Department of the Treasury

Internal Revenue Service

Publication 535
Cat. No. 15065Z

Business Expenses

For use in preparing

1997 Returns

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Contents

Introduction

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

Help from the Problem Resolution Program. The Problem Resolution Program (administered by the Taxpayer Advocate) can often help you with unresolved tax problems. It may be able to offer you special help if you have a significant hardship as a result of a tax problem. For more information, write to the Taxpayer Advocate at the district office or service center where you have the problem, or call 1–800–829–1040 (1–800–829–4059 for TTY/TDD users).

Important Changes for 1997

The following items highlight some changes in the tax law for 1997.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1997 is 31.5 cents per mile for all business miles.

Nondiscrimination rules. Nondiscrimination rules apply to the exclusion of certain fringe benefits from the income of highly compensated employees. For tax years beginning after 1996, the definition of "highly compensated employee" has changed. For more information, see *Nondiscrimination rules* under *Exclusion of Certain Fringe Benefits* in chapter 4.

Adoption assistance. For tax years beginning after 1996, up to $5,000 ($6,000 for a special needs child) you pay or incur under an adoption assistance program for an employee's qualified adoption expenses is excluded from the employee's gross income. For more information, see *Adoption Assistance* in chapter 5.

Educational assistance. Each year, you can exclude from an employee's wages up to $5,250 you pay or incur under an educational assistance program. This exclusion, which expired for tax years beginning after May 31, 1997, has been extended retroactively. It will now expire for expenses paid with respect to courses beginning after May 31, 2000. For more information, see *Educational Assistance* in chapter 5.

Group health plan requirements. Generally effective for plan years beginning after June 30, 1997, you (or the plan, if a multi-employer plan) may be subject to an excise tax if your group health plan does not meet the new accessibility, portability, and renewability requirements. For more information, see *Other Requirements* under *Group Health Plans* in chapter 5.

Medical savings accounts. For tax years beginning after 1996, a new program for a tax-exempt medical savings account (MSA) is available (for up to 4 years) to self-employed persons and employees of a small business. You can contribute (within limits) to an MSA for each employee you cover under a high deductible health plan. You can exclude from an employee's income amounts you contribute to his or her MSA. For more information, see *Medical Savings Accounts* under *Group Health Plans* in chapter 5.

SIMPLE retirement plan. Beginning in 1997, you may be able to set up a savings incentive match plan for employees (SIMPLE). You can set up a SIMPLE plan if you have 100 or fewer employees and meet other requirements. For more information, see *SIMPLE Retirement Plans* in chapter 6.

Repeal of salary reduction arrangement under a SEP (SARSEP). Beginning in January 1997, an employer is no longer allowed to establish a SARSEP. However, participants (including new participants hired after 1996) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. For more information, see *Salary Reduction Arrangement* under *Simplified Employee Pension (SEP)* in chapter 6.

Minimum required distribution rule modified. Beginning in 1997, the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans takes into account whether a plan participant has retired. This does not apply to a **5% owner,** who must still begin to receive distributions on April 1 of the year following the calendar year in which he or she reaches age 70½. Also, the new law does not apply to IRAs. For more information, see *Required Distributions* under *Keogh Plans* in Publication 560.

Interest on loans with respect to life insurance policies. For tax years ending after May 31, 1997, you generally cannot deduct interest paid or accrued with respect to any life insurance, annuity or endowment contract that was issued or deemed issued after June 8, 1997, and covers any individual, unless that individual is a key person. For partnerships, corporations, and S corporations, there are new proration rules that apply. For more information, see *Interest on loans with respect to life insurance policies* in chapter 8.

Self-employed health insurance deduction. Beginning in 1997, the deduction for health insurance of self-employed individuals increases from 30% to 40% of the amount paid for the insurance. The percentage will further increase to 45% for tax years 1998 and 1999. After 1999, the deduction increases even further. For more information, see *Self-Employed Health Insurance Deduction* in chapter 10.

Long-term care insurance. A qualified long-term care insurance contract issued after 1996 will generally be treated as an accident and health insurance contract. For more information, see *Long-term care insurance deduction* in chapter 10.

Life insurance and annuities. For contracts issued after June 8, 1997, you generally cannot deduct premiums on any life insurance policy, endowment contract, or annuity contract, if you are directly or indirectly a beneficiary. For contracts issued prior to June 9, 1997, the deduction is denied only when you are directly or indirectly a beneficiary, and the life insurance policy covers an officer, employee, or other person financially interested in your trade or business. For more information, see *Nondeductible Premiums* in chapter 10.

Important Changes for 1998

The following items highlight some changes in the tax law for 1998.

Deduction for meals furnished to employees. For tax years beginning after 1997, your annual revenue from meals you furnish to employees both on your business premises and for your convenience is considered to equal your direct operating costs of providing these meals. A meal is considered provided for your convenience if you provide it for a substantial noncompensatory business reason. This legislative change may allow your eating facility for employees to qualify as a de minimis fringe benefit. As a de minimis fringe benefit, your deduction for meals provided in the facility is not limited to 50% of the cost of furnishing the meals. For more information, see chapters 3 and 4.

Qualified parking in place of pay. For tax years beginning after 1997, you can exclude qualified parking from an employee's wages even if you provide it in place of pay. You cannot exclude from an employee's wages any other qualified transportation fringe benefit that you provide in place of pay. For more information, see *Qualified Transportation Fringe* in chapter 4.

New group health plan requirements. For plan years beginning on or after January 1, 1998, you (or the plan, if a multi-employer plan) may be subject to an excise tax if your plan does not meet certain new requirements. These requirements generally:

- Obligate plans to pay for a minimum hospital stay following birth for mothers and newborns if the plan otherwise provides maternity benefits, and
- Prevent certain special limits from being placed on mental health benefits.

For more information, see *Other Requirements* under *Group Health Plans* in chapter 5.

Temporary suspension of taxable income limit for certain percentage depletion. For tax years beginning after 1997, percentage depletion deductions on the marginal production of oil or natural gas will no longer be limited to the taxable income from the property figured without the depletion deduction. For more information, see *Suspension of taxable income limit for marginal production* in chapter 13.

Meal expense deduction increases for certain individuals. Beginning in 1998, if an employee is subject to the Department of Transportation's hours of service limits, you may be able to deduct 55% of the meal and beverage expenses you reimburse for their travel away from their tax home. For more information, get Publication 553, *Highlights of 1997 Tax Changes.*

Important Change for 1999

Business use of your home. One situation in which you currently can deduct home office expenses is if you use part of your home exclusively and regularly as your principal place of business. ***Beginning in 1999,*** the definition of "principal place of business" is expanded. Your home office generally will qualify as a principal place of business if:

1) You use it exclusively and regularly for the administrative or management activities of your trade or business, and
2) You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

For more information about this, get Publication 553, *Highlights of 1997 Tax Changes.* For the current definition, get Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers).*

Important Reminders

Business use of your home. For tax years beginning after 1995, you may be able to deduct expenses for the part of your home you use to store product samples. For more information, see chapter 1.

Basis reduction for qualified electric vehicle. If you elect to claim a tax credit for a qualified electric vehicle you place in service during the year, you must reduce your basis in that vehicle. For vehicles placed in service after August 19, 1996, you must reduce your basis in that vehicle by the lesser of $4,000 or 10% of the cost of the vehicle, even if the credit allowed is less than that amount. For more information on the electric vehicle credit, see chapter 15.

1.

Deducting Business Expenses

Introduction

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

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **334** Tax Guide for Small Business
- ☐ **463** Travel, Entertainment, Gift and Car Expenses
- ☐ **529** Miscellaneous Deductions
- ☐ **536** Net Operating Losses
- ☐ **538** Accounting Periods and Methods
- ☐ **547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- ☐ **551** Basis of Assets
- ☐ **587** Business Use of Your Home (Including Use by Day-Care Providers)
- ☐ **925** Passive Activity and At-Risk Rules
- ☐ **936** Home Mortgage Interest Deduction
- ☐ **946** How To Depreciate Property

Form (and Instructions)

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

See chapter 17 for information about getting these forms and publications.

What Can Be Deducted?

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

It is important to separate business expenses from:

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

TIP *If you have an expense that is partly for business and partly personal, separate the personal part from the business part.*

Cost of Goods Sold

If your business manufactures products or purchases them for resale, some of your expenses are for the products you sell. You use these expenses to figure the cost of the goods you sold during the year. You 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.

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

1) The cost of products or raw materials in your inventory, including the cost of having them shipped to you,
2) The cost of storing the products you sell,
3) Direct labor costs (including contributions to pension or annuity plans) for workers who produce the products,
4) Depreciation on machinery used to produce the products, and
5) Factory overhead expenses.

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

For more information, see the following.

- Cost of goods sold—chapter 6 of Publication 334.
- Inventories—Publication 538
- Uniform capitalization rules—section 1.263A or the Income Tax Regulations

Capital Expenses

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

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

Recovery. Although you generally cannot directly deduct a capital expense, you may be able to take deductions for the amount you spend through a method of depreciation, amortization, or depletion. These methods allow you to deduct part of your cost each year over a number of years. In this way you are able to “recover” your capital expense. See *Amortization* (chapter 12) and *Depletion* (chapter 13) in this publication. For information on depreciation, see Publication 946.

Going Into Business

The costs of getting started in business, before you actually begin business operations, are capital expenses. This may include expenses for advertising, travel, utilities, repairs, or employees' wages.

If you go into business. When you go into business, treat all costs you had to get it started as capital expenses.

Usually you recover costs for a particular asset through depreciation. Other start-up costs can be recovered through amortization. If you do not choose to amortize these costs, you generally cannot recover them until you sell or otherwise go out of business.

See *Going Into Business* in chapter 12 for more information on business start-up costs.

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

1) The costs you had before making a decision to acquire or begin a specific business. These costs are personal and nondeductible. They include any costs incurred during a general search for, or preliminary investigation of, a business or investment possibility.
2) The costs you had in your attempt to acquire or begin a specific business. These costs are capital expenses and you can deduct them 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. You will recover the costs of these assets when you dispose of them.

Business Assets

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

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

Improvements

The costs of making improvements to a business asset are capital expenses, if the improvements add to the value of the asset, appreciably lengthen the time you can use it, or adapt it to a different use. You can deduct repairs that keep your property in a normal efficient operating condition as a business expense.

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

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

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

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

Capital or Deductible Expenses

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

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

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

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

Roads and driveways. The costs 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 parts. 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.

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

Personal Expenses

Generally, you cannot deduct personal, living or family expenses. However, if you have an expense for something that is used partly for business and partly for personal purposes, divide the total cost between the business and personal parts. You can deduct as a business expense only the business part.

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

Business use of your home. If you use your home in your business, you may be able to claim part of the expenses of maintaining your home as a business expense. These expenses include mortgage interest, insurance, utilities, and repairs.

The business use of your home must meet strict requirements before you can take any of these expenses as business deductions. You can take a limited deduction for its business use if you use part of your home ***exclusively*** and ***regularly*** :

1) As the principal place of business for any trade or business in which you engage.

2) As a place to meet or deal with patients, clients, or customers in the normal course of your trade or business, or

3) In connection with your trade or business, if you are using a separate structure that is not attached to your home.

There are two exceptions to the exclusive use test:

1) The use of part of your home for the storage of inventory or product samples, and

2) The use of part of your home as a daycare facility.

For more information, see Publication 587.

Business use of your car. If you use your car in your business, you can deduct car expenses. If you use your car for both business and personal purposes, you must divide your expenses based on mileage. Only your expenses for the miles you drove it for business are deductible as business expenses.

You can deduct actual car expenses, which include, depreciation, gas and oil, tires, repairs, tune-ups, insurance, and registration fees. Instead of figuring the business part of these actual expenses, you may be able to use a standard mileage rate to figure your deduction. For 1997, the standard mileage rate for a car that you own is 31.5 cents for each business mile.

If you are self-employed, you can deduct the business part of interest on your car loan, state and local personal property tax on the car, parking fees, and tolls whether or not you claim the standard mileage rate. You can use the nonbusiness part of the personal property tax to determine your deduction for taxes on Schedule A (Form 1040) if you itemize your deductions.

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

How Much Can Be Deducted?

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

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

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

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

At-risk limits. Generally, a deductible loss from a business or investment activity is limited to the investment you have “at risk” in the activity. You are “at risk” in any activity for:

1) The money and adjusted basis of property you contribute to the activity, and

2) Amounts you borrow for use in the activity if:

   a) You are personally liable for repayment, or

   b) You pledge property (other than property used in the activity) as security for the loan.

For more information, see Publication 925.

Passive activities. Generally, you are in a passive activity if you have a trade or business activity in which you do not materially participate during the year, or a rental activity. Deductions from passive activities generally can only offset your income from passive activities. You cannot deduct any excess deductions against your other income. In addition, you can take passive activity credits only from tax on net passive income. Any excess loss or credits are carried over to later years.

For more information, see Publication 925.

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

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

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

When Can an Expense Be Deducted?

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

For more information on accounting methods, see Publication 538.

Economic performance rule. Under an accrual method, you generally do not deduct or capitalize business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided, or as the property is used. If your expense is for property or services you provide to others, economic performance occurs as you provide the property or service.

Example. Your tax year is the calendar year. In December 1997, the Field Plumbing Company did some repair work at your place of business and sent you a bill for $150. You paid it by check in January 1998. If you use an accrual method of accounting, deduct the $150 on your tax return for 1997 because all events that set the amount of liability and economic performance occurred in that year. If you use the cash method of accounting, take the deduction on your 1998 return.

Prepayment. You cannot deduct expenses in advance, even if you pay them in advance. This rule applies to both the cash and accrual methods. It applies to prepaid interest, prepaid insurance premiums, and any other expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

Example. In 1997, you sign a 10-year lease and immediately pay your rent for the first three years. Even though you paid the rent for 1997, 1998, and 1999, you can deduct only the rent for 1997 on your current tax return. You can deduct on your 1998 and 1999 tax returns the rent for those years.

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

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

Not-for-Profit Activities

If you do not carry on your business or investment activity to make a profit, there is a limit on the deductions you can take. You cannot use a loss from the activity to offset other income. Activities you do as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors.

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

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

1) Whether you carry on the activity in a businesslike manner.
2) Whether the time and effort you put into the activity indicate you intend to make it profitable.
3) Whether you are depending on income from the activity for your livelihood.
4) Whether your losses 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 profitability.
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). You can only deduct a nonbusiness casualty loss to the extent it is more than $100 and all these losses exceed 10% of your adjusted gross income. See Publication 547 for more information on casualty losses.

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

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than 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.

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

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

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

Ida must limit her deductions to $3,200, the gross income she earned from the activity. The limit is reached in category (3), as follows:

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

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

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

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

The basis of each asset is reduced accordingly.

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

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

More than one activity. If you have several undertakings, each may be a separate activity, or several undertakings may be one activity. 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.

TIP *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 later, 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.

TIP *Form 5213 generally must 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.

2. Employees' Pay

Introduction

This chapter is about deducting salaries, wages, and other forms of pay you make to your employees. It discusses:

- Common types of payments,
- What you can deduct for each type,
- How to deduct each type on your tax return,
- Whether you include the payment in your employees' income as wages, and
- If the payment is subject to employment taxes and income tax withholding.

You also may pay your employees indirectly through employee benefit programs. For example, you can deduct group term life insurance premiums you pay or incur on a policy covering an employee if you are not the direct or indirect beneficiary of the policy. You can deduct the cost of providing coverage of $50,000 or less for an employee as an employee benefit. You must include the cost of providing coverage over $50,000 in the employee's income, and you can deduct it as wages. For more information about employee benefit programs, see chapter 5.

The rules discussed in this chapter can apply to sole proprietors, partnerships, corporations, estates, trusts, and any other entity that carries on a trade or business and pays an employee for services.

Topics

This chapter discusses:

- Deductibility of pay
- Kinds of payments

Useful Items

You may want to see:

Publication

- ☐ **15** Circular E, Employer's Tax Guide
- ☐ **15–A** Employer's Supplemental Tax Guide
- ☐ **521** Moving Expenses
- ☐ **551** Basis of Assets
- ☐ **946** How To Depreciate Property

Form (and Instructions)

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

See chapter 17 for information about getting publications and forms.

Deductibility of Pay

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

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

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

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

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

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

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

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

Uniform capitalization rules. 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 you acquire for resale is not subject to these rules if your average annual gross receipts for the 3 preceding tax years are $10 million or less. You can deduct these costs as a current business expense. For more information, see Publication 551.

Construction of capital asset. You cannot deduct salaries and other wages incurred for constructing a capital asset. You must include them in the basis of the asset and recover your cost through depreciation deductions. See Publication 946 for information about depreciation.

Tests for Deductibility

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

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

Test 1 — Ordinary and necessary. You must be able to show that the salary, wage, or other payment for services an employee performs for you is an ordinary and necessary expense. You also must be able to show that it is directly connected with your trade or business. For more information, seen *What Can Be Deducted?* in chapter 1.

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 your employee's services only if the payment is ordinary and necessary to carry on your trade or business.

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

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

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

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

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

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

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

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

If you use the cash method of accounting, deduct the salary or wages paid to an employee in the year you pay it to the employee.

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

Kinds of Payments

Some of the ways you may provide pay to your employees are discussed next.

Bonuses and Awards

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

Bonuses. You can deduct a bonus paid to an employee if you intended the bonus as additional pay for services, not as a gift, and the services were actually performed. However, to deduct the amount as wages the total bonuses, salaries, and other pay must be reasonable for the services performed. Include the bonus in the employee's income. You can pay a bonus in cash, property, or a combination of both.

Gifts of nominal value. If, 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 even though the employees do not include the items in income.

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

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

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

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

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

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

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

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

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

Limits on deductible awards. Deductible nonqualified plan awards made to any one employee cannot be more than $400 during the tax year. The total deductible awards, including both qualified and nonqualified plan awards, made to any one employee cannot be more than $1,600 during the tax year.

If the employee achievement awards do not exceed the limits, you can exclude them from the employee's income and you can deduct them on the “Other deductions” line of your tax return or business schedule.

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

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

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

Loans or Advances

You generally can 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 you add the loan or advance to the employee's other pay, and it must meet the tests for deductibility, discussed earlier. However, if the employee performs no services, treat the amount you advanced to the employee as a loan, which you cannot deduct.

Below-market interest rate loans. On certain loans you make to an employee or stockholder, you are treated as having received interest income and as having paid compensation or dividends equal to that interest. See *Below-Market Interest Rate Loans* in chapter 8 for more information.

Vacation Pay

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

Cash method. If you use the cash method of accounting, deduct vacation pay as wages when you pay it to an employee.

Accrual method. If you use an accrual method of accounting, you can deduct vacation pay earned by an employee as wages in the year earned only if you pay it:

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

Deduct vacation pay in the year 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, figure your deduction for the salary using the following rules.

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

If you made no definite prior arrangement, no fixed obligation exists to make the later payments and you can deduct in the first year only the amount paid in that year. This rule is the same for the cash method and for any accrual method of accounting.

Special rule for accrual method payer. If you use an accrual method of accounting, you cannot deduct salaries, wages, and other expenses owed to a related taxpayer (defined next) 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 before the amount is includible in that person's gross income.

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

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

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

- Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.
- Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. See *Related taxpayers,* earlier, for persons considered members of a family.
- Stock in a corporation owned by an individual (other than because of rule (2) above) is considered owned by or for the individual's partner.
- Stock considered owned by a person because of rule (1) is treated, for applying rules (1), (2), or (3), as actually owned by that person. But stock considered owned by an individual because of rules (2) or (3) is not treated as owned by that individual for applying either rule (2) or (3) again to consider another the owner of that stock.

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

Because of a temporary cash shortage, Tom pays Bob $600 in January of the next year and the $400 balance in April. Tom cannot deduct the $1,000 until the year in which he pays it, the year Bob must include the amount in his income.

Example 2. The Lomar Corporation uses the calendar year as its tax year and an accrual method of accounting. Frank Wilson, an officer of the corporation, also uses the calendar year and the cash method of accounting. At the end of the calendar year, Frank owns 50% of the outstanding stock of the corporation. In March of the next year, he buys additional shares that bring his holdings to 51%. At the end of the first year, the corporation accrues salary of $1,000 payable to Frank.

The Lomar Corporation pays Frank $600 in January of the second year, and the balance that March. The corporation can deduct the salary of $1,000 in the first year. Frank and the Lomar Corporation are not related taxpayers at the end of Lomar's first tax year.

Guaranteed Annual Wage

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

Pay for Sickness and Injury

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

Meals and Lodging

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

You may have to include the value of meals or lodging in an employee's income. For meals, this depends on whether you furnished them on your premises for your convenience. For lodging, it depends on whether you required it as a condition of employment. See chapter 3 for more information.

Payment of Employee Expenses

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

1) You deduct the payment under an ***accountable plan*** in the category of the expense paid. For example, if you pay an employee for travel expenses incurred on your behalf, deduct this payment as a travel expense on your return.

See the instructions for the form you file for information on which lines to use.

2) Include the payment under a ***nonaccountable plan*** in the compensation you pay your employees and deduct it as wages on your return.

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

Education Expenses

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

If you pay or reimburse education expenses for an employee enrolled in a job-related course, you can deduct the payment as a noncompensatory business expense. Since this expense would be deductible if paid by the employee, it is called a working condition fringe benefit. Do not include a working condition fringe benefit in an employee's income. Working condition fringe benefits are discussed in more detail in chapter 4.

Moving Expenses

Deduct as a qualified fringe benefit amounts you pay employees or pay for them 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:

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

Qualified moving expenses do not include any expenses for meals.

Deduct as wages any payment you make as an allowance or payment for a nonqualified moving expense (that is, an expense the employee cannot deduct). You must include the payment of nonqualified moving expenses in the employee's income. The payment is wages for income tax withholding and FICA and FUTA taxes. Treat the payment 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, report any amount considered a qualified fringe benefit in box 13, not as wages in box 1.

More information. For more information about moving expenses, see Publication 521. For information about excluding fringe benefits, see chapter 4.

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 it as wages. The amount you can deduct is its fair market value on the date of the transfer minus 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. Your gain or loss is the difference between the fair market value of the asset and its adjusted basis on the date of transfer.

Payment in Restricted Property

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 property is not subject to a substantial risk of forfeiture. 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. You must report the amount on a timely filed Form W–2 or Form 1099–MISC (even if the recipient is a corporation) to take the deduction. However, You do not have to report if the transfer:

- Is exempt from reporting because the payment is less than the $600 reporting requirement for Form 1099–MISC, or
- Meets any other reporting exception that applies to a recipient other than a corporation.

3. Meals and Lodging Furnished to Employees

Important Change for 1998

Deduction for meals. For tax years beginning after 1997, your annual revenue from meals you furnish to employees both on your business premises and for your convenience is considered to equal your direct operating costs of providing these meals. This change makes it easier for these meals to qualify as a de minimis fringe benefit. As a de minimis fringe benefit, your deduction for these meals is not limited to 50% of the costs of furnishing them. For more information, see chapter 4 and *Deduction limit on meals,* later.

Introduction

This chapter discusses the deduction for meals and lodging you furnish to your employees. It also describes the tests you must meet to exclude the value of meals and lodging from your employees' wages.

For information on the requirements that all business expenses must meet, see chapter 1. If you include the value of the meals and lodging in an employee's wages, that value, when added to all other compensation you pay to that employee, must meet all the tests described under *Tests for Deductibility* in chapter 2. See chapter 4 for rules you must use to value any meals or lodging you must include in your employees' wages.

Topics

This chapter discusses:

- Deduction for meals and lodging
- Exclusion from employee wages

Useful Items

You may want to see:

Publication

☐ **15** Circular E, Employer's Tax Guide

See chapter 17 for information about getting this publication.

Deduction for Meals and Lodging

You can usually deduct the cost of furnishing meals and lodging to your employees. However, you can generally deduct only 50% of your costs of furnishing meals. For more information, see *Deduction limit on meals,* next.

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

CAUTION *If you must include the value of the meals and lodging in your employees' wages, do not deduct as wages the amount you claimed elsewhere on your return.*

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

1) Meals that qualify as a de minimis fringe benefit as discussed in chapter 4.
2) Meals where you include their value in an employee's wages. For more information, see *Exclusion From Employee Wages,* later.
3) Meals you furnish to your employees at the work site when you operate a restaurant or catering service.
4) Meals you furnish to your employees as part of the expense of providing recreational or social activities, such as a company picnic.
5) Meals you must furnish to crew members of a commercial vessel under a federal law. This includes crew members of commercial vessels operating on the Great Lakes, the Saint Lawrence Seaway, or any U.S. inland waterway if meals would be required under federal law had the vessel been operated at sea. This does not include meals you furnish on vessels primarily providing luxury water transportation.
6) Meals you furnish on an oil or gas platform or drilling rig located offshore or in Alaska. This includes meals you furnish at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

Exclusion From Employee Wages

Generally, you must include in an employee's wages the value of meals and lodging you furnish to the employee or the employee's spouse or dependents. Use the general valuation rule, discussed in chapter 4, to determine the amount to include in the employee's wages. However, if you provide meals at an employer-operated eating facility, you may be able to use the employer-operated-eating-facility rule to value the meals. For more information, see chapter 4.

You can exclude from an employee's wages the value of meals you furnish to the employee if the meals qualify as a de minimis fringe benefit (see chapter 4). Also, if you meet the following tests, you can exclude from an employee's wages the value of meals and lodging you, or a third party on your behalf, furnish to the employee or the employee's spouse or dependents.

- ***Test 1.*** You furnish the meals or lodging ***on your business premises.***
- ***Test 2.*** You furnish the meals or lodging ***for your convenience.***
- ***Test 3.*** In the case of lodging (but not meals), your employees must accept the lodging on your business premises ***as a condition of their employment.*** This means they must accept the lodging to allow them to properly perform their duties.

However, if an employee can choose to receive additional pay instead of meals or lodging, you must include the value of the meals or lodging in the employee's wages. The examples at the end of this chapter will help you apply these tests.

Test 1—On Your Business Premises

This generally means the place of employment. For example, meals and lodging you furnish to a household employee in your private home are furnished on your business premises. Similarly, meals you furnish to cowhands while herding cattle on land you lease or own are furnished on your business premises.

Test 2—For Your Convenience

Whether you furnish meals or lodging for your convenience as an employer depends on all the facts and circumstances. You furnish the meals or lodging to your employee for your convenience if you do this for a substantial business reason other than to provide the employee with additional pay. This is true even if a law or an employment contract provides that they are furnished as pay. A written statement that the meals or lodging are for your convenience is not sufficient.

Substantial nonpay reasons. The following meals are furnished for a substantial nonpay business reason.

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

Meals you furnish to promote goodwill, boost morale, or attract prospective employees. These meals are considered furnished in your business for pay reasons.

Meals furnished on nonworkdays or with lodging. The value of meals you furnish on any nonworkday is normally not furnished for your convenience. However, if your employees must occupy lodging on your business premises as a condition of employment, as discussed later under *Test 3—Lodging Required As a Condition of Employment,* do not treat the value of any meal you furnish on the business premises as wages.

Meals with a charge. The fact that you charge for the meals and that the employee may accept or decline the meals, is not taken into account in determining whether meals are furnished for your convenience.

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

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

Test 3—Lodging Required As a Condition of Employment

This means that you require your employees to accept the lodging because they need to live on your business premises to be able to properly perform their duties. Examples include employees who must be available at all times and employees who could not perform their required duties without being furnished the lodging.

It does not matter whether you must furnish the lodging as pay under the terms of an employment contract, or a law fixing the terms of employment.

You may furnish the lodging to your employees with or without a charge. If you charge a flat amount for lodging whether or not the employee accepts it, do not include the flat charge in the employee's wages. Whether the value of the lodging is wages depends on whether Tests 1, 2, and 3 are all met. If any one of these tests is not met, you must include the value of the lodging in your employees' wages whether it is more or less than the amount you charged for it. If no evidence indicates otherwise, the value of the lodging is the amount you charged for it.

Employment Taxes

The value of meals and lodging you exclude from an employee's wages is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

Examples

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

Example 1 (Meals). You operate a restaurant business. You furnish your employee, Carol, who is a waitress working 7 a.m. to 4 p.m., two meals during each workday. You encourage but do not require Carol to have her breakfast on the business premises before starting work. She must have her lunch on the premises. Since Carol is a food service employee and works during the normal breakfast and lunch periods, do not include the value of her breakfast and lunch in her wages.

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

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

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

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

4. Fringe Benefits

Important Change for 1997

Nondiscrimination rules. Nondiscrimination rules apply to the exclusion of certain fringe benefits from the income of highly compensated employees. For tax years beginning after 1996, the definition of “highly compensated employee” has changed. For more information, see *Nondiscrimination rules* under *Exclusion of Certain Fringe Benefits,* later.

Important Changes for 1998

Meals furnished to employees. For tax years beginning after 1997, your annual revenue from meals you furnish to employees both on your business premises and for your convenience is considered to equal your direct operating costs of providing these meals. A meal is considered provided for your convenience if you provide it for a substantial noncompensatory business reason. This legislative change may allow your eating facility for employees to qualify as a de minimis fringe benefit. As a de minimis fringe benefit, your deduction for meals provided in the facility is not limited to 50% of the cost of furnishing the meals. For more information, see chapter 3 and *De Minimis (Minimal) Fringe,* later.

Qualified parking in place of pay. For tax years beginning after 1997, you can exclude qualified parking from an employee's wages even if you provide it in place of pay. You cannot exclude from an employee's wages any other qualified transportation fringe benefit that you provide in place of pay. For more information, see *Qualified Transportation Fringe,* later.

Introduction

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

Topics

This chapter discusses:

- General information
- The general valuation rule
- Special valuation rules
- Exclusion of certain fringe benefits from employee income

Useful Items

You may want to see:

Publication

- ☐ **15** Circular E, Employer's Tax Guide
- ☐ **521** Moving Expenses

See chapter 17 for information about getting these publications.

General Information

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

Examples of fringe benefits you may provide include:

- The use of a car.
- Flights on airplanes.
- Discounts on property or services.
- Memberships in country clubs or other social clubs.
- Tickets to entertainment or sporting events.

Provider of fringe benefit. You are the provider of a fringe benefit if it is provided for services performed for you. You may be the provider of the benefit even if it was provided by another person. For example, you are the provider of a fringe benefit your client or customer provides to your employee for services the employee performs for you.

Nonemployer provider. You do not have to be the employer of the recipient to be the provider of a fringe benefit. For example, you may provide fringe benefits to an independent contractor as a client or customer of the contractor.

Recipient of benefit. Your employee or some other person who performs services for you is the recipient of a fringe benefit provided for those services. Your employee may be the recipient of the benefit even if it is provided to someone who did not perform services for you. For example, your employee is the recipient of a fringe benefit you provide to a member of the employee's family.

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

Including benefits in pay. Unless the law says otherwise, you must include fringe benefits in an employee's gross income as wages. The benefits are subject to income and employment taxes.

You and your employees will generally use the general valuation rule, discussed later, to figure the amount of a fringe benefit to include in your employees' income. However, you and your employees can use special rules to value certain fringe benefits. For more information, see *Special Valuation Rules,* later.

Deducting the cost. Even though you include an amount for noncash fringe benefits in an employee's gross income as wages, you cannot deduct that amount as wages. But you can deduct the costs you incurred to provide the benefit. You may be able to take an expense or depreciation deduction. For example, if a noncash fringe benefit you provide to your employee is property you lease, you must include the amount (value) of the benefit in the employee's wages, but you cannot deduct that amount as wages. However, you may be able to deduct the rent as a business expense.

When fringe benefits are treated as paid. You may choose to treat certain noncash fringe benefits as paid by the pay period, or by the quarter, or on any other basis you choose as long as you treat the benefits as paid at least as often as once a year. However, this choice does not apply to fringe benefits that involve the transfer of personal property normally held for investment or the transfer of real property.

You do not have to make a formal choice of payment dates or notify the IRS of the dates you choose. You do not have to use the same time period for all employees. You may change methods as often as you like, as long as you treat all benefits provided in a calendar year as paid by December 31 of that year. However, you may be able to use the special accounting period rule, discussed later, for fringe benefits you actually provide during November and December.

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

Accounting period. You have the option to report taxable noncash fringe benefits by using either of the following rules:

1) The general rule: value the benefit for a full calendar year (January 1 - December 31), or
2) The special accounting period rule (discussed next).

Special accounting period rule. Instead of reporting fringe benefits on a calendar year basis, you may choose to use a special accounting period rule. However, this choice does not apply to fringe benefits that involve the transfer of personal property normally held for investment or the transfer of real property.

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

Benefits you actually provide. Only the benefits you actually provide during the last 2 months of a calendar year can be deferred until the next year. For example, if you treat a fringe benefit as provided equally over the year, as discussed earlier under *When fringe benefits are treated as paid,* you can defer only the benefit you actually provide during the last 2 months.

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

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

More information. For more information on withholding from and reporting of taxable noncash fringe benefits, see Publication 15.

General Valuation Rule

You generally must include in an employee's wages the amount by which the ***fair market value*** of a fringe benefit is more than the sum of:

1) Any amount the employee paid for the benefit, and
2) Any amount the law excludes from income.

However, you and your employees may use special rules to value certain fringe benefits (see *Special Valuation Rules,* later).

Fair market value (FMV). In general, you determine the FMV of a fringe benefit on the basis of all the facts and circumstances. The FMV of a fringe benefit is the amount your employee would have to pay a third party to buy or lease the particular fringe benefit.

Neither the amount the employee considers to be the value of the fringe benefit nor the cost you incur to provide the benefit determines its FMV.

If the law excludes a ***fringe benefit cost*** from income, do not include in the employee's gross income the difference between the FMV and the excludable cost of that fringe benefit. If the law excludes a limited amount of the cost, however, include the FMV of the fringe benefit that is due to any excess cost.

Employer-provided vehicles. In general, the value of an employer-provided vehicle is the amount the employee would have to pay a third party to lease the same or a similar vehicle on the same or comparable terms in the same geographic area where the employee uses the vehicle. Do not determine the value by multiplying the cents-per-mile rate times the number of miles driven unless your employee can prove the vehicle could have been leased on a cents-per-mile basis. A comparable lease term would be the amount of time the vehicle is available for your employee's use, such as a 1-year period.

Special Valuation Rules

You may be able to use special valuation rules instead of the general valuation rule to value certain fringe benefits, including the use of any vehicle or eating facility you provide. The special valuation rules include the:

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

Conditions for use. When reporting fringe benefits, you can choose to use any of the special rules. However, neither you nor your employee may use a special rule to value any benefit, unless one of the following conditions is met:

1) You treat the value of the benefit as wages for reporting purposes by the due date of the return (including extensions) for the tax year you provide the benefit,
2) Your employee includes the value of the benefit in income by the due date of the return for the year the employee receives the benefit,
3) Your employee is not a control employee as defined later under *Commuting Rule,* or
4) You demonstrate a good faith effort to treat the benefit correctly for reporting purposes.

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

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

More information. For more information on special rules, including those (such as the rules for aircraft) not discussed in this chapter, see section 1.61–21(c) of the Income Tax Regulations.

Automobile Lease Rule

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

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

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

Benefits excluded for certain vehicles. These valuation rules do not apply to fringe benefits you can exclude for the use of certain vehicles. See *Qualified Nonpersonal Use Vehicles* under *Working Condition Fringe,* later.

Annual Lease Value

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

1) Determine the FMV of the automobile (discussed later) on the first date the automobile is available to any employee for personal use.

2) Using the following Annual Lease Value Table, read down column 1 until you come to the dollar range within which the FMV of the automobile falls. Then read across to column 2 to find the annual lease value.

Annual Lease Value Table

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

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

Fair market value. The FMV of the automobile is the amount a person would pay to buy it from a third party, in an arm's length transaction, in the area in which the vehicle is bought or leased. That amount includes sales tax and title fees.

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

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

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

Safe-harbor value. You can use the safe-harbor value as the FMV. For an automobile you bought at arm's length, the safe-harbor value is your cost, including tax, title, and other purchase expenses. You cannot have been the manufacturer of the vehicle.

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

1) The manufacturer's invoice price (including options) plus 4%,

2) The manufacturer's suggested retail price less 8% (including sales tax, title, and other expenses of purchase), or

3) The retail value of the automobile reported by a nationally recognized pricing source.

Items included in annual lease value table. Each annual lease value in the table includes the FMV of maintenance and insurance services for the automobile. Do not reduce this value by the FMV of any of these services that you did not provide. For example, do not reduce the annual lease value by the FMV of a maintenance service contract or insurance you did not provide. However, you can take into account the services actually provided for the automobile by using the general valuation rule.

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

If you reimburse an employee for the cost of fuel, or have it charged to you, you generally value the fuel at the amount you reimburse, or the amount charged to you if it was bought at arm's length. If you have 20 or more automobiles, see section 1.61–21(d)(5)(v) of the Income Tax Regulations.

If you provide any service (other than maintenance and insurance) for an automobile, you must add the FMV of that service to the annual lease value of the automobile in determining the value of the benefit.

Consistency rules. If you adopt the automobile lease rule:

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

2) You must use the rule for all later years in which you make the automobile available to any employee, except that for any year during which use of the automobile qualifies, you can use the commuting rule.

3) You must continue to use the rule if you provide a replacement automobile to your employee and your primary reason for the replacement is to reduce federal taxes.

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

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

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

For example, assume that you use the special accounting period rule and that beginning on November 1, 1996, the special accounting period is November 1 to October 31. You elect to use the automobile lease valuation rule as of January 1, 1997. You can refigure the annual lease value on November 1, 2000, rather than on January 1, 2001.

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

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

Prorated annual lease value. If you provide an automobile to your employee for continuous periods of 30 or more days but less than an entire calendar year, you can prorate the annual lease value. Figure the prorated annual lease value by multiplying the annual lease value by a fraction, using the number of days of availability as the numerator and 365 as the denominator.

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

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

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

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

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

Vehicle Cents-Per-Mile Rule

You can use the vehicle cents-per-mile rule if you provide an employee with a vehicle that:

1) You reasonably expect will be regularly used in your trade or business throughout the calendar year (or for a shorter period during which you own or lease it), or

2) Meets the mileage rule requirements discussed later.

Under this cents-per-mile rule, you value the benefit using the standard mileage rate multiplied by the total miles the employee drives the vehicle for personal purposes. For 1997, this rate is 31.5 cents per mile.

CAUTION ***When you cannot use the cents-per-mile rule.*** *You cannot determine the value of the use of an automobile under the vehicle cents-per-mile rule if the FMV of the automobile is more than $15,700 in 1997.*

Determine whether a vehicle is regularly used in your trade or business on the basis of all the facts and circumstances. A vehicle is regularly used in a trade or business if it meets one of the following conditions.

1) At least 50% of the vehicle's total annual mileage is for that trade or business, or

2) You sponsor a commuting pool that generally uses the vehicle each workday to drive at least 3 employees to and from work.

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

Apply the standard mileage rate to personal miles, but disregard business miles. For example, if your employee drives 20,000 personal miles and 35,000 business miles in 1997, the personal use value of the vehicle is $6,300 (20,000 $\times$ 0.315).

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

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

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

1) It is actually driven at least 10,000 miles in that year, and

2) It is used during the year primarily by employees.

Consider the vehicle used primarily by employees if they use it consistently for commuting. For example, if only one employee uses a vehicle during the year and that employee drives the vehicle at least 10,000 miles in that calendar year, the vehicle meets the mileage rule even if all miles driven by the employee are personal. Do not treat use of the vehicle by an individual (other than the employee) whose use would be taxed to the employee as use by the employee. If you own or lease the vehicle only part of the year, reduce the 10,000 mile requirement proportionately.

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

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

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

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

Consistency rules. If you adopt the cents-per-mile rule:

1) You must adopt it by the first day you make the automobile available to one of your employees for personal use. However, if you adopt the commuting rule (discussed later) when you first make the automobile available to your employee for personal use, you can change to the cents-per-mile rule on the first day for which you do not use the commuting rule.

2) You must use the rule for all later years in which you make the automobile available to any employee, except that for any year during which use of the automobile qualifies, you can use the commuting rule.

3) You must continue to use the rule if you provide a replacement automobile to your employee and your primary reason for the replacement is to reduce federal taxes.

If the vehicle does not qualify for the cents-per-mile rule during a later period, you can adopt any other special rule for which the vehicle then qualifies. If you use the automobile lease rule (discussed earlier), treat the first day on which an automobile no longer qualifies for the cents-per-mile rule as the first day on which the automobile is available to your employee for personal use.

Commuting Rule

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

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

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

1) You own or lease the vehicle and provide it to one or more employees for use in your trade or business.

2) For bona fide noncompensatory business reasons, you require the employee to commute in the vehicle.

3) You establish a written policy under which you do not allow employees to use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home).

4) Your employee does not use the vehicle for personal purposes, other than commuting and de minimis personal use.

5) If this vehicle is an automobile, the employee who must use it for commuting is not a ***control employee*** (defined later).

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

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

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

1) Is a board- or shareholder-appointed, confirmed, or elected officer of the employer and whose pay is $70,000 or more,
2) Is a director of the employer,
3) Receives pay of $140,000 or more from the employer, or
4) Owns a 1% or more equity, capital, or profits interest in the employer.

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

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

1) Elected official, or
2) Employee whose pay is at least as much as that paid to a federal government employee at Executive Level V. For 1997, this amount is $108,200.

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

Commuting because of unsafe conditions. The value of the commuting use of employer-provided transportation is $1.50 for a one-way commute if:

1) Your employee is a qualified employee (defined later),
2) The employee does not use the transportation for personal purposes other than commuting because of unsafe conditions,
3) You provide transportation solely because of unsafe conditions to your employee who would ordinarily walk or use public transportation for commuting, and
4) You establish a written policy under which the transportation is not provided for your employee's personal purposes other than for commuting because of unsafe conditions and your practice follows the established policy.

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

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

Qualified employee. A qualified employee is one who:

1) Performs services during the current year,
2) Is paid on an hourly basis,
3) Is not claimed under section 213(a)(1) of the Fair Labor Standards Act of 1938 (as amended) to be exempt from the minimum wage and maximum hour provisions,
4) Is within a classification for which you actually pay, or specify in writing you will pay, overtime pay equal to or exceeding one and one-half times the regular rate provided in section 207 of the 1938 Act, and
5) Does not receive pay of more than $70,000 from you in 1997.

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

Employer-Operated-Eating-Facility Rule

If you must include the value of meals in an employee's wages, determine the amount to include under the general valuation rule. If you provide the meals at an employer-operated eating facility, see the discussions following the definition of that facility, next. For situations where you do not have to include the value of meals in an employee's wages, see chapter 3 and the discussion under *De Minimis (Minimal) Fringe,* later.

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

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

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

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

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

CAUTION

Do not include in direct operating costs the labor cost for a manager of an eating facility who does not primarily perform services on the eating facility premises.

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

Individual meal subsidy. Figure the individual meal subsidy by multiplying the price charged for a particular meal by a fraction, using the total meal value as the numerator and the gross receipts of the eating facility for the calendar year as the denominator. Then subtract the amount paid by the employee for the meal. The taxable value of meals provided to a particular employee during a calendar year is the total of the individual meal subsidies you provide to that employee during the year.

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

Exclusion of Certain Fringe Benefits

Special rules allow you to exclude certain fringe benefits you provide to an employee from the employee's wages. The fringe benefits you can exclude under these rules are:

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

These are not the only employee benefits you can exclude from your employee's wages. You can also exclude certain benefits you provide through employee benefit programs. For more information, see chapter 5.

Generally, an exclusion does not apply if the tax treatment of the fringe benefit is provided by another tax rule. For example, an exclusion does not apply to employer-provided dependent care assistance or tuition reductions, the tax treatments of which are covered by other rules.

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

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

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

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

Highly compensated employee. The definition of "highly compensated employee" has been changed. For tax years beginning in 1997, a highly compensated employee is an employee who:

1) Was a 5% owner at any time during the year or the preceding year, or
2) Received more than $80,000 in pay from the employer for the preceding year.

When you apply requirement (2), you may choose to include only employees who were also in the top 20% of employees when ranked by pay for the preceding year.

For tax years that began in 1996, a highly compensated employee is an employee who during the current or preceding year:

1) Was a 5% owner of the employer,
2) Received more than $100,000 in pay from the employer,
3) Received more than $66,000 in pay from the employer and was in the top 20% of all employees when ranked by pay, or
4) Was at any time an officer of the employer and received more than $60,000 in pay.

If no officer meets requirement (4), the highest paid officer will be treated as a highly compensated employee.

No-Additional-Cost Service

If you provide an employee with the same service you offer to customers in the ordinary course of the line of business in which the employee works, this service is a no-additional-cost service. See the preceding discussion, *Nondiscrimination Rules,* if the employee is highly compensated. You do not include the cost in the employee's wages if you do not have any substantial additional costs to provide the service to the employee. To determine additional costs include lost revenue, but do not reduce the costs you incur by any amount the employees paid for this service.

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

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

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

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

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

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

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

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

Dependent child. For this fringe benefit, "dependent child" means any son, stepson, daughter, or stepdaughter who is a dependent of the employee, or both of whose parents have died and who has not reached age 25. Treat a child of divorced parents as a dependent of both parents.

Qualified Employee Discount

Gross income does not include the value of a qualified employee discount. A qualified employee discount is a price reduction you give an employee on certain property or services you offer to customers in the ordinary course of the line of business in which the employee performs services. If the employee is highly compensated, see *Nondiscrimination rules,* the first discussion in this section.

However, a discount on real property (such as a building or land) or on personal property of a kind commonly held for investment (such as stocks or bonds) is not a qualified employee discount. The exclusion does not apply where there is a reciprocal agreement under which another employer would provide the discount. A qualified employee discount also does not include any amount that is more than the amount determined for the following:

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

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

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

Working Condition Fringe

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

For this fringe benefit, "employee" includes any:

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

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

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

However, instead of excluding the value of the working condition fringe related to the qualified car expense, you may include the entire annual lease value in your employee's wages. The employee can then claim any allowable business car expense on his or her personal income tax return.

The total inclusion option is only allowed if you use the automobile lease rule (discussed under *Special Valuation Rules,* earlier) to value the fringe benefit for a vehicle you furnish to your employee.

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

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

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

Demonstrator cars. You can exclude the value of the use of a demonstrator car by your full-time auto salesperson if the use is primarily to facilitate the services the salesperson provided for you and there are substantial restrictions on personal use. For the definition of "full-time auto salesperson," see section 1.132–5(o) of the Income Tax Regulations.

Qualified Nonpersonal Use Vehicles

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

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

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

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

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

1) Carry firearms,
2) Execute search warrants, and
3) Make arrests (other than citizen's arrests).

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

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

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

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

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

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

Items Not Excludable

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

1) A service or property offered through a flexible spending account. A flexible spending account is an agreement that gives employees over a time period a certain amount of unspecified noncash benefits with a predetermined cash value.
2) Any item for which the employee does not have the necessary substantiation to deduct as a trade, business, or depreciation expense.
3) Expenses the employee can deduct under sections of the Internal Revenue Code other than for trade or business expenses or depreciation.
4) A physical examination program, whether mandatory to some or all employees.
5) A cash payment you made to your employee unless you require your employee to do all of the following:
   a) Use the money for expenses that are deductible in a specific or prearranged activity as trade, business, or depreciation expenses,
   b) Verify that he or she uses the money for these expenses, and
   c) Return any unused money to you.

De Minimis (Minimal) Fringe

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

Examples of de minimis fringes include:

- Typing of a personal letter by a company secretary,
- Occasional personal use of a company copying machine,
- Occasional parties or picnics for employees and their guests,
- Occasional meal money or local transportation fare for employees working overtime not based on hours worked and, for meals, provided to enable the employee to work overtime,
- Holiday gifts, other than cash, with a low FMV,

- Occasional tickets for entertainment events,
- Coffee, doughnuts, or soft drinks furnished to employees, and
- Group-term life insurance payable on the death of an employee's spouse or dependent if it is not more than $2,000.

The value of meals you provide to your employees at an eating facility operated by you is a de minimis fringe benefit only if the annual revenue from the facility equals or exceeds the direct operating costs of the facility. The meals must be available on substantially the same terms to each member of a group of employees (see *Nondiscrimination rules,* the first discussion in this section, *Exclusion of Fringe Benefits).* For more information, including definitions of an employer-operated eating facility and direct operating costs, see *Employer-Operated-Eating-Facility Rule,* the last discussion in the preceding section, *Special Valuation Rules.*

TIP *For tax years beginning after 1997, your annual revenue from meals you furnish to employees both on your business premises and for your convenience is considered to equal your direct operating costs of providing these meals. A meal is considered provided for your convenience if you provide it for a substantial noncompensatory business reason. This legislative change may allow your eating facility for employees to qualify as a de minimis fringe benefit. As a de minimis fringe benefit, your deduction for meals provided in the facility is not limited to 50% of the cost of furnishing the meals. For more information, see chapter 3.*

Qualified Transportation Fringe

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

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

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

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

TIP *For tax years beginning after 1997, you can exclude qualified parking from an employee's wages even if you provide it in place of pay. You cannot exclude from an employee's wages any other qualified transportation fringe benefit that you provide in place of pay.*

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

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

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

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

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

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

Employee. You can provide qualified transportation fringe benefits only to employees. The definition of employee includes common-law employees and other statutory employees, such as officers of corporations. Self-employed individuals, including partners, 2-percent shareholders in S corporations, sole proprietors, and other independent contractors are not employees for purposes of this fringe benefit.

Exclusion Limits

For 1997, you may exclude from the gross income of each employee up to:

1) $65 per month for combined commuter highway vehicle transportation and transit passes, and
2) $170 per month for qualified parking.

Excess benefits taxable. If, for any month, the fair market value of a benefit is more than its limit, include in the employee's wages only the amount over the limit, minus any amount paid for the benefit by or for the employee.

Example 1. Each month, you provide a transit pass valued at $70 to your employee, Tom Travis. He does not pay you for any part of the pass. Because the value of the transit pass exceeds the limit, for each month you provide this pass you must include $5 in his wages for income and employment tax purposes.

Example 2. Each month, you provide qualified parking valued at $180 to Travis Ramon. He does not pay you for any part of the parking. Because the value of the parking exceeds the limit, for each month you provide this parking you must include $10 in his wages for income and employment tax purposes.

Example 3. You provide qualified parking with a fair market value of $200 per month to your employees, but you charge the employees $30 per month. The value of the parking exceeds the limit by $30. You reduce that excess benefit by the amount your employees paid ($30). Do not include any amount in your employees' gross income.

Taxable Benefits – Withholding and Reporting

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

Noncash benefits. For information on when and how to withhold on and report taxable noncash fringe benefits, see *Including benefits in pay* and *When fringe benefits are treated as paid* under *General Information* at the beginning of this chapter.

Cash reimbursements. For employment tax purposes, treat taxable cash reimbursements as paid when actually paid. You must deposit and report amounts withheld along with your FUTA tax and your part of the social security and Medicare taxes.

More Information

For more information on qualified transportation fringe benefits, including van pools, and how to determine the value of parking, see Notice 94–3, 1994–1, C.B. 327.

Qualified Moving Expense Reimbursements

You can exclude from your employee's wages any reimbursements or payments you make for qualified moving expenses. This includes amounts you give your employee, directly or indirectly, as a payment for, or a reimbursement of, expenses that would be deductible as moving expenses if your employee paid or incurred them. You should make the reimbursements under rules similar to those described under *Reimbursements* and its discussion *Accountable Plans* in chapter 16.

Deductible moving expenses. Deductible moving expenses 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.

Deductible moving expenses ***do not include*** *any expenses for meals. For information on moving expenses, see Publication 521.*

Nonqualified reimbursements. Include any reimbursements for moving expenses that are not qualified moving expense reimbursements in your employee's wages. This includes any payment for, or reimbursement of, expenses your employee may have deducted in a prior year.

Where to report reimbursements. Report any reimbursements you make in 1997 that qualify as an excludable fringe benefit in box 13 of the 1997 Form W–2. Use code “P” to identify the reimbursements that are reported in box 13.

Include any reimbursements that you cannot exclude with your employee's wages in box 1.

Athletic Facilities

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

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

5. Employee Benefit Programs

Important Changes for 1997

Adoption assistance. For tax years beginning after 1996, up to $5,000 ($6,000 for a special needs child) you pay or incur under an adoption assistance program for an employee's qualified adoption expenses is excludable from the employee's gross income. For more information, see *Adoption Assistance,* later.

Educational assistance. Each year you can exclude from an employee's wages up to $5,250 you pay or incur under an educational assistance program. This exclusion, which expired for tax years beginning after May 31, 1997, has been extended retroactively. It will now expire for expenses paid with respect to courses beginning after May 31, 2000. For more information, see *Educational Assistance,* later.

Group health plan requirements. Generally effective for plan years beginning after June 30, 1997, you (or the plan, if a multi-employer plan) may be subject to an excise tax if your plan does not meet the new accessibility, portability, and renewability requirements. For more information, see *Other Requirements,* under *Group Health Plans,* later.

Medical savings accounts. For tax years beginning after 1996, a new program for a tax-exempt medical savings account (MSA) is available (for up to 4 years) to self-employed persons and employees of a small business. You can contribute (within limits) to an MSA for each employee you cover under a high-deductible health plan. You can exclude from an employee's income amounts you contribute to his or her MSA. For more information, see *Medical Savings Accounts,* under *Group Health Plans,* later.

Important Change for 1998

New group health plan requirements. For plan years beginning on or after January 1, 1998, you (or the plan, if a multi-employer plan) may be subject to an excise tax if your plan does not meet certain new requirements. These requirements generally:

- Obligate plans to pay for a minimum hospital stay following birth for mothers and newborns if the plan otherwise provides maternity benefits, and
- Prevent certain special limits from being placed on mental health benefits.

For more information, see *Other Requirements,* under *Group Health Plans,* later.

Introduction

This chapter discusses some fringe benefits (defined in chapter 4) you can provide to your employees as part of an employee benefit program.

You can generally deduct the cost of providing the benefits discussed in this chapter on the “employee benefit programs” line of your business income tax return. However, you must be able to show that your cost for each employee represents current pay and that the total of this cost plus your other pay to the employee was reasonable as discussed in chapter 2.

You can generally exclude a limited amount of the cost of providing these benefits to an employee from his or her wages as you withhold, pay, and report employment taxes. This chapter explains how to figure the amount you can exclude from your employee's wages.

Topics

This chapter discusses:

- Adoption assistance
- Cafeteria plans
- Dependent care assistance
- Educational assistance
- Group health plans
- Group-term life insurance
- Welfare benefit funds

Useful Items

You may want to see:

Publication

- ☐ **15** Circular E, Employer's Tax Guide
- ☐ **15–A** Employer's Supplemental Tax Guide
- ☐ **503** Child and Dependent Care Expenses
- ☐ **525** Taxable and Nontaxable Income
- ☐ **968** Tax Benefits for Adoption
- ☐ **969** Medical Savings Accounts (MSAs)

Form (and Instructions)

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

See chapter 17 for information about getting these publications and forms.

Adoption Assistance

This section provides basic tax information about adoption assistance programs.

Deducting the cost. You can deduct the cost of an adoption assistance program on the “employee benefit programs” line of your business income tax return.

Exclusion from income tax withholding. For tax years beginning after 1996, a limited amount of the cost of providing adoption assistance to an employee through an adoption assistance program is excludable from the employee's gross income. You should not withhold federal income tax on amounts that you pay to an employee through your adoption assistance program. However, you must withhold social security and Medicare taxes on these amounts. The employee will figure the amount of assistance (if any) that is subject to income tax when he or she files a federal income tax return.

Exclusion limit. Up to $5,000 of qualifying expenses paid to adopt an eligible child are excludable from an employee's income. This limit can be as much as $6,000 for the expenses of adopting a child (other than a foreign child) with special needs. These are not annual exclusion limits. They are limits on the total cost of adopting an eligible child, including the cost of earlier unsuccessful attempts. For more information, including the definitions of the terms “qualifying expenses” and “child with special needs,” see Publication 968, *Tax Benefits for Adoption.*

Adoption assistance program. An adoption assistance program is a separate written plan of an employer that meets all the following requirements.

1) It benefits employees who qualify under rules set up by you, which do not favor highly compensated employees (defined in chapter 4) or their dependents. To determine whether your plan meets this

test, do not consider employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that adoption assistance was a subject of good-faith bargaining.

2) It does not pay more than 5% of its payments during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.

3) You give reasonable notice of the plan to eligible employees.

4) Employees provide reasonable substantiation that payments or reimbursements are for qualifying expenses.

Employment taxes. The cost of providing adoption assistance to an employee through an adoption assistance program is subject to social security, Medicare, and federal unemployment taxes. However, for tax years beginning after 1996, these amounts are not subject to federal income tax withholding.

TIP *__Form W–2.__ Report the entire cost of providing adoption assistance to an employee in box 13 of the employee's Form W–2. Use code "T" to identify this amount. Also include this amount with the wages you report in boxes 3 and 5. However, do not include this amount with the wages you report in box 1. For more information, see the Form W–2 instructions.*

Cafeteria Plans

This section provides basic tax information about cafeteria plans.

Deducting the cost. You can deduct the cost of a cafeteria plan on the "employee benefit programs" line of your business income tax return.

Cafeteria plan defined. This (including a flexible spending arrangement) is a written plan that allows your employees to choose between receiving cash or qualified benefits.

Generally, a plan that allows employees to choose benefits that will defer pay is not a cafeteria plan. However, a cafeteria plan can include a qualified 401(k) plan as a benefit. Also, certain life insurance plans maintained by educational institutions can be offered as a benefit even though they defer pay.

The fact that your employee could choose to receive cash does not make the value of the other benefits your employee chooses to receive through the plan taxable to the employee.

Qualified benefits. A qualified benefit is a benefit that you can exclude from an employee's wages because of specific tax rules, including those discussed in this chapter. However, a cafeteria plan cannot offer scholarship and fellowship grants, educational assistance, medical savings accounts, long-term care insurance, and, generally, the fringe benefits discussed in chapter 4.

Exclusion from wages. You can generally exclude the cost of providing qualified benefits through a cafeteria plan to an employee from his or her wages as you withhold, pay, and report employment taxes. However, if your plan favors highly compensated or key employees, you must include in wages the cost of providing qualified benefits to a highly compensated or key employee. For more information, see *Plans that favor highly compensated employees,* and *Plans that favor key employees,* later.

Plans that favor highly compensated employees. If your plan favors highly compensated employees as to participation (eligibility to participate), contributions, or benefits, you must include in their wages the value of taxable benefits they could have selected. A plan you maintain under a collective bargaining agreement does not favor highly compensated employees.

Highly compensated employee defined. A highly compensated employee (for this purpose) is:

1) An officer,

2) A shareholder who owns more than 5% of the voting power or value of all classes of the employer's stock, or

3) A spouse or dependent of a person described in (1) or (2).

Plans that favor key employees. If more than 25% of the total of the nontaxed benefits you provide for all employees under the plan go to key employees, you must include in their wages the value of taxable benefits they could have selected. A plan you maintain under a collective bargaining agreement does not favor key employees.

Key employee defined. The term "key employee" is defined later under *Group-Term Life Insurance.*

Employment taxes. The amount you exclude from an employee's wages is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

RECORDS ***Reporting requirements.*** If you maintain a cafeteria plan, you must keep complete records showing all the following.

1) The number of your employees.

2) The number of your employees eligible to participate in the plan.

3) The number of your employees participating in the plan.

4) The total cost of your plan for the tax year.

5) Your name, address, and taxpayer identifying number (TIN).

6) The type of business you are engaged in.

You will need these records to file Form 5500, 5500–C, or 5500–R after the end of the plan year.

Dependent Care Assistance

This section provides basic tax information about dependent care assistance programs.

Deducting the cost. You can generally deduct the cost of a dependent care assistance program on the "employee benefit programs" line of your business income tax return. However, if you provide the care in-kind (operate a dependent care facility), deduct your costs as depreciation, utilities, salaries, etc.

Dependent care assistance program defined. A dependent care assistance program is a separate written plan that provides dependent care assistance only to your employees.

Dependent care assistance defined. Dependent care assistance means the payment of, or the providing of, work-related household and dependent care services. The services are work-related only if:

1) They allow the employee to work, and

2) They are for a qualifying person's care.

This is basically the same as the work-related expense test that the employee would use if he or she paid the expenses and claimed the dependent care credit. For more information, including the definition of the term "qualifying person," see *Qualifying Person Test* and *Work-Related Expense Test* in Publication 503.

Exclusion from wages. You can generally exclude a limited amount of the cost of providing dependent care assistance through a dependent care assistance program to an employee from his or her wages as you withhold, pay, and report employment taxes. However, if your plan favors highly compensated employees, you must include the cost of providing assistance to a highly compensated employee in his or her wages. For more information, see *Plans that favor highly compensated employees,* later.

Exclusion limit. You can generally exclude from an employee's wages up to $5,000 of the cost of providing work-related dependent care assistance during the year. This limit is reduced to $2,500 for married employees filing separate returns. For more information on the work-related expense test, see Publication 503.

However, the exclusion cannot be more than the earned income of either:

1) The employee, or

2) The employee's spouse.

Special rules apply if the spouse is either a student or not able to care for himself or herself. For more information on the earned income limit, see Publication 503.

Plans that favor highly compensated employees. Your plan is considered to favor highly compensated employees (defined in chapter 4) if it does not meet all of the following tests.

1) It benefits employees who qualify under rules set up by you, which do not favor highly compensated employees or their

dependents. To determine whether your plan meets this test, do not consider:

a) Employees who are under age 21 and have not completed 1 year of service, and

b) Employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that dependent care assistance was a subject of good-faith bargaining.

2) The benefits you provide do not favor highly compensated employees or their dependents.

3) It does not pay more than 25% of its payments during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.

4) You give reasonable notice of the plan to eligible employees.

5) By January 31, you provide each employee with a Form W–2 showing the amount you spent on dependent care assistance (if furnished in-kind, its fair market value less any employee payment) for the employee during the preceding year.

6) The average benefits you provide to employees who are not highly compensated is at least 55% of the average benefits you provide to your highly compensated employees under all your plans. To determine whether your plan meets this test, do not consider:

a) Employees who are under age 21 and have not completed 1 year of service,

b) Employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that dependent care assistance was a subject of good-faith bargaining, and

c) If you provide the benefits through a salary reduction agreement, employees whose pay is less than $25,000 before the reduction.

If your plan favors highly compensated employees, you must include the cost of providing dependent care assistance to a highly compensated employee in his or her wages.

Employment taxes. The amount you exclude from an employee's wages is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

TIP ***Form W–2.*** *Report the entire cost of providing dependent care assistance to an employee during the year in box 10 of the employee's Form W–2. For more information, see the Form W–2 instructions.*

Educational Assistance

This section provides basic tax information about educational assistance programs.

Deducting the cost. You can deduct the cost of an educational assistance program on the “employee benefit programs” line of your business income tax return.

Exclusion from wages. You can exclude a limited amount of the cost of providing educational assistance through an educational assistance program to an employee from his or her wages as you withhold, pay, and report employment taxes.

Exclusion limit. You can exclude from an employee's wages up to $5,250 of the cost of providing educational assistance during the year.

Payments over the limit. If your educational assistance program pays or incurs more than $5,250 for an employee's benefit, treat part or all of the excess as:

1) A working condition fringe benefit (see chapter 4), or

2) Additional income to the employee.

Expiration date. This exclusion will not apply to expenses paid with respect to courses beginning after May 31, 2000.

Educational assistance program. An educational assistance program is a separate written plan of an employer that meets all of the following requirements.

1) It benefits employees who qualify under rules set up by you which do not favor highly compensated employees (defined in chapter 4) or their dependents. To determine whether your plan meets this test, do not consider employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that educational assistance was a subject of good-faith bargaining.

2) It does not pay more than 5% of its payments during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.

3) It does not allow employees to choose to receive cash or other benefits that must be included in gross income instead of educational assistance.

4) You give reasonable notice of the plan to eligible employees.

Your plan can cover former employees if their former employment is the reason for the coverage.

Educational assistance defined. Educational assistance means amounts you pay or incur for your employees' education expenses. These expenses generally include the cost of books, equipment, fees, supplies, and tuition. However, these expenses do not include the cost of graduate-level courses beginning after June 30, 1996. (The prohibited graduate-level course is of a kind normally taken by a person pursuing a program leading to an advanced academic or professional degree.) Also, these expenses do not include the cost of a course or other education involving:

- Games,
- Hobbies, or
- Sports.

These expenses do not include the cost of items that your employee is allowed to keep at the end of the course, such as:

- Equipment,
- Supplies (other than textbooks), and
- Tools.

Nor do they include the cost of lodging, meals, or transportation.

Employment taxes. The amount you exclude from an employee's wages is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

TIP ***Form W–2.*** *You may use box 14 of Form W–2 to give an employee the cost of providing him or her with educational assistance. For more information, see the Form W–2 instructions.*

Group Health Plans

This section provides basic tax information about group health plans.

Deducting the cost. You can generally deduct the cost of a group health plan on the “employee benefit programs” line of your business income tax return.

Group health plan defined. This (including a self-insured plan) is a plan that provides medical care to your employees, former employees, or their families. The plan can provide care directly or through insurance, reimbursement, or otherwise. For more information on insurance, see chapter 10.

Exclusion from wages. You can exclude the cost of providing group health insurance to an employee from his or her wages as you withhold, pay, and report employment taxes.

Excise tax on certain plans. You will be subject to an excise tax if your plan does not cover the working aged, active disabled, or those with end-stage renal disease. The tax is 25% of the expenses you incur for all of your group health plans during the year.

Continuation-of-Coverage Requirement

Generally, you (or the plan, if a multiemployer plan) may be subject to an excise tax if your plan does not meet the continuation-of-coverage requirement.

Excise tax. The excise tax generally is $100 per day during the ***noncompliance period*** for each beneficiary. For beneficiaries in the same family, the maximum tax is $200 per day.

The ***noncompliance period*** begins on the first day your plan does not meet this requirement and ends on the earlier of:

1) The first day your plan meets this requirement and the past failures have been corrected, or
2) 6 months after the last day in the period for which your plan could have been required to meet this requirement (see *Period of coverage,* later).

Exceptions. The tax does not apply:

1) For any period during which:
   a) You did not know that your plan failed to meet this requirement, and
   b) By exercising reasonable diligence you would not have known that your plan failed to meet this requirement, ***or***
2) Your plan failed to meet this requirement due to reasonable cause (not willful neglect) and the plan's failure is corrected within a 30-day period beginning when you knew, or would have known if reasonable diligence were used, that this requirement was not met.

However, even if you meet one of these exceptions you may have to pay a minimum tax, discussed next.

Minimum tax. Even if you meet one of the preceding exceptions to the excise tax, you may still owe a minimum tax. To avoid all tax, you must correct the failure to meet the continuation-of-coverage requirement ***before*** the IRS sends you a notice of an income tax examination for a period during which your plan failed to meet this requirement. For more information on this excise tax, see section 4980B of the Internal Revenue Code.

Plans exempt from the excise tax. The excise tax for failing to meet this requirement does not apply to any plan maintained only by employers who normally employed fewer than 20 employees on a typical business day in the preceding calendar year. In addition, certain plans, such as a governmental plan or a church plan, are not subject to these requirements and the excise tax.

Continuation of Coverage

Your plan must provide qualified beneficiaries the choice of continuing to be covered if any of the following occurs.

1) Death of covered employee.
2) Termination of covered employee (other than for gross misconduct) or reduction in hours of employment.
3) Divorce or legal separation from a spouse by covered employee.
4) Entitlement to Medicare benefits for covered employee.
5) A dependent child ceases to be a dependent, which ends the child's coverage under the plan.
6) A bankruptcy proceeding (which began after June 30, 1986) under title 11, United States Code, of the employer of a retired covered employee.

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

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

Qualified beneficiaries. An employee's spouse and dependent children, if covered under the plan, are qualified beneficiaries. A child who is born to or placed for adoption with the covered employee during the period of continuation coverage is also a qualified beneficiary. The covered employee is a qualified beneficiary if the event is a termination or reduction of hours or a bankruptcy proceeding.

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

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

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

Required notice to employees and spouses. You must give your employees and their spouses written notice of their rights to continuation of coverage when their coverage under a plan begins.

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

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

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

Other Requirements

You (or the plan, if a multi-employer plan) may be subject to an excise tax if your plan does not meet certain requirements. These requirements generally:

- Limit the circumstances under which plans can deny coverage for preexisting conditions,
- Bar group health plans from using an individual's health status to exclude him or her from coverage,
- Guarantee continued health coverage to an employer under a multi-employer plan,
- Obligate plans to pay for a minimum hospital stay following birth for mothers and newborns if the plan otherwise provides maternity benefits, and
- Prevent certain special limits from being placed on mental health benefits.

Collective bargaining agreement. If your plan stems from a collective bargaining agreement ratified before August 21, 1996, the accessibility, portability, and renewability requirements (discussed later) will first apply to your plan for plan years that begin after the collective bargaining agreement expires, if that is later than June 30, 1997.

Excise tax. The excise tax generally is $100 per day during the ***noncompliance period*** for each beneficiary. This period begins on the first day your plan does not meet these requirements and ends on the first day your plan meets these requirements and the past failures have been corrected.

Exceptions. The tax does not apply:

1) For any period during which:
   a) You did not know that your plan failed to meet these requirements, and
   b) By exercising reasonable diligence, you would not have known that your plan failed to meet these requirements, or
2) If your plan failed to meet these requirements due to reasonable cause (not willful neglect) and the plan's failure is corrected within a 30-day period beginning when you knew, or would have known if reasonable diligence were used, that these requirements were not met. If your plan is a church plan, the 30-day period is replaced by a special period described in section 414(e)(4)(C) of the Internal Revenue Code.

However, even if you meet one of these exceptions, you may have to pay a minimum tax, discussed next.

Minimum tax. Even if you meet one of the preceding exceptions to the excise tax, you may still owe a minimum tax unless your plan is a church plan. To avoid all tax, you must correct the failure to meet these requirements ***before*** the IRS sends you a notice of an income tax examination for a period during which your plan failed to meet these requirements. For more information on this excise tax, see section 4980D of the Internal Revenue Code.

Plans exempt from the excise tax. The excise tax for failing to meet these requirements does not apply to any plan maintained by a ***small employer*** whose coverage is from a contract with an insurance company. In addition, certain plans, such as a governmental plan or a plan that on the first day of the plan year had fewer than two participants who are current employees, are not subject to these requirements and the excise tax.

Small employer. You are a small employer if you employed an average of at least two but not more than 50 employees on business days during the preceding calendar year. If you were not in business throughout the preceding calendar year, you are a small employer if you can reasonably be expected to employ an average of at least two but not more than 50 employees on business days in the current year.

Benefits exempt from these requirements. These requirements do not apply to certain benefits provided under a separate policy, certificate, or contract of insurance or that are not otherwise an integral part of the plan.

Accessibility

Generally effective for plan years beginning after June 30, 1997, your plan must not base eligibility rules for employees or their dependents on any of the following factors.

1) Health status,
2) Medical condition (physical or mental),
3) Claims experience,
4) Receipt of health care,
5) Medical history,
6) Genetic information,
7) Evidence of insurability, or
8) Disability.

Also, your plan cannot use these factors to charge a higher premium for certain individuals. Special rules apply to church plans.

For more information, see section 9802 of the Internal Revenue Code and the related regulations.

Portability

Generally effective for plan years beginning after June 30, 1997, your plan must limit exclusions based on preexisting conditions and give credit for certain periods of previous coverage.

Preexisting conditions. Your plan can exclude an individual for a preexisting condition only if:

1) The exclusion relates to a condition (whether physical or mental), regardless of the cause, for which medical advice, diagnosis, care, or treatment was recommended or received within the 6-month period ending on the enrollment date,
2) The exclusion extends for not more than 12 months (18 months for a late enrollee) after the enrollment date, and
3) Any ***creditable coverage*** the individual has on the enrollment date reduces the length of the preexisting condition exclusion period.

Your plan cannot exclude certain newborns and adopted children. Also, pregnancy cannot be treated as a preexisting condition. For more information on preexisting conditions, see section 9801 of the Internal Revenue Code and the related regulations.

Creditable coverage. Creditable coverage is coverage that your employee had before he or she enrolled in your plan. Do not count coverage an individual had before any 63-day or longer period during which the individual was not covered under any creditable coverage.

Creditable coverage is coverage under any of the following:

1) A group health plan,
2) Health insurance, or
3) Certain other health plans.

For more information on creditable coverage, see section 9801 of the Internal Revenue Code and the related regulations.

Renewability

Generally effective for plan years beginning after June 30, 1997, a multi-employer plan or a multiple employer welfare arrangement cannot deny an employer continued access to the same or different coverage under the plan other than:

1) For nonpayment of contributions,
2) For fraud or other intentional misrepresentation of material fact,
3) For noncompliance with material plan provisions,
4) Because the plan is ceasing to offer any coverage in the employer's geographic area, or
5) For certain actions related to:
   a) Network plans, or
   b) Collective bargaining agreements.

For more information, see section 9803 of the Internal Revenue Code and the related regulations.

Mother and Newborn Hospital Stays

For plan years beginning on or after January 1, 1998, your plan generally must not restrict benefits for a mother or newborn's hospital stay following birth to:

- Less than 48 hours following a normal delivery, or
- Less than 96 hours following a caesarean section.

However, these minimum stay requirements do not apply when the decision to discharge the mother or her newborn child earlier is made by the attending provider in consultation with the mother.

These requirements also do not apply if the plan does not provide benefits for a hospital stay following either a normal delivery or a caesarean section.

For more information, see section 9811 of the Internal Revenue Code.

Mental Health Benefits

For plan years beginning on or after January 1, 1998, if your plan provides both medical and surgical benefits and mental health benefits:

1) It cannot impose an annual or aggregate lifetime limit on mental health benefits if it does not impose one on substantially all medical and surgical benefits.
2) If the plan does provide an annual or aggregate lifetime limit on medical and surgical benefits, the plan must either:
   a) Include mental health benefits under the same limit, or
   b) Use a separate limit for mental health benefits that is at least as much as this limit.

For more information, see section 9812 of the Internal Revenue Code.

Self-Insured Plans That Favor Certain Employees

If your plan is a self-insured plan and it favors highly compensated individuals, you must include all or part of the amounts you pay to these individuals in their income. Generally, this rule also applies if one of these employees is enrolled in a health maintenance organization (HMO) as an alternative to the self-insured plan.

A self-insured plan is a group health plan that reimburses your employees for medical expenses not covered by an accident or health insurance policy. The plan can be for the employees, their spouses, or their dependents.

A highly compensated individual (for this purpose) is:

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

For more information, see section 105(h) of the Internal Revenue Code.

Medical Savings Accounts

This section provides basic tax information about medical savings accounts.

Deducting the cost. You can deduct any contributions you make to your employees' medical savings accounts on the “employee benefit programs” line of your business income tax return.

Exclusion from wages. For tax years beginning after 1996, you can exclude a limited amount of the contributions you make to an employee's medical savings account from his or her wages as you withhold, pay, and report employment taxes. For more information, see Publication 969, *Medical Savings Accounts (MSAs).*

Medical savings account (MSA) defined. An MSA is a trust or custodial account (similar to an individual retirement arrangement (IRA)) that offers a limited number of individuals who are covered by a small business high-deductible health plan tax advantages to set aside money for qualified medical expenses that are not reimbursable by the plan. You can set up an MSA with a trustee, such as a bank or insurance company. For more information about MSAs, see Publication 969, *Medical Savings Accounts (MSAs).*

Small business. You have a small business for a calendar year if you employed on average 50 or fewer employees during either of the last 2 calendar years. If you were not in business throughout the preceding calendar year, you have a small business if you can reasonably be expected to employ an average of 50 or fewer employees in the current calendar year. However, special rules apply in calendar years after 1997 for growing businesses.

High-deductible health plan. A high-deductible health plan has:

1) An annual deductible that is:

a) Not less than $1,500 and not more than $2,250 for self-only coverage, and

b) Not less than $3,000 and not more than $4,500 for family coverage, and

2) An annual out-of-pocket expense limit of not more than:

a) $3,000 for self-only coverage, and

b) $5,500 for family coverage.

However, a plan providing family coverage is a high-deductible health plan only if (without regard to which family member or members incur expenses):

1) No amounts are payable until the family has incurred annual covered medical expenses in excess of $3,000,

2) Amounts for covered benefits are always payable after the family has incurred annual covered medical expenses in excess of $4,500, and

3) The annual out-of-pocket expenses required to be paid under the plan for covered benefits do not exceed $5,500.

Plans that provide family coverage in effect before November 1, 1997, will not fail to qualify as a high-deductible health plan just because they provide for individual deductibles of at least $1,500 and not more than $2,250. However, these plans must generally be changed to conform to the requirements listed in this paragraph on their first renewal date on or after December 31, 1997.

A plan is not a high-deductible health plan if substantially all of its coverage is for:

1) Accidents,

2) Disability,

3) Dental care,

4) Vision care,

5) Long-term care, or

6) Benefits provided by insurance:

a) Related to workers' compensation laws, tort liabilities, or ownership or use of property,

b) For a specific disease or illness, or

c) That pays a fixed amount per day (or other period) of hospitalization.

Qualified medical expenses. Qualified medical expenses include medical expenses for the employee, his or her spouse, and any dependents. These expenses are generally the types of expenses the employee could include as medical expenses on Schedule A (Form 1040), if he or she itemizes deductions. For more information on medical expenses, see Publication 502.

Failure to make comparable contributions. Generally, employers will be subject to an excise tax if they make a contribution during any calendar year to an employee's MSA and do not make comparable contributions for all comparable participating employees for each coverage period during that year.

Comparable contributions. Comparable contributions are contributions that are either:

1) The same amount, or

2) The same percentage of the annual deductible limit under the high-deductible health plan covering the employees.

Comparable participating employees. Comparable participating employees:

1) Are covered by your high-deductible health plan and eligible to establish an MSA,

2) Have the same category of coverage (either self-only or family coverage), and

3) Have the same category of employment (either part-time or full-time).

Part-time employees are those who usually work fewer than 30 hours a week.

Excise tax. The excise tax for not making comparable contributions is 35% of the total amount the employer contributes to MSAs during the calendar year. If you are subject to this tax, but your case was due to reasonable cause and not willful neglect, the IRS may waive the part of the excise tax that would be excessive relative to the degree of noncompliance involved.

Employment taxes. The amount you exclude from an employee's wages is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

TIP *__Form W–2.__ Show all contributions to an employee's MSA in box 13 of the employee's Form W–2. Use code "R" to identify this amount. For more information, see the Form W–2 instructions.*

Group-Term Life Insurance

This section provides basic tax information about group-term life insurance plans.

Deducting the cost. You can generally deduct the cost of group-term life insurance on the "employee benefit programs" line of your business income tax return. However, you cannot deduct the cost if you are directly or indirectly the beneficiary of the policy. For more information on life insurance, see chapter 10.

Exclusion from wages. You can generally exclude a limited amount of the cost of providing group-term life insurance to an employee from his or her wages as you withhold, pay, and report employment taxes. However, if your plan favors key employees, you must include the cost of providing group-term life insurance to a key employee in his or her wages. For more information, see *Plans That Favor Key Employees,* later.

Exclusion limit. You can generally exclude from an employee's wages the cost of providing up to $50,000 of group-term life insurance coverage during the year.

Coverage over the limit. If you provide an employee with more than $50,000 of coverage at any time during the year, you must include in the employee's income the cost of insurance that is more than the cost of $50,000 of coverage reduced by any amount the employee pays toward the insurance.

The cost of this insurance that you must include in your employees' income is not the actual cost of the excess coverage. Instead, you figure this cost with monthly costs listed under *Cost To Include in Employee Income,* later.

Group-Term Life Insurance Defined

This insurance is term life insurance (insurance for a fixed period) that:

1) Provides a general death benefit that is not included in income,

2) You provide to a group of employees,

3) You provide under a policy you carry directly or indirectly, and

4) Provides an amount of insurance to each employee based on a formula using factors such as age, years of service, pay, or position that prevent individual selection.

Employee. For this purpose, an employee is:

1) A person who works for you whose legal relationship to you is that of an employee,

2) A full-time life insurance agent, or

3) A person who was formerly your employee.

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

Life insurance that includes permanent benefits is group-term life insurance only if it meets both of the following conditions.

1) The policy or you, as the employer, state in writing which part of each employee's death benefit is group-term life insurance.

2) That part for any policy year is not less than the employee's total death benefit minus the employee's deemed death benefit at the end of the policy year. For information on figuring the deemed death benefit, see section 1.79–1(d)(3) of the Income Tax Regulations.

Ten-employee rule. Generally, group-term life insurance is life insurance that you provide to at least 10 full-time employees at some time during the year.

For this rule, count employees who choose not to receive the insurance unless they must contribute to the cost of benefits other than the group-term life insurance. For example, count an employee who could receive insurance by paying part of the cost, even if that employee chooses not to receive it. However, do not count an employee who must pay part or all of the cost of permanent benefits to get insurance, unless that employee chooses to receive it.

Even if you do not meet the ten-employee rule, two exceptions, discussed next, allow you to treat insurance as group-term life insurance.

Exception. Life insurance you do not provide to at least 10 full-time employees is group-term life insurance if you meet all the following conditions.

1) Any required evidence that the employee is insurable is a medical questionnaire (completed by the employee) that does not require a physical.

2) You provide the insurance to all your full-time employees or, if the insurer requires the evidence mentioned in (1), to all full-time employees who provide evidence the insurer accepts.

3) You figure the coverage based on either a uniform percentage of pay or the insurer's coverage brackets.

For more information, see *Special rules for applying these exceptions,* later.

Exception. Also, life insurance you do not provide to at least 10 full-time employees is group-term life insurance if you meet all the following conditions.

1) You provide the insurance under a common plan covering your employees and the employees of at least one other employer who is not related to you.

2) The insurance is restricted to, but mandatory for, all your employees who belong to or are represented by an organization (such as a union) that carries on substantial activities besides obtaining insurance.

3) Evidence of whether an employee is insurable does not affect an employee's eligibility for insurance or the amount of insurance that employee gets.

Special rules for applying these exceptions. When you apply the two preceding exceptions, do not consider employees who were denied insurance for ***any*** of the following reasons:

1) They were 65 or older,

2) They customarily work 20 hours or less a week or 5 months or less in a calendar year, or

3) They have not been employed for the waiting period given in the policy. This waiting period cannot be more than 6 months.

Accidental or other death benefits. A policy that provides accidental death benefits or death benefits other than general death benefits (travel insurance, for example), is not group-term life insurance.

Policy covering employees' spouse or dependent. A policy that provides insurance on the life of your employee's spouse or dependent is not group-term life insurance. However, you may be able to exclude the cost of this insurance from your employee's income as a de minimis fringe benefit. For more information, see *De Minimis (Minimal) Fringe* in chapter 4.

Plans That Favor Key Employees

Generally, if your group-term life insurance plan favors key employees (defined later) you must include the entire cost of the insurance in your key employees' income. However, this rule generally does not apply to church plans.

Defined. A plan favors key employees if it favors them as to participation (eligibility to participate) or benefits (the type and amount of benefits it provides). Apply the participation and benefits tests (discussed later) separately to your active and former employees.

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

1) An officer having, for any year listed below, annual pay of more than:

   a) 1993 — $57,821

   b) 1994 — $59,400

   c) 1995 — $60,000

   d) 1996 — $60,000

   e) 1997 — $62,500

2) One of 10 employees having annual pay of more than $30,000 and owning (or considered to own under the related-party rules) the largest interests in your business,

3) A 5% owner of your business, or

4) A 1% owner of your business whose annual pay is more than $150,000.

A former employee who was a key employee upon retirement or separation from service is also a key employee.

Related party rules. To determine ownership in (2), (3), and (4) of the preceding list, count any related party's interest. Treat your employee as owning both his or her own interest and any related party's interest. The term “related party” includes members of the employee's immediate family (including spouse, children, grandchildren, and parents). It also includes any corporations, partnerships, estates, or trusts in which the employee has at least a 5% interest.

Participation test. Your plan meets this test if all of the following are true.

1) It benefits at least 70% of your employees.

2) At least 85% of those employees are not key employees.

3) It benefits employees who qualify under a set of rules you set up that do not favor key employees.

Your plan also meets this test if it is part of a cafeteria plan (discussed earlier) and it meets the participation test for those plans.

Do not consider the following employees when applying this test. Employees who:

1) Have not completed 3 years of service,

2) Are part time or seasonal,

3) Are nonresident aliens who receive no U.S. source earned income from you, or

4) Are not included in the plan but are in a unit of employees covered by a collective bargaining agreement, if the benefits provided under the plan were the subject of good-faith bargaining between you and employee representatives.

Benefits test. Your plan meets this test if it does not favor key employees as to the type and amount of life insurance it provides. Your plan does not favor key employees just because the amount of insurance you provide to your employees is uniformly related to their pay.

Cost To Include in Employee Income

Generally, you must include in an employee's income, as wages, the cost of group-term life insurance that is more than the cost of $50,000 of this insurance reduced by any amount the employee pays toward the insurance. However, do not include any cost of this insurance in the income of certain employees, discussed next.

No cost included for certain employees. Do not include any cost of this insurance in your employee's income if ***any*** of the following apply.

1) Your employee is disabled and no longer works for you.

2) Your employee's policy named you the beneficiary for the entire period it was in force during the year.

3) Your employee's policy named a charity to which contributions are deductible as the only beneficiary for the entire period it was in force during the year.

4) Your employee is retired and meets certain requirements. (See *Retired employees* under *Group Life Insurance Premiums* in Publication 525.)

Entire cost included for certain employees. You must include in your employee's income the entire cost of group-term life insurance coverage you provide through a qualified pension, profit-sharing, stock bonus, or annuity plan.

You must also include the entire cost in the income of key employees if the plan favors key employees as discussed earlier under *Plans That Favor Key Employees.*

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

1) The actual cost of the insurance, or

2) The cost of the insurance you figure using the monthly cost table, shown later.

Permanent benefits. If your policy includes permanent benefits (defined earlier), you must include in your employees' income, as wages, the cost of the permanent benefits minus the amount the employee pays for them.

Figure the cost of these benefits as explained in section 1.79–1(d)(2) of the Income Tax Regulations.

Employee payments. If your employee pays any part of the cost of this insurance, the employee's payment reduces, dollar for dollar, the amount you would otherwise include in your employee's income.

Monthly cost to include in employee income. Follow these steps to figure the cost to include in your employee's income for the year.

Step one. Subtract 50 (if the $50,000 exclusion applies) from the amount of your employee's insurance coverage for that month (in thousands, figured to the nearest tenth) to get the excess insurance coverage.

Step two. Multiply the result from step one by the cost you find using the employee's age at the end of the year and the following table to get the cost of the excess insurance for one month.

Cost Per $1,000 Of Protection For One Month

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

Step three. Multiply the result from step two by the number of full months during the year the employee had that coverage. If you provide less than a full month of coverage for any month, you must prorate the cost from the table. This step gives you the cost of the employee's excess insurance for the tax year.

Step four. If the amount of your employee's insurance coverage changed during the year, repeat steps one through three for each other level of coverage. Add the step three result for each coverage level to get the total cost of the employee's excess insurance for the tax year.

Step five. Subtract any part of the cost your employee paid from the step four result. Include the resulting amount in your employee's income as wages on Form W–2.

Example. You provide $80,000 of group-term life insurance coverage to an employee for the entire year. Your employee was 51 years old at the end of the year. Your employee pays premiums of $50 a year. You figure the amount to include in your employee's income as follows:

Coverage (in thousands)	$80
Minus: Exclusion (in thousands)	– 50
Excess amount (in thousands)	$30
Multiply by cost per $1,000 per month, age 51 (from table)	× .48
Cost of excess insurance for 1 month	$14.40
Multiply by number of full months coverage at this cost	× 12
Cost of excess insurance for tax year	$172.80
Minus: Premiums the employee paid	– 50.00
Cost to include in income as wages	$122.80

Employment Taxes

The cost of group-term life insurance that you must include in your employee's income is not subject to income tax withholding and is exempt from federal unemployment tax. However, the cost is subject to social security and Medicare tax withholding.

Report the cost of group-term life insurance coverage exceeding $50,000 in box 13 of the employee's Form W–2. Use code C to identify this amount. Also include this amount with the wages you report in boxes 1, 3, and 5. For more information, see the Form W–2 instructions.

Former employees. If you provide group-term life insurance to former employees, including retirees, the following rules apply to the cost of coverage during periods after the employees stopped working for you. (These rules apply to the cost of coverage exceeding $50,000.)

- The cost is included in the former employee's income.
- The cost is not subject to income tax withholding and is exempt from federal unemployment tax.
- The cost is not subject to social security and Medicare tax withholding, however, the former employee must pay the uncollected employee's portion of these taxes.
- The employer must determine the uncollected social security and Medicare taxes and report them to the former employee.
- The former employee must include the uncollected social security and Medicare taxes in the amount on line 53, Form 1040, and write "UT" and the amount included on the dotted line next to line 53.

In completing a Form W–2 for the former employee, include in boxes 1, 3, and 5 the cost of coverage exceeding $50,000. Show in box 13:

1) The cost of coverage exceeding $50,000 with code C,
2) The uncollected social security tax with code M, and
3) The uncollected Medicare tax with code N.

Welfare Benefit Funds

This section provides basic tax information about welfare benefit plans.

Deducting the cost. You can deduct a limited amount of the cost of a welfare benefit fund on the "employee benefit programs" line of your business income tax return.

Deduction limit. You cannot deduct more than the fund's qualified cost, discussed later, for the tax year. However, if you pay more than the fund's qualified cost, you can carry the excess over to the next tax year.

Welfare benefit fund defined. A welfare benefit fund is any fund that is part of a plan through which you provide welfare benefits to your employees, independent contractors, or their beneficiaries.

Welfare benefits do not include:

1) The transfer of stock or other property if the transfer is subject to section 83(h) of the Internal Revenue Code (relating to an employer's deduction on the transfer of property in return for services), and
2) Amounts you put in a deferred pay plan.

The term "fund" means:

1) Any corporation, trust, or other organization that is subject to income tax,
2) Any exempt organization described in IRC 501(c) (7), IRC 501(c)(9), IRC 501(c)(17), or IRC 501(c)(20), and
3) Any account held for you by any person, as described under Temporary Regulations 1.419–1T (later modified by Announcement 86–45, IRB 1986–15).

The term "fund" does not include:

1) Amounts held by an insurance company for a policy covering the life of yourself, an employee, or any person with a financial interest in your business if you are a beneficiary of the policy, or
2) Any life insurance contract that:
   a) Has no guarantee of renewal, and
   b) Other than for insurance protection, provides payments only for experience-rated refunds or policy dividends that are not guaranteed and that are determined by factors other than the amount of welfare benefits you pay to your employees or their beneficiaries.

Your fund's qualified cost. Your fund's qualified cost is the total of your "qualified direct cost" plus any addition you make to a "qualified asset account" for the year. You must reduce this qualified cost by any after-tax income the fund has for the year.

"After-tax income" means the gross income of your fund less the total of:

1) The deductions directly related to producing the gross income, and
2) The fund's income tax liability for the year.

The gross income of your fund for this purpose includes any amounts received from your employees. However, it does not include your contributions.

Qualified direct cost. Qualified direct cost is the total cost (including administrative expenses) that you would deduct for benefits provided during the tax year if:

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

You treat a benefit as provided by you to the employee when the benefit would be included in the employee's gross income if you provided it directly to the employee (or would be included but for any rule excluding the benefit from income).

Child care facility. You must use a special rule to figure the qualified direct costs of a child care facility you provide for your employees' use. Beginning with the month the facility is placed in service, deduct the adjusted basis of the facility ratably over 60 months rather than depreciating it. A child care facility is any tangible depreciable property located in the United States primarily for children of your employees.

Qualified asset account. A qualified asset account is an account holding assets set aside to provide supplemental unemployment, severance pay, disability, medical, or life insurance benefits. A "qualified cost" does not include any part of an addition you make to a qualified asset account that is more than the ***account limit.*** The account limit for a tax year is generally the amount actuarially necessary to fund:

1) Claims incurred but not paid (as of the close of the year) for the benefits listed, and
2) Administrative costs for the claims.

6. Retirement Plans

Important Changes for 1997

SIMPLE retirement plan. Beginning in 1997, you may be able to set up a savings incentive match plan for employees (SIMPLE). You can set up a SIMPLE plan if you have 100 or fewer employees and meet other requirements. See *SIMPLE Retirement Plans* after the *Simplified Employee Pension (SEP)* discussion.

Repeal of salary reduction arrangement under a SEP (SARSEP). Beginning in January 1997, an employer is no longer allowed to establish a SARSEP. However, participants (including new participants hired after 1996) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. See *Salary Reduction Arrangement* under *Simplified Employee Pension (SEP).*

Minimum required distribution rule modified. Beginning in 1997, the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans takes into account whether a plan participant has retired. This does not apply to a **5% owner,** who must still begin to receive distributions on April 1 of the year following the calendar year in which he or she reaches age 70½. Also, the new law does not apply to IRAs. For more information, see *Required Distributions* in the *Keogh Plans* discussion in Publication 560.

Tax law changes for 1998. This chapter does not cover the changes to pension provisions that may affect your 1998 tax return. These changes are covered in Publication 553.

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 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) if the uniform capitalization rules apply to you. If you are subject to these rules, you must capitalize (include in the basis of certain property or in inventory costs) your contributions. See chapter 1.

Kinds of plans. Retirement plans are either:

1) Qualified plans. This includes retirement plans for small businesses, including the self-employed (such as HR–10 (Keogh) plans, SIMPLE plans, and simplified employee pensions (SEPs)), or
2) Nonqualified plans.

Also, in general, individuals who work 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
- SIMPLE retirement plans
- Nonqualified plans
- Individual retirement arrangements (IRAs)

Useful Items
You may want to see:

Publication

- ☐ **533** Self-Employment Tax
- ☐ **560** Retirement Plans for Small Business (SEP, Keogh, and SIMPLE Plans)
- ☐ **590** Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and SIMPLE IRAs)
- ☐ **15** Circular E, Employer's Tax Guide

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
- ☐ **5305–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (for Use With a Designated Financial Institution)
- ☐ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

See Chapter 17 for information about getting these forms and publications.

Qualified Plans

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

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

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

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

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

For more information, get Publication 560.

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 made to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This type of plan is similar to a profit-sharing plan, but it can be set up only by a corporation. Benefits are payable in stock of the employer.

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

Defined Benefit Plans

These are any plans that are not defined contribution plans. In general, a qualified defined benefit plan must provide for set benefits. Your contributions to the plan are based on actuarial assumptions. Generally, you will 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 do not have 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. Attach Form 8717, *User Fee for Employee Plan Determination Letter Request* to your determination letter application.

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 Small Businesses

If you are the owner of a small business (including 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.

Beginning in 1997, a small employer can also set up a SIMPLE retirement plan. See *SIMPLE Retirement Plans* after the *Simplified Employee Pension (SEP)* discussion.

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.

See the glossary near the end of Publication 560 for the definition of employer, employee, *and* common-law employee.

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 generally limited to ***25%*** of the compensation from the business paid during the year to a participating common-law employee. 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.

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 receive from the partnership. If you are a limited partner, your net earnings include only guaranteed payments you receive for services rendered to or for the partnership. For more information, see *Partners* under *Who Must Pay Self-Employment Tax* in Publication 533.

Net earnings do not include income passed through to shareholders of S corporations.

Adjustments. You must reduce your net earnings by the income tax deduction for one-half of your 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 net earnings by your 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 $160,000 of your compensation in figuring your contribution to a defined contribution plan.

For employees in a collective bargaining unit covered by a plan for which the $160,000 limit does not apply for the plan year beginning in 1997, the compensation limit is $250,000.

Figuring your deduction. Use the *Rate Worksheet for Self-Employed* illustrated in the following example to find the reduced contribution rate for yourself. Make no reduction to the contribution rate for any common-law employees.

After you have your self-employed rate, you can figure your maximum deduction for contributions for yourself by using the *Deduction Worksheet for Self-Employed* also illustrated in the example:

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 in line 3 above	0.0950
Step 2 Enter your net earnings (net profit) from: line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (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 26, Form 1040	$6,733
Step 4 Subtract step 3 from step 2 and enter the result	$193,267
Step 5 Multiply step 4 by step 1 and enter the result	$18,360
Step 6 Multiply $160,000 by your plan contribution rate. Enter the result but not more than $30,000	$16,800
Step 7 Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 28, Form 1040.	$16,800

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

More information. See Publication 560 for more information about retirement plans for small business owners, including the self-employed. It also discusses the reporting forms that must be filed for these plans.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make deductible contributions toward your own and your employees' retirement without getting involved in more complex retirement plans. A corporation also can have a SEP and make deductible contributions toward its employees' retirement. But some advantages available to Keogh and other qualified plans, such as the special tax 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.*** You may be able to use ***Form 5305–SEP*** in setting up your SEP. For more information, get Publication 560.

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, generally 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 $160,000 when you figure your contributions limit for that employee.

CAUTION *For employees in a collective bargaining unit for which the $160,000 limit does not apply, the compensation limit is $250,000*

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 all of the plans 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% deduction limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP and 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 employer's SEP contributions. The portion of the IRA 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).

CAUTION *Beginning in January 1997, an employer is no longer allowed to establish a SARSEP. However, participants in a SARSEP that was established before 1997 (including employees hired after 1996) can continue to elect to have their employer contribute part of their pay to the plan.*

This election is available only if:

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

2) You had 25 or fewer 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

3) 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 non-highly compensated employees eligible to participate (the ***ADP test***). You generally cannot consider compensation of an employee in excess of $160,000 in figuring an employee's deferral percentage.

Limits on elective 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 1997 is limited to the lesser of 15% of the participant's compensation (as defined in Publication 560) or $9,500. This limit applies only to the amounts that represent a reduction from the employee's pay, not to any contributions from employer funds.

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

Reporting SEP Contributions on Form W–2

Your SEP contributions are excluded from your employees' income. 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. Jim's salary reduction arrangement calls for a deferral contribution rate of 10% of his salary to be contributed by his employer as an elective deferral to Jim's SEP-IRA. Jim's salary for the year is $30,000 (before reduction for the deferral). The employer did not elect to treat deferrals as compensation under the arrangement. To figure the deferral amount, the employer multiplies Jim's salary of $30,000 by 9.0909%, the reduced rate equivalent of 10% to get the deferral amount of $2,727.27. (This method is the same one that you, as a self-employed person, use to figure the contributions you make on your own behalf.) See *Rate Worksheet for Self Employed,* earlier in the chapter.

On Jim's Form W-2, the employer shows total wages of $27,272.73 ($30,000 minus $2,727.27), social security wages of $30,000, and Medicare wages of $30,000. Jim reports $27,272.73 as wages on his individual income tax return.

If the employer elects to treat deferrals as compensation under the salary reduction arrangement, Jim's deferral amount would be $3,000 ($30,000 x 10%) because, in this case, the employer uses the rate called for under the arrangement (not the reduced rate) to figure the deferral and the ADP test. On Jim's Form W-2, the employer shows total wages of $27,000 ($30,000 minus $3,000), social security wages of $30,000, and Medicare wages of $30,000. Jim reports $27,000 as wages on his return.

In either case, the maximum deductible contribution would be ($30,000 x 13.0435%) $3,913.05.

For more information on employer withholding requirements, see Publication 15.

For more information on SEPs, see Publication 560.

SIMPLE Retirement Plans

A SIMPLE plan is a written salary reduction arrangement that allows a small business (an employer with 100 or fewer employees) to make elective contributions to a simple retirement account on behalf of each eligible employee. An ***eligible employer*** is not allowed to maintain another retirement plan.

Setting Up a SIMPLE Plan

If an employer has 100 or fewer employees (who received at least $5,000 of compensation from the employer for the preceding year), the employer may be able to set up a SIMPLE retirement plan on behalf of eligible employees. The plan can be either:

- An IRA for each eligible employee, or
- Part of a qualified cash or deferred arrangement (a 401(k) plan).

The SIMPLE plan must be the only retirement plan of the employer to which contributions are made, or benefits are accrued, for service in any year beginning with the year the SIMPLE plan becomes effective.

Under the *qualified salary reduction arrangement* the employer's contributions on behalf of the employee (elective deferrals) are stated as a percentage of the employee's *compensation* and are limited to $6,000. The dollar limit is indexed for inflation in $500 increments.

Under the *qualified salary reduction arrangement* the employer is also required to make either a matching contribution to the simple retirement account on behalf of each employee who elects to make elective deferrals, or a nonelective contribution to the simple retirement account on behalf of each eligible employee. These two methods for determining the employer contribution formula are explained under *Dollar-for-dollar employer matching contributions* and *2% nonelective contributions.*

Contributions to a SIMPLE Plan are deductible by the employer and are excluded from the gross income of the employee.

Definitions

SIMPLE retirement account. The simple retirement account of an *eligible employee* is an individual retirement plan that can be either an individual retirement account or an individual retirement annuity, as described in Publication 590. Employees' rights to the contributions cannot be forfeited.

A SIMPLE plan can also be set up as a 401(k). See Publication 560 for information on how to adopt a SIMPLE plan as part of a 401(k) plan.

Qualified salary reduction arrangement. An employee eligible to participate in the SIMPLE plan may elect (during the 60-day period before the beginning of any year) to have the employer make contributions (called elective deferrals) to the simple retirement account on his or her behalf. An employee who so elects may also stop making elective deferrals at any time during the year. The employer is required to match the employee's contributions or to make nonelective contributions. No other types of contributions are allowed under the qualified salary reduction arrangement.

Eligible employer. Any employer who has 100 or fewer *eligible employees* in any year can establish a SIMPLE plan provided the employer does not maintain another employer-sponsored retirement plan.

Eligible employee. Any employee who receives at least $5,000 in compensation during any 2 years preceding the plan year can elect to have his or her employer make contributions to a simple retirement account under a qualified salary reduction arrangement. The employee must be expected to earn at least $5,000 during the calendar year.

Compensation. Compensation for employees is the total amount of wages required to be reported on Form W-2, plus elective deferrals. For the self-employed individual, compensation is the net earnings from self-employment (without regard to any contribution made to the SIMPLE plan for the self-employed individual).

Any SIMPLE elective deferrals relating to an employee's wages under a salary reduction arrangement are included in the Form W-2 wages for social security and Medicare tax purposes only.

Contribution Limits

Contributions are made up of employee elective deferrals and employer contributions. The employer is required to satisfy one of two contribution formulas: the matching contribution formula or a two-percent nonelective contribution. No other contributions can be made to the SIMPLE plan. These contributions, which are deductible by the employer, must be made timely.

Employee elective deferral limit. The amount that the employee elects to have the employer contribute to a simple retirement account on his or her behalf (elective deferrals) must not exceed $6,000 for any year and must be expressed as a percentage of the employee's compensation.

Dollar-for-dollar employer matching contributions. The employer is required to match all eligible employees' elective contributions, on a dollar-for-dollar basis, up to 3% of the employee's compensation.

If the employer elects a matching contribution that is less than 3%, the percentage must not be less than 1%. The employer must notify the employees of the lower match within a reasonable time before the employee's 60-day election period for the calendar year. A percentage less than 3% cannot be elected for more than two years during a five-year period.

2% nonelective contributions. In lieu of the dollar-for-dollar matching contributions, the employer may elect to make nonelective contributions of 2–percent of compensation on behalf of each eligible employee. Only $160,000 of the employee's compensation can be taken into account to figure the contribution limit.

If the employer elects this 2% contribution formula, he or she must notify the employees timely (within the employee's 60-day election period described earlier).

Time limits for contributing funds. The employer is required to contribute the employee's deferral to the SIMPLE account within 30 days after the end of the month for which the payments to the employee were deferred. The employer's matching contributions to the SIMPLE plan, however, are required to be made by the tax return filing deadline, including extensions, for the taxable year that begins with or within the calendar year for which the contributions are made.

Distributions (Withdrawals)

Distributions from a SIMPLE retirement account are subject to IRA rules and are includible in income when withdrawn. Tax-free rollovers can be made from one SIMPLE account into another SIMPLE account or into an IRA. Early withdrawals generally are subject to a 10% (or 25%) penalty.

See Publication 590 for information about IRA rules, including those on the tax treatment of distributions, rollovers, required distributions, and income tax withholding.

Exceptions. A rollover to an IRA can be made tax free only after a 2-year participation in the SIMPLE plan. A 25% penalty for early withdrawal applies if funds are withdrawn within 2 years of beginning participation.

Employee notification. The *employer* who sets up a SIMPLE plan must notify each eligible employee of his or her opportunity to make contributions under the plan. The employer must also notify all eligible employees of the contribution alternative that was chosen. This information must be provided before the beginning of the employee's 60-day election period.

Where to find out more. This chapter does not contain all the rules and exceptions that apply to a SIMPLE-IRA or a SIMPLE 401(k) plan. See Publication 560 for additional information, including reporting and disclosure requirements for SIMPLE plans.

You may also get the following forms and their instructions:

- **5304–SIMPLE,** *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)* (Not Subject to the Designated Financial Institution Rules), and
- **5305–SIMPLE,** *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)* (for Use With a Designated Financial Institution).

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 were not age 70½ by the end of the year.

New IRA rules. The Taxpayer Relief Act of 1997 amended the IRA rules and created new types of IRAs that will take effect in 1998. The following discussion does not reflect these tax law changes that include the creation of a new tax-free, nondeductible “Roth IRA.” For more information, see Publication 590.

Compensation. Compensation (for IRA purposes) includes taxable wages, salaries, commissions, bonuses, tips, professional fees, and other amounts received for providing personal services. Compensation also includes taxable alimony and separate maintenance payments.

The IRS treats as compensation 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 your net earnings from your trade or business (provided your personal services are a material income-producing factor), 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 any of the following:

1) Income received from property, (i.e., rental, interest, and dividend income).
2) Pension or annuity income, and deferred compensation.
3) Foreign earned income and housing cost amounts that you exclude from income.
4) Any other amounts that you exclude from income.

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

1) $2,000, or
2) Your compensation that you must include in income for the year.

Deductible contributions. Generally, you can take a deduction for the contributions that 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 allowable IRA deduction may be less than your contribution. It may be reduced or eliminated, depending on your filing status and the amount of your income.

Nondeductible contributions. Although your deduction for IRA contributions may be reduced or eliminated, you can still make contributions of up to $2,000 or 100% of your compensation, whichever is less. Often the difference between your total permitted contributions and your total deductible contributions, if any, is your nondeductible contributions.

For details on these rules and other IRA rules (including the new tax law changes), get Publication 590.

7.

Rent Expense

Introduction

This chapter discusses the tax treatment of rent or lease payments you make for property you use in your business but do not own. It also discusses how to treat other kinds of payments you make that are related to your use of this property. These include payments you make for taxes on the property, improvements to the property, and getting a lease. At the end of the chapter is a discussion about capitalizing (including in the cost of property) certain rent expenses.

The rules in this chapter can apply to sole proprietors, partnerships, corporations, estates, trusts, and any other entity that carries on a trade or business.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **334** Tax Guide for Small Business
- ☐ **538** Accounting Periods and Methods
- ☐ **946** How To Depreciate Property

See chapter 17 for information about getting these publications.

Rent

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

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

Rent on your home. 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. You must meet the requirements for business use of your home. For more information, see *Qualifying for a Deduction* in Publication 587.

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

Example 1. In May you leased a building for 5 years beginning July 1 and ending June 30 five years later. 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. You can deduct only $6,000 ($^6/_{12} \times$ $12,000) for the rent that applies to the first year.

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

Lease or purchase. There may be instances in which you must determine whether your payments are for rent or for the purchase of the property. You must first determine whether your agreement is a lease or a conditional sales contract. If, under the agreement, you acquired or will acquire title to or equity in the property, you should treat the agreement 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 on the ***intent of the parties.*** Determine intent based on the facts and circumstances that exist when you make the agreement.

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

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

Leveraged leases. Leveraged lease 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 the following apply:

- The lessor must maintain a minimum unconditional “at risk” investment in the property (at least 20%) during the entire lease.
- The lessee may not have a contractual right to buy the property from the lessor at less than fair market value when the right is exercised.
- The lessee may not invest in the property, except as provided by Revenue Procedure 79–48.
- The lessee may not lend any money to the lessor to buy the property or guarantee the loan used to buy the property.
- The lessor must have a profit motive apart from the tax deductions, allowances, credits, and other tax attributes.

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

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

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

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

Taxes on Leased Property

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

Cash method. If you use the cash method of accounting, you can 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:

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

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

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

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

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, Oak will deduct the real estate taxes as rent on its tax return for the earlier year. This is the year in which Oak's liability under the lease becomes fixed.

Cost of Getting a Lease

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

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

The cost of getting a lease is not subject to the amortization rules that apply to section 197 intangibles discussed in chapter 12.

Option to renew. The term of the lease for amortization includes all renewal options if less than 75% of the cost is for the term remaining on the purchase date. Treat as renewal options any period for which the lessee and lessor reasonably expect the lease to be renewed. In determining the term of the lease remaining on the purchase date, do not include any period for which the lessee may choose to renew, extend, or continue the lease. Allocate the lease cost to the original term and any option term based on the facts and circumstances. Make the allocation 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 get a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, you paid $7,000 for the original lease and $3,000 for the renewal options. Because $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. That is 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 is $8,000. You can amortize the entire $10,000 over the 20-year remaining life of the original lease. The $8,000 cost of getting the original lease was not less than 75% of the total cost of the lease.

Cost of a modification agreement. You may have to pay an additional “rent” amount over part of the lease period 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 pay during each of the first 5 years as rent.

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

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

Improvements by Lessee

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

If you do not keep the improvements when you end the lease, figure your gain or loss based on your adjusted basis of the improvements then.

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

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

The part that is for the increased rental value of the land is a cost of getting a lease, and you 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:

- Produce real or tangible personal property for use in a trade or business or an activity engaged in for profit,
- Produce real or tangible personal property for sale to customers, or
- 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. You must capitalize as part of the cost of the building the rent you paid for the equipment. You recover your cost by claiming a deduction for depreciation on the building.

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

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

8. Interest

Important Change for 1997

Interest on loans with respect to life insurance policies. For tax years ending after May 31, 1997, you generally cannot deduct interest paid or accrued with respect to any life insurance, annuity or endowment contract that was issued or deemed issued after June 8, 1997, and covers any individual, unless that individual is a key person. For partnerships, corporations and S corporations there are new proration rules that apply. For more information, see *Interest on loans with respect to life insurance policies,* later.

Introduction

This chapter discusses the tax treatment of business interest expenses. Interest is the amount charged 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, special rules apply to:

- Interest you must capitalize (see *Capitalization of Interest,* discussed later.)
- Loans on which the interest rate is less than the applicable federal rate (see *Below-Market Interest Rate Loans,* later).

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

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

See chapter 17 for information about getting these forms and publications.

Allocation of Interest

The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, 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, qualified home mortgage interest is fully deductible regardless of how the funds are used. For more information on home mortgage interest, see Publication 936.

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

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

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

Any interest allocated to proceeds used for personal purposes is treated as personal interest, which is not deductible. Proceeds are used for personal purposes if they are not used in connection with your trade or business, passive activity, or investment activity.

Allocation based on use of loan's proceeds. Loan proceeds and the related interest are allocated based on 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 for which a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the date the loan is:

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

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

Proceeds deposited in borrower's account. Treat loan proceeds deposited in an account as property held for investment. It does not matter whether the account pays interest. Any interest you pay on the loan is investment interest expense. If you withdraw the proceeds of the loan, you must reallocate the loan based on the use of the funds.

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

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

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

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

Example. On January 9, Edith opened a checking account, depositing $500 of the proceeds of Loan A and $1,000 of unborrowed funds. The following table shows the transactions in her account during the tax year.

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

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

Edith treats the $600 used for personal purposes as made from the remaining $200 proceeds of Loan C and $400 of unborrowed funds. Note that for the periods during which loan proceeds are held in the account, they are treated as property held for investment.

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

Amounts paid within 30 days. If loan proceeds are deposited in an account, you can treat any payment (up to the amount of the proceeds) made from any account you own, or from cash, as made from those proceeds. This applies to any payment made within ***30 days*** before or after the proceeds are deposited in your account. You can apply this rule even if the rules stated earlier under *Order of funds spent* would otherwise require you to treat the proceeds as used for other purposes. If you apply this rule to any payments, disregard those payments (and the proceeds from which they are made) when applying the rules stated under *Order of funds spent.*

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

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

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

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

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

If you withdraw $20,000 from the savings account for personal purposes, you can treat the $20,000 as coming first from the interest, $867, and then from the loan proceeds, $19,133 ($20,000 – $867). The total amount of interest you are charged on the $20,000 from the time it was deposited in the account until the time of the withdrawal is investment interest. The amount charged on the proceeds used for personal purposes ($19,133) from the time you withdraw it until you either repay it or reallocate it to some other use is personal interest. The amount charged on the proceeds you left in the account ($867) continues to be investment interest until you either repay it or reallocate it to some other use.

Loan proceeds received in cash. If you receive the proceeds of a loan in cash, you can treat any payment (up to the amount of the proceeds) made from any account you own, or from cash, as made from those proceeds. This applies to any payment you make within ***30 days*** before or after you receive the proceeds of the loan. Also, you can treat the payment as made on the date you received the cash instead of the date you actually made the payment.

Example. Frank gets a loan of $1,000 on August 4 and receives the proceeds in cash. Frank deposits $1,500 in an account on August 18 and on August 28 writes a check on the account for a passive activity expense. Also, Frank deposits his paycheck, deposits other loan proceeds, and pays his bills during the same period. Regardless of these other transactions, Frank can treat $1,000 of the deposit he made on August 18 as being paid from the loan proceeds on August 4. In addition, Frank can treat the passive activity expense he paid on August 28 as made from the $1,000 loan proceeds treated as deposited in the account.

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

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

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

1) All borrowings on which interest accrues at the same fixed or variable rate are treated as a single loan, and
2) Borrowings or parts of borrowings on which interest accrues at different fixed or variable rates are treated as different loans. These loans are treated as repaid in the order in which they are treated as repaid under the loan agreement.

Loan refinancing. Allocate the replacement loan to the same items to which the repaid loan was allocated. This is true only to the extent you use the proceeds of the new loan to repay any part of the original loan.

Partnerships and S Corporations

Special rules apply to the allocation of interest expense in connection with debt-financed acquisitions of, and distributions from, partnerships and S corporations. These rules do not apply if the partnership or S corporation is formed or used for the principal purpose of avoiding the interest allocation rules.

Debt-financed acquisitions. This is the use of loan proceeds to purchase an interest in an entity or to make a contribution to the capital of the entity.

If you purchase an interest in an entity, (other than by way of a contribution to capital), allocate the loan proceeds and the interest expense among all the assets of the entity. You can use any reasonable method. Reasonable methods include a pro-rata allocation 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, you can make the allocation using any reasonable method. For this purpose, reasonable methods ordinarily include allocating the debt among all the assets or tracing the loan proceeds to the entity's expenditures.

Treat the purchase of an interest in an entity 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 $\times$ $20,000) and the interest expense on that part are allocated to trade or business use. The remaining $4,000 ($15,000/$75,000 $\times$ $20,000) and the interest on that part are allocated to investment use.

Reallocation. If you allocate the loan proceeds among the assets, you must make a reallocation if the assets or the use of the assets change.

How to report. Individuals should report their deductible interest expense either on Schedule A or Schedule E of Form 1040 depending on the type of asset (or expenditure if the allocation is based on the tracing of loan proceeds) to which the interest expense is allocated.

For interest allocated to trade or business assets (or expenditures), report the interest in Part II, Schedule E (Form 1040). On a separate line, put “business interest” and the name of the entity in column (a) and the amount in column (i).

For passive activity use, enter the interest on Form 8582 as a deduction from the passive activity of the entity. Show any deductible amount in Part II, Schedule E (Form 1040). On a separate line, put “passive interest” and the name of the entity in column (a) and the amount in column (g).

For investment use, enter the interest on Form 4952. Carry any deductible amount allocated to royalties to Part II, Schedule E (Form 1040). On a separate line enter “investment interest” and the name of the entity in column (a) and the amount in column (i). Carry the balance to line 13, Schedule A (Form 1040).

Any interest allocated to proceeds used for personal purposes is personal interest which is not deductible.

Debt-financed distributions. Generally, if the entity borrows funds, the general allocation rules discussed earlier in this section apply. If those funds are allocated to distributions made to partners or shareholders, the distributed loan proceeds and related interest expense must be reported to the partners and shareholders separately. This is because the loan proceeds and the interest expense must be allocated depending on how the partner or shareholder uses the proceeds. For example, if a shareholder uses distributed loan proceeds to invest in a passive activity, that shareholder's portion of the entity's interest expense on the loan proceeds is allocated to a passive activity use.

Optional method. The entity can choose to allocate the distributed loan proceeds to other expenditures it makes during the tax year of the distribution. This allocation is limited to the amount of the other expenditures less any loan proceeds already allocated to them. For any distributed loan proceeds that are more than the amount allocated to the other expenditures, the rules in the previous paragraph apply.

How to report. If the entity does not use the optional method, it reports the interest expense on the loan proceeds on the line on Schedule K–1 (Form 1065 or Form 1120S) for “Other deductions.” The expense is identified on an attached schedule as “Interest expense allocated to debt-financed distributions.” The partner or shareholder claims the interest expense depending on how the distribution was used.

If the entity uses the optional method, it reports the interest expense on the loan proceeds allocated to other expenditures on the appropriate line or lines of Schedule K–1. For example, if the entity chooses to allocate the loan proceeds and related interest to a rental activity expenditure, the entity will take the interest into account in figuring the net rental income or loss reported on Schedule K–1.

More information. For more information on allocating and reporting these interest expenses, see Notice 88–37, 1988–1 C.B. 522, and Notice 89–35, 1989–1 C.B. 675, which are available at most IRS offices.

Interest You Can Deduct

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

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

Generally, the amount you can deduct is the amount agreed upon by both you and the lender as interest.

You cannot currently deduct interest that must be capitalized and (except for corporations) you can never deduct personal interest.

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

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

If you receive a refund of interest you overpaid in an earlier year, this amount will be reported in box 3 of Form 1098. You ***cannot deduct*** this amount. For information on how to report this refund, see *Refunds of interest* later in this chapter.

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 (points) are solely for the use of money, they are interest.

These points are interest paid in advance and you cannot deduct them all in one tax year. Instead, you deduct part of the interest each tax year during the period of the loan, unless the interest must be capitalized.

To figure how much to deduct each year, divide the part of the loan period falling within your tax year by the total loan period. Then multiply this answer by the amount of prepaid interest. For example, if you are a calendar year taxpayer and take out a 10-year loan on October 1, 1997, 3 months of the loan period fall in your 1997 tax year. You can deduct 3/120 of the payment you made for the points on your 1997 tax return. You can deduct 12/120 of the prepaid interest on your 1998 tax return.

Any points you paid on a mortgage to acquire business property that have not been deducted over the life of the mortgage may be deducted in the year the mortgage ends. A mortgage may end due to a refinancing, prepayment, foreclosure, or similar event.

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. If the property mortgaged is business or income-producing property, you can deduct the costs over the life of the mortgage.

Partial liability. If you are liable for part of a business debt, you can deduct only your share of the total interest paid or accrued.

Example. You and your brother borrow money. You are liable for 50% of the note. You use your half of the loan in your business, and you make one-half of the loan payments. You can deduct your half of the total interest payments as a business deduction.

Partial payments on a nontax debt. If you make partial payments on a debt (other than a debt owed IRS), the payments, in the absence of an agreement between you and the lender, are applied first to interest and any remainder to principal. You can deduct only the interest.

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 you cannot deduct them as interest.

Payment by cash or equivalent. A cash-basis taxpayer cannot deduct interest unless it is paid in cash or its equivalent. If you use the cash method of accounting, 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 can deduct the interest expense once you start making payments on the new loan. When you make partial payments on loans, you first apply the payment to interest and then to the principal. This rule will not apply if both you and the lender intend 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. In addition to the capitalization of interest rules, discussed later, there are certain interest expenses you must capitalize rather than deduct.

If you buy property and pay interest owed by the seller (for example, by assuming the debt and any interest accrued on the property), you cannot deduct the interest. Add to the basis of the property the interest you paid that the seller owed.

Commitment fees or standby charges. Fees you incur to have business funds available on a standby basis, but not for the actual use of the funds, are not deductible as interest payments. You may be able to deduct them as business expenses.

If the funds are for inventory or certain property used in your business, the fees are indirect costs and you must capitalize them under the uniform capitalization rules. For more information on uniform capitalization rules, see section 1.263A of the Income Tax Regulations.

Income tax owed. Interest charged on income tax assessed on your individual income tax return is not a business deduction even though the tax due is related to income from your trade or business. Treat this interest as a business deduction only in figuring a net operating loss deduction.

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

Interest on loans with respect to life insurance policies. For contracts issued before June 9, 1997, you generally cannot deduct interest paid or accrued after October 13, 1995, on debt incurred with respect to any life insurance, annuity or endowment contract covering someone who is or was an employee, officer, or someone financially interested in your business unless that person is a ***key person.*** For contracts issued or deemed issued after June 8, 1997, you generally cannot deduct interest with respect to any life insurance, annuity or endowment contract that covers any individual, unless that individual is a ***key person.***

If the policy or contract covers a key person, you can deduct the interest to the extent:

1) The aggregate debt is not more than $50,000 for that key person, and
2) The interest paid or accrued for any month beginning after 1995 is not more than the Moody's Corporate Bond Yield Average-Monthly Average Corporates (Moody's rate) for that month.

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

1) Five individuals, or
2) The lesser of 5% of the total officers and employees of the company or 20 individuals.

Proration rule. A new rule applies to disallow a portion of the entire interest deduction for the taxable year of corporations, partnerships and S corporations allocable, under proration rules, to the unborrowed cash values of certain life insurance, annuity or endowment contracts issued or deemed issued after June 8, 1997, of which they are a direct or indirect (including by separate agreement) beneficiary. These proration rules generally do not apply with respect to such contracts that cover only a single officer, director, employee or 20% owner of the taxpayer. See new section 264(f) of the Internal Revenue Code.

Existing debt and contracts. Notwithstanding the general rules of nondeductibility, a limited deduction exists for otherwise allowable interest expense paid or accrued after October 13, 1995, but before January 1, 1999, on debt with respect to certain life insurance, endowment or annuity contracts, if the debt was incurred within an applicable period before 1997. Also, special rules allow income arising from the complete surrender of certain life insurance, endowment and annuity contracts in 1996, 1997 or 1998 to be spread over a 4-year period. For more information, see PL 104–191, section 501(c) and (d).

Pre-June 21, 1986 contracts. With a few exceptions, otherwise allowable interest (not in excess of the maximum rates set by law) paid or accrued on debt with respect to contracts purchased before June 21, 1986, can be deducted no matter when the debt was incurred.

For more information, see section 264 of the Internal Revenue Code.

Interest related to tax-exempt income. Generally, you cannot deduct interest related to tax-exempt income. You cannot take a deduction for:

1) Interest on a debt incurred to buy or carry tax-exempt securities.
2) Amounts paid or incurred in connection with personal property used in a short sale.
3) Amounts paid or incurred by others for the use of any collateral used in connection with a short sale.

If you deposit cash as collateral in a sale and the cash does not earn a material return during the period of sale, item (2) above does not apply. For more information on short sales, see *Short Sales* in Publication 550.

Limit on investment interest. Your deduction for investment interest expense is limited to the amount of your net investment income. This rule applies only if:

1) You are a noncorporate taxpayer (including shareholders and partners of S corporations and partnerships), and
2) You paid or accrued interest on money you borrowed to buy or carry property held for investment (including amounts allowable as a deduction in connection with personal property used in a short sale).

For more information about the limit on the investment interest expense deduction, see Publication 550.

Capitalization of Interest

Under the uniform capitalization rules, you generally must capitalize interest on debt used to finance the production of real or tangible personal property. The property must be produced by you for use in your trade or business or produced by you for sale to customers. Interest on a debt on property acquired and held for resale does not have to be capitalized.

Interest you paid or incurred during the production period 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.

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

Capitalized interest. Treat capitalized interest as a cost of the property produced. You recover the interest when you sell or use the property, or dispose of it under the rules that apply to such transactions. You recover capitalized interest through cost of goods sold, an adjustment to basis, depreciation, amortization, or other method.

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 costs.

If you are a shareholder in an S corporation or a partner in a partnership, you may have to capitalize interest you incur during the tax year for the production costs of the S corporation or partnership. You may also have to capitalize interest incurred by the S corporation or partnership for your own production costs. You must provide the required information in an attachment to the Schedule K–1 to properly capitalize interest for this purpose.

Additional information. The procedures for applying the uniform capitalization rules are complex and beyond the scope of this publication. For more information, 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 the earlier discussion of capitalized interest does not apply to you, deduct interest as follows.

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

Prepaid interest. 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. You must prorate this discount over the loan period and you can deduct interest only when you make payments on the loan.

Refunds of interest. If you pay interest and then receive a refund in the same tax year of any part of the interest, reduce your interest deduction by the refund. If you receive the refund in a later tax year, include the refund in income if the deduction for the interest reduced your tax. You should include in income only the amount of the interest deduction that reduced your tax.

Accrual method. You can deduct only interest that has accrued during the tax year.

Prepaid interest. If you pay interest in advance, deduct it as it accrues over the period of the debt. This rule also applies to the amount subtracted on a ***discounted loan.***

Payments unlikely to be made. You can take a deduction for accrued interest even if it is unlikely you will make the interest payments because of financial difficulty.

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

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

Related taxpayer. If you use the accrual method, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. The relationship is determined as of the end of the tax year for which the interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ceases to exist before the interest is includible in the gross income of that person. See *Related Persons* in Publication 538.

However, you can deduct the amount if you pay it within 2½ months after the end of your tax year, and if the amount is paid:

1) On debt incurred by September 29, 1983, or
2) Under a contract binding on September 29, 1983, and thereafter before the amount is paid or incurred.

Below-Market Interest Rate Loans

A ***below-market loan*** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan generally is treated as an arm's-length transaction in which you, the borrower, are treated as having received:

1) A loan in exchange for a note that requires the payment of interest at the applicable federal rate, and
2) An additional payment.

The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on whether the loan is a gift loan, demand loan, term loan, or a gift term loan. These loans are discussed later.

If these rules apply to a below-market loan, two transactions are assumed to have taken place:

1) A transfer of forgone interest from the lender to the borrower, and
2) A retransfer of the forgone interest from the borrower to the lender.

Forgone interest. For any period, forgone interest is:

1) The amount of interest that would be payable for that period if interest accrued at the applicable federal rate and was payable annually on December 31, minus
2) Any interest actually payable on the loan for the period.

Applicable federal rates are published by the IRS each month in the *Internal Revenue Bulletin*. You can also contact an Internal Revenue Service office to get these rates.

How you treat the forgone interest depends on the type of loan you have. The various loans and types of treatment of forgone interest are discussed next.

Gift and demand loans. A ***gift loan*** is any below-market loan where the forgone interest is in the nature of a gift. A ***demand loan*** is one payable in full at any time upon the lender's demand.

If you receive a below-market gift loan or demand loan, you are treated as receiving an additional payment (as a gift, dividend, etc.) equal to the forgone interest on the loan. You then treat this amount as being transferred back to the lender as interest. You may be entitled to deduct that amount as an interest expense, if it qualifies. The lender must report this amount as interest income. These transfers are considered to occur annually, generally on December 31.

Term loans. If you receive a below-market term loan (a loan that is not a demand loan), you are treated as receiving an additional lump-sum cash payment (as a gift, dividend, etc.) on the date the loan is made. This payment is the loan amount minus the present value of all payments due under the loan. This excess is treated as original issue discount and the original issue discount rules apply. See *Original Issue Discount (OID)* in Publication 550.

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

1) Gift loans,
2) Compensation-related loans,
3) Corporation-shareholder loans,
4) Tax avoidance loans,
5) Loans to qualified continuing care facilities (made after October 11, 1985), and
6) Other below-market loans.

Exceptions. The rules for below-market loans do not apply to certain loans on days on which the total amount of outstanding loans between the borrower and lender is $10,000 or less. The rules do not apply on those days to:

1) Gift loans between individuals if the gift loan is not directly used to purchase or carry income-producing assets; or
2) Compensation-related loans or corporation-shareholder loans if the avoidance of federal tax is not a principal purpose of the loan.

A compensation-related loan is any below-market loan between an employer and an employee or between an independent contractor and a person for whom the contractor provides services.

Limit on forgone interest for gift loans of $100,000 or less. For gift loans between individuals, if the outstanding loans between the lender and borrower total $100,000 or less, the forgone interest included in income by the lender and deducted by the borrower is limited to the borrower's net investment income for the year. If the borrower's net investment income is $1,000 or less, it is treated as zero. This limit does not apply to a loan if the avoidance of federal tax is one of the main purposes of the interest arrangement.

Loans not subject to the rules. Some loans are specifically excluded from the rules for below-market loans, such as:

1) Loans made available by lenders to the general public on the same terms and conditions and which are consistent with the lender's customary business practices,
2) Loans subsidized by a federal, state, or municipal government that are made available under a program of general application to the public,
3) Certain employee-relocation loans,
4) Certain loans to or from a foreign person, unless the interest income would be effectively connected with the conduct of a U.S. trade or business and not exempt from U.S. tax under an income tax treaty, and
5) Any loan if the taxpayer can show the interest arrangement has no significant effect on the federal tax liability of the lender or the borrower. See *Significant effect on federal tax liability,* later.

Certain loans to qualified continuing care facilities. The below-market interest rules do not apply to loans made by a lender to a qualified continuing care facility pursuant to a continuing care contract. These loans are exempt only if:

1) The principal amount of the loan, when added to the total outstanding amount of all loans from the lender (or lender's spouse) do not exceed $131,300 for 1997.
2) The lender (or lender's spouse) is age 65 or older, by the end of the calendar year.

A continuing care facility is one or more facilities that are designed to provide services under continuing care contracts and where substantially all of the residents living there have entered into continuing care contracts. In addition, substantially all of the facilities used to provide services required under the continuing care contract must be owned or operated by the loan borrower.

A written contract between an individual and a qualified continuing care facility must meet all four of the following conditions.

1) The individual and/or the individual's spouse must be entitled to use the facility for the rest of their life or lives.
2) The residential use must begin in a separate, independent living unit provided by the continuing care facility and continue until the individual (or individual's spouse) is incapable of living independently. The facility must provide various "personal care" services to the resident such as maintenance of the residential unit, meals, and daily aid and supervision relating to routine medical needs.
3) The facility must also be obligated to provide long-term nursing care if the resident is no longer capable of living independently.
4) The contract must require the facility to provide the "personal services" and "long-term nursing care" without substantial additional cost to the individual.

Tax avoidance loans. If one of the principal purposes of structuring a transaction as an exempted loan is the avoidance of federal tax, the loan will be considered a tax avoidance loan and will be subject to the rules for below-market loans.

Significant effect on federal tax liability. Whether an interest arrangement has a significant effect on the federal tax liability (item 5) of the lender or the borrower will be determined by all the facts and circumstances. Factors to be considered include:

1) Whether items of income and deduction generated by the loan offset each other,
2) The amount of the items,
3) The cost of complying with the below-market loan provisions if they applied, and
4) Any reasons, other than taxes, for structuring the transaction as a below-market loan.

Effective dates. Except as provided above, these rules apply to term loans made after June 6, 1984, and to demand loans outstanding after that date.

For more information, see section 7872 of the Internal Revenue Code and 1.7872–5T of the regulations.

Sale or exchange of property. Different rules generally apply to a loan connected with the sale or exchange of property. If the loan does not provide adequate stated interest, part of the principal payment may be considered interest. However, there are exceptions that may require you to apply the below-market interest rate rules to these loans. See the *Unstated Interest* discussion in Publication 537.

9. Taxes

Introduction

You can deduct various federal, state, local, and foreign taxes directly attributable to your trade or business as business expenses.

When to deduct taxes. Generally, you can only deduct taxes in the year you pay them. This applies whether you use the cash method or an accrual method of accounting.

If you use an accrual method, you can deduct a tax before you pay it if you meet the exception for recurring items discussed under *Economic Performance* in Publication 538. You can also choose to ratably accrue real estate taxes as discussed later under *Real Estate Taxes.*

Limit on accrual of taxes. A taxing jurisdiction can require the use of an earlier date for accruing taxes than that which it previously required. However, if you use an accrual method and can deduct the tax before you pay it, a special rule applies. The special rule sets the accrual date for federal income tax purposes as the date on which the tax would have accrued had no action been taken.

Uniform capitalization rules. 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. They also apply to taxpayers who acquire property for resale. Under these rules, you may have to include in inventory costs or capitalize certain expenses related to the property, such as taxes. For more information, see Publication 551.

Carrying charges. Carrying charges include taxes you pay to carry or develop real estate or to carry, transport, or install personal property. You can choose to capitalize carrying charges not subject to the uniform capitalization rules if they are otherwise deductible. For more information, see chapter 11.

CAUTION *You cannot deduct federal estate and gift taxes, or state inheritance, legacy, and succession taxes.*

Refunds of taxes. If you receive a refund for any taxes you deducted in an earlier year, include the refund in income only to the extent the deduction reduced your tax in the earlier year. For more information, see *Recovery of amount deducted* in chapter 1.

TIP *You must include any interest you receive with state or local tax refunds in income.*

Topics

This chapter discusses:

- Real estate taxes
- Income taxes
- Employment taxes
- Other taxes

Useful Items

You may want to see:

Publication

- ☐ **15** Circular E, Employer's Tax Guide
- ☐ **378** Fuel Tax Credits and Refunds
- ☐ **533** Self-Employment Tax
- ☐ **538** Accounting Periods and Methods
- ☐ **551** Basis of Assets

Form (and Instructions)

- ☐ **1040** U.S. Individual Income Tax Return
- ☐ **Sch SE (Form 1040)** Self-Employment Tax
- ☐ **3115** Application for Change in Accounting Method

See chapter 17 for information about getting these forms and publications.

Real Estate Taxes

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

If you use an accrual method of accounting, you generally cannot accrue real estate taxes until you pay them to the government authority. You can, however, choose to ratably accrue the taxes during the year. See *Election to ratably accrue,* later.

Taxes for local benefits. Generally, you cannot deduct taxes charged for local benefits and improvements that tend to increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, and public parking facilities. You should increase the basis of your property by the amount of the assessment.

You can deduct taxes for these local benefits only if the taxes are for maintenance, repairs, or interest charges related to those benefits. If part of the tax is for maintenance, repairs, or interest, you can deduct that part if you can show how much it is. If you cannot show how much of the tax is for maintenance, repairs, or interest, you cannot deduct any of it.

Example. City X, to improve downtown commercial business, converted a downtown business area street into an enclosed pedestrian mall. The city assessed the full cost of construction, financed with 10-year bonds, against the affected properties. The city is paying the principal and interest with the annual payments made by the property owners.

The assessments for construction costs 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.

Purchase or sale of real estate. If real estate is sold during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and seller must divide the real estate taxes according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each owned the property. Treat the seller as paying the taxes up to but not including the date of sale. Treat the buyer as paying the taxes beginning with the date of sale. For this purpose, disregard the accrual or lien dates under local law. You can usually find this information on the settlement statement you received at closing.

If you (the 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 of the tax at the time of the sale. This lets you deduct the part of the tax to the date of sale even though you did not pay it. You must also include the amount of that tax in the selling price of the property.

If you (the seller) use an accrual method and have not chosen to ratably accrue real estate taxes, you are considered to have accrued your part of the tax on the date you sell the property.

Example. Al Green, a calendar year accrual method taxpayer, owns real estate in X County. He has not chosen to ratably accrue property taxes. November 30 of each year is the assessment and lien date. He sold the property on June 30, 1997. Under his accounting method he would not be able to claim a deduction for the taxes because the sale occurred before November 30. He is treated as having accrued his part of the tax, $^{180}/_{365}$ (January 1–June 29), on June 30, and he can deduct it for 1997.

Election to ratably accrue. If you use an accrual method, you can choose to accrue real estate tax that is related to a definite period ratably over that period.

Example. John Smith is a calendar year taxpayer who uses an accrual method. His real estate taxes for the real property tax year, July 1, 1997, to June 30, 1998, amount to $1,200. The assessment and lien date is July 1.

If John chooses to ratably accrue the taxes, $600 will accrue in 1997 ($1,200 × $^{6}/_{12}$, July 1–December 31) and the balance will accrue in 1998.

Separate elections. You can make a choice for each separate trade or business and for nonbusiness activities if you account for them separately. Once you choose to ratably accrue real estate taxes, you must use that method unless you get permission from the IRS to change from that method. See *Revoking the election,* later.

Making the election. If you make your election for the first year in which you incur real estate taxes, attach a statement to your income tax return for that year. You must file your return by the due date (including extensions). The statement should show:

1) The trades or businesses to which the election applies and the accounting method or methods used,

2) The period to which the taxes relate, and

3) The computation of the real estate tax deduction for the first year of the election.

If you make the election for a year after the first year in which you incur real estate taxes, file Form 3115, *Application for Change in Accounting Method.* Generally, you must file this form during the tax year for which the election is to be effective. For more information, see the instructions for Form 3115 .

Revoking the election. To revoke an election to ratably accrue real estate taxes, file Form 3115, as discussed above.

Income Taxes

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

Federal income taxes. You cannot deduct federal income taxes.

State and local income taxes. State income taxes imposed on a corporation or partnership are deductible by the corporation or partnership as business expenses. State income taxes imposed on an individual are deductible by the individual only as an itemized deduction on Schedule A (Form 1040).

However, an individual can deduct a state tax on gross income (as distinguished from net income) directly attributable to a trade or business as a business expense.

Accrual of contested income taxes. If you use an accrual method, can deduct taxes before you pay them, and contest a state or local income tax liability, a special rule applies. The special rule requires you to accrue and deduct any contested amount only in the tax year in which the liability is finally determined.

Filing a tax return is not considered contesting a liability. If you do not make an objective act of protest or show some affirmative evidence of denial of the liability, you can deduct any additional state or local income taxes found to be due for a prior year only in the year for which they were originally imposed. You cannot deduct them in the year in which the liability is finally determined.

Foreign income taxes. Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, an individual cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. For information on these exclusions, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Employment Taxes

If you have employees, you must withhold various taxes from your employees' pay. Most employers must withhold their employees' share of social security and Medicare taxes along with state and federal income taxes. You may also need to pay certain taxes from your own funds. You may need to pay your share of social security and Medicare taxes along with unemployment taxes.

You should treat the taxes you withhold from your employees' pay as wages on your tax return. You can deduct the employment taxes you must pay from your own funds as taxes.

Example. You pay your employee $18,000 a year. However, after you withhold various taxes, your employee receives $14,500. You also pay an additional $1,500 in employer taxes. You should deduct the full $18,000 as wages. You can deduct the $1,500 you pay from your own funds as taxes.

For more information on employment taxes, see Publication 15.

Other Taxes

The following are other taxes that you can deduct if you incur them in the ordinary course of your trade or business.

Excise taxes. You can deduct all excise taxes you pay or incur as ordinary and necessary expenses of carrying on your trade or business.

Franchise taxes. You can deduct corporate franchise taxes as a business expense. If you are a cash method taxpayer, deduct the franchise tax in the year paid. If you are an accrual method taxpayer, deduct the tax in the year you become legally liable to pay it regardless of the year the tax is based on. For example, if your state imposes a franchise tax for 1997 that is based on your corporate net income for 1996, deduct the tax in 1997 if you use an accrual method because that is the year you became legally liable for the tax.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that you use in your business are usually included as part of the cost of the fuel. Do not deduct these taxes as a separate item.

You may be entitled to a credit or refund for federal excise tax you paid on fuels used for certain purposes. For more information, see Publication 378.

Occupational taxes. You can deduct as a business expense an occupational tax charged at a flat rate by a locality for the privilege of working or conducting a business in the locality.

Personal property tax. You can deduct any tax imposed by a state or local government on personal property used in your trade or business.

Sales tax. Treat any sales tax you pay on a service or on the purchase or use of property as part of the cost of the service or property. If the service or the cost or use of the property is a deductible business expense, you can deduct the tax as part of that service or cost. If the property is merchandise bought for resale, the sales tax is part of the cost of the merchandise. If the property is depreciable, add the sales tax to the basis for depreciation. For more information on basis, see Publication 551.

CAUTION *Do not deduct state and local sales taxes imposed on the buyer that you must collect and pay over to the state or local government. Do not include these taxes in gross receipts or sales.*

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

To deduct the tax, enter on Form 1040, line 26, the amount shown on the "Deduction for one-half of self-employment tax" line of the Schedule SE (Form 1040).

For more information on self-employment tax, see Publication 533.

Unemployment fund taxes. As an employer, you may have to make payments to a state unemployment compensation fund or to a state disability benefit fund. Deduct these payments as taxes.

10.

Insurance

Important Changes for 1997

Self-employed health insurance deduction. Beginning in 1997, the deduction for health insurance of self-employed individuals increases from 30% to 40%. The percentage will further increase to 45% for tax years 1998 and 1999. After 1999, the deduction increases even further. See *Self-Employed Health Insurance Deduction,* later.

Long-term care insurance. A qualified long-term care insurance contract issued after 1996 will generally be treated as an accident and health insurance contract. For more information, see *Long-term care insurance deduction,* later.

Medical savings account. Beginning after 1996, a self-employed individual may be able to take a deduction for contributions made to a medical savings account (MSA) to help cover medical expenses for the self-employed individual and his or her employees. For more information on MSAs, see chapter 5, and get Publication 969, *Medical Savings Accounts (MSAs).*

Life insurance and annuities. For contracts issued after June 8, 1997, you generally cannot deduct premiums on any life insurance policy, endowment contract, or annuity contract, if you are directly or indirectly a beneficiary. For contracts issued prior to June 9, 1997, the deduction is denied only when you are directly or indirectly a beneficiary, and the life insurance policy covers an officer, employee, or other person financially interested in your trade or business. See *Nondeductible Premiums,* later.

Introduction

You generally can deduct the ordinary and necessary cost of insurance as a business expense if it is for your trade, business, or profession. However, you may have to capitalize certain insurance costs under the uniform capitalization rules. For more information, see *Capitalizing Premiums,* later.

Topics

This chapter discusses:

- Deductible premiums
- Nondeductible premiums
- Capitalizing premiums
- When to deduct premiums

Useful Items

You may want to see:

Publication

☐ **538** Accounting Periods and Methods

Form (and Instructions)

☐ **1040** U.S. Individual Income Tax Return

See chapter 17 for information about getting this form and publication.

Deductible Premiums

You can generally deduct premiums you pay for the following kinds of insurance related to your trade or business.

1) Fire, theft, flood, or similar insurance.
2) Credit insurance on losses from unpaid debts.
3) Group hospitalization and medical insurance for employees including long-term care insurance.
   a) For partnerships, accident and health insurance for its partners as guaranteed payments made to the partners.
   b) For S corporations, accident and health insurance for its 2% shareholder-employees.
4) Liability insurance.
5) Malpractice insurance that covers your professional personal liability for negligence resulting in injury or damage to patients or clients.
6) Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.
   a) If a partnership pays workers' compensation premiums for its partners, it can deduct these amounts as guaranteed payments to the partners.
   b) If an S corporation pays the workers' compensation premiums for its shareholders, it can deduct these amounts.
7) Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered taxes under state law.
8) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness.
9) Car and other vehicle insurance. This insurance covers vehicles used in your business for liability, damages, and other losses. 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.
10) Life insurance covering your officers and employees if you are not directly or indirectly the beneficiary under the contract.
11) Use and occupancy and business interruption insurance. This insurance pays you for lost profits if your business is shut down due to a fire or other cause.

Self-Employed Health Insurance Deduction

You can deduct 40% of the amount paid during 1997 for medical insurance and qualified long-term care insurance premiums for yourself and your family, if you are:

1) Self-employed,
2) A general partner (or a limited partner receiving guaranteed payments) in a partnership, or
3) A shareholder owning more than 2% of the outstanding stock of an S corporation.

You are allowed this deduction whether you paid the premiums yourself or your partnership or S corporation paid them and you included the premium amounts in your gross income. Take this deduction on line 27 of Form 1040.

Percentage increases after 1997. For tax years beginning after 1997, the deductible percentage of your self-employed health insurance premiums gradually increases. The increases for later tax years are shown in the following table.

For Tax Years Beginning in:	Deductible Percentage
1998 and 1999	45
2000 and 2001	50
2002	60
2003 — 2005	80
2006	90
After 2006	100

Long-term care insurance deduction. Beginning January 1, 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. You can deduct the premiums you pay for your employees as an employee benefit as discussed in chapter 5. Include these amounts in your employees' gross income. (The employees may be able to deduct the premiums as a medical expense. Medical expenses are explained in Publication 502, *Medical Expenses.*)

If you are self-employed and pay long-term care insurance premiums when figuring your self-employed health insurance deduction, include the lesser of:

1) The amount you pay, or
2) The amount shown below.

- Age 40 or less–$200
- Age 41 to 50–$375
- Age 51 to 60–$750
- Age 61 to 70–$2,000
- Age 71 and above–$2,500

Use your age at the end of the tax year.

Long-term care insurance contract. A long-term care insurance contract is any insurance contract that only provides coverage of qualified long-term care services. The contract must:

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

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

1) Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and
2) Maintenance or personal care services

that are required by a chronically ill individual and prescribed by a licensed health care practitioner.

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

1) An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
2) An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment. The certification must have been made by a licensed health care practitioner within the previous 12 months.

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

Limits. You cannot deduct an amount more than your net earnings from the trade or business in which the medical insurance plan or long-term care insurance plan is established. If the business in which the insurance plan is established is an S corporation, you cannot deduct more than your wages from the S corporation. Do not subtract the self-employed health insurance 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.

Other coverage. You cannot take the deduction for any month if you were eligible to participate in any employer (including your spouse's) subsidized health plan at any time during that month. This rule is applied separately to plans that provide long-term care insurance and plans that do not provide long-term care insurance. However, any medical insurance payments not deductible on line 27 of Form 1040 can be included as part of your medical expenses on Schedule A (Form 1040) if you itemize your deductions.

How to figure the deduction. Generally, you can use the worksheet in the Form 1040 instructions to figure your deduction. However, if either of the following applies, you must use the worksheet that follows.

1) You have more than one source of income subject to self-employment tax, or
2) You file Form 2555 or Form 2555–EZ (relating to foreign earned income).

CAUTION *If you have more than one health plan during the year, and each plan is established under a different business, you must use separate worksheets (in this chapter) to figure each plan's net earnings limit. Include your insurance payments under that plan on line 1 of the separate worksheet and your net profit (or wages) from that business on line 4 (or line 11).*

Worksheet (Keep for your records.)

1) Enter total payments made during the taxable year for health insurance coverage for yourself, your spouse, and your dependents. (***Do not include*** payments for coverage for any month during which you were eligible to participate in a health plan subsidized by your or your spouse's employer.)	______
2) Percentage used to figure deduction for 1997	×.40
3) Multiply the amount on line 1 by the percentage on line 2	______
4) Enter your net profit and any other earned income* from the trade or business under which the insurance plan is established. (If the business is an S corporation, skip to line 11.)	______
5) Enter the total of all net profits from: line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065); plus any other income allocable to the profitable businesses. See the instructions for Schedule SE (Form 1040). (***Do not include*** any net losses shown on these schedules.)	______
6) Divide the amount on line 4 by the amount on line 5	______
7) Multiply the amount on Form 1040, line 26, by the percentage on line 6	______
8) Subtract the amount on line 7 from the amount on line 4	______
9) Enter the amount, if any, from Form 1040, line 28, attributable to the same trade or business in which the health insurance plan is established	______
10) Subtract the amount on line 9 from the amount on line 8	______
11) Enter your wages from your S corporation in which the health insurance plan is established	______
12) Enter the amount from Form 2555, line 43, attributable to the amount entered on line 4 or 11 above, or the amount from Form 2555–EZ, line 18, attributable to the amount entered on line 11 above	______
13) Subtract the amount on line 12 from the amount on line 10 or 11, whichever applies	______
14) Compare the amounts on lines 3 and 13 above. Enter the ***smaller*** of the two amounts here and on Form 1040, line 27. (***Do not include*** this amount when figuring a medical expense deduction on Schedule A (Form 1040).)	______

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

Nondeductible Premiums

You cannot deduct the following kinds of insurance premiums.

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. See Publication 547, *Casualties, Disasters, and Thefts.*.
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, item (8), under *Deductible Premiums.*
3) ***Certain life insurance and annuities.*** For contracts issued ***before June 9, 1997,*** you cannot deduct the 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. For this purpose, you are included among possible beneficiaries of the policy if the policy owner is obligated to repay a loan from you using the proceeds of the policy. A person has a financial interest in your business if the person is an owner or part owner of the business or has lent money to the business. For contracts issued ***after June 8, 1997,*** you generally cannot deduct the premiums on any life insurance policy, endowment contract, or annuity contract, if you are directly or indirectly a beneficiary. The disallowance applies without regard to whom the policy covers.

   Partners. If, as a partner in a partnership, you take out an insurance policy on your own life and name your partners as beneficiaries to induce them to retain their investments in the partnership, you are considered a beneficiary. You cannot deduct the insurance premiums.
4) ***Insurance to secure a loan.*** If you take out a policy on your life or on the life of another person with a financial interest in your business to get or protect a business loan, you cannot deduct the premiums as a business expense. Nor can you deduct the premiums as interest on business 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.

Capitalizing Premiums

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for production or resale activities. Include these costs in the basis of property you produce or in inventory, rather than claiming them as a current deduction. Also, recover the costs through depreciation, amortization, cost of goods sold, or by an adjustment to basis when you use, place in service, or dispose of the property.

When the uniform capitalization rules apply. You must use the uniform capitalization rules if, in your trade or business or 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, you generally do not have to use the uniform capitalization rules for personal property acquired for resale 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. For the year in which you make the payment or incur the liability, you can deduct only the part of the premium that applies to that year. For 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, 1997, and paid a premium of $1,200 for 2 years of coverage. On your 1997 return, you can deduct only the part of the total premium that applies to the 3 months of coverage in 1997. For 1998 and 1999, you can deduct the part of the premium that applies to each of 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 1997, you can deduct $150; for 1998, you can deduct $600; and for the 9-month period in 1999, you can deduct $450.

If you use the cash method of accounting and you pay the $1,200 premium in January 1998, you cannot deduct any amount on your 1997 return. However, you can deduct $750 (the $150 that applies to 1997 plus the $600 that applies to 1998) on your return for 1998.

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 *Tax Benefit Rule* in Publication 525.

11. Costs You Can Deduct or Capitalize

Introduction

This chapter discusses the two ways of treating certain costs—deduction or capitalization.

If you deduct a cost as an expense, you generally can recover the cost by subtracting it from your income in either the year you incur the cost or the year you pay it.

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

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

- Certain carrying charges,
- Research and experimental costs,
- Intangible drilling and development costs for oil, gas, and geothermal wells,
- Exploration costs for mineral deposits,
- Mine development costs for mineral deposits,
- Costs of establishing or increasing the circulation of a newspaper or other periodical, and
- Costs of removing barriers to the disabled and the elderly.

Except for exploration costs for mineral deposits, a partnership, corporation, estate, or trust makes the choice to deduct or capitalize these costs. Each individual partner, shareholder, or beneficiary chooses whether to deduct or capitalize exploration costs.

CAUTION *You may be subject to the alternative minimum tax (AMT) if you deduct any of the expenses listed in the topics area except carrying charges and the costs of removing architectural barriers. However, any cost you deduct over the optional write-off period will not make you subject to the alternative minimum tax (AMT).*

For more information on alternative minimum tax, see the instructions for Form 6251 (individuals) or Form 4626 (corporations).

For information on the optional write-off method, see Internal Revenue Code section 59(e).

Topics

This chapter discusses:

- Carrying charges
- Research and experimental costs
- Drilling and development costs
- Exploration costs
- Circulation costs
- Costs of removing barriers to the disabled and the elderly

Useful Items

You may want to see:

Publication

- ☐ **538** Accounting Periods and Methods
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **3115** Application for Change in Accounting Method
- ☐ **3468** Investment Credit
- ☐ **6251** Alternative Minimum Tax—Individuals
- ☐ **6765** Credit for Increasing Research Activities
- ☐ **8826** Disabled Access Credit

See chapter 17 for information about getting these forms and publications.

Carrying Charges

Carrying charges are the taxes and interest you pay to carry or develop real property or to carry, transport, or install personal property. Certain carrying charges must be capitalized under the uniform capitalization rules. (For more information on capitalization of interest, see chapter 8.) You can choose to capitalize carrying charges not subject to the uniform capitalization rules, but only if they are otherwise deductible.

You can choose to capitalize carrying charges separately 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 decide whether to capitalize carrying charges each year the property remains unimproved and unproductive. For other property, your choice to capitalize carrying charges remains in effect until construction, development, or installation is completed (or, for personal property, the date you first use it, if later).

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

You may be able to extend the time you have to make the choice. See Revenue Procedures 92-85 and 93-28 for more information.

Research and Experimental Costs

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

Generally, you can only make the choice to deduct these costs in the first year you incur such costs. See *How and when to choose,* later.

For information on amortizing these costs, see *Research and Experimental Costs* in chapter 12.

Research and experimental costs defined. Research and experimental costs are reasonable costs you incur in your trade or business for activities intended to provide information to help eliminate uncertainty about the development or improvement of a product. Uncertainty exists if the information available to you does not establish how to develop or improve a product or the appropriate design of a product. Whether costs qualify as research and experimental costs depends on the nature of the activity related to the costs. Neither the nature of the product or improvement being developed nor the level of technological advancement matters when making this determination.

The costs of obtaining a patent, including attorneys' fees in making and perfecting a patent application, are research and experimental costs.

If you:	Then:
Deduct research and experimental costs as a current business expense,	Deduct all research and experimental costs for the year of choice and all later years.
Do not deduct research and experimental costs as a current business expense,	Amortize them over at least 60 months, starting the month you first receive an economic benefit from the research.

Product. The term "product" includes any:

1) 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.

Costs not included. 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.

How and when to choose. You can choose to deduct research and experimental costs, rather than capitalize them, by deducting them on your tax return for the year in which you first have this type of cost.

Intangible Drilling Costs

The costs of developing ***oil, gas, or geothermal wells*** are ordinarily capital expenses. You can usually recover them 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. You can only deduct costs for drilling or preparing a well for the production of oil, gas, geothermal steam, or geothermal hot water.

You can choose to deduct only costs for items that do not have a salvage value. These include wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production. The costs to you of any drilling or development work, exclusive of depreciable items, done by contractors under any form of contract is also an intangible drilling and development cost.

You can also choose to deduct the cost of drilling bore holes to determine the location and delineation of offshore hydrocarbon deposits if the shaft is capable of conducting hydrocarbons to the surface on completion. It does not matter whether there is any intent to produce hydrocarbons.

If you do not choose to deduct your intangible drilling and development costs currently, you can choose to deduct them over the 60-month period beginning with the month they were paid or incurred.

How to make the choice. You choose to deduct intangible drilling and development costs currently by taking the deduction on your income tax return for the first tax year you have eligible costs. No formal statement is required. If you file Form 1040 (Schedule C), enter these costs under "Other Expenses."

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

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

Costs incurred outside the United States. You cannot deduct all of the intangible drilling and development costs paid or incurred for an oil, gas, or geothermal well located outside the United States in one year. However, you can choose to include them in the adjusted basis of the well to figure depletion. If you do not make this choice, you can deduct the costs over the 10–year period beginning with the tax year in which you paid or incurred them. These rules do not apply to a nonproductive well.

Exploration Costs

The costs of determining the existence, location, extent, or quality of any mineral deposit that lead to the development of a mine are ordinarily capital expenses. You recover these costs through depletion as the mineral is removed from the ground. However, you can deduct currently the costs of exploration in the United States (except those for oil, gas, and geothermal wells) paid or incurred before the development stage began.

Partnerships. Each partner, not the partnership, chooses whether to capitalize or to deduct that partner's share of exploration costs.

How to make the choice. To deduct exploration costs currently, take the deduction on your income tax return or an amended income tax return. Your return must adequately describe and identify each property or mine, and clearly state how much is being deducted for each one. The choice applies to all the domestic exploration costs you have during the tax year that you make this choice and all following tax years.

Reduced corporate deductions for exploration costs. A corporation (other than an S corporation) can deduct only 70% of its domestic exploration costs. It must capitalize the remaining 30% and amortize them over the 60-month period starting with the month the exploration costs are paid or incurred. The 30% the corporation capitalizes cannot be added to its basis in the property for purposes of figuring cost depletion. However, the amount amortized is treated as additional depreciation and is subject to recapture as ordinary income on a disposition of the property. See *Depreciation Recapture on Section 1250 Property* in chapter 4 of Publication 544.

These rules also apply to the deduction of ***development costs for corporations.*** See *Development Costs,* later.

Recapture of exploration expenses. When your mine reaches the producing stage, you must recapture any exploration costs you chose to deduct for it. Use either of the following methods.

Method 1—include the deducted costs in gross income for the tax year the mine reaches the producing stage. You must choose this recapture method by the due date (including extensions) of your return. Your choice must be clearly indicated on the return. Increase your adjusted basis in the mine by the amount included in income.

Method 2— reduce the depletion deduction you would otherwise take for the tax year the mine reaches the producing stage and following tax years, until your deducted costs have been recaptured.

You must also recapture deducted exploration costs if you receive a bonus or royalty from mine property before it reaches the producing stage. Reduce the depletion deduction you would otherwise take for the tax year you receive the bonus or royalty and following tax years, until you have recaptured your deducted costs.

If you dispose of the mine before your deducted exploration costs have been fully recaptured, recapture the balance by treating all or part of your gain as ordinary income.

Foreign exploration. If you pay or incur exploration costs for a mine or other natural deposit located outside the United States, you cannot deduct all of the costs in the current year. You can choose to include the costs (other than for an oil, gas, or geothermal well) in the adjusted basis of the mineral property to figure cost depletion. If you do not make this choice, you must deduct the costs over the 10-year period beginning with the tax year in which you pay or incur them. These rules also apply to ***foreign development costs.***

Cost depletion is discussed in chapter 13.

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. These costs must be paid or incurred after the discovery of ores or minerals in commercially marketable quantities. Development costs include those incurred by a contractor for you. Also, development costs include depreciation on improvements used in the development of ores or minerals. They do not include costs for depreciable improvements.

You can choose to treat development costs as deferred expenses and deduct them ratably as the units of produced ores or minerals related to the expenses are sold. This choice applies each tax year to expenses paid or incurred in that year. Once made, the choice is binding for the year and cannot be revoked for any reason.

How to make the choice. The choice to deduct development costs ratably as the ores or minerals are sold must be made for each mine or other natural deposit by a clear indication on your return or by a statement filed with the IRS office where you file your return. You must make the choice by the due date of the return (including extensions).

Foreign development costs. The same rules discussed earlier for foreign exploration costs apply to foreign development costs.

Reduced corporate deductions for development costs. The treatment of corporate deductions for exploration costs, discussed earlier, also applies to corporate deductions for development costs.

See *Reduced corporate deductions for exploration costs,* earlier.

Circulation Costs

A publisher can deduct as a business expense the costs of establishing, maintaining, and increasing the circulation of a newspaper, magazine, or other periodical. For example, a publisher can deduct the cost of hiring extra employees for a limited time to get new subscriptions through telephone calls. Circulation costs are deductible even if they result in an asset (i.e., a subscriber list) having a useful life of more than one year.

Other treatment of circulation costs. A publisher can choose to capitalize the costs of establishing or increasing circulation. Also, a publisher can choose to deduct circulation costs over the 3–year period beginning with the tax year they were paid or incurred.

These rules do not apply to the purchase of land or depreciable property acquisitions of circulation through the purchases of any part of the business of another publisher. These costs ***must*** be capitalized.

How to make the choice. Indicate you choose to capitalize circulation costs by attaching a statement to your return for the first tax year the choice applies. Your choice is binding for the year it is made and for all later years, unless you get IRS approval to revoke it.

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 the costs of making a facility or public transportation vehicle owned or leased for use in connection with your trade or business more accessible to and usable by those who are disabled or elderly.

For this discussion, a facility is all or any part of buildings, structures, equipment, roads, walks, parking lots, or similar real or personal property. A public transportation vehicle is a vehicle, such as a bus or railroad car, that provides transportation service to the public (including service for your customers, even if you are not in the business of providing transportation services).

You cannot deduct any costs that you paid or incurred to completely renovate or build a new facility or public transportation vehicle, or to replace depreciable property.

Deduction limits. The most you can deduct as a cost of removing barriers to the disabled and the elderly for any tax year is $15,000. However, any amount over this limit can be added to the basis of the property and depreciated.

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

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

Example. John Duke's distributive share of ABC partnership's deductible expenses for the removal of architectural barriers was $20,000. John had $10,000 of similar expenses in his sole proprietorship. He chose to deduct $5,000 of them. John allocated the remaining $10,000 of the $15,000 limit to his share of ABC's expenses. John can add the excess $5,000 in the sole proprietorship to the basis of his property. Also, if ABC can show that John could not deduct $10,000 of his share of the partnership's expenses, ABC can add that amount to the basis of its property.

Qualification standards. You must meet the following specific standards for improved access for the disabled or the elderly to deduct your costs as a current expense.

Grading. The ground must be graded to the level of a normal entrance to make the facility accessible to people with physical disabilities.

Walks.

1) A public walk must be at least 48 inches wide and cannot slope more than 5%. A fairly long walk of maximum or near maximum steepness must have level areas at regular intervals. A walk or driveway must have a nonslip surface.
2) A walk must have a continuing common surface and must not have steps or sudden changes in level.
3) Where a walk crosses another walk, a driveway, or a parking lot, they must blend to a common level. However, this does not require the removal of curbs which are a safety feature for those with disabilities, especially blindness.
4) A sloping walk must have a level platform at the top and at the bottom. If a door swings out onto the platform at the top or bottom of the walk, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform, the platform must be at least 3 feet deep and 5 feet wide. The platform must extend at least 1 foot past the opening side of any doorway.

Parking lots.

1) At least one parking space close to a facility must be set aside and marked for use by persons with disabilities.
2) A parking space must be open on one side to allow room for a person in a wheelchair or on braces or crutches to get in and out of a car onto a level surface suitable for wheeling and walking.
3) A designated parking space placed between two regular diagonal or head-on parking spaces must be at least 12 feet wide.
4) A parking space must be located so that a person in a wheelchair or on braces or crutches does not have to go behind parked cars.

Ramps.

1) A ramp must not rise more than 1 inch for each foot of length.
2) A ramp must have at least one handrail that is 32 inches high, measured from the surface of the ramp. The handrail must be smooth and extend at least 1 foot past the top and bottom of the ramp. However, this does not require a handrail extension which is itself a hazard.
3) A ramp must have a nonslip surface.
4) A ramp must have a level platform at the top and at the bottom. If a door swings out onto the platform, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform, the platform must be at least 3 feet deep and 5 feet wide. The platform must extend at least 1 foot past the opening side of any doorway.
5) A ramp must have level platforms no farther than 30 feet apart and at any turn.
6) A curb ramp with a nonslip surface must be provided at an intersection. The curb ramp must not be less than 4 feet wide and must not slope more than 1 inch for each foot of length. The two surfaces must blend smoothly.

Entrances. A building must have at least one main entrance a person in a wheelchair can use. The entrance must be on a level accessible to an elevator.

Doors and doorways.

1) A door must have a clear opening at least 32 inches wide and must be operable by a single effort.
2) The floor on the inside and outside of a doorway must be level for at least 5 feet from the door in the direction that the door swings and must extend at least 1 foot past the opening side of the doorway.
3) There must not be any sharp slopes or sudden changes in level at a doorway. The threshold must be flush with the floor. The door closer must be selected, placed, and set so as not to impair the use of the door by persons with disabilities.

Stairs.

1) Stairsteps must have round nosing of between 1 and 1½ inch radius.
2) Stairs must have a handrail 32 inches above the front of the tread at the face of the riser.
3) Stairs must have at least one handrail that extends at least 18 inches past the top step and the bottom step. But this does not require a handrail extension which is itself a hazard.
4) Each step must not be more than 7 inches high.

Floors.

1) Floors must have a nonslip surface.
2) Floors on each story of a building must be on the same level or must be connected by a ramp, as discussed previously.

Toilet rooms.

1) A toilet room must have enough space for a person in a wheelchair to move around.
2) A toilet room must have at least one toilet stall that—
   a) Is at least 36 inches wide,
   b) Is at least 56 inches deep,
   c) Has a door, if any, that is at least 32 inches wide and swings out,
   d) Has handrails on each side that are 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches away from the wall, and fastened securely at the ends and center, and
   e) Has a toilet with a seat 19 to 20 inches from the finished floor.
3) A toilet room must have, in addition to or instead of the toilet stall described in (2), at least one toilet stall that:
   a) Is at least 66 inches wide,
   b) Is at least 60 inches deep,
   c) Has a door, if any, that is at least 32 inches wide and swings out,
   d) Has a handrail on one side, 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches away from the wall, and fastened securely at the ends and center, and
   e) Has a toilet with a seat 19 to 20 inches from the finished floor with a centerline 18 inches from the side wall on which the handrail is located.
4) A toilet room must have sinks with narrow aprons. Drain pipes and hot water pipes under a sink must be covered or insulated.
5) A mirror and a shelf above a sink must not be higher than 40 inches above the floor, measured from the top of the shelf and the bottom of the mirror.
6) A toilet room for men must have wall-mounted urinals with the opening of the basin 15 to 19 inches from the finished floor or floor-mounted urinals that are level with the main floor.
7) Towel racks, towel dispensers, and other dispensers and disposal units must not be mounted higher than 40 inches from the floor.

Water fountains.

1) A water fountain and a cooler must have up-front spouts and controls.
2) A water fountain and a cooler must be hand-operated or hand-and-foot-operated.
3) A water fountain mounted on the side of a floor-mounted cooler must not be more than 30 inches above the floor.
4) A wall-mounted, hand-operated water cooler must be mounted with the basin 36 inches from the floor.
5) A water fountain must not be fully recessed and must not be set into an alcove unless the alcove is at least 36 inches wide.

Public telephones.

1) A public telephone must be placed so that the dial and the headset can be reached by a person in a wheelchair.
2) A public telephone must be equipped for a person who is hearing impaired and is identified as such with instructions for its use.
3) Coin slots of public telephones must not be more than 48 inches from the floor.

Elevators.

1) An elevator must be accessible to, and usable by, persons with disabilities and the elderly on the levels they use to enter the building and all levels and areas normally used.
2) Cab size must measure at least 54 by 68 inches to allow for turning a wheelchair.
3) Door clear opening width must be at least 32 inches.
4) All controls needed must be within 48 to 54 inches from the cab floor. These controls must be usable by a person with a visual impairment and must be identifiable by touch.

Controls. Switches and controls for light, heat, ventilation, windows, draperies, fire alarms, and all similar controls needed or used often must be placed within the reach of a person in a wheelchair. These switches and controls must not be higher than 48 inches from the floor.

Identification.

1) Raised letters or numbers must be used to identify rooms and offices. These identification marks must be placed on the wall to the right or left of the door at a height of 54 to 66 inches from the finished floor.
2) A door that might prove dangerous if a person who is blind were to use it, such as a door leading to a loading platform, boiler room, stage, or fire escape, must be identifiable by touch.

Warning signals.

1) An audible warning signal must be accompanied by a simultaneous visual signal for the benefit of those who are hearing impaired.
2) A visual warning signal must be accompanied by a simultaneous audible signal for the benefit of persons who are blind.

Hazards. Hanging signs, ceiling lights, and similar objects and fixtures must be at least 7 feet from the floor.

International accessibility symbol. The international accessibility symbol must be displayed on routes to a wheelchair-accessible entrance to a facility, at the entrance itself, and on public transportation vehicles.

Rail facilities.

1) A rail facility must have at least one entrance with a clear opening at least 36 inches wide.
2) A boarding platform edge bordering a drop-off or other dangerous condition must be marked with a strip of floor material different in color and texture from the rest of the floor surface. The gap between the boarding platform and vehicle doorway must be as small as possible.

Buses.

1) A bus must have a mechanism such as a lift or ramp to enter the bus and enough clearance to let a wheelchair user reach a secure location.

2) The bus must have a wheelchair-securing device. However, this does not require a wheelchair-securing device that is itself a barrier or hazard.

3) The vertical distance from a curb or from street level to the first front doorstep must not be more than 8 inches. Each front doorstep after the first step up from the curb or street level must also not be more than 8 inches high, and the steps at the front and rear doors must be at least 12 inches deep.

4) The bus must have clear signs that indicate that seats in the front of the bus are priority seats for persons who have a disability or are elderly. The signs must encourage other passengers to make these seats available to those who have priority.

5) Handrails and stanchions must be provided in the entrance to the bus so that passengers who have a disability or are elderly can grasp them from outside the bus and use them while boarding and paying the fare. This system must include a rail across the front of the bus interior for passengers to lean against while paying fares. Overhead handrails must be continuous except for a gap at the rear doorway.

6) Floors and steps must have nonslip surfaces. Step edges must have a band of bright contrasting color running the full width of the step.

7) A stepwell next to the driver must have, when the door is open, at least 2 foot-candles of light measured on the step tread. Other stepwells must have, at all times, at least 2 foot-candles of light measured on the step tread.

8) The doorways of the bus must have outside lighting that provides at least 1 foot-candle of light on the street surface for a distance of 3 feet from the bottom step edge. This lighting must be below window level and must be shielded from the eyes of entering and exiting passengers.

9) The fare box must be located as far forward as practical and must not block traffic in the vestibule.

Rapid and light rail vehicles.

1) Passenger doorways on the vehicle sides must have clear openings at least 32 inches wide.

2) Audible or visual warning signals must be provided to alert passengers of closing doors.

3) Handrails and stanchions must permit safe boarding, moving around, sitting and standing assistance, and getting off by persons who have a disability or are elderly. On a level-entry vehicle, handrails, stanchions, and seats must be located to allow a wheelchair user to enter the vehicle and position the wheelchair in a location that does not block the movement of other passengers. On a vehicle with steps, handrails and stanchions must be provided in the entrance so that persons who have a disability or are elderly can grasp them and use them from outside the vehicle while boarding.

4) Floors must have nonslip surfaces. Step edges on a light rail vehicle must have a band of bright contrasting color running the full width of the step.

5) A stepwell next to the driver must have, when the door is open, at least 2 foot-candles of light measured on the step tread. Other stepwells must have, at all times, at least 2 foot-candles of light measured on the step tread.

6) Doorways on a light rail vehicle must have outside lighting that provides at least 1 foot-candle of light on the street surface for a distance of 3 feet from the bottom step edge. This lighting must be below window level and must be shielded from the eyes of entering and exiting passengers.

Other barrier removals. To be deductible, expenses of removing any barrier not covered by the above standards must meet three tests.

1) The removed barrier must be a substantial barrier to access or use of a facility or public transportation vehicle by persons who have a disability or are elderly,

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

3) The barrier must be removed without creating any new barrier that significantly impairs access to or use of the facility or vehicle by these persons.

How to make the choice. If you choose to deduct your costs for removing barriers to the disabled or the elderly, claim the deduction on your income tax return (partnership return for partnerships) for the tax year the expenses were paid or incurred. Identify the deduction as a separate item. For your choice to be valid, you must file your return by its due date, including extensions. Your choice is irrevocable after the due date of your return. The choice applies to all the qualifying costs you have during the year, up to the $15,000 limit. If you make this choice, you must maintain adequate records to support your deduction.

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

For more information, see Form 8826.

12. Amortization

Introduction

You may be able to amortize and deduct each year a part of certain capital expenses. Amortization allows you to recover these expenses similar to straight line depreciation. It also allows you to write off expenses that are not ordinarily deductible.

The purpose of this chapter is to explain:

- The rules of amortization,
- What expenses you can amortize, and
- How and when you can amortize these expenses.

These subjects are discussed later under each type of expense.

Topics

This chapter discusses:

- Section 197 intangibles
- Going into business
- Reforestation expenses
- Pollution control facilities
- Research and experimental costs
- Bond premium
- Cost of acquiring a lease

Useful Items

You may want to see:

Publication

- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses
- ☐ **551** Basis of Assets

Form (and Instructions)

- ☐ **3468** Investment Credit
- ☐ **4562** Depreciation and Amortization
- ☐ **6251** Alternative Minimum Tax—Individuals

See chapter 17 for information about getting these publications and forms.

How To Deduct Amortization

The purpose of this section is to explain how you can deduct amortization.

Form 4562. You elect to amortize your expenses in Part VI of Form 4562 in the year in which you make the election.

For later years, do not report your deduction for amortization on Form 4562 unless you must file the form for another reason. You must file Form 4562 to:

1) Start claiming amortization this tax year,

2) Claim depreciation on property placed in service this year,

3) Claim a section 179 deduction,

4) Claim a deduction for any vehicle reported on a form other than Schedule C (Form 1040) or Schedule C–EZ (Form 1040),

5) Claim depreciation on any listed property, or

6) Claim depreciation on a return for a corporation (other than an S corporation).

Other forms. If you do not have to file Form 4562, claim amortization directly on the "Other expenses" line of Schedule C (Form 1040) or the "Other deductions" line of Form 1065 or Form 1120.

Optional write-off of tax preferences. The optional write-off periods for intangible drilling and development costs, circulation costs, and mining exploration and development costs are discussed in Internal Revenue Code section 59(e).

Section 197 Intangibles

You must amortize over 15 years the capitalized costs of "section 197 intangibles" you acquired after August 10, 1993. These costs are defined later. You must amortize these costs if you hold the section 197 intangibles in connection with your trade or business or in an activity engaged in for the production of income. Your deduction each year is the part of the adjusted basis (for purposes of determining gain) of the intangible amortized ratably over a 15-year period, beginning with the month acquired. You are not allowed any other depreciation or amortization deduction for a section 197 intangible.

Section 197 Intangibles Defined

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, or any other information base including lists or other information concerning 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 item similar to 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 the acquisition of an interest in a trade or business, and
11) A franchise, trademark, or trade name (including renewals).

CAUTION *You cannot amortize any of the intangibles listed in items 1) through 8) that you created, unless you created them in connection with the acquisition of assets constituting a trade or business or a substantial part of a trade or business.*

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

Going concern value. Going concern value is the additional value of a trade or business attached to property because it is an integral part of a going concern. It includes value based on the ability of a business to continue to function and generate income even though there is a change in ownership.

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

For example, you must amortize the part of a purchase price of a trade or business based on the existence of a highly skilled workforce. You must also amortize the cost of acquiring an existing employment contract or relationship with employees or consultants as part of the acquisition of a trade or business.

Business books and records, etc. This includes the cost of technical manuals, training manuals or programs, data files, and accounting or inventory control systems. It also includes the cost of customer lists, subscription lists, insurance expirations, patient or client files, and lists of newspaper, magazine, radio, or television advertisers.

Patents, copyrights, etc. This category includes package designs, computer software, and any interest in a film, sound recording, videotape, book, or other similar property, except as discussed later under *Other Intangibles.*

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. You must amortize part of the purchase price of a trade or business for a:

1) Customer base,
2) Circulation base,
3) Undeveloped market or market growth,
4) Insurance in force,
5) Mortgage servicing contract,
6) Investment management contract, or
7) Relationship with customers that involves the future provision of goods or services.

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

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. These goods and services must be used or sold by the business.

For example, you must amortize the part of the purchase price of a trade or business that is based on the existence of a favorable:

1) Relationship with distributors (such as favorable shelf or display space at a retail outlet),
2) Credit rating, or
3) Supply contract.

Government-granted license, permit, etc. Any license, permit, or other right granted by a governmental unit or an agency or instrumentality of a governmental unit is a section 197 intangible. For example, you must amortize the capitalized costs of acquiring (including issuing or renewing) a liquor license, a taxicab medallion or license, or a television or radio broadcasting license.

Covenant not to compete. A covenant not to compete (or similar arrangement) entered into in connection with the acquisition of an interest in a trade or business interest is a section 197 intangible. An interest in a trade or business includes an interest in a partnership or stock in a corporation engaged in a trade or business.

If you pay or incur an amount under a covenant not to compete (or similar arrangement) after the year in which you entered into the covenant (or similar arrangement), you must amortize that amount over the months remaining in the 15-year amortization period.

You cannot amortize amounts paid under a covenant not to compete (or similar arrangement) that represent additional consideration for the purchase of stock in a corporation. You must add them to the basis of the acquired stock.

Franchise, trademark, or trade name. A franchise, trademark, or trade name is a section 197 intangible. You can deduct amounts paid or incurred on the transfer of a franchise, trademark, or trade name if all of the following apply to the payments:

1) Contingent on the productivity, use, or disposition of the franchise, trademark, or trade name,
2) Part of a series of payments payable at least annually throughout the term of the transfer agreement, and
3) Substantially equal in amount or payable under a fixed formula.

You must amortize any other amount, whether fixed or contingent that you paid or incurred because of the transfer of a franchise, trademark, or trade name.

Other Intangibles

The following assets are not section 197 intangibles:

1) Any interest in a corporation, partnership, trust or estate,
2) Any interest under an existing futures contract, foreign currency contract, notional principal contract, or similar financial contract,
3) Any interest in land,
4) Most computer software (see *Computer software defined,* later),
5) 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:

i) Has a fixed life of less than 15 years, or

ii) 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.

6) An interest under:

a) An existing lease or sublease of tangible property,

b) A debt that was in existence when the interest was acquired,

7) A sports franchise,

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,

3) Not substantially changed, and

4) Not acquired in the acquisition of a substantial part of a business.

If you are allowed to depreciate 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.

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

Costs associated with nonsection 197 intangibles. Amounts you take into account in determining the cost of non-section 197 property are not considered section 197 intangibles. These amounts are added to the basis of the real property. For example, none of the costs of acquiring real property held for the production of rental income are considered goodwill, going concern value, or any other section 197 intangible.

Disposition of Section 197 Intangibles

A section 197 intangible is treated as depreciable property used in your trade or business. If you dispose of property held for more than one year, any gain on the disposition, up to the amount of allowable amortization, is ordinary income (section 1245 gain). Any remaining gain, or loss, is a section 1231 gain or loss. If you held the property one year or less, any gain or loss on its disposition is an ordinary gain or loss. For more information on ordinary or capital gain or loss, see chapter 2 in Publication 544, *Sales and Other Dispositions of Assets.*

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 the intangible. Instead increase the adjusted basis of each remaining amortizable section 197 intangible by part of the loss not recognized. Figure the increase by multiplying the loss not recognized on the disposition by a fraction:

- The numerator is the adjusted basis of that remaining intangible as of the date of its disposition, and
- The denominator is the total adjusted basis of all retained amortizable section 197 intangibles as of the date of the disposition.

Covenant not to compete. A covenant not to compete or similar arrangement is not considered disposed of or worthless before you dispose of your entire interest in the trade or business for which you entered into the covenant.

Nonrecognition transfers. If you dispose of one section 197 intangible and acquire another section 197 intangible in a nonrecognition transfer, treat the part of the adjusted basis of the acquired intangible that is not more than the adjusted basis of the transferred intangible as the transferred section 197 intangible. This includes your continuing to amortize the part of the adjusted basis treated as the transferred section 197 intangible over its remaining amortization period. Nonrecognition transfers include transfers to a corporation, partnership contributions and distributions, like-kind exchanges, and involuntary conversions.

Example. You own a section 197 intangible you have amortized for 4 full years. It has a remaining unamortized basis of $30,000. You exchange the asset plus $10,000 for a like-kind section 197 intangible. The nonrecognition provisions of like-kind exchanges apply. You amortize $30,000 of the basis of the acquired section 197 intangible over the 11 years remaining in the original 15-year amortization period for the transferred asset and the other $10,000 of adjusted basis over 15 years.

Anti-Churning Rules

You cannot amortize certain section 197 intangibles over 15 years. Special rules prevent you from converting section 197 intangibles from property that does not qualify for amortization to property that would qualify for amortization.

You cannot use 15-year amortization for goodwill, going concern value, or any intangible for which you cannot claim a depreciation deduction and for which an amortization deduction is only allowable under section 197 if:

1) You acquired the goodwill, going concern value, or other intangible after August 10, 1993, and

2) Any of the following conditions apply:

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

b) You acquired the intangible from a person who held the intangible at any time from July 25, 1991, through August 10, 1993, and as part of the transaction, the user does not change, or

c) You grant the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time from July 25, 1991, through August 10, 1993.

Exception. The anti-churning rules do not apply to an intangible acquired from a decedent if the property's basis is stepped up to fair market value.

Related person. For purposes of the anti-churning rules related persons are:

1) Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).

2) An individual and a corporation when the individual owns, directly or indirectly, more than 20% in value of the corporation's outstanding stock.

3) 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 20% ” is substituted for “at least 80%” in that definition and the determination is made without regard to subsection (a)(4) and (e)(3)(C) of section 1563.

4) A trust fiduciary and a corporation when the trust or grantor of the trust owns, directly or indirectly, more than 20% in value of the corporation's outstanding stock.

5) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.

6) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.

7) A tax-exempt educational or charitable organization and a person who, directly or indirectly, controls the organization, or a member of that person's family.

8) A corporation and a partnership if the same persons own more than 20% in value of the outstanding stock of the corporation and more than 20% of the capital or profits interest in the partnership.

9) Two S corporations if the same persons own more than 20% in value of the outstanding stock of each corporation.

10) Two corporations, one of which is an S corporation, if the same persons own more than 20% in value of the outstanding stock of each corporation.

11) Two partnerships if the same persons own, directly or indirectly, more than 20% of the capital or the profits interests in both partnerships.

12) A person and a partnership when the person owns, directly or indirectly, more than 20% of the capital or profits interests in the partnership.

Treat these persons as related to you if the relationship exists immediately before or immediately after you acquire the intangible.

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

Rule 1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning (other than by applying rule 2) any stock in a corporation is considered to own the stock owned, directly or indirectly, by or for his or her partner.

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

Exception. An exception to the anti-churning rules applies if you acquire an intangible from a person related to you by more than 20%, but not more than 50%, under the following conditions:

1) The seller recognizes gain on the disposition of the intangible, and

2) The tax the seller pays on the gain plus any other federal income tax imposed on the gain equals tax on the gain at the highest tax rate.

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

Note. The seller reports any additional tax under this exception on line 39 of the seller's Form 1040. On the dotted line next to line 39, the seller should also write “197.”

Anti-abuse rule. You cannot amortize any section 197 intangible acquired in a transaction in which one of the principal purposes was to:

1) Avoid the requirement that the intangible be acquired after August 10, 1993, or

2) Avoid any of the anti-churning rules.

Incorrect Amount of Amortization Deducted

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

Basis adjustment. Even if you do not claim amortization you are entitled to deduct, you must reduce the basis of the section 197 intangible by the full amount of amortization you were entitled to deduct. If you deduct more amortization than you should, you must decrease your basis by any amount deducted from which you received a tax benefit.

Amended Return

If you did not deduct the correct amount of amortization, you can file an amended return to make any of the following three corrections.

1) To correct a mathematical error made in any year.

2) To correct a posting error made in any year.

3) To correct the amount of amortization for section 197 intangibles for which you have not adopted a method of accounting. See *Changing Your Accounting Method,* later.

If you did not deduct the correct amount of amortization for the section 197 intangible on two or more consecutively filed tax returns, you have adopted a method of accounting for that property. If you have adopted a method of accounting, you cannot change the method by filing amended returns.

If an amended return is allowed, you must file it by the later of:

1) 3 years from the date you filed your original return for the year in which you did not deduct the correct amount, or

2) 2 years from the time you paid your tax for that year.

A return filed early is considered filed on the due date.

Changing Your Accounting Method

If you did not deduct the correct amount of amortization for the section 197 intangible on any two or more consecutively filed tax returns, you have adopted a method of accounting for that property. You can change your method of accounting for amortization to claim the correct amount of amortization. You will then be able to take into account any unclaimed or excess amortization from years before the year of change.

Consent required. You must have the consent of the Commissioner of Internal Revenue to change your method of accounting. You can get the Commissioner's consent by following the instructions in Revenue Procedure 97–27 which is in Internal Revenue Bulletin (IRB) 1997–21. Internal Revenue Bulletins are available at many libraries and IRS offices. To get the consent, you must file Form 3115 requesting a change to a permissible method of accounting for amortization. You cannot use Revenue Procedure 97–27 to correct any mathematical or posting error. See *Amended Return,* earlier.

In some instances, you can receive automatic consent from the Commissioner to change your method of accounting. See *Automatic consent,* next.

Automatic consent. You may be able to obtain automatic consent from the Commissioner if you deducted ***less*** than the allowable amount of amortization for the section 197 intangible in at least two years immediately preceding the year of change. Instead of following the instructions in Revenue Procedure 97–27, you can receive an automatic consent by following the instructions in Revenue Procedure 97–37 and section 2.01 of the Appendix of Revenue Procedure 97–37, which are in Internal Revenue Bulletin (IRB) 1997–33. This will enable you to change your accounting method to take into account previously unclaimed allowable amortization. To get the consent, you must file Form 3115 requesting a change to a permissible method of accounting for amortization.

You generally can use this procedure for property that meets all of the following three conditions.

1) It is property for which you compute amortization under section 197 of the Internal Revenue Code.

2) It is property for which, under your present accounting method, you claimed less than the amount of amortization allowable in at least the two years immediately preceding the year of change. (The year of change is the year you designate on the Form 3115 and for which you have timely filed the Form 3115.)

3) It is property you owned at the beginning of the year of change.

Exceptions. You generally cannot use the automatic consent procedure if any of the exceptions listed in section 2.01(2)(b) of the Appendix of Revenue Procedure 97–37 apply.

Other restrictions. You generally cannot use the automatic consent procedure under any of the following situations.

1) You are under examination.

2) You are before a federal court or an appeals office for any income tax issue and the method of accounting for amortization to be changed is an issue under consideration by the federal court or appeals office.

3) You are correcting a mathematical or posting error. See *Amended Return,* discussed earlier.

4) During the four years before the year of change, you changed the same method of accounting for amortization (with or without obtaining the consent of the Commissioner).

5) During the four years before the year of change, you filed a Form 3115 to change the same method of accounting for amortization but did not make the change because the Form 3115 was withdrawn, not perfected, denied, or not granted.

More information. For more information on how to get this automatic consent to change your method of accounting in order to claim previously unclaimed allowable amortization and when you cannot use it, see Revenue Procedure 97–37 and section 2.01 of the Appendix of Revenue Procedure 97–37, Internal Revenue Bulletin 1997–33.

Recapture of Amortization

Amortization you claim on section 197 property is subject to the recapture rules of section 1245 of the Internal Revenue Code. For more information on these rules, see chapter 4 in Publication 544.

Going Into Business

When you go into business, treat all costs you incur to get your business started as capital expenses. Capital expenses are part of your basis in the business. Generally, you recover costs for particular assets through depreciation deductions. However, you generally cannot recover other costs until you sell the business or otherwise go out of business. (See *Capital Expenses* in chapter 1 for a discussion of how to treat these costs if you do not go into business.)

You can elect to amortize certain costs for setting up your business. To be amortizable, the cost must qualify as a:

1) Business start-up cost,
2) Organizational cost for a corporation, or
3) Organizational cost for a partnership.

Business Start-Up Costs

Start-up costs are costs for setting up an active trade or business or investigating the possibility of creating or acquiring an active trade or business. Start-up costs include any amounts paid or incurred in connection with an activity engaged in for profit and the production of income in anticipation of the activity becoming an active trade or business.

To be amortizable, your start-up cost must meet the following tests.

1) It must be a cost you could deduct if you paid or incurred it to operate an existing trade or business.
2) You must pay or incur the cost before you begin your business operations.

Start-up costs ***include*** what you pay for investigating a prospective business and getting the business started. They may include costs for the following items:

- A survey of potential markets,
- An analysis of available facilities, labor, supplies, etc.,
- Advertisements for the opening of the business,
- Salaries and wages for employees who are being trained, and their instructors,
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers, and
- Salaries and fees for executives and consultants, or for other professional services.

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

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

Cost of Organizing a Corporation

The costs of organizing a corporation are the direct costs of creating the corporation.

Qualifying costs. To qualify for amortization, the organizational cost must meet all three of the following tests. These costs must be:

1) Incident to the creation of the corporation.
2) Chargeable to a capital account.
3) Amortizable over the life of the corporation, if the corporation had a fixed life.

You must have incurred the cost before the end of the first tax year in which the corporation was in business. A corporation using the cash method of accounting may amortize organizational expenses incurred within the first tax year, even if it does not pay them in that year.

Examples of organizational costs include:

1) Expenses of temporary directors,
2) The cost of organizational meetings,
3) State incorporation fees,
4) Accounting services for setting up the organization, and
5) The cost of legal services (such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings).

Costs you cannot amortize. You cannot amortize costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs because they are not organizational costs. Also, you cannot amortize cost associated with the transfer of assets to the corporation. You must capitalize these costs.

Costs of Organizing a Partnership

Partnership organizational costs are the direct costs of creating a partnership.

Qualifying costs. You can amortize an organizational cost only if it meets all three of the following tests:

1) It must be for the creation of the partnership and not for starting or operating the partnership trade or business,
2) It is chargeable to a capital account, and
3) You could amortize the cost over the life of the partnership if the partnership had a fixed life.

Organizational costs include:

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

Costs you cannot amortize. Partnership organizational costs do not include expenses connected with:

1) Acquiring assets for the partnership or transferring assets to the partnership,
2) Admitting or removing partners other than at the time the partnership is first organized,
3) Making a contract concerning the operation of the partnership trade or business (including a contract between a partner and the partnership), and
4) Syndication fees.

Syndication fees are costs for issuing and marketing interests in the partnership (such as commissions, professional fees, and printing costs). You must capitalize syndication fees; 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 deduction, divide your total start-up or organizational costs by the months in the amortization period. The result is the amount you can deduct each month.

CAUTION *A partnership using the cash method of accounting cannot deduct an expense it has not paid by the end of the tax year. However, any expense the partnership could have deducted as an organizational expense in an earlier tax year can be deducted in the tax year of payment.*

When to begin amortization. The amortization period starts with the month you begin business operations. A corporation or partnership is considered to begin business operations, regardless of whether a corporate charter is granted or a partnership agreement is signed, when either:

1) It acquires the assets it needs to operate its business, or
2) It starts the activities for which it is organized.

Making the election. 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 below. If you have both start-up and organizational costs, attach a separate statement to your return for each type of cost. Each statement should:

1) Show the total start-up or organizational costs you will amortize,
2) Describe what each cost 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 the accompanying statements to your return for the first tax year you are in business. You must file the return by the due date (including any extensions).

Corporations and partnerships. If your business is organized as a corporation or partnership, only your corporation or partnership can elect to amortize its start-up or organizational costs. A shareholder or partner cannot make this election.

You as shareholder or partner cannot amortize any costs you incur in setting up your corporation or partnership. The corporation or partnership can amortize these costs, but only if it reimburses you for 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 corporation or partnership.

TIP *You as an individual can elect to amortize costs you incur to investigate an interest in an existing partnership. These costs qualify as business start-up costs if you succeed in acquiring an interest in the partnership.*

Reforestation Expenses

You can elect to amortize part of your qualified timber property reforestation expenses. These are the direct costs of planting or seeding for forestation or reforestation.

Qualifying expenses. Qualifying expenses include only those costs you must capitalize and include in the adjusted basis of the property. They include costs for:

1) Site preparation,
2) Seeds or seedlings,
3) Labor,
4) Tools, and
5) Depreciation on equipment used in planting and seeding.

Costs you can deduct currently are not qualifying expenses.

If the government reimburses you for expenses under a cost-sharing program, you can amortize these expenses only if you include the reimbursement in your income.

Qualified timber property. Qualified timber property can be a woodlot or other site that you own or lease. To qualify, the property must:

1) Be located in the United States,
2) Be held for the growing and cutting of timber you will:
   a) Use in the commercial production of timber products, or
   b) Sell for use in the commercial production of timber products, and
3) Consist of at least one acre planted with tree seedlings in the manner normally used in forestation or reforestation.

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

Annual limit. Each year, you can elect to amortize up to $10,000 of qualified expenses you incur during the tax year. If you are married and file a separate return, the annual limit is $5,000. You cannot carry over or carry back qualifying expenses over the annual limit. The annual limit applies to expenses you pay or incur during a tax year on all of your qualified timber property.

If you incur more than $10,000 in expenses for more than one piece of timber property, you can allocate the annual limit among the properties in any proportion.

For example, if you incurred $10,000 of qualifying expenses on each of four qualified timber properties last year, you can allocate $2,500 to each property, $5,000 to two properties, or the entire $10,000 to any one property.

Partnerships and S corporations. Similar rules apply to partnerships and S corporations.

A partnership or S corporation makes the election to amortize its qualified expenses. The annual limit ($10,000) applies to the partnership or S corporation, as well as to each partner or shareholder. The amortizable expenses are allocated among the partners or shareholders.

A partner or shareholder is also subject to the annual limit of $10,000 ($5,000, if married and filing a separate return) in the aggregate. For example, if a married individual is a partner in two or more partnerships that elect to amortize qualified expenses, the individual's total share of partnership amortizable basis acquired during the year cannot be more than $10,000 on a joint return or $5,000 on a separate return. ***Amortizable basis*** is the part of the basis of qualified property that is from reforestation expenses.

Estates. Estates can elect to amortize up to $10,000 of qualified reforestation expenses incurred in each tax year. Any amortizable basis acquired by an estate is divided between the estate and the income beneficiary based on the income of the estate allocable to each. The amortizable basis distributed from an estate to a beneficiary is taken into account in determining the beneficiary's annual limit.

Life tenant and remainderman. If one person holds the property for life with the remainder going to another person, the life tenant is entitled to the full amortization (up to the annual limit) for reforestation expenses made by the life tenant. The remainder interest is ignored for amortization purposes.

Amortization period. You can amortize qualified reforestation expenses over a period of 84 months. The 84-month period starts on the first day of the seventh month of the tax year you incur the expenses (July 1st). You can claim amortization deductions for only 6 months of the first and last (eighth) tax years of the period.

Example. Last year, John Jones incurred qualified reforestation expenses of $8,400. His monthly deduction ($100) is figured by dividing $8,400 by 84 months. Since it was the first year of the 84-month period, he can deduct only $600 ($100 × 6 months).

Maximum annual amortization. The maximum annual amortization deduction for expenses incurred in any taxable year is $1,428.57 ($10,000 ÷ 7). The maximum deduction in the first and last tax year of the 84-month amortization period is (½) one half of $1,428.57 or $714.29.

Recapture. If you dispose of qualified timber property within 10 years after the tax year you elect to amortize reforestation expenses for it, report any gain as ordinary income up to the amount of the amortization taken.

Investment credit. Reforestation expenses eligible to be amortized qualify for the investment credit, whether or not they are amortized. See the instructions for Form 3468 for information on the investment credit.

How to elect amortization. To make this election, attach Form 4562 to your income tax return and enter the deduction in Part VI. Also, attach a statement to Form 4562 that describes the expenses and provides the dates you incurred them. Show the type of timber being grown and the purpose for which it is grown. Attach a separate statement for each property for which you amortize reforestation expenses. You can make the election only on a timely filed return (including extensions) for the tax year in which you incurred the expenses.

Where to report. If you do not have to file Schedule C, C-EZ, or F for the activity in which you incurred reforestation expenses, include your amortization deduction in the total on line 31 of Form 1040. Enter the amount and “RFST” (for reforestation) on the dotted line next to line 31.

Revocation.

You must get IRS approval to revoke an election to amortize reforestation expenses. Your application to revoke the election must include your name, address, the years for which your election was in effect, and your reason for revoking it. You must sign the application and file it at least 90 days before the due date (without extensions) for filing your income tax return for the first tax year for which your election is to end.

Send the application to:

Commissioner of Internal Revenue
Washington, DC 20224

Pollution Control Facilities

You can elect to amortize over 60 months the cost of a certified pollution control facility used with a plant (or other property) in operation before 1976.

Certified pollution control facility. A certified pollution control facility is a new identifiable treatment facility used to reduce or control water or atmospheric pollution or contamination. The facility must do so by removing, changing, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The facility must be certified by state and federal certifying authorities.

The facility must not significantly increase the output or capacity, extend the useful life, or reduce the total operating costs of the plant or other property. It also must not significantly change the nature of the manufacturing or production process or facility.

If it appears you will recover all or part of the cost of a facility from the profit based on its operation (such as through sales of recovered wastes), the federal certifying authority will not certify that part of the amortizable basis. The federal certifying authority will describe the nature of the potential cost recovery. You must then reduce the amortizable basis of the facility.

New identifiable treatment facility. A new identifiable treatment facility is tangible depreciable property. This does not include a building and its structural components unless the entire building is a treatment facility.

For more information, see section 169 of the Internal Revenue Code and the appropriate Income Tax Regulations.

Alternative minimum tax.

CAUTION *Individuals, estates, and trusts who elect amortization may be liable for alternative minimum tax. Individuals should see Form 6251 and its instructions. Estates and trusts should see Form 1041.*

Research and Experimental Costs

You can either amortize your research and experimental costs or deduct them as current business expenses. If you choose to amortize these costs, deduct them in equal amounts over 60 months or more. The amortization period begins the month you first receive an economic benefit from the research. For a definition of "research and experimental costs" and information on deducting them as current business expenses, see chapter 11.

Optional write-off method. Rather than deduct these costs over a 60-month period, you have the option of deducting research and experimental costs ratably over a 10-year period beginning with the tax year in which you incurred the costs.

For more information on the optional write-off method, see Internal Revenue Code section 59(e).

Costs you can amortize. You can amortize costs chargeable to a capital account if:

1) You paid or incurred in your trade or business, and
2) You are not deducting currently.

For more information, see sections 174 and 59(e) of the Internal Revenue Code and the Income Tax Regulations.

Election to amortize. To make this election, attach Form 4562 to your income tax return and enter the deduction in Part VI.

Bond Premium

Bond premium is generally the amount you pay for a bond that is greater than the amount the bond issuer will pay upon maturity of the bond. For taxable bonds, bond premium is determined by the amount the issuer will pay upon an earlier call date if it results in a smaller amortizable bond premium for the period ending on the call date. Bond premium does not include any amount for the conversion features of a bond.

The term "bond," as used in this discussion, means any interest-bearing bond, debenture, note, or certificate or other evidence of debt issued by a corporation or a government or political subdivision of a government. The term does ***not*** include any obligation which:

1) Is your stock in trade or business,
2) Would properly be included in inventory if on hand at the close of the taxable year, or
3) Is 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. You cannot deduct the amortizable premium in figuring your taxable income. You must reduce your basis in the bond each year by the premium amortized for the year.

Taxable bonds. You can elect to amortize the premium on taxable bonds. This means that you deduct a part of the premium each year over the life of the bond. If you make this choice, you must reduce your basis in the bond by the amortization for the year. The premium on the bond is part of your basis in 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 considered part of the cost of the bonds. See section 75 of the Internal Revenue Code to determine your gross income if you are a dealer in tax-exempt bonds.

Basis adjustment. If you are required to amortize bond premium, or elect to do so, you must decrease the basis of the bond by the amortizable bond premium. The result is the adjusted basis you used to figure gain or loss on the sale or redemption of the bond.

More information. For more information and a discussion of how to report bond premium, see Publication 550.

Cost of Acquiring a Lease

If you acquire a lease for business property, you recover the cost by amortizing it over the term of the lease. The term of the lease for amortization includes all renewal options (and any other period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost is for the term of the lease remaining on the acquisition date. The remaining term of the lease on the acquisition date does not include any period for which the lease may later be renewed, extended, or continued under an option exercisable by the lessee.

Enter your deduction in Part VI of Form 4562, if you must file that form, or on the appropriate line of your tax return. Enter "178" as the code section under which you are amortizing these costs.

13. Depletion

Important Change for 1998

Temporary suspension of taxable income limit for certain percentage depletion. For tax years beginning after 1997, percentage depletion on the marginal production of oil or natural gas will no longer be limited to taxable income from the property figured without the depletion deduction. For more information, see *Suspension of taxable income limit for marginal production,* later.

Introduction

Depletion occurs when natural resources are used up by mining, quarrying, drilling, or felling. The depletion deduction is for the reduction of a product's reserves.

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

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

You have an ***economic interest*** if both of the following apply.

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

A contractual relationship you have that allows you an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest.

The term "mineral property" means each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat mineral properties separately or as a group. See section 614 of the Internal Revenue Code for rules on how to treat separate properties.

The term "timber property" means your economic interest in standing timber in each tract or block representing a separate timber account.

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

For more information on individual alternative minimum tax, see the instructions for Form 6251. For more information on corporate alternative minimum tax, see Publication 542. For more information on estate and trust alternative minimum tax, see Form 1041 and its instructions.

Topics

This chapter discusses:

- Mineral property
- Oil and gas wells
- Mines and geothermal deposits
- The lessor's gross income
- Timber

Useful Items

You may want to see:

Publication

☐ **544** Sales and Other Dispositions of Assets

Form (and Instructions)

☐ **T** Forest Activities Schedules

☐ **Sch E (Form 1040)** Supplemental Income and Loss

☐ **6198** At-Risk Limitations

☐ **6251** Alternative Minimum Tax—Individuals

☐ **8582** Passive Activity Loss Limitations

See chapter 17 for information about getting this publication and these forms.

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 or percentage depletion. You must use the method that gives you the larger deduction.

However, you generally cannot use percentage depletion for oil and gas wells. See *Oil and Gas Wells,* later.

Cost depletion. Figure cost depletion by dividing the property's basis for depletion by the total recoverable units in the property's natural deposit. The result is the rate per unit. Multiply the rate per unit by the number of units sold during the tax year, which is:

1) The units sold for which you receive payment during your tax year (regardless of the year of sale), if you use the cash method of accounting, or
2) The units sold based on your inventories, if you use the accrual method of accounting.

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

Basis for depletion. To figure the property's basis for depletion start with its adjusted basis and subtract the following:

1) The amounts recoverable through—
   a) Depreciation deductions,
   b) Deferred expenses (including deferred exploration and development costs), and
   c) Deductions other than depletion,
2) The residual value of land and improvements at the end of operations, and
3) The cost or value of land acquired for purposes other than mineral production.

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

Recoverable units. The total recoverable units is:

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

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

Percentage depletion. Figure percentage depletion by multiplying a certain percentage, specified for each mineral, by your gross income from the property during the tax year. The depletion deduction under this method cannot be more than ***50%*** (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction. See *Mines and other natural deposits,* later for the percentages for each mineral.

For tax years beginning after December 31, 1997, percentage depletion on the marginal production of oil or natural gas will no longer be limited to taxable income from the property figured without the depletion deduction. For more information, see *Suspension of taxable income limit for marginal production,* later.

Gross income. When figuring your percentage depletion, exclude from your gross income from the property an amount equal to any rents and royalties you pay or incur for the property.

Also, exclude from your gross income from the property an amount equal to any bonus you paid for a lease on the property that is allocable to the product sold (or that otherwise gives rise to gross income) for the tax year. This would include a bonus for either a mineral lease or an oil and gas lease. Figure the part of the bonus to exclude by multiplying the total bonus you paid by a fraction. The numerator (top number) of the fraction is the number of units you sold in that tax year and the denominator (bottom number) is the total estimated recoverable units from the property.

Taxable income. In figuring the taxable income limit, do not deduct a net operating loss deduction from the gross income from the property.

Corporations do not deduct charitable contributions from gross income from the property when figuring the taxable income limit.

Also reduce mining expenses by any gain you must report as ordinary income that is allocable to the property and results from the disposition of section 1245 property.

Oil and Gas Wells

Generally, you are not allowed to claim percentage depletion for any oil or gas well. However, you may be able to claim percentage depletion for:

1) Natural gas sold under a fixed contract (see *Natural Gas Wells,* later),
2) Natural gas from geopressured brine (see *Natural Gas Wells,* later), and
3) Domestic gas and oil production — if you are a small producer (explained next).

Small Producers

You figure percentage depletion using a rate of 15% on your average daily production of domestic crude oil or domestic natural gas up to depletable oil or natural gas quantity. Average daily production and depletable oil and natural gas quantity are explained later.

Refiners who cannot claim percentage depletion. You cannot claim percentage depletion if you or a related person refine crude oil and the refinery runs of you and that related person are more than 50,000 barrels on any day during the tax year.

Related person. You and another person are related persons if either of you hold a significant ownership interest in the other person or if a third person holds a significant ownership interest in both of you.

For example, a corporation, partnership, estate, or trust and anyone who holds a significant ownership interest in it are related persons. A partnership and a trust are related persons if one person holds a significant ownership interest in each of them.

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

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

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

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

1) You sell oil or natural gas or their by-products directly or through a related person:
   a) Through a retail outlet operated by you or a related person,
   b) To any person who is required under an agreement with you or a related person to use a trademark, trade name, or service mark or name owned by you or a related

person in marketing or distributing oil, natural gas, or their by-products, or

c) To any person given authority under an agreement with you or a related person to occupy any retail outlet owned, leased, or controlled by you or a related person.

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

For this purpose, do not count:

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

Sales through a related person. You are considered to be selling through a related person if any sale by the related person produces gross income from which you may benefit because of your direct or indirect ownership interest in the person.

You are not considered to be selling through a related person who is a retailer if all of the following apply.

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

Transferees who cannot claim percentage depletion. You cannot claim percentage depletion if you received your interest in a proven oil or gas property by transfer after 1974 and before October 12, 1990. For this rule, the term “transfer” usually does ***not*** include:

- Transfers at death,
- Certain transfers to controlled corporations,
- Certain changes of beneficiaries of a trust,
- Transfers between businesses under common control,
- Transfers between members of the same family,
- Transfers between a trust and related persons in the same family, and
- Certain transfers by individuals to corporations solely in exchange for stock.

An election by a corporation to become an S corporation is treated as a transfer of all its properties on the day on which the election first takes effect. If an S corporation ceases to be an S corporation and becomes a C corporation, each shareholder is treated as transferring to the corporation the shareholder's pro rata share of all the S corporation's assets.

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

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

Average daily production. Figure your average daily production by dividing your total production for the tax year by the number of days in your tax year.

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

You have a part interest in property, for example, if you have a net profits interest. To figure the share of production for your net profits interest, you must determine your percentage participation (as measured by the net profits) in the gross revenue from the property. To figure this percentage, you divide the income you receive for your net profits interest by the gross revenue from the property.

Example. John Oak owns oil property in which Paul Elm owns a 20% net profits interest. During the year, the property produced 10,000 barrels of oil, which John sold for $200,000. John had expenses of $90,000 attributable to the property. The property generated a net profit of $110,000. Paul received income of $22,000 ($110,000 × .2) for his net profits interest.

Paul determined his percentage participation to be 11% by dividing $22,000 (the income he received) by $200,000 (the gross revenue from the property). Paul determined his share of the oil production to be 1,100 barrels (10,000 barrels × 11%).

Depletable oil or natural gas quantity. Generally, your depletable oil quantity is 1,000 barrels and your depletable natural gas quantity is 6,000 cubic feet multiplied by the number of barrels of your depletable oil quantity that you choose to apply. If you claim depletion on both oil and natural gas, you must reduce your depletable oil quantity by the number of barrels you use to figure your depletable natural gas quantity. If you are involved in marginal production, see section 613A(c) and the related regulations to figure your depletable oil or natural gas quantity.

You must allocate the depletable oil or natural gas quantity among corporations that are members of the same controlled group (the common control test is more than 50%).

You must allocate the depletable oil among:

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

For purposes of this allocation, a related person is anyone mentioned in *Related person* in chapter 15 except that the term “family” is limited to a spouse and minor children.

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

1) Your taxable income from the property figured without the deduction for depletion, or
2) 65% of your taxable income from all sources, figured without the depletion allowance, any net operating loss carryback, and any capital loss carryback.

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

Suspension of taxable income limit for marginal production. For tax years beginning after 1997, percentage depletion on the marginal production of oil or natural gas will no longer be limited to taxable income from the property figured without the depletion deduction. This suspension of the taxable income limit does not apply to tax years beginning after 1999.

Marginal production. This is domestic crude oil or domestic natural gas produced during any tax year from a property that is:

1) A stripper well property for the calendar year in which the tax year begins, or
2) A property from which substantially all of the production during the calendar year is heavy oil.

Stripper well property. This means, for any calendar year, any property for which the production is 15 barrel equivalents or less. This is determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year, by the number of wells.

Heavy oil. This means, as used here, domestic crude oil produced from any property if the crude oil had a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

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 if you 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 you sold gas after you removed it from the premises, for a price that is lower than the RMFP, determine gross income from the property for percentage depletion purposes without regard to the RMFP.

Gross income from the property does not include lease bonuses, advance royalties, or other amounts payable without regard to production from the property.

Partnerships

Each partner, and not the partnership, figures the depletion allowance separately. Each partner must decide whether to use cost or percentage depletion. If a partner uses percentage depletion, the partner must apply the 65% of taxable income limit to the partner's taxable income from all sources.

For partnership tax years beginning after 1997, a large partnership generally can elect to figure the depletion allowance instead of the partner.

Partner's adjusted basis. The partnership must allocate to each partner that partner's proportionate share of the adjusted basis of each partnership domestic oil or gas property. The partnership makes the allocation as of the date it acquires the oil or gas property. The partner's share of the adjusted basis of the oil or gas property is figured according to that partner's interest in partnership:

1) Capital, or
2) Income, provided for by a partnership agreement.

The partnership adjusts the partner's share of the adjusted basis of the oil and gas property for any capital expenditures made for the property and for any change in partnership interests.

Recordkeeping. Each partner, after receiving the information from the partnership, must separately keep records of the partner's share of the adjusted basis in each oil and gas property of the partnership. 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. The partner must use that reduced adjusted basis to figure any cost depletion or the partner's gain or loss if the partnership disposes of the property.

Reporting the deduction. Deduct oil and gas depletion for a partnership interest on Schedule E (Form 1040). If you have a loss, see the Schedule E (Form 1040) instructions for Parts II and III to determine whether you first need to use Form 6198 to figure the deductible loss. Further, if the loss is from a passive activity, you generally need to complete Form 8582 to figure the allowable loss to enter in Part II, column (g) of Schedule E, for that activity.

Enter your net income or loss from the partnership, before depletion, in either the passive or nonpassive section of Part II. Use the same lettered line for which you enter the name of the partnership, the employer identification number and other partnership information. On the next lettered line of that section's loss column, enter the depletion deduction. If you are entitled to a depletion deduction from more than one oil and gas partnership, show this information for each partnership.

S Corporation

Each shareholder, and not the S corporation, figures the depletion allowance separately in the same way as a partner in a partnership.

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 corporation makes the allocation as of the date it acquires the property. The S corporation adjusts the shareholder's share of the adjusted basis of the oil and gas property for any capital expenditures made for the property and for any change in the shareholder's interest.

Recordkeeping. 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. The shareholder must use that reduced adjusted basis to figure cost depletion or the shareholder's gain or loss on the disposition of the property by the S corporation.

For any distribution of the oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property is the total of all the shareholders' adjusted bases in the property.

See *Reporting the deduction,* earlier under *Partnerships* for information on how S corporation shareholders should report their deduction.

Natural Gas Wells

You are allowed percentage depletion for natural gas sold under a fixed contract or produced from geopressured brine.

Fixed contract. Natural gas sold under a fixed contract qualifies for a percentage depletion rate of 22%.

Natural gas sold under a fixed contract is domestic natural gas sold by the producer with a certain provision in the contract. The contract must have been in effect from February 1, 1975, until the date of sale of the gas. The contract must have provided that the price cannot be adjusted to reflect any increase in the seller's tax liability because of the repeal of percentage depletion for gas. Price increases after February 1, 1975, are presumed to take the increase in tax liability into account unless demonstrated otherwise by clear and convincing evidence.

Natural gas from geopressured brine. Qualified natural gas from geopressured brine is eligible for a percentage depletion rate of 10% if it is produced from a well you began to drill after September 1978 and before 1984. Qualified natural gas from geopressured brine is natural gas determined in accordance with section 503 of the Natural Gas Policy Act of 1978 to be produced from geopressured brine.

Mines and Geothermal Deposits

Certain mines, wells, and other natural deposits, including geothermal deposits, qualify for percentage depletion.

Mines and other natural deposits. The percentage of your gross income from a natural deposit that you can deduct as depletion is based on the type of deposit.

Some of the depletion percentages for the more common minerals follow:

DEPOSITS	**PERCENT**
Sulphur, uranium, and, if from deposits in the United States, asbestos, lead ore, zinc ore, nickel ore, and mica	22
Gold, silver, copper, iron ore, and certain oil shale, if from deposits in the United States	15
Coal, lignite, and sodium chloride	10
Clay and shale used or sold for use in making sewer pipe or bricks or used or sold for use as sintered or burned lightweight aggregates	7½
Clay used or sold for use in making drainage and roofing tile, flower pots, and kindred products, and gravel, sand, and stone (other than stone used or sold for use by a mine owner or operator as dimension or ornamental stone)	5
Borax, granite, limestone, marble, mollusk shells, potash, slate, soapstone, and carbon dioxide produced from a well	14

You can find a complete list of deposits and the percentage depletion rates that apply to them in section 613(b) of the Internal Revenue Code.

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

1) The percentage depletion deduction for the tax year (figured without regard to this reduction), minus
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. In the case of property other than a geothermal deposit or an oil or gas well, gross income from the property means the gross income from mining. Mining includes:

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

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

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

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

Transportation of more than 50 miles. If the Internal Revenue Service finds that the ore or mineral must be transported more than 50 miles to plants or mills to be treated because of physical and other requirements, the additional transportation that is authorized is included in the computation of gross income from mining.

If you wish to include transportation of more than 50 miles in the computation of gross income from mining, file an application in duplicate. Include on the application the facts concerning the physical and other requirements which prevented the construction and operation of the plant within 50 miles of the point of extraction. Send this application to:

Internal Revenue Service
Washington, DC 20224
Attention: Assistant Chief Counsel,
Passthroughs and Special Industries

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 disposed of after holding it for more than 1 year if you retained an economic interest in it.

Disposal to related party. This rule does not apply if you dispose of the coal or iron ore to:

1) A related person (as listed in chapter 15), or
2) A person owned or controlled by the same interests that own or control you.

Geothermal deposits. Geothermal deposits located in the United States or its possessions qualify for a percentage depletion 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.

Figure gross income from a geothermal steam well 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 advanced royalties. Bonuses and advanced royalties are payments a lessee makes to a lessor for the lease or for minerals, gas, or oil to be extracted from leased property. Both types of payments are made before production. If you are the lessor, your income from bonuses and advanced royalties is subject to an allowance for depletion.

Figuring cost depletion on bonuses and advanced royalties. To figure cost depletion on a bonus, multiply your adjusted basis in the property by a fraction, the numerator (top number) of which is the bonus and the denominator (bottom number) of which is the total bonus and royalties expected to be received. To figure cost depletion on advanced royalties, use the computation explained earlier under *Cost depletion,* treating the units for which the advanced royalty is received as the units sold.

When you figure percentage depletion (for other than gas, oil, or geothermal property), the bonus or advanced royalty payments are part of your gross income from the property.

Terminating the lease. For a bonus on a lease that has expired, been terminated, or abandoned before you derived any income from the extraction of mineral or cutting of timber, include in income the depletion deduction you took. Also increase your adjusted basis in the property to restore the depletion deduction you previously subtracted.

For advanced royalties, include in income the depletion claimed on minerals for which the advanced royalties were paid if the minerals were not produced before lease termination. Increase your adjusted basis in the property by the amount you include in income.

Delay rentals. These are payments for deferring development of the property. Since delay rentals are ordinary rent, they are ordinary income that is not subject to depletion. These rentals can be avoided by abandoning the lease, by beginning development operations, or by obtaining production.

Timber

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

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

Figure your depletion allowance by multiplying the number of timber units cut by your depletion unit.

Figure your depletion unit as follows:

1) Determine your cost or adjusted basis of the timber on hand at the beginning of the year.
2) Add to the amount determined in 1) the cost of any units acquired during the year and any additions to capital.
3) Figure the number of units to take into account by adding the number of units acquired during the year to the number of units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the number of units remaining in the account.
4) Divide the result of 2) by the result of 3). This is your depletion unit.

Example. You bought a timber tract for $160,000 and the land was worth as much as the timber. Your basis for the timber is $80,000. Based on an estimated one million board feet (1,000 MBF) of standing timber, you figure your depletion unit to be $80 per MBF ($80,000 divided by 1,000). If you cut 500 MBF of timber, your depletion allowance would be $40,000 (500 MBF multiplied by $80).

When to claim depletion. Claim your depletion allowance as a deduction in the year of sale or other disposition of the products cut from the timber, unless you elect to treat the cutting of timber as a sale or exchange. Include allowable depletion for timber products not sold during the tax year the timber is cut as a cost item in the closing inventory of timber products for the year. The inventory is your basis for determining gain or loss in the tax year that you sell the timber products.

Example. In the previous example under *Figuring the deduction,* if you sold half of the timber products in the cutting year, you would deduct $20,000 of the $40,000 depletion that year. You would add the remaining $20,000 depletion to your closing inventory of timber products.

Electing to treat the cutting of timber as a sale or exchange. You can elect, under certain circumstances, to treat the cutting of timber as a sale or exchange. If you make this election, subtract the adjusted basis for depletion from the fair market value of the timber at the beginning of the tax year in which you cut it to figure the gain or loss to report on the cutting. You generally report the gain as long-term capital gain. The fair market value then becomes your basis for figuring your ordinary gain or loss on the sale or other disposition of the products cut from the timber. See Publication 544.

Form T. Attach Form T to your income tax return if you are claiming a deduction for timber depletion.

14. Business Bad Debts

Introduction

If someone owes you money you cannot collect, you have a bad debt. You may be able to deduct the uncollectible amount when you figure your tax.

There are two kinds of bad debts — business bad debts and nonbusiness bad debts. A business bad debt is generally one that comes from operating your trade or business. You can deduct business bad debts as an expense on your business tax return to figure your business income or loss. All other bad debts are nonbusiness bad debts and deductible as short-term capital losses on Schedule D (Form 1040). For more information on nonbusiness bad debts, see Publication 550.

Topics

This chapter discusses:

- Definition of business bad debts
- How to treat business bad debts
- Where to deduct business bad debts

Useful Items

You may want to see:

Publication

- ☐ **525** Taxable and Nontaxable Income
- ☐ **536** Net Operating Losses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses

See chapter 17 for information about getting these publications.

Defined

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

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

The bad debts of a corporation are always business bad debts.

A debt is closely related to your trade or business if your primary motive for incurring the debt is a business reason.

Example. John Smith, an advertising agent, made loans to certain clients to retain their business. His main reason for making these loans was to help 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.

Debts from sales or services. Business bad debts are mainly the result of credit sales to customers. They can also be the result of loans to suppliers, clients, employees, or distributors. Goods and services customers have not paid for are shown in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. Accounts or notes receivable valued at fair market value at the time of the transaction are deductible only at that fair market value, even though the value may be less than face value.

You can take a bad debt deduction for these accounts and notes receivable only if the amount owed you was included 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 qualify under certain rules, you can use the nonaccrual-experience method of accounting, discussed later. Under this method, you do not have to accrue income that, based on your experience, you expect to be uncollectible.

Accrual method taxpayers. Accrual method taxpayers normally report income as they earn it. They can take a bad debt deduction for uncollectible receivables if they have included the uncollectible amount in income.

Cash method taxpayers. Cash method taxpayers normally report income when they receive payment. They cannot take a bad debt deduction for payments they have not received or cannot collect.

Debts from a former business. If you sell your business but keep its accounts receivable, these debts are business debts since they arose in your trade or business. If an account becomes worthless, the loss is a business bad debt. These accounts would also be business debts if sold to the new owner of the business.

If you sell your business to one person and sell your accounts receivable to someone else, the character of the debts as business or nonbusiness is based on the activities of the holder of these debts. If the new holder engages in a trade or business, a loss from these accounts is a business bad debt. If the new holder does not engage in a trade or business, a loss from these accounts is a nonbusiness bad debt.

Debt acquired from a decedent. The character of a loss from a business acquired from a decedent is determined in the same way as a debt sold by a business. If you are in a trade or business, the loss is a business bad debt. If you are not in a trade or business, the loss is a nonbusiness bad debt.

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

Debts of political parties. If a political party (or other organization that accepts contributions or spends money to influence elections) owes you money and the debt becomes worthless, you cannot take a bad debt deduction unless you use an accrual method of accounting and meet all the following tests:

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

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

Debts of an insolvent partner. If your business partnership breaks up and one of your former partners 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. If you pay any part of the insolvent partner's share of the debts, you can take a bad debt deduction.

Business loan guarantee. If you guarantee a debt that becomes worthless and can show the reason for guaranteeing it was closely related to your trade or business, then the debt can qualify as a business bad debt. Consider any guarantee you make to protect or improve your job as closely related to your trade or business as an employee.

Example. Bob Zayne owns the Zayne Dress Company. He guaranteed payment of a $20,000 note for Elegant Fashions, a dress outlet. Elegant Fashions is one of Zayne's largest clients. Elegant Fashions later filed for bankruptcy and defaulted on the loan. Mr. Zayne made full payment to the bank. He can take a business bad debt deduction, since his guarantee was closely related to his trade or business. He was motivated by the desire to retain one of his better clients and keep a sales outlet.

Deductible in the year paid. You can deduct a payment you make on a loan you guaranteed in the year of payment unless you have rights against the borrower.

Rights against a borrower. When you make payment on a loan you guaranteed, you may have the right to take the place of the lender. The debt is then owed to you. If you have this right, or some other right to demand payment from the borrower, you cannot take a bad debt deduction until these rights become partly or totally worthless.

How To Treat

There are two ways to treat business bad debts: the specific charge-off and nonaccrual-experience methods. Most taxpayers, except certain financial institutions, must use the specific charge-off method. However, certain taxpayers can use the nonaccrual-experience method if they meet the requirements discussed later.

Recovery of bad debt. If you deduct a bad debt and later recover (collect) all or part of it, you may have to include all or part of the recovery in gross income. The amount you include is limited to the amount you actually deducted. You can exclude the amount deducted that did not reduce your tax.

Example. In 1996, the Willow Corporation had gross income of $158,000, a bad debt deduction of $3,500, and other allowable deductions of $49,437. The corporation reported on the accrual method of accounting and used the specific charge-off method for bad debts. The entire bad debt deduction reduced the tax on the 1996 corporate return. In 1997, the corporation recovers part of the $3,500 deducted in 1996. It must include the part recovered in income for 1997. For 1997, Willow reports the recovery as “Other income” on its corporate return.

Net operating loss (NOL) carryover. If a bad debt deduction increases an NOL carryover that has not expired before the beginning of the tax year in which the recovery takes place, the deduction is treated as having reduced your tax.

More information. See *Recoveries* in Publication 525 for more information on recovered amounts.

Bankruptcy claim. You can deduct as a bad debt only the difference between the amount owed to you by a bankrupt entity and the amount you received from the distribution of its assets.

Sale of mortgaged property. If you sell mortgaged or pledged property for less than the debt, the unpaid, uncollectible balance of the debt after the sale is a bad debt. If the debt represents capital or an amount you previously included in income, you can deduct it as a bad debt in the year it becomes totally worthless or in the year you charged it off as partially worthless.

Net operating loss. A bad debt deduction may produce or increase a net operating loss. If you have a net operating loss one year, you can carry it to other tax years and deduct it from income you earned in those years. As a result, a bad debt deduction that contributes to a net operating loss helps lower taxes in the year to which you carry the net operating loss.

See Publication 536 for more information.

Specific Charge-Off Method

If you use the specific charge-off method, you can deduct specific business bad debts that become either partly or totally worthless during the tax year.

Partly worthless debts. You can deduct specific bad debts that are partly uncollectible. Your deduction is limited to the amount you charge off on your books during the tax year. You do not have to charge off and deduct your partly worthless debts annually. You can delay the charge-off until a later year. You can wait until more of the debt becomes worthless, or you have collected 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. You can generally take a partial bad debt deduction only in the year you make the charge-off on your books. If the Internal Revenue Service (IRS) does not allow your deduction and the debt becomes partly worthless in a later tax year, you can deduct the amount you charge off in that year, plus the amount charged off in the earlier year. The charge-off in the earlier year, unless reversed on your books, fulfills the charge-off requirement for the later year.

Totally worthless debts. Deduct a totally worthless debt only in the tax year it becomes totally worthless. You cannot 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 you do not and the IRS later rules the debt is only partly worthless, you will not be allowed a deduction for the debt in that tax year. A deduction of a partly worthless bad debt is limited to the amount actually charged off.

Property received for debt. If you receive property in partial settlement of a debt, reduce the debt by the fair market value of the property received. You can deduct the remaining debt as a bad debt in the year you determine it is worthless and charge it off.

If you later sell the property, include any gain from the sale in gross income. The gain is a recovery of a bad debt you deducted that reduced your tax.

For information on the sale of an asset, see Publication 544.

Nonaccrual-Experience Method

If you use an accrual method of accounting and qualify under the rules explained in this section, you can use the nonaccrual-experience method of accounting for bad debts. Under this method, you do not 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 your gross income for the tax year.

Performing services. You can use the nonaccrual-experience method only for amounts earned by performing services that you would otherwise include in income. You cannot use this method for amounts owed to you from activities such as lending money, selling goods, or acquiring receivables or other rights to receive payments.

Interest or penalty charged. Generally, you cannot use the nonaccrual-experience method for amounts due on which you charge interest or a late payment penalty. However, do not treat a discount offered for early payment as interest or a late payment penalty charged if:

1) You accrue the full amount due as gross income at the time you provide the services, and
2) You treat the discount allowed for early payment as an adjustment to gross income in the year of payment.

You can apply the nonaccrual-experience method under either a separate receivable system or a periodic system. Under the ***separate receivable system,*** apply the nonaccrual-experience method separately to each account receivable. Under the ***periodic system,*** apply the nonaccrual-experience method to total qualified accounts receivable at the end of your tax year.

Treat each system as a separate method of accounting. You generally cannot change from one system to the other without IRS approval.

Generally, you also need IRS approval 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.

Where To Deduct

Use the following guide to find where to deduct your business bad debts.

Individuals. Deduct a bad debt from operating a trade or business on line 9 of Schedule C (Form 1040) or line 2 of Schedule C–EZ (Form 1040). Deduct a bad debt from operating a farm business on line 34 of Schedule F (Form 1040).

Corporations. Corporations deduct bad debts on line 15 of Form 1120, line 15 of Form 1120–A, or line 10 of Form 1120S.

Partnerships. Partnerships deduct business bad debts on line 12 of Form 1065.

15. Electric and Clean-Fuel Vehicles

Important Reminder

Basis reduction for qualified electric vehicle. If you elect to claim a tax credit for a qualified electric vehicle you place in service during the year, you must reduce your basis in that vehicle. For vehicles placed in service after August 19, 1996, you must reduce your basis in that vehicle by the lesser of $4,000 or 10% of the cost of the vehicle, even if the credit allowed is less than that amount.

Introduction

You are allowed a limited deduction for the cost of clean-fuel vehicle property and clean-fuel vehicle refueling property you place in service during the tax year. Also, you are allowed a tax credit of 10% of the cost of any qualified electric vehicle you place in service during the tax year.

TIP *You can take the electric vehicle credit or the deduction for clean-fuel vehicle property regardless of whether you use the vehicle or vehicle property in a trade or business. However, you can only take a deduction for clean-fuel vehicle refueling property if you use the property in your trade or business.*

Topics

This chapter discusses:

- The deduction for clean-fuel vehicle property
- The deduction for clean-fuel vehicle refueling property
- Recapture of the deductions
- The electric vehicle credit
- Recapture of the credit

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **946** How To Depreciate Property

Form (and Instructions)

☐ **8834** Qualified Electric Vehicle Credit

See chapter 17 for information about getting this form and these publications.

Deductions for Clean-Fuel Vehicle and Refueling Property

You are allowed a limited deduction for the cost of qualified clean-fuel vehicle property and a limited deduction for clean-fuel vehicle refueling property. These deductions are allowed only in the tax year you place the property in service.

Nonqualifying property. You cannot deduct the part of a property's cost that you claim as a section 179 deduction. You also cannot claim the deduction for property:

1) Used predominantly outside the United States,
2) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
3) Used by certain tax-exempt organizations, or
4) Used by governmental units or foreign persons or entities.

Clean-burning fuels. Clean-burning fuels include:

1) Natural gas,
2) Liquefied petroleum gas,
3) Hydrogen,
4) Electricity, and
5) Any fuel that is at least 85% alcohol (any kind) or ether.

Deduction for Clean-Fuel Vehicle Property

The deduction for this property may be claimed regardless of whether the property is used in a trade or business.

Clean-fuel vehicle property. Clean-fuel vehicle property is made up of two kinds of property.

1) Motor vehicles produced by an original equipment manufacturer and designed to be propelled by a clean-burning fuel. The only part of a vehicle's basis that qualifies for the deduction is:
   a) A clean-fuel engine that can use a clean-burning fuel,
   b) The property used to store or deliver the fuel to the engine, or
   c) The property used to exhaust gases from the combustion of the fuel.
2) Any property installed on a motor vehicle (including installation costs) to enable it to be propelled by a clean-burning fuel if:
   a) The property is an engine (or modification of an engine) that can use a clean-burning fuel, or
   b) The property is used to store or deliver that fuel to the engine or to exhaust gases from the combustion of that fuel.

For vehicles propelled by both a clean-burning fuel and any other fuel, your deduction is generally the additional cost of permitting the use of the clean-burning fuel.

CAUTION *Clean-fuel vehicle property does not include an electric vehicle that qualifies for the qualified electric vehicle credit. The electric vehicle credit is discussed later under Electric Vehicle Credit.*

Motor vehicle defined. A motor vehicle is any vehicle that has four or more wheels and is manufactured primarily for use on public streets, roads, and highways. It does not include a vehicle operated exclusively on a rail or rails.

Qualifying requirements. For your property to qualify for the deduction:

1) It must be acquired for your own use and not for resale,
2) Its original use must begin with you,
3) It must satisfy any federal or state emissions standards that apply to each fuel for which it is designed to be propelled if it is a motor vehicle, and
4) It must satisfy any federal and state emissions certification, testing, and warranty requirements that apply if it is installed on a retrofitted vehicle.

Deduction limit. The maximum deduction you can claim for each qualified clean-fuel vehicle is:

1) $50,000 for a truck or van with a gross vehicle weight rating over 26,000 pounds and for a bus with a seating capacity of at least 20 adults (excluding the driver),
2) $5,000 for a truck or van with a gross vehicle weight rating over 10,000 pounds but not more than 26,000 pounds, and
3) $2,000 for a vehicle not included in (1) or (2).

Deduction for Clean-Fuel Vehicle Refueling Property

Property is eligible for the deduction if:

1) The property is depreciable property, and
2) The original use of the property begins with you.

Clean-fuel vehicle refueling property defined. Clean-fuel vehicle refueling property includes any property (other than a building or its structural components) used to:

1) Store or dispense a clean-burning fuel into the fuel tank of a motor vehicle propelled by the fuel, but only if the storage or dispensing is at the point where the fuel is delivered into the tank, or
2) Recharge motor vehicles propelled by electricity, but only if the property is located at the point where the vehicles are recharged.

Recharging property. This property includes any equipment used to provide electricity to the battery of a vehicle propelled by electricity. It includes low-voltage and high-voltage (quick) charging equipment and ancillary connection equipment, such as inductive charging equipment. It does not include property used to generate electricity, such as solar panels or windmills, and does not include the battery used in the vehicle.

Deduction limit. The maximum deduction you can claim for clean-fuel vehicle refueling property placed in service at one location is $100,000. To figure your maximum deduction for any tax year, subtract from $100,000 the total you (or any related person or predecessor) claimed for clean-fuel vehicle refueling property placed in service at that location for all earlier years.

CAUTION *You must specify on your tax return the property (and portions of the property's cost) that you are using as a basis for the deduction.*

Related person. For this purpose, a related person includes:

1) An individual and his or her brothers and sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
2) An individual and a corporation when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
3) Two corporations that are members of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
4) A grantor and a fiduciary of the same trust.
5) Fiduciaries of two separate trusts if the same person is a grantor of both trusts.
6) A fiduciary and a beneficiary of the same trust.
7) A fiduciary and a beneficiary of two separate trusts if the same person is a grantor of both trusts.
8) A fiduciary of a trust and a corporation when the trust or a grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
9) A person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by that person or by members of the family of that person.
10) A corporation and a partnership if the same person owns more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
11) Two S corporations or an S corporation and a regular corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
12) A partnership and a person owning, directly or indirectly, more than 50% of the

capital or profits interest in the partnership.

13) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital or profits interest in both partnerships.

For the indirect stock ownership rules, see *Indirect ownership of stock,* under *Unpaid Salaries,* in chapter 2.

How To Claim the Deductions

How you claim the deductions for clean-fuel vehicles and refueling property depends on the use of the property and the kind of income tax return you file.

Nonbusiness use of clean-fuel vehicle property by individuals. Individuals can claim the deduction for the nonbusiness use of clean-fuel vehicle property by including the deduction in the total on line 31 of Form 1040. Also, enter your deduction and “Clean-Fuel” on the dotted line next to line 31. If you use the vehicle partly for business, see the next two discussions.

Business use by employees. Employees who use clean-fuel vehicle property for business or partly for business and partly for nonbusiness purposes should enter the entire deduction in the total on line 31 of Form 1040. Also, enter your deduction and “Clean-Fuel” on the dotted line next to line 31.

Business use by sole proprietors. Individuals who operate a business as a sole proprietor can claim their deduction for the business use of clean-fuel vehicles and clean-fuel vehicle refueling property on the *Other expenses* line of either Schedule C (Form 1040) or Schedule F (Form 1040). If clean-fuel vehicle property is used partly for nonbusiness purposes, claim the nonbusiness part of the deduction as explained earlier under *Nonbusiness use of clean-fuel vehicle property by individuals.*

Partnerships. Partnerships claim the deduction for the business use of clean-fuel vehicle and clean-fuel vehicle refueling property on line 20 of Form 1065.

S corporations. S corporations claim the deduction for the business use of clean-fuel vehicle and clean-fuel vehicle refueling property on line 19 of Form 1120S.

Other corporations. Corporations claim the deduction for the business use of clean-fuel vehicle and clean-fuel vehicle refueling property on line 26 of Form 1120 (line 22 of Form 1120–A).

Recapture of the Deductions

If the property no longer qualifies, you must recapture the deduction. You recapture the deduction by including it, or a part of it, in your income in the year recapture occurs.

Clean-Fuel Vehicle Property

Clean-fuel vehicle property ceases to qualify if it:

1) Is modified so that it can no longer be propelled by a clean-burning fuel,
2) Ceases to be a qualified clean-fuel vehicle property (such as failing to meet emissions standards), or
3) Is used—
   a) Predominantly outside the United States,
   b) Predominantly to furnish lodging or in connection with the furnishing of lodging,
   c) By certain tax-exempt organizations, or
   d) By governmental units or foreign persons or entities.

Recapture date. If the recapture date for an event is within 3 years after the date you placed the property in service, you must include the recapture amount in income. The recapture date is generally the date of the event that causes the recapture. However, the recapture date for item (3) is the first day of the year in which the use occurs.

Sales or other dispositions. If you sell or otherwise dispose of the vehicle and know or have reason to know that it will be used in a manner described above, you are subject to the recapture rules. In other sales or dispositions (including a disposition by reason of an accident or other casualty), the recapture rules do not apply.

If the vehicle was subject to depreciation, the deduction (minus any recapture) is considered depreciation when figuring the part of the gain that is ordinary income. See Publication 544 for more information on dispositions of depreciable property.

Recapture amount. Figure your recapture amount by multiplying the deduction by a recapture percentage. The percentages are:

1) 100% if the recapture date is within the first full year after the date the vehicle was placed in service,
2) $66\frac{2}{3}\%$ if the recapture date is within the second full year after the date the vehicle was placed in service, and
3) $33\frac{1}{3}\%$ if the property ceases to qualify within the third full year after the date it was placed in service.

How to report. How you report the recapture amount for clean-fuel vehicle property as income depends on how you claimed the deduction for that property.

Nonbusiness use by individuals. Include the amount on line 21 of Form 1040.

Business use by employees. Include the amount on line 21 of Form 1040.

Business use by sole proprietors. Include the amount on the *Other income* line of either Schedule C (Form 1040) or Schedule F (Form 1040).

Partnerships and corporations (including S corporations). Include the amount on the *Other income* line of the form you file.

Clean-Fuel Vehicle Refueling Property

Your clean-fuel vehicle refueling property ceases to qualify if it is:

1) No longer used to store or dispense clean-burning fuel into the fuel tanks of motor vehicles propelled by the fuel,
2) Not used to recharge motor vehicles propelled by electricity,
3) Not used 50% or more in your trade or business, or
4) Used—
   a) Predominantly outside the United States,
   b) Predominantly to furnish lodging or in connection with the furnishing of lodging,
   c) By certain tax-exempt organizations, or
   d) By governmental units or foreign persons or entities.

Recapture date. If the recapture date for an event is at any time before the end of the property's depreciation recovery period, you must include the recapture amount in income. The recapture date is generally the date of the event that causes the recapture. However, the recapture date for items (3) and (4) is the first day of the year in which the event occurs.

Sales or other dispositions. If you sell or otherwise dispose of the property and know or have reason to know that it will be used in a manner described above, you are subject to the recapture rules. In other sales or dispositions, the recapture rules do not apply.

The deduction (minus any recapture amount) is considered depreciation when figuring the part of the gain that is ordinary income upon its disposition. See Publication 544 for more information on dispositions of depreciable property.

Recapture amount. Figure your recapture amount by multiplying the deduction you claimed by the following fraction.

$$\frac{\text{Recovery period for the property} - \text{Recovery years before the recapture year}}{\text{Total recovery period}}$$

How to report. How you report the recapture amount for clean-fuel vehicle refueling property depends on how you claimed the deduction for that property.

Business use by sole proprietors. Include the amount on the *Other income* line of either Schedule C (Form 1040) or Schedule F (Form 1040).

Partnerships and corporations (including S corporations). Include the amount on the *Other income* line of the form you file.

Basis Adjustment

You must reduce the basis of your clean-fuel vehicle or clean-fuel vehicle refueling property by the amount of the deduction claimed. If, in a later year, you must recapture part or all of the deduction, increase the basis of the property by the amount recaptured.

If the property is depreciable property, you can recover the additional basis over the property's remaining recovery period beginning with the tax year of recapture.

If you were using the percentage tables to figure your depreciation on the property, you will not be able to continue to do so. See Publication 946 for information on figuring your depreciation without the tables.

Electric Vehicle Credit

You can choose to claim a tax credit for a qualified electric vehicle you place in service during the year. You can make this choice regardless of whether the property is used in a trade or business.

Qualified Electric Vehicle

A vehicle is a qualified electric vehicle if it meets all of the following requirements:

1) It has four wheels and is manufactured primarily for use on public streets, roads, and highways,
2) It is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current,
3) You were the first person to use it, and
4) You acquired it for your own use and not for resale.

Generally, an electric vehicle is not qualified if it is:

1) Operated exclusively on a rail or rails,
2) Used predominantly outside the United States,
3) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
4) Used by certain tax-exempt organizations, or
5) Used by governmental units or foreign persons or entities.

Amount of the Credit

The credit is generally 10% of the cost of each vehicle you place in service during the year. If your vehicle is a depreciable business asset, you must reduce the cost of the vehicle by any section 179 deduction before figuring the 10% credit. If you need information on the section 179 deduction, get Publication 946.

Credit limits. The credit is limited to $4,000 for each vehicle. The total credit is limited to the excess of your regular tax liability reduced by certain credits over your tentative minimum tax. To figure the maximum amount of credit you can take, complete Form 8834 and attach it to your tax return.

How To Claim the Credit

You must complete and attach Form 8834 to your tax return to claim the electric vehicle credit. Enter your credit on your tax return as discussed next.

Individuals. Individuals claim the credit by entering the amount from line 19 of Form 8834 on line 44 of Form 1040. Check box "d" and specify Form 8834.

Partnerships. Partnerships enter the amount from line 19 of Form 8834 on line 13 of Schedule K (Form 1065). The partnership then allocates the credit to the partners on line 13 of Schedule K–1 (Form 1065). See the instructions for Form 1065.

S corporations. S corporations enter the amount from line 19 of Form 8834 on line 13 of Schedule K (Form 1120S). The S corporation then allocates the credit to the shareholders on line 13 of Schedule K–1 (Form 1120S). See the instructions for Form 1120S.

Other corporations. Corporations other than S corporations claim the credit by entering the amount from line 19 of Form 8834 in the total for line 4c of Schedule J (Form 1120) and checking the Form 8834 box to the left of the entry. See the instructions for Form 1120.

Recapture of the Credit

The electric vehicle credit is subject to recapture if, within 3 years after the date you place the vehicle in service, it ceases to qualify for the electric vehicle credit.

The vehicle ceases to qualify if it is:

1) Modified so that it is no longer primarily powered by electricity,
2) Used predominantly outside the United States,
3) Used predominantly to furnish lodging or in connection with the furnishing of lodging,
4) Used by certain tax-exempt organizations, or
5) Used by governmental units or foreign persons or entities.

Sales or other dispositions. If you sell or dispose of the vehicle and know or have reason to know that it will be used in a manner described above, you are subject to the recapture rules. In other sales or dispositions, the recapture rules do not apply.

If the vehicle was subject to depreciation, the credit (minus any recapture amount) is considered depreciation when figuring the part of the gain that is ordinary income. See Publication 544 for more information on dispositions of depreciable property.

Recapture date. The recapture date is generally the date of the event that causes the recapture. However, the recapture date for items (2) through (5) is the first day of the year in which the use occurs.

Recapture amount. Figure your recapture amount by multiplying the credit by a recapture percentage. The percentages are:

1) 100% if the recapture date is within the first full year after the date it was placed in service.
2) 66⅔% if the recapture date is within the second full year after the date it was placed in service.
3) 33⅓% if the recapture date is within the third full year after the date it was placed in service.

How to report. How you report the recapture amount of the electric vehicle credit depends on how the credit was claimed.

Individuals. Include the amount on line 53 of Form 1040. Write "QEVCR"on the dotted line next to line 53.

Partnerships. Include on line 25 of Schedule K-1 (Form 1065) the information a partner needs to figure the recapture of the credit.

S corporations. Include on line 23 of Schedule K-1 (Form 1120S) the information a shareholder needs to figure the recapture of the credit.

Other corporations. Include the amount on line 8 of Schedule J (Form 1120), or line 5 of Part I (Form 1120–A). Write "QEV recapture" on the dotted line next to that entry space.

Basis Adjustment

If you claim a tax credit for a qualified electric vehicle you place in service during the year, you must reduce your basis in that vehicle by the lesser of:

1) $4,000, or
2) 10% of the cost of the vehicle.

This basis reduction rule applies even if the credit allowed is less than that amount.

If you must recapture part or all of the credit, increase the basis of your vehicle by the amount recaptured. If the qualified electric vehicle is depreciable property, you can recover the additional basis over the vehicle's remaining recovery period beginning with the tax year of recapture.

If you were using the percentage tables to figure your depreciation on the vehicle, you will not be able to continue to do so. See Publication 946 for information on figuring your depreciation without the tables.

16.

Other Expenses

Important Change for 1997

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1997 is 31.5 cents per mile for all business miles.

Important Change for 1998

Meal expense deduction increases for certain individuals. Beginning in 1998, if an employee is subject to the Department of Transportation's hours of service limits, you may be able to deduct 55% of the meal and beverage expenses you reimburse for their travel away from their tax home. For more information, get Publication 553, *Highlights of 1997 Tax Changes.*

Introduction

This chapter covers some expenses you as a business owner may have that are not explained earlier.

If you use an accrual method of accounting, your deduction for the expenses discussed in this chapter depends on when economic performance occurs. The economic performance rule is discussed under *When Can an Expense Be Deducted?* in chapter 1.

Topics

This chapter discusses:

- Travel, meals, and entertainment
- Bribes and kickbacks
- Charitable contributions
- Education expenses
- Franchises, trademarks, and trade names
- Lobbying expenses
- Penalties and fines
- Repayments, (claim of right)

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **529** Miscellaneous Deductions
- ☐ **542** Corporations
- ☐ **946** How To Depreciate Property
- ☐ **1542** Per Diem Rates

Form (and Instructions)

- ☐ **Sch A** (Form 1040) Itemized Deductions
- ☐ **1099–MISC** Miscellaneous Income
- ☐ **6069** Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction

See chapter 17 for information about getting these forms and publications.

Travel, Meals, and Entertainment

To be deductible, expenses incurred for travel, meals, and entertainment must be ordinary and necessary expenses of carrying on your trade or business. Generally, you also must show that entertainment expenses (including meals) are directly related to, or associated with, the conduct of your trade or business.

The following discussion explains how you deduct any reimbursements or allowances you make for these expenses incurred by your employees. If you are self-employed and incur these expenses yourself, see Publication 463 for information on how you can deduct them.

Reimbursements

How you deduct a reimbursement or allowance arrangement (including per diem allowances, discussed later) for travel, meals, and entertainment expenses incurred by your employees depends on whether you have an accountable plan or a nonaccountable plan. A reimbursement or allowance arrangement is a system by which you substantiate and pay the advances, reimbursements, and charges for your employees' business expenses. If you make a single payment to your employees and it includes both wages and an expense reimbursement, you must specify the amount of the reimbursement.

If you reimburse these expenses under an accountable plan, deduct them as travel, meal, and entertainment expenses. If you reimburse these expenses under a nonaccountable plan, you must report the reimbursements as wages on Form W–2 and deduct them as wages. See Table 16-1, *Reporting Reimbursements.*

Accountable Plans

To be an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all of the following rules:

1) They must have paid or incurred deductible expenses while performing services as your employees,
2) They must adequately account to you for these expenses within a reasonable period of time, and
3) They must return any excess reimbursement or allowance within a reasonable period of time.

TIP *A reasonable period of time depends on the facts and circumstances. Generally, you can consider the period reasonable if your employees adequately account for the expenses within 60 days after they pay or incur them and if they return any excess reimbursement within 120 days after they pay or incur the expense. Also, the period is considered reasonable if you give your employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days.*

If any expenses reimbursed under this arrangement are not substantiated, or are an excess reimbursement that is not returned within a reasonable period of time by an employee, you cannot treat these expenses as reimbursed under an accountable plan. Instead, treat the reimbursed expenses as paid under a nonaccountable plan, discussed later.

How to deduct. You can take a deduction for travel, meals, and entertainment if you reimburse your employees for these expenses under an accountable plan. The amount you reimburse for meals and entertainment, however, may be subject to a 50% limit, discussed later. If you are a sole proprietor, deduct the reimbursement on line 24 of Schedule C (Form 1040). If you file a corporation income tax return, include the reimbursement in the amount claimed on the “Other deductions” line of Form 1120 or Form 1120–A. If you file any other income tax return, such as a partnership or S Corporation return, deduct the reimbursement on the appropriate line of the return, as provided in the instructions for that return.

Per Diem or Other Fixed Allowance

You may reimburse your employees, under an accountable plan, based on travel days, miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you for the amount of the expense that does not exceed the rates established by the federal government. Your employee must actually substantiate to you the other elements of the expense, such as time, place, and business purpose.

For 1997, the ***standard mileage rate*** is 31.5 cents a mile for all business miles. However, see Revenue Procedure 96–63 in the 1996–2 Cumulative Bulletin for information on using a fixed and variable rate (FAVR) allowance. You can read Revenue Procedure 96–63 at many public libraries. The ***federal per diem rates*** for meals and lodging within the continental U.S. are listed in Publication 1542.

Reporting and deducting allowances. How you report and deduct the per diem allowance depends on whether it is more than the federal rate. For this purpose, the ***federal rate*** can be figured by using any of three methods:

1) The regular federal per diem rate (discussed later),
2) The high-low method (discussed later), or
3) The standard meal allowance (see chapter 1 in Publication 463).

Per diem allowance LESS than or EQUAL to the federal rate. If your per diem allowance for the employee is less than or equal to the federal rate, that allowance is not part of the employee's pay. Deduct the allowance as travel expenses (including meals that may be subject to the 50% limit, discussed later). See *How to deduct* under *Accountable Plans,* discussed earlier.

Per diem allowance MORE than the federal rate. If your employee's per diem allowance is more than the federal rate, you must report the allowance as two separate items.

You include the allowance amount up to the federal rate in box 13 (code L) of the employee's Form W–2. Deduct it as travel expenses (as explained above). This part of

Table 16-1. **Reporting Reimbursements**

IF the type of reimbursement (or other expense allowance) arrangement is under:	**Then the employer reports on Form W-2:**
An accountable plan with:	
Actual expense reimbursement: Adequate accounting made and excess returned	No amount.
Actual expense reimbursement: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1.
Per diem or mileage allowance up to the federal rate: Adequate accounting and excess returned	No amount.
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting up to the federal rate only and excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.
A nonaccountable plan with:	
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.
No reimbursement plan	The entire amount as wages in box 1.

the allowance is treated as reimbursed under an accountable plan.

You include the allowance amount that is more than the federal rate in box 1 (and in boxes 3 and 5 if they apply) of the employee's Form W–2. Deduct it as wages subject to income tax withholding, social security, Medicare, and federal unemployment taxes. This part of the allowance is treated as reimbursed under a nonaccountable plan as explained later under *Nonaccountable Plans.*

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. Publication 1542 lists the rates in the continental U.S.

The federal rates for meal and incidental expenses are the same as those rates discussed under *Standard Meal Allowance* in chapter 1 in Publication 463.

High-low method. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel during 1997 is $166 for certain locations. All other areas have a per diem amount of $109. The areas eligible for the $166 per diem amount under the high-low method are listed in Publication 1542.

Meals and Entertainment

Under an accountable plan, you can generally deduct only 50% of any otherwise deductible business-related meal and entertainment expenses that you reimburse your employees. The deduction limit applies even if you reimburse them for 100% of the expenses.

Application of the 50% limit. The 50% deduction limit applies to reimbursements you make to your employees for expenses they incur while traveling away from home on business and for entertaining business customers at your place of business, a restaurant, or other location. It applies to attending a business convention or reception, business meeting, or business luncheon at a club. The deduction limit may also apply to meals you furnish on your premises to your employees (discussed in chapter 3).

Related expenses. Taxes and tips relating to expenses for a meal or entertainment activity that you reimburse to your employee under an accountable plan are included in the amount that is subject to the 50% limit. Reimbursements you make for expenses, such as cover charges for admission to a nightclub, rent paid for a room to hold a dinner or cocktail party, or the amount you pay for parking at a sports arena, are all subject to the 50% limit. However, the cost of transportation to and from a business meal or entertainment activity that is otherwise allowable is not subject to the 50% limit.

How to apply the 50% limit. If you provide your employees with a per diem allowance (discussed earlier) only for meal and incidental expenses, the amount treated as an expense for food and beverages is the lesser of:

1) The per diem allowance, or
2) The federal meal and incidental expense rate (M & IE).

If you provide your employee with a per diem allowance that covers lodging, meals, and incidental expenses, you must treat an amount equal to the federal M & IE rate for the area of travel as an expense for food and beverages. If the per diem allowance you provide for a full day of travel is less than the federal per diem rate for the area of travel you can treat 40% of the per diem allowance as the amount for food and beverages.

Drilling rigs. The 50% limit does not apply to the food or beverages an employer provides on an oil or gas platform or drilling rig located offshore or in Alaska. This exception also applies to meals provided by an employer at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

De minimis (minimal) fringe benefit. The 50% limit does not apply to an expense for food or beverage that is excluded from the gross income of an employee because it is a de minimis fringe benefit. A de minimis benefit is one you provide your employees that is so small in value it would be unreasonable or impractical for you to account for it. You must consider the frequency with which you provide similar fringes to your employees in determining if the value is minimal. Although certain entertainment expenses, such as occasional tickets to the theater or sporting events, may qualify as a de minimis fringe benefit, this exception to the 50% limit does not apply to entertainment expenses.

Example. You operate an employee cafeteria for all your employees. The cafeteria is on your business premises and the prices you charge your employees cover the direct operating costs of the cafeteria. The cafeteria is considered a de minimis fringe benefit and you are not subject to the 50% limit for these expenses.

Company cafeteria or executive dining room. You can deduct the cost of food and beverages you provide primarily to your employees on your business premises. This includes the cost of maintaining the facilities for providing the food and beverages. These expenses are subject to the 50% limit unless they qualify as de minimis fringe benefits, discussed earlier.

Employee activities. You can deduct the expense of providing recreational, social, or similar activities (including the use of a facility) for your employees. The benefit must be primarily for your employees who are not highly compensated employees as defined in chapter 4 under *Exclusion of Certain Fringe Benefits.* These expenses are not subject to the 50% limit. For example, the expenses for food, beverages, and entertainment for a company-wide picnic are not subject to the 50% limit.

Nonaccountable Plans

A nonaccountable plan is an arrangement that does not meet the requirements for an accountable plan. All amounts paid, or treated as paid, under a nonaccountable plan are reported as wages on Form W–2. The payments are subject to income tax withholding, social security, Medicare, and federal unemployment taxes. You can deduct the reimbursement as compensation or wages only to the extent it meets the deductibility tests for employees' pay in chapter 2. Deduct the allowable amount as compensation or wages on the appropriate line of your income tax return, as provided in its instructions.

Other Reimbursed Expenses

You may provide meals and entertainment expenses to individuals other than your employees. These expenses may or may not be subject to the 50% limit, depending on the circumstances.

Nonemployee. If you provide a person who is not your employee with meals, goods, services, or the use of a facility and the item you provide is considered entertainment, you can deduct the expense only to the extent it is included in the gross income of the recipient as compensation for services or as a prize or award. If you are required to include these expenses on an information return (Form 1099–MISC), you cannot claim a deduction for them unless you file the necessary information return. For more information about when to file Form 1099–MISC, see the separate *Instructions for Forms 1099, 1098, 5498, and W–2G.* These expenses are not subject to the 50% limit.

Director, stockholder, or employee meetings. You can deduct entertainment expenses directly related to business meetings of your employees, partners, stockholders, agents, or directors. You can provide some minor social activities, but the main purpose of the meeting must be your company's business. These expenses are subject to the 50% limit.

Trade association meetings. You can deduct expenses directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations can include business leagues, chambers of commerce, real estate boards, and trade and professional associations. These expenses are subject to the 50% limit.

Sale of meals or entertainment. You can deduct the cost of providing meals, entertainment, goods and services, or use of facilities that you sell to the public. For example, if you run a nightclub, your expense for the entertainment you furnish to your customers, such as a floor show, is a business expense. These expenses are not subject to the 50% limit.

Advertising to promote goodwill. You can deduct the cost of providing meals, entertainment, or recreational facilities to the general public as a means of advertising or promoting goodwill in the community. For example, the expense of sponsoring a television or radio show is deductible. You can also deduct the expense of distributing free food and beverages to the general public. These expenses are not subject to the 50% limit.

Charitable sports event. The 50% limit does not apply to the expenses covered by a package deal that includes a ticket to a charitable sports event. See *Entertainment tickets* in Publication 463 for a list of the conditions a charitable sports event must meet before you can deduct 100% of the cost of the package deal.

Miscellaneous Expenses

In addition to travel, meal, and entertainment expenses, there are other expenses that you can deduct. This section briefly covers some of these expenses (listed in alphabetical order).

Advertising expenses. You can deduct reasonable advertising expenses if they relate to your business activities. Generally, you cannot deduct the cost of advertising to influence legislation. See *Lobbying expenses,* later in this chapter.

You can usually deduct as a business expense the cost of public service advertising to keep your name before the public if it relates to business you reasonably expect to gain in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross, to buy U.S. Saving Bonds, or to participate in similar causes is usually deductible.

Foreign expenses. You cannot deduct the costs of advertising on foreign radio and television (including cable) where the advertising is primarily for a market in the United States. However, this rule only applies to advertising expenses in countries that deny a deduction for advertising on a United States broadcast primarily for that country's market.

Anticipated liabilities. Anticipated liabilities or reserves for anticipated liabilities are not deductible. For example, assume you sold one-year TV service contracts this year totaling $50,000. From experience, you know you will have expenses of about $15,000 in the coming year for these contracts. You cannot deduct any of the $15,000 this year by charging expenses to a reserve or liability account. You can deduct your expenses only when you actually pay or accrue them, depending on your accounting method.

Black lung benefit trust contributions. If you, as a coal mine operator, make a contribution to a qualified black lung benefit trust, you may be able to deduct your contribution. To be deductible, you must make your contribution during the tax year or pay it to the trust 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. Mr. Green cannot deduct these payments if they are in violation of any federal or state law as explained previously in (2).

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. 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.*

Car and truck expenses. You can deduct the cost of operating a car, truck, or other vehicle in your business. These costs include gas, oil, repairs, license tags, insurance, and depreciation. Only the expenses for business use are deductible. Traveling between your home and your place of business is not business use.

Under certain conditions, you can use the standard mileage rate instead of deducting the actual expenses for your vehicle. The standard mileage rate for 1997 is 31.5 cents a mile for all business miles put on a car, van, pick-up, or panel truck. For more information on how to figure your deduction, see Publication 463.

Charitable contributions. Cash payments to charitable, religious, educational, scientific, or similar organizations may be deductible as business expenses if the payments are not charitable contributions or gifts. If the payments are charitable contributions or gifts, you cannot deduct them as business expenses. However, corporations can deduct charitable contributions on their income tax returns. See *Charitable Contributions* in Publication 542 for more information. Individuals, partners in a partnership, or shareholders in an S corporation may be able to deduct charitable contributions made by their business on their individual income tax returns.

Example. You paid $15 to a local church for a half-page ad in a program for a concert it is sponsoring. Since your payment is not a contribution, you cannot deduct it as such. However, you can deduct it as an advertising expense.

Inventory. You can take a charitable contribution deduction for inventory items donated to a qualified charitable organization. Your deduction is limited to the fair market value of the property on the date of the contribution less any gain you would have realized if you had sold the property at its fair market value. You must remove from opening inventory for the year you make the contribution any costs for the donated property included from prior years. These costs are not part of the cost of goods sold for determining gross income for the year of the contribution. Use them in figuring the basis of the donated property. However, you can include (as part of the cost of goods sold) costs in the year of the contribution if you treat them as part of the cost of goods sold under your accounting method. Do not use these costs to increase the basis of the donated property.

Example 1. You own an auto repair shop and in 1997 you donated auto parts to your local school for its auto repair class. The fair market value of the parts at the time of the contribution was $600 and you had included $400 for the parts in your opening inventory for 1997. Your charitable contribution is $400, determined as follows:

Fair market value	$600
Minus: Gain if sold ($600 – 400 basis)	200
Charitable contribution	$400

You reduce your opening inventory by the $400 for the donated property.

Example 2. Assume the same facts as Example 1, except you purchased the auto parts in 1997 for $400 (not part of the opening inventory). The $400 is included as part of the cost of goods sold for 1997 but not in figuring the basis of the property. Your charitable contribution is $0, determined as follows:

Fair market value	$600
Minus: Gain if sold ($600 – 0 basis)	600
Charitable contribution	$0

Demolition expenses or losses. You cannot deduct any amount paid or incurred to demolish a structure or any loss for the undepreciated basis of a demolished structure. Add these amounts to the basis of the land where the demolished structure was located.

Depreciation. If property you buy to use in your business has a useful life longer than one year, you generally cannot deduct the entire cost as a business expense in the year you buy it. You must spread the cost over more than one tax year and deduct part of it each year. This method of deducting the cost of business property is called depreciation.

However, you can choose to deduct a limited amount of the cost of certain depreciable property in the year you place it in service in your business. This is referred to as a “section 179 deduction.”

For information on depreciation and the section 179 deduction, see Publication 946.

Dues and subscriptions. Generally, you cannot deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes country clubs, athletic clubs, luncheon clubs, sporting clubs, airline clubs, and hotel clubs.

Exception. Unless a main purpose 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 the ordinary and necessary expenses you pay for the education and training of your employees. For more information, see *Education Expenses* in chapter 2.

You can also deduct your expenses that are related to your own education expenses that are related to your trade or business, along with certain related travel. You must be able to show the education maintains or improves skills required in your trade or business, 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 or business, or those that qualify you for a new trade or business. This is true even if the education maintains or improves skills presently required in your business.

Example 1. Dr. Carter, who is a psychiatrist, begins a program of study at an accredited psychoanalytic institute to qualify as a psychoanalyst. She can deduct the cost of the program because the study maintains or improves skills required in her profession and does not qualify her for a new one.

Example 2. Herb Jones owns a repair shop for electronic equipment. The bulk of the business is television repairs, but occasionally he fixes tape decks and disc players. To keep up with the latest technical changes, he takes a special course to learn how to repair disc players. Since the course maintains and improves skills required in his trade, he can deduct its cost.

Example 3. Peter Green, an architect in New York, decided to take a special 2-week course in Los Angeles on the latest building techniques. While there, he spent an extra 8 weeks on personal activities. The time he spent on personal activities indicates his main reason for going to Los Angeles was to take a vacation. He can deduct his education expenses and meals and lodging for the 2 weeks he attended the course. He cannot deduct his round trip transportation expense to Los Angeles or any of the expenses for the 8 weeks spent on personal activities.

Environmental cleanup 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 for the construction of groundwater treatment facilities. You must capitalize those costs and you can recover them through depreciation.

Franchise, trademark, trade name. A franchise includes an agreement that gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area.

If you buy a franchise, trademark, or trade name you can deduct the amount you pay or incur for the transfer as a business expense only if the payments are part of a series of payments that are:

1) Contingent on productivity, use, or disposition of the item,
2) Payable at least annually for the entire term of the transfer agreement, and
3) Substantially equal in amount (or payable under a fixed formula).

Any amounts you pay or incur for the transfer (after August 10, 1993) that are not described in (1) through (3) must be charged to a capital account. These are “section 197 intangibles” and are amortized over 15 years. See chapter 12 for more information on amortization.

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.

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:

1) 10 years, or
2) The life of the agreement.

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:

1) The period of the transfer agreement, or

2) A period of more than 10 years, regardless of the life of the agreement.

CAUTION *The above business deductions do not apply to transfers after October 2, 1989, and before August 11, 1993, if the principle sum is over $100,000.*

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.

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. The rules for annual and substantially equal payments do not apply.

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,

2) An amortized payment deducted over 25 years, or

3) The amortization claimed on section 197 intangibles.

Interview expense allowances. Reimbursements you make to job candidates for transportation or other expenses related to interviews for possible employment are not wages. They are not subject to social security and Medicare taxes (FICA), federal unemployment taxes (FUTA), or the withholding of income tax. However, you can deduct the allowances as a business expense.

Legal and professional fees. Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses directly related to operating your business are deductible as business expenses. However, you usually cannot deduct legal fees you pay to acquire business assets. Add them to the basis of the property.

If the fees include payments for work of a personal nature (such as making a will), you take a business deduction only for the part of the fee related to your business. The personal portion of legal fees for producing or collecting taxable income, doing or keeping your job, or for tax advice may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529.

Tax preparation fees. You can deduct as a trade or business expense the cost of preparing that part of your tax return relating to your business as a sole proprietor. The remaining cost is deductible on Schedule A (Form 1040) if you itemize your deductions.

You can also take a business deduction 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 generally are deductible. Some licenses and fees may have to be amortized. See chapter 12 for more information.

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 (defined later) in any attempt to influence the official actions or positions of such officials.

Lobbying expenses include amounts paid or incurred for research, preparation, planning, or coordination of any activity described in the preceding list.

Your expenses for influencing legislation and communicating directly with a covered executive branch official include a portion of your labor costs and general and administrative costs of your business. For information on making this allocation, see section 1.162-28 of the income tax regulations.

You cannot take a charitable deduction or business expense for amounts paid to an organization described in section 170(c) of the Internal Revenue Code if:

1) The organization conducts lobbying activities on matters of direct financial interest to your business, and

2) A principal purpose of your contribution is to the disallowance of a business expense for lobbying expenses.

If a tax-exempt organization, other than a section 501(c)(3) 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.

Covered executive branch official. For purposes of this discussion, a covered executive branch official 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) above.

Exceptions to denial of deduction. The general denial of the deduction does not apply to:

1) Expenses for attempting to influence the legislation of any local council or similar governing body ***(local legislation).*** An Indian tribal government shall be treated as a local council or similar governing body.

2) Any in-house expenses for influencing legislation and 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).

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.

Impairment-related expenses. If you are disabled, you can deduct expenses necessary for you to be able to work (impairment-related expenses) as a business expense, rather than as a medical expense.

You are disabled if you have:

1) A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed, or

2) A physical or mental impairment that substantially limits one or more of your major life activities.

You can deduct the expenses as a business expense if:

1) Your work clearly requires the expense for you to satisfactorily perform the work,

2) The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities, and

3) Their treatment is not specifically provided for under other tax law provisions.

Example. You are blind. You must use a reader to do your work, both at and away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as a business expense.

Moving machinery. Generally, the cost of moving your machinery from one city to another is a deductible expense. So is the cost of moving machinery from one plant to another, or from one part of your plant to another. You can deduct the cost of installing the machinery in the new location. However, 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, resume assistance, skills assessment, etc.).

The costs of outplacement services may cover more than one deduction category. For example, deduct as a utilities expense the cost of telephone calls made under this service, and deduct as rental expense the cost of renting machinery and equipment for this service.

Penalties and fines. Penalties you pay for late performance or nonperformance of a contract are generally deductible. For instance, if you contracted to construct a building by a certain date and had to pay an amount for each day the building was not finished after that date, you can deduct the amounts paid or incurred.

On the other hand, you cannot deduct penalties or fines you pay to any government agency or instrumentality because of a violation of any law. These fines or penalties include amounts:

1) Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.
2) Paid as a penalty imposed by federal, state, or local law in a civil action, including certain additions to tax and additional amounts and assessable penalties imposed by the Internal Revenue Code.
3) Paid in settlement of actual or possible liability for a fine or penalty, whether civil or criminal.
4) Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Examples of nondeductible penalties and fines include:

1) Fines for violating city housing codes.
2) Fines paid by truckers for violating state maximum highway weight laws and air quality laws.
3) Civil penalties for violating federal laws regarding mining safety standards and discharges into navigable waters.

A fine or penalty does not include:

1) Legal fees and related expenses to defend yourself in a prosecution or civil action for a violation of the law imposing the fine or civil penalty.
2) Court costs or stenographic and printing charges.
3) Compensatory damages paid to a government.

Nonconformance penalty. You can deduct a nonconformance penalty assessed by the Environmental Protection Agency for failing to meet certain emission standards.

Political contributions. You cannot deduct contributions or gifts to political parties or candidates as business expenses. In addition, you cannot deduct expenses you pay or incur to take part in any political campaign of a candidate for public office.

Indirect political contributions. You also cannot deduct indirect political contributions and costs of taking part in political activities as business expenses. Examples of nondeductible expenses include:

1) Advertising in a convention program of a political party, or in any other publication if any of the proceeds from the publication are for, or intended for, the use of a political party or candidate.
2) Admission to a dinner or program (including, but not limited to, galas, dances, film presentations, parties, and sporting events) if any of the proceeds from the function are for, or intended for, the use of a political party or candidate.
3) Admission to an inaugural ball, gala, parade, concert, or similar event if identified with a political party or candidate.

Repairs. The cost of repairing or improving property used in your trade or business is either a deductible or capital expense. You can deduct expenses to keep your property in a normal efficient operating condition. But you must capitalize expenses that add to the value of your property or significantly increase its life. Although you cannot deduct capital expenditures as current expenses, you can usually deduct them over a period of time as depreciation.

TIP *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 costs of labor, supplies, and certain other items. You* **cannot** *deduct the value of your own labor.*

Examples of repairs include:

- Patching and repairing floors.
- Repainting the inside and outside of a building.
- Repairing roofs and gutters.
- Mending leaks.

You cannot deduct the cost of repairs that you added to the ***cost of goods sold*** as a separate business expense.

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.

TIP *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 1996, 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 1997. In 1997, you repaid the $2,000 you received in 1996.

You included the $2,000 in your income for 1996 because you had an unrestricted right to it. No deduction arose from the inclusion. In 1997, you can deduct the $2,000 repayment.

Repayment over $3,000. If the amount you repaid is more than $3,000, your tax is the lesser of:

1) Your tax for this year figured with a deduction for the amount repaid, or
2) Your tax for this year:
   a) Figured without deducting the repaid amount, and
   b) Reduced by the amount your tax for the earlier year (or years) increased because you included the amount repaid in income.

If your tax is the amount figured under (2), you cannot deduct the amount repaid in figuring a net operating loss for this year. However, take the amount into account in figuring the decrease in tax for the earlier tax year.

This discussion does not apply if your deduction results from any of the following:

1) Sales of inventory items to customers in the ordinary course of trade or business.
2) Sales returns and allowances and similar items.
3) Bad debts.
4) Legal and other expenses of contesting the repayment.

Accounting for repayments. If you use the cash method of accounting, you can claim the deduction only in the year the income item is repaid. If you included the amount in income because of the rule of constructive receipt, but never received it, you can deduct the amount in the tax year you must give up your right to receive it. If you use any other accounting method, you can deduct the repayment only in the proper tax year under that accounting method.

Supplies and materials. 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. Generally, any cellular telephone or similar telecommunications equipment is listed property. If listed property is not used more than 50% for qualified business use during any tax year, special rules apply to the section 179 deduction and the depreciation deduction. See chapter 4 of Publication 946.

17. How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). Or write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check you income tax package or telephone book for the local number, or call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

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