as your gain from the sale for the tax year payment is received.

Income from sale. Each year you receive a payment on the installment sale, multiply the payment (less interest) by the gross profit percentage to determine the amount you must include in income for the tax year.

Gain reported in year of sale. For sales of depreciable property, figure your depreciation recapture income (including the section 179 deduction and the section 179A deduction recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. You cannot use the installment method to report your gain that is equal to the recapture income. Any gain that exceeds the recapture income can be reported on the installment method. For more information on the section 179 deduction, see *Section 179 Deduction* in chapter 12.

For more information on the section 179A deduction, see chapter 15 in Publication 535. See chapter 23 for more information on depreciation recapture.

Sale of home. If you sell your home, you may be able to postpone or exclude all or part of the gain on the sale. See Publication 523. If the sale is an installment sale, any gain you postpone or exclude is not taken into account. Therefore, you figure your gross profit percentage by including in gross profit only the part of the gain not postponed or excluded.

Seller-financed mortgages. If you finance the sale of your home to an individual, special reporting procedures apply.

When reporting the interest income, you report the name, address, and social security number of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A), if the buyer used the property as a personal residence.

When taking the mortgage interest deduction, the buyer must report your name, address, and social security number (or employer identification number) on line 11 of Schedule A (Form 1040).

Both you and the buyer must exchange social security numbers (or employer identification numbers if applicable). If you fail to include the other person's social security number or employer identification number, you may have to pay a penalty of $50.

Sales to related persons. Two special rules apply to installment sales between related persons.

Rule 1: Sale of depreciable property. If you sell depreciable property to certain related persons, you may not report the sale using the installment method. Instead, all payments to be received are considered received in the year of sale. Depreciable property for this rule is any property that can be depreciated by the person or entity to whom you transfer it.

This rule will not apply to your sale if no significant tax deferral benefits will be derived from the sale. It does not apply if you can show to the satisfaction of the IRS that avoidance of federal income taxes was not one of the principal purposes of your sale.

Rule 2: Sale and resale. There is, generally, a special rule if you make a first disposition (sale or exchange) that you report under the installment method to a related person who then makes a second disposition (sale, exchange, gift, or cancellation of installment note):

Before making all payments on the first disposition, and

Within 2 years of the first disposition.

Under this rule, you treat part or all of the amount the related person realizes (or the fair market value if disposed property is not sold or exchanged) from the second disposition as if you received it from the first disposition at the time of the second disposition.

Rule 2 might not apply to a second disposition, and any later transfer. The rule will not apply if you can show that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, the second disposition will qualify under this exception in situations when the disposition is involuntary, such as when a creditor of the related person forecloses on the property or the related person declares bankruptcy.

Spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation that you have an interest in, or an estate or trust that you have a connection with, can also be considered a related person. For more information on the two rules, see Publication 537.

Trading property for like-kind property (like-kind exchanges). If you trade your business or investment property for other property of the same kind, you can postpone reporting part of the gain. These trades are known as 'like-kind exchanges.' The property you receive in a like-kind exchange is treated as if it were a continuation of the old investment. See *Like-Kind Exchanges* under *Nontaxable Exchanges* in chapter 21 for more information. If the trade includes an installment obligation, the following rules apply:

1) The contract price must not include the fair market value of the like-kind property received in the trade.
2) The gross profit is reduced by any gain on the trade that can be postponed.
3) Like-kind property received in the trade is not considered payment on the installment obligation.

Example. In 1995, George Brown trades personal property with an installment sale basis of $40,000 for like-kind property having a fair market value of $20,000. He also received an installment note for $80,000 in the trade. Under the terms of the note, he is to receive $10,000 (plus interest) in 1996 and the balance of $70,000 (plus interest) in 1997.

George's gross profit is $60,000 (selling price of $100,000 minus installment sale basis of $40,000). The contract price is $80,000 ($100,000 minus the fair market value of the like-kind property received, $20,000). The gross profit percentage is 75% ($60,000 divided by $80,000). He reports no gain for 1995 because the like-kind property he received is not treated as payment for figuring gain. He reports $7,500 gain for 1996 (75% of $10,000) and $52,500 gain for 1997 (75% of $70,000).

Payments

You must figure your gain each year on the payments you receive, or are treated as receiving, from an installment sale. These payments include the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

Buyer assumes expenses. If the buyer assumes and pays your expenses from selling your property, it is considered a payment to you in the year of sale. Include these expenses in both the selling and the contract prices when figuring the gross profit percentage.

Mortgage assumed. If the buyer assumes or pays off your mortgage, or otherwise takes the property subject to it, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered payment to you. The contract price equals the selling price minus the mortgage. This difference is all that you will directly collect from the buyer.

Example. You sell property with an adjusted basis of $19,000. You have selling expenses of $1,000. The buyer assumes your existing mortgage of $15,000 and agrees to pay you a total of $10,000 (a cash down payment of $2,000 and $2,000 (plus 8% interest) in each of the next 4 years).

The selling price is $25,000 ($15,000 + $10,000). The contract price is $10,000 ($25,000 − $15,000 mortgage). Your gross profit is $5,000 ($25,000 − $20,000 installment sale basis), and your gross profit percentage is 50% ($5,000 divided by $10,000). Therefore, you report half of each $2,000 payment you receive as gain from the sale. You also report all of the interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage in excess of your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. To this amount, add the "payment" you are considered to receive (the excess of the mortgage over your installment sale basis). The contract price is then the same as your gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than your installment sale basis in the property, the gross profit percentage will always be 100%.

Example. The selling price for your property is $9,000. The buyer will pay you $1,000 annually (plus 8% interest) over the next 3 years, and assume an existing mortgage of $6,000. Your basis in the property is $4,400. You have selling expenses of $600, for an installment sale basis of $5,000. The part of the mortgage that is more than your installment sale basis is

$1,000 ($6,000 – $5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is $4,000.

Selling Price		$ 9,000
Minus Mortgage		(6,000)
Add difference:		
Mortgage	6,000	
Less Installment sale basis	5,000	1,000
Contract Price		**$ 4,000**

Your gross profit on the sale is also $4,000.

Selling Price	$9,000
Minus Installment sale basis	5,000
Gross Profit	**$4,000**

Therefore, your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. You also treat the $1,000 difference between the mortgage and your installment sale basis as a payment, and report 100% of it as gain in the year of sale.

Debts. If the buyer pays off any of your debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only a part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than the installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. This follows the same rules discussed earlier under *Mortgage assumed.*

However, these rules apply only to two types of debts that the buyer assumes:

1) Those you acquired from your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and

2) Those you acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated as if the buyer paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of sale.

Payments of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Trading property for like-kind property (like-kind exchanges),* discussed earlier. The value of the payment is the property's fair market value on the date you receive it.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this definition, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

Third-party notes. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on your installment sale, any payments you later receive from the third party are not considered payments on your sale.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned you a $5,000, 8% note of a third party. The fair market value of the third-party note at the time of your sale was $3,000. This amount, and not $5,000, is a payment to you in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value ($3,000 divided by $5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full as ordinary income.

Bonds. A bond or other evidence of indebtedness you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received payment equal to the bond's fair market value. Accrual basis taxpayers should see section 15A.453–1(e)(2) of the Income Tax Regulations.

Buyer's note. The buyer's note (unless payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. Payments you receive on the note are used to figure your gain in the year you receive them.

Installment obligation used as security (pledge rule). If you use an installment obligation to secure any debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This is known as the pledge rule. The pledge rule applies if the selling price of the property was over $150,000. It does not apply to the sale of:

1) Property used or produced in the trade or business of farming, or

2) Personal use property.

For more information, see *Installment obligation used as security (pledge rule)* under *Payments* in Publication 537.

Guarantees. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered payment.

Deposits. Deposits that you receive before the year of sale are treated as payments in the year of sale if, under the contract, they become part of the down payment.

Single Sale of Several Assets

If you sell different types of assets in a single sale, you have to identify each of the assets to determine whether you can use the installment method to report the sale of that asset. You also have to allocate a part of the selling price to each asset. If you sell assets that constitute a trade or business, see *Sale of a Business,* in Publication 537.

Unless an allocation of the selling price has been agreed to by both parties in an arm's length transaction, you must allocate the selling price to an asset based on its fair market value (FMV). If the buyer assumes a debt, or takes the property subject to a debt, you must use net fair market value. This is the FMV reduced by such debt.

A sale, at a gain, of separate and unrelated assets of the same class under a single contract is reported as a single transaction. However, if an asset is sold at a loss, its disposition may not be reported on the installment method but must be reported separately. The remaining assets sold at a gain are reported together. See Publication 537.

Unstated Interest

Both the buyer and the seller must treat a part of each installment sale payment as interest. For the most part, this interest will be stated in the sales agreement. However, in some situations you may have to treat a certain amount of each payment as interest, even though it is not called interest in your agreement with the buyer. This amount, generally referred to as ***unstated interest*** or ***imputed interest,*** reduces the stated selling price of the property and increases the seller's interest income and the buyer's interest expense.

You generally have unstated interest if your interest rate is less than the applicable federal rate. The applicable federal rates are published monthly by the IRS in the Internal Revenue Bulletin. You can get this information at most IRS offices.

For more information on unstated interest, see *Unstated Interest* in Publication 537.

Dispositions of Installment Obligations

If you are using the installment method and you dispose of the installment obligation, (the buyer's note, mortgage, etc.), you will usually have a gain or loss to report. For detailed information, get Publication 537.

Repossessions

If the buyer defaults on the contract and you repossess the property, you may have a gain, loss, or bad debt. The rules used to figure the gain or loss from repossessions of personal property are different from those used to figure the gain or loss from repossessions of most real property.

A detailed explanation of the tax treatment of repossessions is in Publication 537.

25. Casualties, Thefts, and Condemnations

Important Changes

Caution. As this publication was being prepared for print, Congress was considering tax law changes that could affect your 1995 tax return and 1996 estimated taxes. These changes include:

- Capital gains and losses, and
- Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Introduction

A ***casualty*** occurs when property is damaged, destroyed, or lost due to a sudden, unexpected, or unusual event. A ***theft*** occurs when property is stolen. A ***condemnation*** occurs when private property is legally taken for public use without the owner's consent. A casualty, theft, or condemnation may result in a deductible loss on your federal income tax return. Report a deductible loss as explained in chapter 26.

An ***involuntary conversion*** occurs when you receive money or other property as reimbursement for a casualty, theft, condemnation, or disposition of property under threat of condemnation.

If an involuntary conversion results in a gain, you can postpone recognition of the gain on your income tax return if you receive or buy qualified replacement property within the specified replacement period. For more information, see *Postponing Gain*, later. If you do not choose to postpone recognition of the gain, report the gain as explained in chapter 26.

Topics

This chapter discusses:

- Casualties and thefts
- Condemnations
- Postponing gain

Useful Items

You may want to see:

Publication

- ☐ **547** Nonbusiness Disasters, Casualties, and Thefts

Form (and Instructions)

- ☐ **1040X** Amended U.S. Individual Income Tax Return
- ☐ **4684** Casualties and Thefts

Casualties and Thefts

The damage, destruction, or loss of your business or income-producing property as the result of a casualty or theft may result in a reportable gain or a deductible loss on your income tax return.

For information on casualties and thefts of personal-use property, see Publication 547.

Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A ***sudden*** event is one that is swift, not gradual or progressive.
- An ***unexpected*** event is ordinarily unanticipated and unintentional on the part of the one who has the loss.
- An ***unusual*** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you are engaged.

Events that may cause casualty damage, destruction, or loss include:

1) Fire, earthquake, hurricane, tornado, flood, storm, volcanic eruption, shipwreck, mine cave-in, sonic boom, vandalism,
2) Car or truck accidents, but if your willful negligence or act caused the accident, the damage, destruction, or loss of your car or truck is not a casualty.

Gradual deterioration. Damage from gradual or progressive deterioration, such as from rust, corrosion, or termites, is not a casualty.

Theft

A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. It includes, but is not limited to, larceny, robbery, and embezzlement.

If money or property is taken as the result of extortion, kidnaping, threats, or blackmail, it may also be a theft if the taking of your property was illegal under the law of the state in which it occurred and it was done with criminal intent.

Mislaid or lost property. The mere disappearance of money or property is not a theft. However, an accidental loss or disappearance of property may be a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was a casualty or theft. You must also be able to support the amount of your deduction.

For a casualty loss, you should be able to show:

1) The type of casualty (car accident, fire, storm, etc.) and when it occurred,
2) That the loss was a direct result of the casualty, and
3) That you were the owner of the property, or if you leased the property from someone else, that you were contractually liable to the owner for the damage.

For a theft loss, you should be able to show:

1) When you discovered that your property was missing,
2) That your property was stolen, and
3) That you were the owner of the property.

Related Expenses

Related expenses that are not deductible as part of a casualty or theft loss are discussed next.

The cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, what you spend on insurance or to board up your business building against a storm is not part of your loss. These expenses are deductible as business expenses.

If you make permanent improvements to your property to protect it against casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Incidental expenses. The incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, temporary housing, or a rental car, are not deductible as part of a casualty or theft loss. However, they may be deductible as business expenses.

Loss of inventory. A casualty or theft loss of inventory, including items you hold for sale to customers, is automatically claimed through the increase in the cost of goods sold by properly reporting your opening and closing inventories. Do not claim this loss again as a casualty or theft loss. If you take the loss automatically through the increase in the cost of goods sold, include any insurance or other reimbursement you receive for the loss in gross income.

You can choose to deduct the loss separately. If you deduct it separately, eliminate the items from cost of goods sold by a downward adjustment to opening inventory or purchases.

If you deduct the loss separately, reduce it by the reimbursement you received. Do not include the reimbursement in gross income. If you do not receive the reimbursement by the end of the year, you may not claim a loss to the extent you have a reasonable prospect of recovery. See *Insurance and Other Reimbursements,*later.

Figuring Gains and Losses

If a single casualty or theft involves more than one item of business or income-producing property, you must figure the gain or loss on each item separately. For example, if casualty damage occurs to both a building and trees, both of which are part of the same realty, figure the loss in value by taking them both into account separately.

Lump-sum reimbursement. If you have a casualty or theft loss of several assets at the same time, without an allocation of reimbursement to specific assets, divide the lump-sum reimbursement you receive among the assets according to the fair market value of each at the time of the loss. Figure the gain or loss separately for each asset that has a separate basis.

Casualty loss. If any insurance or other reimbursement you receive or expect to receive as a result of casualty damage, destruction, or loss to an item of your business or income-producing property ***is less than*** your adjusted basis in the property, you may have a deductible casualty loss.

If the reimbursement ***is more than*** your adjusted basis, you have a gain. See *Casualty or theft gain*, later.

If your property is not completely destroyed or lost as the result of a casualty, figure your deductible casualty loss by subtracting any insurance or other reimbursement you receive or expect to receive from the smaller of:

1) The decrease in fair market value of the property as a result of the casualty, or
2) Your adjusted basis in the property immediately before the casualty.

You do not have a deductible casualty loss if the decrease in fair market value of the property as a result of the casualty is smaller than both:

1) Any insurance or other reimbursement you receive or expect to receive, and
2) Your adjusted basis in the property.

If your property is completely destroyed or lost as the result of a casualty, figure your deductible casualty loss by subtracting any insurance or other reimbursement you receive or expect to receive from your adjusted basis in the property before the casualty. The decrease in fair market value is not considered.

Theft loss. If an item of your business or income-producing property is stolen, figure your deductible theft loss by subtracting any insurance or other reimbursement you receive or expect to receive from your adjusted basis in the property before the theft.

If the reimbursement is more than your adjusted basis, you have a gain. See *Casualty or theft gain*, next.

If you get your stolen property back, see *Recovered Property*, later.

Casualty or theft gain. If the insurance or other reimbursement you receive as a result of a casualty or theft of an item of your business or income-producing property ***is more than*** your adjusted basis in the property, you have a casualty or theft gain. Your gain is:

1) The insurance or other reimbursement you receive, less
2) Your adjusted basis in the property immediately before the casualty or theft.

This is true even if the decrease in fair market value of the property is more than your adjusted basis. If you have a gain, you may be able to postpone reporting it. For more information, see *Postponing Gain*, later.

Leased property. If you are liable for casualty damage to property you lease from someone else, figure your deductible casualty loss by subtracting any insurance or other reimbursement you receive or expect to receive from the amount you must pay to repair the property.

Decrease in Fair Market Value

To figure the decrease in fair market value due to casualty or theft, determine the fair market value of your property immediately before and immediately after the casualty or theft. Fair market value is defined in chapter 5. An appraisal is the best way to make this determination.

General decline in market value. The decrease in value of your property is not deductible simply because it is in or near an area that had a casualty, and might again have a casualty.

Appraisals. A competent appraiser will generally determine the difference between the fair market value of the property immediately before a casualty and immediately afterwards. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This is necessary so that any deduction is limited to the actual loss resulting from damage to the property.

The appraiser should be reliable and experienced. Several factors are important in evaluating the accuracy of an appraisal, including the appraiser's:

- Familiarity with your property before and after the casualty,
- Knowledge of sales of comparable property in the area,
- Knowledge of conditions in the area of the casualty, and
- Method of appraisal.

Cars. Books issued by various automobile organizations may be useful in figuring the value of your car, if your car is listed in the books. You can use the books' retail values and modify them by factors such as the mileage and condition of your car to figure its value. The prices are not ''official,'' but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, you determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Repair cost. You can use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in fair market value if you meet all the following conditions.

1) The repairs are needed to restore the property to its condition before the casualty.
2) The cost of repairs is not excessive.
3) The repairs only take care of the damage.
4) The value of the property after the repairs is not, due to the repairs, more than its value before the casualty.

Restoration of landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in fair market value. You may be able to measure your loss by what you spend on the following:

1) Removing destroyed or damaged trees and shrubs, minus any salvage you receive,
2) Pruning and other measures taken to preserve damaged trees and shrubs, and
3) Replanting necessary to restore the property to its approximate value before the casualty.

Adjusted Basis

Basis is the measure of your investment in the property you own. For property you buy, your basis is usually its cost to you. For property you acquire in some other way, such as inheriting it, receiving it as a gift, or getting it in a tax-free exchange, you must figure your basis in another way, as explained in chapter 5.

While you own the property, various events may take place that change your basis. Some events, such as additions or permanent improvements to the property, increase basis. Others, such as earlier deductible casualty or theft losses and depreciation deductions, decrease basis. When you add the increases to the basis and subtract the decreases from the basis, the result is your ***adjusted basis***. For more information on figuring the adjusted basis of your property, see chapter 5.

Insurance and Other Reimbursements

If you receive insurance or another type of reimbursement for your loss, you must subtract it from the loss when you figure your deduction. You cannot deduct the reimbursed part of a casualty or theft loss.

Reimbursement. The amount you receive includes any money plus the value of any property you receive, minus any expenses you have in obtaining reimbursement. It also includes any reimbursement used to pay off a mortgage or other lien on the property that was damaged, destroyed, or lost by casualty or theft.

Example. A hurricane destroyed your office building and the insurance company awarded you $45,000. You received $40,000 in cash. The remaining $5,000 was paid directly to the holder of a mortgage on the property. The reimbursement you received includes the $5,000 paid on the mortgage.

If you expect to be reimbursed, but have not yet received payment, you must still subtract the expected reimbursement from the loss.

Reimbursement from creditors or suppliers. If your creditors forgive part of what you owe them because of your inventory loss, treat this amount as a reimbursement. Account for it in the same manner as an insurance reimbursement, discussed earlier.

Other reimbursements. Insurance is the most common way to be reimbursed for a casualty or theft loss. But you may be reimbursed in some other way. The following items are considered reimbursements:

- The forgiven part (the part you do not have to pay back) of a federal disaster loan under the Disaster Relief and Emergency Assistance Act,
- The repayment and the cost of repairs by the person who leases your property,
- The court awards for damages for a casualty or theft loss (the amount you are able to collect) minus lawyers' fees and other necessary expenses,
- The repairs, restoration, or cleanup services provided by relief agencies, and
- A bonding company payment for a theft loss.

When to Report Gains and Losses

Casualty losses are generally deductible only in the tax year they occur. This is true even if you do not repair or replace the damaged property until a later year. (But see *Disaster Area Losses*, later.)

Theft losses are generally deductible only in the year they are discovered. You must prove there was a theft, but you do not have to know when it occurred.

Casualty or theft gains are generally included in income in the tax year in which you received the reimbursement that produced the gain, unless you choose to postpone the gain as explained under *Postponing Gain*, later.

Lessee's loss. If your loss is on leased property and you were liable to the owner for the loss, you can deduct the loss only in the year the liability becomes fixed. The lessee cannot deduct a loss until liability under the lease is ascertainable with reasonable accuracy. This could include a settlement, adjudication, or abandonment of the claim. This is true even if the loss occurred or the liability was paid in a different year.

Reimbursement Claims

If there is a reasonable prospect you will be reimbursed for part or all of your loss, you must subtract the expected reimbursement to figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. You are believed to have a reasonable prospect of reimbursement if you have filed suit for damages.

If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example. A collision with another car in 1994 completely destroyed your business automobile. The negligence of the other driver caused the accident. Your automobile had a fair market value of $4,000 and an adjusted basis of $3,000. As of December 31, 1994, it was reasonable to believe you would recover the total damages from the owner of the other car. You do not have a deductible loss in 1994.

In January 1995, the court awards you a judgment of $4,000, but in July 1995 you can show with reasonable certainty the other driver has nothing against which you can enforce your judgment. You can claim a $3,000 loss for 1995.

If you later receive more reimbursement than you expected, after you have claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. Do not refigure your tax for the year you claimed the deduction. For more information, see *Recovery of items previously deducted* in chapter 6.

Note. If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a ***gain*** on the casualty or theft. If you have already taken a deduction for a loss and you receive the reimbursement in a later year, you must include it in your income for the later year. Include the reimbursement as ordinary income to the extent your deduction reduced your tax for the earlier year.

You must also report your gain in the later year. But you may be able to postpone reporting your gain as explained under *Postponing Gain*, later.

Recovered Property

Recovered property is your property that was stolen and later returned to you. If you recover property after you had already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained under *Figuring Gains and Losses*, earlier) or the decrease in fair market value from the time it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

This is your refigured loss. If this amount is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax.

Disaster Area Losses

If you have a deductible casualty loss from a disaster in an area declared by the President of the United States to be eligible for federal disaster assistance, you can choose to deduct that loss on your return or amended return for the immediately preceding tax year. If you do this, the loss is treated as having occurred in the preceding year.

Make the election to deduct the loss in the preceding year by the later of:

1) The due date (without extensions) for filing your income tax return for the tax year in which the disaster occurred, or
2) The due date (with extensions) for the preceding year's return.

Disaster loss to inventory. If your inventory loss is from a disaster in an area declared by the President of the United States to be eligible for federal assistance, you may choose to deduct the loss on your return or amended return for the immediately preceding year. However, decrease your opening inventory for the year of the loss so that the loss will not show up again in inventories.

Disaster unemployment pay. Disaster unemployment assistance payments are taxable unemployment benefits.

Grants. Do not include grants you receive under the Disaster Relief and Emergency Assistance Act in your gross income. Also, do not deduct a casualty loss to the extent you are specifically reimbursed by the grant.

For more information on disaster area losses, see Publication 547.

How to Report Gains and Losses

Use Section B of Form 4684 to figure and report casualties and thefts of property used in a trade or business or for income-producing purposes. For more information, see chapter 26.

Adjustments to Basis

If your property is partly or totally destroyed by casualty, you must decrease your basis in the property by any insurance or other reimbursement you receive and by any deductible loss. The insurance or reimbursement represents a return of part or all of the capital you invested in the property. You must increase your basis by any amounts spent to rebuild or restore the property after a casualty.

For more information on adjusted basis, see chapter 5.

Example 1. Your business truck is involved in an accident. After appraisals, you determine the loss to be $2,000. You carry $250 deductible insurance. You receive $1,750 from insurance. Your deductible casualty loss is $250 ($2,000 minus $1,750 insurance). Reduce the basis of your truck by your deductible casualty loss, $250, and by the insurance, $1,750.

Example 2. Before being partly destroyed by fire, your building had an adjusted basis of $115,000. Its value was $130,000 just before the fire and $120,000 immediately after. You collected $10,000 insurance. You have no casualty loss deduction because the insurance you received equaled your casualty loss. Reduce the basis of your building by the $10,000 insurance.

If Loss Is More Than Income

If your casualty or theft loss deduction is more than your income, you may have a ***net operating loss***. You can use a net operating loss to lower your tax in an earlier year allowing you to get a refund for tax you already paid. Or, you can use it to lower your taxes in a later year. For more information, see chapter 20.

Part Business and Part Personal-Use Property

When property is partly personal-use and partly business or income-producing property, figure the casualty or theft loss deduction as though there were two separate casualties or thefts. Figure the one affecting the personal-use property and the other affecting the business or income-producing property.

Personal-use property. You can deduct the total casualty or theft loss to your personal-use property only if it is more than 10% of your adjusted gross income. You also must first reduce each separate casualty or theft loss by $100.

For more information on losses to personal-use property, see Publication 547.

Example. You own a 3-story building that you built on leased land. You use two floors (2/3 of the building) in your business and you live on the third floor (1/3 of the building). The cost of the building was $140,000 and you made no improvements or additions to it. A flood in March damaged the entire building. The fair market value of the building was $133,000 immediately before the flood and $120,000 afterwards. Your insurance company reimbursed you $9,000 for the flood damage. Depreciation on the business part of the building before the flood totaled $8,400. Your adjusted gross income is $50,000.

You have a deductible business casualty loss of $2,667. You do not have a deductible personal casualty loss because of the $100 and 10% rules. You figure the loss as follows:

	Business loss	Personal loss
1) Adjusted basis of building before flood: Business part (cost $93,333 minus depreciation $8,400)	$84,933	
Personal-use part (basis equals cost) ...		$46,667
2) Value before flood (total $133,000)	$88,667	$44,333
3) Value after flood (total $120,000)	80,000	40,000
4) Decrease in value	$ 8,667	$ 4,333
5) Amount of loss (line 1 or line 4, whichever is less)	$ 8,667	$ 4,333
6) Minus: Insurance	6,000	3,000
7) Loss after reimbursement	$ 2,667	$ 1,333
8) Minus: $100 on personal-use property	–0–	100
9) Loss after $100 rule	$ 2,667	$ 1,233
10) Minus: 10% of $50,000 on personal-use property	–0–	5,000
11) Deductible business loss	$ 2,667	
12) Deductible personal loss		–0–

Listed property. Special rules apply to listed property not used 100% in your business. Listed property includes:

1) Any passenger automobile,
2) Other property used for transportation,
3) Property used for entertainment, such as photographic, communication, and video recording equipment, and
4) Computers and related peripheral equipment not used exclusively at a regular business location.

For listed property not used 100% in your trade or business, figure its adjusted basis as if all its use were in your trade or business. This will require you to reduce the adjusted basis of listed property by depreciation figured as if you used it 100% for business. This is true even if a lesser amount was allowable because your trade or business use of the property was less than 100%.

For more information on listed property, see chapter 12.

Condemnations

Condemnation is the process by which private property is legally taken for public use without the owner's consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take it. The owner receives a condemnation award (money or property) in exchange for the condemned property. A condemnation is like a forced sale, the owner being the seller and the condemning authority being the buyer.

Example. A local government authorized to acquire land for public parks told you that it wished to acquire your property. After the local government took action to condemn your property, you went to court to keep it. But the court ruled for the local government, which took your property and paid you an amount fixed by the court. This is a condemnation of private property for public use.

Threat of condemnation. A threat of condemnation exists if a representative of a government body or a public official authorized to acquire property for public use tells you that the government body or official has decided to acquire your property. You must have reasonable grounds to believe that, if you do not sell voluntarily, your property will be condemned.

The sale of your property to someone other than the condemning authority qualifies as an involuntary conversion, if you have reasonable grounds to believe that your property will be condemned. If the buyer of this property knows that it will be condemned at the time of purchase and sells it to the condemning authority, that sale also qualifies as an involuntary conversion.

Reports of condemnation. A threat of condemnation exists if you learn of a decision to acquire your property for public use through a report in a newspaper or other news medium, and this report is confirmed by a representative of the government body or public official involved.

You must have reasonable grounds to believe that they will take the necessary steps to condemn your property if you do not sell voluntarily. If you relied on oral statements made by a government representative or public official, the Internal Revenue Service may ask you to get written confirmation of the statements.

Example 1. A public utility company that does not have the authority to condemn property, but can get that authority, wants to acquire your property. If, during negotiations, a representative tells you your property will be condemned and also reveals the identity of the condemning authority, you have reasonable grounds to believe condemnation will occur if you do not voluntarily sell the property.

Example 2. Tom Young received a health department notice that a building he owns is unfit and will be condemned if necessary repairs are not made. He is not under threat of condemnation because the notice is not related to a condemnation of private property for public use.

Related property voluntarily sold. A voluntary sale of your property may be treated as a forced sale that qualifies as an involuntary conversion if the property had a ***substantial economic relationship*** to your condemned property. A substantial economic relationship exists if together the properties were one economic unit. You must also show that the condemned property could not reasonably or adequately be replaced. You can choose to postpone reporting the gain by buying replacement property; see *Postponement of Gain* later.

Example. Green Corporation rented its manufacturing plant from your father and an adjacent warehouse from you. Your father owns 51% of Green's stock. You and your brother own the remaining stock. Last year your father sold his plant under threat of condemnation. You sold your warehouse because the plant was relocated. Your voluntary sale is not a condemnation because you do not own the condemned property (the plant).

Easements. Treat the granting of an easement on your property (for example, a right-of-way over it) under condemnation or threat of condemnation, as a forced sale, even though you keep the legal title. Although you figure gain or loss on the easement in the same way as a sale of property, treat the gain or loss as from a condemnation. See *Figuring Gain or Loss*, later.

Condemnation award. A condemnation award is the money or the value of other property you receive for your condemned property. The award is also the amount paid to you for the sale of your property under threat of condemnation.

Deposits made by the condemning authority. The condemning authority may deposit with the clerk of the court, for example, any award that is being disputed. Treat the award as received in the first year you have an unrestricted right to it. This can occur when you can withdraw the money for your own use. Report the award on your return for that year, not the settlement year of the dispute.

Amounts withheld from award. Amounts withheld from the award to pay your debts are considered paid to you. Amounts paid directly to the holder of a mortgage or other lien (claim) against your property are part of your award, even though the debt attaches to the property and is not your personal liability.

Example. The state condemned your property for public use. The award was set at $200,000. The state paid you only $148,000 because it paid $50,000 to your mortgage holder and $2,000 accrued real estate taxes. You are considered to have received the entire $200,000 as a condemnation award.

Net condemnation award. A net condemnation award is the total award you received, or are considered to have received, for the condemned property minus your expenses of obtaining the award. If only a part of your property was condemned, you must also reduce the award by any special assessment levied against the part of the property you retain. See *Special assessment withheld and you do not receive severance damages*, later.

Interest on award. If the condemning authority pays you interest for its delay in paying your award, it is not part of the condemnation award. You must report the interest separately as ordinary income.

Payments to relocate. Payments you receive to relocate and replace housing because you have been displaced from your home, business, or farm as a result of federal or federally assisted programs are not part of the condemnation award. Do not include them in your income. Replacement housing payments used to buy new property are included in the property's basis as part of your cost.

Severance damages. Severance damages are not part of the award paid for the property condemned. They are compensation paid to you if part of your property is condemned and the value of the part you keep decreases because of the condemnation.

The condemnation of part of your property may also damage the part you keep. For example, you may receive severance damages if your property is subject to flooding. Severance damages may also be given to you to replace fences, dig new wells or ditches, or plant trees to restore your remaining property to the same usefulness it had before the condemnation.

The contracting parties should agree on amount of the severance damages and put that in writing. If this is not done, all proceeds from the condemning authority are considered awarded for your condemned property.

You cannot make a completely new allocation of the total award after the transaction is completed. However, you may show how much of the award both parties intended to be for severance damages. Determine the part of the award for severance damages from all the facts and circumstances.

Treatment of severance damages. Your net severance damages are treated as the amount realized from an involuntary conversion of the remaining part of your property. To figure that amount, you must first reduce your severance damages by your expenses in obtaining the damages. You then reduce them by any special assessment levied against the remaining property if the assessment was withheld from the award by the condemning authority. The balance is your net severance damages.

You reduce the basis of the remaining property by your net severance damages. If the severance damages are based on damage to a specific part of the remaining property, reduce only the basis of that part by the net severance damages. If your net severance damages are more than the basis of the remaining property, you have a gain. You can choose to postpone reporting the gain by buying replacement property. See *Postponing Gain*, later.

You can also make this choice if you spend the severance damages, together with other money you received for the condemned property, to acquire nearby property that will allow you to continue your business. If suitable nearby property is not available and you are forced to sell the remaining property and relocate in order to continue your business, see see Property voluntarily sold, earlier.

If you restore the remaining property to its former use, you can treat the cost of restoring it as the cost of replacement property.

Consequential damages. You may receive consequential damages and similar awards for damage from improvements made to your property by a state, city, or other public body that did not take your property. These amounts are awarded for the same reasons as severance damages, discussed earlier, and treated in the same way.

Expenses of obtaining awards and damages. Subtract the expenses of obtaining a condemnation award, such as legal, engineering, and appraisal fees, from the total award. Also subtract the expenses of obtaining severance damages from the severance damages paid to you. If you cannot determine which part of your expenses is for each part of the condemnation proceeds, you must make a proportionate allocation.

Special assessment withheld and you do not receive severance damages. When part of your property is condemned, you must reduce the condemnation award by any amount withheld because of a special assessment levied against the remaining property. An assessment may be levied if the remaining property benefited from the improvement resulting from the condemnation. Examples of improvements that may cause a special assessment are widening a street and installing a sewer.

The assessment must be withheld from the award. The award cannot be reduced by any assessment levied after the award is made, even if the assessment is levied in the same year the award is made.

Example. To widen the street in front of your home, the city condemned part of your land. It awarded you $5,000. You spent $300 to get the award. Before paying the award, the city levied a special assessment of $700 for the street improvement against your remaining property. The city then paid you only $4,300. Your net award is $4,000 ($5,000 total award minus $300 expenses to get the award and $700 for the special assessment withheld).

If the $700 special assessment were not withheld from the award and you received $5,000, your net award would be $4,700 ($5,000 minus $300). The net award is not changed even if you later paid the assessment from the amount you received.

Severance damages received. If the condemnation proceeds includes severance damages, you must first reduce the severance damages by any special assessment withheld. Use any balance of the special assessment to reduce the remaining condemnation award.

Figuring Gain or Loss

If your property was condemned or disposed of under threat of condemnation, figure your gain or loss by comparing your adjusted basis in the condemned property with the your net condemnation award.

If your net condemnation award is more than your adjusted basis in the condemned property, you have a gain. You may be able to postpone reporting it. If your award is less than your adjusted basis, you have a loss. You must report any deductible loss in the tax year in which it happened. If your loss is from property you held for personal use, you cannot deduct it.

Part business or part rental. If you used part of your condemned property as your home and part as business or rental property, treat each part as a separate property and figure your gain or loss separately because different treatment may apply to each gain or loss.

Some examples of this type of property are a building in which you live and operate a grocery, and a building in which you live on the first floor and rent out the second floor.

Postponing Gain

Do not report the gain on condemned, damaged, destroyed, or stolen property if you receive only property that is similar or related in service or use to it. Your basis for the new property is the same as your basis for the old property.

Choosing to postpone gain. You must ordinarily report the gain if you receive money or unlike property as reimbursement. You can choose to postpone reporting the gain if, within a specified replacement period, discussed later, you purchase:

1) Property similar or related in service or use to the condemned, etc., property, or
2) A controlling interest (at least 80%) in a corporation owning such property.

To postpone all the gain, you must buy replacement property costing at least as much as the amount realized for the condemned property.

Report your election to postpone your gain, along with all necessary details, on your return for the tax year in which you realize the gain.

If a partnership or a corporation owns the condemned, damaged, destroyed, or stolen property, ***only the partnership or corporation*** can choose to postpone reporting the gain.

Changing your mind. You can change your mind about reporting or postponing the gain at any time before the end of the specified replacement period. However, see *Substituting replacement property*, later.

Example. Your property was condemned and you had a gain of $5,000. You reported the gain on your return for the year in which you received it, and paid the tax due. You buy replacement property within the replacement period. You used all but $1,000 of your gain to buy the replacement property. You now change your mind and want to postpone the tax on the $4,000 of gain spent for the replacement property. You should file a claim for refund on Form 1040X. Explain on Form 1040X that you previously reported the entire gain from the condemnation, but you now want to report only the part of the gain ($1,000) not spent for replacement property.

Postponing gain on severance damages. If you received severance damages for part of your property because another part was condemned and you buy replacement property, you can choose to postpone reporting gain. See *Treatment of severance damages,* earlier. You can postpone reporting all your gain if the replacement property costs at least as much as your net severance damages plus your net condemnation award.

Postponing gain on the sale of related property. If part of your property is condemned, and you sell the related part and buy replacement property, you can choose to postpone reporting gain on the sale. You must meet the requirements explained earlier under *Related property voluntarily sold.* You can postpone reporting all your gain if the replacement property costs at least as much as the amount realized from the sale, plus your net condemnation award (if resulting in gain), plus your net severance damages, if any (if resulting in gain).

Replacing real property held for business or investment. If the condemned property is real property you held for use in your trade or business or for investment (other than property held mainly for sale), your replacement property will qualify as similar or related in service or use if it is like-kind property. For a discussion of like-kind property, see *Like-kind property* later.

Replacement Property

You must buy replacement property for the specific purpose of replacing your condemned, damaged, destroyed, or stolen property. You do not have to use the actual award or reimbursement from your old property to acquire the replacement property. Property or stock you acquire by gift or inheritance does not qualify as replacement property.

Similar or related in service or use. Your replacement property must be similar or related in service or use to the property it replaces. If the condemning authority acquired real estate that you used in your business or for rental or investment purposes, see *Special rule for certain real property*, later.

You can treat qualified property bought with the proceeds from the sale of timber downed by a casualty (such as high winds, earthquakes, or volcanic eruptions) as a replacement property. If the proceeds are invested in property similar or related in service or use to the timber property within the specified replacement period, you can postpone reporting the gain.

Fee simple property. ''Fee simple'' property you will use in your trade or business or for investment can qualify as replacement property that is similar or related in service or use to a condemned 15-year leasehold if you use the ''fee simple'' property in the same business and for the identical purpose as the condemned leasehold.

A ''fee simple'' property interest generally is one in which the owner is entitled to the entire property, with unconditional power to dispose of it during his or her lifetime. A leasehold is property held under a lease usually for a term of years.

Owner-user. If you are an owner-user, similar or related in service or use means that replacement property must function in the same way as the property it replaces.

Example. Your home was destroyed by fire. Your insurance reimbursement resulted in a gain. To postpone reporting the gain, you must replace your home with another home that costs at least as much as the reimbursement. If you replace your home with an apartment house you buy to rent out to others, you cannot postpone reporting the gain because the apartment house is not similar or related in service or use to your destroyed home.

Owner-investor. If you are an owner-investor, similar or related in service or use means that any replacement property must have the same relationship of services or uses to you as the property it replaces. You decide this by determining:

1) Whether the properties are of similar service to you,
2) The nature of the business risks connected with the properties, and
3) What the properties demand of you in the way of management, service, and relations to your tenants.

Example. You owned land and a building you rented to a manufacturing company. The building was condemned. During the replacement period, you had a new building constructed on other land you already owned. You rented out the new building for use as a wholesale grocery warehouse. Because the replacement property is also rental property, the two properties are considered similar or related in service or use if there is a similarity in:

1) Your management activities,

2) The amount and kind of services you provide to your tenants, and

3) The nature of your business risks connected with the properties.

Advance payment. You have not purchased replacement property if you pay a contractor in advance to build your replacement property unless it is finished before the end of the replacement period.

Controlling interest in a corporation. You can replace property by acquiring a controlling interest in a corporation that owns property similar or related in service or use to your condemned, damaged, destroyed, or stolen property. You can postpone the tax on your entire gain if the cost of the stock that gives you controlling interest is at least as much as the amount realized (reimbursement) for your property. You have controlling interest if you own stock having at least 80% of the combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock.

Special rule for certain real property. A special rule applies to the replacement of real property used in your trade or business or held for the production of income or for investment that is condemned or sold under threat of condemnation. Real property means property relating to land, and generally anything that is erected on, growing on, or attached to the land. This special rule does not apply to the acquisition of real property held as stock in trade or primarily for sale.

In such cases, you can postpone reporting your gain on the condemnation of your real property if, within the replacement period, you replace it with "like-kind property" that will be used in your trade or business or held for the production of income or for investment. If you do not replace the condemned property with like-kind property, you can still postpone reporting the gain by replacing it with property that is similar or related in service or use.

Like-kind property. Like-kind property, for the special rule, generally means real property. It does not matter if the condemned property or your replacement property is improved or unimproved. In determining whether the two properties qualify as like-kind property, consider the nature and character of each property.

For example, replacement with real property held for use in a trade or business or for the production of income for the following are like-kind exchanges:

1) Easements,

2) Rights-of-way,

3) Leaseholds for a term of 30 years or more (the term includes the initial term of the lease and all optional renewal periods),

4) Perpetual water rights, if considered real property rights under state law, and

5) Any similar continuing interests in real property.

Example 1. You planned to build warehouses for your business on your vacant land. The land was condemned before you built the warehouses. You bought land with a garage, a service station, and sales rooms on it. You rent out these buildings. The improved land qualifies as replacement property because it is held for the production of income and of a like kind.

Example 2. Assume that in Example 1 you used the amount you received from the condemnation to buy a controlling interest in a corporation that owns land with a garage, a service station, and sales rooms on it. Your purchase of the controlling interest does not qualify as replacement property because stock is not like-kind property to vacant land nor is the new property similar or related in service or use to your vacant land.

Outdoor advertising displays. You can make an election to treat a qualifying outdoor advertising display as real property if you did not claim a section 179 deduction for the display. You cannot revoke this election unless you get the consent of the Internal Revenue Service.

If you make this election and you replace your condemned, etc., outdoor advertising display with real property in which you hold a different kind of interest, your replacement property can qualify as like-kind property. For example, real property purchased to replace a destroyed billboard and leased property on which the billboard was located qualify as property of a like kind.

An outdoor advertising display is a sign or device rigidly assembled and permanently attached to the ground, a building, or any other permanent structure used for commercial or other advertisement to the public.

Basis of replacement property. If you acquire property as the result of a condemnation, the basis of the replacement property is the same as that of the condemned property. Decrease that basis by any money received but not spent for replacing the property, and increase it by the amount of gain or decrease it by the amount of loss to be reported on your income tax return. If you spend more for the replacement property than you received from the condemnation, add that amount to the basis of the replacement property. For more information on basis, see chapter 5.

Replacement Period

To postpone reporting your gain from a condemnation, casualty, or theft, you must buy replacement property within a specified period of time. This is the "replacement period."

Casualty or theft. The replacement period for a casualty or theft begins on the date the property was damaged, destroyed, or stolen. The replacement period ***ends 2 years*** after the close of the first tax year in which you realize any part of the gain on the casualty or theft.

Condemnation. The replacement period for a condemnation begins on the earlier of:

1) The date the condemned property was disposed of, or

2) The date the threat of condemnation began.

The replacement period ***ends 2 years*** after the close of the first tax year in which any part of the gain on the condemnation is realized.

If ***real property held for use in a trade or business*** or for investment (not including property held primarily for sale) is condemned, the replacement period ***ends 3 years*** after the close of the first tax year in which any part of the gain on the condemnation is realized. However, this 3-year replacement period cannot be used if you replace the condemned property by acquiring control of a corporation owning property that is similar or related in service or use.

Example. You are a calendar year taxpayer. The city council notified you on December 1, 1994, of its intent to acquire your business real property. On June 1, 1995, when the property had an adjusted basis of $40,000 to you, the city condemned the property and paid you $50,000. The replacement period began on December 1, 1994, the date you were notified of the intent to condemn the property. Because the condemned property was business real estate, the replacement period ends on December 31, 1998, three years after the last day of the year in which the gain was realized.

Replacement property acquired before the condemnation. If you acquire your replacement property after there is a threat of condemnation, but before the actual condemnation, and you still hold the replacement property at the time of the condemnation, you have acquired your replacement property within the replacement period. Property you acquire before there is a threat of condemnation does not qualify as replacement property acquired within the replacement period.

Constructive receipt of condemnation payments. The replacement period ends 2 (or 3) years after the close of the first tax year in which you realize any part of the gain. You realize gain when you receive payments that exceed your basis in the property. This applies even though the amounts received are only partial or advance payments and the full amount of the award has not yet been determined. A replacement will be too late if you wait for a final determination that does not take place in the applicable replacement period after you first realize gain.

In addition, the replacement period begins when the condemning authority makes deposits into the court and you withdraw amounts in excess of your basis.

For accrual basis taxpayers, gain begins to accrue in the year of condemnation and not in the year of payment.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. Make your application before the end of the replacement period. Include all the details about your need for an extension. You may file an application within a reasonable time after the replacement period ends if you can show reasonable cause for the delay. You will get an extension of time if you can show reasonable cause for not making the replacement within the regular period.

How to Postpone Gain

If your property is condemned, damaged, destroyed, or stolen, report your election to postpone your gain, along with all the necessary details, on your return for the tax year in which you realize the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year you realize gain, attach a statement to your return. Show in the statement the amount realized from the condemnation, casualty, or theft. Also show how you figured the gain, and any gain you will report.

Substituting replacement property. Once you designate certain property as replacement property, you may not substitute other qualified property. But if your previously designated replacement property does not qualify, you can substitute qualified property if you acquire it within the replacement period.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year you realize gain, attach a statement to your return. Show in the statement all the facts relating to the condemnation, casualty, or theft. Also show how you figured the gain, and that you choose to replace the property within the required replacement period.

You then attach another statement to your return for the year you buy the replacement property. Show in the statement detailed information on the replacement property. If you make the replacement in separate years, attach a statement with the return for each year. Include in the statement detailed information on the balance of the replacement property.

Amended return. File an amended return and refigure your tax liability for the tax year you made the choice if:

1) You did not acquire replacement property within the replacement period,

2) You got replacement property within the replacement period but for less than you expected when you made the election, or

3) You decided not to replace the property.

Effect of taxpayer's death. If a taxpayer dies in the year the gain is realized, but before replacement property is acquired, there can be no election to postpone the gain. Instead, report the gain on the decedent's final income tax return.

26.

Reporting Gains and Losses

Important Changes

Caution. As this publication was being prepared for print, Congress was considering tax law changes that would affect your 1995 tax return and 1996 estimated taxes. These changes include:

- Capital gains and losses, and
- Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Introduction

This chapter discusses the reporting of capital gains and losses and ordinary gains and losses from sales, exchanges, and other dispositions of property. It covers the use of Schedule D (Form 1040), Form 4684, and Form 4797.

Although this chapter refers to Schedule D (Form 1040), the rules discussed here also apply to taxpayers other than individuals. However, the rules for property held for personal use will usually not apply to taxpayers other than individuals.

Topics

This chapter discusses:

- Schedule D (Form 1040)
- Form 1099-B
- Form 1099-S
- Form 4797
- Form 4684

Useful Items

You may want to see:

Publication

- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses

Form (and Instructions)

- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **4684** Casualties and Thefts
- ☐ **4797** Sales of Business Property
- ☐ **8824** Like-Kind Exchanges

Information Returns

If you sell or exchange certain assets, you should receive an information return showing the proceeds of the sale. This information is also provided to the Internal Revenue Service.

Form 1099–B. If you sold stocks, bonds, commodities, etc., you should receive Form 1099–B or an equivalent statement. Whether or not you receive Form 1099–B, you must report all taxable sales of stocks, bonds, commodities, etc., on Schedule D. For more information on figuring gains and losses from these transactions, see chapter 4 in Publication 550.

Form 1099–S. Information reporting must be provided on certain real estate transactions. Generally, the person responsible for closing the transaction must report on Form 1099–S sales or exchanges of the following:

1) Land (improved or unimproved), including air space,
2) Inherently permanent structures, including any residential, commercial, or industrial building,
3) A condominium unit and its appurtenant fixtures and common elements (including land), or
4) Stock in a cooperative housing corporation.

If you sold or exchanged the above types of property, the reporting person must give you a copy of Form 1099–S or a statement containing the same information as the Form 1099–S.

If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting it does not have to value that property or those services. In that case, the gross proceeds reported on Form 1099–S will be less than the sales price of the property you sold. Figure any gain or loss according to the sales price, which is the total amount you realized on the transaction.

Schedule D (Form 1040)

Where you report a sale or exchange on Schedule D (Form 1040) depends on how long you held (owned) the property. See chapter 22.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would affect capital gains and losses. The line numbers on Schedule D (Form 1040) could change for 1995. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Before completing Schedule D (Form 1040), you may have to complete other forms. For the sale of business property, complete Form 4797 (discussed later). Form 4797 is used along with Form 1040, as well as Forms 1065, 1120, and 1120S.

For a like-kind exchange, complete Form 8824. See *Reporting the exchange* under *Like-Kind Exchanges,* in chapter 21.

For an installment sale, complete Form 6252. See *Installment Sales,* in chapter 23.

Personal use property. Report gain on the sale or exchange of property held for personal use (such as your home) on Schedule D. Loss from the sale or exchange of property held for personal use is not deductible. But if you had a loss from the sale or exchange of real estate held for personal use (other than your main home), report the transaction on Schedule D even though the loss is not deductible. Complete columns (a) through (e) and write "Personal loss" across columns (f) and (g).

Short-term gains and losses. Gain or loss on the sale or exchange of capital assets held 1 year or less is short-term capital gain or loss. Report it in Part I.

Net short-term gain or loss. Combine your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries with your short-term capital loss carryovers and other short-term gains and losses to figure your net short-term capital gain or loss.

Long-term gains and losses. A gain or loss on the sale or exchange of capital assets held more than 1 year is long-term capital gain or loss. Report it in Part II.

Net long-term gain or loss. A net section 1231 gain from Part I of Form 4797, after any reduction for nonrecaptured section 1231 losses from prior tax years, is long-term capital gain. See chapter 23. Report this gain in Part II of Schedule D (Form 1040). Also, you report the following in Part II:

1) Capital gain distributions from regulated investment companies, mutual funds, and real estate investment trusts,
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries, and
3) Long-term capital loss carryovers.

The result from combining these items with other long-term capital gains and losses is your net long-term capital gain or loss.

Total net gain or loss. Figure your total net gain or loss by combining your net short-term capital gain or loss with your net long-term capital gain or loss. Enter the result on line 18, Part III. If losses are more than gains, see *Treatment of Capital Losses* in chapter 22.

Form 4797

Use Form 4797 to report gain or loss from a sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties.

Section 1231 gains and losses. Any section 1231 gains and losses are shown in Part I. A net gain is carried to Schedule D (Form 1040) as a long-term capital gain. A net loss is carried to Part II of Form 4797 as an ordinary loss.

If you had any nonrecaptured net section 1231 losses from the preceding 5 tax years, reduce your net gain by those losses and report the amount of the reduction as an ordinary gain in Part II. Any remaining gain is reported on Schedule D (Form 1040). See *Section 1231 Property,* in chapter 23.

Ordinary gains and losses. Any ordinary gains and losses are shown in Part II. This includes a net loss or a recapture of losses from prior years figured in Part I of Form 4797. It also includes ordinary gain figured in Part III.

Ordinary income due to depreciation recapture. The ordinary income due to the recapture of depreciation on personal property and additional depreciation on real property (as discussed in chapter 23) is figured in Part III. The ordinary income is carried to Part II of Form 4797 as an ordinary gain. Any remaining gain is carried to Part I as section 1231 gain, unless it is from a casualty or theft. Any remaining gain that is from a casualty or theft is carried to Form 4684.

Form 4684

Use Form 4684 to figure and report casualty and theft losses and gains. Section B, Part I, has space to figure a gain or loss on four items of business or income-producing property. List each item or article for which you are claiming a casualty or theft loss. If more than four items of property were damaged or stolen in a single casualty or theft, use additional sheets following the format of Section B, Part I, through line 27.

If you had more than one casualty or theft during the year, fill out a separate Form 4684 for each casualty or theft.

Section B, Part II, is used to summarize all your gains and losses from casualties and thefts of business or income-producing property during the tax year. Your net gain or loss is then carried to other tax forms. Short-term gains and losses are listed separately from long-term gains and losses. Part II also separates losses by the type of property. Losses on business property and property that earns rent or royalty income are listed in column (b)(i). Losses on income-producing property are listed in column (b)(ii). Gains are listed in column (c).

Part Six.

The Business Activity

This Part discusses some of the tax rules that may differ, depending on whether you operate your business as a sole proprietor, a partnership, a corporation, or an S corporation.

27. Sole Proprietorships

Introduction

This chapter explains the filing requirements for a sole proprietor and how a sole proprietor should report the sale or disposition of a business. For information on how to treat the expenses of starting a new business or buying an existing business, see chapters 4 and 13.

You are a sole proprietor if you are self-employed and are the sole owner of an unincorporated business.

Topics

This chapter discusses:

- Schedule C (Form 1040)
- Schedule C–EZ (Form 1040)
- The sale of a business

Useful Items

You may want to see:

Publication

- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **544** Sales and Other Dispositions of Assets

Form (and Instructions)

- ☐ **Schedule C (Form 1040)** Profit or Loss From Business
- ☐ **Schedule C–EZ (Form 1040)** Net Profit From Business
- ☐ **1040–ES** Estimated Tax for Individuals
- ☐ **2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- ☐ **4868** Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
- ☐ **8594** Asset Acquisition Statement Under Section 1060

Schedule C and Schedule C–EZ

If you are a sole proprietor, you report your income and expenses from your business or profession on Schedule C or Schedule C–EZ (Form 1040) and file it with your Form 1040. Report the amount of net profit (or loss) from Schedule C on line 12 of Form 1040. If you operate more than one business as a sole proprietor, you must prepare a ***separate Schedule C or Schedule C–EZ for each business*** and attach each of them to your tax return. If you do not prepare a separate Schedule C or Schedule C–EZ for each business, you may have to pay a ***penalty*** because you did not properly report your income and deductions.

It is important to use the correct business code, since this information will identify market segments of the public for IRS Taxpayer Education programs. This information is also used by the U.S. Census Bureau for their economic census.

Schedule C–EZ (Form 1040). You may be able to use Schedule C–EZ, *Net Profit From Business,* if you had gross receipts from your nonfarm business of $25,000 or less and business expenses of $2,000 or less. Other requirements that must be met are listed on Schedule C–EZ.

Due date. Form 1040 is due, for calendar year 1995, by April 15, 1996. If you use a fiscal year, your return is due by the 15th day of the 4th month after the close of your fiscal year. See the *Checklist* near the end of this publication.

Automatic extension of time to file Form 4868. If you cannot file your return on time, use Form 4868 to request an automatic 4–month extension.

You may not use Form 4868 if:

1) You want the IRS to figure your tax, or
2) You are under a court order to file your return by the regular due date.

You must file Form 4868 by the date your Form 1040 would be due. When you file Form 4868, estimate any tax you will owe and any balance due. Pay as much as you can at this time to limit the interest you will owe. Also, you may be charged the late payment penalty on the unpaid tax from the regular due date of your return.

Form 9465. If you are unable to pay the tax owed on or before the end of the automatic 4-month extension period, you can attach Form 9465, *Installment Agreement Request,* to your income tax return. IRS encourages you to make installment payments as large as possible in order to reduce the interest and penalties required by law.

Withdrawals. If you are a sole proprietor, there is no tax effect if you take money out of your business, or transfer money to or from your business. It is a good idea to set up a drawing account. This will help you identify amounts that are not for business expenses but that are for your own personal use.

Self-employment tax. Generally, if you are a sole proprietor, you will have to pay self-employment tax. See chapter 32.

Estimated Tax

If you are a sole proprietor, you may have to make estimated tax payments if the total of your estimated income tax and self-employment tax for 1996 will exceed your total withholding and credits by $500 or more.

You use ***Form 1040–ES*** to estimate your tax. See Publication 505 and the instructions for Form 1040–ES for information on estimated taxes.

Underpayment of tax. If you did not pay enough income tax and self-employment tax for 1995 by withholding or by making estimated tax payments, you may have to pay a penalty on the amount not paid. IRS will figure the penalty for you and send you a bill. Or you can use ***Form 2210*** to see if you have to pay a penalty and to figure the penalty amount. For more information, see Publication 505.

Sale of a Business

If you are a sole proprietor and sell your business, you are really selling all the individual assets of your business.

Classification of assets. To determine whether the gain or loss on the sale of an asset is capital gain or loss or ordinary gain or loss, you must classify the assets sold into one of the following categories:

1) Capital assets,
2) Real property and depreciable property used in your business and held for more than one year (this includes amortizable

section 197 intangibles) (see chapter 23), and

3) Other property—for example, stock-in-trade, inventory, or property used in your business and held one year or less.

Accounts and notes receivable. Accounts and notes receivable acquired in the ordinary course of your business for services rendered, or from the sale of stock-in-trade, are not capital assets. They should be classified in category (3).

Installment notes. Installment notes from the sale of stock-in-trade should be classified in category (3). The gain, which is the difference between the basis of the note and the amount realized, is ordinary income.

Merchandise inventories. Merchandise inventories are not capital assets and belong in category (3).

Land and leaseholds. Land and leaseholds used in your business are not capital assets. If you hold them for more than one year, they belong in category (2), and, if you hold them one year or less, in category (3).

Buildings, machinery, furniture, and fixtures. Buildings, machinery, furniture, and fixtures that you use in your business are not capital assets. You should put them in category (2) if you hold them for more than one year, and in (3) if you hold them for one year or less.

Patents. Patents that you use in your business should ordinarily be classified in category (2) if you hold them more than one year, and in (3) if you hold them one year or less. But if you are the inventor (or if you are entitled to the same treatment as the inventor, as explained under *Patents,* in chapter 22) and you sell all substantial rights to patent property or a patent, or an undivided interest in all such rights, to a person other than a related person, treat the sale as a sale of a long-term capital asset and include it in category (1).

Copyrights. Copyrights that you use in your business should be classified in category (2) if you hold them more than one year, and in (3) if you hold them one year or less. However, if you sell a copyright that you created, or if you sell a copyright that gets its basis from the person who created the property, you should not classify it in category (2). Instead, you should classify it in category (3).

If you acquired patents and copyrights as part of the acquisition of a substantial portion of a business after August 10, 1993 (or after July 25, 1991, if elected), you must amortize their costs over 15 years. If the patent or copyright is not acquired as part of an acquisition of a substantial portion of a business, you must depreciate the cost. For more information, see chapter 13.

Goodwill. Goodwill is a section 197 intangible. It belongs in category (2). The basis of goodwill is usually its cost if you bought it. When you buy a going business and intend to continue the business, goodwill may be included in the price.

If you acquired a business after August 10, 1993 (or July 25, 1991, if elected), and part of the price included goodwill, you may amortize the cost of the goodwill over 15 years. For more information on section 197 intangibles, see chapter 13.

Agreement not to compete. An agreement not to compete (also called a covenant not to compete) entered into in connection with the acquisition of an interest in a trade or business is a section 197 intangible and should be classified in category (2). See chapter 22.

Professional skill or other characteristics of an owner. The amount received from the sale of a professional practice that is for goodwill is determined by the facts in the particular case and not by whether the business is, or is not, dependent solely on the owner's professional skill or other personal characteristics.

If the seller has the right to keep fees collected after the sale for services performed before the sale, or receives payment for giving up all or part of the right to these fees, the amount received is treated as if it were for services performed before the sale rather than for the sale of goodwill, and is ordinary income.

If the seller retains a right to any fees or revenue collected for services performed after the sale, or if the purchaser agrees to pay an amount equal to any part of these fees or revenues, these amounts are ordinary income from the business, not proceeds from the sale of goodwill.

Amounts received by a professional person when admitting partners to that person's practice may be payment for a partial transfer of goodwill (rather than an assignment of anticipated future earnings). In such a case, the goodwill must in fact exist and the consideration allocated to it must actually be a payment for it.

Allocation of selling price. You must allocate the selling price proportionately among all the assets sold. You and the buyer may enter into a written agreement as to the allocation of any consideration, or the fair market value of any of the assets. This agreement is binding on both parties unless the Internal Revenue Service determines that the amounts are not appropriate.

You and the buyer must report to the IRS the allocation of the sales price among section 197 intangibles and the other business assets. Use Form 8594, *Asset Acquisition Statement Under Section 1060,* to provide this information. Both you and the buyer must each attach Form 8594 to your federal income tax returns for the year in which the sale occurred.

See chapter 2 in Publication 544 for a discussion of the allocation rules.

Figuring gain or loss. After classifying each asset sold and allocating the selling price, you are ready to figure your gain or loss. You must figure separately the gain or loss for each asset sold, and then treat it according to its classification. The treatment of assets in categories (1) and (2) is discussed in chapters 21, 22, and 23. Also see Publication 544.

You should treat the gains or losses relating to assets in category (3) as ordinary income or loss.

Transactions between related parties. If there is a direct or indirect sale or exchange of depreciable property between related parties, any gain will be taxed as ordinary income. Losses between related parties are not deductible. See chapter 22.

Other disposition of a business. You can change the present form of your business without selling your assets. You may do this by joining one or more persons who want to consolidate their individual businesses into a partnership or other form of organization and by transferring your assets to the new form of business. You may change the form of your business by incorporating a sole proprietorship or a partnership. You also may transfer the property of a sole proprietorship or partnership to a previously existing corporation.

28. Partnerships

Important Changes for 1995

Self-employed health insurance deduction. The deduction for health insurance costs for self-employed persons has been permanently extended for tax years beginning after 1993. The deduction is increased to 30% for tax years beginning after 1994. See *Self-employed health insurance premiums* in Publication 541.

Distribution of marketable securities. A distribution of marketable securities made to a partner after December 8, 1995, is treated as money in determining whether gain is recognized by the partner on the distribution. See *Distributions From a Partnership* in Publication 541.

Introduction

A partnership is the relationship between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill, and each expects to share in the profits and losses. ''Person,'' when used to describe a partner, means an individual, a corporation, a trust, an estate, or another partnership.

Topics

This chapter discusses:

- Form 1065
- Partnership income
- Partner's income
- Family partnership
- Partner's dealings with the partnership
- Contributed property
- Basis of partner's interest
- Sales, exchanges, and other transfers

Useful Items

You may want to see:

Publication

- ☐ **541** Tax Information on Partnerships
- ☐ **551** Basis of Assets
- ☐ **556** Examination of Returns, Appeal Rights, and Claims for Refund
- ☐ **925** Passive Activity and At-Risk Rules

Form (and Instructions)

- ☐ **Sch SE (Form 1040)** Self-Employment Tax
- ☐ **Sch K–1 (Form 1065)** Partner's Share of Income, Credits, Deductions, Etc.
- ☐ **8082** Notice of Inconsistent Treatment or Amended Return
- ☐ **8736** Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts

Form 1065

Every partnership engaged in a trade or business must file Form 1065 showing its income, deductions, and other required information. In addition, the partnership return shows the names and addresses of each partner and each partner's distributive share of taxable income. This is an information return and must be signed by a general partner. If a limited liability company is treated as a partnership, it must file Form 1065 and one of the company members must sign the return. See the instructions for Form 1065 for more information.

Due date. Form 1065 generally must be filed by April 15 following the close of the partnership's tax year if its accounting period is the calendar year. A fiscal year partnership generally must file its return by the 15th day of the 4th month following the close of its fiscal year. However, if the date for filing a return falls on a Saturday, Sunday, or legal holiday, the partnership can file the return on the next business day.

If a partnership needs more time to file its partnership return, it should file Form 8736 by the regular due date of its Form 1065. The automatic extension is 3 months.

Schedule K–1 due to partners. The partnership must furnish copies of Schedule K–1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions.

Penalties. A penalty is assessed against any partnership that must file a partnership return and, unless the failure is due to reasonable cause, it fails to file on time (including extensions), or fails to file a return with all the information required. The penalty is $50 times the total number of partners in the partnership during any part of the tax year for each month (or part of a month) the return is late or incomplete, up to 5 months. For more information, see Publication 541.

The partnership will also receive a penalty if it fails to provide copies of Schedules K–1 (Form 1065) to the partners, unless the failure is due to reasonable cause and not willful negligence.

Partnership Income

Partnership profits (and other income and gains) are not taxed to the partnership. A partnership determines its income in the same manner as an individual. However, a partnership must state certain items of gain, loss, income, etc. separately and certain deductions are not allowed to the partnership.

Partnership chooses how to compute income. The partnership makes most choices about how to compute income. These include choices for accounting methods (chapter 3), depreciation methods (chapter 12), accounting for specific items such as depletion, amortization of certain organization fees, amortization of business start-up costs of the partnership, and reforestation expenditures (chapter 13), installment sales (chapter 24), and nonrecognition of gain on involuntary conversions of property (chapter 25).

However, each partner chooses how to treat foreign and U.S. possessions taxes, certain mining exploration expenses, and income from discharge of debt.

Tax year. Generally, a partnership must use the same tax year as its majority partners. For exceptions to this rule and for more information, see chapter 3.

Partner's Income

A partner's taxable income for the year includes his or her distributive share of certain partnership items (whether distributed or not). These items are reported to the partner on Schedule K–1 (Form 1065). See the instructions for Form 1065 for more information.

Estimated tax. Tax is not withheld on partnership distributions and a partner may have to pay estimated tax. For more information, see *Estimated tax* under *Partner's Distributive Share* in Publication 541.

Treatment of partnership items. Partners must treat partnership items on their individual tax returns the same way they are treated on the partnership return. If a partner treats an item differently on his or her individual return, the IRS can automatically assess and collect any tax and penalties that result from adjusting the item to make it consistent with the partnership return. However, this does not apply if a partner files Form 8082 with his or her return identifying the different treatment.

Distributive Share

Generally, the partnership agreement determines a partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit.

Distributive share determined by interest in partnership. A partner's distributive share of each item is determined by his or her interest in the partnership (taking into account all facts and circumstances) if either of the following applies:

1) The partnership agreement does not provide for the allocation of any item of

income, gain, loss, deduction, or credit, or

2) The allocation of any item of income, gain, loss, deduction, or credit to any partner under the agreement does not have substantial economic effect.

The allocation is done by taking into account the partner's contributions to the partnership, the interests of all partners in profits and losses (if different from interests in taxable income or loss), cash flow, and the rights of the partners to distributions of capital upon liquidation.

Substantial economic effect. An allocation has substantial economic effect if both of the following apply:

1) There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners' shares of partnership income or loss independently of tax consequences, and

2) The partner to whom an allocation is made actually receives the economic benefit or bears the economic burden corresponding to that allocation.

Character of items. The character of certain items of income, gain, loss, deduction, or credit included in a partner's distributive share is determined as if the partner:

1) Realized the item directly from the same source as the partnership, or

2) Incurred the item in the same manner as the partnership.

For example, a partner's distributive share of gain from the sale of partnership depreciable property used in a trade or business of the partnership is treated as gain from the sale of depreciable property that the partner used in a trade or business.

Self-employment tax. A partner is not an employee of the partnership. The partner's distributive share of income from the partnership is usually included in figuring net earnings from self-employment. If an individual partner has net earnings from self-employment of $400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040). See chapter 32.

Losses. A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of the partner's interest in the partnership. The adjusted basis is figured at the end of the partnership's tax year in which the loss occurred, before taking the loss into account. Any loss that is more than the partner's adjusted basis is not deductible for that year. However, any loss not allowed for this reason will be allowed as a deduction (up to the partner's basis) at the end of any succeeding year in which the partner increases his or her basis to more than zero. See *Basis of Partner's Interest,* later.

Example. Mike and Joe are equal partners in a partnership. Mike files his individual return on a calendar year basis. The partnership return is also filed on a calendar year basis. The partnership incurred a $10,000 loss last year. Mike's distributive share of the loss is $5,000. The adjusted basis of his partnership interest, before considering his share of last year's loss, was $2,000. He could claim only $2,000 of the loss on last year's individual return. The adjusted basis of his interest at the end of last year was then reduced to zero.

The partnership showed an $8,000 profit for this year. Mike's $4,000 share of the profit increased the adjusted basis of his interest by $4,000 (not taking into account the $3,000 excess loss he could not deduct last year). His return for this year will show his $4,000 distributive share of this year's profits and the $3,000 loss not allowable last year. The adjusted basis of his partnership interest at the end of this year is $1,000.

At-risk limits. At-risk rules apply to most trade or business activities including activities conducted through a partnership, or activities for the production of income. The at-risk rules limit the loss a partner can deduct on the amounts for which that partner is considered at risk in the activity.

For more information on determining the amount at risk, see Publication 925.

Passive activities. Generally, Code section 469 limits the amount a partner can deduct for passive activity losses and credits. The passive activity limits do not apply to the partnership. Instead, they apply to each partner's share of loss or credit from passive activities. Because the treatment of each partner's share of partnership income, loss, or credit depends upon the nature of the activity that generated it, the partnership must report income, loss, or credits separately for each activity.

Generally, passive activities include activities that involve the conduct of a trade or business, if the partner does not materially participate in the activity. The level of each partner's participation in an activity must be determined by the partner.

Rental activities. Passive activities also include rental activities, regardless of the partner's participation. However passive activities do not include a rental real estate activity in which the partner materially participates.

Limited partners. Limited partners are generally not considered to materially participate in trade or business activities conducted through partnerships.

More information. For more information on passive activities, see Publication 925 and the instructions to Forms 1065 and 8582.

Family Partnership

Members of a family can be partners. Members of a family include only spouses, ancestors, and lineal descendants, or any trust for their primary benefit.

Family members will be recognized as partners only if one of the following requirements is met.

1) If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest, or

2) If capital is not a material income-producing factor, they must have joined together in good faith to conduct a business. In addition, they must have agreed that contributions of each entitle them to a share in the profits. Some capital or service must be provided by each partner.

Capital is material. Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital. Capital is ordinarily an income-producing factor if the operation of the business requires substantial inventories or investments in plant, machinery, or equipment.

Capital is not material. In general, capital is not a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

Capital interest. A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest if:

1) He or she withdraws from the partnership, or

2) The partnership liquidates.

The mere right to share in the earnings and profits is not a capital interest in the partnership.

Gift. If a family member receives a gift of a capital interest in a family partnership in which capital is a material income-producing factor, there are limits on the amount that can be allocated to that member (donee) as a distributive share of partnership income. See Publication 541 for information about the limits.

Purchase. An interest purchased by one member of a family from another member of the family is considered to be created by gift.

Example. A father sold 50% of his business to his son. The resulting partnership had a profit of $60,000. Capital is a material income-producing factor. The father performed services worth $24,000, which is reasonable compensation, and the son performed no services. The $24,000 must be allocated to the father as compensation. Of the remaining $36,000 of income that is due to capital, at least 50%, or $18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership income cannot be more than $18,000.

Husband-wife partnership. If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss on Form 1065. They should ***not*** report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor.

Each spouse should include his or her share of self-employment income shown on Schedule K–1 (Form 1065) on a separate Schedule SE (Form 1040). Usually this will not increase their total tax, but it will give each spouse credit for social security earnings on which retirement benefits are based.

Partner's Dealings with the Partnership

For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership. See Publication 541 for more information on the transactions.

Sales and exchanges. Special rules apply to sales or exchanges of property between certain persons and partnerships.

Losses. Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than 50%.

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than 50% interest of the capital or profits in each partnership, no deduction of a loss is allowed.

In either case, if the purchaser later sells the property, any gain realized will be taxable only to the extent that it is more than the loss that was not allowed.

Gains. Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following apply:

1) More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s), and
2) The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is not a capital asset includes trade accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

See Publication 541 for information on the rules for determining if there is more than 50% ownership in partnership capital or profits.

Payments by accrual basis partnership to cash basis partner. A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amounts are paid and the partner includes the payment in income. However, this does not apply to guaranteed payments made to a partner, which are generally deductible when accrued.

Guaranteed payments. A partnership treats guaranteed payments to a partner for services, or for the use of capital, as if they were made to a person who is not a partner. This is true only to the extent the payments are figured without regard to the partnership's income. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to tax withholding.

The payments are generally deductible by the partnership as a business expense. They are included in Schedules K and K–1 of the partnership return and are reported by the individual partner on Form 1040 as ordinary income, in addition to the appropriate distributive share of the other ordinary income of the partnership.

A partner includes the guaranteed payments in income in the partner's tax year in which the partnership's tax year ends.

Example. Under the terms of the partnership agreement, Erica is entitled to a fixed annual payment of $10,000 without regard to the income of the partnership. Her distributive share of the partnership income is 10%. After deducting the guaranteed payment, the partnership has $50,000 of ordinary income. She must include $15,000 as ordinary income on her individual income tax return for her tax year in which the partnership's tax year ends ($10,000 guaranteed payment plus $5,000 ($50,000 × 10%) distributive share).

Minimum payment. If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income ***before*** taking into account the guaranteed payment.

Example. Under a partnership agreement, Chris is to receive 30% of the partnership income, but not less than $8,000. The partnership has net income of $20,000. Chris's share, without regard to the minimum guarantee, is $6,000 (30% of $20,000). Thus, the amount of the guaranteed payment that may be deducted by the partnership is $2,000 ($8,000 less $6,000). Chris's income from the partnership is $8,000, and the remaining $12,000 will be reported by the other partners in proportion to their shares under the partnership agreement.

If the partnership net income had been $30,000, there would have been no guaranteed payment since his share, without regard to the guarantee, would have been greater than the guarantee.

Payments resulting in loss. If a partnership agreement provides for guaranteed payments to a partner and the payments result in a partnership loss in which the partner shared, the partner must:

1) Report the full amount of the guaranteed payments as ordinary income, and
2) Separately take into account the appropriate distributive share of the partnership loss.

Contributed Property

Usually, neither the partners nor the partnership recognize a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

However, a transaction may be treated as an exchange of property on which gain or loss is recognized if a partner contributes property to a partnership and within a short period:

1) Before or after the contribution, other property is distributed to the contributing partner and the contributed property is kept by the partnership, or
2) After the contribution, the contributed property is distributed to another partner.

Interest acquired as compensation. A partner can acquire an interest in partnership capital as compensation for services performed or to be performed. The fair market value of such an interest must generally be included in the partner's gross income in the first tax year in which the partner's interest can be transferred or is not subject to a substantial risk of forfeiture. Such a transfer of partnership interest as compensation for services is subject to the rules discussed under *Payment in Restricted Property* in chapter 9.

Basis of contributed property. If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, gain, or loss on property contributed by a partner is the same as the partner's adjusted basis of the property when it was contributed, increased by any gain recognized by the partner at that time.

The fair market value of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for all or any part of the difference.

However, the total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allowable to the partnership or the gain or loss realized by the partnership. The allocation can apply to all property contributed or only to specific items. This rule also applies to accounts payable and other accrued but unpaid items of a cash basis partner. See Publication 541 for an example of this allocation.

Basis of Partner's Interest

A partner's basis is determined by using the following rules.

General Basis Rules

The general rules cover the partner's original basis, adjusted basis, and share of partnership liabilities.

Original Basis

The original basis of a partnership interest acquired by a contribution of property, including money, is the money a partner contributed plus the adjusted basis of any property he or she contributed. If the property contribution results in taxable income to the partner, this income will generally be included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is also treated as a contribution of money to the partnership by the partner.

Partner's liabilities assumed by partnership. If the property contributed is subject to debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the liability is treated as though they contributed money to the partnership.

Example 1. John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of $8,000 and a $4,000 mortgage. The partnership assumed payment of the mortgage. The adjusted basis of John's interest is:

Adjusted basis of contributed property	$8,000
Minus: Part of mortgage assumed by other partners and treated as a distribution (80% of $4,000)	3,200
Basis of John's partnership interest	$4,800

Example 2. If, in the above example, the property John contributed had a $12,000 mortgage, the adjusted basis of his partnership interest would be zero. The difference between the amount of the mortgage assumed by the other partners, $9,600 (80% × $12,000), and his basis of $8,000 would be treated as his gain from the sale or exchange of a capital asset. However, this gain ***would not*** increase the basis of his partnership interest.

Interest acquired by gift, etc. If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the rules described in Publication 551.

Debt-financed acquisitions. The interest expense on loan proceeds used to purchase an interest in, or make a contribution to, a partnership must be allocated as explained in chapter 8 of Publication 535.

Adjusted Basis

A partner's original basis is increased or decreased by the following items.

Increases. The partner's basis of an interest is increased by the partner's:

1) Additional contributions to the partnership, including assumption of partnership liabilities.
2) Distributive share of both taxable and nontaxable partnership income.
3) Distributive share of the excess of the deductions for depletion over the basis of the depletable property.

Decreases. The partner's basis is decreased (but never below zero) by:

1) Money (including the partner's decreased share of partnership liabilities or the partner's individual liabilities assumed by the partnership) and the adjusted basis of property distributed to the partner by the partnership. (See *Partner's Basis of Property Received,* later.)
2) The partner's distributive share of the partnership losses (including capital losses).
3) The partner's distributive share of nondeductible partnership expenses that are not capital expenditures.
4) The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.
5) The partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.

Book value of partner's interest. The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account.

Example. Sam contributes to the partnership property that has an adjusted basis of $400 and a value of $1,000. His partner contributes $1,000 cash. While under the partnership agreement each has a capital account in the partnership of $1,000, which will be reflected in the partnership books, the adjusted basis of Sam's interest is only $400 and his partner's basis is $1,000.

Determination of adjusted basis. The adjusted basis of a partner's partnership interest is ordinarily determined at the end of a partnership's tax year. However, if there has been a sale or exchange of all or part of the partner's interest or a liquidation of his or her entire interest in a partnership, the adjusted basis is determined on the date of the sale, exchange, or liquidation.

Partnership liabilities. If a partner's share of partnership liabilities ***increases,*** or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

If a partner's share of partnership liabilities ***decreases,*** or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

For more information on liabilities, see Publication 541.

Alternative rule for figuring adjusted basis. In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributable to the partner if the partnership terminated.

This alternative rule can be used to determine the adjusted basis of a partner's interest if either of the following applies:

1) The circumstances are such that the partner cannot practicably apply the general basis rules.
2) It is, in the opinion of the IRS, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in figuring a partner's adjusted basis of a partnership interest under the alternative rule. For example, adjustments would be required to include in the partner's share of the adjusted basis of partnership property any significant discrepancies that resulted from contributed property, transfers of partnership interests, or distributions of property to the partners.

Partner's Basis for Distributed Property

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

Example 1. The adjusted basis of Betty's partnership interest is $30,000. She receives a distribution of property that has an adjusted basis of $20,000 to the partnership and $4,000 in cash. Her basis for the property is $20,000.

Example 2. The adjusted basis of Mike's partnership interest is $10,000. He receives a distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 minus the $4,000 cash he receives).

Holding period for distributed property. A partner's holding period for property distributed to the partner by the partnership includes the period that the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included. However, this does not apply for determining the 5-year period for substantially appreciated inventory items. See Publication 541.

Complete liquidation of partner's interest. The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

Basis divided among properties. Generally, the basis of property received is limited to the adjusted basis of the partner's interest in the partnership, reduced by money received in the same transaction. This basis must be divided among any properties distributed to a partner.

The basis must first be allocated to unrealized receivables and inventory items included in the distribution. Any basis not allocated to unrealized receivables and inventory items must then be divided among any other properties distributed to the partner in the same transaction. The division must be in proportion to their adjusted bases in the hands of the partnership before the distribution.

More information. See Publication 541 for more information on unrealized receivables and substantially appreciated inventory.

Sale, Exchange, or Other Transfer

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any partnership liabilities, the selling partner must include the amount of liability relief as part of the amount realized for his or her interest.

Example 1. Fred became a limited partner in the ABC Partnership by contributing $10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is $20,000, which includes his share of partnership liabilities of $15,000. The partnership has no other liabilities and no unrealized receivables or substantially appreciated inventory items. Fred sells his interest in the partnership for $10,000 in cash. He had been paid his share of the partnership income for the tax year.

The amount realized by Fred from the sale of his partnership interest is $25,000, consisting of the $10,000 cash payment and his share of partnership liabilities of which he is relieved, $15,000. Since the adjusted basis of his interest in the partnership is $20,000, he realizes a gain of $5,000, which he reports as a capital gain.

Example 2. The facts are the same as Example 1, except that instead of selling his interest for $10,000, Fred withdraws from the partnership when the adjusted basis of his interest in the partnership is zero. In this situation he is considered to have received a distribution of money from the partnership of $15,000, the amount of liabilities of which he is relieved. Since the partnership has no unrealized receivables or substantially appreciated inventory items, he reports a capital gain of $15,000.

See Publication 541 for more information on partnerships.

29. Corporations

Introduction

This chapter explains the application of various tax provisions to corporations. Certain areas of corporate taxation are not covered in this publication. For a more complete discussion of corporate taxation, please get Publication 542.

Topics

This chapter discusses:

- Special provisions for corporations
- Figuring tax
- Estimated tax
- Filing requirements

Useful Items

You may want to see:

Publication

- ☐ **542** Tax Information on Corporations

Form (and Instructions)

- ☐ **1120** U.S. Corporation Income Tax Return
- ☐ **1120–A** U.S. Corporation Short-Form Income Tax Return
- ☐ **1120–W** (WORKSHEET) Estimated Tax for Corporations
- ☐ **1120X** Amended U.S. Corporation Income Tax Return
- ☐ **2220** Underpayment of Estimated Tax by Corporations
- ☐ **7004** Application for Automatic Extension of Time To File Corporation Income Tax Return
- ☐ **8109** Federal Tax Deposit Coupon

Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, some of the following special provisions apply only to corporations.

Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year.

Dividends from domestic corporations. A corporation can deduct, with certain limits, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the distributing corporation.

20%-or-more owners allowed 80% deduction. A corporation can deduct, with certain limits, 80% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. The paying corporation is a ***20%-owned corporation.***

Ownership. Determine ownership, for these rules, by the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) the receiving corporation owns.

Dividends on debt-financed portfolio stock. For dividends received on debt-financed portfolio stock of domestic corporations, reduce the 70%, or 80% dividends-received deduction. Reduce the deduction by a percentage related to the amount of debt incurred to purchase the stock. This applies to stock whose holding period begins after July 18, 1984. For more information, see section 246A of the Internal Revenue Code.

Small business investment companies. Small business investment companies can deduct 100% of the dividends received from a taxable domestic corporation.

Affiliated corporations. Members of an affiliated group of corporations can deduct 100% of the dividends received from a member of the same affiliated group if they meet certain conditions. See section 243 of the Internal Revenue Code for the definition of an affiliated group of corporations.

Dividends from regulated investment company. Regulated investment company dividends received are subject to certain limits. Capital gain dividends do not qualify for the deduction. For more information, see section 854 of the Internal Revenue Code.

Dividends on preferred stock of public utilities. A Corporation can deduct 42% of the dividends it receives on certain preferred stock (issued before October 1942) of a less-than-20%-owned taxable public utility. A corporation can deduct 48% of the dividends it receives on certain preferred stock of a 20%-or-more-owned taxable public utility. For more information, see section 244 of the Internal Revenue Code.

Dividends from Federal Home Loan Banks. Certain dividends received from Federal Home Loan Banks qualify for the dividends-received deduction. For more information, see section 246 of the Internal Revenue Code.

Dividends from foreign corporations. A corporation can deduct a percentage of the dividends it receives from 10%-owned foreign corporations. For more information, see section 245 of the Internal Revenue Code.

No deduction allowed for certain dividends. Corporations cannot take a deduction for dividends received from:

1) A real estate investment trust,
2) A corporation exempt from tax either for the tax year of the distribution or the preceding tax year,
3) A corporation whose stock has been held by your corporation for 45 days or less,
4) A corporation whose stock has been held by your corporation for 90 days or less, if the stock has preference as to dividends and the dividends received on it are for a period or periods totaling more than 366 days, or
5) Any corporation, if your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments for positions in substantially similar or related property.

Dividends on deposits. So-called dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest. They do not qualify for this deduction.

Limit on deduction for dividends. The total deduction for dividends received or accrued is generally limited (in the following order) to:

1) 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, and
2) 70% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring the limit. In figuring this limit, determine taxable income without:

1) The net operating loss deduction,
2) The deduction for dividends received,
3) Any adjustment due to the part of an extraordinary dividend that is not taxable (see *Reduction in Basis of Stock,* in Publication 542),
4) The deduction for contributions to a Capital Construction Fund (CCF), and
5) Any capital loss carryback to the tax year.

Effect of net operating loss. If a corporation has a net operating loss (defined in Chapter 20) for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has a net operating loss, figure the dividends-received deduction without the 80% (or 70%) of taxable income limit.

Example 1. A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $75,000 before the deduction for dividends received. If it claims the full dividends-received deduction of $80,000 ($100,000 × 80%) and combines it with the operations loss of $25,000, it will have a net operating loss of $5,000. The 80% of taxable income limit does not apply. The corporation can deduct $80,000.

Example 2. Assume the same facts as in Example 1 except that the corporation loses $15,000 from operations. Its taxable income is $85,000 before the deduction for dividends received. However, after claiming the dividends-received deduction of $80,000 ($100,000 × 80%), its taxable income is $5,000. But because the corporation will not have a net operating loss after a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 × 80%).

Charitable Contributions

A corporation can claim a limited deduction for any charitable contributions made in cash or other property. The contribution is deductible if made to or for the use of community chests, funds, foundations, corporations, or trusts organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes. The contribution can also be made to foster national or international amateur sports competition or the prevention of cruelty to children or animals.

You cannot take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

Cash method corporation. A corporation using the cash method of accounting can deduct contributions only in the tax year paid.

Accrual method corporation. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them within 2½ months after the close of that tax year. Make the choice by reporting the contribution on the corporation's return for the tax year. A copy of the resolution authorizing the contribution and a declaration stating the board of directors adopted the resolution during the tax year must accompany the return. The president or other principal officer must sign the declaration.

Limit. A corporation cannot deduct contributions that total more than 10% of its taxable income. Figure taxable income for this purpose without the following:

Deduction for contributions,

Deduction for dividends received and dividends paid,

Deduction for contributions to a Capital Construction Fund (CCF),

Any net operating loss carryback to the tax year, and

Any capital loss carryback to the tax year.

Carryover of excess contributions. You can carry over (with certain limits) any charitable contributions made during the year that are more than the 10% limit to each of the following 5 years. You lose any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 1994 and it does not use all the excess on its return for 1995, it can carry the remainder over to 1996, 1997, 1998, and 1999. Do not deduct a carryover of excess contributions in the carryover year until after you deduct contributions made in that year (subject to the 10% limit). You cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover to a succeeding tax year.

Related Taxpayers

The related-party rules apply to transactions between an individual and a corporation the individual controls. They apply to sales or exchanges of property and the deduction of certain unpaid business expenses and interest. Under certain conditions, the IRS may reallocate income and deductions between two or more businesses directly or indirectly controlled by the same interests. These rules are discussed in chapters 3 and 22.

Accrual basis corporation. An accrual basis taxpayer cannot deduct expenses owed to a related cash basis person until payment is made, and the amount is includible in the gross income of the person paid. This rule applies even if the relationship ceases before the amount is includible in the gross income of the person paid.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related parties does not apply to liquidating distributions. It does not apply to any loss of either the distributing corporation or a distributee for a distribution in complete liquidation.

Interest paid to related parties. A corporation's deduction for interest expense may be limited if it paid (or accrued) interest to related parties ***not subject to tax on the interest*** received. The deduction for this interest is disallowed for any tax year that the corporation has:

1) Excess interest expense, and
2) A debt to equity ratio greater than 1.5 to 1 at the end of that tax year.

However, the deduction is disallowed only to the extent of the corporation's excess interest expense. The corporation can carry the disallowed interest to later years.

Not subject to tax on the interest means that the related party is not subject to U.S. income tax on the interest income. For example, the related party may be a foreign parent corporation not subject to U.S. tax.

Excess interest expense. Excess interest expense is the excess of the corporation's net interest expense over the sum of 50% of its adjusted taxable income plus any ***excess limit*** carryforward.

Excess limit. Excess limit means the excess of 50% of the corporation's adjusted taxable income over its net interest expense.

If a corporation has an excess limit for a tax year, that amount becomes an excess limit carryforward to the next tax year. When the corporation does not use it up in the next tax year, it can carry it forward to the following 2 tax years.

More information. For more information, including the definition of ***adjusted taxable income,*** see section 163(j) of the Internal Revenue Code.

Figuring Tax

Corporate taxable income is subject to the tax rates shown in Table 1.

Controlled group of corporations. A controlled group of corporations gets only one apportionable $50,000, $25,000, and $9,925,000 (in that order) amount for each taxable income bracket. For more information, see the instructions for Schedule J of Form 1120.

Personal service corporations. The tax rate for qualified personal service corporations is 35% of taxable income. These corporations cannot use the graduated tax rates that apply to other corporations.

A corporation is a ***qualified personal service corporation*** if:

1) At least 95% of the value of its stock is held by employees, or their estates or beneficiaries, and
2) Its employees perform services at least 95% of the time in any of the following fields:

   Health,

   Law,

   Engineering,

   Architecture,

   Accounting,

   Actuarial science,

   Veterinary services,

   Performing arts, or

   Consulting.

Credits

A corporation ***decreases*** its tax liability by credits, such as the:

1) Credit for fuels used for certain purposes (see Publication 378),

Table 1. **Tax Rate Schedule**

If taxable income (line 30, Form 1120, or line 26, Form 1120-A) on page 1 is:

Over—	But not over—	Tax is:	Of the amount over—
$0	$50,000	15%	$0
50,000	75,000	$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	-----	35%	0

2) Foreign tax credit (use Form 1118),

3) General business credit (see chapter 31),

4) Possessions tax credit (use Form 5735),

5) Credit for fuel produced from a nonconventional source, and

6) Qualified electric vehicle credit (use Form 8834).

Other Taxes

A corporation ***increases*** its tax liability by the:

1) Personal holding company tax (attach Schedule PH (Form 1120)),

2) Investment credit recapture (see Chapter 31),

3) Low-income housing credit recapture (Form 8611),

4) Qualified electric vehicle credit recapture,

5) Indian employment credit recapture,

6) Alternative minimum tax (see Chapter 34), and

7) Environmental tax.

Environmental tax. A corporation is liable for the tax if its modified alternative minimum taxable income is over $2 million.

Modified alternative minimum taxable income. This is alternative minimum taxable income, figured in chapter 34, but without the:

1) Alternative tax net operating loss deduction, and

2) Deduction for the environmental tax.

Estimated Tax

Every corporation that expects its tax to be $500 or more must make estimated tax payments. A corporation's estimated tax is its expected tax liability (including alternative minimum tax (AMT) and environmental tax) less its allowable tax credits.

Time and amount of deposits. If a corporation's estimated tax is $500 or more, it deposits its estimated tax with an authorized financial institution or a Federal Reserve Bank. Use Form 8109 to make deposits. Follow the instructions in the coupon book.

Determine the due date of deposits from the table below (but see *Saturday, Sunday, or holiday,* discussed later, under *Due Date of Return*).

Deposit a corporation's estimated tax in installments by the 15th day of the following months of the corporation's tax year.

Required Installment	Month Due
1st	4th month
2nd	6th month
3rd	9th month
4th	12th month

Generally, each installment payment must equal 25% of the required annual estimated tax.

Example 1. The Penn Corporation, a calendar year taxpayer, estimates its tax will be $40,000. The corporation deposits the estimated tax in four $10,000 installments on April 15, June 15, September 15, and December 15.

Example 2. The Jones Company has a fiscal year beginning April 1 and ending March 31. Its estimated tax is $12,000. It deposits $3,000 of its estimated tax on July 15, September 15, December 15, and March 15.

How To Figure Each Payment

Use Form 1120–W to figure the corporation's estimated tax and determine the required installment to pay by the due date of each payment period. Pay enough by each due date to avoid a penalty for that period. If you do not pay enough during each payment period, the corporation may be charged a penalty even if it is due a refund when you file its tax return.

Amended estimated tax. If, after depositing the corporation's estimated tax, you determine its tax will be substantially larger or smaller than estimated, refigure the tax before the next installment to determine its remaining deposits.

If earlier installments were underpaid, the corporation may owe a penalty for underpayment of estimated tax. If that is the case, you should make an immediate catchup payment to reduce the amount of the penalty, whether caused by a change in estimate, failure to make a deposit, or a mistake. The penalty is discussed next.

Penalty

A corporation that fails to pay a correct installment of estimated tax in full by the due date may be subject to a penalty. The penalty rate applies to the period of underpayment for any installment. Figure the penalty at a rate of interest published quarterly by the IRS in the Internal Revenue Bulletin.

Figuring the underpayment. The underpayment of any installment is the required payment minus the amount paid by the due date.

The estimated tax payment required in installments is the lesser of:

1) 100% of the tax shown on the return for the preceding year, or

2) 100% of the tax shown for the current year (the current year tax may be determined on the basis of actual income or annualized income).

However, a large corporation can use (1) or (2), whichever applies, only for determining its first installment in any tax year. If the installment determined under (1) is greater than that determined and paid under (2), add the difference to the next required installment. A large corporation is one with at least $1 million of taxable income in any of the last 3 years. For this purpose, taxable income is modified to exclude net operating loss or capital loss carrybacks or carryovers.

Order of crediting payments. Credit an estimated tax payment against unpaid installments in the required order of payment.

Annualizing. If you base an installment on 100% of the current year's tax that you would owe if you annualized income, ***no penalty*** applies. You can estimate total income for the tax year by annualizing income. You annualize income by treating income received over a specified period in the tax year as if received at the same rate over the full 12-month year. Add any reduction in a required installment from using the annualization exception to the next required installments if not taken into account in earlier installments.

You have three sets of periods over which income may be annualized. The tax law specifies a particular set of periods for annualizing income unless you elect one of two alternative sets of periods by making an election on Form 8842. For the election to be effective, you must file Form 8842 by the due date of the first required installment. Once made, the election cannot be revoked. See the instructions for Form 8842 for more information.

Recurring seasonal income. When figuring the penalty for an underdeposit of an installment of estimated tax, there is a special rule for a corporation with recurring seasonal income. The rule applies to corporations whose taxable income for any period of 6 consecutive months has averaged 70% or more of its taxable income for the year during each of the past 3 tax years.

No penalty applies to an installment of estimated tax if the total deposits made by the installment date equals or exceeds 100% of the amount figured as follows:

1) Take the taxable income for all months in the tax year before the month the installment is due,
2) Divide the amount in (1) by the base period percentage, defined next, for those months,
3) Figure the tax on the amount figured in (2), and
4) Multiply the tax figured in (3) by the base period percentage for the filing month and all months during the tax year before the filing month.

The ***base period percentage*** for any period of months is the average percentage that the taxable income for the same period of months in each of the 3 preceding tax years bears to the taxable income for those 3 tax years.

Form 2220. Use Form 2220 to determine any underpayment of the corporation's estimated tax. If it appears from the Form 1120 or 1120–A that you underpaid the estimated tax, use Form 2220 to compute any penalty.

You generally do not have to file Form 2220 for the corporation because the IRS will figure any penalty and bill it. However, you must complete and attach the form to the tax return of the corporation if it:

1) Used the annualizing or recurring seasonal income method to determine any installment required, or
2) Is a large corporation computing its first required installment based on the prior year's tax.

Quick Refund of Overpayments

A corporation that overpays its estimated tax can apply on Form 4466 for a quick refund of any overpayment. File the form after the close of the corporation's tax year but before:

1) The 16th day of the 3rd month after the close of the tax year, and
2) The day the corporation files its return for that tax year.

The overpayment must be:

1) At least 10% of the amount estimated by the corporation on its application as its income tax liability for the tax year, and
2) At least $500.

The IRS will credit or refund the overpayment within 45 days after you file the application.

Filing Requirements

Each corporation, unless specifically exempt, must file a tax return even if it had no taxable income for the year and regardless of its gross income for the tax year. The income tax return for ordinary corporations is ***Form 1120.*** Certain small corporations can file Form 1120–A. Corporations that normally file Form 1120 may save time if they can use Form 1120–A.

Who Can File Form 1120–A

A corporation can use Form 1120–A to report its taxable income if it meets the following requirements:

- Its gross receipts are under $500,000,
- Its total income is under $500,000,
- Its total assets are under $500,000,
- It does not have ownership in a foreign corporation,
- It does not have foreign shareholders who own, directly or indirectly, 50% or more of its stock,
- It is not a member of a controlled group,
- It is not a personal holding company,
- It is not a consolidated corporate return filer,
- It is not a corporation undergoing a dissolution or liquidation,
- It is not filing its final tax return,
- Its only dividend income (none of which represents debt-financed securities) is from domestic corporations and those dividends qualify for the 70% deduction,
- It has no nonrefundable tax credits other than the general business credit and the credit for prior-year minimum tax,
- It is not subject to environmental tax,
- It has no liability for interest on certain installment sales of timeshares and residential lots, or interest on deferred tax liability or installment payments of tax,
- It has no liability for interest due under the look-back method on completion of a long-term contract,
- It is not required to file Form 8621,
- It has no liability for tax on a nonqualified withdrawal from a capital construction fund,
- It is not making an election to forgo the carryback period of an NOL,
- It is not electing to pay tax on gain from the sale of an intangible as described in section 197(f)(9)(B)(ii) of the Internal Revenue Code, and
- It is not an organization such as an S corporation, life or mutual insurance company, political organization, etc., required to file a specialized form such as Form 1120S, 1120–L, 1120–POL, etc.

For more information, see the instructions for Forms 1120 and 1120–A.

Amending Return

If, after filing Form 1120 or 1120–A, you have to correct an error on the return, use ***Form 1120X.*** File this form if you understated or overstated income, or failed to claim deductions or credits.

Due Date of Return

If a corporation figures its taxable income on a calendar year basis, file its income tax return by March 15 following the close of the tax year. If a corporation uses a fiscal year, file its return by the 15th day of the 3rd month following the close of its fiscal year. See the checklist at the end of this publication.

Saturday, Sunday, or holiday. If the last day for performing any act for tax purposes, such as filing a return or making a tax payment, falls on a Saturday, Sunday, or legal holiday, you may perform the act on the next day that is not a Saturday, Sunday, or legal holiday.

Extension of time to file (Form 7004). A corporation will receive an automatic 6-month extension of time for filing its return by submitting an application for extension on Form 7004. File this form with the Internal Revenue Service Center where the corporation will file its income tax return. The IRS can terminate this extension at any time by mailing a notice of termination to the corporation. File Form 7004 by the due date of the corporation's income tax return.

Any automatic extension of time for filing a corporation income tax return will not extend the time for paying the tax due on the return. Deposit the tax on line 6 of Form 7004 using Form 8109.

Interest. If the tax reported on Form 7004 is less than the actual tax due, interest is charged on the difference.

Where To File

A corporation files its income tax return with the Internal Revenue Service Center serving the area for the location of the principal office for keeping its books and records. The instructions to the forms have the service center locations.

The separate income tax returns of a group of corporations located in several service center regions can be filed with the service center for the area in which the principal office of the managing corporation (that keeps all the books and records) is located.

Payment of Tax

Deposit the balance of any tax due, after estimated tax installments, by the due date of the return.

Make income tax deposits to either an authorized financial institution or a Federal Reserve Bank. Make all deposits with Form 8109 according to the instructions in the coupon book.

Penalties

There are several penalties that can apply to a corporation. Some of these penalties are discussed next.

Failure to file. If a corporation does not file its income tax return by the due date (including extensions), and it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for one month or less. An additional 5% is imposed for each additional month or part of a month that the delinquency continues, not exceeding a total of 25%. The tax due is the tax liability that would be shown on a return, less credits and any tax payments made before the due date. Reduce the delinquency penalty by an amount equal to that imposed under the failure-to-pay tax penalty, discussed next.

If the return is not filed within 60 days of the due date (including extensions), the penalty for failure to file will be at least $100 or the balance of tax due, whichever is less, unless reasonable cause is shown.

Reasonable cause. A corporation that wishes to avoid a penalty for failure to file a tax return, pay the tax, or deposit taxes must show reasonable cause. This is done by filing a statement of the facts establishing reasonable cause for the failure with the Director of the Service Center where the corporation must file the return. In addition, the statement must contain a declaration that it was made under the penalties of perjury.

Failure to pay tax. Payments made after the due date are subject to an interest charge, even if filing extensions were granted. Payments of tax, other than estimated tax, made after the due date may also be subject to a penalty of 0.5% a month or part of a month up to a maximum of 25%. In certain situations, the penalty will increase to 1% a month or part of a month up to a maximum of 25%.

Failure to deposit taxes. If a corporation deposits taxes after the due date or does not deposit the required tax, it may be charged a penalty. Deposits of tax after the due date are subject to a penalty on the underpayment. The underpayment is the excess of the required tax deposit over the tax deposited by the due date.

Figuring the penalty. The penalty is figured by multiplying the underpayment by one of the following percentages:

1) 2% if deposited by the 5th day after the deposit due date,
2) 5% if deposited after the 5th day but by the 15th day after the deposit due date, or
3) 10% if deposited after the 15th day after the deposit due date.

The percentage is 15% if the tax is not deposited by the earlier of:

1) The day that is 10 days after the date of the first delinquency notice to the corporation, or
2) The day on which notice and demand for immediate payment is given.

This penalty does not apply to estimated taxes when the penalty discussed earlier under *Estimated Tax* applies.

Other penalties. There are other civil penalties that can apply because of negligence, substantial understatement of tax, and fraud. Criminal penalties apply to willful failure to file, tax evasion, or making a false statement.

30.

S Corporations

Important Change for 1995

Self-employed health insurance deduction. The deduction for health insurance costs for self-employed persons has been permanently extended for tax years beginning after 1993. A 2% shareholder-employee may take this deduction. You may be able to file an amended return (Form 1040X) to take the 25% deduction for 1994. The deduction is increased to 30% for tax years beginning after 1994. For more information, see Publication 589.

Introduction

An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation under the rules of Subchapter S of the Internal Revenue Code. In this way, the S corporation passes its items of income, loss, deduction, and credits through to its shareholders to be included on their separate returns. Individual shareholders may benefit from a reduction in their taxable income during the first years of the corporation's existence when it may be operating at a loss.

This chapter discusses how to become an S corporation and how to terminate an S corporation. For a complete discussion of S corporations, see Publication 589.

Topics

This chapter discusses:

- Becoming an S corporation
- Terminating S corporation status

Useful Items

You may want to see:

Publication

- ☐ **589** Tax Information on S Corporations
- ☐ **538** Accounting Periods and Methods

Form (and Instructions)

- ☐ **1120S** U.S. Income Tax Return for an S Corporation
- ☐ **1128** Application To Adopt, Change, or Retain a Tax Year
- ☐ **2553** Election by a Small Business Corporation
- ☐ **6251** Alternative Minimum Tax—Individuals
- ☐ **8716** Election To Have a Tax Year Other Than a Required Tax Year
- ☐ **8752** Required Payment or Refund Under Section 7519

Becoming an S Corporation

A corporation can become an S corporation if:

1) It meets the requirements of S corporation status,
2) All its shareholders consent to S corporation status,
3) It uses a permitted tax year, or elects to use a tax year other than a permitted tax year, explained later, and
4) It files Form 2553 to indicate it chooses S corporation status.

Requirements of an S Corporation

To qualify for S corporation status, a corporation must meet ***all*** the following requirements:

1) It must be a domestic corporation that is either organized in the United States or organized under federal or state law. The term ''corporation'' includes joint-stock companies, insurance companies, and associations.
2) It must have only one class of stock. See *One class of stock,* later.
3) It must have no more than 35 shareholders. See *Counting shareholders,* later.
4) It must have as shareholders only individuals, estates (including estates of individuals in bankruptcy), and certain trusts. See *Trusts,* later. Partnerships and corporations cannot be shareholders in an S corporation.
5) It must have no nonresident alien shareholders.

Certain Domestic Corporations Ineligible

Certain domestic corporations are ineligible to elect S corporation status. They are:

1) A member of an affiliated group of corporations.
2) A DISC (Domestic International Sales Corporation) or former DISC.
3) A corporation that takes the Puerto Rico and possessions tax credit for doing business in a United States possession.
4) A financial institution that is a bank, including mutual savings banks, cooperative banks, and domestic building and loan associations.
5) An insurance company taxed under Subchapter L of the Internal Revenue Code.

One Class of Stock

The one-class-of-stock rules, discussed here, apply to corporate tax years beginning after May 27, 1992. However, an S corporation and its shareholders may apply these rules to prior years. For more information, see *Effective date,* later in this discussion.

A corporation that has more than one class of stock does not qualify as an S corporation. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Stock may have differences in voting rights and still be considered one class of stock. For example, a corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Identical rights to distribution and liquidation proceeds. Generally, the determination of whether stock has identical rights to distribution and liquidation proceeds is made based on the governing provisions of the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds.

Treatment of straight debt. An instrument or obligation that is straight debt is generally not treated as a second class of stock. The term ''straight debt'' means any written unconditional promise to pay a fixed amount on demand or on a specified date if:

1) The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors,
2) The debt cannot be converted into stock, or any other equity interest of the S corporation, and
3) The creditor is an individual (other than a nonresident alien), an estate, or a trust eligible to hold stock in an S corporation.

Subordination. An obligation that is subordinated (placed in a lower position) to other debt of the corporation is not prevented from qualifying as straight debt.

Straight debt modified or transferred. An obligation that originally qualifies as straight debt ceases to qualify if:

1) The obligation is materially modified so that it no longer satisfies the definition of straight debt, or
2) It is transferred to a third party who is not an eligible shareholder in the S corporation.

Second class of stock. Instruments, obligations, or other arrangements issued by a corporation may be treated as a second class of stock in the following two situations:

1) They are treated as equity.
2) They are call options or warrants.

Treated as equity. An instrument, obligation, or other arrangement, regardless of whether it is called a debt, is treated as a second class of stock if:

1) It constitutes equity or otherwise results in the holder being the owner of stock under federal tax law principles, and
2) A principal purpose of the transaction is to get around the one-class-of-stock rules or the limitations on eligible shareholders listed earlier under *Requirements of an S Corporation.*

See *Treatment of straight debt,* earlier and section 1.1361–1(l) of the Income Tax Regulations for certain exceptions.

Call options and warrants. A call option, warrant, or similar instrument is treated as a second class of stock if, taking into account all facts and circumstances:

1) It is substantially certain to be exercised, and
2) It has a strike price substantially below the fair market value of the underlying stock on the date the call option is issued.

See section 1.1361–1(l) of the regulations for exceptions and more information.

Not treated as outstanding stock. The general requirement for having only one class of stock is that all outstanding shares of stock have identical rights to distribution and liquidation proceeds. Exceptions to the requirement that all outstanding shares of stock are taken into account apply to:

1) Restricted stock, and
2) Deferred compensation plans.

Restricted stock. Stock that is issued in connection with the performance of services, and that is substantially nonvested, is generally not treated as outstanding stock. The holder of that stock is not treated as a shareholder unless he or she makes an election to include in income the fair market value of the stock at the time of the transfer minus the amount paid for the stock. Whether that nonvested stock is treated as a second class of stock depends on the facts and circumstances.

Deferred compensation plans. An instrument, obligation, or arrangement is not treated as outstanding stock if:

1) It does not convey the right to vote,
2) It is an unfunded and unsecured promise to pay money or property in the future,
3) It is issued to an employee or independent contractor in connection with the performance of services for the corporation,
4) It is not excessive by reference to the services performed, and
5) It is issued pursuant to a plan under which the employee or independent contractor is not taxed currently on income.

Unissued stock. Authorized but unissued stock and treasury stock are not considered in determining if a corporation has more than one class of stock. Nor is special stock issued to the Federal Housing Administration considered when making this determination. The existence of outstanding options, warrants to acquire stock, or convertible debentures will not, by itself, be considered a second class of stock.

Effective date. The rules for one class of stock generally apply to tax years beginning after May 27, 1992. However, they do not apply to an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date. Nor do they apply to a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, or a call option or similar instrument issued before that date, provided the agreement, option, or similar instrument was not materially modified after that date. In addition, an S corporation and its shareholders can apply these rules to prior tax years.

Counting Shareholders

An S corporation cannot have more than 35 shareholders. When counting shareholders, the following rules apply:

1) Count the individual, estate, or other person who is considered the shareholder if the stock is actually held by a trust. See *Trusts,* later. Do not count the trust itself as a shareholder.
2) Count a husband and wife, and their estates, as one shareholder, even if they own stock separately.
3) Otherwise, count everyone who owns any stock, even if the stock is owned jointly with someone else.

Trusts

The following trusts, other than foreign trusts, can be shareholders of an S corporation:

1) A trust that is treated as entirely owned by an individual who is a United States citizen or resident. The individual, not the trust is treated as the shareholder.
2) A trust that qualified under (1) immediately before the owner's death, and continues to exist after the owner's death, can continue to be an S corporation shareholder for stock held by the trust when the owner died. This is valid only for a period of 60 days, beginning on the date of the owner's death. However, if the entire corpus of the trust is included in the owner's gross estate, the 60-day period becomes a 2-year period. The owner's estate is treated as the shareholder.
3) A trust created primarily to exercise the voting power of stock transferred to it. Each beneficiary of the trust is treated as a shareholder.
4) Any trust the stock is transferred to under the terms of a will, but only for 60 days, beginning with the day the stock was transferred to the trust. The estate of the person leaving the will is treated as the shareholder.

Ineligible trust. A trust that qualifies as an IRA cannot be a shareholder in an S corporation.

Qualified subchapter S trusts. The beneficiaries of certain other trusts can choose to have their trusts qualify as a trust described in (1), above. These trusts are known as "qualified subchapter S trusts (QSST)." See Publication 589 for the definition of a QSST and how to elect to qualify a QSST as a shareholder.

Shareholder Consents

The corporation's election of S corporation status is valid only if all shareholders consent to the election. A shareholder's consent is binding and cannot be withdrawn after a valid election is made by the corporation.

Form of consent. Shareholders can consent by providing the required information on Form 2553 and signing in the appropriate space.

The shareholder can also consent by signing a separate written consent statement, under penalties of perjury, which should be attached to Form 2553. The separate consent should provide the following information:

1) The name, address, and taxpayer identification number of the corporation,
2) The name, address, and taxpayer identification number of the shareholder,
3) The number of shares of stock owned by the shareholder and the date or dates acquired,
4) The day and month of the end of the shareholder's tax year, and
5) A statement that the shareholder consents to the election of S corporation status.

The consents of all shareholders can be included in one statement. The corporation's election of S corporation status is invalid if any consent is not filed on time. However, if the corporation's election would be valid except for the failure of a shareholder to file a consent on time, an extension of time to file the consent can be requested. The request for an extension of time to file should be sent to the Internal Revenue Service Center where Form 2553 was filed.

The time for filing a consent can be extended, if:

1) It is shown to IRS's satisfaction that there was reasonable cause for the failure to file the consent and that the government's interest will not be jeopardized by treating the election of S corporation status as valid, and
2) The request for the extension is made within a reasonable period of time under the circumstances.

Consents must be filed within the extended period by all persons:

1) Who were shareholders at any time beginning with the date of the invalid election and ending on the date the extension of time is granted, and
2) Who have not previously consented to the election.

Who must consent. Each person who is a shareholder at the time Form 2553 is filed must consent. If the consent is filed before the 16th day of the 3rd month of the year for which it is to be effective, all shareholders in the corporation who held stock on any day in the tax year before the date Form 2553 is filed must also consent.

An election made before the 16th day of the 3rd month of the tax year is considered made for the following tax year if one or more of the persons who held stock in the corporation during the tax year and before the election was made did not consent to the election.

An election made after the 15th day of the 3rd month but before the end of the tax year will also be considered as made for the following tax year.

Co-owners. Each co-owner, tenant by the entirety, tenant in common, and joint tenant must consent. If stock is owned as community property, or if income from the stock is community property, both husband and wife must consent.

Minors. The consent of a minor must be made by the minor or his or her legal representative (or a natural or adoptive parent of the minor if no legal representative has been appointed).

Estates. The consent of an estate holding stock in an S corporation must be made by the executor or administrator of the estate.

Trusts. The consent of a qualified trust holding stock in a newly electing S corporation must be made by the person who is treated as a shareholder to determine whether the corporation meets the S corporation requirements. If a husband and wife have a community interest in the trust, both must consent. See *Trusts,* earlier, under *Requirements of an S Corporation.*

Form 2553—Electing S Corporation Status

To be treated as an S corporation, a corporation must file Form 2553 to indicate its election of S corporation status. The corporation must qualify as an S corporation when it files its Form 2553. Form 2553 should also be used to file shareholder consents and to select a tax year.

Form 2553 should be filed with the Internal Revenue Service Center shown in the instructions to the form.

When to file Form 2553. In general, the election of S corporation status is effective for a tax year if Form 2553 is filed:

1) Any time during the previous tax year, or
2) By the 15th day of the 3rd month of the tax year to which the election is to apply.

For detailed information on filing Form 2553, see the instructions for Form 2553.

Tax Year

The term ''tax year'' is the annual accounting period that is used for keeping records and reporting income and expenses. It is either a calendar year or a fiscal year.

Permitted tax year. A permitted tax year is a calendar year or any other accounting period for which the corporation establishes a substantial business purpose to the satisfaction of the IRS. In addition, an S corporation can elect under section 444 to have a tax year other than the permitted tax year.

For more information on substantial business purpose, see Publication 589.

A corporation electing S corporation status does not need the approval of the IRS to choose a calendar year as its tax year if all its principal shareholders either use the calendar year as their tax year or adopt the calendar year as their tax year at the same time as the corporation makes the choice. An electing S corporation should use Form 2553, discussed later, to request a tax year other than a calendar year or to make the section 444 election.

Change of tax year. An S corporation should file Form 1128 to apply for permission to change its tax year to a year other than a year ending December 31. This form should be filed by the 15th day of the 2nd calendar month after the close of the short tax year. This short tax year begins on the first day after the end of the corporation's present tax year and ends on the day before the opening date of its new tax year.

User fee. The corporation must submit a ***user fee*** with Form 1128. Form 1128 and the user fee should be filed with:

Associate Chief Counsel (Domestic)
Internal Revenue Service
Attention:CC:DOM:CORP:T
P.O. Box 7604
Benjamin Franklin Station
Washington, DC 20044

The package should be marked ''Ruling Request Submission.''

The application should contain all the requested information. It should show that there is a business purpose for the change. The deferral of income to shareholders generally will not be treated as a business purpose.

Note. Form 1128 should not be used to request a tax year for or during the first year the corporation elects to be an S corporation.

User fees are charged by the Internal Revenue Service for requests for changes in accounting periods and methods, and for certain tax rulings and determination letters. For more information and a schedule of fees, see Publication 1375, *Procedures for Issuing Rulings.*

Section 444 election. S corporations can elect, under section 444, to use a tax year that is different from the permitted tax year.

For more information on the section 444 election, see Publication 538.

Making the election. Unless you are a corporation electing S corporation status, make the section 444 election by filing ***Form 8716*** with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

1) The 15th day of the 6th month of the tax year for which the election will first be effective, or
2) The due date, without extensions, of the income tax return resulting from the section 444 election.

In addition, you must attach a copy of Form 8716 to your Form 1120S for the first tax year for which the election is made.

Required payment for S corporations. S corporations generally must make a required payment for any tax year that:

1) The section 444 election is in effect, and
2) The required payment amount is more than $500 for the tax year or any previous tax year.

Form 8752. Form 8752 is used to figure the required payment or refund.

For more information on the required payment, see the instructions for Form 8752.

Ending the election. The section 444 election remains in effect until it is terminated. The election ends when the S corporation:

1) Changes to its required tax year,
2) Liquidates,
3) Willfully fails to comply with the required payments or distributions, or
4) Becomes a member of a tiered structure (unless the tiered structure consists entirely of S corporations with the same tax year).

The election will also end if an S corporation's S election is terminated. If an S corporation terminates its S election and immediately becomes a personal service corporation, the personal service corporation can continue the section 444 election of the S corporation.

If an S corporation with a tax year other than the required tax year decides to terminate its section 444 election, the entity must file a ''short-period'' return for the required tax year by its due date (including extensions) to effect a valid termination. When filing the short-period return or extension request, type or print legibly at the top of the first page of Form 1120S or the extension request, ***SECTION 444 ELECTION TERMINATED.***

If the election is terminated, another section 444 election cannot be made for any tax year.

Terminating S Corporation Status

The corporation's status as an S corporation can be terminated in any of the following ways:

1) By revoking the election.
2) By ceasing to qualify as an S corporation.
3) By violating the passive investment income restrictions on S corporations with pre-S corporation earnings and profits for three consecutive tax years.

Five-year waiting period. If a corporation's status as an S corporation has been terminated, it generally must wait 5 tax years before it can again become an S corporation. If it gets the permission of the IRS, the waiting period can be less than 5 years.

Revoking S Corporation Status

An S corporation election can be revoked by the corporation for any tax year. The S corporation status can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S corporation's stock (including any nonvoting stock) consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

How to revoke. The revocation must be made by the corporation in the form of a statement. The statement must provide:

1) That the corporation is revoking its election to be treated as an S corporation under section 1362(a) of the Internal Revenue Code,
2) The name, address, and taxpayer identification number of the corporation,
3) The number of shares of stock (including nonvoting stock) outstanding at the time the revocation is made, and
4) The date on which the revocation is to be effective for revocations that specify a prospective revocation date.

This statement must be signed by any person authorized to sign the S corporation's return. It must be sent to the Service Center where the corporation filed its election to be an S corporation.

To this statement of revocation, the corporation should attach a statement of consent, which must be signed by each shareholder, under penalties of perjury, who consents to the revocation. It must also provide the name, address, and taxpayer identification number of each shareholder, the number of shares of outstanding stock (including nonvoting stock) each consenting shareholder holds at the time the revocation is made, the date or dates the stock was acquired, the date the shareholder's tax year ends, the name and taxpayer identification number of the S corporation, and the election to which the shareholder consents.

Effective date of revocation. The revocation is effective:

1) On the first day of the tax year if the revocation is made by the 15th day of the 3rd month of the same tax year.
2) On the first day of the following tax year if the revocation is made after the 15th day of the 3rd month of a tax year.
3) On the date specified if the revocation specifies a date on or after the day the revocation is made.

A corporation that specifies a prospective date for revocation that is other than the first day of the tax year will create an S termination year.

See *S Termination Year,* later, for information on filing returns for the S termination year.

Ceasing To Qualify

A corporation's status as an S corporation will be terminated if at any time the corporation ceases to qualify as an S corporation. If the corporation inadvertently ceases to qualify, see the discussion of *Inadvertent termination.*

Certain events can cause the corporation to cease qualifying as an S corporation. Some of these include:

1) Having more than 35 shareholders,
2) Transferring stock in the S corporation to:
   - A corporation,
   - A partnership,
   - An ineligible trust, or
   - A nonresident alien,
3) Creating a second class of stock, and
4) Acquiring a subsidiary, other than certain nonoperating subsidiaries.

Effective date of termination. A termination of S corporation status will be effective as of the date the terminating event occurred.

A corporation that ceases to be an S corporation on a date other than the first day of the tax year will create an S termination year.

For more information on filing tax returns for the S termination year, see *S Termination Year,* later.

Violating the Passive Income Restriction

A corporation's status as an S corporation will be terminated if both of the following conditions occur for 3 consecutive tax years:

1) It has pre-S corporation earnings and profits at the end of each tax year, and
2) Its passive investment income for each tax year is more than 25% of gross receipts.

See Publication 589 for a discussion of passive investment income.

Effective date of termination. A termination of S corporation status because of a violation of the passive income restriction will be effective on and after the first day of the tax year that follows the third consecutive tax year referred to above. See also *Inadvertent termination,* discussed later.

S Termination Year

Any termination described previously in *Revoking S Corporation Status* and *Ceasing To Qualify* that is effective during the tax year on a date other than the first day of that tax year will create an S termination year. The part of the S termination year ending on the date before the effective date of the termination is an 1120S (S corporation) short tax year. The part of the S termination year beginning on the first day on which the termination is effective is an 1120 (C corporation) short tax year.

After the S termination year is divided into an 1120S short year and an 1120 short year, the separately stated items of income, loss, credit, and deduction, and the amount of the nonseparately stated income or loss must be divided between the periods. There are two methods that can be used to make this division. They are:

1) A pro rata allocation, or
2) An allocation based on normal tax accounting rules.

After the separately stated items and the nonseparately stated income or loss are divided, one set of amounts is used for the 1120S short year and the other set of amounts is used for the 1120 short year.

The corporation will have to file two returns to cover the S termination year. One covers the 1120S short year and one covers the 1120 short year. The S termination year will count only as one year for figuring carrybacks and carryovers, even though two returns are filed for the year.

For more information, see Publication 589.

Inadvertent Termination

If the corporation is terminated because it ceased to qualify as an S corporation, or it violated the restriction on passive investment income, the IRS may waive the termination. The termination may be waived if the IRS determines that the termination was inadvertent, the corporation takes steps to correct the terminating event within a reasonable period of time, after discovering it, and the corporation and its shareholders agree to any adjustments the IRS may require.

For more information on inadvertent terminations, see Publication 589.

Part Seven.

Credits, Other Taxes, and Information Returns

This Part discusses certain tax credits you may be able to claim, certain federal taxes you may have to pay, and information returns you may have to file in the course of your trade or business.

31. General Business Credit

Important Reminders

Jobs credit. The jobs credit for qualified first-year wages paid or incurred during your tax year to employees who are certified members of targeted groups does not apply to employees who begin working for you after December 31, 1994.

Research credit. The research credit does not apply to amounts paid or incurred after June 30, 1995.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would extend the jobs credit and the research credit. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Introduction

Your general business credit consists of your carryover of business credits from prior years plus the total of your current year business credits. Current year business credits include the:

1) Investment credit,
2) Jobs credit,
3) Alcohol fuels credit,
4) Research credit,
5) Low-income housing credit,
6) Disabled access credit,
7) Enhanced oil recovery credit,
8) Renewable electricity production credit,
9) Empowerment zone employment credit,
10) Indian employment credit,
11) Credit for employer social security and Medicare taxes paid on certain employee tips, and
12) Credit for contributions to selected community development corporations.

In addition, your general business credit for the current year may be increased later by the carryback of business credits from subsequent years.

If you need more information about these credits than you find in this chapter, see the credit forms listed under *Useful Items,* later.

Topics

This chapter discusses:

- Claiming the general business credit
- Carrybacks and carryovers
- Credit for contributions to selected community development corporations
- Credit for taxes paid on certain employee tips
- Disabled access credit
- Empowerment zone employment credit
- Enhanced oil recovery credit
- Indian employment credit
- Investment credit
- Jobs credit
- Low-income housing credit
- Renewable electricity production credit
- Research credit

Useful Items

You may want to see:

Form (and Instructions)

- ☐ **1040X** Amended U.S. Individual Income Tax Return
- ☐ **1045** Application for Tentative Refund
- ☐ **1120X** Amended U.S. Corporation Income Tax Return
- ☐ **1139** Corporation Application for Tentative Refund
- ☐ **3468** Investment Credit
- ☐ **3800** General Business Credit
- ☐ **4255** Recapture of Investment Credit
- ☐ **4626** Alternative Minimum Tax—Corporations
- ☐ **5884** Jobs Credit
- ☐ **6251** Alternative Minimum Tax—Individuals
- ☐ **6478** Credit for Alcohol Used as Fuel
- ☐ **6765** Credit for Increasing Research Activities
- ☐ **8582–CR** Passive Activity Credit Limitations
- ☐ **8586** Low-Income Housing Credit
- ☐ **8826** Disabled Access Credit
- ☐ **8830** Enhanced Oil Recovery Credit
- ☐ **8835** Renewable Electricity Production Credit
- ☐ **8844** Empowerment Zone Employment Credit
- ☐ **8845** Indian Employment Credit
- ☐ **8846** Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips
- ☐ **8847** Credit for Contributions to Selected Community Development Corporations

Claiming the General Business Credit

Disregarding any empowerment zone employment credit, if you have only one current year business credit, no carryback or carryover, and the credit (other than the low-income housing credit) is not from a passive activity, use only the applicable credit form listed under *Useful Items,* earlier, to claim the general business credit. For information about passive activity credits, see Form 8582–CR.

If you have more than one credit, a carryback or carryover, or a credit (other than the low-income housing credit) from a passive activity, you must use Form 3800 to figure your general business credit.

Claiming the empowerment zone employment credit. The empowerment zone employment credit is subject to special rules. The credit is figured separately on Form 8844 and is not carried to Form 3800. For more information, see the instructions for Form 8844.

Carrybacks and Carryovers

Note: The following discussion does not apply to the empowerment zone employment credit.

There is a limit on how much general business credit you can take in any one tax year. If your credit is more than this limit, you can generally carry the excess to another tax year and subtract it from your income tax for that year. See *Rule for carrybacks and carryovers,* later.

Tax limit. Your general business credit is limited to your net income tax minus the larger of:

1) Your tentative minimum tax, or
2) 25% of your net regular tax liability that is more than $25,000.

Net income tax. Your net income tax is your net regular tax liability plus your alternative minimum tax. Your ***net regular tax liability*** is your regular tax liability minus certain credits. For more information, see Form 3800 or any of the credit forms listed under *Useful Items,* earlier.

Tentative minimum tax. You must determine your tentative minimum tax before you figure your general business credit. Use Form 6251 (Form 4626 for a corporation) to figure your tentative minimum tax.

Example. Your general business credit for the year is $30,000. Your net income tax is $27,500. Your tentative minimum tax, figured on Form 6251, is $18,487. The amount of general business credit you can take for the tax year is limited to $9,013. This is your net income tax, $27,500, minus the ***larger of*** your tentative minimum tax, $18,487, or 25% of your net regular tax liability that is more than $25,000 (25% of $2,500 = $625).

Married persons filing separate returns. If you are married and file a separate return, you and your spouse must each figure your tax limit separately. In figuring your separate limit, use $12,500 instead of $25,000. However, if one spouse has no credit for the tax year and no carryovers or carrybacks of any credit to that year, the other spouse can use the full $25,000 instead of $12,500 in figuring the limit based on the separate tax.

Rule for carrybacks and carryovers. In general, you can carry the unused portion of your credit back to your last 3 tax years and then forward to your next 15 tax years to reduce your tax in those years. There are generally limits on the carryback of a new credit to periods before the enactment of the credit provision. See the instructions for Form 3800 for more information on these limits.

First, carry the unused portion to the earliest of your last 3 years. Then, if you cannot use it all in that year, carry the remaining unused portion to the second earliest year and so on. Any unused credit that you could not take in these 3 earlier years can be carried forward in the same way to the next 15 tax years until it is used up.

Credits must be used in the order in which they are earned.

1) First, for any tax year, use your credit carryover (earliest year first).
2) Next, use the current year's credit.
3) Finally, use your credit carrybacks (earliest year first).

Unused carryover. If you have any unused credit carryover in the year following the end of the 15-year carryover period, you can generally deduct the unused amount.

If an individual dies or a corporation, trust, or estate ceases to exist, the deduction is generally allowed for the tax year in which the death or cessation occurs.

Claiming carryovers. Use Form 3800 to claim a carryover of an unused credit from a previous tax year. The carryover becomes part of your general business credit for the tax year to which it is carried.

Claiming carrybacks. You can make a claim for refund based on your general business credit carryback to a prior tax year by filing an amended return for the tax year to which you carry the unused credit. Use Form 1040X if your original return was a Form 1040. Use Form 1120X if your original return was a Form 1120 or 1120–A. Attach Form 3800 to your amended return.

Generally, you must file the amended return for the carryback year no later than 3 years after the due date, including extensions, for filing the return for the year that resulted in the credit carryback.

Quick refunds. You can apply for a quick refund of taxes for a prior year by filing Form 1045 (Form 1139 for a corporation) to claim a tentative adjustment of tax from a general business credit carryback. The application should be filed on or after the date of filing the tax return for the carryback year, but must be filed no later than 12 months after the end of the tax year in which you earn the credit.

Credit for Contributions to Selected Community Development Corporations

This credit is equal to 5% of each qualified cash contribution (including 10-year loans and long-term investments) made to a selected community development corporation (CDC). The credit is taken for each tax year during a 10-year period beginning with the tax year during which the contribution was made. Over the 10-year period, you can claim a total credit of 50% of your CDC contribution.

The contribution must be made to one of 20 CDCs selected by the Secretary of Housing and Urban Development (HUD). For more information, including a list of selected CDCs, see Form 8847.

Credit for Taxes Paid on Certain Employee Tips

The credit is equal to the employer portion of social security and Medicare taxes paid on tips received and reported to the employer by employees of food and beverage establishments. Only tips received from customers for providing food or beverages for consumption on the premises of the establishment are taken into account. The credit is reduced if employees are paid below the federal minimum wage. No deduction is allowed for any amount taken into account in determining the credit.

A food or beverage establishment is any trade or business (or portion of a business) that provides food or beverages for consumption on the premises and in which employees serving food or beverages are customarily tipped by the customers. For more information, see Form 8846.

Disabled Access Credit

The disabled access credit is a nonrefundable tax credit for an eligible small business that pays or incurs expenses to provide access to persons with disabilities. The expenses must be paid or incurred to enable the eligible small business to comply with the Americans with Disabilities Act of 1990. The credit is equal to 50% of the expenses over $250, but not more than $10,250. The maximum credit is $5,000. You cannot take a double benefit for the amount of the credit. Only amounts that are more than your credit can be deducted as expenses for the removal of barriers, capitalized, or used to figure other credits.

Eligible small business. An eligible small business is one that elects to claim the credit and for the preceding year either:

1) Had 30 or fewer ***full-time*** employees, or
2) Had $1 million or less in gross receipts (reduced by returns and allowances).

A ***full-time*** employee is one employed at least 30 hours a week for 20 or more calendar weeks in the preceding year.

Qualifying expenses. Expenses to provide access to persons with disabilities include:

1) Removing barriers that prevent an individual with disabilities from having access to a business.
2) Providing qualified interpreters or other methods of making audio materials available to individuals who are hearing impaired.
3) Providing readers, tapes, and other methods of making visual materials available to individuals who are visually impaired.
4) Acquiring or modifying equipment for individuals with disabilities.
5) Providing other similar services, modifications, materials, or equipment.

Partnerships and S corporations. The maximum credit of $5,000 applies to the partnership and to each partner. The partnership allocates the credit among the partners and each partner takes the credit on his or her individual tax return. A similar rule applies to an S corporation and its shareholders.

Claiming the credit. To claim the credit, file Form 8826. You may also need to file Form 3800. See *Claiming the General Business Credit,* earlier.

Empowerment Zone Employment Credit

This credit is available to any employer engaged in a trade or business in an empowerment zone.

Amount of credit. Initially, an employer can claim a tax credit equal to 20% of the first $15,000 of qualified wages paid or incurred to each employee who meets the criteria listed later.

For purposes of the $15,000 limit, all employers of a controlled group (or partnerships or proprietorships under common control) are treated as a single employer.

Reduction of limit. The $15,000 limit must be reduced by the amount of wages taken into account in determining the jobs credit.

Qualified employees. An employer can claim the credit for wages paid to all full- or part-time employees who:

1) Are qualified zone residents, and
2) Perform substantially all of their services for the employer within the qualified zone in the employer's trade or business.

Nonqualified employees. The credit cannot be claimed for wages paid to:

1) An individual employed for less than 90 days (unless he or she meets certain exceptions relating to disability or misconduct),
2) Certain related taxpayers,
3) Any 5% owner,
4) An individual employed at any:
   a) Private or commercial golf course,
   b) Country club,
   c) Massage parlor,
   d) Hot tub facility,
   e) Suntan facility,
   f) Racetrack or other gambling facility, or
   g) Store whose principal business is the sale of alcoholic beverages for off-premise consumption, or
5) An individual employed in a trade or business the principal activity of which is farming, but only if the unadjusted bases (or, if greater, the fair market value) of the farm assets exceed $500,000 at the close of the tax year.

Qualified wages. Salaries and wages (as defined for federal unemployment tax purposes but without any dollar limitations) and certain training and educational expenses paid on behalf of a qualified employee are considered qualified wages.

An employer cannot use wages taken into account for the jobs credit. The employer must also reduce the deduction for wages on his or her tax return by the amount of the empowerment zone employment credit.

Alternative minimum tax. The empowerment zone employment credit can be used to offset up to 25% of the employer's alternative minimum tax liability.

For more information, see Form 8844.

Enhanced Oil Recovery Credit

You can take a credit for 15% of your qualified enhanced oil recovery costs for the tax year. See Form 8830 for more information.

Indian Employment Credit

The credit is generally 20% of the amount of an employer's qualified wages and health insurance costs (up to $20,000 per employee) paid or incurred during a tax year that is more than the sum of the comparable costs paid or incurred during calendar year 1993 by the employer (or predecessor). The employee must be an enrolled member, or the spouse of an enrolled member, of an Indian tribe. The employee must perform substantially all of his or her services within an Indian reservation while living on or near the reservation. For more information, see Form 8845.

Investment Credit

The investment credit is the total of the:

1) Reforestation credit,
2) Rehabilitation credit, and
3) Energy credit.

Reforestation credit. The 10% reforestation credit applies to up to $10,000 of the expenses you incur each year to forest or reforest property you hold for growing trees for sale or use in the commercial production of timber products. These expenses must qualify for amortization. You can take the investment credit for reforestation expenses whether you choose to amortize them or add them to the basis of your property. For more information about these expenses, see *Timber* in chapter 13.

Rehabilitation credit. The rehabilitation credit applies to expenses you incur for rehabilitation and reconstruction of certain buildings. Rehabilitation includes renovation, restoration, or reconstruction. It does not include enlargement or new construction. The percentage of expenses you can take as a credit is 10% for buildings placed in service before 1936 and 20% for certified historic structures. See the instructions for Form 3468 for more information.

Energy credit. The 10% energy credit applies to certain expenses for solar or geothermal energy property you placed in service during your tax year. See the instructions for Form 3468 for more information.

Basis adjustment. You must generally reduce the depreciable basis of assets on which you take an investment credit. The reduction is 100% of the rehabilitation credit and 50% of the reforestation and energy credits. See the instructions for Form 3468 for more information.

How to take the investment credit. Use Form 3468 to figure your credit. You may also need to file Form 3800. See *Claiming the General Business Credit,* earlier.

Carrybacks and carryovers. Even if you cannot take an investment credit for 1995, you may have unused credits from earlier years that may reduce your 1995 tax. These unused credits from earlier years are carried to your current tax year as general business credit carryovers and the rules for the general business credit, discussed earlier, apply.

Recapture of Investment Credit

At the end of each tax year, you must determine whether you disposed of or stopped using in your business (either partially or entirely) any property for which you claimed an investment credit in a prior year. If you dispose of property before the end of the recapture period, you must recapture a percentage of the credit by adding it to your tax. See *Recapture Rule,* later, for a discussion of recapture period.

Use Form 4255 to figure the recapture tax or attach a detailed statement to your return for the year you dispose of the asset showing the computation of the recapture tax and the decrease in any investment credit carryover.

Dispositions

An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when you exchange or trade worn-out or obsolete business assets for new ones. If the property ceases to be qualifying property, it is considered to be disposed of for investment credit recapture purposes. For example, the conversion of business property to personal use is considered a disposal for investment credit recapture purposes.

Certain transactions result in dispositions for investment credit recapture purposes. The following illustrate those that are and those that are not dispositions.

Mortgaging and foreclosure. There is no disposition if title to property is transferred as security for a loan. However, a disposition does occur if there is a transfer of property by foreclosure.

Leased property. The leasing of investment credit property by the lessor who took the credit is generally not a disposition. However, if the lease is treated as a sale for income tax purposes, it is a disposition. A disposition also occurs if the property ceases to be investment credit property in the hands of the lessor, the lessee, or any sublessee.

Decrease in basis. If the basis of investment credit property decreases, the decrease is considered to be a disposition. This occurs, for example, if you buy property and later receive a refund of part of the original purchase price. You must then refigure the credit as if the amount of the decrease in basis was never part of the original basis. If your refigured credit is less than the credit you originally took, you must add the difference to your tax.

Retirement or abandonment. You dispose of property if you abandon it or otherwise retire it from use. Normal retirements are also dispositions.

Transfer by reason of death. There is no disposition of investment credit property if the property is transferred because the owner-taxpayer died.

Gifts. You are considered to have disposed of property that you transferred by gift.

Transfers between spouses. If you transfer investment credit property to your spouse, or you transfer the property to your former spouse incident to a divorce, you generally are not considered to have disposed of the property. This also applies if the transfer is made in trust for the benefit of your spouse or former spouse. However, if your spouse or former spouse later transfers the property, your spouse or former spouse will receive the same tax treatment that would have applied to you if you had made the transfer.

Casualty or theft loss. You are considered to have disposed of property that was destroyed by casualty or lost by theft.

Choosing S corporation status. The choice by a corporation to become an S corporation generally will not cause the recapture of investment credit previously claimed by the corporation. The choice is treated as a change in the form of doing business and not as a disposition of property. No disposition occurs when an S corporation terminates or revokes its choice not to be taxed as a corporation.

Disposition of assets by S corporation, partnership, estate, or trust. If you are a shareholder of an S corporation that disposes of assets on which you figured the investment credit, you are treated as having disposed of the share of the investment on which you figured your credit. This same rule applies if you are a member of a partnership or a beneficiary of an estate or trust.

Change in form of doing business. A disposition does not occur because of a change in the form of doing business if certain conditions are met. For more information, see section 1.47–3(f) of the Income Tax Regulations.

Sale and leaseback. There is no disposition when investment credit property is sold by the taxpayer who claimed the credit and then is leased back to that taxpayer as part of the same transaction.

At-risk reduction. If the amount of your investment for which you are at risk is reduced, you are subject to the recapture rules (discussed next). See the instructions for Form 3468 for more information.

Recapture Rule

If you dispose of investment credit property before the end of the recapture period (defined in the next paragraph), you must recapture, as an additional tax, part of the original credit you claimed. You may also have to recapture part or all of the credit if you change the use of investment credit property to one that would not have originally qualified for the credit.

The amount of credit you must recapture depends on when during the recapture period you dispose of, or change the use of, the property. The ***recapture period*** is the length of time the property must be used to get the full investment credit.

Use Form 4255 to figure the recapture amount. The credit recapture is figured by multiplying the original investment credit taken by the recapture percentage from the tables on Form 4255. The result of this computation is the amount of the recapture. See Form 4255 for more information.

If the refigured credit is less than the credit you originally took, you must add the difference to your tax.

Net operating loss carrybacks. If you have a net operating loss carryback from the recapture year or a later year that reduces your tax for the recapture year or an earlier year, you may have to refigure your recapture. See section 1.47–1(b)(3) of the Income Tax Regulations.

Jobs Credit

The jobs credit provides an incentive to hire persons from targeted groups that have a particularly high unemployment rate or other special employment needs. The credit is based on qualified wages paid to these employees. In general, you must receive or request in writing, by the employee's first workday, a certification from your state employment security agency (jobs service).

The jobs credit does not apply to wages you pay employees who begin working for you after December 31, 1994.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would extend the jobs credit. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Wages to use for determining the credit. Only qualified first-year wages can be used to figure the credit. In addition, you cannot take a credit on wages paid to an otherwise eligible employee who works for you less than 90 days or 120 hours (14 days or 20 hours for a qualified summer youth employee).

Wages you pay to an employee in any tax year qualify for the credit only if more than one-half of the wages are for work done in your trade or business.

To take this credit, your employee must be certified as a member of a targeted group. An individual is a member of a targeted group if that individual is one of the following:

1) A vocational rehabilitation referral,
2) An economically disadvantaged youth,

3) An economically disadvantaged Vietnam-era veteran,
4) A Supplemental Security Income (SSI) recipient,
5) A general assistance recipient,
6) A youth participating in a cooperative education program,
7) An economically disadvantaged ex-convict,
8) An eligible work incentive employee, or
9) A qualified summer youth employee.

Certification must be made by the designated local agency, or for a cooperative education student, by the participating school. Designated agencies are local offices of a state employment security agency (jobs service).

You cannot claim a credit for wages you pay to certain related individuals.

For more information, see Form 5884.

Low-Income Housing Credit

This credit generally applies to qualified low-income housing buildings placed in service after 1986. For more information, see Form 8586 and section 42 of the Internal Revenue Code.

Renewable Electricity Production Credit

The renewable electricity production credit is based on electricity that was sold to unrelated persons and was produced from qualified energy resources at a qualified facility during the 10-year period after the facility is placed in service. The credit for calendar year 1994 is 1.5 cents per kilowatt hour of such electricity sold. The credit for calendar year 1995 is 1.6 cents per kilowatt hour sold.

Qualified energy resources are wind and closed-loop biomass. Closed-loop biomass is any organic material from a plant that is planted exclusively for use at a qualified facility to produce electricity. A qualified facility is one you own that is within the United States or a U.S. possession and that is originally placed in service after 1993 (after 1992 for a facility using closed-loop biomass to produce electricity) but before July 1, 1999.

For more information, see Form 8835.

Research Credit

The research credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities. The credit is generally 20% of the amount by which your research expenses (paid or incurred) for the year are more than your base amount. For more information, see Form 6765.

This credit does not apply to amounts paid or incurred after June 30, 1995.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would extend the research credit. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

32. Self-Employment Tax

Important Change for 1995

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings remains the same for 1995 and 1996. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for 1995 is $61,200. For 1996, that amount increases to $62,700. For 1995 and 1996, all of your net earnings are subject to the Medicare part.

Important Reminders

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax (SE tax) contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, and medical insurance (Medicare) benefits.

You must be *insured* under the social security system before you begin receiving social security benefits (described above). You are insured if you have the required number of quarters of coverage. A ''quarter of coverage'' means a period of 3 calendar months during which you were paid a certain amount of income subject to social security tax.

For 1995, you receive a quarter of social security coverage, up to four quarters, for each $630 of income subject to social security. Therefore, for 1995, if you had income of $2,520 that was subject to social security taxes (self-employment and wages), you will receive four quarters of coverage.

For an explanation of the number of quarters of coverage you must have to be insured, and of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Social security number. You must have a social security number to pay SE tax. If you do not have a number, you should apply for one on Form SS-5, *Application for a Social Security Card.* You can get this form at any Social Security office.

Estimated tax. You may be required to pay estimated tax. This depends on how much income and SE taxes you expect for the year and how much of your income will be subject to withholding tax.

If you are also an employee, you may be able to cover your estimated SE tax payments by having your employer increase the amount of income tax withheld from your pay.

Self-employment tax deduction. You can deduct one-half of your SE tax as a business expense in figuring your adjusted gross income. This is an income tax adjustment only. It does not affect your net earnings from self-employment or your SE tax.

To deduct the tax, enter on Form 1040, line 25, the amount shown on the ''Deduction for one-half of self-employment tax'' line of the Schedule SE.

Introduction

The SE tax is a social security and Medicare tax for individuals who work for themselves. It is similar to the social security and Medicare tax withheld from the pay of wage earners.

Topics

This chapter discusses:

- Who must pay self-employment tax
- Figuring self-employment tax

Useful Items

You may want to see:

Publication

- ☐ **225** Farmer's Tax Guide
- ☐ **533** Self-Employment Tax

Form (and Instructions)

- ☐ **SS–5** Application for a Social Security Card
- ☐ **Sch C (Form 1040)** Profit or Loss From Business
- ☐ **Sch SE (Form 1040)** Self-Employment Tax
- ☐ **4137** Social Security and Medicare Tax on Unreported Tip Income

Who Must Pay Self-Employment Tax

You must pay SE tax if :

1) You were self-employed and your net earnings from self-employment (excluding any church employee income) were $400 or more, or
2) You had church employee income of $108.28 or more.

However, if you are a member of the clergy or a religious worker, you may not have to pay SE tax. See *Religious Exemptions,* in Publication 533.

You are self-employed if you carry on a business as a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do on the side in addition to your regular job, may also be self-employment.

A ***trade or business*** is generally an activity carried on for a livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. Regularity of activities and transactions and the production of income are important elements. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.

The SE tax rules apply even if you are fully insured under social security or have started receiving benefits.

Statutory employees. If you earned wages as a statutory employee, the box titled ''Statutory employee'' in box 15 of Form W–2, *Wage and Tax Statement,* will be checked. You do not pay SE tax on those earnings because social security and Medicare taxes (FICA taxes) were withheld. Do not file Schedule SE if you have no other earnings from self-employment. You should file a separate Schedule C (or Schedule C–EZ) to report only the income and expenses related to your earnings as a statutory employee.

Self-Employment Income

Different types of income can be SE income. The source of your income and your involvement in the activity from which your income is received will determine whether it is SE income.

Aliens. Resident aliens are generally subject to the same rules as U.S. citizens. Nonresident aliens do not have to pay SE tax. Residents of the Virgin Islands, Puerto Rico, Guam, or American Samoa, however, are subject to the tax. For SE tax purposes, they are not nonresident aliens. For more information on U.S. possession SE income, see Publication 533.

Gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring SE income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included:

1) Investment property.
2) Depreciable property or other fixed assets used in your trade or business.

3) Livestock held for draft, dairy, breeding, or sporting purposes and not held primarily for sale, regardless of how long the livestock were held or whether they were raised or purchased.
4) Standing crops sold with land held more than one year.
5) Timber, coal, or iron ore held for more than one year, if an economic interest was retained, such as a right to receive coal royalties.

A gain or loss from the cutting of timber ***is not*** included if the cutting is treated as a sale or exchange.

However, any amounts for depreciation, including any section 179 deduction, recaptured because the business use of certain property was reduced to 50% or less, are taken into account in figuring your net earnings from self-employment. (This does not include amounts recaptured on the disposition of property.)

Fishing crew members. Certain members of the crew on a boat that catches fish or other water life are self-employed if:

1) They do not get any money for their work (other than their share of the catch or of the proceeds from the sale of the catch),
2) They get shares of the catch or shares of the proceeds from the sale of the catch,
3) Their shares depend on the amount of the catch, and
4) The operating crew usually numbers less than ten individuals.

Crew members who meet these conditions are considered self-employed and must pay SE tax and generally need to make estimated tax payments.

Lost income payments. If you are self-employed and reduce or stop business activities, any payment you receive for the lost income of your business from insurance or other sources is SE income. If you are not working when you receive the payment, it still relates to your business (even though the business is temporarily inactive) and is SE income.

If there is a connection between any payment you receive and your trade or business, the payment is SE income. A connection exists if it is clear that the payment would not have been made but for your conduct of the trade or business.

Corporate payments. Whether income received from a corporation is SE income depends on the reason for the payment.

Corporate director. Fees received for performing services as a director of a corporation are SE income. It does not matter whether the fees are for going to directors' meetings or for serving on committees.

Corporate employee. Even if you own most or all of the stock of a corporation, your income as an employee or officer of the corporation is not SE income.

S corporations. If you are a shareholder in an S corporation, your share of the corporation's taxable income is not SE income, even though you include it in your gross income for income tax purposes.

If you are a shareholder and also an officer of an S corporation and perform substantial services, you are an employee of the S corporation. Your payment for services is subject to withholding for social security and Medicare taxes and is not SE income, no matter what the S corporation calls the payments.

Dividends. Dividends on securities are not SE income unless you are a dealer in securities.

Independent contractor. People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the general public, are generally not employees. However, whether such people are employees or independent contractors depends on all the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not the means and methods of accomplishing the result. Income earned by an independent contractor is SE income.

For more information in determining whether you are an independent contractor or an employee, get Publication 15-A, *Supplemental Employer's Tax Guide.*

Interest. Interest is SE income if you receive it in your trade or business. This includes interest on accounts receivable or from bonds, notes, etc., if you are a dealer in stocks or securities.

Newspaper carriers. The wages newspaper carriers receive for delivering newspapers or shopping news to customers is not SE income. If the carriers are age 18 or over, the wages are subject to withholding for social security and Medicare taxes (FICA taxes).

However, if a carrier is 18 or over and works under an arrangement in which the carrier's pay is the difference between a fixed sales price and the cost of the newspapers to the carrier, the income is SE income.

Newspaper vendors. The income newspaper vendors receive for selling newspapers or magazines directly to customers for a profit is not SE income if the vendor is under age 18. However, if the vendor is 18 or over, the income is SE income.

Partnerships. If you are a member of a partnership that carries on a trade or business, your distributive share of partnership income or loss is includible in your income from self-employment. Guaranteed payments from your partnership should be included, along with your share of earnings or losses when you figure your net earnings from self-employment. See chapter 28.

Inactive partner. An inactive partner figures income from self-employment by including the distributive share of partnership income or loss and any guaranteed payments.

Limited partner. A limited partner figures SE income by excluding the distributive share of partnership income or loss. But guaranteed payments, such as salary and professional fees, received for services performed during the year are included as SE income.

Retired partner. A retired partner pays no SE tax on retirement income received from the partnership under a written plan if:

1) The retired partner receives life-long periodic payments,
2) The retired partner's share of the partnership capital was fully repaid to the retired partner,
3) The retired partner performs no services for the partnership during the year, and
4) The partnership owes the retired partner nothing but the retirement payments.

Different tax years. If your tax year is not the same as your partnership's, report your share of partnership income or loss on your return for the year that includes the end of the partnership tax year.

Example. You file your return on a calendar year basis, but your partnership uses the fiscal year ending January 31. You must include on your return for calendar year 1995 your distributive share of partnership earnings and your guaranteed payments for the fiscal year ending January 31, 1995.

For additional information on figuring your income from a partnership, see chapter 28.

Part-time business. Income from an activity you carry on part-time is SE income. For example, in your spare time you fix televisions and radios. You have your own shop, equipment, and tools. You get your customers from advertising and word-of-mouth. The income you earn from your repair shop is SE income.

Public officials. Public officials generally do not pay SE tax on what they earn in their official positions. Public office includes any elective or appointive office of the United States or its possessions, the District of Columbia, a state or its political subdivisions, or a wholly owned instrumentality of any of these.

However, public officials of state or local governments must pay SE tax on their fees if they are paid solely on a fee basis and if their services are eligible for, but not covered by, social security under a federal–state agreement.

Real estate rent. Rent from real estate and from personal property leased with real estate is not SE income. However, if you receive rent as a real estate dealer, include the rental income and related deductions in figuring SE income.

Hotels, apartments, etc. Rents received for the use or occupancy of hotels, boarding houses, or apartment houses are not rentals from real estate if services are provided for the occupants. These payments are included in figuring net earnings from self-employment. Services are generally provided for the occupants if they are primarily for their convenience and not services normally provided with the rental of rooms or space for occupancy only. Maid service, for example, is a service provided for the convenience of the occupants. However, heat and light, the cleaning of stairways, exits, and lobbies, and the collection of trash are not services primarily for the occupants' convenience.

Trailer park owners. Rent received by trailer park owners who provide trailer lots, facilities, and services is rent from real estate. It is not included in SE income unless the services provided by the owners are substantial and for the convenience of tenants. Providing services, such as city sewerage, electrical connections, and roadways are services required to maintain space for tenant occupancy and not services for the convenience of tenants. Although the operation and maintenance of a trailer park laundry facility is a service provided for the convenience of tenants, it is not, by itself, substantial.

If, however, the owners provide services for tenants that are beyond those required for occupancy and are substantial in nature, the owner's earnings are included in SE income. Services for tenants that are beyond those required for occupancy include supervising and maintaining a recreational hall provided by the park; distributing a monthly newsletter to tenants; operating a laundry facility; and helping tenants buy or sell their trailers.

Religious exemptions. Members of the clergy and Christian Science practitioners are subject to SE tax unless they get an exemption. Members of certain religious sects, however, may be exempt from SE tax. See Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

Retired insurance agents. The income paid by insurance companies to retired insurance agents that is based on a percentage of commissions received prior to retirement is SE income. Also, the income for renewal and deferred commissions for sales made prior to retirement is SE income.

Sole proprietor. If you own your own business and operate as a sole proprietor, the income from your business is SE income.

U.S. citizens working in U.S. for foreign government or international organization. If you are a U.S. citizen employed in the United States by a foreign government, a wholly owned instrumentality of a foreign government, or an international organization, you are subject to the SE tax if your employer does not deduct social security and Medicare taxes from your income.

International social security agreements. The United States has social security agreements with many countries to eliminate dual taxes under two social security systems. Under these agreements, you must generally pay social security and Medicare taxes to only the country you live in.

The United States now has social security agreements with the following countries: Austria, Belgium, Canada, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Additional agreements are expected in the future. For more information, contact:

Social Security Administration
Office of International Policy
P.O. Box 17741
Baltimore, MD 21235

Wages, salaries, and tips. Wages received for services performed as an employee and covered by social security or railroad retirement are not SE income. Tips received for work done as an employee are also excluded from SE income.

Net Self-Employment Income

Net SE income usually includes all business income less all business deductions allowed for income tax purposes. You must determine your net SE income by using the same accounting method you use for income tax purposes. You must claim all allowable deductions when figuring net SE income. Your net SE income is used to figure your net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

More than one business. If you have more than one trade or business, you must combine the net earnings from each business to determine your net SE income. A loss you incur in one business will reduce your gain in another business. You net these gains and losses only for purposes of the SE tax. Keep separate records for each business and file the appropriate form or schedule for each separate business.

Example. You are the sole proprietor of two separate businesses. You operate a restaurant that made a net profit of $25,000 last year. You also have a cabinetmaking business that had a net loss of $500 last year. You file one Schedule SE showing net SE income of $24,500. You must also file a Schedule C for each business—a Schedule C for the restaurant showing your net profit of $25,000, and another Schedule C for the cabinetmaking business showing your net loss of $500.

Deductions and exemptions. Your SE income should not be reduced by certain deductions used to figure your income tax. Specifically, do not use:

1) Deductions for personal exemptions for yourself, your spouse, or dependents,
2) The standard deduction or itemized deductions,
3) The net operating loss deduction,
4) Nonbusiness deductions (including contributions to a retirement plan for yourself), and
5) The self-employed health insurance deduction.

Example. You own a grocery store that reported the following items for the year:

Gross profit on sales	$87,400
Salaries	30,000
Rent	6,000
Heat, light, and air conditioning	2,400
Other expenses	1,900
Gain on sale of refrigerator	350
Fire loss on store building	1,200
Net operating loss carryover	1,000

To figure taxable income, consider all the above items. But to figure ***net self-employment income,*** use only the following:

Gross profit on sales		$87,400
Expenses:		
Salaries	$30,000	
Rent	6,000	
Heat, light, and air conditioning	2,400	
Other expenses	1,900	
Total expenses		40,300
Net operating profit		$47,100

The $47,100 is your net SE income. The refrigerator sale, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation.

Figuring Self-Employment Tax

There are three steps to figure the amount of SE tax you owe.

1) Determine your net earnings from self-employment.
2) Determine the amount that is subject to the tax.
3) Multiply that amount by the tax rate.

There are three ways to figure self-employment net earnings. These are the regular method, the farm optional method, and the nonfarm optional method. For a discussion of the farm optional method, see Publication 533 or Publication 225.

Tax rates. The SE tax rate is 15.3% (12.4% social security plus 2.9% Medicare tax). It is the same for net earnings figured under each method. The general rules for figuring SE tax are presented in the regular method, discussed later.

Fiscal year taxpayer. If you use a tax year other than the calendar year, you must use the tax rate and maximum income limit in effect at the beginning of your tax year. Even if the tax rate or maximum income limit changes during your tax year, you should continue to use the same rate and limit throughout your tax year.

Net earnings subject to SE tax. Whether you have to pay SE tax on any part of your net earnings from self-employment generally depends on the total amount of your net earnings for the year, and on the total amount of any wages or tips you earn for the year.

Minimum amount. You must have $400.00 or more of net earnings from self-employment to be subject to the tax. For this purpose, net earnings are figured on line 4 of Schedule SE, Section A or line 4c of Schedule SE, Section B. If your net earnings are less than $400, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you had church employee income of $108.28 or more.

Maximum amount. No more than $61,200 of your combined wages, tips, and net earnings in 1995 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All of your combined wages, tips, and net earnings in 1995 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

If your wages and tips are subject to either social security or railroad retirement (tier 1) tax, or both, and total at least $61,200, you do not have to pay the 12.4% social security part of the SE tax on any of your net earnings. However, you must pay the 2.9% Medicare part of the SE tax on all of your net earnings.

Optional methods. You can generally use the optional methods when you have a loss or small amount of net income from self-employment and:

1) You want to receive credit for social security benefit coverage,
2) You incurred child or dependent care expenses for which you could claim a credit (this method will increase your earned income, which could increase your credit), or
3) You are entitled to the earned income credit (this method will increase your earned income, which could increase your credit).

Effect on taxes. If you use either or both optional methods, you must figure and pay the SE tax due under these methods, even if you would have had a smaller tax or no tax using your actual SE income or loss under the regular method.

The optional methods may be used only to figure your SE tax. To figure your income tax, include your actual SE income in gross income, regardless of which method you use to figure SE tax.

Example. Your gross nonfarm income is $900 and your net nonfarm earnings are $200. You use the nonfarm optional method to get a larger earned income credit. Your net earnings using the optional method are $600. You must pay SE tax on this amount.

Forms. Use Schedule SE (Form 1040) to figure your SE tax on line 47 of Form 1040. If you have to pay SE tax, you must file Form 1040 (with Schedule SE attached) even if you are not otherwise required to file a federal income tax return.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has SE income, it is independently subject to the SE tax, and should be reported on a separate Schedule SE. If you file a joint return and you both have SE income, each of you must complete a separate Schedule SE (Form 1040); attach both schedules to the joint return.

Community income. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to SE tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

Schedule SE

You must file Schedule SE if:

1) You were self-employed, and your net earnings from self-employment (excluding church employee income) were $400 or more, or
2) You had church employee income of $108.28 or more.

Even if you are not required to file Schedule SE, it may be to your benefit to file it and use either optional method in Part II of Section B.

Most taxpayers can use *Short Schedule SE* (Section A) to figure SE tax. However, the following taxpayers must use *Long Schedule SE* (Section B):

1) Individuals whose total wages and tips subject to social security (or railroad retirement (tier)) tax plus net earnings from self-employment are more than $61,200,
2) Ministers, members of religious orders, or Christian Science practitioners, not taxed on earnings from these sources (with IRS consent), but who owe SE tax on other earnings,
3) Employees who earned wages reported on Form W–2 of $108.28 or more working for a church or church-controlled organization that elected exemption from social security taxes,
4) Individuals with tip income subject to social security and Medicare taxes that was not reported to their employers, and
5) Individuals who want to use one of the optional methods to figure SE tax.

Regular Method

Use the following steps to figure SE tax under the regular method.

Step 1. Figure your net SE income. The net profit from your business or profession is generally your net SE income.

Step 2. After you figure your net SE income, determine how much is subject to SE tax. The amount subject to SE tax is called net earnings from self-employment. It is figured on *Short Schedule SE,* line 4, or *Long Schedule SE,* line 4a.

Step 3. Figure your SE tax as follows.

1) If your net earnings from self-employment plus any wages and tips are not more than $61,200, and you do not have to use *Long Schedule SE,* use *Short Schedule SE.* On line 5, multiply your net earnings by 15.3% (0.153). The result is the amount of your SE tax.
2) If you had no wages, your net earnings from self-employment are more than $61,200, and you do not have to use *Long Schedule SE,* use *Short Schedule SE.* On line 5, multiply the line 4 net earnings by the 2.9% (0.029) Medicare tax and add the result to $7,588.80 (12.4% of $61,200). The total is the amount of your SE tax.
3) If your net earnings from self-employment plus any wages and tips are more than $61,200, you must use *Long Schedule SE.* Subtract your total wages and tips from $61,200 to find the maximum amount of earnings subject to the 12.4% social security part of the tax. If more than zero, multiply the amount by 12.4% (0.124). The result is the social security tax amount. Then multiply your net earnings from self-employment by 2.9% (0.029). The result is the Medicare tax amount. The total of the social security tax amount and the Medicare tax amount is your SE tax.

Example 1. During 1995, you have $30,000 in net SE income, and receive no wages subject to social security and Medicare taxes. You multiply the $30,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of $27,705. Your SE tax is 15.3% (0.153) of $27,705, or $4,238.87.

Example 2. During 1995, you have $20,000 in net SE income, and receive $15,000 in wages subject to social security and Medicare taxes. You multiply the $20,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of $18,470. Your SE tax is 15.3% (0.153) of $18,470, or $2,825.91.

Example 3. During 1995, you have $70,000 in net SE income, and receive no wages subject to social security and Medicare taxes. You multiply the $70,000 by 0.9235 on *Short Schedule SE* to get your net earnings of $64,645. Since only $61,200 of your earnings is subject to the social security part of the SE tax, your tax for this part is $7,588.80 (12.4% of $61,200).

Since all of your earnings are subject to the Medicare part of the SE tax, multiply $64,645 by 2.9% (0.029) on *Short Schedule SE* for the Medicare part, and the result is $1,874.71. Add this to $7,588.80 and your SE tax is $9,463.51.

Example 4. During 1995, you have $70,000 in net SE income, and receive $10,000 in wages subject to social security and Medicare taxes. You figure your net earnings on *Long Schedule SE,* line 4a, to be $64,645. Next, you subtract your wages of $10,000 from $61,200, the maximum income subject to the social security part of the SE tax. The result is $51,200. Since only $51,200 of your earnings is subject to the social security part of the SE tax, your tax for this part is 12.4% (0.124) × $51,200, or $6,348.80.

Since all of your earnings are subject to the Medicare part of the SE tax, you multiply all of your net earnings from self-employment, $64,645, by 2.9% (0.029) on *Long Schedule SE* for the Medicare part, and the result is $1,874.71. Add this to the $6,348.80 figured above for total SE tax of $8,223.51.

Nonfarm Optional Method

Use the nonfarm optional method only for SE income that does not come from farming. You may use this method if you meet all the following tests.

1) Your net nonfarm profits as shown on line 31 of Schedule C (Form 1040), line 3 of Schedule C–EZ (Form 1040), and line 15a of Schedule K–1 (Form 1065), are less than $1,733.
2) Your net nonfarm profits are less than 72.189% of your gross nonfarm income.
3) You are self-employed on a regular basis. This means that your actual net earnings from self-employment were $400 or more in at least 2 of the 3 tax years before the one for which you use this method.
4) You have not previously used this method more than 4 years (there is a 5-year lifetime limit). The years do not have to be one after another.

Gross Income of $2,400 or Less

If your gross income from all nonfarm trades or businesses is $2,400 or less, and you meet the four tests in the preceding paragraph, you may report two-thirds of the gross income from your nonfarm self-employment as net earnings from self-employment.

Example 1. Ann Green had actual net earnings from self-employment of $800 in 1993 and $900 in 1994 from running a craft store. Thus, she meets the test for being self-employed on a regular basis. Her earnings from the craft business in 1995 are as follows:

Gross income	$2,100
Net profits	$1,200

Because her actual net profits are less than $1,733 and less than 72.189% of her gross nonfarm income, Ann may either use her actual net earnings or she may use the optional method to report $1,400 (two-thirds of $2,100).

Example 2. Assume that in Example 1 Ann Green has gross income of $1,000 and her net profits are $800. Ann must use her actual net profits. She may not use the optional method because her actual net profits are not less than 72.189% of her gross income.

Example 3. Assume that in Example 1 Ann has a net loss of $700. In this situation, she may use $1,400 (two-thirds of $2,100) as her net earnings under the optional method.

Gross Income of More Than $2,400

If your gross income from all nonfarm trades or businesses is more than $2,400 and you meet the four tests for using the nonfarm optional method, you may report $1,600 as your net earnings from nonfarm self-employment.

Example 1. John White runs an appliance repair shop. His net earnings from self-employment in 1992 were $8,500; in 1993, $10,500; and in 1994, $9,500. Thus, he meets the test for being self-employed on a regular basis. His earnings in 1995 are as follows:

Gross income	$12,000
Net profits	$ 1,200

Because his net profits ($1,200) are less than $1,733 and less than 72.189% of his gross nonfarm income, John may use $1,600 as his net earnings from self-employment for 1995, or he may report $1,200 under the regular method.

Example 2. Assume that in Example 1 John's actual net profits for 1995 are $1,800. He must use the full $1,800 under the regular method. He may not use the optional method because his actual net nonfarm profits are not less than $1,733.

Example 3. Assume that in Example 1 John has a net loss of $700 for 1995. He may use the optional method and report $1,600 as his net earnings from self-employment.

Figuring the Tax

If your net earnings under the nonfarm optional method are $400 or more, multiply the net earnings figure by the tax rate for 1995 (15.3%). The result is the amount of SE tax you owe.

33. Employment Taxes

Important Changes for 1996

Social security and Medicare taxes. For 1996, the employer and the employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. For 1996, the maximum amount of wages subject to social security tax (6.2%) is $62,700 ($61,200 for 1995). There is no wage base limit for the Medicare tax (1.45%). All covered wages are subject to the tax.

Federal unemployment (FUTA) tax. The gross FUTA tax rate remains at 6.2% through 1996. The maximum amount of wages subject to FUTA tax remains at $7,000.

Electronic deposit of taxes. TAXLINK, an electronic funds transfer system (EFT), allows tax deposits without coupons, paper checks, or visits to an authorized depositary. Generally, taxpayers whose total deposits of withheld income, social security, and Medicare taxes exceeded $47 million during calendar years 1993 or 1994 must deposit the taxes through the EFT system, beginning in 1996.

Employers can also voluntarily enroll in the system. For more information, call 1–800–829–5469, or write to:
Internal Revenue Service
Cash Management Site Office
Atlanta Service Center
P.O. Box 47669 Stop 295
Doraville, GA 30362

Introduction

You are generally required to withhold federal income tax from the wages of your employees. You may also be subject to social security and Medicare taxes under the Federal Insurance Contributions Act (FICA) and federal unemployment tax under the Federal Unemployment Tax Act (FUTA).

For information about what constitutes taxable wages, the treatment of special types of employment and payments, and similar matters, see Publication 15 (Circular E) and Publication 15–A.

Records. See *Employment taxes* in chapter 2 for information on specific employment tax records you must maintain. You must keep these records available for inspection by the IRS.

Employer identification number (EIN). Every employer subject to employment taxes is required to have an EIN. You can apply for an EIN either by mail or by telephone. You can get an EIN immediately by calling the Tele-TIN phone number for the service center for your state, or you can send a completed SS–4, *Application for Employer Identification Number,* directly to the service center to receive your EIN in the mail. See the instructions for Form SS–4 for more information.

Employee's social security number (SSN). An employee who does not have an SSN should submit Form SS–5, *Application for a Social Security Card,* to the nearest social security office. Form SS–5 can be obtained from any social security office or by calling 1–800–772–1213.

The employee must furnish evidence of age, identity, and U.S. citizenship with the Form SS–5. An employee who is 18 or older must appear in person with this evidence at a social security office.

INS Form I–9. You must ask each new employee to complete the employee section of an Immigration and Naturalization Service (INS) Form I–9, *Employment Eligibility Verification.* You must then complete the employer section to verify the employee's identity and eligibility to work. You can get M–274, *Handbook for Employers,* which contains Forms I–9 and instructions, from INS regional and district offices.

Topics
This chapter discusses:

- Who employees are
- Withholding income tax
- Social security and Medicare taxes
- Pensions, awards, and other benefits
- Employee tips
- Reporting and paying employment taxes
- Federal unemployment tax (FUTA)
- Earned income credit (EIC)
- Example of how to figure employment taxes

Useful Items
You may want to see:

Publication

- ☐ **15** Employer's Tax Guide (Circular E)
- ☐ **15–A** Employer's Supplemental Tax Guide
- ☐ **51** Agricultural Employer's Tax Guide (Circular A)
- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **535** Business Expenses
- ☐ **911** Tax Information for Direct Sellers

Form (and Instructions)

This chapter discusses various forms you may be required to file. We have not listed them separately here.

Who Are Employees?

Whether you must withhold or pay taxes on payments you make for services rendered to you depends on the business relationship that exists between you and the person performing those services. The person performing the services may be:

- An independent contractor
- A common-law employee
- A statutory employee
- A statutory nonemployee

Independent contractor. A person who follows an independent trade, business, or profession in which he or she offers services to the general public is generally not an employee. This can include a lawyer, contractor, subcontractor, public stenographer, auctioneer, etc. However, whether an individual is an employee or an independent contractor depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the payer, have the right to control or direct only the result of the work and not the means and methods of accomplishing that result.

You do not have to withhold or pay taxes on payments you make to an independent contractor. However, you may have to file an information return to report the payments. See *Form 1099–MISC* in chapter 36.

Common-law employee. Under common-law rules, every individual who performs services subject to the will and control of a payer, as to both ***what*** must be done and ***how*** it must be done, is an employee. It does not matter that the employer allows the employee discretion and freedom of action, as long as the employer has the ***legal right*** to control both the method and the result of the services.

Two usual characteristics of an employer-employee relationship are:

1) The employer has the right to discharge the employee, and
2) The employer supplies tools and a place to work.

If you have an employer-employee relationship, it makes no difference how it is described. It does not matter if the employee is called an employee, partner, coadventurer, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called.

Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. A superintendent, manager, or other supervisor is an employee. An officer of a corporation is generally an employee, but a director is not. An officer is not considered an employee if he or she:

1) Performs no services or only minor services, and
2) Receives no pay nor is entitled to receive any pay.

You generally have to withhold and pay income, social security, and Medicare taxes and pay FUTA tax on wages you pay to a common-law employee.

Employee or independent contractor? In doubtful cases, the facts will determine whether a worker is your employee. For an in-depth discussion and examples of the common-law employer-employee relationship, see *Employee or Independent Contractor?* in Publication 15–A.

If you want the IRS to determine whether a worker is an employee, file Form SS–8 with the district director for the area in which your business is located.

Penalty for treating an employee as an independent contractor. If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you can be held liable to pay employment taxes for that worker. The relief provision discussed next does not apply. Also, if you do not withhold income, social security, and Medicare taxes from his or her wages, you may be held personally liable for a penalty equal to such taxes if you are the person responsible for the collection and payment of withholding taxes.

Relief provision. If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal tax returns, including information returns, on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any period beginning after 1977. For more information, see Revenue Procedure 85–18 in Internal Revenue Cumulative Bulletin 1985–1, page 518.

This relief provision does not apply to your liability for employment taxes for a ***technical service specialist*** who provides services to your client under an arrangement between you and the client. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. This rule does not automatically make the specialist your employee for employment tax purposes. The common-law standards control whether the specialist is treated as your employee or as an independent contractor. However, if you directly contract with a technical service specialist to provide services for your own business rather than for a client, you may still be entitled to the relief provision.

Statutory employee. If an individual who works for you is not an employee under the common-law rules, you do not have to withhold federal income tax from that individual's pay. However, for social security and Medicare taxes, the term ***employee*** can include any individual who works for you for pay in one of the following four categories:

1) A driver who distributes meat products, vegetable products, fruit products, bakery products, or beverages (other than milk), or picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2) A full-time life insurance salesperson.
3) An individual who works at home on materials or goods you supply that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4) A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyers' business operations.

An individual in any of these categories is an employee whose wages are subject to social security and Medicare taxes if all of the following apply.

1) The service contract states or implies that almost all of the services are to be performed personally by the individual.
2) The individual has little or no investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
3) The individual performs services for you on a continuing basis.

FUTA tax. For FUTA tax, the term ***employee*** means the same as it does for social security and Medicare taxes, except that it does not include an insurance salesperson or an individual who works at home.

Form W–2. Furnish a Form W–2, *Wage and Tax Statement,* to a statutory employee and check *Statutory employee* in box 15. Show your payments to the employee as "other compensation" in box 1. Also, show social security wages in box 3, social security tax withheld in box 4, Medicare wages in box 5, and Medicare tax withheld in box 6.

Schedule C (Form 1040). A statutory employee reports his or her earnings on line 1 of Schedule C (Form 1040) and can deduct trade or business expenses on Part II of Schedule C. A statutory employee's business expenses are not subject to the 2% reduction of adjusted gross income that applies to common-law employees.

Statutory nonemployee. A direct seller or a licensed real estate agent is treated as self-employed if:

1) Substantially all payments for services performed are directly related to sales or other output, rather than to the number of hours worked.
2) Services are performed under a written contract providing that he or she will not be treated as an employee for federal tax purposes.

For more information on direct sellers, see Publication 911.

Leased employees. Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For more information, see *Leased employees* in Publication 15–A.

Withholding Income Tax

You generally must withhold income tax from wages you pay an employee if the wages for any payroll period exceed the dollar value of the withholding allowances claimed for that period. The amount to be withheld is figured separately for each payroll period.

Payroll period. A payroll period is the period of time for which you usually make a payment of wages to an employee. It can be either of the following.

1) ***Regular***. This is a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual period.
2) ***Miscellaneous***. This is any other period. Sundays and holidays are included in computing the number of days in a miscellaneous payroll period.

Exemption from withholding. You should not withhold income tax from the wages of an employee who claims exemption from withholding on Form W–4, *Employee's Withholding Allowance Certificate.* See *Exempt employee* under *Form W–4 Withholding Allowances,* next.

Form W–4 Withholding Allowances

Note. You should make 1996 Forms W–4 available to your employees and encourage them to check their income tax withholding situation for 1996. Those employees who owed a large amount of tax or received a large refund for 1995 may need to file a new Form W–4.

In general, an employee can claim withholding allowances equal to the number of exemptions the employee will be entitled to claim on his or her income tax return. An employee may also be able to claim a special withholding allowance and allowances for deductions and credits. Publication 505 includes detailed instructions for completing Form W–4.

New employee. You should ask each new employee to give you a Form W–4 by his or her first day of work. This certificate is effective for the first payment of wages and will last until the employee files a new one, unless the employee claims exemption from withholding. The certificate must include the employee's social security number.

No W–4. If an employee does not give you a Form W–4, you must withhold tax as if the employee were a single person who has claimed no withholding allowances. Married employees (and widows and widowers qualified to figure their income tax as married persons) who have not indicated on Form W–4 that they are married will be treated as single persons for withholding purposes.

Change in allowances or marital status. An employee who has changed his or her allowances or marital status during the year can give you a new Form W–4 to change his or her withholding for the rest of the year. The employee must file a new form within 10 days if the number of allowances decreases to fewer than the number the employee is now claiming. You can use Publication 213, *You May Need to Check Your Withholding,* to give your employees information about changing their withholding.

Effective date of Form W–4. You must put a new Form W–4 into effect no later than the start of the first payroll period ending on or after the 30th day from the date that you receive it. If you pay wages without regard to a payroll period, you must put the new Form W–4 into effect no later than the first payment of wages on or after the 30th day from the date that you receive it. A Form W–4 that makes a change for the next calendar year will not take effect in the current year.

Repayment or reimbursement. If an employee gives you a new Form W–4 claiming additional withholding allowances, you cannot reimburse the employee for income tax collected during the year before the effective date of the new Form W–4. But you can reimburse the employee for income tax you overcollected on or after the effective date if you did not take the new certificate into account.

Exempt employee. An employee can claim an exemption from income tax withholding on Form W–4 if he or she had a right to a refund of all federal income tax withheld last year because of no income tax liability, and because he or she expects the same situation to exist this year.

A student is not automatically exempt from income tax withholding. Also, an employee who can be claimed as a dependent by someone else usually cannot claim this exemption if he or she has nonwage income and expects that income plus wages to be more than $650.

An employee who has claimed exemption from withholding and later discovers he or she will incur a tax liability must give you a new Form W–4 within 10 days.

An employee who wants to continue claiming exemption from withholding must file a new Form W–4 by February 15 each year. If the employee does not do so, you must withhold tax as if the employee were single with zero withholding allowances.

Invalid withholding certificate. Any alteration of, or unauthorized addition to, a withholding certificate makes it invalid. If an employee indicates to you, either orally or in writing, that the information on the withholding certificate is false, the certificate will be invalid even if it is not yet in effect. If you realize the certificate is invalid, you must ask your employee to furnish a new one. If the employee does not comply, you must withhold from the employee's pay the same amount you would withhold from a single person claiming no withholding allowances. However, if a prior certificate is still in effect, you should withhold according to that certificate.

Sending Form W–4 to IRS. You must send the IRS a copy of any Form W–4 received from an employee still employed by you at the end of the quarter if:

1) The employee claims 11 or more withholding allowances, or

2) The employee claims exemption from income tax withholding and the employee's wages would normally be $200 or more a week.

Send copies of the Forms W–4 that must be submitted to the IRS with your quarterly employment tax return, Form 941. You can send them more often if you like. If you do, please include a statement giving your name, address, employer identification number, and the number of forms you are sending. If you would like to report this material on magnetic tape, see Publication 1245, *Specifications for Filing Form W–4, Employee's Withholding Allowance Certificate, on Magnetic Tape and 5¼- and 3½-Inch Magnetic Diskettes.*

Figuring Withholding

You must figure withholding on gross wages before any deductions for social security and Medicare taxes, pension, union dues, insurance, etc., are made.

Methods of withholding. You can figure withholding by any of several methods. The most common are the percentage method and the wage bracket method. You can choose to use a different method for each employee and each paycheck.

Publication 15 (Circular E) contains withholding tables and more detailed instructions for using the percentage and wage bracket methods. Also, see Publication 15–A for a discussion of other methods you can use to compute withholding.

Withholding on supplemental wages. If you add any of the supplemental wages discussed later under *Pensions, Awards, and Other Benefits* to the employee's regular wages, you can figure the income tax to be withheld as if the total were a single wage payment for the regular payroll period. However, if you withhold tax on the regular wages at the appropriate rate and specifically indicate on your payroll records the amount of each payment, you can withhold on the supplemental wages using a flat 28% rate without considering withholding allowances or the amount of regular wages.

If supplemental wages are paid separately, you can figure the tax to withhold by adding the supplemental wages to the regular wages for either the current payroll period or the last preceding payroll period within the same calendar year. If you have already withheld tax from the regular wages, you can figure the tax to withhold on the supplemental wages by using a flat rate of 28% without considering withholding allowances and without referring to a regular wage payment.

Social Security and Medicare Taxes

The ***Federal Insurance Contributions Act (FICA)*** provides for the federal system of old-age, survivors, disability, and hospital insurance. The old-age, survivors, and disability part is financed by the social security tax. The hospital part is financed by the Medicare tax. Each of these taxes is reported separately.

Social security and Medicare taxes are levied on both you and your employees. You, as an employer, must collect and pay the employee's part of the taxes and you must pay a matching amount.

Tax rates and social security wage limits. For 1996, the employer and the employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and

2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. For 1996, the maximum amount of wages subject to social security tax (6.2%) is $62,700 ($61,200 for 1995). There is no wage base limit for the Medicare tax (1.45%). All covered wages are subject to the tax.

Employer's spouse. Wages you pay to your spouse for services in your trade or business are subject to social security and Medicare taxes. Wages you pay to your spouse for services not in your trade or business, such as domestic service in your private home, are exempt from social security and Medicare taxes.

Employer's child. Wages you pay to your child for services are subject to social security and Medicare taxes if:

1) Your child is 18 or older and the services are in your trade or business, or
2) Your child is 21 or older and the services are not in your trade or business, such as domestic service in your private home.

Pensions, Awards, and Other Benefits

Withholding may also apply to any payments (other than regular wages) you make, or benefits you provide, to your employees.

Annuity or pension payments. Pension and annuity payments are generally subject to income tax withholding unless the recipient elects not to have tax withheld. See *Pensions and Annuities* in Publication 15–A for more information.

Bonus or award. A bonus or award paid to an employee is considered wages subject to social security, Medicare, and FUTA taxes and income tax withholding.

Deferred compensation arrangement. Employer contributions to a cash or deferred compensation arrangement that is part of a qualified profit-sharing or stock bonus plan are included in social security and Medicare wages. This will apply even if the contributions are exempt from income tax withholding. See Publication 15–A for more information.

Employee fringe benefit. Certain fringe benefits you provide to an employee are excluded from the employee's wages. They are not subject to social security, Medicare, and FUTA taxes, or income tax withholding. See chapter 9 for more information.

Group-term life insurance. Include in wages the cost of group-term life insurance you provided to an employee for coverage over $50,000 or for coverage that discriminated in favor of the employee. This insurance cost is subject to social security and Medicare taxes, but not income tax withholding or FUTA tax. It can be treated as if paid by the pay period, by the quarter, or on any basis so long as the cost is treated as paid at least once a year.

If you provide group-term life insurance to former employees (including retirees), they must pay the employee's share of social security and Medicare taxes on the taxable cost of the insurance with their income tax returns. You must separately include on their Form W–2s the portion of wages that consists of the taxable cost of group-term life insurance and the amount of social security and Medicare taxes they owe.

For information on determining the cost of group-term life insurance, see Publication 15–A.

Health insurance plan. If you pay the cost of an accident or health insurance plan for your employees, your payments are not wages and are not subject to social security, Medicare, or FUTA tax or income tax withholding.

Interest-free or below-market interest rate loan. If you lend an employee more than $10,000 at less than the applicable federal interest rate, you are considered to have paid additional compensation to the employee. The difference between the interest charged at the applicable federal rate and the interest charged at the lower rate is the amount of compensation. It is subject to social security, Medicare, and FUTA taxes, but not to income tax withholding. Include it in compensation on Form W–2. For more information, see chapter 8 in Publication 535.

Meals and lodging. The value of meals is not subject to income tax withholding or social security, Medicare, or FUTA taxes if the meals are furnished for the employer's convenience and on the employer's premises. The value of lodging is not subject to these taxes if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment. For more information, see chapter 3 in Publication 535.

Medical care reimbursement. A medical care reimbursement paid to an employee under your self-insured medical reimbursement plan is not wages and is not subject to social security, Medicare, or FUTA tax or income tax withholding.

Reimbursement of employee expenses. A reimbursement or allowance arrangement is a system by which you substantiate and pay advances, reimbursements, and charges for your employees' business expenses. How you treat a reimbursement or allowance depends on whether it was paid under an accountable plan or a nonaccountable plan. If a single payment includes both wages and an expense reimbursement, you must specify the amount of the reimbursement to the employee.

Accountable plan. Amounts paid under an accountable plan are not wages and are not subject to income tax withholding or social security, Medicare, or FUTA tax.

Nonaccountable plan. A nonaccountable plan is an arrangement that does not meet the requirements for an accountable plan. All amounts paid under a nonaccountable plan are wages and are subject to income tax withholding and social security, Medicare, and FUTA taxes when paid.

More information. See *Accountable Plans and Nonaccountable Plans* under *Reimbursement of Employee Expenses* in chapter 15 for more information.

Sick pay. In general, sick pay is any amount paid under a plan because of an employee's absence from work due to sickness or injury. Employers and third-party payers such as insurance companies must withhold employee social security and Medicare taxes and pay employer social security and Medicare taxes on most sick pay payments.

The requirements for income tax withholding on sick pay and the methods for figuring it depend on whether the sick pay is paid by the employer (or agent) or by a third party that is not an agent. For more information, see section 7 of Publication 15–A.

Supplemental unemployment benefits. Supplemental unemployment benefits are amounts you pay under a plan to an employee who is involuntarily separated because of a reduction in force, discontinuance of a plant or operation, or other similar condition. It does not matter whether the separation is temporary or permanent.

If you pay supplemental unemployment benefits to a former employee, all or part of the payments may be taxable, depending on how the plan is funded. Amounts that represent a return to the employee of amounts previously subject to tax are not taxable and not subject to withholding. You must withhold income tax on the taxable part of the payments made. Withholding is based on the Form W–4 the employee gave you.

Supplemental unemployment benefit payments are not subject to social security and Medicare taxes if the payments are linked to state unemployment payments. A lump sum payment is not considered linked to state unemployment payments because the lump sum is paid regardless of the period of unemployment. See Publication 525, *Taxable and Nontaxable Income,* for more information on unemployment benefits.

Employee Tips

Your employees must report cash tips of $20 or more to you each month. This includes tips they receive directly from customers and those that customers charge to their bill and you pay to the employee. Tips should be reported to you every month regardless of the total wages and tips the employee receives for the year. However, no report is required for any month in which the tips are less than $20. The written report must be made by the 10th day of the month after the month the tips are received.

Your employees can use Form 4070, *Employee's Report of Tips to Employer,* for reporting tips. You or your employees can get Form 4070 from the IRS. See *Ordering* *publications and forms* under *Important Reminders* at the beginning of this publication.

Social security, Medicare, and income taxes. You must collect employee social security tax, Medicare tax, and income tax on tips reported by an employee. You can withhold these taxes either from wages due the employee or from other funds the employee makes available. You must also pay the employer part of the social security and Medicare taxes on tips reported by an employee. Stop collecting and paying ***social security tax*** when the employee's combined wages and reported tips total $62,700 for 1996.

You are not required to withhold or pay on tips that are not reported to you.

Large food or beverage establishment. If you operate a large food or beverage establishment, additional tip reporting requirements may apply.

More information. See section 6 of Publication 15 (Circular E) for more information on tips, including:

1) Reporting tips,
2) Figuring income tax withholding, and
3) Additional requirements for large establishments.

Reporting and Paying Employment Taxes

Social security and Medicare taxes and withheld income tax are reported and paid together. The following rules apply to both types of tax.

Liability for Taxes

You must withhold income, social security, and Medicare taxes that are required to be withheld from the salaries and wages of your employees. ***You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees.*** If, for example, you withhold less than the correct tax from your employees' wages, you are still liable for the full amount.

Liability of third parties. Any lender, surety, or other third party who pays wages directly to the employees of an employer, or to an employee's agent, is liable for any taxes required to be withheld from those wages. This includes income, social security, Medicare, and railroad retirement taxes. The third party is also liable for any interest and penalties accruing on these amounts. For more information, see the discussion of third party liability in section 8 of Publication 15–A.

Reporting the Taxes

Generally, social security and Medicare taxes and withheld income tax are reported together on **Form 941,** *Employer's Quarterly Federal Tax Return.* However, there are three exceptions:

1) If your employees are agricultural workers, use **Form 943,** *Employer's Annual Tax Return for Agricultural Employees.* See Publication 51 (Circular A) for information on completing and filing Form 943.
2) If your employees do household work in or around your private home, i.e., child care, housekeeping, or gardening work, and you do not file Form 941 or Form 943, report and pay your employment taxes annually on **Schedule H (Form 1040).** For more information, see Publication 926, *Household Employer's Tax Guide.*
3) **Form 945,** *Annual Return of Withheld Income Tax,* is used to report income tax withheld from nonpayroll payments such as:
   a) Pensions, annuities, and IRAs.
   b) Military retirement.
   c) Gambling winnings.
   d) Indian gaming profits.
   e) Backup withholding.

See the detailed example (including a filled-in form) of how to complete Form 941 at the end of this chapter.

When to file Form 941. Form 941 is a quarterly return due one month after the end of each calendar quarter. The periods covered are the same whether you use a fiscal year or the calendar year as your tax year. The due dates are:

Return Period	Due Date
1st quarter: January–February–March	April 30
2nd quarter: April–May–June	July 31
3rd quarter: July–August–September	October 31
4th quarter: October–November–December	January 31

However, if you must deposit any tax and you deposit it on time and in full (see *Deposits,* later), you are given an extra 10 days to file the return.

If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next business day. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state. A return postmarked by the U.S. Post Office by the due date is considered filed on time.

Seasonal or intermittent employer. If you are a seasonal or intermittent employer, you do not have to file Form 941 when you have paid no wages during a quarter. However, you must check the *Seasonal employer* box on each return you file so the IRS will not expect a return each quarter.

Correcting Form 941. Use Form 941c, *Supporting Statement To Correct Information,* to correct income, social security, and Medicare tax information reported on Form 941. Attach Form 941c to the tax return making the adjustment. Generally, social security and Medicare tax information can be corrected for prior years, but income tax information can be corrected only for earlier periods of the current calendar year. See section 13 in Publication 15 (Circular E) for more information.

Form W–2. Form W–2 must show the total wages and other compensation paid (whether or not they are subject to withholding), total wages subject to social security and Medicare taxes, the amounts deducted for income, social security, and Medicare taxes, and any other information required on the statement. More detailed information for preparing, filing, and correcting Form W–2, and for giving copies to employees, is contained in the *Instructions for Form W–2.*

Paying the Taxes

Deposits. You will generally have to make deposits of social security and Medicare taxes and withheld income tax before Form 941 is due. You must deposit both your part and your employees' part of social security and Medicare taxes.

Check or money order. When you pay social security, Medicare, and withheld income taxes—whether through deposits or with your return—you should write the following information on your check or money order:

1) Your employer identification number.
2) The type of tax you are paying.
3) The period covered by the payment.

Penalties. If you pay your taxes late, you may have to pay a penalty as well as interest on any overdue amounts. There are also both civil and criminal penalties for intentionally not paying taxes, filing a false tax return, or filing no return at all.

Trust fund recovery penalty. If you are responsible for withholding, accounting for, or depositing or paying withholding taxes and willfully fail to do so, you can be held liable for a penalty equal to the tax not paid, plus interest. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty.

''Willfully'' in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered to be acting willfully.

More information. For more information on deposits, including deposit rules and penalties for late deposits, see section 11 of Publication 15 (Circular E).

Federal Unemployment Tax (FUTA)

The federal unemployment tax system, along with the state systems, provides unemployment payments to workers who have lost their jobs. Unless an exception applies, this tax applies to wages you pay your employees. Most employers pay both a state unemployment tax and the federal unemployment tax. Even if you are exempt from the state tax, you may still have to pay the federal tax.

Are you subject to FUTA? You must pay FUTA tax if you meet one of the tests for three categories of employees. The test is different for each of the following categories:

1) Farm workers.
2) Household workers.
3) All other employees.

It is possible to be liable for the tax for one category of employees, but not another. If one of the tests describes your situation, you are subject to FUTA tax on the wages you pay to employees in that category during the current calendar year.

See section 14 of Publication 15 (Circular E) for information on each category's test. The farm worker's test is also explained in section 13 of Publication 51 (Circular A).

Wages for FUTA tax purposes. The FUTA tax applies to cash wages you pay your employees, as well as other forms of pay. Certain payments are not considered wages for FUTA tax purposes. See Publication 15 (Circular E) for a chart showing different kinds of employment and whether payments are exempt from FUTA tax.

Figuring the Tax

The FUTA tax is figured on the first $7,000 in wages paid to each employee annually. The tax is imposed on you as the employer. You must not collect or deduct it from the wages of your employees.

Example. In November 1995, you hired Al Green and paid him $3,500 in wages before the year ended. All $3,500 was subject to the FUTA tax. The first $7,000 you pay him in 1996 is also subject to the tax. Al's wages reach the $7,000 mark in mid-March. None of the wages you pay him after that in 1996 are subject to the tax.

In July Al quits his job and you hire someone to replace him. The first $7,000 you pay his replacement in 1996 is also subject to the tax.

Tax rate and credit. The gross FUTA tax rate is 6.2%. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The net tax rate, therefore, can be as low as 0.8% (6.2% − 5.4%) if your state is not subject to a credit reduction. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit.

You cannot take the credit for any state taxes you fail to pay. If for any reason you are exempt from state unemployment tax, the full 6.2% rate applies.

Credit reduction. The 5.4% credit may be reduced for employers in some states. A credit reduction is required if a state's unemployment fund borrows from the federal government and keeps an outstanding balance for two or more years.

If your state is subject to a credit reduction for 1996, the state's name and the amount of the credit reduction will be shown on the 1996 Form 940.

More information. For more information on figuring the tax, including special rules for a ''successor employer,'' see section 14 of Publication 15 (Circular E).

Reporting and Paying FUTA Tax

You report and pay FUTA tax on Form 940 or, if you qualify, on the simpler Form 940–EZ.

Form 940. The FUTA tax is reported on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return.* This form covers one calendar year and is generally due January 31 after the year ends. However, you may have to make deposits of the tax before filing the return. If you deposit the tax on time and in full, you have an extra 10 days to file—until February 10.

Form 940–EZ. You can use Form 940–EZ, a simplified version of Form 940, if:

1) You paid unemployment tax to only one state.
2) You paid the state tax by the due date of Form 940 or 940–EZ.
3) All of your wages taxable for FUTA tax were also taxable for state unemployment tax.
4) You did not pay wages subject to the unemployment compensation laws of a credit reduction state.

Deposits. If at the end of any calendar quarter you owe, but have not yet deposited, more than $100 in FUTA tax for the year, you must make a deposit by the end of the next month.

If the undeposited tax is $100 or less at the end of a quarter, you do not have to deposit it. You must add it to the tax for the next quarter. If the total undeposited tax is more than $100 in the next quarter, a deposit will be required. If the undeposited tax for the 4th quarter (plus any undeposited tax for an earlier quarter) is less than $100, you can either make a deposit or pay it with your return by the January 31 due date.

More information. For more information on FUTA tax, including the amount to deposit and due dates of deposits, see section 14 of Publication 15 (Circular E).

Earned Income Credit (EIC)

The EIC is a special credit for certain employees that reduces the tax they owe. Even if they do not owe any tax, the credit may give them a refund. Eligible employees can choose to receive advance payment of the EIC from you. To ensure that certain employees are aware of the EIC, you must notify them about the credit.

Advance Payment

You must pay part of the EIC in advance to eligible employees who have filed a Form W–5, *Earned Income Credit Advance Payment Certificate,* with you. This allows those employees to receive part of the benefit of their credit each payday, rather than having a single amount credited to them later on their tax return.

The payment is added to the employee's pay each payday. It is figured from tables in Publication 15 (Circular E). You reduce your liability for income tax withholding, social security taxes, and Medicare taxes by the total amount of the advance EIC payments made. For more information, see section 10 of Publication 15 (Circular E).

Employees not eligible. Employees whose wages are exempt from withholding of income, social security, or Medicare tax are not eligible to receive advance EIC payments.

Notification

You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the EIC. However, you do not have to notify employees who claim exemption from withholding on Form W–4.

You meet the notification requirement by giving each employee one of the following:

1) Form W–2, which contains the notification on the back of Copy C.
2) A substitute Form W–2 with the exact EIC wording shown on the back of copy C of Form W–2.
3) Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC).*
4) Your own written statement with the exact wording of Notice 797.

For more information about notification requirements and claiming the EIC, see Notice 1015, *Employers—Have You Told Your Employees About the Earned Income Credit (EIC)?*

Example of How To Figure Employment Taxes

Peter Cone owns a small furniture business that he runs with three part-time employees. In 1995, he paid one employee $600 a week, one employee $500 a week, and one employee $400 a week. He did not hire anyone else during the year, and the employees stayed with him the entire year.

It is Peter's practice to pay his employees on Monday. If Monday is a holiday, payday is Tuesday.

The sections that follow discuss how Peter figured his employment taxes for the year. They show how he figured his deposits and how he filled out Forms 940–EZ and 941. Only the fourth quarter Form 941 is illustrated.

Form 941 Taxes

Peter files Form 941 quarterly. On it, he reports:

- Income tax he withholds from his employees' wages.
- Social security and Medicare taxes, both the part he withholds from his employees' wages and the part he pays as an employer.

Because his net tax liability each quarter exceeds $500, Peter must deposit the taxes during the quarter.

Each of Peter's employees has filled out a Form W–4. Form W–4 tells him:

- How many withholding allowances the employee claims.
- Whether to withhold at the ''Married'' or ''Single'' rate.

Using this information, Peter finds the correct amount to withhold in Circular E. He uses the wage bracket table in the January 1995 Circular E to find the correct amount to withhold during the fourth quarter. The tables are for wages paid after December 1994.

In the fourth quarter of 1995, the first payday for Peter's employees is Monday, October 2. His income tax withholding for this payday is shown in the chart below:

Employee	Wages	Withholding Rate and Allowances	Amount Withheld
R. Apple	$ 600	Married – 3	$ 51
J. Jones	500	Married – 2	43
F. Plum	400	Single – 1	46
Total	$1,500		$140

Peter's liability for withheld income tax on this payday totals $140. If any of his employees had asked him (on Form W–4) to withhold an extra amount, he would have included it with the total.

Peter also withholds 6.2% of each employee's wages as social security tax and pays a matching share for each employee, for a total of 12.4% in 1995. In addition, he withholds 1.45% of each employee's wages as Medicare tax and pays a 1.45% share, for a total of 2.9%. The total social security tax for this payday is $186.00 ($1,500 total wages times 12.4%), and the total Medicare tax is $43.50 ($1,500 total wages times 2.9%).

Social security tax applies to only the first $61,200 paid to each employee in 1995. The Medicare tax applies to all wages in 1995. If any of Peter's employees had already earned $61,200, or reached this limit on the October 2 payday, he would have included only the Medicare tax for those employees on wages exceeding the $61,200 limit. However, none of his employees will earn more than $61,200 in 1995.

None of the employees are eligible for advance earned income credit payments (discussed earlier).

On this payday, Peter's total liability for social security tax, Medicare tax, and withheld income tax is $369.50 ($186.00 + $43.50 + $140.00). The following chart shows his tax liability for the paydays in the fourth quarter:

Payday	Total Wages	Income Tax	Social Security (12.4%)	Medicare (2.9%)
10/02	$ 1,500	$ 140	$ 186	$ 43.50
10/10	1,500	140	186	43.50
10/16	1,500	140	186	43.50
10/23	1,500	140	186	43.50
10/30	1,500	140	186	43.50
11/06	1,500	140	186	43.50
11/13	1,500	140	186	43.50
11/20	1,500	140	186	43.50
11/27	1,500	140	186	43.50
12/04	1,500	140	186	43.50
12/11	1,500	140	186	43.50
12/18	1,500	140	186	43.50
12/26	1,500	140	186	43.50
Total	$19,500	$1,820	$2,418	$565.50

Depositing Form 941 Taxes

Peter's schedule for making deposits depends on whether he is a semiweekly or a monthly depositor. The total employment taxes for his lookback period (July 1, 1993, to June 30, 1994) is less than $50,000. Therefore, he is a monthly depositor for all of 1995. The taxes accumulated for October ($1,847.50) must be deposited by November 15.

During November, Peter's payroll remains the same. The following chart shows how the social security, Medicare, and withheld income taxes he owes add up during November:

Payday	Wages	Taxes	Undeposited Taxes
11/06	$1,500	$369.50	$ 369.50
11/13	1,500	369.50	739.00
11/20	1,500	369.50	1,108.50
11/27	1,500	369.50	1,478.00

Because Peter is a monthly depositor for all of 1995, he must make a deposit of the taxes accumulated for November ($1,478.00) by December 15.

During December, Peter's payroll remains the same. The following chart shows how the social security, Medicare, and withheld income taxes he owes add up during December.

Payday	Wages	Taxes	Undeposited Taxes
12/04	$1,500	$369.50	$ 369.50
12/11	1,500	369.50	739.00
12/18	1,500	369.50	1,108.50
12/26	1,500	369.50	1,478.00

A $1,478.00 deposit is required by January 16, 1996. (January 15 is a holiday).

Filling Out Form 941

Peter begins filling out Form 941 by entering his name, address, employer identification number, and the date the quarter ended (December 31, 1995). If he received Form 941 in the mail, this information would be preprinted on the form. Since it is a fourth quarter return, he does not have to fill in line 1. If he had gone out of business in 1995, he would fill in the final return entries above line 1 on the form. Because he made all his deposits in the state shown in his address, he does not have to make an entry in the state code box.

Line 2. Peter enters the total wages he paid in the quarter, $19,500.

Line 3. Peter enters the total income tax he withheld from his employees' wages during the quarter, $1,820.

Lines 4 and 5. Peter does not have to make any adjustments for errors in the income tax withholding he reported for the first three quarters of 1995 (line 4). He enters the amount from line 3 on line 5.

Line 6a. None of Peter's employees earned more than the $61,200 limit for 1995. The amount they were paid during the quarter, $19,500, is entered as ''Taxable social security wages.'' He enters 12.4% of this amount, or $2,418, as his social security tax on this line. This includes both his share and the amount he withheld from his employees' wages.

Line 6b. Peter's employees did not earn any taxable tips.

Line 7. Peter again enters the wages he paid, $19,500. He enters 2.9% of this amount, or $565.50, as his Medicare tax on this line. This includes both his share and the amount he withheld from his employees' wages.

Lines 8, 9, and 10. Peter has no current period adjustments or adjustments for errors in social security or Medicare taxes he reported previously (line 9). He enters the total amount of social security and Medicare taxes on lines 8 and 10.

Line 11. Peter adds the withheld income, social security, and Medicare taxes (lines 5 and 10). He enters the total, $4,803.50.

Lines 12 and 13. None of Peter's employees received advance payments of the earned income credit (line 12). He enters the amount from line 11 on line 13.

Lines 14, 15, and 16. Peter shows that the amount of tax he owed for the quarter (line 13) and the amount he deposited (line 14) are the same. There is no balance due (line 15). Nor is he owed a refund (line 16).

Note: If his tax liability for the quarter exceeded his deposits, he would have deposited the excess amount rather than paying it with his return (line 15). Because his tax liability for the quarter exceeded $500 and he is required to deposit, he could be subject to a 10% penalty on any amount paid with his return.

Line 17. Peter completes the Monthly Summary of Federal Tax Liability section by filling in the monthly liability totals in line 17, columns (a), (b), (c), and the quarterly total in column (d). He confirms that the amount in column (d) equals the amount reported on line 13.

Signature and date. Peter signs the return, prints his name and title, and enters the date. Because Peter deposited the tax on time and in full, he has an extra 10 days to file his return.

Federal Unemployment (FUTA) Tax

Peter must pay state as well as federal unemployment (FUTA) tax. His state gave him an experience rate of 3.0% for 1995. Since his state, like the federal government, bases its tax on the first $7,000 of wages paid to each employee, and since he paid each of his employees more than that amount in 1995, he must pay the state tax on $21,000 ($7,000 times three employees). He paid $630 (3.0% of $21,000) in state unemployment tax during 1995.

For FUTA tax, Peter must fill out Form 940, or Form 940–EZ if he qualifies, for the year and make any deposits required. A deposit is required if an employer has more than $100 of tax outstanding at the end of a calendar quarter.

Depositing FUTA Tax

The FUTA tax rate is 6.2% of the first $7,000 in wages paid to each employee in 1995. Peter figures his deposits under the assumption that he will receive full credit for the state unemployment tax he paid. The maximum credit allowed is 5.4%. He figures his deposits using an effective tax rate of 0.8% (6.2% minus 5.4%). Although he has a state experience rate of less than 5.4%, he is still able to take the 5.4% credit.

Peter will not know until the end of the year whether the 5.4% credit will be reduced for employers in his state. If it is reduced, he must take the reduction into account when figuring the deposit for the fourth quarter.

First quarter. There were 13 paydays for Peter's employees in the first quarter of 1995. Each employee's wages remained the same each payday. The following table shows how much of each employee's total wages for the first quarter was subject to FUTA tax:

Employee	**First Quarter Wages**	**First Quarter FUTA Wages**
R. Apple	$ 7,800	$ 7,000
J. Jones	6,500	6,500
F. Plum	5,200	5,200
Total	$19,500	$ 18,700
Tax Rate		× .008
First Quarter FUTA Tax Liability		$ 149.60

Peter figures his tax for the quarter as 0.8% of $18,700, or $149.60. Because this is more than $100, he must deposit it by May 1, 1995 (since April 30 falls on a Sunday).

Second quarter. There were 13 paydays for Peter's employees in the second quarter also. Each employee's wages remained the same. The following table shows how much of each employee's total wages for the second quarter were subject to FUTA tax:

Employee	**Second Quarter Wages**	**First Quarter FUTA Wages**	**Second Quarter FUTA Wages**
R. Apple	$ 7,800	$ 7,000	$ -0-
J. Jones	6,500	6,500	500
F. Plum	5,200	5,200	1,800
Total	$19,500		$2,300
			×
Tax Rate			.008
Second Quarter FUTA Tax Liability			$18.40

The wages he paid to all his employees reached the yearly $7,000 limit during the second quarter. For example, all the wages paid to J. Jones in the first quarter, $6,500, were subject to the tax. Therefore, only $500 ($7,000 minus $6,500) of Jones's second quarter wages are subject to the tax.

Peter's FUTA tax liability for the second quarter is $18.40. This is figured by multiplying the total wages subject to the tax in the quarter ($2,300) by the tax rate (0.8%). He does not have to make a deposit for the second quarter because the amount he owes is not more than $100.

Third quarter. Peter carried over his second quarter tax liability of $18.40 to the third quarter. However, since he already reached the $7,000 limit for all his employees in the second quarter, none of the wages paid in the third quarter are subject to FUTA tax.

Fourth quarter. Peter carried his tax liability of $18.40 to the fourth quarter. Since Peter did not pay wages that are subject to the unemployment compensation laws of a credit reduction state, he does not have to figure a credit reduction for the fourth quarter. He can either deposit the $18.40 or pay it with his Form 940 or Form 940–EZ by January 31, 1996.

Peter can file Form 940–EZ, a simplified version of Form 940, because (1) he paid state unemployment taxes to only one state, (2) he paid all the state unemployment taxes by the due date of Form 940 or Form 940–EZ, (3) all his wages taxable for FUTA tax were also taxable for state unemployment tax, and (4) he paid no wages in 1995 subject to the unemployment compensation laws of a credit reduction state. If Peter did not meet these four conditions, he would have to file Form 940.

Filling Out Form 940–EZ

Peter begins filling in Form 940–EZ by entering his name, address, calendar year, and employer identification number.

Items A and B. Peter enters the amount he paid to the state unemployment fund, $630.00. He then enters the name of his state and his state reporting number.

Part I

Line 1. Peter enters the total amount he paid to his employees during 1995. His payroll was $78,000 for 1995.

Line 2. None of the wages he paid in 1995 were exempt from FUTA tax. Peter does not enter anything on this line. (Wages paid to a family member are an example of wages exempt from FUTA tax.)

Line 3. Peter enters $57,000, the amount of wages he paid that was over the $7,000 limit for each employee. Any amount included on line 2 should not be included on this line.

Line 4. Peter enters $57,000, the sum of lines 2 and 3.

Line 5. Peter subtracts his total exempt payments on line 4 from his total payments on line 1. He enters the difference, $21,000, on line 5. This is the amount of his 1995 wage payments subject to FUTA tax.

Line 6. Peter enters $168.00, 0.8% of the $21,000 in wages subject to FUTA tax listed on line 5.

Line 7. Peter enters $149.60, the amount of his FUTA tax deposit for the first quarter. He made no other deposits during the year.

Line 8. Because his deposits do not equal his tax liability for the year, Peter writes a check for the additional amount ($18.40).

Line 9. Because he did not overpay the tax, Peter leaves this line blank.

Part II (record of tax liability). Peter enters his tax for the first quarter, $149.60, in the first column. He enters his tax for the second quarter, $18.40, in the second column. He enters -0- in the third and fourth quarter columns because he has no tax liability for those quarters. Peter enters his total tax liability, $168.00, in the last column.

Signature and date. Peter signs the return, enters his title as ''Owner,'' and enters the date.

Form **941** (Rev. January 1995) Department of the Treasury Internal Revenue Service (T)

4141

Employer's Quarterly Federal Tax Return

▶ See separate instructions for information on completing this return.

Please type or print.

Enter state code for state in which deposits made ▶ [:] (see page 3 of instructions).

Name (as distinguished from trade name): Peter Cone

Date quarter ended: Dec. 31, 1995

Trade name, if any

Employer identification number: 10-1234567

Address (number and street): 362 Main Street

City, state, and ZIP code: Pinetown, VA 23000

OMB No. 1545-0029

T
FF
FD
FP
I
T

If address is different from prior return, check here ▶ ☐ IRS Use

If you do not have to file returns in the future, check here ▶ ☐ and enter date final wages paid ▶

If you are a seasonal employer, see **Seasonal employers** on page 1 of the instructions and check here ▶ ☐

1	Number of employees (except household) employed in the pay period that includes March 12th ▶		
2	Total wages and tips, plus other compensation	2	19500 00
3	Total income tax withheld from wages, tips, and sick pay	3	1820 00
4	Adjustment of withheld income tax for preceding quarters of calendar year	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	1820 00
6a	Taxable social security wages . . . $ 19500 00 × 12.4% (.124) =	6a	2418 00
b	Taxable social security tips . . . $ × 12.4% (.124) =	6b	
7	Taxable Medicare wages and tips . . . $ 19500 00 × 2.9% (.029) =	7	565 50
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7). Check here if wages are not subject to social security and/or Medicare tax ▶ ☐	8	2983 50
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay $ ____ ± Fractions of Cents $ ____ ± Other $ ____ =	9	
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions)	10	2983 50
11	**Total taxes** (add lines 5 and 10)	11	4803 50
12	Advance earned income credit (EIC) payments made to employees, if any	12	
13	Net taxes (subtract line 12 from line 11). **This should equal line 17, column (d) below** (or line D of Schedule B (Form 941))	13	4803 50
14	Total deposits for quarter, including overpayment applied from a prior quarter	14	4803 50
15	**Balance due** (subtract line 14 from line 13). Pay to Internal Revenue Service	15	

16 **Overpayment,** if line 14 is more than line 13, enter excess here ▶ $ ____
and check if to be: ☐ Applied to next return **OR** ☐ Refunded.

- **All filers:** If line 13 is less than $500, you need not complete line 17 or Schedule B.
- **Semiweekly depositors:** Complete Schedule B and check here ▶ ☐
- **Monthly depositors:** Complete line 17, columns (a) through (d), and check here ▶ ☒

17 Monthly Summary of Federal Tax Liability.

(a) First month liability	(b) Second month liability	(c) Third month liability	(d) Total liability for quarter
1847.50	1478.00	1478.00	4803.50

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Peter Cone Print Your Name and Title ▶ Peter Cone, Owner Date ▶ 2/5/96

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 17001Z Form **941** (Rev. 1-95)

Form **940-EZ**

Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

OMB No. 1545-1110

1995

T	
FF	
FD	
FP	
I	
T	

Name (as distinguished from trade name): Peter Cone

Calendar year: 1995

Trade name, if any

Address and ZIP code: 362 Main Street, Pinetown, VA 23000

Employer identification number: 10 1234567

*Follow the chart under **Who May Use Form 940-EZ** on page 2. If you cannot use Form 940-EZ, you must use Form 940 instead.*

A Enter the amount of contributions paid to your state unemployment fund. (See instructions for line A on page 4.) ▶ $ 630.00

B (1) Enter the name of the state where you have to pay contributions ▶ Virginia

(2) Enter your state reporting number as shown on state unemployment tax return. ▶ 0-0000000-0

If you will not have to file returns in the future, check here (see Who Must File on page 2) and complete and sign the return ▶ ☐

If this is an Amended Return, check here ▶ ☐

Part I Taxable Wages and FUTA Tax

			Amount paid		
1	Total payments (including payments shown on lines 2 and 3) during the calendar year for services of employees			1	78000 00
2	Exempt payments. (Explain all exempt payments, attaching additional sheets if necessary.) ▶	2			
3	Payments for services of more than $7,000. Enter only amounts over the first $7,000 paid to each employee. Do not include any exempt payments from line 2. Do not use your state wage limitation. The $7,000 amount is the Federal wage base. Your state wage base may be different	3	57000 00		
4	Total exempt payments (add lines 2 and 3)			4	57000 00
5	**Total taxable wages** (subtract line 4 from line 1) ▶			5	21000 00
6	**FUTA tax.** Multiply the wages on line 5 by .008 and enter here. (If the result is over $100, also complete Part II.)			6	168 00
7	Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)			7	149 60
8	**Amount you owe** (subtract line 7 from line 6). This should be $100 or less. Pay to "Internal Revenue Service." ▶			8	18 40
9	**Overpayment** (subtract line 6 from line 7). Check if it is to be: ☐ **Applied to next return, or** ☐ **Refunded** ▶			9	

Part II Record of Quarterly Federal Unemployment Tax Liability (Do not include state liability.) Complete only if line 6 is over $100.

Quarter	First (Jan. 1 – Mar. 31)	Second (Apr. 1 – June 30)	Third (July 1 – Sept. 30)	Fourth (Oct. 1 – Dec. 31)	Total for year
Liability for quarter	149.60	18.40	-0-	-0-	168.00

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and, to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees.

Signature ▶ Peter Cone Title (Owner, etc.) ▶ Owner Date ▶ 1/25/96

Cat. No. 10983G Form **940-EZ** (1995)

DETACH HERE

Form **940-EZ(V)**

Department of the Treasury
Internal Revenue Service

Form 940-EZ Payment Voucher

For Paperwork Reduction Act Notice, see Instructions.

OMB No. 1545-1110

1995

Complete boxes 1, 2, 3, and 4. Do not send cash and do not staple your payment to this voucher. Make your check or money order, with your employer identification number written on it, payable to the **Internal Revenue Service.**

1 Enter the amount of the payment you are making	2 Enter the first four characters of your business name	3 Enter your employer identification number
▶ $ 18.40	P E T E	10 1234567

Do not staple your payment to this voucher.

4 Enter your name: Peter Cone

Enter your address: 362 Main Street

Enter your city, state, and ZIP code: Pinetown, VA 23000

34. Alternative Minimum Tax

Introduction

The tax laws give special treatment to certain kinds of income and allow special deductions and credits for certain kinds of expenses. So that taxpayers who benefit from these laws will pay at least a minimum amount of tax, a special tax was enacted, the ''alternative minimum tax (AMT)'' for corporations and individuals.

The rules discussed in this chapter apply to corporations. For information on the alternative minimum tax rules that apply to individuals, see Form 6251, *Alternative Minimum Tax—Individuals* and its instructions.

A partnership does not itself pay minimum tax. However, each member of a partnership must take into account his or her distributive share of the partnership's adjustments and tax preference items.

Topics

This chapter discusses:

- Adjustments and preferences
- Adjusted current earnings (ACE)
- Other adjustments
- Figuring alternative minimum tax
- Minimum tax credit

Useful Items

You may want to see:

Publication

- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **1118** Foreign Tax Credit–Corporations
- ☐ **4562** Depreciation and Amortization
- ☐ **4626** Alternative Minimum Tax–Corporations
- ☐ **8582** Passive Activity Loss Limitations
- ☐ **8827** Credit For Prior Year Minimum Tax–Corporations

Alternative Minimum Tax (AMT)

The AMT rate for corporations is 20%. There is an exemption of up to $40,000. This amount is reduced (but not below zero) by 25% of the amount by which alternative minimum taxable income (AMTI) exceeds $150,000.

You can apply a minimum tax credit against your regular tax liability in later years for the AMT caused by certain preferences and adjustments.

The adjustment and preference items for AMT purposes are listed in *Table 35-1* with a brief description for each item. However, each adjustment and preference item is discussed in more detail separately. These adjustment and preference items are reported on Form 4626 in figuring AMT.

Form 4626. You use Form 4626 to figure the corporation's AMT. File this form if the corporation's taxable income before the net operating loss (NOL) deduction plus adjustments and preference items totals more than the allowable exemption amount. Also, you use this form to figure the corporation's environmental tax, discussed in chapter 29.

Formula to figure AMT. You figure the AMT by beginning with ***taxable income before any net operating loss deduction*** on the return. For Form 1120, this is line 28 minus line 29b and for Form 1120–A, it is line 24 minus line 25b. With that taxable income, use the following formula to figure AMT.

Add or subtract
Adjustments and preferences
Equals
Preadjustment alternative minimum taxable income
Add or subtract
Adjusted current earnings (ACE) adjustment
Equals
Tentative alternative minimum taxable income
Subtract
Alternative tax net operating loss deduction
Equals
Alternative minimum taxable income
Subtract
Exemption amount
Multiply by
20%
Subtract
Alternative minimum tax foreign tax credit
Equals
Tentative minimum tax
Subtract
Regular tax
Equals
Alternative minimum tax

Adjustments and Preferences

To figure AMT, you make certain adjustments to the taxable income on the return. These adjustments eliminate the tax advantages of certain items that receive preferential tax treatment. These items are called ''adjustments and preferences.'' The adjustment for these items is the difference between the recomputed item for AMT purposes and the amount on the return. They can be either increases or decreases (entered as negative amounts on Form 4626).

Increase or decrease. If an expense or loss claimed for regular tax purposes is more than the recomputed AMT expense or loss, the difference is an increase to taxable income. If the expense or loss claimed for regular tax purposes is less than the recomputed AMT expense or loss, the difference is a decrease to taxable income.

If income or gain reported for regular tax purposes is less than the recomputed AMT income or gain, the difference is an increase to taxable income. If the income or gain reported for regular tax purposes is more than the recomputed AMT income or gain, the difference is a decrease to taxable income.

Accelerated depreciation on property. This adjustment applies to property placed in service after 1986. The depreciation deduction used for AMT is the amount calculated under the alternative depreciation system (ADS) under the modified accelerated cost recovery system (MACRS). For real property, use the straight line method with a 40-year recovery period and the mid-month convention. For most property other than real property, use the 150% declining balance method switching to the straight line method when it gives a larger allowance. For more information on depreciation, see Publication 946.

This adjustment applies to property placed in service after 1986, other than transition property not subject to MACRS. It also applies to property placed in service after July 31, 1986, and before 1987, if you elected to use MACRS.

Do not consider the following types of property in figuring this adjustment item.

Property you elect to exclude from MACRS that is depreciated under the unit-of-production method or most other methods of depreciation not expressed in terms of years,

Certain public utility property,

Any motion picture film or video tape, or

Any sound recording.

The adjustment is the difference between the total depreciation for all property for alternative minimum tax purposes and the total depreciation for regular income tax purposes.

The effect of using two different types of depreciation (one for regular income tax and one for alternative minimum tax) is that a corporation will have a different basis in the property for alternative minimum tax. This means, for example, that if a corporation sells the property, the gain will be different for alternative minimum tax purposes. See the later discussion of *Adjusted gain or loss.*

Depreciation for property placed in service before 1987. For property placed in service before 1987, accelerated depreciation is a preference item. Continue to treat depreciation on that property as a preference item. See *Accelerated depreciation on real property placed in service before 1987* and *Accelerated depreciation on leased personal property placed in service before 1987,* discussed later.

Table 35-1. **Alternative Minimum Tax Adjustments and Preferences**

Item	Description
Accelerated depreciation on property	Figure depreciation under the alternative depreciation system (ADS) of MACRS. Except for real property, you must use the 150% declining balance method. This does not apply to property described in IRC 168(f)(1) through (4).
Pollution control facilities	Figure amortization under the alternative depreciation system of MACRS.
Mining exploration and development costs	Figure amortization ratably over 10 years.
Circulation expenses	Amortize expenses over 3 years. Applies only to personal holding companies.
Adjusted gain or loss	Refigure gain or loss on the sale of property using certain adjustments listed in this table.
Long-term contracts	Figure income for contracts entered into after 2-28-86 under the percentage of completion method (as modified by IRC 460(b)).
Installment sales	Figure income without using the installment method. This generally applies to dispositions of inventory or stock in trade.
Merchant Marine Fund	Figure income to include amounts deposited in a capital construction fund if deducted, and earnings (including gains and losses) on amounts in the fund that were excludable.
Section 833(b) deduction	Adjustment is the amount of any deduction claimed. (Applies only to certain health insurance organizations.)
Tax shelter farm activities	Refigure all gains and losses from a tax shelter farm activity that is not a passive activity. Take into account all AMT adjustments and preferences. (Applies only to personal service corporations.)
Passive activity losses	Net losses from passive activities (closely held and personal service corporations only), including tax shelter farm activities that are passive activities.
Certain loss limitations	Adjustment is any excess of the loss amount not allowable for AMT over the loss amount not allowable for regular tax purposes. If the loss amount not allowable for regular tax is more than the loss amount not allowable for AMT, the adjustment is a negative amount.
Depletion	Excess of the depletion deduction over your adjusted basis in the property.
Certain tax-exempt interest	Certain interest on specified private activity bonds.
Charitable contributions	Refigure the limit based on taxable income using the adjustments and preferences listed in this table.
Intangible drilling costs	Excess of IDCs to the extent the excess amount exceeds 65% of net income from the property. If the optional 60-month write-off was elected, IDCs are not a tax preference.
Reserves for losses on bad debts of financial institutions	Excess of the deduction allowable over the amount that would have been allowable under the experience method.
Accelerated depreciation on real property and leased personal property placed in service before 1987 (pre-ACRS and ACRS)	Excess of the depreciation or amortization taken over the amount allowable under straight line (leased personal property; for personal holding companies only).
Other adjustments	Adjustment is for certain income reported for regular tax purposes including: 1) Income eligible for the possession tax credit, and 2) Income from the alcohol fuel credit. Also, the adjustment can be for any minimum taxable income adjustment from Schedule K-1 (Form 1041), line 8, if the corporation is the beneficiary of a trust, for an AMT adjustment from a cooperative, or for any related adjustments*.
Adjusted current earnings (ACE)	Adjustment is 75% of the excess (if any) of the corporation's ACE over the corporation's preadjustment alternative minimum taxable income.
Alternative tax net operating loss (NOL) deduction	Alternative tax NOL deduction (ATNOLD) allowed against AMTI.

* AMT adjustments and tax preference items may affect deductions (such as the section 179 deduction) that are based on an income limit. If so, you may have to make related adjustments. You do this by refiguring these deductions using the income limit as modified for AMT purposes.

Certified pollution control facilities. For the AMT, determine your amortization deduction for a certified pollution control facility using the alternative depreciation system under MACRS (see Publication 946).

Mining exploration and development costs. If you did not choose the *Optional Write-Off,* discussed later, recompute your regular tax deduction for mining exploration and development costs by amortizing it ratably over a 10-year period. The adjustment is the difference between the deduction claimed for regular tax and the deduction allowed for AMT.

If you have a loss for mining property, in figuring AMT, deduct all mining exploration and development costs for the property that have not been written off. A loss occurs when you abandon a worthless mine.

Circulation expenses. This adjustment is for personal holding companies only. If you did not choose the *Optional Write-Off,* discussed later, this adjustment applies. In figuring AMT, amortize circulation costs over 3 years beginning with the tax year you make the expenditures. The adjustment is the difference between the amount deducted for regular tax purposes and the amortized amount.

Adjusted gain or loss. If a corporation sold property during the year, refigure the gain or loss from the sale using the corporation's adjusted basis for AMT purposes. The following AMT adjustments require changes to the corporation's regular tax basis.

Depreciation,

Circulation expenses,

Mining exploration and development costs, and

Certified pollution control facilities.

The adjustment is the difference between the gain (or loss) reported for regular tax purposes and the recomputed gain (or loss) for AMT purposes. See *Increase or decrease,* earlier.

Long-term contracts. For any long-term contract you enter into after February 28, 1986, apply the percentage of completion method (as modified by the rules for long-term contracts under section 460(b) of the Internal Revenue Code) in determining AMT for that contract.

The adjustment is the difference between income determined using the method of accounting used for regular tax purposes and income determined using the percentage of completion method of accounting.

Home construction contracts. The rules for long-term contracts do not apply to any home construction contract you entered into in a tax year beginning after September 30, 1990, regardless of whether you meet the small home construction contract requirements.

For a construction contract not described above, determine the percentage of the contract completed using the simplified procedures for allocating costs (see section 460(b)(4) of the Internal Revenue Code).

Installment sales. For any disposition of inventory or stock in trade, the installment method of accounting does not apply for the AMT. Because of this, a corporation recognizes all gain realized on the disposition in the year of sale. The adjustment for AMT is the difference between the recognition of all gain in the year of disposition and the gain recognized under the installment method of accounting. However, this adjustment does not apply to certain dispositions of timeshares or residential lots for which you elected to pay interest.

Merchant Marine Fund. Deposits into a capital construction fund (CCF) established under section 607 of the Merchant Marine Act of 1936 are not deductible in figuring AMT. Also, the earnings (including gains and losses) on amounts in the fund are not excludable in determining AMT. The adjustment is the total of these deposits deducted or earnings excluded from income. Do not make any reduction in basis required by section 607(g) of the Merchant Marine Act of 1936 for amounts withdrawn from the fund if you included the amounts for purposes of AMT.

Section 833(b) deduction. This deduction is not allowed for AMT purposes. If a corporation (Blue Cross or Blue Shield or similar health insurance providers) took this deduction for regular tax purposes, the adjustment is to add back the amount deducted.

Tax shelter farm activities. This adjustment applies only to personal service corporations. Refigure all gains and losses from a tax shelter farm activity that is not a passive activity by taking into account all AMT adjustment and preference items. You do this by determining the corporation's tax shelter farm activity gain or loss for AMT using the same rules used for regular tax purposes with the following modifications:

1) No recomputed loss is allowed, except to the extent the personal service corporation is insolvent, and
2) You cannot use a recomputed loss in the current tax year to offset gains from other tax shelter farm activities. Instead, you must suspend any recomputed loss and carry it forward until either the corporation has a gain in a later tax year from the same activity or it disposes of the activity.

The adjustment is the difference between the gain or loss for AMT purposes and the amount that was reported for regular tax purposes.

Caution: To avoid duplication, do not include any AMT adjustment or preference item that is included as a gain or loss in the computation for a passive activity loss, discussed next.

A corporation is insolvent to the extent its liabilities exceed the FMV of its assets.

Passive activity loss. This adjustment applies only to closely held and personal service corporations. To determine the adjustment for a passive activity, refigure all gains and losses by taking into account the corporation's AMT adjustments, preferences, and AMT prior year unallowed losses. You do this by determining the corporation's passive activity gain or loss for AMT using the same rules used for regular tax purposes. You reduce the loss disallowed by the amount a corporation is insolvent. The adjustment is the difference between the allowable loss reported for regular tax and the refigured AMT loss.

Caution: To avoid duplication, do not include any AMT adjustment or preference item that is taken into account in this passive activity computation in the amounts to be entered on any other line of Form 4626.

Certain loss limitations. You must take into account the corporation's AMT adjustments and preferences before you apply certain loss deferral rules.

The loss deferral rules include limits on losses due to:

A partner's basis in the partnership interest, and

The at-risk limits.

The adjustment is the excess of the loss amount that is not allowable for AMT purposes over the loss amount that is not allowable for regular tax purposes. If the loss amount that is not allowable for regular tax purposes is more than the loss amount that is not allowable for AMT purposes, the difference is entered on line 2l of Form 4626 as a negative amount.

Depletion. If a corporation's depletion deduction for the year is more than its adjusted basis in the property at the end of the year (figured before reducing the basis by the depletion deduction), the difference is a preference item. You figure this item separately for each separate piece of property being depleted. Depletion figured using the small producer's and royalty owner's exemption is not a preference item.

In computing the year-end adjusted basis, do not add the unrecovered cost of machinery and other depreciable equipment to the adjusted depletable basis of mineral property. If you added such costs to the adjusted basis, deduct them before figuring the 1995 depletion preference.

Percentage depletion of coal and iron ore. Figure a corporation's (other than an S corporation's) preference for the percentage depletion of coal (including lignite) and iron ore as follows:

1) Subtract the corporation's basis in the property at the end of the year (before adjusting it for the year's depletion) from the year's percentage depletion on the property.
2) Reduce the corporation's percentage depletion by 20% of the amount figured in (1). This is the most the corporation can deduct for percentage depletion on the property.
3) Subtract the corporation's basis in the property (before adjusting it for the year's depletion) from the amount figured in (2). The result is the corporation's preference item for percentage depletion on the property.

Certain tax-exempt interest. This preference item is the tax-exempt interest on specified private activity bonds reduced by any deduction that would have been allowable if the interest had been included in gross income for regular tax purposes. A specified private activity bond is one issued after August 7, 1986, or, on or after September 1, 1986, for bonds satisfying pre-Tax Reform Act of 1986 definitions of governmental bonds.

For this preference item, a private activity bond does not include:

1) A qualified section 501(c)(3) bond, or
2) Any refunding bond (whether a current or advance refunding) if the refunded bond (or for a series of refundings, the original bond) was issued before August 8, 1986.

Treat any exempt-interest dividends a corporation receives from a mutual fund as interest on a specified private activity bond to the extent of its proportionate share of the interest on such bonds received by the company paying the dividend.

Charitable contributions. Refigure the charitable contributions deduction for the AMT. Use only income and deductions allowed for the AMT when refiguring the limit based on taxable income. Also, any AMT carryover of charitable contributions is limited to the cost or other basis (instead of fair market value) for any contribution of capital gain or section 1231 property for which the preference for charitable contributions applied.

Intangible drilling costs (IDCs). If you elected the optional 60-month write-off for IDCs, discussed later, these costs are not a preference item. If you do not elect the 60-month write-off, this preference item is the amount by which excess IDCs paid or incurred during the year on a corporation's oil, gas, and geothermal properties are ***more than 65%*** of the net income from these properties.

Excess IDCs. These are costs incurred or paid for oil, gas, and geothermal wells over the amount allowable if the costs had been amortized using a 120-month period or any permitted cost depletion method.

Net income. Net income from oil, gas, and geothermal properties for this purpose is the gross income received or accrued from all these properties less the deductions allocated to these properties. Deductions do not include excess IDCs or costs for nonproductive wells. Nonproductive wells are those plugged and abandoned without producing oil, gas, or geothermal energy in commercial quantities for any substantial period of time. A well that is temporarily shut in is not a nonproductive well.

Special rule. Excess IDCs for any oil or gas well are a preference item only for integrated oil companies. However, if you are not an integrated oil company, the reduction in your alternative minimum taxable income (AMTI) cannot exceed 40% of your AMTI for the year figured by taking into account this item, but without regard to the alternative tax NOL deduction, discussed later, under *Other Adjustments.*

Reserves for losses on bad debts of financial institutions. The deduction allowed for a reasonable addition to a financial institution's reserve for bad debts minus the amount that would have been allowable based on actual loss experience is a preference item. Add back the difference.

Accelerated depreciation on real property placed in service before 1987. This preference item is the depreciation or amortization a corporation took during the tax year on real property placed in service before 1987, minus straight line depreciation. Figure this amount separately for each separate item of property. Generally, each building (or its component) is a separate item of property. Do not figure this amount for an item of property you dispose of during the tax year.

For property depreciated as 15-year real property under the accelerated cost recovery system (ACRS), figure straight line depreciation using a recovery period of 15 years.

For property depreciated as 18-year real property under ACRS, figure straight line depreciation using a recovery period of 18 years.

For property depreciated as 19-year real property under ACRS, figure straight line depreciation using a recovery period of 19 years.

For low-income housing property depreciated under ACRS, figure straight line depreciation using a recovery period of 15 years.

For property a corporation placed in service between July 31, 1986, and 1987, and elected to depreciate under MACRS, see *Accelerated depreciation on property,* earlier.

If you use a recovery period longer than these periods in depreciating the property, you do not have a preference item.

For property depreciated under another method, figure straight line depreciation using the same basis, useful life, and salvage value you first used to depreciate the property. If the corporation did not use a useful life or salvage value, figure straight line depreciation as if it had taken depreciation using that method.

Accelerated depreciation on leased personal property placed in service before 1987. This preference item is the depreciation a corporation took during the tax year on personal property it leased to others minus the depreciation using the straight line method.

This item applies only if the corporation is a personal holding company.

Other adjustments. You must make an adjustment as a negative amount for certain income reported for regular tax purposes including:

1) Income eligible for the possession tax credit, and
2) Income for the alcohol fuel credit.

Also, the adjustment can be either a positive or negative amount for (a) any minimum taxable income adjustment from Schedule K–1 (Form 1041), line 8, if the corporation is the beneficiary of a trust, (b) any AMT adjustment from a cooperative, or (c) any related adjustment discussed next.

Related adjustments. AMT adjustments and preferences may affect deductions that are based on an income limit. You must refigure these deductions using the income limit as modified for AMT purposes. You include this adjustment on line 2t of Form 4626 for the total difference between the regular tax and AMT amounts for all items not taken into account on any other line on Form 4626. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount. See the instructions for Form 4626 for more information.

Preadjustment Alternative Minimum Taxable Income (AMTI)

The adjustment and preference items just discussed result in the amount on line 3, Form 4626, called the preadjustment alternative minimum taxable income (AMTI). You are now ready to make the ACE adjustment and figure any alternative tax net operating loss deduction (ATNOLD) for AMT purposes. However, if your corporation has undergone an ownership change, see the following note before beginning your ACE adjustment.

Note: If your corporation has a net unrealized built-in loss (within the meaning of section 382(h) of the IRC), and undergoes an ownership change, you must first adjust the basis of each asset of the corporation (immediately after the ownership change). The new adjusted basis of each asset is its proportionate share (based on the respective fair market values) of the fair market value (FMV) of the corporation's assets (determined under section 382(h) of the IRC), immediately before the ownership change. To determine if your corporation has a net unrealized built-in loss, use the total adjusted basis of its assets that it used for figuring its ACE.

Adjusted Current Earnings (ACE)

You increase AMTI by 75% of any excess of the corporation's ACE for the tax year over preadjustment AMTI. Preadjustment AMTI is the corporation's AMTI for the tax year determined without the adjustment for ACE and without the alternative tax net operating loss deduction. Make a negative (reduction) adjustment for 75% of any excess preadjustment AMTI over ACE to the extent of the net positive adjustments for ACE in prior tax years.

ACE is the corporation's preadjustment AMTI for the tax year determined by taking into account certain specified adjustments. You can determine the ACE by completing the *Adjusted Current Earnings Worksheet.* This worksheet is provided in the instructions for Form 4626. The worksheet lists all of the adjustments that may affect the ACE.

Some of these adjustments are briefly discussed next.

ACE depreciation. The adjustment is the excess of AMT depreciation over ACE depreciation. If ACE depreciation exceeds AMT depreciation, the adjustment is a negative amount. The ADS system of MACRS is used for property placed in service after 1989 and before 1994. This system requires use of the straight line method over a specified recovery period. For property placed in service after December 31, 1993, the ACE depreciation expense is the same as the AMT depreciation expense discussed earlier in *Accelerated depreciation on property* under *Adjustments and Preferences.*

Inclusion in ACE of items included in earnings and profits (E & P). These are items that are not taken into account in determining the corporation's preadjustment AMTI but that are included in determining E & P. An adjustment must be made to include them in ACE. These items are listed on the *Adjusted Current Earnings Worksheet* on lines 3a through 3e.

Disallowance of items not deductible in computing E & P. These are items that are not taken into account in figuring E & P. No deduction is allowed for them when figuring ACE. These items will generally increase ACE to the extent they were deductible in figuring the preadjustment AMTI. However, there are some exceptions to this rule discussed in the instructions for Form 4626. These items are listed on the *Adjusted Current Earnings Worksheet* on lines 4a through 4e.

Intangible drilling costs. To figure the ACE expense, capitalize and amortize these costs over a 60-month period beginning with the month you paid or incurred them. For amounts paid or incurred in tax years beginning after December 31, 1992, this adjustment does not apply to any oil or gas well except for those of integrated oil companies. Subtract the ACE expense (if any) from the AMT expense used to figure the adjustment for line 2p of Form 4626. The difference is the ACE adjustment. If the ACE expense exceeds the AMT expense, the difference is a negative adjustment. You enter any adjustment on line 5a of the worksheet.

Circulation expenses. For purposes of figuring ACE, the amortization provisions do not apply to expenses paid or incurred after 1989. You must treat the expenses in accordance with the case law in effect prior to the enactment of section 173 of the Internal Revenue Code (IRC). The adjustment is the result of subtracting the ACE expense (if any) from the expense claimed for regular tax purposes (or for personal holding companies, from the expense refigured for AMT purposes in figuring the adjustment for line 2d of Form 4626). If the ACE expense exceeds the regular tax expense (or AMT expense for a personal holding company), the adjustment is a negative amount. You enter any adjustment on line 5b of the worksheet.

Organizational expenses. For purposes of figuring ACE, the amortization provisions do not apply to expenses paid or incurred after 1989. All organizational expenses are capitalized and are not taken into account until the corporation is sold or otherwise disposed of. You enter any adjustment on line 5c of the worksheet.

LIFO inventory adjustments. The adjustments outlined in section 312(n)(4) of the IRC apply in computing the ACE. You enter any adjustment on line 5d of the worksheet. For more information on figuring this adjustment, see Income Tax Regulation 1.56(g)–1(f)(3).

Installment sales. For any installment sale that occurs in a tax year beginning after 1989, you figure the ACE as if the corporation did not use the installment method. However, this does not apply to the Internal Revenue Code section 453A percentage of the gain from an installment sale to which that section applies. The adjustment is the result of subtracting the installment sale income for AMT purposes from the ACE income. If the ACE income is less than the AMT income, the adjustment is a negative amount. You enter any adjustment on line 5e of the worksheet.

Disallowance of loss on exchange of debt pools. A corporation may not recognize any loss on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities for purposes of ACE. The adjustment is added back to ACE to the extent the corporation recognized such a loss for regular tax purposes. You enter the adjustment on line 6 of the worksheet.

Acquisition expenses of life insurance companies for qualified foreign contracts. For purposes of computing ACE, acquisition expenses of life insurance companies for qualified foreign contracts (as defined in section 807(e)(4) of the IRC without regard to the treatment of reinsurance contract rules) must be capitalized and amortized. The adjustment is the result of subtracting the ACE expense (if any) from the expense recognized for regular tax purposes. If the ACE expense exceeds the regular tax expense, the adjustment is a negative amount. You enter the adjustment on line 7 of the worksheet.

Depletion. For purposes of ACE, you compute depletion using the cost depletion method for property placed in service in a tax year beginning after 1989. This adjustment does not apply to independent producers and royalty owners. You subtract the ACE expense (if any) from the expense refigured for AMT purposes (i.e., the preference amount entered on line 2m of Form 4626). You enter the result on line 8 of the worksheet. If the ACE expense exceeds the amount refigured for AMT purposes, you enter the result as a negative amount.

Basis adjustments for determining gain or loss from dispositions of pre-1994 property. For purposes of ACE, if a corporation disposed of property during a tax year for which it is making or has made any of the ACE adjustments described in section 56(g), you must refigure the property's adjusted basis for ACE purposes. The difference is a negative amount if:

a) The ACE gain is less than the AMT gain,

b) The ACE loss is more than the AMT loss, or

c) You have a loss for ACE and a gain for AMT.

See the instructions to line 4 of Form 4626 for more information on the ACE computation. Also, you can figure the ACE using the worksheet provided in the instructions.

Alternative Tax Net Operating Loss Deduction

The last adjustment for AMT is to figure the corporation's alternative tax net operating loss deduction (ATNOLD).

Figuring an ATNOLD after 1986. For AMT purposes, you figure a net operating loss (NOL) for a tax year beginning after 1986 in generally the same manner as for regular tax purposes, except:

- You make the AMT adjustments, under sections 56 and 58 of the IRC, to that year's NOL that you figured for regular tax purposes, and
- You reduce that year's NOL by the preference items under section 57 of the IRC, to the extent they increased the NOL for the tax year.

Carrybacks and carryovers. After making the above calculations, determine the NOL you can deduct in a carryback or carryover year. It cannot exceed 90% of the corporation's AMTI for that year figured before the NOL deduction.

You can carry the NOL back 3 years or carry it forward 15 years. This is the same as under the regular NOL rules. However, if you elect not to use the carryback of an NOL for regular tax purposes, you cannot carry it back for AMT purposes.

In years that a corporation does not have an AMT liability, you still reduce the NOL deduction. Use Form 4626 to figure AMTI even though the corporation does not have an AMT liability.

Figuring the amount of pre-1987 carryovers. The NOL carryforward from tax years beginning before 1987 that you can carry to tax years beginning after 1986 is the amount of your regular NOL carryover. Adjust the NOL carryforward if the corporation had a deferred add-on minimum tax liability for a year before 1987. See section 701(f)(2)(B) of Public Law 99–514 (10/22/86).

Optional Write-Off

A corporation can choose an optional 60-month, 3-year, or 10-year write-off of certain adjustments and preference items in figuring its regular income tax. If it does, do not consider these items as adjustments or preference items for the alternative minimum tax. A corporation may choose the following optional write-off periods.

60-month write-off. A corporation can choose to deduct intangible drilling and development costs in equal installments over a 60-month period beginning with the month the costs were paid or incurred.

3-year write-off. The cost a corporation can choose to deduct, in equal installments over a 3-year period, is the cost of increasing the circulation of a newspaper or periodical.

10-year write-off. The costs a corporation can choose to deduct in equal installments over 10 years are: mining exploration costs; development expenses; and research and experimental expenses.

Choosing the optional write-off. Choose the optional write-off by the due date (including extensions) of the corporation's income tax return for the year for which you are making the choice. Attach a statement to the corporation's return that includes:

The corporation's name, address, and employer identification number,

The specific write-off you are choosing,

A note that states you make this choice under section 59(e) of the Internal Revenue Code, and

The year for which you make the choice and the preference item to which it applies.

You can use Form 4562 to choose the optional write-off. Once you select the optional write-off for any qualified expense, you can revoke it only with IRS consent.

Figuring Alternative Minimum Tax

After you arrive at AMTI, you figure the tax. First, you subtract an ***exemption amount*** from the corporation's AMTI. Next, you multiply the balance by the AMT rate of 20%. This result is the ***tentative minimum tax.*** Now you subtract the corporation's ***regular tax liability*** from the tentative minimum tax. The result is the corporation's AMT liability.

Exemption Amount

The AMT does not apply to corporations in the lower tax brackets with small amounts of adjustments or preference items. This is accomplished by subtracting the exemption amount from the corporation's AMTI before figuring the tentative minimum tax. The exemption amount phases out as the AMTI income gets higher.

The maximum exemption is $40,000. However, you must reduce it by $0.25 for every dollar that the corporation's AMTI exceeds $150,000. This reduction causes the exemption to be zero when the corporation's AMTI is $310,000 or more.

Tentative Minimum Tax

You figure the tentative minimum tax by multiplying the corporation's AMTI, minus the exemption amount, by 20%. This is the corporation's tentative minimum tax unless the corporation has an AMT foreign tax credit. If the corporation has an AMT foreign tax credit, subtract it to arrive at the tentative minimum tax.

AMT foreign tax credit. You figure a corporation's AMT foreign tax credit by first using taxable income, adjustments, and preference items from sources outside the United States. This is the corporation's AMTI from sources outside the United States. Then, using both this amount for taxable income from sources outside the United States and the corporation's AMTI for total taxable income, compute the AMT foreign tax credit. You figure the credit on Form 1118.

Limit. The AMT foreign tax credit cannot be more than the amount on Form 4626, line 11, less 10% of the amount that would be on that line if Form 4626 were refigured using zero on line 6 and if the exception for intangible drilling costs under section 57(a)(2)(E) of the IRC does not apply. This 90% limit does not apply to certain corporations that meet the requirements of section 59(a)(2)(C) of the IRC.

Regular Tax

After you figure the corporation's tentative minimum tax, subtract its regular tax to get the AMT. Regular tax is the corporation's income tax shown on page 2, line 1, Part I, Form 1120–A; or line 3, Schedule J, Form 1120, minus any foreign tax credit or possessions tax credit (lines 4a and 4b, Schedule J, Form 1120).

Credits. If a corporation pays AMT, it will not get any tax benefit from certain credits (listed below). If a corporation has adjustments or preference items but does not pay AMT because of the exemption amount, it may or may not receive any benefit from these credits.

A corporation can only use these credits to the extent its regular tax liability exceeds its tentative minimum tax. You may apply any unused credit as a carryback or carryover under the usual rules for that credit.

The credits include the:

Credit for fuel from a nonconventional source, and

Qualified electric vehicle credit.

Also, the general business credit generally cannot be used to reduce AMT, except for certain parts of the credit indicated next.

Reduction of Alternative Minimum Tax

Reduce alternative minimum tax by any amounts from Form 3800, *General Business Credit,* line 34, Schedule A, and Form 8844, *Empowerment Zone Employment Credit,* line 21. To make this reduction, follow the instructions for line 9a of Schedule J, Form 1120; or line 6 of Part I, Form 1120–A.

Minimum Tax Credit

A corporation may be eligible to take a minimum tax credit against its regular income tax liability. A corporation figures a minimum tax credit based on the full AMT incurred in tax years beginning after 1989. For tax years beginning after 1986 but before 1990, a corporation figured the credit on the AMT based on deferral items.

Figuring the credit. For 1995, use Form 8827 to figure the credit and any carryforward to later years.

The corporation can qualify for the minimum tax credit if it had:

- An AMT liability in 1994,
- A minimum tax credit carryforward from 1994 to 1995, or
- A 1994 credit for fuel from nonconventional sources or orphan drug credit that was not allowed solely because of the tentative minimum tax limit.

The credit cannot be greater than the corporation's regular tax liability for the tax year to which you carry it, less the following:

1) Foreign tax credit,
2) Possession tax credit,
3) Credit for fuel from nonconventional sources,
4) Qualified electric vehicle credit,
5) General business credit, and
6) The tentative minimum tax for the year in which you use the credit.

Reduction for canceled debt. You may have to reduce the minimum tax credit if you exclude from income a debt canceled after 1993:

- In a bankruptcy case,
- When you were insolvent, or
- That was a qualified farm debt.

You reduce the minimum tax credit available at the beginning of the tax year ***following*** the year in which the debt was canceled. For this purpose, complete Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and attach it to the corporation's return for the year in which the debt was canceled.

Carryforward of credit. A corporation may carry the minimum tax credit forward (indefinitely) to reduce its regular tax liability in future years. If the corporation does not use all the credit in 1995, it carries the balance to 1996 and later tax years. If the corporation's minimum tax in later tax years results in getting an additional credit, add that credit to any carryforward balance from earlier years.

35.

Excise Taxes

Important Changes

Luxury tax on passenger vehicles. The base amount not subject to tax for passenger vehicles is $34,000 for 1996.

Introduction

This chapter outlines certain federal excise taxes and tells what forms are needed to report and pay these taxes.

Topics

This chapter discusses:

- Taxes reported on Form 720
- Taxes not reported on Form 720

Useful Items

You may want to see:

Publication

- ☐ **349** Federal Highway Use Tax on Heavy Vehicles
- ☐ **378** Fuel Tax Credits and Refunds
- ☐ **510** Excise Taxes For 1996

Form (and Instructions)

- ☐ **11-C** Occupational Tax and Registration Return for Wagering
- ☐ **720** Quarterly Federal Excise Tax Return
- ☐ **730** Tax on Wagering
- ☐ **2290** Heavy Vehicle Use Tax Return
- ☐ **6627** Environmental Taxes
- ☐ **8807** Certain Manufacturers and Retailers Excise Taxes
- ☐ **8849** Claim for Refund of Excise Taxes

Form 720

Form 720 is used to report most excise taxes. Some of these taxes are figured on a separate form which is attached to Form 720. Form 720 is filed quarterly, but the taxes generally must be deposited before the return is due. For details of each tax, get Publication 510, and the appropriate forms.

Publication 378 discusses federal fuel tax credits you can claim on your 1995 income tax return. It also explains when you may claim a quarterly refund during 1996 instead of waiting to claim a credit on your 1996 income tax return.

The taxes reported on Form 720 include:

Environmental taxes,

Communications taxes,

Fuel taxes,

Retail tax,

Ship passenger tax,

Luxury tax,

Manufacturers taxes, and

Other excise taxes.

Environmental taxes. Environmental taxes are imposed on Ozone-depleting chemicals and imported products containing those chemicals when sold or used by the manufacturer, producer, or importer.

Use Form 6627 to figure your environmental taxes and attach it to Form 720.

Communications taxes. Tax is imposed on:

1) Toll telephone service,
2) Teletypewriter exchange service and,
3) Local telephone service.

The person paying for the service is liable for the tax, but the person furnishing the service and receiving the payment is required to collect the tax, to file the return, and to pay the tax to the government.

Fuel taxes. Excise taxes are imposed on:

1) Gasoline,
2) Gasohol,
3) Gasoline used in aviation,
4) Diesel fuel,
5) Aviation fuel other than gasoline,
6) Special motor fuels,
7) Fuels used on certain inland waterways, and
8) Compressed natural gas.

Manufacturers taxes. Excise taxes are imposed on the sale, use, or lease of the following articles by the manufacturer, producer, or importer:

1) Sport fishing equipment—Form 8807,
2) Electric outboard motors and certain sonar devices—Form 8807,
3) Bows and arrows—Form 8807,
4) Highway-type tires,
5) Gas guzzler cars—Form 6197,
6) Certain vaccines, and
7) Coal.

Complete the form indicated in the list (if one is listed) and attach it to Form 720.

Retail tax. Tax is imposed on the first retail sale by the manufacturer or importer of tractors, and of certain chassis and bodies for trucks, trailers, and semitrailers. Figure the tax on Form 8807 and attach it to Form 720.

Ship passenger tax. A tax of $3 per passenger is imposed on the operator of commercial ships in two situations. The first situation is voyages on commercial passenger vessels extending over one or more nights. A commercial passenger vessel is a vessel with stateroom or berth accommodations for more than 16 passengers. The second situation is voyages on commercial vessels transporting passengers engaged in gambling on the vessels in international waters. The tax is imposed only once for each passenger either when the passenger first embarks or disembarks in the United States.

Luxury tax. For 1996, tax is imposed on the first retail sale of a passenger vehicle with a price exceeding $34,000. The tax is 10% of the amount the sales price exceeds that base amount. Compute the tax on Form 8807 and attach it to Form 720.

Other excise taxes. Taxes are imposed on:

1) Insurance policies issued by foreign insurers,
2) Registration-required obligations not in registered form, and
3) Alcohol sold as fuel but not used as fuel.

Excise Taxes Not Reported on Form 720

In addition to the taxes reported on Form 720, report other excise taxes on other forms and to other organizations. These forms and taxes are:

1) Form 2290—Highway Use Tax,
2) Forms 730 and 11–C—Wagering,
3) ATF Form 5300.26—Firearms,
4) ATF Form 5630.5—Alcohol, Tobacco,
5) ATF Form 5630.7—Firearms.

A number of excise taxes apply to alcoholic beverages, tobacco products, and firearms and are filed with the Bureau of Alcohol, Tobacco, and Firearms (ATF). For more information, see Publication 510.

If any of the IRS taxes appear to apply to you, see the following discussions for information about them.

Form 2290—Highway Use. Report the federal excise tax on the use of certain trucks, truck tractors, and buses on public highways on Form 2290. The tax applies to vehicles having taxable gross vehicle weights of 55,000 pounds or more. Vans, pickup trucks, panel trucks, and trucks of that nature generally are not subject to highway use tax.

A public highway is any road in the United States that is not a private roadway. This includes federal, state, county, and city roads. Canadian and Mexican heavy vehicles operated on U.S. highways may be liable for this tax. For more information, see Publication 349 and the instructions for Form 2290.

Registration of vehicles. You must generally prove that you paid your federal highway use tax before registering your taxable vehicle with your state motor vehicle departments. Generally, a copy of Schedule 1 of Form 2290, stamped after payment and returned to the owner by the IRS, is acceptable proof of payment.

Forms 730 and 11–C—Wagering. If you are in the business of accepting bets or running a betting pool or lottery, you may be liable for federal taxes on wagering. Form 730 is used to report a tax on the bets you receive. Form 11–C is used to pay an annual tax and register your place of business. For more information, see Publication 510 and the instructions to these forms.

36. Information Returns

Introduction

Information returns are forms that provide information required by the Internal Revenue Service (IRS). There are four main categories:

1) Information returns of persons subject to special provisions of the law. For example, returns showing income, deductions, and distributions of:
   a) Partnerships (discussed in Publication 541, *Tax Information on Partnerships*).
   b) Exempt organizations (discussed in Publication 557, *Tax-Exempt Status for Your Organization*).
   c) S corporations (discussed in Publication 589, *Tax Information on S Corporations*).
2) Information returns of employers reporting wages and other payments to employees (discussed in the Form W–2 instructions).
3) Information returns of employee benefit plans (discussed in part in the *Instructions for Form 5500*).
4) Information returns for payments to nonemployees and transactions with other persons (discussed in the *Instructions for Forms 1099, 1098, 5498, and W–2G*).

This chapter discusses the fourth category of returns. It provides general information about the forms and requirements for reporting payments on them.

Topics

This chapter discusses:

- Form 1099 series
- Form 5498
- Form W–2G
- Filing information returns
- Statements for recipients
- Backup withholding
- Penalties
- Other information returns

Form 1099 Series

This series of forms is used to report payments such as dividends, interest, retirement distributions, and other payments and transactions. Most payments to sole proprietors or individuals made in the course of a trade or business are reported on Forms 1099.

Corporations. Except for the following items, payments to corporations are not required to be reported on Forms 1099.

1) Payments to suppliers or providers of medical or health care services.
2) Withheld federal income tax or foreign tax.
3) Barter exchange transactions.
4) Substitute payments in lieu of dividends and tax-exempt interest.
5) Interest and original issue discount paid or accrued to a regular interest holder of a real estate mortgage investment conduit (REMIC).
6) Acquisitions or abandonments of secured property.
7) Cancellation of debt.

Partnerships. Reporting is required for payments to partnerships.

Nominee or middleman returns. If you receive an information return for a payment that belongs to another person, you should file the same type of information return showing the actual owner as the recipient and you as the payer.

Form 1099–MISC

Form 1099-MISC, *Miscellaneous Income,* is the information return used most often by small businesses.

File Form 1099–MISC if you:

1) Paid $600 or more for fees, commissions, or other forms of compensation to an individual who is not your employee for services performed in your trade or business. For example, use Form 1099–MISC to report payments to an independent contractor.
2) Gave prizes, awards, or made other payments of $600 or more that are not for services performed in your trade or business, or made direct sales of $5,000 or more of consumer products to a buyer for resale.
3) Made payments of $10 or more for royalties or $600 or more for rents, other than rents paid to real estate agents.
4) Withheld federal income tax on miscellaneous income under the backup withholding rules.
5) Made payments of $600 or more to physicians or other suppliers or providers of health care services including payments made under health, accident, and sickness insurance programs.
6) Made a payment as a share of the proceeds from the sale of a fishing catch or made a distribution in-kind, reported at the fair market value of the catch, to each crew member of a fishing boat with normally fewer than 10 members.
7) Received payments of $10 or more as a broker on behalf of a customer in lieu of a dividend or tax-exempt interest as a result of the transfer of a customer's securities for use in a short sale.
8) Exchanged property or services with an individual in the course of a trade or business. If the exchange was made through a barter exchange, Form 1099–B may be required. See the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Report only payments made in the course of your trade or business (including government agencies and nonprofit organizations) or from which you withheld federal income tax or foreign tax.

Royalties. Examples of royalties to be reported on Form 1099–MISC include payments for the right to exploit natural resources such as oil, gas, coal, timber, sand, gravel, and other mineral interests. Also included are payments for the right to exploit intangible property such as copyrights, trade names, trademarks, franchises, books and other literary compositions, musical compositions, artistic works, secret processes or formulas, and patents. However, timber royalty payments made under a ''pay-as-cut'' contract are reported on Form 1099–S.

Nonemployee compensation. Payments that must be reported on Form 1099–MISC as nonemployee compensation include fees, commissions, prizes, awards, or other forms of compensation for services performed for your trade or business by an individual who is not your employee.

Payments not reportable on Form 1099–MISC. Payments that do ***not*** require a Form 1099–MISC include the following:

1) Payments for merchandise, including inventory, freight, storage, and similar charges.
2) Payments for telephone, telegraph, and similar services.
3) Payments of rent to real estate agents.
4) Payments to your employees for any services they perform in the course of their employment, or for their traveling and other business expenses.
5) Payments to corporations, except those discussed earlier.

Examples. The following examples illustrate the filing of information returns for miscellaneous payments.

Example 1. Mr. Adams, a real estate agent in New York, refers a customer to Mrs. Williams, a real estate agent in California. Mrs. Williams sells a house to the customer and pays a $700 referral commission to Mr. Adams. Mrs. Williams must report $700 on Form 1099–MISC.

Example 2. Mr. Black, a real estate agent, collected $1,000 in rental payments from the tenants of a building. He deducted his commission of $100 and paid $900 to the building owner. He must report the gross amount of $1,000 on Form 1099–MISC even though he deducted his commission of $100 from the $1,000 and paid the owner $900.

Example 3. Mr. Jones is in the business of renting houses. He pays Mr. Smith, who operates a painting business as a sole proprietor, $1,750 to paint one of his rental houses. Mr. Jones must report the $1,750 on Form 1099–MISC.

Other Forms 1099

Other information returns in the 1099 series that you may be required to file are listed below:

Form 1098 for mortgage interest (including certain points) of $600 or more that you received from individuals in the course of your trade or business.

Form 1099–A for lenders to report acquisition of an interest in property that was security for a loan, or who have reason to know that the property has been abandoned.

Form 1099–B for: (a) brokers to report the gross proceeds from the sale of stocks, bonds, commodities, regulated futures or forward contracts, debt instruments, etc.; or (b) barter exchanges to report the exchange of property or services.

Form 1099–C for financial institutions, credit unions, or federal agencies to report canceled debt of $600 or more.

Form 1099–DIV for: (a) payments of $10 or more in gross dividends and other distributions on stock, (b) withheld foreign tax on dividends and other distributions on stock, or (c) distributions of $600 or more in a liquidation.

Form 1099–G for certain payments made by a unit of the federal or a state or local government, such as unemployment compensation and state and local income tax refunds.

Form 1099–INT for: (a) interest of $10 or more paid or credited on earnings from savings and loan associations, credit unions, bank deposits, corporate bonds, bearer certificates of deposit, etc.; (b) interest of $600 or more from sources other than those listed in (a) if paid in the course of your trade or business; (c) forfeited interest due to premature withdrawals of time deposits; (d) any foreign tax withheld and paid on interest; or (e) backup withholding on interest payments, regardless of the amount of the payment.

Form 1099–OID for original issue discount of $10 or more on obligations including bonds or other evidences of indebtedness, time and savings deposits, and certificates of deposit made, purchased, or renewed after 1970 if the term of the obligation or deposit arrangement is more than one year.

Form 1099–PATR for patronage dividends or other distributions of $10 or more by cooperatives.

Form 1099–R for distributions from retirement or profit-sharing plans, IRAs, SEPs, or insurance contracts.

Form 1099–S for most real estate transactions.

Form 5498

File Form 5498, *Individual Retirement Arrangement Information,* by May 31, 1996, with the IRS for each person for whom you maintained an individual retirement arrangement (IRA) or simplified employee pension plan (SEP) during 1995.

For more information, see the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Form W–2G

File Form W–2G, *Certain Gambling Winnings,* by February 28, 1996, if you paid any of the following:

1) $600 or more in gambling winnings from any of the following:
   a) Horse racing, dog racing, jai alai, state lotteries, and other wagering transactions in which the winnings are at least 300 times the amount of the wager (excluding the transactions in *1b, 2,* or *3).*
   b) Lotteries, raffles, sweepstakes, wagering pools, or drawings, such as those held by churches or civic organizations.
2) $1,200 or more from bingo or slot machines.
3) $1,500 or more in proceeds (winnings less the amount of the wager) from keno.
4) Any gambling winnings subject to income tax withholding.

Certain payments of more than $5,000 are subject to 28% income tax withholding. Gambling winnings may also be subject to backup withholding of 31%. See the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Filing Information Returns

File Forms 1099, W–2G, and 1098 by February 28, 1996. If you file paper forms, transmit them to the IRS with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns.* You must use a separate Form 1096 for each type of form.

Send Form 1096 and the appropriate information returns to the IRS Center listed on the form.

For information on filing Forms 4789, 5498, and 8300, see the sections on those forms in this chapter.

Magnetic media. If you file at least 250 information returns, you must use magnetic media unless you apply for and receive an undue hardship waiver. The 250-or-more requirement applies separately to each form.

Send all information returns filed on magnetic media to :

IRS-Martinsburg Computing Center
P.O. Box 1359
Martinsburg, WV 25401–1359.

See Publication 1120, *Specifications for Filing Forms 1098, 1099, 5498, and W–2G Magnetically or Electronically,* for more information on magnetic filing.

Approval. In order to file on magnetic media, you must get approval from the IRS. File Form 4419, *Application for Filing Information Returns Magnetically/Electronically,* at least 30 days (45 days for some electronic filing) before the due date of the returns. The IRS will provide you with a written reply and further instructions. Once you have received approval, you do not need to reapply each year.

Waiver request. Submit Form 8508, *Request for Waiver From Filing Information Returns on Magnetic Media,* to request an undue hardship waiver from filing on magnetic media. You can apply for a waiver for only one year at a time.

Extension of time to file. If you are unable to file information returns with the IRS by the due date, send Form 8809, *Request for Extension of Time To File Information Returns,* to the address shown on the form.

Statements for Recipients

If you are required to file an information return, you must also furnish statements to recipients showing the information reported to the IRS. Be sure the statements are clear and legible.

Substitute form. A substitute form is generally any statement other than Copy B of the official form. You can develop a substitute form yourself or buy them from a private printer. However, substitute forms must comply with the format and content requirements in Publication 1179, *Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W–2G.*

Interest, dividend, and royalty payments. If you make payments of dividends or interest (including original issue discount), you must furnish an official or substitute Form 1099 to a recipient either by first-class mail or in person. Payers of royalties must also furnish the statement to a recipient either by first-class mail or in person. However, the statement need not be on the official form. You can also send these statements by intraoffice mail.

Mailing requirements. When you mail your statements, you can include the following enclosures:

1) Forms W–8 and W–9 or other 1099s, 1098, and 5498 statements.
2) Form W–2.
3) A check or a letter explaining why no check is enclosed.
4) A letter explaining the tax consequences of the information shown on a recipient statement.
5) A statement of the person's account shown on Form 1099.

A recipient statement can be perforated to a check or account statement showing payments on the recipient's account. The enclosure to which the recipient statement is attached must contain, in bold and conspicuous type, the legend ''Important Tax Return Document Attached.''

No enclosures, other than those mentioned above, and no advertising or promotional material are permitted in the mailing of statements to recipients.

For a statement mailing, the envelope must state on the outside in a conspicuous manner the legend ''Important Tax Return Document Enclosed.'' The check, letter, or account statement must also contain this legend in a conspicuous manner. However, this legend is not required on the outside of the envelope or on the enclosures if the envelope only contains recipient statements, Forms W–8 and W–9, and a letter explaining the tax consequences of the information shown on the enclosed recipient statement. Nor is it required on a check or statement perforated to the recipient statement.

Other payments. For information reported on Forms 1098, 1099–A, 1099–B, 1099–C, 1099–G, 1099–MISC, 1099–R, 1099–S, 5498, or W–2G, the statement to the recipient need not be, but can be, a copy of the paper form filed with the IRS. You can combine the statements with other reports or notices, or expand them to include other information of interest to the recipient. Be sure to provide the recipient with applicable instructions similar to those on the back of the recipient's copy of the official IRS form.

Time for furnishing forms or statements. You must generally provide Forms 1098, 1099, and W–2G information by January 31 of the following year. However, you can issue them earlier in some situations. For example, you can furnish Form 1099–INT when U.S. savings bonds are redeemed. Cooperatives can furnish Forms 1099–PATR with the final dividend payment, regardless of the date. Brokers and barter exchanges can furnish Form 1099–B at any time, but not later than January 31.

Form 5498 information. If you are a trustee or issuer of an IRA or SEP, you must provide each participant with a statement of the December 31, 1995, value of his or her account by January 31, 1996. IRA contribution information must be provided to the participant by May 31, 1996.

Backup Withholding

In certain cases, you may be required to withhold income tax at a 31% rate (backup withholding) on payments of interest, dividends, patronage dividends, rents, royalties, commissions, nonemployee compensation, and certain other payments you make in the course of your trade or business. Transactions by brokers and barter exchanges and certain payments made by fishing boat operators are also subject to backup withholding. Real estate transactions and canceled debts, however, are not subject to backup withholding.

If the payment is a reportable interest, dividend, or other payment, backup withholding applies if:

1) The payee does not furnish a taxpayer identification number (TIN) to you, OR
2) IRS notifies you to impose backup withholding because the payee furnished an incorrect TIN, OR
3) You are notified that the payee is subject to backup withholding, OR
4) For interest and dividend accounts opened (or instruments acquired) after 1983, the payee does not certify to you, under penalties of perjury, that he or she is not subject to backup withholding under item (3) above, OR
5) For interest, dividend, broker, or barter exchange accounts opened (or instruments acquired) after 1983, or broker accounts considered inactive in 1983, the payee does not certify to you, under penalties of perjury, that the TIN furnished is correct.

Except as explained in *5,* reportable ''other'' payments are subject to backup withholding only if *1* or *2* applies.

Note: For information on backup withholding on gambling winnings, see the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Form W–9. You can use Form W–9, *Request for Taxpayer Identification Number and Certification,* to request a payee's taxpayer identification number and to certify that the number is correct.

You can also use Form W–9 to obtain certifications from payees that they are not subject to backup withholding or that they are exempt from backup withholding.

You can use taxpayer identification numbers provided to you only to comply with tax laws. If you disclose or use taxpayer identification numbers, including social security numbers, in violation of federal law, you may be liable for criminal penalties and civil damages.

Form W–8. Form W–8, *Certificate of Foreign Status,* is used by nonresident aliens and foreign entities to certify that they are not subject to U.S. information return reporting or backup withholding rules on payments of interest, broker transactions, or barter exchange transactions. Payers of interest, brokers, and barter exchanges should send Form W–8 to nonresident alien individuals and foreign corporations, partnerships, estates, and trusts to obtain this certification.

Reporting. Report backup withholding on Form 945, *Annual Return of Withheld Federal Income Tax.* You must deposit taxes reported on Form 945 separately from employment taxes reported on Form 941 or Form 943.

Show any income tax withheld under the backup withholding rules on the information returns used to report payments for the year.

Penalties

You may be subject to a penalty if you do not file information returns by the due date, if you file them without all required information, or you file them with incorrect information. The amount of the penalty is based on when the return (or corrected return) is filed.

1) If the return is filed within 30 days after the due date, the penalty is $15 for each return, up to a maximum of $75,000 a year.
2) If the return is filed after the 30-day period but by August 1, the penalty is $30 for each return, up to a maximum of $150,000 a year.
3) If the return is filed after August 1 or never filed, the penalty is $50 for each return, up to a maximum of $250,000 a year.

Small businesses pay the same penalty per return, but the maximums are lowered to $25,000, $50,000, and $100,000 a year, respectively. A small business is one with average annual gross receipts of $5 million or less for the 3 most recent tax years ending before the calendar year the return is due, or the period the business was in existence, if shorter.

Recipient statements. If you do not furnish a required statement to a recipient by the required date, there is a penalty of $50 for each statement, up to a maximum of $100,000 a year. The penalty also applies if you do not include all required information, or if you report incorrect information.

Penalty waiver. No penalty will apply if you can show that the failure to perform a required act was due to reasonable cause and not to willful neglect.

Also, if errors are corrected by August 1, a penalty will not apply to a small number (or percentage) of returns that were filed with incomplete or incorrect information. The number is the greater of 10 returns or 1/2 of 1% of the total number of returns you are required to file for the year.

Other Information Returns

The following section discusses information returns that apply to certain types of transactions.

Form 4789

Each financial institution other than a casino must file a Form 4789, *Currency Transaction Report,* for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through, or to the financial institution, that involves a transaction in currency of more than $10,000. Multiple transactions by or for any person that total more than $10,000 in any one day should be treated as a single transaction if the financial institution is aware of them.

For purposes of Form 4789, a financial institution includes:

1) A bank.
2) A broker or dealer in securities.
3) A person in the business of dealing in or exchanging currency, including a check casher.
4) A person who issues, sells, or redeems checks, money orders, or similar instruments (except as provided in 31 CFR 103.11).
5) A person in the business of transmitting funds.
6) A telegraph company.
7) The U.S. Postal Service with respect to selling money orders.

A ***currency transaction*** means the physical transfer of cash from one person to another. It does not include a transfer of funds by bank check, bank draft, wire transfer, or other written order.

The financial institution must file Form 4789 by the 15th day after the date of the transaction with the IRS at the address shown on the form, or hand carry it to a local IRS office by that date. The financial institution should keep a copy of each Form 4789 for 5 years from the date it is filed.

Penalties. Civil and criminal penalties, including a fine of up to $500,000 and up to 10 years in prison, are provided for not filing Form 4789 or for filing a false or fraudulent form.

Form 8300

File Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business,* if, in connection with a trade or business, you receive more than $10,000 in cash or foreign currency in one or more related transactions within a one year period.

Cash includes any monetary instrument other than personal checks, whether or not in bearer form, in the amount of $10,000 or less.

Note. This reporting requirement does not apply to financial institutions required to file Form 4789 and casinos required to file Form 8362, *Currency Transaction Report by Casinos.* Casinos exempt from filing Form 8362 are also exempt from filing Form 8300.

A ''transaction'' includes the underlying event causing the transfer of cash from the payer to the recipient. Examples include the purchase of property or services, payment of debt, exchange of a negotiable instrument for cash, and the receipt of cash to be held in escrow or trust.

Any transactions conducted between the same parties in a 24-hour period are related. If you have reason to know that a transaction is one of a series, the transactions will be considered related even if they occur over a period of more than 24 hours.

File Form 8300 by the 15th day after the date the cash was received. If you receive multiple cash payments that total more than $10,000 in a 12-month period, Form 8300 is due within 15 days of the date you receive the payment that causes the total to exceed $10,000. You can mail the form to the IRS at the address shown on the form or hand carry it to your local IRS office. Keep a copy of each Form 8300 for 5 years from the date it is filed. See the instructions for Form 8300.

For the calendar year in which you file a Form 8300, you must give to each person named on it a written statement by January 31 of the following year. The statement must show the name and address of your business and the total cash received from the payer during the year. It must also state that the information is being furnished to the IRS.

Penalties. Civil and criminal penalties, including up to 5 years in prison, are provided for not filing Form 8300 or for filing (or causing the filing) of a false or fraudulent form, or for structuring a transaction to evade reporting requirements.

Part Eight.

Filled-In Forms

The purpose of this Part is to illustrate the tax forms used to report business income or loss. The use of each form is illustrated by an example of a business and how that business would fill out its tax return.

37. Schedule C Sole Proprietorship

If you are the sole owner of an unincorporated business or are a ***statutory employee*** (see chapter 32), you must report business income and expenses on Schedule C or C–EZ (Form 1040). A sample Schedule C with Form 4562 and Schedule SE (Form 1040) for Susan J. Brown are illustrated on the following pages. She does not qualify to use Schedule C–EZ.

Preparing Schedule C

Susan J. Brown owns and operates Milady Fashions, a ladies' ready-to-wear apparel shop. She uses an accrual method of accounting and files her return on a calendar year basis.

Five employees worked in her shop during 1995. She had filed all the necessary employment tax forms and made the required tax deposits. See chapter 33.

First, Susan fills in the information required at the top of Schedule C. On line A, she enters ''Retail, ladies' apparel'' and on line B, she enters the 4–digit business code for a ladies' apparel shop. These codes are found on page C–6 of the instructions for Schedule C. Susan locates the major business category that describes her business. She reads down the items under ''Trade, Retail'' to find the code that applies to her business. This is 3913—''Clothing, women's.'' Susan enters 3913 on line B. She then completes items C through J.

Part I — Income

Susan enters items of income in Part I.

Line 1. Susan had sales of $397,742 in 1995. She enters her total sales on line 1.

Line 2. On line 2, she enters the refunds she gave on merchandise her customers returned, as well as other adjustments she made to customers' purchases. They total $1,442.

Line 4. Susan uses ***Part III*** on page 2 of Schedule C to figure her cost of goods sold.

Part III, line 33. Her inventory at the beginning of 1995, $42,843, is the same as her inventory at the end of 1994. This figure matches the amount on Part III, line 39 of her 1994 Schedule C.

Part III, line 34. The total cost of goods she bought to sell to customers, minus the cost of the goods she returned to her suppliers, was $241,026. From this stock, she withdrew clothing and accessories for her own use that cost $774. She subtracts the cost of these items from her total purchases to figure net purchases of $240,252.

Part III, line 38. She adds her net purchases to her beginning inventory. This sum is the total goods Susan had available for sale during the year.

Part III, line 39. Susan's inventory at the end of the year was $43,746.

Part III, line 40. Subtracting her inventory at the end of the year (line 39) from the goods that were available for sale (line 38) gives Susan the cost of goods sold during the year. For more information on inventories and cost of goods sold, see chapters 3 and 7.

Line 5. Gross profit, $156,951, is the difference between Susan's net sales (line 3) and the cost of goods sold (line 4).

Line 7. Because Susan did not have any income to report on line 6, the gross income is the same as the gross profit (line 5).

Part II — Expenses

Susan enters her expense items in Part II.

Line 8. Susan paid $3,500 for ads.

Line 9. During 1995, Susan determined that she would not be able to collect $479 from bad checks and deducted this amount as bad debts. See chapter 14.

Line 10. She used her van 75% for business in 1995. She spent a total of $3,000 for gas and oil. She can deduct 75% of $3,000 or $2,250 for gas and oil. Other van expenses include $713 (75% of $950) for insurance, $812 (75% of $1,083) for repairs and upkeep, and $75 (75% of $100) for tags. She enters the total, $3,850, on line 10.

Line 13. Susan figures her depreciation on Form 4562. On March 20, 1995, she bought a van that she placed in service in her business. The van weighs over 6,000 pounds; therefore, it is not a passenger automobile for the special deduction limits. The van is 5–year property and the deduction is figured using the 200% declining balance method and applying the half-year convention under MACRS.

The van cost $18,667. Susan can depreciate 75% of $18,667, or $14,000. Susan did not choose to deduct any part of the cost of the van as a section 179 deduction. Since the van is listed property, Susan must complete Part V on page 2 of Form 4562. The depreciation for listed property from Part V is entered on line 20, Part IV of Form 4562.

Susan also bought and placed in service on May 19, 1995, a new adding machine and some clothing racks. The adding machine is 5–year property and the clothing racks are 7–year property. The adding machine cost $200 and the clothing racks cost $800.

Susan chooses to deduct the cost of the adding machine as a section 179 deduction. The deduction for the clothing racks is figured using the 200% declining balance method and applying the half-year convention under MACRS. Susan must complete Part I and Part II of Form 4562.

For items bought after 1980 and before 1987, she uses the regular Accelerated Cost Recovery System (ACRS) percentages. For items bought before 1981, she uses the straight-line method. The total depreciation for these items, $1,117, appears on line 19, Part III of Form 4562. See chapter 12.

Susan has no deduction for amortization. However, if she had recently acquired or set up the business, she could choose to deduct amortization for certain business start-up expenses. See chapter 13.

Line 15. Susan's $238 deduction is for insurance on her business property (van insurance included in line 10). The deduction is only for premiums that give her coverage for 1995. See chapter 17.

Line 16b. Susan had borrowed money to use in her business. The interest on these loans was $2,633 for 1995.

Line 18. The $216 Susan paid for postage in 1995 is her only office expense.

Line 20b. Her rent for the store was $1,000 a month, or $12,000 for the year.

Line 21. She had her store counters refinished and other painting was done at a total cost of $964. See chapter 19.

Line 22. She spent $1,203 on supplies.

Line 23. Susan renewed her business license and paid property tax on her store fixtures. She also paid the employer's share of social security and Medicare taxes for her employees, and paid state and federal unemployment taxes. She enters the total of all these taxes, $5,727, on this line. See chapter 18.

Line 25. Susan's total expense for heat, light, and telephone for the year is $3,570.

Line 26. Susan paid her employees a total of $63,450 for the year. She does not include in wages any amounts she paid to herself or withdrew from the business for her own use.

Susan has two employees whose wages qualify for the jobs credit. She figures the jobs credit on Form 5884, *Jobs Credit,* and uses it to reduce her income tax on Form 1040. However, Susan must subtract the credit of $4,400 from her wage and salary expense for the year. She figures her deductible salary expense to be $59,050 ($63,450 – $4,400) and enters this amount on line 26. See chapter 31.

Since Susan has claimed only the jobs credit, she does not have to prepare Form 3800. The general business credit consists of the investment, jobs, research, low-income housing, alcohol fuel, disabled access, enhanced oil recovery credits, and other credits. If she had more than one of these credits, or a carryforward or carryback of any of these credits, she would have to summarize them on Form 3800.

Line 27. Susan enters the total of her other business expenses on this line. These expenses are not included on lines 8–26. She lists the type and amount of the expenses separately in Part V of page 2, and carries the total entered on line 46 to line 27. See chapter 19.

Completing Schedule C

Susan completes Schedule C to determine her net profit (or loss) for 1995.

Line 28. Susan adds all her deductions listed in Part II and enters the total on this line.

Line 29. She subtracts her total deductions (line 28) from her gross income (line 7). Susan has a tentative profit of $51,212.

Line 30. Susan did not use any part of her home for business, so she does not make an entry here.

Line 31. Susan has a net profit of $51,212 (line 30 from line 29). She enters her net profit here, on line 12 of Form 1040, and on line 2, Section A of Schedule SE (Form 1040).

Line 32. Susan does not have a loss, so she skips this line. If she had a loss and she was not ''at risk'' for all of her investment in the business, the amount of loss she could enter on line 12 of Form 1040 might be limited. See chapter 20 and the instructions for Schedule C for an explanation of an investment ''at risk.''

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (T)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065.

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

1995

Attachment Sequence No. 09

Name of proprietor: SUSAN J. BROWN

Social security number (SSN): 111 00 1111

A Principal business or profession, including product or service (see page C-1): RETAIL, LADIES' APPAREL

B Enter principal business code (see page C-6) ▶ 3 9 1 1 3

C Business name. If no separate business name, leave blank.: MILADY FASHIONS

D Employer ID number (EIN), if any: 10 1123 4567

E Business address (including suite or room no.) ▶ 725 BIG SUR DRIVE

City, town or post office, state, and ZIP code: FRANKLIN, NY 18725

F Accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶

G Method(s) used to value closing inventory: (1) ☒ Cost (2) ☐ Lower of cost or market (3) ☐ Other (attach explanation) (4) ☐ Does not apply (if checked, skip line H)

	Yes	No
H Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation		X
I Did you "materially participate" in the operation of this business during 1995? If "No," see page C-2 for limit on losses.	X	

J If you started or acquired this business during 1995, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here* ▶ ☐	1	397,742
2	Returns and allowances	2	1,442
3	Subtract line 2 from line 1	3	396,300
4	Cost of goods sold (from line 40 on page 2)	4	239,349
5	**Gross profit.** Subtract line 4 from line 3	5	156,951
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-2)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	156,951

Part II Expenses. Enter expenses for business use of your home only on line 30.

8	Advertising	8	3,500
9	Bad debts from sales or services (see page C-3)	9	479
10	Car and truck expenses (see page C-3)	10	3,850
11	Commissions and fees	11	
12	Depletion	12	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	4,231
14	Employee benefit programs (other than on line 19)	14	
15	Insurance (other than health)	15	238
16	Interest:		
a	Mortgage (paid to banks, etc.)	16a	
b	Other	16b	2,633
17	Legal and professional services	17	
18	Office expense	18	216
19	Pension and profit-sharing plans	19	
20	Rent or lease (see page C-4):		
a	Vehicles, machinery, and equipment	20a	
b	Other business property	20b	12,000
21	Repairs and maintenance	21	964
22	Supplies (not included in Part III)	22	1,203
23	Taxes and licenses	23	5,727
24	Travel, meals, and entertainment:		
a	Travel	24a	
b	Meals and entertainment		
c	Enter 50% of line 24b subject to limitations (see page C-4)		
d	Subtract line 24c from line 24b	24d	
25	Utilities	25	3,570
26	Wages (less employment credits)	26	59,050
27	Other expenses (from line 46 on page 2)	27	8,078

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	105,739
29	Tentative profit (loss). Subtract line 28 from line 7	29	51,212
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If a loss, you MUST go on to line 32.	31	51,212

32 If you have a loss, check the box that describes your investment in this activity (see page C-5).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you MUST attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 1995**

Part III Cost of Goods Sold (see page C-5)

33	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	33	42,843
34	Purchases less cost of items withdrawn for personal use	34	240,252
35	Cost of labor. Do not include salary paid to yourself	35	
36	Materials and supplies	36	
37	Other costs	37	
38	Add lines 33 through 37	38	283,095
39	Inventory at end of year	39	43,746
40	**Cost of goods sold.** Subtract line 39 from line 38. Enter the result here and on page 1, line 4	40	239,349

Part IV Information on Your Vehicle. Complete this part ONLY if you are claiming car or truck expenses on line 10 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-3 to find out if you must file.

41 When did you place your vehicle in service for business purposes? (month, day, year) ▶ ...../...../.....

42 Of the total number of miles you drove your vehicle during 1995, enter the number of miles you used your vehicle for:

a Business .... b Commuting .... c Other ....

43 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

44 Was your vehicle available for use during off-duty hours? ☐ Yes ☐ No

45a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

BANK SERVICE CHARGES	180
Chamber of Commerce	60
FREE CREDIT CARD Co	6,000
TRASH REMOVAL	1,600
WINDOW WASHING	238

46	**Total other expenses.** Enter here and on page 1, line 27	46	8,078

Printed on recycled paper

Form **4562**

Department of the Treasury
Internal Revenue Service (T)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172

1995

Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
SUSAN J BROWN	MILADY FASHIONS	111-00-1111

Part I **Election To Expense Certain Tangible Property (Section 179) (Note:** *If you have any "Listed Property," complete Part V before you complete Part I.)*

1	Maximum dollar limitation. If an enterprise zone business, see page 1 of the instructions	1	$17,500
2	Total cost of section 179 property placed in service during the tax year. See page 2 of the instructions	2	15,000
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	-0-
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	17,500

	(a) Description of property	(b) Cost	(c) Elected cost
6	Adding Machine	200	200
7	Listed property. Enter amount from line 27	7	-0-

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	200
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	200
10	Carryover of disallowed deduction from 1994. See page 2 of the instructions	10	-0-
11	Taxable income limitation. Enter the smaller of taxable income (not less than zero) or line 5 (see instructions)	11	17,500
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	200
13	Carryover of disallowed deduction to 1996. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1995 Tax Year (Do Not Include Listed Property.)**

Section A—General Asset Account Election

14 If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 2 of the instructions ▶ ☐

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
Section B—General Depreciation System (GDS) (See page 2 of the instructions.)						
15a 3-year property						
b 5-year property						
c 7-year property		800	7	HY	200DB	114
d 10-year property						
e 15-year property						
f 20-year property						
g Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
h Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	
Section C—Alternative Depreciation System (ADS) (See page 4 of the instructions.)						
16a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property.)** (See page 4 of the instructions.)

17	GDS and ADS deductions for assets placed in service in tax years beginning before 1995	17	
18	Property subject to section 168(f)(1) election	18	
19	ACRS and other depreciation	19	1,117

Part IV **Summary** (See page 4 of the instructions.)

20	Listed property. Enter amount from line 26	20	2,800
21	**Total.** Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	21	4,231
22	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	22	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions. Cat. No. 12906N Form **4562** (1995)

Part V **Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement**

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See page 5 of the instructions for limitations for automobiles.*)

23a Do you have evidence to support the business/investment use claimed? ☐ Yes ☐ No | **23b** If "Yes," is the evidence written? ☐ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost
24 Property used more than 50% in a qualified business use (See page 5 of the instructions.):								
USA 280 VAN	3-20-95	75%	18,667	14,000	5 yr	200 DB/HY	2,800	---
		%						
		%						
25 Property used 50% or less in a qualified business use (See page 5 of the instructions.):								
		%				S/L –		
		%				S/L –		
		%				S/L –		

26 Add amounts in column (h). Enter the total here and on line 20, page 1 . . . . . . **26** 2,800

27 Add amounts in column (i). Enter the total here and on line 7, page 1 . . . . **27** ---

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.
If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
28 Total business/investment miles driven during the year (DO NOT include commuting miles)	7,500											
29 Total commuting miles driven during the year	2,025											
30 Total other personal (noncommuting) miles driven	475											
31 Total miles driven during the year. Add lines 28 through 30	10,000											
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
32 Was the vehicle available for personal use during off-duty hours?	✓											
33 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
34 Is another vehicle available for personal use?	✓											

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons.

	Yes	No
35 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
36 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 6 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
37 Do you treat all use of vehicles by employees as personal use?		
38 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
39 Do you meet the requirements concerning qualified automobile demonstration use? See page 6 of the instructions . .		

Note: *If your answer to 35, 36, 37, 38, or 39 is "Yes," you need not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
40 Amortization of costs that begins during your 1995 tax year:					

41 Amortization of costs that began before 1995 . . . . **41**

42 **Total.** Enter here and on "Other Deductions" or "Other Expenses" line of your return . . . **42**

SCHEDULE SE (Form 1040)

Department of the Treasury Internal Revenue Service (T)

Self-Employment Tax

▶ See instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

OMB No. 1545-0074

1995

Attachment Sequence No. 17

Name of person with self-employment income (as shown on Form 1040)	Social security number of person with self-employment income ▶
Susan J. Brown	111 00 1111

Who Must File Schedule SE

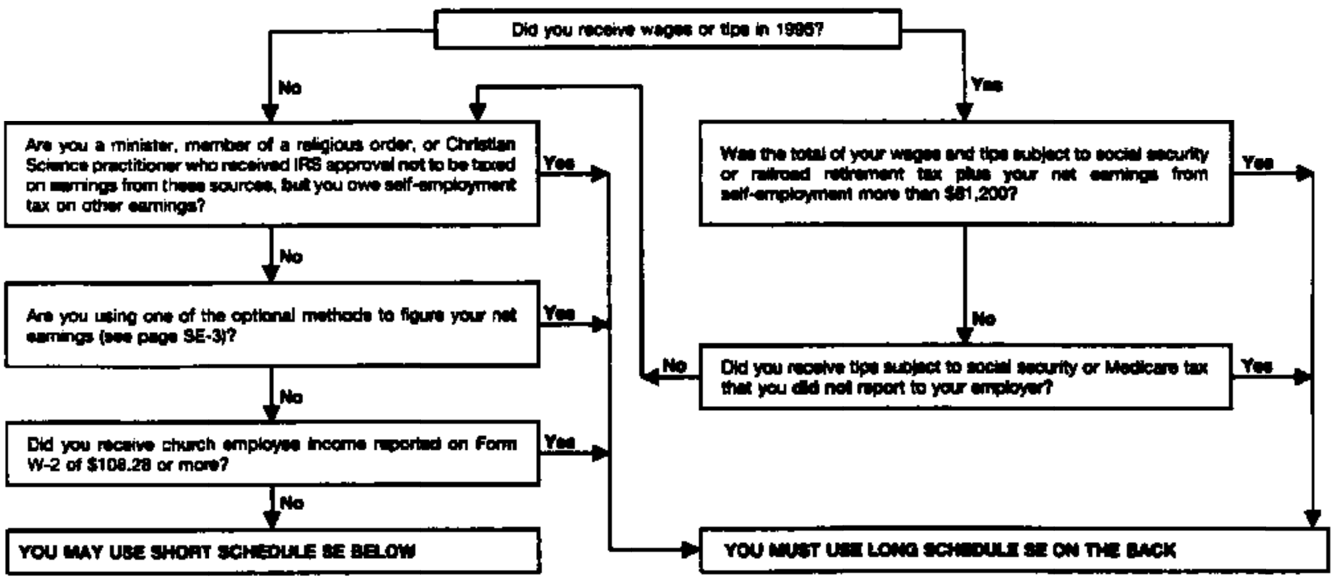
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **OR**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: *Even if you have a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.*

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 47.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	51,212
3	Combine lines 1 and 2	3	51,212
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	47,294
5	**Self-employment tax.** If the amount on line 4 is: • $61,200 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 47.** • More than $61,200, multiply line 4 by 2.9% (.029). Then, add $7,588.80 to the result. Enter the total here and on **Form 1040, line 47.**	5	7,236
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 25** . . . 6 3,618		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1995**

38.

Form 1065 Partnership

This filled-in Form 1065 is for the AbleBaker Book Store, a partnership composed of Frank Able and Susan Baker. The partnership uses an accrual method of accounting and a calendar year for reporting income and loss. Frank works full time in the business, while Susan works approximately 25% of her time. Both partners are general partners.

The partnership agreement states that Frank will receive a yearly guaranteed payment of $20,000 and Susan will receive $5,000. Any profit or loss will be shared equally by the partners. The partners are personally liable for all partnership liabilities. Both partners materially participate in the operation of the business.

In addition to income and expenses from partnership business operations, AbleBaker made a $650 cash charitable contribution and received $50 tax-exempt interest from municipal bonds and $150 from dividends.

Note that each partner's distributive share of specially allocated items should be shown on the appropriate line of the applicable partner's Schedule K–1, and the total amount on Schedule K instead of on page 1, Form 1065. An item is specially allocated if it is allocated to a partner in a ratio different from the ratio for sharing income or loss generally.

Page 1

When the return is completed, the preaddressed label from the cover of the Form 1065 package that was mailed to the partnership is placed in the address area of the form. Any necessary corrections should be made on the label. If a partnership does not receive a Form 1065 package with a preaddressed label, the partnership should enter its legal name as it appears in the partnership agreement and address in this area. The partnership must supply all the information asked for at the top of page 1, Form 1065.

Income

The partnership's ordinary income (loss) from a trade or business activity is shown on lines 1a through 8.

Line 1. Gross sales of $409,465 are entered on line 1a. Returns and allowances of $3,365 are entered on line 1b, resulting in net sales of $406,100, entered on line 1c.

Line 2. Cost of goods sold, $267,641, from Schedule A, line 8, is entered here.

Line 3. Gross profit of $138,459 is shown on this line.

Line 7. Interest income on accounts receivable, $559, is entered on this line. The schedule that must be attached for this line is not shown.

Line 8. Total income, $139,018 (lines 3 through 7), is shown on line 8.

Deductions

The partnership's allowable deductions are shown next on lines 9 through 21.

Line 9. All salaries and wages are included on line 9 except guaranteed payments to the partners (shown on line 10). The AbleBaker Book Store lists $29,350 on line 9. They had no employment credits to reduce that amount.

Line 10. Guaranteed payments of $25,000 to partners Frank ($20,000) and Susan ($5,000) are entered here. A guaranteed payment for interest paid to a partner is entered here, not on line 15.

Line 11. Repairs of $1,125 made to partnership equipment are entered on this line. To qualify for the deduction, repairs must not add to the value or appreciably prolong the life of the property repaired.

Line 12. During the year, $250 owed to the partnership was determined to be a wholly worthless business bad debt. If this had been a nonbusiness bad debt, it would be included in the partnership's separately stated short-term capital loss.

The $250 is shown on line 12. If business bad debts previously written off and deducted are collected in later years, the amount collected generally must be included in partnership gross income for the year the amount is collected. See chapter 14 in Publication 535 for more information.

Line 13. Rent paid for the business premises, $20,000, is listed on this line.

Line 14. Deductible taxes of $3,295 are entered on this line.

Line 15. Interest paid to suppliers during the year totaled $1,451. This is business interest, so it is entered on line 15. Interest paid to a partner that is not a guaranteed payment is also included on this line. For more information, see chapter 8 in Publication 535.

Lines 16a and 16c. Depreciation of $1,174 claimed on assets used in a trade or business is entered on these lines. Line 16b is for depreciation claimed elsewhere on the return. Form 4562 should be completed only if the partnership placed property in service in 1995 or it claims any depreciation on a car or other listed property. Form 4562 is not shown in this example.

Line 20. Other allowable deductions of $8,003 not claimed elsewhere on the return or for which a separate line is not provided on page 1 are included on this line. The partnership attaches a schedule that lists each deduction and the amount included on line 20. This schedule is not illustrated.

Line 21. The total of all deductions, $89,648 (lines 9 through 20), is entered on this line.

Line 22. The amount on line 21 is subtracted from the amount on line 8. The result, $49,370, is entered on line 22 of page 1 and is allocated to each partner on line 1 of Schedule K–1. The total is shown on line 1 of Schedule K.

Signatures

The return must be signed by a general partner. Also, anyone who is paid to prepare the return, other than a full-time employee of the partnership, must sign it. The AbleBaker Book Store did not have a paid preparer who was required to sign the return.

Page 2

Schedule A

Schedule A shows the computation of cost of goods sold. Beginning inventory, $18,125, is entered on line 1 and net purchases, $268,741, are entered on line 2. The total, $286,866, is entered on line 6. Ending inventory, $19,225 (entered on line 7), is subtracted from the amount on line 6 to arrive at cost of goods sold, $267,641 (entered on line 8 and on page 1, line 2).

The partnership answered all applicable questions for item 9.

Schedule B

Schedule B contains 11 questions about the partnership. Answer question 1 by marking the appropriate box. Answer questions 2 through 11 by marking the ''Yes'' or ''No'' boxes.

Question 5 asks if the partnership meets all the requirements listed in items 5a, b, and c. If all three of these requirements are met, mark the ''Yes'' box of question 5 and the partnership is not required to complete Schedules L, M–1, and M–2; item F on page 1 of Form 1065; or item J on Schedule K–1.

Page 3

Schedule K

Schedule K must be completed by all partnerships. It lists the total of all partners' shares of income, deductions, credits, etc. The partnership agreement provides for the manner in which the partners will share each item of income, gain, loss, deduction, or credit, etc., of the partnership. If the main purpose of any provision in the partnership agreement regarding a partner's share of any item is to evade or avoid federal income tax, the provision will be disregarded.

Each partner's distributive share of income, deductions, credits, etc., should be reported on Schedule K–1. The line items for Schedule K are discussed in combination with the Schedule K–1 line items, later.

Page 4

Schedules L, M–1, and M–2

Partnerships do not have to complete Schedules L, M–1, or M–2 if all of the tests listed under question 5 are met and question 5 on page 2 is marked ''Yes.'' The AbleBaker Book Store does not meet all of the tests, so these schedules must be completed.

Schedule L

Schedule L contains the partnership's balance sheets at the beginning and end of the tax year. All information shown on the balance sheets for the AbleBaker Book Store should agree with its books of record. Any differences should be reconciled and explained in a separate schedule attached to the return.

The entry for total assets at the end of the year, $45,391, is carried to item F at the top of page 1 since the answer to question 5 on Schedule B was ''No.''

Schedule M–1

Schedule M–1 is the reconciliation of income per the partnership books with income per Form 1065.

Line 1. This line shows the net income per books of $48,920. This amount is from the profit and loss account (not shown in this example).

Line 3. This line shows the guaranteed payments to partners.

Line 5. This is the total of lines 1 through 4 of $73,920.

Line 6. Included in line 6 is the $50 tax-exempt interest income from municipal bonds that is recorded on the books but not included on Schedule K, lines 1 through 7. Each partner's share of this interest is reported on his or her Schedule K–1 on line 19.

Line 9. This line is the same as Schedule K, line 25a. It is also the same as line 5 less line 8 (Schedule M–1), $73,870.

Schedule M–2

Schedule M–2 is an analysis of the partners' capital accounts. It shows the total equity of all partners at the beginning and end of the tax year and shows the adjustments that caused any increase or decrease. The total of all the partners' capital accounts is the difference between the partnership's assets and liabilities shown on Schedule L. A partner's capital account will not necessarily represent the tax basis for an interest in the partnership.

Line 1. As of January 1, the total of the partners' capital accounts was $27,550 (Frank—$14,050; Susan—$13,500). This amount should agree with the beginning balance shown on Schedule L for the partners' capital accounts.

Line 3. This is the net income per the books.

Line 5. This is the total of lines 1 through 4.

Line 6. Each partner withdrew $26,440 (totaling $52,880) from the partnership. The partners' guaranteed payments, which were actually paid, are not included in this column because they were deducted when figuring the amount shown on line 3. Any other distributions to the partners, in cash or other property, would also be included here.

Line 9. This shows the total equity of all partners as shown in the books of account as of December 31. This amount should agree with the year-end balance shown on Schedule L for the partners' capital accounts.

Item J on Schedule K–1 reflects each partner's share of the amounts shown on lines 1 through 9 of Schedule M–2.

Schedule K–1

Schedule K–1 lists each partner's share of income, deductions, credits, etc. It also shows where to report the items on the partner's individual income tax return. Illustrated is a copy of the Schedule K–1 for Frank W. Able. All information asked for at the top of Schedule K–1 must be supplied for each partner.

Since all line items on Schedule K–1 are not applicable to every partnership, a substitute Schedule K–1 may be used. See the instructions for Form 1065 for more information.

Allocation of Partnership Items

The partners' shares of income, deductions, etc., are shown next.

Income (Loss)

Line 1. This line on Schedule K–1 shows Frank's share ($24,685) of the income from the partnership shown on Form 1065, page 1, line 22. The total income to all partners is shown on line 1, Schedule K.

Line 4b. Dividends must be separately stated. They are not included in the income (loss) of the partnership on Form 1065, page 1, line 22. This line on Schedule K–1 shows Frank's share, $75. This line on Schedule K shows the total dividends of $150.

Line 5. This line on Schedule K–1 shows only the guaranteed payments to Frank of $20,000. This line on Schedule K shows the total guaranteed payments to both partners of $25,000.

Deductions

Line 8. During the year, the partnership made a $650 cash contribution to the American Lung Association. Each partner who itemizes deductions can deduct all or part of his or her share of the partnership's charitable contributions on his or her individual income tax return. Frank's share of the contribution ($325) is entered on line 8, Schedule K–1. This line on Schedule K shows the total contribution. For more information, see Publication 526, *Charitable Contributions.*

Investment Interest

Lines 12a–12b. The partnership's total interest on investment debt and items of investment income and expenses are entered on the applicable lines of Schedule K, and each partner's share is entered on Schedule K–1. For more information, see Publication 550, *Investment Income and Expenses,* and the instructions for Form 1065. This partnership did not have any investment interest expense or other investment expenses. It did have investment income as shown on line 4b, Schedule K. The total of all investment income, lines 4a, b, c, and f, is shown on line 12b(1), Schedule K, and the partner's share is shown on line 12b(1), Schedule K–1.

Self-Employment Tax

Line 15a. Net earnings (loss) from self-employment are entered on Schedule K, and each individual partner's share is shown on his or her Schedule K–1.

Tax-Exempt Interest Income

Line 19. Frank enters $25 on line 19.

Distributions

Line 22. Frank enters the $52,880 cash withdrawals made by the partners during the year on Schedule K and the amount each partner withdrew on the partner's Schedule K–1.

Analysis

Lines 25a–25b (Schedule K only). An analysis must be made of the distributive items on Schedule K. This analysis is based on the type of partner. Since the AbleBaker Book Store has two general partners, the entries are $73,870 on lines 25a and 25b(1), column (b)i.

Form **1065**
Department of the Treasury
Internal Revenue Service

U.S. Partnership Return of Income

For calendar year 1995, or tax year beginning ...., 1995, and ending ...., 19 ....
▶ See separate instructions.

OMB No. 1545-0099

1995

A Principal business activity: Retail	Use the IRS label. Otherwise, please print or type.	Name of partnership: 10-9876543 DEC95 D71 I R S / AbleBaker Book Store / 334 West Main Street / Orange, MD 20904	D Employer identification number
B Principal product or service: Books			E Date business started: 10-1-79
C Business code number: 5942			F Total assets (see page 10 of the instructions): $ 45,391

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return
H Check accounting method: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ 2

Caution: *Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income	1a	Gross receipts or sales	1a	409,465		
	b	Less returns and allowances	1b	3,365	1c	406,100
	2	Cost of goods sold (Schedule A, line 8)			2	267,641
	3	Gross profit. Subtract line 2 from line 1c			3	138,459
	4	Ordinary income (loss) from other partnerships, estates, and trusts *(attach schedule)*			4	
	5	Net farm profit (loss) *(attach Schedule F (Form 1040))*			5	
	6	Net gain (loss) from Form 4797, Part II, line 20			6	
	7	Other income (loss) *(attach schedule)*			7	559
	8	**Total income (loss).** Combine lines 3 through 7			8	139,018
Deductions (see page 11 of the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	29,350
	10	Guaranteed payments to partners			10	25,000
	11	Repairs and maintenance			11	1,125
	12	Bad debts			12	250
	13	Rent			13	20,000
	14	Taxes and licenses			14	3,295
	15	Interest			15	1,451
	16a	Depreciation (if required, attach Form 4562)	16a	1,174		
	b	Less depreciation reported on Schedule A and elsewhere on return	16b	-0-	16c	1,174
	17	Depletion **(Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	
	20	Other deductions *(attach schedule)*			20	8,003
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	89,648
	22	**Ordinary income (loss)** from trade or business activities. Subtract line 21 from line 8			22	49,370

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member) is based on all information of which preparer has any knowledge.

▶ Frank W. Able — Signature of general partner or limited liability company member ▶ 3/12/96 — Date

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address ▶		EIN ▶	
		ZIP code ▶	

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 11390Z Form **1065** (1995)

Schedule A Cost of Goods Sold (see page 13 of the instructions)

1	Inventory at beginning of year	1	18,125
2	Purchases less cost of items withdrawn for personal use	2	268,741
3	Cost of labor	3	-0-
4	Additional section 263A costs *(attach schedule)*	4	-0-
5	Other costs *(attach schedule)*	5	-0-
6	**Total.** Add lines 1 through 5	6	286,866
7	Inventory at end of year	7	19,225
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	267,641

9a Check all methods used for valuing closing inventory:
- (i) ☐ Cost as described in Regulations section 1.471-3
- (ii) ☑ Lower of cost or market as described in Regulations section 1.471-4
- (iii) ☐ Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c). ▶ ☐

c Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)*. ▶ ☐

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? ☐ Yes ☑ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☑ No
If "Yes," attach explanation.

Schedule B Other Information

		Yes	No
1	What type of entity is filing this return? Check the applicable box ▶ ☑ General partnership ☐ Limited partnership ☐ Limited liability company		
2	Are any partners in this partnership also partnerships?		✓
3	Is this partnership a partner in another partnership?		✓
4	Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see **Designation of Tax Matters Partner below**		✓
5	Does this partnership meet **ALL THREE** of the following requirements?		
a	The partnership's total receipts for the tax year were less than $250,000;		
b	The partnership's total assets at the end of the tax year were less than $600,000; **AND**		
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item J on Schedule K-1		✓
6	Does this partnership have any foreign partners?		✓
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		✓
8	Has this partnership filed, or is it required to file, **Form 8264,** Application for Registration of a Tax Shelter?		✓
9	At any time during calendar year 1995, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 14 of the instructions for exceptions and filing requirements for Form TD F 90-22.1.) If "Yes," enter the name of the foreign country. ▶		✓
10	Was the partnership the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the partnership or any partner has any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		✓
11	Was there a distribution of property or a transfer (e.g., by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under **Elections Made By the Partnership** on page 5 of the instructions		✓

Designation of Tax Matters Partner (see page 14 of the instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶ Identifying number of TMP ▶

Address of designated TMP ▶

Schedule K Partners' Shares of Income, Credits, Deductions, etc.

	(a) Distributive share items		(b) Total amount
Income (Loss)	1 Ordinary income (loss) from trade or business activities (page 1, line 22)	1	49,370
	2 Net income (loss) from rental real estate activities *(attach Form 8825)*	2	
	3a Gross income from other rental activities — 3a		
	b Expenses from other rental activities *(attach schedule)* — 3b		
	c Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4 Portfolio income (loss): a Interest income	4a	
	b Dividend income	4b	150
	c Royalty income	4c	
	d Net short-term capital gain (loss) *(attach Schedule D (Form 1065))*	4d	
	e Net long-term capital gain (loss) *(attach Schedule D (Form 1065))*	4e	
	f Other portfolio income (loss) *(attach schedule)*	4f	
	5 Guaranteed payments to partners	5	25,000
	6 Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*	6	
	7 Other income (loss) *(attach schedule)*	7	
Deductions	8 Charitable contributions *(attach schedule)*	8	650
	9 Section 179 expense deduction *(attach Form 4562)*	9	
	10 Deductions related to portfolio income (itemize)	10	
	11 Other deductions *(attach schedule)*	11	
Investment Interest	12a Interest expense on investment debts	12a	
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	12b(1)	150
	(2) Investment expenses included on line 10 above	12b(2)	
Credits	13a Low-income housing credit:		
	(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	13a(1)	
	(2) Other than on line 13a(1) for property placed in service before 1990	13a(2)	
	(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	13a(3)	
	(4) Other than on line 13a(3) for property placed in service after 1989	13a(4)	
	b Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*	13b	
	c Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities	13c	
	d Credits related to other rental activities	13d	
	14 Other credits	14	
Self-Employment	15a Net earnings (loss) from self-employment	15a	74,370
	b Gross farming or fishing income	15b	
	c Gross nonfarm income	15c	
Adjustments and Tax Preference Items	16a Depreciation adjustment on property placed in service after 1986	16a	
	b Adjusted gain or loss	16b	
	c Depletion (other than oil and gas)	16c	
	d (1) Gross income from oil, gas, and geothermal properties	16d(1)	
	(2) Deductions allocable to oil, gas, and geothermal properties	16d(2)	
	e Other adjustments and tax preference items *(attach schedule)*	16e	
Foreign Taxes	17a Type of income ▶ .... b Foreign country or U.S. possession ▶		
	c Total gross income from sources outside the United States *(attach schedule)*	17c	
	d Total applicable deductions and losses *(attach schedule)*	17d	
	e Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	17e	
	f Reduction in taxes available for credit *(attach schedule)*	17f	
	g Other foreign tax information *(attach schedule)*	17g	
Other	18 Section 59(e)(2) expenditures: a Type ▶ .... b Amount ▶	18b	
	19 Tax-exempt interest income	19	50
	20 Other tax-exempt income	20	
	21 Nondeductible expenses	21	
	22 Distributions of money (cash and marketable securities)	22	52,880
	23 Distributions of property other than money	23	
	24 Other items and amounts required to be reported separately to partners *(attach schedule)*		
Analysis	25a Income (loss). Combine lines 1 through 7 in column (b). From the result, subtract the sum of lines 8 through 12a, 17e, and 18b	25a	73,870

b Analysis by type of partner:

	(a) Corporate	(b) Individual i. Active	(b) Individual ii. Passive	(c) Partnership	(d) Exempt organization	(e) Nominee/Other
(1) General partners		73,870				
(2) Limited partners						

Note: *If Question 5 of Schedule B is answered "Yes," the partnership is not required to complete Schedules L, M-1, and M-2.*

Schedule L Balance Sheets

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash		3,455		3,350
2a Trade notes and accounts receivable	7,150		10,990	
b Less allowance for bad debts		7,150		10,990
3 Inventories		18,125		19,225
4 U.S. government obligations				
5 Tax-exempt securities		1,000		1,000
6 Other current assets *(attach schedule)*				
7 Mortgage and real estate loans				
8 Other investments *(attach schedule)*		1,000		1,000
9a Buildings and other depreciable assets	15,000		15,000	
b Less accumulated depreciation	4,000	11,000	5,174	9,826
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets *(attach schedule)*				
14 **Total** assets		41,730		45,391
Liabilities and Capital				
15 Accounts payable		10,180		10,462
16 Mortgages, notes, bonds payable in less than 1 year		4,000		3,600
17 Other current liabilities *(attach schedule)*				
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more				7,739
20 Other liabilities *(attach schedule)*				
21 Partners' capital accounts		27,550		23,590
22 **Total** liabilities and capital		41,730		45,391

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return (see page 23 of the instructions)

1 Net income (loss) per books	48,920	6 Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize): a Tax-exempt interest $	50
2 Income included on Schedule K, lines 1 through 4, 6, and 7, not recorded on books this year (itemize):			
3 Guaranteed payments (other than health insurance)	25,000	7 Deductions included on Schedule K, lines 1 through 12a, 17e, and 18b, not charged against book income this year (itemize): a Depreciation $	
4 Expenses recorded on books this year not included on Schedule K, lines 1 through 12a, 17e, and 18b (itemize): a Depreciation $ b Travel and entertainment $		8 Add lines 6 and 7	50
5 Add lines 1 through 4	73,920	9 Income (loss) (Schedule K, line 25a). Subtract line 8 from line 5	73,870

Schedule M-2 Analysis of Partners' Capital Accounts

1 Balance at beginning of year	27,550	6 Distributions: a Cash	52,880
2 Capital contributed during year		b Property	
3 Net income (loss) per books	48,920	7 Other decreases (itemize):	
4 Other increases (itemize):		8 Add lines 6 and 7	52,880
5 Add lines 1 through 4	76,470	9 Balance at end of year. Subtract line 8 from line 5	23,590

Printed on recycled paper

SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1995 or tax year beginning , 1995, and ending , 19

OMB No. 1545-0099

1995

Partner's identifying number ▶ 123-00-6789 **Partnership's identifying number ▶** 10 9876543

Partner's name, address, and ZIP code
Frank W. Able
10 Green Street
Orange, MD 20904

Partnership's name, address, and ZIP code
Able Baker Book Store
334 West Main Street
Orange, MD 20904

A This partner is a ☑ general partner ☐ limited partner ☐ limited liability company member

B What type of entity is this partner? ▶ Individual

C Is this partner a ☑ domestic or a ☐ foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	%	50 %
Loss sharing	%	50 %
Ownership of capital	%	50 %

E IRS Center where partnership filed return: Philadelphia

F Partner's share of liabilities (see instructions):
Nonrecourse . . . $
Qualified nonrecourse financing . $
Other . . . $ 10,900

G Tax shelter registration number ▶ N/A

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) . . . . ☐

I Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

J **Analysis of partner's capital account:**

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
14,050		24,460	(26,440)	12,070

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	24,685	See pages 5 and 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a		Sch. B, Part I, line 1
	b Dividends	4b	75	Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e Net long-term capital gain (loss)	4e		Sch. D, line 13, col. (f) or (g)
	f Other portfolio income (loss) *(attach schedule)*	4f		Enter on applicable line of your return
	5 Guaranteed payments to partner	5	20,000	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	6 Net gain (loss) under section 1231 (other than due to casualty or theft)	6		
	7 Other income (loss) *(attach schedule)*	7		Enter on applicable line of your return
Deductions	8 Charitable contributions (see instructions) *(attach schedule)*	8	325	Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
	10 Deductions related to portfolio income *(attach schedule)*	10		
	11 Other deductions *(attach schedule)*	11		
Investment Interest	12a Interest expense on investment debts	12a		Form 4952, line 1
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)	75	See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
	(2) Investment expenses included on line 10 above	b(2)		
Credits	13a Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
	(2) Other than on line 13a(1) for property placed in service before 1990	a(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
	(4) Other than on line 13a(3) for property placed in service after 1989	a(4)		
	b Qualified rehabilitation expenditures related to rental real estate activities	13b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	c Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities	13c		
	d Credits related to other rental activities	13d		
	14 Other credits	14		

For Paperwork Reduction Act Notice, see Instructions for Form 1065. Cat. No. 11394R **Schedule K-1 (Form 1065) 1995**

Section		(a) Distributive share item	Line	(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Self-employment	15a	Net earnings (loss) from self-employment	15a	44,685	Sch. SE, Section A or B
	b	Gross farming or fishing income	15b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	c	Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16a	Depreciation adjustment on property placed in service after 1986	16a		See pages 8 and 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251.
	b	Adjusted gain or loss	16b		
	c	Depletion (other than oil and gas)	16c		
	d	(1) Gross income from oil, gas, and geothermal properties	d(1)		
		(2) Deductions allocable to oil, gas, and geothermal properties	d(2)		
	e	Other adjustments and tax preference items *(attach schedule)*	16e		
Foreign Taxes	17a	Type of income ▶			Form 1116, check boxes
	b	Name of foreign country or U.S. possession ▶			Form 1116, Part I
	c	Total gross income from sources outside the United States *(attach schedule)*	17c		
	d	Total applicable deductions and losses *(attach schedule)*	17d		
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	17f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	17g		See Instructions for Form 1116
Other	18	Section 59(e)(2) expenditures: a Type ▶			See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	b	Amount	18b		
	19	Tax-exempt interest income	19	25	Form 1040, line 8b
	20	Other tax-exempt income	20		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	21	Nondeductible expenses	21		
	22	Distributions of money (cash and marketable securities)	22	24,440	
	23	Distributions of property other than money	23		
	24	Recapture of low-income housing credit:			
	a	From section 42(j)(5) partnerships	24a		Form 8611, line 8
	b	Other than on line 24a	24b		

Supplemental Information

25 Supplemental information required to be reported separately to each partner *(attach additional schedules if more space is needed)*:

39.

Form 1120-A Corporation (Short-Form)

Rose Flower Shop, Inc., is the corporation for which this sample return is filled out. Rose Flower Shop operates a business that sells fresh cut flowers and plants. It uses an accrual method of accounting and files its return on the calendar year.

A corporation can file Form 1120–A if it has gross receipts under $500,000, total income under $500,000, total assets under $500,000, and meets certain other requirements. Since Rose Flower Shop met all these requirements for 1995, it filed Form 1120–A.

Page 1

When you prepare your return, use the preaddressed label sent to you by the IRS. It is designed to expedite processing and prevent errors. If you do not have a pre-addressed label, enter your corporation's name, street address, city, state, ZIP code, and employer identification number in the appropriate spaces on the first page.

Show the name and employer identification number of the corporation in the top margin of schedules and attachments to Form 1120–A.

Fill in the items of income, deduction, tax, and payments listed on page 1 that apply to the business. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales, line 1a, for the year totaled $248,000 using an accrual method of accounting. After subtracting returned goods and allowances of $7,500, line 1c shows net sales of $240,500.

Line 2. Cost of goods sold is $144,000. Figure this using the worksheet (not illustrated) in the form instructions.

Line 3. Net sales less cost of goods sold results in a gross profit of $96,500.

Lines 4 through 10. Other items of income are next. During the year, the only other item of income was taxable interest of $942, shown on line 5.

Line 11. Total income is $97,442.

Line 12. The $23,000 is the salary of the company president.

Line 13. Other salaries and wages of $24,320 are entered here. This includes only salaries and wages neither included on line 12 nor deducted as part of cost of goods sold on line 2.

Line 16. Rent for Rose Flower Shop's store was $6,000 for the year.

Line 17. Deductible taxes totaled $3,320.

Line 18. Interest expense accrued during the year was $1,340. This includes interest both on debts for business operations and debts to carry investments. It does not include interest to carry tax-exempt securities. See chapter 8 of Publication 535, *Business Expenses,* for a discussion of deductible interest.

Line 19. During the year, Rose Flower Shop contributed $1,820 to various charitable organizations. The $1,820 is less than the limit for deductible contributions, which is 10% of taxable income figured without the contribution deduction and special deductions entered on line 25b.

Line 22. Other business deductions consist of $3,000 for advertising. If there had been several expenses included in the total, Rose Flower Shop would have to prepare and attach a supporting schedule.

Line 23. Total of lines 12 through 22 is $62,800.

Lines 24, 25, and 26. Taxable income, before the net operating loss deduction and special deductions, on line 24 is $34,642. Since Rose Flower Shop did not have a net operating loss or special deduction, the same amount is shown on line 26.

Tax summary. Rose Flower Shop enters on line 27 the total tax ($5,196) from Part I, line 7, page 2. It lists payments that can be applied against the tax on line 28. The only payments on the Rose Flower Shop return are four estimated tax deposits totaling $6,000. Enter this amount on lines 28b, 28d, and 28h. The resulting overpayment is $804, which Rose Flower Shop chooses to have credited to its 1996 estimated tax. Rose Flower Shop could have the overpayment refunded.

Signature. An authorized corporate officer must manually sign the return.

Page 2

Part I—Tax Computation. Use the tax rate schedule in the form instructions to figure the tax on line 1. Lines 3, 5, and 6, the other taxes and credits listed on Part I, do not apply to Rose Flower Shop. The tax of $5,196 is entered on lines 1, 4, and 7.

Part II—Other Information. Answer all questions that apply to your business. Provide the business activity code number, business activity, and product or service information on lines (a), (b), and (c) of question 1. The business activity codes are provided in the instructions for Forms 1120 and 1120–A. Purchases of $134,014 appear on line (1) of question 5a. Other costs of $9,466 appear on line (3) of question 5a. The supporting itemization is not illustrated. These costs consist of costs directly related to the sale of flowers, wreaths, and plants, such as flower pots, vases, stands, boxes, and tissue paper.

Part III—Balance Sheets. Provide comparative balance sheets for the beginning and end of the tax year. Entries in Part III should agree with amounts shown elsewhere on the return or included on a worksheet. For example, the figures for beginning and ending inventories must be the same as those appearing on the worksheet in the form instructions for cost of goods sold.

Part IV—Reconciliation of Income (Loss) per Books With Income per Return. All Form 1120–A corporate filers must complete Part IV unless total assets on line 12, column (b) of Part III are less than $25,000. Since total assets of Rose Flower Shop exceed this amount, it completes Part IV.

To properly complete Part IV, you need additional information from the corporation's books and records. The following profit and loss account appeared in the books of Rose Flower Shop for the calendar year 1995:

Account	Debit	Credit
Gross sales		$248,000
Sales returns and allowances	$ 7,500	
Cost of goods sold	144,000	
Interest income		942
Compensation of officers	23,000	
Salaries and wages	24,320	
Rents	6,000	
Taxes	3,320	
Interest expense	1,340	
Contributions	1,820	
Advertising	3,000	
Federal income tax accrued	5,196	
Net income per books after tax	29,446	
Total	$248,942	$248,942

Part IV starts with the net income (loss) per books, after reduction for federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 24, page 1.

Line 1. $29,446 is the net income per books. It appears in the profit and loss account as net income per books after tax.

Line 2. $5,196 is the federal income tax accrued for the tax year.

Line 8. $34,642 is the taxable income on line 24, page 1.

Form **1120-A** Department of the Treasury Internal Revenue Service

U.S. Corporation Short-Form Income Tax Return

See separate instructions to make sure the corporation qualifies to file Form 1120-A.

For calendar year 1995 or tax year beginning ...., 1995, ending ...., 19.....

OMB No. 1545-0890

1995

A Check this box if the corp. is a personal service corp. (as defined in Temporary Regs. section 1.441-4T—see instructions) ▶ ☐

Use IRS label. Otherwise, print or type.

10-2134567 DEC95 5995
Rose Flower Shop, Inc.
38 Superior Lane
Fair City, MD 20715

B Employer identification number

C Date incorporated 7-1-82

D Total assets (see page 6 of instructions) $ 65,987

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Change of address

F Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶

Income

1a	Gross receipts or sales 248,000 b Less returns and allowances 7,500 c Balance ▶	1c	240,500
2	Cost of goods sold (see page 12 of instructions)	2	144,000
3	Gross profit. Subtract line 2 from line 1c	3	96,500
4	Domestic corporation dividends subject to the 70% deduction	4	
5	Interest	5	942
6	Gross rents	6	
7	Gross royalties	7	
8	Capital gain net income (attach Schedule D (Form 1120))	8	
9	Net gain or (loss) from Form 4797, Part II, line 20 (attach Form 4797)	9	
10	Other income (see page 7 of instructions)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	97,442

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (see page 8 of instructions)	12	23,000
13	Salaries and wages (less employment credits)	13	24,320
14	Repairs and maintenance	14	
15	Bad debts	15	
16	Rents	16	6,000
17	Taxes and licenses	17	3,320
18	Interest	18	1,340
19	Charitable contributions (see page 9 of instructions for 10% limitation)	19	1,820
20	Depreciation (attach Form 4562) 20		
21	Less depreciation claimed elsewhere on return 21a	21b	
22	Other deductions (attach schedule)	22	3,000
23	**Total deductions.** Add lines 12 through 22 ▶	23	62,800
24	Taxable income before net operating loss deduction and special deductions. Subtract line 23 from line 11	24	34,642
25	**Less:** a Net operating loss deduction (see page 11 of instructions) 25a; b Special deductions (see page 11 of instructions) 25b	25c	

Tax and Payments

26	**Taxable income.** Subtract line 25c from line 24	26	34,642
27	**Total tax** (from page 2, Part I, line 7)	27	5,196
28	**Payments:**		
a	1994 overpayment credited to 1995 28a		
b	1995 estimated tax payments 28b 6,000		
c	Less 1995 refund applied for on Form 4466 28c ( ) Bal ▶ 28d 6,000		
e	Tax deposited with Form 7004 28e		
f	Credit from regulated investment companies (attach Form 2439) 28f		
g	Credit for Federal tax on fuels (attach Form 4136). See instructions 28g		
h	**Total payments.** Add lines 28d through 28g	28h	6,000
29	Estimated tax penalty (see page 12 of instructions). Check if Form 2220 is attached ▶ ☐	29	
30	**Tax due.** If line 28h is smaller than the total of lines 27 and 29, enter amount owed	30	
31	**Overpayment.** If line 28h is larger than the total of lines 27 and 29, enter amount overpaid	31	804
32	Enter amount of line 31 you want: **Credited to 1996 estimated tax** ▶ 804 **Refunded** ▶	32	

Sign Here

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

George Rose — Signature of officer | 2-15-96 — Date | President — Title

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ▶ ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address | EIN ▶ | ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of the instructions. Cat. No. 11456E Form **1120-A** (1995)

Part I Tax Computation (See page 14 of instructions.)

1 Income tax. If the corporation is a qualified personal service corporation (see page 15), check here ▶ ☐		1	5,196
2a General business credit. Check if from: ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586 ☐ Form 8830 ☐ Form 8826 ☐ Form 8835 ☐ Form 8844 ☐ Form 8845 ☐ Form 8846 ☐ Form 8847	2a		
b Credit for prior year minimum tax (attach Form 8827)	2b		
3 **Total credits.** Add lines 2a and 2b		3	
4 Subtract line 3 from line 1		4	5,196
5 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611		5	
6 Alternative minimum tax (attach Form 4626)		6	
7 **Total tax.** Add lines 4 through 6. Enter here and on line 27, page 1		7	5,196

Part II Other Information (See page 17 of instructions.)

1 See page 19 of the instructions and state the principal:
- a Business activity code no. ▶ 5995
- b Business activity ▶ Flower Shop
- c Product or service ▶ Flowers

2 Did any individual, partnership, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) Schedule not shown ☑ Yes ☐ No

If "Yes," attach a schedule showing name and identifying number.

3 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ -0-

4 Enter amount of cash distributions and the book value of property (other than cash) distributions made in this tax year ▶ $ -0-

5a If an amount is entered on line 2, page 1, see the worksheet on page 12 for amounts to enter below:
- (1) Purchases 134,014
- (2) Additional sec. 263A costs (attach schedule)
- (3) Other costs (attach schedule) 9,466

b Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☑ No

6 At any time during the 1995 calendar year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the corporation may have to file Form TD F 90-22.1 ☐ Yes ☑ No

If "Yes," enter the name of the foreign country ▶

Part III Balance Sheets

		(a) Beginning of tax year	(b) End of tax year
Assets	1 Cash	20,540	18,498
	2a Trade notes and accounts receivable		
	b Less allowance for bad debts	( )	( )
	3 Inventories	2,530	2,010
	4 U.S. government obligations	13,807	45,479
	5 Tax-exempt securities (see instructions)		
	6 Other current assets (attach schedule)		
	7 Loans to stockholders		
	8 Mortgage and real estate loans		
	9a Depreciable, depletable, and intangible assets		
	b Less accumulated depreciation, depletion, and amortization	( )	( )
	10 Land (net of any amortization)		
	11 Other assets (attach schedule)		
	12 Total assets	36,877	65,987
Liabilities and Stockholders' Equity	13 Accounts payable	6,415	6,079
	14 Other current liabilities (attach schedule)		
	15 Loans from stockholders		
	16 Mortgages, notes, bonds payable		
	17 Other liabilities (attach schedule)		
	18 Capital stock (preferred and common stock)	20,000	20,000
	19 Paid-in or capital surplus		
	20 Retained earnings	10,462	39,908
	21 Less cost of treasury stock	( )	( )
	22 Total liabilities and stockholders' equity	36,877	65,987

Part IV Reconciliation of Income (Loss) per Books With Income per Return *(You are not required to complete Part IV if the total assets on line 12, column (b), Part III are less than $25,000.)*

1 Net income (loss) per books	29,446	6 Income recorded on books this year not included on this return (itemize)	
2 Federal income tax	5,196	7 Deductions on this return not charged against book income this year (itemize)	
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)			
5 Expenses recorded on books this year not deducted on this return (itemize)		8 Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	34,642

Printed on recycled paper

40.

Form 1120 Corporation

Tentex Toys, Inc., is the corporation for which this sample return is filled out. Tentex manufactures and sells children's toys and games. It uses an accrual method of accounting and files its return on the calendar year.

Page 1

When you prepare your return, use the preaddressed label sent to you by the IRS. It is designed to expedite processing and prevent errors. If you do not have a pre-addressed label, enter your corporation's name, street address, city, state, ZIP code, and employer identification number in the appropriate spaces on the first page.

Show the name and employer identification number of the corporation in the top margin of schedules and attachments to Form 1120.

Fill in the items of income, deduction, tax, and payments listed on page 1 that apply to the business. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales, line 1a, for the year totaled $2,010,000 using an accrual method of accounting. After subtracting returned goods and allowances of $20,000, line 1c shows net sales of $1,990,000.

Line 2. Cost of goods sold is $1,520,000. This is the total from Schedule A (line 8) on page 2.

Line 3. Net sales less cost of goods sold results in gross profit of $470,000.

Lines 4 through 10. Enter other items of income next. During the year, Tentex received $10,000 of dividends from domestic corporations, $5,000 of tax-exempt interest from state bonds, and $4,000 of taxable interest. It also received $1,500 interest on its business accounts receivable. Enter the gross amount of dividends on line 4 (you take the dividends-received deduction on line 29b). Line 5 shows total taxable interest of $5,500. Do not include tax-exempt interest in income.

Line 11. Total income is $485,500.

Line 12. Enter the salaries of $70,000 paid to company officers listed on Schedule E. Complete Schedule E because total receipts (line 1a plus lines 4 through 10 of page 1) exceed $500,000.

Line 13. Enter other salaries and wages of $38,000. This includes only salaries and wages neither included on line 12 nor deducted as part of cost of goods sold on line 2. For a manufacturing company such as Tentex, this amount represents nonmanufacturing salaries and wages, such as office salaries. See chapter 9 for a discussion of salaries and wages.

Tentex is eligible for a $6,000 jobs credit figured on Form 5884 (not illustrated). You reduce the total amount of other salaries and wages, $44,000, by the $6,000 credit that is included on line 4d, Schedule J. Only the balance, $38,000, is shown on line 13.

Line 14. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. Repairs total $800. See chapter 19 for information on repairs, improvements, and replacements.

Line 15. Tentex uses the specific charge-off method of accounting for bad debts. Actual accounts written off during the year total $1,600. See chapter 14 for information on bad debt deductions.

Line 16. Rent for Tentex's office facilities was $9,200 for the year.

Line 17. Deductible taxes totaled $15,000.

Line 18. Interest expense accrued during the year was $27,200. This includes interest both on debts for business operations and debts to carry investments. It does not include interest to carry tax-exempt securities. See chapter 16 for a discussion of deductible interest.

Line 19. During the year, Tentex contributed $11,400 to the United Community Fund and $12,600 to the State University Scholarship Fund. The total, $24,000, is more than the limit for deductible contributions, which is 10% of taxable income figured without the contribution deduction and special deductions entered on line 29b. The amount allowable on line 19 is $23,150. The excess, $850, not deductible this year, can be carried over to a later year, as explained in chapter 29. Also, during the year, Tentex made nondeductible contributions of $500.

Lines 20 and 21. Depreciation from Form 4562 (not illustrated) is $17,600. Enter it on line 20. Reduce this amount by the depreciation claimed on Schedule A ($12,400) and enter it on line 21a. Deduct the balance ($5,200) on line 21b since it is the depreciation on the assets used in the indirect operations of the business.

Line 22. Tentex does not have a depletion deduction. For information on depletion, see chapter 13.

Line 23. Advertising expense was $8,700.

Lines 24 and 25. Tentex does not have a profit-sharing, stock bonus, pension, or annuity plan. For information on retirement plans, see chapter 10.

Line 26. Other business deductions total $78,300. This includes miscellaneous office expenses, sales commissions, legal fees, etc. Attach a schedule that itemizes these expenses to the return. This example does not show the supporting itemization.

Line 27. Total of lines 12 through 26 is $277,150.

Lines 28, 29, and 30. Taxable income before the net operating loss deduction and special deductions on line 28 is $208,350. Since Tentex did not have a net operating loss, its only entry on line 29 is the dividends-received deduction of $8,000 from Schedule C, page 2. Enter this amount on lines 29b and 29c. Taxable income on line 30 is $200,350.

Tax summary. Enter on line 31 the total tax ($55,387) from Schedule J, page 3. List payments that you can apply against the tax on line 32. The only payments on the Tentex return are four estimated tax deposits totaling $69,117. Enter this amount on lines 32b, 32d, and 32h. The resulting overpayment is $13,730, which Tentex chooses to have credited to its 1996 estimated tax. Tentex could have the overpayment refunded.

Signature. An authorized corporate officer must manually sign the return.

Page 2

Schedule A—Cost of Goods Sold. Use Schedule A to report your cost of goods sold. This figure is beginning inventory, plus merchandise bought or produced during the year, less ending inventory. Because Tentex is a manufacturer, it must account for its costs of manufacturing as part of cost of goods sold. It valued goods on hand at the beginning of the year at $126,000 and at the end of the year at $298,400, using the lower of cost or market.

Add cost of goods manufactured during the year to beginning inventory. This cost consists of three items: direct materials, direct labor, and overhead. List material costs of $1,127,100 on line 2. This includes subcontracted parts as well as raw materials.

Salaries and wages on line 3 are $402,000. This amount includes wages paid to production-line workers and the part of the supervisory salaries that was for actual production of goods. It also includes 30% of the salaries paid to officers. Do not include payments already deducted on line 12 or 13 of page 1.

The $40,000 on line 4 is for indirect general administration costs. Other costs of $123,300 appear on line 5. These costs include factory overhead such as electricity, fuel, water, small tools, and depreciation on production-line machinery. This example does not show the supporting itemization. Note that $12,400 is depreciation on the assets used in the direct operations of the business. See chapter 7 for a detailed discussion of cost of goods sold.

Lines 9a through 9f. Check all of the boxes that apply to the business.

Schedule C—Dividends and Special Deductions. Dividend income is $10,000, all of which qualified for the 80% dividends-received deduction, line 2, because Tentex is a 20%-or-more owner. Enter the total dividends received on line 19, Schedule C, and on line 4 of page 1. Enter the total dividends-received deduction on line 20, Schedule C and on line 29b of page 1.

Schedule E—Compensation of Officers. Complete this schedule only if your total receipts (line 1a plus lines 4 through 10 of page 1) are $500,000 or more. (Tentex meets this requirement.) Since Tentex has only three officers, these are the only entries on the schedule. Include here only compensation for services rendered. Do not include dividends on stock held by the corporate officers.

Page 3

Schedule J—Tax Computation. Use the tax rate schedules in the form instructions to figure the tax on line 3. Applying the rates to Tentex's taxable income of $200,350 results in income tax of $61,387. Decrease this amount by the jobs credit of $6,000, resulting in a total tax of $55,387.

Figure the jobs credit by multiplying $15,000 of wages paid to five qualified employees in their first year of employment by the 40% rate. They are certified members of a targeted group. Each was hired before December 31, 1994, and earned $3,000 in salary in 1995. Tentex files Form 5884 (not illustrated) with its return to support this credit.

Other taxes and credits listed on Schedule J do not apply to Tentex for 1995.

Schedule K—Other Information. Answer all questions that apply to the business.

Page 4

Schedule L—Balance Sheets. Provide comparative balance sheets for the beginning and end of the tax year. Entries on this page should agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing on Schedule A, page 2. Note that the appropriated retained earnings of Tentex increased from $30,000 to $40,000 during the year, due to the setting aside of $10,000 as a reserve for contingencies. Tentex took this amount out of unappropriated retained earnings, as shown on Schedule M–2.

Schedules M–1 and M–2. Tentex completes Schedules M–1 and M–2 because the amount of total assets (line 15, column (d), Schedule L) is over $25,000. To properly complete these schedules, you need additional information from the books and records. The following profit and loss account appeared in the books of Tentex for the calendar year 1995:

Account		Debit	Credit
Gross sales			$2,010,000
Sales returns and allowances		$ 20,000	
Cost of goods sold		1,520,000	
Dividends received			10,000
Interest income:			
On state bonds	$ 5,000		
Taxable	5,500		10,500
Proceeds from life insurance			9,500
Premiums on life insurance		9,500	
Compensation of officers		70,000	
Salaries and wages—indirect		44,000	
Repairs		800	
Bad debts		1,600	
Rental expense		9,200	
Taxes		15,000	
Interest expense:			
On loan to buy tax-exempt bonds	$ 850		
Other	27,200	28,050	
Contributions:			
Deductible	$24,000		
Other	500	24,500	
Depreciation—indirect		3,580	
Advertising		8,700	
Other expenses of operations		78,300	
Loss on securities		3,600	
Federal income tax accrued		55,387	
Net income per books after tax		147,783	
Total		$2,040,000	$2,040,000

Tentex analyzed its retained earnings and the following appeared in this account on its books:

Item	Debit	Credit
Balance, January 1, 1995		$238,000
Net profit (before federal income tax)		203,170
Reserve for contingencies	$ 10,000	
Income tax accrued for 1995	55,387	
Dividends paid during 1995	65,000	
Refund of 1992 income tax		18,000
Balance, December 31, 1995	328,783	
Total	$459,170	$459,170

Schedule M–1—Reconciliation of Income (Loss) per Books With Income per Return. Schedule M–1 starts with the net income (loss) per books, after reduction for federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 28, page 1.

Line 1. $147,783 is the net income per books. It appears in the profit and loss account as net income per books after tax.

Line 2. $55,387 is the federal income tax accrued for the tax year.

Line 3. $3,600 is the excess of capital losses over capital gains. The net loss is from the sale of securities.

Line 4. This would show all income subject to tax but not recorded on the books for this year. This can happen if the corporation valued assets on its books at an amount greater than that used for tax purposes. When it has a sale of such assets, the gain included in taxable income is greater than that recorded on the books. It shows the difference here.

Line 5. Tentex shows expenses recorded on its books that it does not deduct. The $850 listed on line 5b is for contributions over the 10% limit. Tentex itemizes the remaining nondeductible expenses on a statement (not illustrated) attached to the return. These include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	850
Nondeductible contributions	500
Reduction of salaries by jobs credit	6,000
Total	$16,850

Line 6. Enter the total of lines 1 through 5.

Line 7. This is income recorded on the corporation's books during the year that is not taxable and is not included on the return. This total, $14,500, includes insurance proceeds of $9,500 and tax-exempt interest on state bonds of $5,000.

Line 8. This includes all deductions claimed for tax purposes but not recorded in the corporation's books. Tentex enters $1,620 on line 8a. This is the difference between depreciation claimed on the tax return and the depreciation shown on the corporation's books. If the corporation had other deductions to itemize on this line but not enough space, it would attach an itemized statement to the return.

Line 9. Enter $16,120, the total of lines 7 and 8.

Line 10. The difference, $208,350, between lines 6 and 9 must agree with line 28, page 1.

Schedule M–2—Analysis of Unappropriated Retained Earnings per Books. Schedule M–2 analyzes the unappropriated retained earnings as shown in the corporation's balance sheets on Schedule L.

Line 1. This is from line 25 of Schedule L for the beginning of the tax year. Tentex enters $238,000.

Line 2. This is the net income per books (after federal income tax), $147,783.

Line 3. This shows all other increases to retained earnings. Enter the $18,000 refund of 1992 income tax.

Line 4. This is the total of lines 1, 2, and 3.

Line 5. This includes all distributions to shareholders charged to retained earnings during the tax year. Enter the $65,000 dividends paid.

Line 6. This shows any decreases (other than those on line 5) in unappropriated retained earnings. These decreases are not deductible on the tax return at the time of the appropriation, but a deduction may be allowable on a later return. A common example is amounts set aside for contingencies. A customer was injured on company property during 1995 and the company retained an attorney. Tentex set up a contingent liability of $10,000 for the customer's claim. If they settle the claim during 1996 for $5,000 and the attorney's fee is $2,500, Tentex will charge $7,500 to retained earnings (appropriated). It will also deduct $7,500 in arriving at taxable income for 1996. Another common example of items entered on this line is the payment of the prior year's federal tax. Attach a schedule to the return listing all items taken into account for the amount shown on this line.

Line 7. This is the total of lines 5 and 6.

Line 8. $328,783 is Tentex's retained earnings at the end of its tax year. It determined this figure by subtracting the total on line 7 from the total on line 4. This figure must agree with the amount on Schedule L for the end of the tax year.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1995 or tax year beginning ...., 1995, ending ...., 19 ...
▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No. 1545-0123
1995

A Check if a:
1 Consolidated return (attach Form 851) ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (as defined in Temporary Regs. sec. 1.441-4T—see instructions) ☐

Use IRS label. Otherwise, print or type.

10-0395674 DEC95 071 3998
Tentex Toys, Inc.
36 Division Street
Anytown, IL 60930

B Employer identification number

C Date incorporated: 3-1-72

D Total assets (see page 6 of instructions): $ 879,417

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change of address

Income	1a	Gross receipts or sales 2,010,000 b Less returns and allowances 20,000 c Bal ▶	1c	1,990,000
	2	Cost of goods sold (Schedule A, line 8)	2	1,520,000
	3	Gross profit. Subtract line 2 from line 1c	3	470,000
	4	Dividends (Schedule C, line 19)	4	10,000
	5	Interest	5	5,500
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	
	9	Net gain or (loss) from Form 4797, Part II, line 20 (attach Form 4797)	9	
	10	Other income (see page 7 of instructions—attach schedule)	10	
	11	**Total income.** Add lines 3 through 10 ▶	11	485,500
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)	12	70,000
	13	Salaries and wages (less employment credits)	13	38,000
	14	Repairs and maintenance	14	800
	15	Bad debts	15	1,600
	16	Rents	16	9,200
	17	Taxes and licenses	17	15,000
	18	Interest	18	27,200
	19	Charitable contributions (see page 9 of instructions for 10% limitation)	19	23,150
	20	Depreciation (attach Form 4562) — 20: 17,600		
	21	Less depreciation claimed on Schedule A and elsewhere on return — 21a: 12,400	21b	5,200
	22	Depletion	22	
	23	Advertising	23	8,700
	24	Pension, profit-sharing, etc., plans	24	
	25	Employee benefit programs	25	
	26	Other deductions (attach schedule)	26	78,300
	27	**Total deductions.** Add lines 12 through 26 ▶	27	277,150
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	208,350
	29	**Less:** a Net operating loss deduction (see page 11 of instructions) — 29a: ; b Special deductions (Schedule C, line 20) — 29b: 8,000	29c	8,000
Tax and Payments	30	**Taxable income.** Subtract line 29c from line 28	30	200,350
	31	**Total tax** (Schedule J, line 10)	31	55,387
	32	**Payments:** a 1994 overpayment credited to 1995 — 32a:		
	b	1995 estimated tax payments — 32b: 69,117		
	c	Less 1995 refund applied for on Form 4466 — 32c: ( ) d Bal ▶ 32d: 69,117		
	e	Tax deposited with Form 7004 — 32e:		
	f	Credit from regulated investment companies (attach Form 2439) — 32f:		
	g	Credit for Federal tax on fuels (attach Form 4136). See instructions — 32g:	32h	69,117
	33	Estimated tax penalty (see page 12 of instructions). Check if Form 2220 is attached ▶ ☐	33	
	34	**Tax due.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed	34	
	35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35	13,730
	36	Enter amount of line 35 you want: **Credited to 1996 estimated tax** ▶ 13,730 **Refunded** ▶	36	

Sign Here

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

▶ James O. Barclay — Signature of officer | 3-7-96 — Date | ▶ President — Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | EIN ▶ | ZIP code ▶

Cat. No. 11450Q

Schedule A **Cost of Goods Sold** (See page 12 of instructions.)

1	Inventory at beginning of year	1	126,000
2	Purchases	2	1,127,100
3	Cost of labor	3	402,000
4	Additional section 263A costs (attach schedule)	4	40,000
5	Other costs (attach schedule)	5	123,300
6	**Total.** Add lines 1 through 5	6	1,818,400
7	Inventory at end of year	7	298,400
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	1,520,000

9a Check all methods used for valuing closing inventory:
(i) ☐ Cost as described in Regulations section 1.471-3
(ii) ☑ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶ ☐
c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐
d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO | 9d |
e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☑ Yes ☐ No
f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

Schedule C **Dividends and Special Deductions** (See page 13 of instructions.)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)	10,000	80	8,000
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8	Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9	**Total.** Add lines 1 through 8. See page 13 of instructions for limitation			8,000
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12	Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13	Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up (section 78)			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on line 4, page 1 ▶	10,000		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			8,000

Schedule E **Compensation of Officers** (See instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1, Form 1120) are $500,000 or more.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1	James O. Barclay	581-00-0936	100 %	45 %	%	55,000
			%	%	%	
	George M. Collins	447-00-2604	100 %	15 %	%	31,000
			%	%	%	
	Samuel Adams	401-00-2611	50 %	2 %	%	14,000
2	Total compensation of officers					100,000
3	Compensation of officers claimed on Schedule A and elsewhere on return					30,000
4	Subtract line 3 from line 2. Enter the result here and on line 12, page 1					70,000

Schedule J — Tax Computation (See page 14 of instructions.)

1 Check if the corporation is a member of a controlled group (see sections 1561 and 1563) . . . . . ▶ ☐
Important: Members of a controlled group, see instructions on page 14.

2a If the box on line 1 is checked, enter the corporation's share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order):
(1) $ (2) $ (3) $

b Enter the corporation's share of:
(1) Additional 5% tax (not more than $11,750) $
(2) Additional 3% tax (not more than $100,000) $

3	Income tax. Check this box if the corporation is a qualified personal service corporation as defined in section 448(d)(2) (see instructions on page 15) . . . ▶ ☐			3	61,387
4a	Foreign tax credit (attach Form 1118)	4a			
b	Possessions tax credit (attach Form 5735)	4b			
c	Check: ☐ Nonconventional source fuel credit ☐ QEV credit (attach Form 8834)	4c			
d	General business credit. Enter here and check which forms are attached: ☐ 3800 ☐ 3468 ☑ 5884 ☐ 6478 ☐ 6765 ☐ 8586 ☐ 8830 ☐ 8826 ☐ 8835 ☐ 8844 ☐ 8845 ☐ 8846 ☐ 8847	4d	6,000		
e	Credit for prior year minimum tax (attach Form 8827)	4e			
5	**Total credits.** Add lines 4a through 4e			5	6,000
6	Subtract line 5 from line 3			6	55,387
7	Personal holding company tax (attach Schedule PH (Form 1120))			7	
8	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611			8	
9a	Alternative minimum tax (attach Form 4626)			9a	
b	Environmental tax (attach Form 4626)			9b	
10	**Total tax.** Add lines 6 through 9b. Enter here and on line 31, page 1			10	55,387

Schedule K — Other Information (See page 17 of instructions.)

		Yes	No
1	Check method of accounting: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	See page 19 of the instructions and state the principal: a Business activity code no. ▶ 3998 b Business activity ▶ Manufacturing c Product or service ▶ Toys		
3	Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name and identifying number, (b) percentage owned, and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year.		✓
4	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter employer identification number and name of the parent corporation ▶		✓
5	Did any individual, partnership, corporation, estate or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing name and identifying number. (Do not include any information already entered in 4 above.) Enter percentage owned ▶		✓
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See secs. 301 and 316.) If "Yes," file Form 5452. If this is a consolidated return, answer here for the parent corporation and on **Form 851,** Affiliations Schedule, for each subsidiary.		✓
7	Was the corporation a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 5471 for each such corporation. Enter number of Forms 5471 attached ▶		✓
8	At any time during the 1995 calendar year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the corporation may have to file Form TD F 90-22.1. If "Yes," enter name of foreign country ▶		✓
9	Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation has any beneficial interest in it? If "Yes," the corporation may have to file Forms 926, 3520, or 3520-A		✓
10	Did one foreign person at any time during the tax year own, directly or indirectly, at least 25% of: (a) the total voting power of all classes of stock of the corporation entitled to vote, or (b) the total value of all classes of stock of the corporation? If "Yes," a Enter percentage owned ▶ b Enter owner's country ▶ c The corporation may have to file Form 5472. Enter number of Forms 5472 attached ▶		✓
11	Check this box if the corporation issued publicly offered debt instruments with original issue discount . ▶ ☐ If so, the corporation may have to file Form 8281.		
12	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ 5,000		
13	If there were 35 or fewer shareholders at the end of the tax year, enter the number ▶		
14	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ▶ ☐		
15	Enter the available NOL carryover from prior tax years (Do not reduce it by any deduction on line 29a.) ▶ $		

Schedule L — Balance Sheets

	Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1	Cash		14,700		28,331
2a	Trade notes and accounts receivable	98,400		103,700	
b	Less allowance for bad debts	( )	98,400	( )	103,700
3	Inventories		126,000		298,400
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		100,000		120,000
6	Other current assets (attach schedule)		26,300		17,266
7	Loans to stockholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)		100,000		80,000
10a	Buildings and other depreciable assets	272,400		296,700	
b	Less accumulated depreciation	(88,300)	184,100	(104,280)	192,400
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)		20,000		20,000
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (attach schedule)		14,800		19,300
15	Total assets		684,300		879,417
	Liabilities and Stockholders' Equity				
16	Accounts payable		28,500		34,834
17	Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18	Other current liabilities (attach schedule)		6,800		7,400
19	Loans from stockholders				
20	Mortgages, notes, bonds payable in 1 year or more		176,700		264,100
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock	200,000	200,000	200,000	200,000
23	Paid-in or capital surplus				
24	Retained earnings—Appropriated (attach schedule)		30,000		40,000
25	Retained earnings—Unappropriated		238,000		328,783
26	Less cost of treasury stock		( )		( )
27	Total liabilities and stockholders' equity		684,300		879,417

Note: *You are not required to complete Schedules M-1 and M-2 below if the total assets on line 15, column (d) of Schedule L are less than $25,000.*

Schedule M-1 — Reconciliation of Income (Loss) per Books With Income per Return (See page 18 of instructions.)

1	Net income (loss) per books	147,783	7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 5,000; Insurance proceeds 9,500	14,500
2	Federal income tax	55,387			
3	Excess of capital losses over capital gains	3,600			
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):			a Depreciation $ 1,620	
	a Depreciation $			b Contributions carryover $	
	b Contributions carryover $ 850				
	c Travel and entertainment $ See attached itemized statement (not shown) $16,850	17,700			1,620
			9	Add lines 7 and 8	16,120
6	Add lines 1 through 5	224,470	10	Income (line 28, page 1)—line 6 less line 9	208,350

Schedule M-2 — Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year	238,000	5	Distributions: a Cash	65,000
2	Net income (loss) per books	147,783		b Stock	
3	Other increases (itemize): Refund of 1992 income tax due to IRS examination			c Property	
			6	Other decreases (itemize): Reserve for contingencies	10,000
		18,000	7	Add lines 5 and 6	75,000
4	Add lines 1, 2, and 3	403,783	8	Balance at end of year (line 4 less line 7)	328,783

Printed on recycled paper

41.

Form 1120S S Corporation

StratoTech Inc., is a distributor of machinery, equipment, and supplies for the building trades. It uses an accrual method of accounting and files its returns on the calendar year. In December 1994, StratoTech Inc., made a timely and proper election to be treated as an S corporation.

Page 1

When the corporation's return is prepared for 1995, the preaddressed label sent to the corporation by the IRS should be used. The preaddressed label is designed to expedite processing and prevent errors. If the corporation does not have such a label, the corporation's name, street address, room number, suite, or unit, and city, state, and ZIP code should be entered in the appropriate spaces on the first page. After entering the identifying information at the top of the page, StratoTech's items of income and deductions are then reported in summary form.

The name and employer identification number of the corporation is shown in the top margin of all schedules and other attachments to Form 1120S.

Line items. All items for income, deductions, and tax listed on page 1 of Form 1120S are filled in, even though totals can be shown in schedules attached to the return. Do not alter, substitute, or cross out the line captions printed on the official return forms.

Line 1. Gross sales for the year totaled $1,545,700 (line 1a), determined on the accrual method of accounting. After subtracting returned goods and allowances of $21,000 (line 1b), net sales of $1,524,700 are entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $954,700, is the total from Schedule A (line 8) on page 2.

Line 3. Net sales minus cost of goods sold result in gross profit of $570,000.

Line 6. Total income on line 6 is $570,000.

Line 7. The salaries of the company president, vice president, and secretary-treasurer total $170,000 and are included on line 7. Compensation paid to corporate officers must be separated from other salaries and wages and must be entered on line 7 rather than on line 8.

Line 8. Other salaries and wages are entered on line 8. The entry includes only salaries and wages not included on line 7 and not deducted as part of cost of goods sold. Salaries and wages of $144,000 are reduced by $6,000, the amount of the employment credits, discussed later, passed through to the shareholders. $138,000 is entered on line 8.

Line 9. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. StratoTech incurred $800 for repairs.

Line 10. StratoTech must use the specific charge-off method for bad debts. Actual accounts written off during the year total $1,600.

Line 11. Rental expense for StratoTech's office and service building is $9,200 for the year.

Line 12. Deductible taxes total $15,000.

Line 13. Interest expense accrued during the year amounts to $14,200. This includes interest on debts for business operations only. Interest of $850 to carry tax-exempt securities and investments is not included. Interest on the debt to carry investments that produce taxable income is $3,000. It is shown on line 11a of Schedule K and passed through to the shareholders on Schedule K–1.

Lines 14a and 14b. Depreciation of $15,200 is brought forward from Form 4562, *Depreciation and Amortization* (not illustrated). If StratoTech had a section 179 deduction, it would not be included here. It is passed through to the shareholders on Schedule K–1.

Line 16. Advertising expense of $8,700 is entered on line 16.

Line 19. Other ordinary and necessary business deductions total $78,300. These include miscellaneous office expenses, sales commissions, legal fees, etc. A schedule (not illustrated) itemizing these expenses must be attached to the return.

Line 20. Total deductions are $451,000.

Line 21. Ordinary income (nonseparately stated income) is $119,000.

Corporate officer's signature. The corporation return must be signed manually by the corporate officer authorized to sign. Use of the corporate seal is optional.

Page 2

Schedule A. Schedule A is used to report the cost of goods sold. This figure is beginning inventory plus merchandise bought or produced during the year minus ending inventory.

Line 1. Because it is a distributor, StratoTech accounts for its purchasing costs as part of the cost of goods sold. Goods on hand at the beginning of the year were properly valued at $126,000, using the lower of cost or market valuation method. StratoTech reports this amount on line 1.

Line 2. Purchases cost of $1,127,100 is reported on line 2.

Line 7–8. StratoTech had goods on hand at the end of the year properly valued at $298,400. StratoTech reports that amount on line 7.

Lines 9a–9e. All applicable questions on these lines should be answered.

Other information. All applicable questions in this section should also be answered and the appropriate boxes checked.

Designation of tax matters person. Information relating to the shareholder designated as the tax matters person should be provided as indicated at the bottom of page 2, Form 1120S. For information on the rules for designating a tax matters person (TMP), see Temporary Income Tax Regulations section 301.6231(a)(7)–1T.

Page 3

Schedule K. Schedule K summarizes the corporation's income, deductions, credits, etc., that are reportable by the shareholders.

Line 1. On line 1, StratoTech shows the ordinary income (nonseparately stated income) of $119,000 from line 21, page 1.

Line 4. Line 4 is used to report portfolio income and loss items. Portfolio items include interest income, dividend income, royalty income, short-term capital gain or loss, and long-term capital gain or loss. StratoTech had the following portfolio items:

1) Taxable interest income of $4,000 reportable on ***line 4a,*** and
2) Taxable dividends of $16,000 reportable on ***line 4b.***

Line 7. Line 7 is for charitable contributions. During 1995, StratoTech contributed $11,400 to the United Community Fund and $12,600 to the State University Scholarship Fund. The total of $24,000 is entered in the total column on line 7.

Lines 11a and 11b(1). These lines show the items that must be taken into account by shareholders to figure their interest deduction on investment indebtedness. ***Line 11a*** is used for investment interest expense. StratoTech had investment interest expense of $3,000. ***Line 11b(1)*** is for investment income. StratoTech had taxable interest from investments (line 4a) totaling $4,000. StratoTech also had dividends from investments (line 4b) totaling $16,000. StratoTech enters $20,000 on line 11b(1). Each shareholder's share of these items must be reported on Schedule K–1.

Line 13. Line 13 is for the employment credits. StratoTech has $6,000 of employment credits in 1995. The credit was figured on Form 5884, *Jobs Credit* (not shown here).

Line 17. Tax-exempt interest is entered on line 17. StratoTech earned $5,000 of tax-exempt interest from state bonds.

Line 19. StratoTech had $16,350 of nondeductible expenses, consisting of $9,500 for premiums paid on term life insurance for corporate officers, $850 for interest paid to purchase tax-exempt securities, and a $6,000 reduction of salaries due to the jobs credit.

Line 20. Line 20 is for distributions other than those reported on line 22. StratoTech distributed $65,000 in 1995.

Line 23. Income of $112,000 is entered here. This is the total of Schedule K lines 1, 4a, and 4b minus the amounts on line 7 and 11a. The amount is the same as that on line 8 of Schedule M–1.

Schedule K–1. A separate Schedule K–1 is completed by the S corporation for each shareholder.

Generally, shareholders must treat items of income, loss, deduction, credit, etc., on their returns consistent with the way the S corporation reported them on its return. A shareholder who shows the items differently from the way the S corporation reported them on Schedule K–1 should complete Form 8082, *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)).*

A copy of each shareholder's Schedule K–1 should be filed with Form 1120S. A copy is kept as a part of the corporation's records, and each shareholder receives a copy with instructions attached.

StratoTech must prepare a Schedule K–1 for each shareholder. The illustrated Schedule K–1 is for John H. Green who owns 9,000 shares (45%) of the corporation's stock, which he acquired on March 3, 1976. He devotes 100% of his time to the business for which he is paid $40,000.

Lines 1 through 10 are for each shareholder's distributive share of nonseparately stated income or loss and separately stated income or loss and deductions.

Line 1. Line 1 shows Mr. Green's share of nonseparately stated income of $53,550 (45% of $119,000). It makes no difference whether this income was distributed to him in 1995. He must report $53,550 on Schedule E (Form 1040) when he files his individual income tax return, Form 1040.

Line 4. Line 4 is for portfolio income and loss items. Mr. Green's share of interest income is $1,800 (45% of $4,000). His share of dividend income is $7,200 (45% of $16,000).

Line 7. Line 7 is for Mr. Green's share of StratoTech's charitable contributions for 1995. His share is $10,800 (45% of $24,000). Because all StratoTech's contributions were given to public charities, they qualify for the 50% limitation.

Lines 11a and 11b(1). These lines are used to show each shareholder's share of interest on investment indebtedness. The amounts reported on these lines will be used to complete Form 4952, *Investment Interest Expense Deduction.* ***Line 11a*** shows Mr. Green's share of StratoTech's investment interest expense, $1,350 (45% × $3,000). Investment interest expense is that part of StratoTech's total interest for loans made to carry its investment. ***Line 11b(1)*** shows Mr. Green's share of StratoTech's investment income, $9,000 (45% × $20,000). This represents StratoTech's income from ordinary dividends and interest. It does not include interest on municipal bond investments, which is tax-exempt.

Line 13. Line 13 is for the jobs credit. Mr. Green's share of StratoTech's jobs credit is $2,700 (45% × $6,000).

Line 17. In 1995, StratoTech had $5,000 of tax-exempt interest from state bonds. Mr. Green's 45% share of the tax-exempt interest is $2,250 (45% 0f $5,000). This amount is entered on line 17.

Line 19. Mr. Green's 45% share of nondeductible expenses is $7,358 (45% × $16,350). This amount is entered on line 19.

Line 20. Line 20 is for distributions paid during the year other than those paid from accumulated earnings and profits and reported on Form 1099–DIV. During 1995, StratoTech distributed $65,000. Mr. Green's 45% share of the distribution was $29,250 (45% of $65,000).

Page 4

Schedule L. Comparative balance sheets for the beginning and end of the tax year are shown on Schedule L. The balance sheets should agree with the S corporation's books and records. Entries on this page should also agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing in the analysis of cost of goods sold. In addition, the figures on the balance sheet for the beginning of the tax year will normally agree with the balance sheet figures for the end of the last tax year.

Schedules M–1 and M–2. These schedules must be completed if the total assets (line 15, column (d), Schedule L) are $25,000 or more. To properly complete these schedules, additional information must be obtained from the corporation's books and records.

The following appeared on the books of StratoTech for the calendar year 1995.

Account		Debit	Credit
Gross sales			$1,545,700
Sales returns and allowances		$ 21,000	
Cost of goods sold		954,700	
Dividend income			16,000
Interest income:			
State bonds			5,000
Other—taxable			4,000
Premiums on life insurance		9,500	
Compensation of officers		170,000	
Salaries/wages		144,000	
Repairs		800	
Bad debts		1,600	
Rental expense		9,200	
Taxes		15,000	
Interest expense:			
Loan—tax-exempt bonds	$ 850		
Other	17,200	18,050	
Contributions		24,000	
Depreciation		9,580	
Advertising		8,700	
Other expenses of operation		78,300	
Net income per books		106,270	
Total		$1,570,700	$1,570,700

Schedule M–1. Schedule M–1 starts with the net income per books as shown in the corporation's books and records. It provides for necessary adjustments to reconcile this amount with the income shown on line 23, Schedule K.

Line 1. Line 1 is the net income per books, $106,270, shown on the corporation's books.

Line 2. Line 2 should show all income and credits included in income subject to tax that are not recorded on the books for this year. This can happen if assets are valued on the corporate books at an amount greater than that used for tax purposes. When these assets are sold, the gain included in taxable income is greater than that recorded on the books, and the difference is shown here.

Line 3. Line 3 is for expenses recorded on the corporation's books that cannot be deducted. They are shown in an itemized statement attached to the return (not illustrated). It would include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	850
Reduction of salaries due to jobs credit	6,000
Total	$ 16,350

Line 4. The total of lines 1 through 3, $122,620, goes on line 4.

Line 5. Line 5 shows nontaxable income recorded on the corporation's books during the year that is not on the return. This totals $5,000, the interest on state bonds.

Line 6. Line 6 includes all deductions claimed for tax purposes that are not recorded on the corporation's books. StratoTech enters $5,620 on line 6a. This represents the difference between depreciation claimed on the tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there was not enough space on the line, it would have to attach a statement to the return listing them.

Line 7. The total of lines 5 and 6, $10,620, goes on line 7.

Line 8. The difference, $112,000, between lines 4 and 7 must agree with line 23, Schedule K.

Schedule M–2. Schedule M–2 provides an analysis of certain earned equity accounts of the corporation for the tax year. The schedule shows the changes to the equity accounts for the income, deductions, distributions, etc., that are reported on the return for the tax year.

Column (a), Line 1. The first column is the accumulated adjustments account. For an S corporation's first year beginning after 1982, the initial balance in the account is zero. StratoTech enters zero on line 1.

Line 2. StratoTech's ordinary income for 1995 (page 1, line 21) is $119,000. This is entered on line 2.

Line 3. StratoTech enters $20,000 ($16,000 dividends plus $4,000 interest) on line 3. This is made up of amounts on lines 4a and 4b of Schedule K.

Line 4. Line 4 is for any loss shown on page 1, line 21. Because StratoTech has no losses in 1995, line 4 is zero.

Line 5. StratoTech enters $42,500 on line 5. This is made up of $3,000 interest on a loan to carry investments, $6,000 reduction in salaries and wages due to the jobs credit, $9,500 for premiums paid on term life insurance for corporate officers, and $24,000 charitable contributions.

Line 6. Line 6 is the total of lines 1 through 5, or $96,500.

Line 7. Line 7 is for distributions other than dividend distributions. StratoTech enters $65,000 on this line.

Line 8. Line 8 shows the balance in the accumulated adjustments account at the end of the year. StratoTech subtracts line 7 from line 6 and enters $31,500 here.

Column (b), Line 1. The second column is the other adjustments account. It is for other items, such as tax-exempt income and related expenses. The balance at the beginning of the year is zero. This is entered on line 1.

Line 3. StratoTech had $5,000 of tax-free interest income from state bonds. This amount is entered on line 3.

Line 5. Line 5 is the nondeductible interest paid to purchase tax-exempt securities. StratoTech enters $850 on this line.

Line 6. The total of lines 1 through 5, $4,150, is entered on line 6.

Line 7. Because the total distributions, other than dividends, were not more than the balance in the accumulated adjustments account, none of the distribution is applied to the other adjustments account. StratoTech enters zero on line 7.

Line 8. The balance in the other adjustments account at the end of the year is $4,150. StratoTech enters this amount here.

Column (c). The third column is for undistributed taxable income that was included in shareholders' income for years that began before 1995. Since this is StratoTech's first year as an S corporation, there are no entries in this column.

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation.

▶ See separate instructions.

OMB No. 1545-0130

1995

For calendar year 1995, or tax year beginning , 1995, and ending , 19

A Date of election as an S corporation: 12-1-94

B Business code no. (see Specific Instructions): 5008

Use IRS label. Otherwise, please print or type.

10-4487965 DEC95 D74 3070
StratoTech, Inc.
482 Winston Street
Metro City, OH 43705

C Employer identification number: 10 : 4487965

D Date incorporated: 3-1-75

E Total assets (see Specific Instructions): $ 771,334

F Check applicable boxes: (1) ☑ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

G Check this box if this S corporation is subject to the consolidated audit procedures of sections 6241 through 6245 (see instructions before checking this box) ▶ ☐

H Enter number of shareholders in the corporation at end of the tax year ▶ 6

Caution: *Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Section	Line	Description	Sub-line	Sub-amount	Line no.	Amount
Income	1a	Gross receipts or sales 1,545,700 b Less returns and allowances 21,000 c Bal ▶			1c	1,524,700
	2	Cost of goods sold (Schedule A, line 8)			2	954,700
	3	Gross profit. Subtract line 2 from line 1c			3	570,000
	4	Net gain (loss) from Form 4797, Part II, line 20 *(attach Form 4797)*			4	
	5	Other income (loss) *(attach schedule)*			5	
	6	**Total income (loss).** Combine lines 3 through 5 ▶			6	570,000
Deductions (see page 10 of the instructions for limitations)	7	Compensation of officers			7	170,000
	8	Salaries and wages (less employment credits)			8	138,000
	9	Repairs and maintenance			9	800
	10	Bad debts			10	1,600
	11	Rents			11	9,200
	12	Taxes and licenses			12	15,000
	13	Interest			13	14,200
	14a	Depreciation *(if required, attach Form 4562)*	14a	15,200		
	b	Depreciation claimed on Schedule A and elsewhere on return	14b			
	c	Subtract line 14b from line 14a			14c	15,200
	15	Depletion **(Do not deduct oil and gas depletion.)**			15	
	16	Advertising			16	8,700
	17	Pension, profit-sharing, etc., plans			17	
	18	Employee benefit programs			18	
	19	Other deductions *(attach schedule)*			19	78,300
	20	**Total deductions.** Add the amounts shown in the far right column for lines 7 through 19 ▶			20	451,000
	21	Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6			21	119,000
Tax and Payments	22	**Tax:** a Excess net passive income tax *(attach schedule)*	22a			
	b	Tax from Schedule D (Form 1120S)	22b			
	c	Add lines 22a and 22b (see page 13 of the instructions for additional taxes)			22c	
	23	**Payments:** a 1995 estimated tax payments and amount applied from 1994 return	23a			
	b	Tax deposited with Form 7004	23b			
	c	Credit for Federal tax paid on fuels *(attach Form 4136)*	23c			
	d	Add lines 23a through 23c			23d	
	24	Estimated tax penalty. Check if Form 2220 is attached ▶☐			24	
	25	**Tax due.** If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See page 3 of the instructions for depositary method of payment ▶			25	
	26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid ▶			26	
	27	Enter amount of line 26 you want: **Credited to 1996 estimated tax** ▶ **Refunded** ▶			27	

Please Sign Here

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

▶ John H. Gien — Signature of officer | 3/10/96 — Date | ▶ President — Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | EIN ▶ | ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 11510H Form **1120S** (1995)

Schedule A Cost of Goods Sold (see page 14 of the instructions)

1	Inventory at beginning of year	1	126,000
2	Purchases	2	1,127,100
3	Cost of labor	3	
4	Additional section 263A costs *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	**Total.** Add lines 1 through 5	6	1,253,100
7	Inventory at end of year	7	298,400
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	954,700

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☑ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (specify method used and attach explanation) ▶

b Check if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO | 9d |

e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☑ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☑ No
If "Yes," attach explanation.

Schedule B Other Information

		Yes	No
1	Check method of accounting: (a) ☐ Cash (b) ☑ Accrual (c) ☐ Other (specify) ▶		
2	Refer to the list on page 24 of the instructions and state the corporation's principal: (a) Business activity ▶ 5008 DISTRIBUTOR (b) Product or service ▶ HEAVY EQUIPMENT		
3	Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name, address, and employer identification number and (b) percentage owned		✓
4	Was the corporation a member of a controlled group subject to the provisions of section 1561?		✓
5	At any time during calendar year 1995, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 14 of the instructions for exceptions and filing requirements for Form TD F 90-22.1.) If "Yes," enter the name of the foreign country ▶		✓
6	Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation had any beneficial interest in it? If "Yes," the corporation may have to file Forms 3520, 3520-A, or 926		✓
7	Check this box if the corporation has filed or is required to file **Form 8264,** Application for Registration of a Tax Shelter ▶ ☐		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	If the corporation: (a) filed its election to be an S corporation after 1986, (b) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and (c) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see page 14 of the instructions) ▶ $ 37,200		
10	Check this box if the corporation had subchapter C earnings and profits at the close of the tax year (see page 15 of the instructions) ▶ ☐		

Designation of Tax Matters Person (see page 15 of the instructions)

Enter below the shareholder designated as the tax matters person (TMP) for the tax year of this return:

Name of designated TMP ▶ JOHN H. GREEN Identifying number of TMP ▶ 458-00-0327

Address of designated TMP ▶ 4340 HOLMES PARKWAY, METRO CITY, OH 43704

Schedule K — Shareholders' Shares of Income, Credits, Deductions, etc.

		(a) Pro rata share items		(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	119,000
	2	Net income (loss) from rental real estate activities *(attach Form 8825)*	2	
	3a	Gross income from other rental activities — 3a		
	b	Expenses from other rental activities *(attach schedule)* — 3b		
	c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4	Portfolio income (loss):		
	a	Interest income	4a	4,000
	b	Dividend income	4b	16,000
	c	Royalty income	4c	
	d	Net short-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4d	
	e	Net long-term capital gain (loss) *(attach Schedule D (Form 1120S))*	4e	
	f	Other portfolio income (loss) *(attach schedule)*	4f	
	5	Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*	5	
	6	Other income (loss) *(attach schedule)*	6	
Deductions	7	Charitable contributions *(attach schedule)*	7	24,000
	8	Section 179 expense deduction *(attach Form 4562)*	8	
	9	Deductions related to portfolio income (loss) (itemize)	9	
	10	Other deductions *(attach schedule)*	10	
Investment Interest	11a	Interest expense on investment debts	11a	3,000
	b (1)	Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)	20,000
	(2)	Investment expenses included on line 9 above	11b(2)	
Credits	12a	Credit for alcohol used as a fuel *(attach Form 6478)*	12a	
	b	Low-income housing credit:		
	(1)	From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)	
	(2)	Other than on line 12b(1) for property placed in service before 1990	12b(2)	
	(3)	From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)	
	(4)	Other than on line 12b(3) for property placed in service after 1989	12b(4)	
	c	Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*	12c	
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d	
	e	Credits related to other rental activities	12e	
	13	Other credits	13	6,000
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a	
	b	Adjusted gain or loss	14b	
	c	Depletion (other than oil and gas)	14c	
	d (1)	Gross income from oil, gas, or geothermal properties	14d(1)	
	(2)	Deductions allocable to oil, gas, or geothermal properties	14d(2)	
	e	Other adjustments and tax preference items *(attach schedule)*	14e	
Foreign Taxes	15a	Type of income ▶		
	b	Name of foreign country or U.S. possession ▶		
	c	Total gross income from sources outside the United States *(attach schedule)*	15c	
	d	Total applicable deductions and losses *(attach schedule)*	15d	
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e	
	f	Reduction in taxes available for credit *(attach schedule)*	15f	
	g	Other foreign tax information *(attach schedule)*	15g	
Other	16	Section 59(e)(2) expenditures: a Type ▶		
	b	Amount	16b	
	17	Tax-exempt interest income	17	5,000
	18	Other tax-exempt income	18	
	19	Nondeductible expenses	19	16,350
	20	Total property distributions (including cash) other than dividends reported on line 22 below	20	65,000
	21	Other items and amounts required to be reported separately to shareholders *(attach schedule)*		
	22	Total dividend distributions paid from accumulated earnings and profits	22	
	23	**Income (loss).** (Required only if Schedule M-1 must be completed.) Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16b	23	112,000

Schedule L — Balance Sheets

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		14,700		14,514
2a Trade notes and accounts receivable	98,400		33,700	
b Less allowance for bad debts		98,400		33,700
3 Inventories		126,000		298,400
4 U.S. Government obligations				
5 Tax-exempt securities		100,000		100,000
6 Other current assets (attach schedule)		26,300		26,300
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)		100,000		100,000
10a Buildings and other depreciable assets	204,700		204,700	
b Less accumulated depreciation	36,000	168,700	45,580	159,120
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)		20,000		20,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets (attach schedule)		14,800		19,300
15 Total assets		668,900		771,334
Liabilities and Shareholders' Equity				
16 Accounts payable		28,500		34,834
17 Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18 Other current liabilities (attach schedule)		6,800		7,400
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		161,300		215,530
21 Other liabilities (attach schedule)				
22 Capital stock		2,000		2,000
23 Paid-in or capital surplus		198,000		198,000
24 Retained earnings		268,000		309,270
25 Less cost of treasury stock		( )		( )
26 Total liabilities and shareholders' equity		668,900		771,334

Schedule M-1 — Reconciliation of Income (Loss) per Books With Income (Loss) per Return (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income (loss) per books	106,270	5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize): a Tax-exempt interest $ 5,000	5,000
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):	-0-		
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16b (itemize): a Depreciation $ b Travel and entertainment $ Itemized Statement attached	16,350	6 Deductions included on Schedule K, lines 1 through 11a, 15e, and 16b, not charged against book income this year (itemize): a Depreciation $ 5,620	5,620
		7 Add lines 5 and 6	10,620
4 Add lines 1 through 3	122,620	8 Income (loss) (Schedule K, line 23). Line 4 less line 7	112,000

Schedule M-2 — Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see page 22 of the instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year	-0-	-0-	
2 Ordinary income from page 1, line 21	119,000		
3 Other additions	20,000	5,000	
4 Loss from page 1, line 21	(-0-)		
5 Other reductions	(42,500)	(850)	
6 Combine lines 1 through 5	96,500	4,150	
7 Distributions other than dividend distributions	65,000	-0-	
8 Balance at end of tax year. Subtract line 7 from line 6	31,500	4,150	

SCHEDULE K-1 (Form 1120S)

Department of the Treasury Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1995 or tax year beginning , 1995, and ending , 19

OMB No. 1545-0130

1995

Shareholder's identifying number ▶ 458-00-0327

Corporation's identifying number ▶ 10-4487965

Shareholder's name, address, and ZIP code

John H. Green
4340 Holmes Parkway
Metro City, OH 43704

Corporation's name, address, and ZIP code

StratoTech, Inc.
482 Winston St.
Metro City, OH 43705

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . . ▶ 45 %

B Internal Revenue Service Center where corporation filed its return ▶ Cincinnati, OH

C Tax shelter registration number (see instructions for Schedule K-1) . . . . ▶

D Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1	53,550	See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):			
	a	Interest	4a	1,800	Sch. B, Part I, line 1
	b	Dividends	4b	7,200	Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e	Net long-term capital gain (loss)	4e		Sch. D, line 13, col. (f) or (g)
	f	Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return.)
	5	Net gain (loss) under section 1231 (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	6	Other income (loss) *(attach schedule)*	6		(Enter on applicable line of your return.)
Deductions	7	Charitable contributions *(attach schedule)*	7	10,800	Sch. A, line 15 or 16
	8	Section 179 expense deduction	8		See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	9	Deductions related to portfolio income (loss) *(attach schedule)*	9		
	10	Other deductions *(attach schedule)*	10		
Investment Interest	11a	Interest expense on investment debts	11a	1,350	Form 4952, line 1
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)	9,000	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
		(2) Investment expenses included on line 9 above	b(2)		
Credits	12a	Credit for alcohol used as fuel	12a		Form 6478, line 10
	b	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
		(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
		(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities	12c		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e	Credits related to other rental activities	12e		
	13	Other credits	13	2,700	
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b	Adjusted gain or loss	14b		
	c	Depletion (other than oil and gas)	14c		
	d	(1) Gross income from oil, gas, or geothermal properties	d(1)		
		(2) Deductions allocable to oil, gas, or geothermal properties	d(2)		
	e	Other adjustments and tax preference items *(attach schedule)*	14e		

For Paperwork Reduction Act Notice, see page 1 of Instructions for Form 1120S. Cat. No. 11520D **Schedule K-1 (Form 1120S) 1995**

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Foreign Taxes	15a	Type of income ▶			Form 1116, Check boxes
	b	Name of foreign country or U.S. possession ▶			
	c	Total gross income from sources outside the United States *(attach schedule)*	15c		Form 1116, Part I
	d	Total applicable deductions and losses *(attach schedule)*	15d		
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	15f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	15g		See Instructions for Form 1116
Other	16	Section 59(e)(2) expenditures: a Type ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	b	Amount	16b		
	17	Tax-exempt interest income	17	2,250	Form 1040, line 8b
	18	Other tax-exempt income	18		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	19	Nondeductible expenses	19	7,358	
	20	Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20	29,250	
	21	Amount of loan repayments for "Loans From Shareholders"	21		
	22	Recapture of low-income housing credit:			
	a	From section 42(j)(5) partnerships	22a		Form 8611, line 8
	b	Other than on line 22a	22b		

Supplemental Information

23 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*:

Printed on recycled paper

We examine returns for correctness of income, exemptions, credits, and deductions.

Fairness if Your Return is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1, *Your Rights as a Taxpayer,* explains the many rights you have as a taxpayer. You can get free publications by calling us at 1-800-829-3676.

Pay only the required tax. You have the right to plan your business and personal finances so that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly.

Privacy and confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for information, exactly how we will use it and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We use the results of these examinations to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W–2 and the 1099 series, with returns.

Arranging the examination. Many examinations are handled by mail. However, if we notify you that your examination is to be conducted through a personal interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your individual return is examined in the IRS district office nearest your home. However, not all offices have examination facilities. Your business return is examined where your books and records are maintained. If the place of examination is not convenient, you can ask to have the examination done in another office or transferred to a different district.

Representation. Throughout the examination, you can represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, a C.P.A., an enrolled agent, or any other person permitted to represent a taxpayer during an examination, we will reschedule the interview. We cannot suspend the interview if you are there on administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us at least 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting and you can get a copy at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the examination.

Explanation of changes. If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you can sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on this tax is generally figured from the due date of your return to the billing date. But you will not be billed for more than 30 days additional interest, even if the bill is delayed. Also, you will not have to pay any more interest or penalties if you pay the amount due within 10 days of the billing date.

Appealing the Examination Findings

If you do not agree with the examiner's report, you can meet with the examiner's supervisor to discuss your case further. If you still don't agree after receiving the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* This free publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled this way without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Court of Federal Claims, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not pay the additional tax and disagree that you owe it, you generally have the right to take your case to the Tax Court. We will mail you a formal notice (called a ''notice of deficiency'') saying that you owe additional tax. You ordinarily have 90 days to file a petition with the Tax Court.

If you already paid the disputed tax in full and filed a claim for refund (discussed later) that we disallowed (or did not take action on within 6 months), you can take your case to the U.S. District Court or U.S. Court of Federal Claims.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS.

Free Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* explains your appeal rights.

Other remedies. If you believe that tax, penalty, or interest was unjustly charged, you have rights that can remedy the situation.

Claims for refund. Once you pay your tax, you can file a claim for a credit or refund if you believe the tax is too much. The procedure for filing a claim is explained in Publication 556.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the standard for the penalty).

If you relied on wrong advice from IRS employees given to you by phone, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest that would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply. If you are a member of a partnership or a shareholder in a small business corporation, special rules may apply to the examination of your partnership or corporation items. The examination of these items is discussed in Publication 556. You can get this publication free by calling us at 1-800-829-3676.

Checklist

Some of the federal taxes for which a sole proprietor, a corporation, or a partnership may be liable are listed below. If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state. Certain exceptions to these due dates may apply. For more information, see Publication 509, *Tax Calendars for 1996.*

You may be liable for:	If you are:	Use Form:	Due on or before:
Income tax	Sole proprietor	Schedule C or C–EZ (Form 1040)	File with Form 1040
	Individual who is a partner or S corporation shareholder	1040	15th day of 4th month after end of tax year
	Corporation	1120 or 1120–A	15th day of 3rd month after end of tax year
	S corporation	1120S	15th day of 3rd month after end of tax year
Self-employment tax	Sole proprietor, or individual who is a partner	Schedule SE (Form 1040)	File with Form 1040
Estimated tax	Sole proprietor, or individual who is a partner or S corporation shareholder	1040–ES	15th day of 4th, 6th, and 9th months of tax year, and 15th day of 1st month after the end of tax year
	Corporation	1120–W (WORKSHEET) 8109 (to make deposits)	15th day of 4th, 6th, 9th and 12th months of tax year
Annual return of income	Partnership	1065	15th day of 4th month after end of tax year
Social security and Medicare taxes (FICA taxes) and the withholding of income tax	Sole proprietor, corporation, S corporation, or partnership	941	4–30, 7–31, 10–31, and 1–31
		8109 (to make deposits)	See chapter 33
Providing information on social security and Medicare taxes (FICA taxes) and the withholding of income tax	Sole proprietor, corporation, S corporation, or partnership	W–2 (to employee)	1–31
		W–2 and W–3 (to the Social Security Administration)	Last day of February
Federal unemployment (FUTA) tax	Sole proprietor, corporation, S corporation, or partnership	940–EZ or 940	1–31
		8109 (to make deposits)	4–30, 7–31, 10–31, and 1–31, but only if the liability for unpaid tax is more than $100
Information returns for payments to nonemployees and transactions with other persons	Sole proprietor, corporation, S corporation, or partnership	See chapter 36	Forms 1099—to the recipient by 1–31 and to the Internal Revenue Service by 2–28
			Other forms —see chapter 36
Excise taxes	Sole proprietor, corporation, S corporation, or partnership	See chapter 35	See the instructions to the forms