Department of the Treasury

Internal Revenue Service

Publication 535
Cat. No. 15065Z

Business Expenses

For use in preparing
2003 Returns

Contents

Get forms and other information faster and easier by:

Internet • www.irs.gov or **FTP** • ftp.irs.gov

FAX • 703–368–9694 (from your fax machine)

Introduction

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

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can email us at ***taxforms@irs.gov**. Please put "Publications Comment" on the subject line.

You can write to us at the following address:

Internal Revenue Service
Business Forms and Publications
SE:W:CAR:MP:T:B
1111 Constitution Ave. NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Important Changes for 2003

The following items highlight some changes in the tax law for 2003.

Elective deferrals. The limit on elective deferrals increases to $12,000 for tax years beginning in 2003 and then increases $1,000 each tax year thereafter until it reaches $15,000 in 2006. These new limits will apply for participants in SARSEPs, 401(k) plans (excluding SIMPLE plans), and deferred compensation plans of state or local governments and tax-exempt organizations. The $15,000 figure is subject to cost-of-living increases after 2006.

Catch-up contributions. A plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2003 is $2,000. This limit increases by $1,000 each year thereafter until it reaches $5,000 in 2006. The limit is subject to cost-of-living increases after 2006. The catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

See chapter 3.

SIMPLE plan salary reduction contributions. The limit on salary reduction contributions to a SIMPLE plan increases to $8,000 beginning in 2003 and then increases $1,000 each tax year thereafter until it reaches $10,000 in 2005. The $10,000 figure is subject to adjustment after 2005 for cost-of-living increases.

Catch-up contributions. A SIMPLE plan can permit participants who are age 50 or over at the end of the calendar year to make catch-up contributions. The catch-up contribution limit for 2003 is $1,000. This limit increases by $500 each year thereafter until it reaches $2,500 in 2006. The limit is subject to cost-of-living increases after 2006. The catch-up contributions a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

See chapter 3.

Health insurance deduction for the self-employed. Beginning in 2003, the self-employed health insurance deduction percentage increases to 100%. See chapter 7.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2003 is 36 cents a mile for all business miles. See chapter 13.

Important Changes for 2004

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2004 is 37.5 cents a mile for all business miles. See chapter 13.

Meal expense deduction subject to "hours of service" limits. In 2004, this deduction increases to 70% of the reimbursed meals your employees consume while they are subject to the Department of Transportation's "hours of service" limits. See chapter 13.

Important Reminders

Qualified environmental cleanup (remediation) costs. The deduction for qualified environmental cleanup (remediation) costs has been extended to include costs you pay or incur before 2004. After December 31, 2003, these costs must be capitalized. See chapter 8.

Marginal production of oil and gas. The suspension of the taxable income limit on percentage depletion from the marginal production of oil and natural gas has been extended to tax years beginning before 2004. For more information on marginal production, see section 613A(c) of the Internal Revenue Code.

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

For more information on alternative minimum tax, see the following sources.

If you are:	See:
An individual	The instructions for Form 6251, *Alternative Minimum Tax — Individuals.*
A corporation	Form 4626, *Alternative Minimum Tax — Corporations.*
An estate or trust	Form 1041, *U.S. Income Tax Return for Estates and Trusts,* and its instructions.

See chapter 10.

Maximum clean-fuel vehicle deduction. The maximum clean-fuel vehicle deduction and qualified electric vehicle credit were scheduled to be 25% lower for 2002 and both were scheduled to be phased out completely by 2005. The full deduction and credit are now allowed for qualified property placed in service in 2002 and 2003. The phaseout of the deduction and the credit will begin in 2004, and no deduction or credit will be allowed for property placed in service after 2006. See chapter 12.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1 – 800 – THE – LOST (1 – 800 – 843 – 5678)** if you recognize a child.

1.

Deducting Business Expenses

Introduction

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

Topics

This chapter discusses:

- What you can deduct
- How much you can deduct
- When 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
- ❑ **525** Taxable and Nontaxable Income
- ❑ **529** Miscellaneous Deductions
- ❑ **536** Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- ❑ **538** Accounting Periods and Methods
- ❑ **542** Corporations
- ❑ **547** Casualties, Disasters, and Thefts
- ❑ **587** Business Use of Your Home (Including Use by Daycare 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 14 for information about getting publications and forms.

What Can I Deduct?

To be deductible, a business expense must be both ordinary and necessary. An ***ordinary*** expense is one that is common and accepted in your 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 the following expenses.

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

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

Cost of Goods Sold

If your business manufactures products or purchases them for resale, some of your expenses may be included in figuring cost of goods sold. You deduct cost of goods sold from your gross receipts to figure your gross profit for the year. If you use an expense to figure the cost of goods sold, you cannot deduct it again as a business expense.

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

- The cost of products or raw materials, including the cost of having them shipped to you.
- The cost of storing the products you sell.
- Direct labor costs (including contributions to pension or annuity plans) for workers who produce the products.
- Factory overhead expenses.

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

For more information, see the following sources.

- Cost of goods sold — chapter 6 of Publication 334.
- Inventories — Publication 538.
- Uniform capitalization rules — section 263A of the Internal Revenue Code and the related regulations.

Capital Expenses

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

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

Recovery. Although you generally cannot take a current deduction for a capital expense, you may be able to take deductions for the amount you spend through depreciation, amortization, or depletion. These 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 9) and *Depletion* (chapter 10) 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. These costs may include expenses for advertising, travel, or wages for training employees.

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

Usually you recover costs for a particular asset through depreciation. Generally, you cannot recover other costs until you sell the business or otherwise go out of business. However, you can choose to amortize certain costs for setting up your business. See *Going Into Business* in chapter 9 for more information on business start-up costs.

If you do not go into business. If you are an individual and 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.

If you are a corporation and your attempt to go into a new trade or business is not successful, you may be able to deduct all investigatory costs as a 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–2 of the 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 as repairs amounts paid to replace parts of a machine that only keep it in a normal operating condition. 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 can 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 1 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 add to its life is a deductible expense.

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

Personal 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 5 for information on deducting interest and the allocation rules.

Business use of your home. If you use part of your home for business, you may be able to deduct expenses for the business use of your home. These expenses may include mortgage interest, insurance, utilities, repairs, and depreciation.

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

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

You generally do not have to meet the exclusive use test for the part of your home that you regularly use in either of the following ways.

- For the storage of inventory or product samples.
- As a daycare facility.

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

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

Alternatively, if you use your home exclusively and regularly for your business, but your home office does not qualify as your principal place of business based on the previous rules, you determine your principal place of business based on the following factors.

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

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 the car for business are deductible as business expenses.

You can deduct actual car expenses, which include depreciation (or lease payments), 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 the standard mileage rate to figure your deduction. For 2003, the standard mileage rate is 36 cents a mile for all business miles driven.

If you are self-employed, you can also deduct the business part of interest on your car loan, state and local personal property tax on the car, parking fees, and tolls, whether or not you claim the standard mileage rate. 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 rules for using the standard mileage rate, see Publication 463.

How Much Can I Deduct?

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 tax loss may be limited.

Recovery of amount deducted. If you recover part of an expense in the same tax year for which you would have claimed a deduction, 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 the part that did not reduce your tax.

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

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.

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. See *Not-for-Profit Activities,* later.

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

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

For more information, see Publication 925.

Passive activities. Generally, you are in a passive activity if you have a trade or business activity in which you do not materially participate during the year, or a rental activity. In general, deductions for losses from passive activities only offset your income from passive activities. You cannot use any excess deductions to offset your other income. In addition, passive activity credits can only offset the 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. See Publication 542 for information about net operating losses of corporations.

When Can I Deduct an Expense?

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

For more information on accounting methods, see Publication 538.

Cash method. Under the cash method of accounting, you generally deduct business ex-

penses in the tax year you actually paid them, even if you incurred them in an earlier year.

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

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

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

Example. Your tax year is the calendar year. In December 2003, 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 2004. If you use an accrual method of accounting, deduct the $150 on your tax return for 2003 because all events occurred to fix the fact of liability, the liability can be determined, and economic performance occurred in that year. If you use the cash method of accounting, you can deduct the expense on your 2004 return.

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

Example. In 2003, you sign a 10-year lease and immediately pay your rent for the first 3 years. Even though you paid the rent for 2003, 2004, and 2005, you can deduct only the rent for 2003 on your current tax return. You can deduct on your 2004 and 2005 tax returns the rent for those years.

Contested liability. Under the cash method, you can deduct a contested liability 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 taxes), in the tax year you pay the liability (or transfer money or other property to satisfy the obligation) or in the tax year you settle the contest. However, to take the deduction in the year of payment or transfer, you must meet certain conditions. See *Contested Liability* in Publication 538 for more information.

Related person. Under an accrual method of accounting, you generally deduct expenses when you incur them, even if you have not paid them. However, if you and the person you owe are related and the person 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 consider are whether:

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

Presumption of profit. An activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least 2 of the last 7 tax years, including the current year. The activity must be substantially the same for each year within this period. You have a profit when the gross income from an activity 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 the limits discussed here will not apply. You can take all your business deductions from the activity, even for the years that you have a loss. You can rely on this presumption 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 (or 2) years showing a profit, you may want to elect to have the presumption made 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 that your activity is not carried on for profit until 5 (or 7) years have passed since you started the activity.

The benefit gained by making this 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 (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.

TIP *You must file Form 5213 within 3 years after the due date of your return for the year in which you first carried on the activity, or, if earlier, within 60 days after receiving written notice from the Internal Revenue Service proposing to disallow deductions attributable to the activity.*

Limit on Deductions 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 deduct a casualty loss on property you own for personal use only to the extent it is more than $100 and all these losses are more than 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) 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) 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
Minus expenses:		
Real estate taxes	$700	
Home mortgage interest	900	
Insurance	400	
Utilities	700	
Maintenance	200	
Depreciation on an automobile	600	
Depreciation on a machine	200	3,700
Loss		**$ 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.

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

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

The basis of each asset is reduced accordingly.

The $1,600 for category (1) is deductible in full on the appropriate lines for taxes and interest on Schedule A (Form 1040). Ida deducts the remaining $1,600 (the total of categories (2) and (3)) as other miscellaneous deductions on Schedule A (Form 1040) 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 following are the most significant facts and circumstances in making this determination.

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

2. Employees' Pay

Introduction

You can generally deduct the pay you give your employees for the services they perform for your business. The pay may be in cash, property, or services. It may include wages, salaries, vacation allowances, bonuses, commissions, and fringe benefits. This chapter provides information about deductions allowed for various kinds of pay.

For information about determining who is an employee and about employment taxes on your employees' pay, see Publication 15, *Circular E, Employer's Tax Guide,* Publication 15–A, *Employer's Supplemental Tax Guide,* and Publication 15–B, *Employer's Tax Guide to Fringe Benefits.* For information about deducting employment taxes paid on your employees' pay, see chapter 6.

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

- *Empowerment zone and renewal community employment credit.*
- *Indian employment credit.*
- *New York Liberty Zone business employee credit.*
- *Welfare-to-work credit.*
- *Work opportunity credit.*

However, you must reduce your deduction for employee wages by the amount of any employment credits you claim. For more information about these credits, see Publication 954, Tax Incentives for Distressed Communities.

Topics

This chapter discusses:

- Tests for deducting pay
- Kinds of pay

Useful Items

You may want to see:

Publication

- ❑ **15** Circular E, Employer's Tax Guide
- ❑ **15–A** Employer's Supplemental Tax Guide
- ❑ **15–B** Employer's Tax Guide to Fringe Benefits

See chapter 14 for information about getting publications and forms.

Tests for Deducting Pay

To be deductible, your employees' pay must be an ordinary and necessary expense and you must pay or incur it in the tax year. These and other requirements that apply to all business expenses are explained in chapter 1.

In addition, the pay must meet both the following tests.

- ***Test 1.*** The pay must be ***reasonable.***
- ***Test 2.*** The pay must be ***for services performed.***

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

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

Test 1—Reasonable

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

You must be able to prove the pay is reasonable. Base this test on the circumstances that exist when 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 gross and net income of the business, as well as with distributions to shareholders if the business is a corporation.
- Your policy regarding pay for all your employees.
- The history of pay for each employee.

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

Test 2—For Services Performed

You must be able to prove the payment was made for services actually performed.

Kinds of Pay

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

Awards

You can generally deduct amounts you pay to your employees as awards, whether paid in cash or property. (For awards paid in property, see *Property,* later.) If you give property to an employee as an employee achievement award, your deduction may be limited.

Achievement awards. An achievement award is an item of tangible personal property that meets all the following requirements.

- It is given to an employee for length of service or safety achievement.
- It is awarded as part of a meaningful presentation.
- It is awarded under conditions and circumstances that do not create a significant likelihood of disguised pay.

Length-of-service award. An award will not qualify as a length-of-service award if either of the following applies.

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

Safety achievement award. An award will not qualify as a safety achievement award if either of the following applies.

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

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

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

Deduct achievement awards as a nonwage business expense on your return or business schedule.

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

A highly compensated employee for 2003 is an employee who meets either of the following tests.

1) The employee was a 5% owner at any time during the year or the preceding year.
2) The employee received more than $90,000 in pay for the preceding year.

You can choose to ignore test (2) if the employee was not also in the top 20% of employees ranked by pay for the preceding year.

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) is more than $400. To figure this average cost, do not take into account awards of very small value.

TIP *You may not owe employment taxes on the value of achievement awards you provide to an employee. See Publication 15–B.*

Bonuses

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

Gifts of nominal value. If, to promote employee goodwill, you distribute turkeys, hams, or other merchandise of nominal value to your employees at holidays, you can deduct the cost of these items as a nonwage business expense. Your deduction for de minimis gifts of food or drink are not subject to the 50% deduction limit that generally applies to meals. For more information on this deduction limit, see *Meals and lodging,* later.

Education Expenses

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

Fringe Benefits

A fringe benefit is a form of pay provided to any person for the performance of services by that person. The following are examples of fringe benefits.

- Benefits under employee benefit programs.
- Meals and lodging.
- 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.

You can generally deduct the cost of fringe benefits you provide on your tax return or business schedule in whatever category the cost falls. For example, if you allow an employee to use a car or other property you lease, deduct the cost of the lease as a rent or lease expense. If you own the property, include your deduction for its cost or other basis as a section 179 deduction or a depreciation deduction.

TIP *You may not owe employment taxes on the value of the fringe benefits you provide to an employee. See Publication 15–B.*

Employee benefit programs. Employee benefit programs include the following.

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

You can generally deduct amounts you spend on employee benefit programs on the "employee benefit programs" line of your tax return or business schedule. However, you may deduct certain costs on other lines. For example, if you provide dependent care by operating a dependent care facility for your employees, deduct your costs in whatever categories they fall (depreciation, utilities, salaries, etc.).

Group-term life insurance coverage. You cannot deduct the cost of group-term life insurance coverage if you are directly or indirectly the beneficiary of the policy. See *Nondeductible Premiums* in chapter 7.

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

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

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

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

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

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 the cost of furnishing meals.

Deduct the cost on your tax return or business schedule 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 cost of furnishing lodging to an employee as expenses for utilities, linen service, salaries, depreciation, etc.

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

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

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. However, if the employee performs no services, treat the amount you advanced to the employee as a loan, which you cannot deduct unless it becomes a bad debt. For information on the deduction for bad debts, see chapter 11.

Below-market interest rate loans. On certain loans you make to an employee or shareholder, you are treated as having received interest income and as having paid compensation or dividends equal to that interest. See *Below-Market Loans* in chapter 5 for more information.

Property

If you transfer property (including your company's stock) to an employee as payment for services, you can generally 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 can claim the deduction only for the tax year in which your employee includes the property's value in income. Your employee is deemed to have included the value in income if you report it on Form W–2 in a timely manner.

You treat the deductible amount as received in exchange for the property, 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 property and its adjusted basis on the date of transfer.

A corporation recognizes no gain or loss when it pays for services with its own stock.

These rules also apply to property transferred to an independent contractor, generally reported on Form 1099–MISC.

Restricted property. If the property you transfer for services is subject to restrictions that affect its value, you generally cannot deduct it and do not report gain or loss until it is substantially vested in the recipient. However, if the recipient pays for the property, you must report any gain at the time of the transfer up to the amount paid.

"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.

Reimbursements for Business Expenses

You can generally deduct the amount you pay or reimburse employees for business expenses they incur for you for items such as travel and entertainment. However, your deduction for meal and entertainment expenses is usually limited to 50% of the payment.

If you make the payment under an ***accountable plan,*** deduct it 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 tax return or business schedule. See the instructions for the form you file for information on which lines to use.

If you make the payment under a ***nonaccountable plan,*** deduct it as wages on your tax return or business schedule.

See *Travel, Meals, and Entertainment* in chapter 13 for more information about deducting reimbursements and an explanation of accountable and nonaccountable plans.

Sick Pay

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

Vacation Pay

Vacation pay is an amount you pay to an employee while the employee is on vacation. It includes an amount you pay an employee for unused vacation leave. Vacation pay does not include any sick pay or holiday pay.

You can deduct vacation pay only in your tax year in which the employee actually receives it. This rule applies regardless of whether you use the cash method or an accrual method of accounting.

3.

Retirement Plans

Important Changes for 2003

Elective deferrals. The limit on elective deferrals increases to $12,000 for tax years beginning in 2003 and then increases $1,000 each tax year thereafter until it reaches $15,000 in 2006. These new limits will apply for participants in SARSEPs, 401(k) plans (excluding SIMPLE plans), and deferred compensation plans of state or local governments and tax-exempt organizations. The $15,000 figure is subject to cost-of-living increases after 2006.

Catch-up contributions. A plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2003 is $2,000. This limit increases by $1,000 each year thereafter until it reaches $5,000 in 2006. The limit is subject to cost-of-living increases

after 2006. The catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

SIMPLE plan salary reduction contributions. The limit on salary reduction contributions to a SIMPLE plan increases to $8,000 beginning in 2003 and then increases $1,000 each tax year thereafter until it reaches $10,000 in 2005. The $10,000 figure is subject to adjustment after 2005 for cost-of-living increases.

Catch-up contributions. A SIMPLE plan can permit participants who are age 50 or over at the end of the calendar year to make catch-up contributions. The catch-up contribution limit for 2003 is $1,000. This limit increases by $500 each year thereafter until it reaches $2,500 in 2006. The limit is subject to cost-of-living increases after 2006. The catch-up contributions a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

Introduction

This chapter discusses retirement plans you can set up and maintain for yourself and your employees. Retirement plans are savings plans that offer you tax advantages to set aside money for your own and your employees' retirement.

In general, a sole proprietor or a partner is treated as an employee for retirement plan purposes.

SEP, SIMPLE, and qualified plans offer you and your employees a tax favored way to save for retirement. You can deduct contributions you make to the plan for your employees. If you are a sole proprietor, you can deduct contributions you make to the plan for yourself. You can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until you or your employees receive distributions from the plan.

Under certain plans, employees can have you contribute limited amounts of their before-tax pay to a plan. These amounts (and the earnings on them) are generally tax free until your employees receive distributions from the plan.

In general, individuals who are employed or self-employed can also set up and contribute to individual retirement arrangements (IRAs).

Topics

This chapter discusses:

- Simplified employee pension (SEP) plans
- SIMPLE (Savings incentive match plan for employees) retirement plans
- Qualified plans (also called H.R. 10 plans or Keogh plans when covering self-employed individuals)
- Individual retirement arrangements (IRAs)

Useful Items

You may want to see:

Publication

- ❑ **560** Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
- ❑ **590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- ❑ **W–2** Wage and Tax Statement
- ❑ **5304–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for Use With a Designated Financial Institution
- ❑ **5305–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—for Use With a Designated Financial Institution

See chapter 14 for information about getting publications and forms.

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. However, certain advantages available to 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 a traditional individual retirement arrangement (called a SEP-IRA) set up for each eligible employee.

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

Form 5305–SEP. You may be able to use Form 5305–SEP, *Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement,* in setting up your SEP.

Contribution Limits

Contributions you make for 2003 to a common-law employee's SEP-IRA are limited to the lesser of $40,000 or 25% of the employee's compensation. Compensation generally does not include your contributions to the SEP, but does include certain elective deferrals unless you choose not to include them.

Annual compensation limit. You generally cannot consider the part of an employee's compensation over $200,000 when you figure your contribution limit for that employee.

More than one plan. If you also contribute to a defined contribution retirement plan (defined later), annual additions to all a participant's accounts are limited to the lesser of $40,000 or 100% of the participant's compensation. When you figure this limit, you must add your contributions to all defined contribution plans. A SEP is considered a defined contribution plan for this limit.

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.

Deduction Limit

The most you can deduct for employer contributions (other than elective deferrals) for a common-law employee is 25% of the compensation (limited to $200,000 per participant) paid to him or her during the year from the business that has the plan, not to exceed $40,000 per participant.

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 minus the following amounts.

1) The deduction for one-half of your self-employment tax.
2) The deduction for contributions to your own SEP-IRA.

The deduction for contributions to your own SEP-IRA and your net earnings depend on each other. For this reason, you determine the deduction for contributions to your own SEP-IRA indirectly by reducing the contribution rate called for in your plan. Use *Worksheet 3–A,* shown under *Qualified Plan,* later, to figure the rate.

SEP and defined contribution plan. If you also contributed to a qualified defined contribution plan, you must reduce the 25% deduction limit for that plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the defined contribution plan.

SEP and another qualified plan. If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing (defined contribution) plan when applying the overall 25% deduction limit described in section 404(h)(3) of the Internal Revenue Code.

TIP *If your SEP contribution is more than the deduction limit (nondeductible contribution), you can carry over and deduct the difference in later years. However, the contribution carryover, when combined with the contribution for the later year, is subject to the deduction limit for that year.*

Employee contributions. Employees can also make contributions of up to $3,000 (or $4,000 if they are 50 or older) for 2003 to their SEP-IRAs independent of the employer's SEP contributions. However, the employee's deduction for IRA contributions may be reduced or eliminated because the employee is covered by

an employer retirement plan (the SEP plan). See Publication 590 for details.

Salary Reduction Simplified Employee Pension (SARSEP)

CAUTION *An employer is no longer allowed to set up a SARSEP. However, participants in a SARSEP set up before 1997 (including employees hired after 1996) can continue to have their employer contribute part of their pay to the plan.*

A SARSEP is a SEP set up before 1997 that included a salary reduction arrangement. Under the arrangement, employees can choose to have you contribute part of their pay to their SEP-IRAs rather than receive it in cash. This contribution is called an elective deferral because employees choose (elect) to set aside the money and the tax on the money is deferred until it is distributed.

This choice is available only if all the following requirements are met.

- The SARSEP was set up before 1997.
- At least 50% of the eligible employees choose the salary reduction arrangement.
- You had 25 or fewer eligible employees (or employees who would have been eligible if you had maintained a SEP) at any time during the preceding year.
- Each eligible highly compensated employee's deferral percentage each year is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate (the ADP test). See Publication 560 for the definition of a highly compensated employee and information on how to figure the deferral percentage.

Limit on elective deferrals. In general, the total income an employee can defer under a SARSEP and certain other elective deferral arrangements for 2003 is limited to the lesser of $12,000 or 25% of the employee's compensation (as defined in Publication 560). This limit applies only to amounts that reduce the employee's pay, not to any contributions from employer funds.

Catch-up contributions. A SEP can permit participants who are age 50 or older at the end of the calendar year to make catch-up contributions. The catch-up contribution limit for 2003 is $2,000 ($3,000 for 2004). Elective deferrals are not treated as catch-up contributions for 2003 until they exceed the limit discussed earlier under *Limit on elective deferrals,* the SARSEP ADP test (see Publication 560), or the plan limit (if any). However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

Catch-up contributions are not subject to the limit discussed under *Limit on elective deferrals*, earlier.

Deduction limit and elective deferrals. Compensation, as discussed earlier, under *Deduction Limit,* includes elective deferrals. Elective deferrals are no longer subject to this deduction limit. However, the combined deduction for a participant's elective deferrals, and other SEP contributions, cannot exceed $40,000.

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

Reporting SEP Contributions on Form W–2

Your contributions to an employee's SEP-IRA are excluded from the employee's income. Do not include these contributions in your employee's wages on Form W–2 for income, social security, or Medicare tax purposes. However, your SEP contributions under a salary reduction arrangement are included in your employee's wages for social security and Medicare tax purposes only.

Example. Jim's salary reduction arrangement calls for 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 choose to treat deferrals as compensation under the arrangement. To figure the deferral, the employer multiplies Jim's salary of $30,000 by 9.0909%, the reduced rate equivalent of 10%, to get the deferral of $2,727.27. (This method is the same one you, as a self-employed person, use to figure the contributions you make on your own behalf. See *Worksheet 3–A,* under *Qualified Plan,* later.)

On Jim's Form W–2, his employer shows total wages of $27,272.73 ($30,000 – $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 his employer does not make the choice explained above, Jim's deferral would be $3,000 ($30,000 x 10%). 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 – $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 $6,000 ($30,000 x 20%).

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

For more information on SEPs, see Publication 560.

SIMPLE Retirement Plans

A Savings Incentive Match Plan for Employees (SIMPLE plan) is a written arrangement that provides you and your employees with a simplified way to make contributions to provide retirement income. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions.

SIMPLE plans can only be maintained on a calendar-year basis.

A SIMPLE plan can be set up in either of the following ways.

- Using SIMPLE IRAs (SIMPLE IRA plan).
- As part of a 401(k) plan (SIMPLE 401(k) plan).

See Publication 560 for information on SIMPLE 401(k) plans.

TIP *Many financial institutions will help you set up a SIMPLE plan.*

SIMPLE IRA Plan

A SIMPLE IRA plan is a retirement plan that uses SIMPLE IRAs for each eligible employee. Under a SIMPLE IRA plan, a SIMPLE IRA must be set up for each eligible employee. For the definition of an eligible employee, see *Who Can Participate in a SIMPLE IRA Plan?,* next.

Who Can Set Up a SIMPLE IRA Plan?

You can set up a SIMPLE IRA plan if you meet both the following requirements.

- You meet the employee limit.
- You do not maintain another qualified plan unless the other plan is for collective bargaining employees.

Employee limit. You can set up a SIMPLE IRA plan only if you had 100 or fewer employees who received $5,000 or more in compensation from you for the preceding year. Under this rule, you must take into account ***all*** employees employed at any time during the calendar year regardless of whether they are eligible to participate. Employees include self-employed individuals who received earned income and leased employees.

Once you set up a SIMPLE IRA plan, you must continue to meet the 100-employee limit each year you maintain the plan.

Grace period for employers who cease to meet the 100-employee limit. If you maintain the SIMPLE IRA plan for at least 1 year and you cease to meet the 100-employee limit in a later year, you will be treated as meeting it for the 2 calendar years immediately following the calendar year for which you last met it.

A different rule applies if you do not meet the 100-employee limit because of an acquisition, disposition, or similar transaction. Under this rule, the SIMPLE IRA plan will be treated as meeting the 100-employee limit for the year of the transaction and the 2 following years if both the following conditions are satisfied.

- Coverage under the plan has not significantly changed during the grace period.
- The SIMPLE IRA plan would have continued to qualify after the transaction if you had remained a separate employer.

The grace period for acquisitions, dispositions, and similar transactions also applies if, because of these types of transactions, you do not meet the rules explained under Other qualified plan, *next, or* Who Can Participate in a SIMPLE IRA Plan?, *later.*

Other qualified plan. The SIMPLE IRA plan generally must be the only retirement plan to which you make contributions, or benefits accrue, for service in any year beginning with the year the SIMPLE IRA plan becomes effective.

Exception. If you maintain a qualified plan for collective bargaining employees, you are permitted to maintain a SIMPLE IRA plan for other employees.

Who Can Participate in a SIMPLE IRA Plan?

Eligible employee. Any employee who received at least $5,000 in compensation during any 2 years preceding the current calendar year and is reasonably expected to receive at least $5,000 during the current calendar year is eligible to participate. The term ***employee*** includes a self-employed individual who received earned income.

You can use less restrictive eligibility requirements (but not more restrictive ones) by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both. For example, you can allow participation for employees who received at least $3,000 in compensation during any preceding calendar year. However, you cannot impose any other conditions on participating in a SIMPLE IRA plan.

Excludable employees. The following employees do not need to be covered under a SIMPLE IRA plan.

- Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and you.
- Nonresident alien employees who have received no U.S. source wages, salaries, or other personal services compensation from you.

Compensation. Compensation for employees is the total wages required to be reported on Form W–2. Compensation also includes the salary reduction contributions made under this plan, compensation deferred under a section 457 plan, and the employees' elective deferrals under a section 401(k) plan, a SARSEP, or a section 403(b) annuity contract. If you are self-employed, compensation is your net earnings from self-employment (line 4 of Short Schedule SE (Form 1040)) before subtracting any contributions made to the SIMPLE IRA plan for yourself.

How To Set Up a SIMPLE IRA Plan

You can use ***Form 5304–SIMPLE*** or ***Form 5305–SIMPLE*** to set up a SIMPLE IRA plan. Each form is a model savings incentive match plan for employees (SIMPLE) plan document. Which form you use depends on whether you select a financial institution or your employees select the institution that will receive the contributions.

Use Form 5304–SIMPLE if you allow each plan participant to select the financial institution for receiving his or her SIMPLE IRA plan contributions. Use Form 5305–SIMPLE if you require that all contributions under the SIMPLE IRA plan be deposited initially at a designated financial institution.

The SIMPLE IRA plan is adopted when you (and the designated financial institution, if any) have completed all appropriate boxes and blanks on the form and you have signed it. Keep the original form. Do not file it with the IRS.

Other uses of the forms. If you set up a SIMPLE IRA plan using Form 5304–SIMPLE or Form 5305–SIMPLE, you can use the form to satisfy other requirements, including the following.

- Meeting employer notification requirements for the SIMPLE IRA plan. Page 3 of Form 5304–SIMPLE and Page 3 of Form 5305–SIMPLE contain a *Model Notification to Eligible Employees* that provides the necessary information to the employee.
- Maintaining the SIMPLE IRA plan records and proving you set up a SIMPLE IRA plan for employees.

Deadline for setting up a SIMPLE IRA plan. You can set up a SIMPLE IRA plan effective on any date from January 1 thru October 1 of a year, provided you did not previously maintain a SIMPLE IRA plan. This requirement does not apply if you are a new employer that comes into existence after October 1 of the year the SIMPLE IRA plan is set up and you set up a SIMPLE IRA plan as soon as administratively feasible after your business comes into existence. If you previously maintained a SIMPLE IRA plan, you can set up a SIMPLE IRA plan effective only on January 1 of a year. A SIMPLE IRA plan cannot have an effective date that is before the date you actually adopt the plan.

Setting up a SIMPLE IRA. SIMPLE IRAs are the individual retirement accounts or annuities into which the contributions are deposited. A SIMPLE IRA must be set up for each eligible employee. ***Forms 5305–S,*** *SIMPLE Individual Retirement Trust Account,* and ***5305–SA,*** *SIMPLE Individual Retirement Custodial Account,* are model trust and custodial account documents the participant and the trustee (or custodian) can use for this purpose.

A SIMPLE IRA cannot be designated as a Roth IRA. Contributions to a SIMPLE IRA will not affect the amount an individual can contribute to a Roth IRA.

Deadline for setting up a SIMPLE IRA. A SIMPLE IRA must be set up for an employee before the first date by which a contribution is required to be deposited into the employee's IRA. See *Time limits for contributing funds*, later, under *Contribution Limits.*

Notification Requirement

If you adopt a SIMPLE IRA plan, you must notify each employee of the following information before the beginning of the election period.

- The employee's opportunity to make or change a salary reduction choice under a SIMPLE IRA plan.
- Your choice to make either reduced matching contributions or nonelective contributions (discussed later).
- A summary description and the location of the plan. The financial institution should provide you with this information.
- Written notice that his or her balance can be transferred without cost or penalty if you use a designated financial institution.

Election period. The election period is generally the 60-day period immediately preceding January 1 of a calendar year (November 2 to December 31 of the preceding calendar year). However, the dates of this period are modified if you set up a SIMPLE IRA plan in mid-year (for example, on July 1) or if the 60-day period falls before the first day an employee becomes eligible to participate in the SIMPLE IRA plan.

A SIMPLE IRA plan can provide longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE IRA plan can provide a 90-day election period instead of the 60-day period. Similarly, in addition to the 60-day period, a SIMPLE IRA plan can provide quarterly election periods during the 30 days before each calendar quarter, other than the first quarter of each year.

Contribution Limits

Contributions are made up of salary reduction contributions and employer contributions. You, as the employer, must make either matching contributions or nonelective contributions, discussed later. No other contributions can be made to the SIMPLE IRA plan. These contributions, which you can deduct, must be made timely. See *Time limits for contributing funds,* later.

Salary reduction contributions. The amount the employee chooses to have you contribute to a SIMPLE IRA on his or her behalf cannot be more than $8,000 for 2003 ($9,000 for 2004). These contributions must be expressed as a percentage of the employee's compensation unless you permit the employee to express them as a specific dollar amount. You cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the $8,000 limit.

If an employee is a participant in any other employer plan during the year and has elective salary reductions or deferred compensation under those plans, the salary reduction contributions under a SIMPLE IRA plan also are elective deferrals that count toward the overall $12,000 annual limit on exclusion of salary reductions and other elective deferrals.

Catch-up contributions. A SIMPLE plan can permit participants who are age 50 or older at the end of the calendar year to make catch-up contributions. The catch-up contribution limit for 2003 is $1,000. This limit increases by $500 each year thereafter until it reaches $2,500 in 2006. The limit is subject to cost-of-living increases after 2006. The catch-up contributions a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

Employer matching contributions. You generally are required to match each employee's salary reduction contributions (other than catch-up contributions) on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if you make nonelective contributions as discussed later.

Example. In 2003, your employee, John Rose, earned $25,000 and chose to defer 5% of his salary. You make a 3% matching contribution. The total contribution you can make for John is $2,000, figured as follows.

Salary reduction contributions ($25,000 × .05)	$1,250
Employer matching contribution ($25,000 × .03)	750
Total contributions	**$2,000**

Lower percentage. If you choose a matching contribution less than 3%, the percentage must be at least 1%. You must notify the employees of the lower match within a reasonable period of time before the 60-day election period (discussed earlier) for the calendar year. You cannot choose a percentage less than 3% for more than 2 years during the 5-year period that ends with (and includes) the year for which the choice is effective.

Nonelective contributions. Instead of matching contributions, you can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation (or some lower amount of compensation that you select) from you for the year. If you make this choice, you must make nonelective contributions whether or not the employee chooses to make salary reduction contributions. Only $200,000 of the employee's compensation can be taken into account to figure the contribution limit.

If you choose this 2% contribution formula, you must notify the employees within a reasonable period of time before the 60-day election period (discussed earlier) for the calendar year.

Example 1. In 2003, your employee, Jane Wood, earned $36,000 and chose to have you contribute 10% of her salary. You make a 2% nonelective contribution. Both of you are under age 50. The total contributions you can make for her are $4,320, figured as follows.

Salary reduction contributions ($36,000 × .10)	$3,600
2% nonelective contributions ($36,000 × .02)	720
Total contributions	**$4,320**

Example 2. Using the same facts as in *Example 1,* above, the maximum contribution you can make for Jane if she earned $75,000 is $9,500, figured as follows.

Salary reduction contributions (maximum amount)	$8,000
2% nonelective contributions ($75,000 × .02)	1,500
Total contributions	**$9,500**

Time limits for contributing funds. You must make the salary reduction contributions to the SIMPLE IRA within 30 days after the end of the month in which the amounts would otherwise have been payable to the employee in cash. You must make matching contributions or nonelective contributions by the due date (including extensions) for filing your federal income tax return for the year.

When To Deduct Contributions

You can deduct SIMPLE IRA contributions in the tax year with or within which the calendar year for which contributions were made ends. You can deduct contributions for a particular tax year if they are made for that tax year and are made by the due date (including extensions) of your federal income tax return for that year.

Example 1. Your tax year is the fiscal year ending June 30. Contributions under a SIMPLE IRA plan for the calendar year 2003 (including contributions made in 2003 before July 1, 2003) are deductible in the tax year ending June 30, 2004.

Example 2. You are a sole proprietor whose tax year is the calendar year. Contributions under a SIMPLE IRA plan for the calendar year 2003 (including contributions made in 2004 by April 15, 2004) are deductible in the 2003 tax year.

Where To Deduct Contributions

Deduct contributions you make for your common-law employees on your tax return. For example, sole proprietors deduct them on Schedule C (Form 1040) or Schedule F (Form 1040), partnerships deduct them on Form 1065, and corporations deduct them on Form 1120, Form 1120–A, or Form 1120S.

Sole proprietors and partners deduct contributions for themselves on line 30 of Form 1040. (If you are a partner, contributions for yourself are shown on the Schedule K-1 (Form 1065) you receive from the partnership).

Tax Treatment of Contributions

You can deduct your contributions and your employees can exclude these contributions from their gross income. SIMPLE IRA contributions are not subject to federal income tax withholding. However, salary reduction contributions are subject to social security, Medicare, and federal unemployment (FUTA) taxes. Matching and nonelective contributions are not subject to these taxes.

Reporting on Form W–2. Do not include SIMPLE IRA contributions in the "Wages, tips, other compensation" box of Form W–2. However, salary reduction contributions must be included in the boxes for social security wages and Medicare wages. Also include the proper code in Box 12. For more information, see the instructions for Forms W–2 and W–3.

Distributions (Withdrawals)

Distributions from a SIMPLE IRA are subject to IRA rules and generally are includible in income for the year received. Tax-free rollovers can be made from one SIMPLE IRA into another SIMPLE IRA. A rollover from a SIMPLE IRA to a non-SIMPLE IRA can be made tax free only after a 2-year participation in the SIMPLE IRA plan.

Early withdrawals generally are subject to a 10% additional tax. However, the additional tax is increased to 25% if funds are withdrawn within 2 years of beginning participation.

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

More Information on SIMPLE IRA Plans

If you need more help to set up and maintain a SIMPLE IRA plan, see the following IRS notice and revenue procedure.

Notice 98–4. This notice contains questions and answers about the implementation and operation of SIMPLE IRA plans, including the election and notice requirements for these plans. Notice 98–4 is in Cumulative Bulletin 1998–1.

Revenue Procedure 97–29. This revenue procedure provides guidance to drafters of prototype SIMPLE IRAs on obtaining opinion letters. Revenue Procedure 97–29 is in Cumulative Bulletin 1997–1.

Qualified Plan

A qualified retirement plan is a written plan you can set up for the exclusive benefit of your employees and their beneficiaries. It is sometimes called a Keogh or H.R. 10 plan.

You, or you and your employees, can make contributions to the plan. If your plan meets the qualification requirements, you generally can deduct your contributions to the plan. For more information, see Publication 560.

Your employees generally are not taxed on your contributions or increases in the plan's as-

sets until they are distributed. However, certain loans made from qualified plans are treated as taxable distributions. For more information, see Publication 575.

Qualification requirements. To be a qualified plan, the plan must meet many requirements. They include requirements that determine the following.

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

For more information, see 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 may not be allowed to deduct part or all of your IRA contributions. 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 Plan

This plan provides 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 two types of defined contribution plans: profit-sharing and money purchase pension.

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

Money purchase pension plan. Under this plan, contributions are fixed and are not based on your business profits. For example, if the plan requires contributions of 10% of each participating employee's compensation, regardless of whether you have a profit, the plan is a money purchase pension plan.

Defined Benefit Plan

This is any plan that is not a defined contribution plan. In general, contributions to a qualified defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Your contributions to the plan are based on actuarial assumptions. Generally, you will need continuing professional help to administer a defined benefit plan.

Setting Up a Plan

You must adopt a written plan. The plan can be an IRS-approved master or prototype plan offered by a sponsoring organization. Or it can be an individually designed plan.

Master or prototype plans. The following sponsoring organizations generally can provide IRS-approved master or prototype plans.

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

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

Individually designed plan. If you prefer, you can set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, you can apply for approval by paying a fee and requesting a determination letter. You may need professional help with this. Revenue Procedure 2003-6 in Internal Revenue Bulletin 2003-1 may help you decide whether to apply for approval.

Deduction Limits

The deduction limit for contributions to a qualified plan depends on the kind of plan you have.

In figuring the deduction for contributions to these plans, you cannot take into account any contributions or benefits that are more than the limits discussed under Limits on Contributions and Benefits *in Publication 560. However, your deduction can be as much as the plan's unfunded current liability.*

Defined contribution plans. The deduction for contributions to a defined contribution plan (profit sharing plan or money purchase pension plan) cannot be more than 25% of the compensation paid (or accrued) during the year to the eligible employees participating in the plan. You must reduce this limit in figuring the deduction for contributions you make for your own account. See *Deduction of contributions for yourself,* later.

When figuring the deduction limit, the following rules apply.

- Elective deferrals (discussed in Publication 560) are not subject to the limit.
- Compensation includes elective deferrals.
- The maximum compensation that can be taken into account for each employee is $200,000.

Defined benefit plans. An actuary must figure the deduction for contributions to a defined benefit plan because it is based on actuarial assumptions and computations.

Deduction of contributions for yourself. To take a deduction for contributions you make to a plan for yourself, you must have net earnings from the trade or business for which the plan was set up.

Limit on deduction. If the qualified plan is a profit-sharing plan, your deduction for yourself is limited to the lesser of $40,000 or 20% (25% reduced as discussed later) 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. Your net earnings do not include items excluded from 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 the allowable business deductions from that business. Allowable business deductions include contributions to SEP and qualified plans for common-law employees and the deduction for one-half of your self-employment tax.

Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items such as capital gains and losses) and any guaranteed payments. If you are a limited partner, net earnings include only guaranteed payments for services rendered to or for the partnership. For more information, see *Partnership Income or Loss* under *Figuring Earnings Subject to 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 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 make the adjustment 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 $200,000 of your compensation in figuring your contribution to a defined contribution plan.

Worksheet 3–B. **Deduction Worksheet for Self-Employed**

Step 1
Enter your 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) . . . . . _____
*General partners should reduce this amount by the same additional expenses subtracted from line 15a to determine the amount on line 1 or 2 of Schedule SE

Step 2
Enter your deduction for self-employment tax from line 28, Form 1040 . . . . . _____

Step 3
Net earnings from self-employment. Subtract step 2 from step 1 . . . . . _____

Step 4
Enter your rate from the *Worksheet 3–A* . . . . . _____

Step 5
Multiply step 3 by step 4 . . . . . _____

Step 6
Multiply $200,000 by your plan contribution rate (not the reduced rate) . . . . . _____

Step 7
Enter the **smaller** of step 5 or step 6 . . . . . _____

Step 8
Contribution dollar limit $40,000
- **If you made any elective deferrals, go to step 9.**
- **Otherwise, skip steps 9 through 18 and enter the smaller of step 7 or step 8 on step 19.**

Step 9
Enter your allowable elective deferrals made during 2003. Do not enter more than $12,000 . . . . . _____

Step 10
Subtract step 9 from step 8 . . . . . _____

Step 11
Subtract step 9 from step 3 . . . . . _____

Step 12
Enter one-half of step 11 . . . . . _____

Step 13
Enter the **smallest** of step 7, 10, or 12 . . . . . _____

Step 14
Subtract step 13 from step 3 . . . . . _____

Step 15
Enter the **smaller** of step 9 or step 14 . . . . . _____
- **If you made catch-up contributions, go to step 16.**
- **Otherwise, skip steps 16 through 18 and go to step 19.**

Step 16
Subtract step 15 from step 14 . . . . . _____

Step 17
Enter your catch-up contributions, if any. Do not enter more than $2,000 . . . . . _____

Step 18
Enter the **smaller** of step 16 or step 17 . . . . . _____

Step 19
Add steps 13, 15, and 18. This is your ***maximum deductible contribution*** . . . . _____
Next: Enter your deduction on line 30, Form 1040.

Figuring Your Deduction

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

Worksheet 3–A. **Rate Worksheet for Self-Employed**

1) Plan contribution rate as a decimal (for example, 10½% = .105) . . . . . _____
2) Rate in line 1 plus 1 (for example, .105 + 1 = 1.105) . . . . . _____
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2) . . . . . _____

After you have figured your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing *Worksheet 3–B*.

An *Example* of how to complete the worksheets follows.

Example

You are a sole proprietor with no employees. The terms of your plan provide that you contribute 8½% (.085) of your compensation (defined earlier) to your plan. Your net profit from line 31, Schedule C (Form 1040) is $200,000. You have no elective deferrals or catch-up contributions. Your self-employment tax deduction on line 28 of Form 1040 is $8,072. You figure your self-employed rate and maximum deduction for employer contributions you made for yourself as shown in illustrated *Worksheet 3–A* and *Worksheet 3–B*.

Worksheet 3–A. **Rate Worksheet for Self-Employed — Illustrated**

1) Plan contribution rate as a decimal (for example, 10½% = .105) 0.085
2) Rate in line 1 plus 1 (for example, .105 + 1 = 1.105) 1.085
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2) 0.078

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 (generally April 15 for calendar year taxpayers), plus extensions, of your tax return for that year.

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

Individual Retirement Arrangement (IRA)

An individual retirement arrangement (IRA) is a personal savings plan that allows you to set aside money for your retirement. You may be able to deduct your contributions, depending on the type of IRA and your circumstances. Generally, amounts in an IRA, including earnings and gains, are not taxed until they are distributed. In certain cases, your earnings and gains may not be taxed at all if they are distributed according to the rules. For more information on IRAs, see Publication 590.

Worksheet 3–B. **Deduction Worksheet for Self-Employed — Illustrated**

Step 1	
Enter your 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
*General partners should reduce this amount by the same additional expenses subtracted from line 15a to determine the amount on line 1 or 2 of Schedule SE	
Step 2	
Enter your deduction for self-employment tax from line 28, Form 1040	8,072
Step 3	
Net earnings from self-employment. Subtract step 2 from step 1	191,928
Step 4	
Enter your rate from *Worksheet 3–A*	0.078
Step 5	
Multiply step 3 by step 4	14,970
Step 6	
Multiply $200,000 by your plan contribution rate (not the reduced rate)	17,000
Step 7	
Enter the **smaller** of step 5 or step 6	14,970
Step 8	
Contribution dollar limit	$40,000
• **If you made any elective deferrals, go to step 9.**	
• **Otherwise, skip steps 9 through 18 and enter the smaller of step 7 or step 8 on step 19.**	
Step 9	
Enter your allowable elective deferrals made during 2003. Do not enter more than $12,000	
Step 10	
Subtract step 9 from step 8	
Step 11	
Subtract step 9 from step 3	
Step 12	
Enter one-half of step 11	
Step 13	
Enter the **smallest** of step 7, 10, or 12	
Step 14	
Subtract step 13 from step 3	
Step 15	
Enter the **smaller** of step 9 or step 14	
• **If you made catch-up contributions, go to step 16.**	
• **Otherwise, skip steps 16 through 18 and go to step 19.**	
Step 16	
Subtract step 15 from step 14	
Step 17	
Enter your catch-up contributions, if any. Do not enter more than $2,000	
Step 18	
Enter the **smaller** of step 16 or step 17	
Step 19	
Add steps 13, 15, and 18. This is your ***maximum deductible contribution***	$14,970
Next: Enter your deduction on line 30, Form 1040.	

.

4.

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. There is a discussion about capitalizing (including in the cost of property) certain rent expenses at the end of the chapter.

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

See chapter 14 for information about getting publications and forms.

Rent

Rent is any amount you pay for the use of property you do not own. In general, you can deduct rent as an expense only if the rent is for property 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 unreasonable rent. Ordinarily, the issue of reasonableness arises only if you and the lessor are related. Rent paid to a related person is reasonable if it is the same amount you would pay to a stranger for use of the same property. Rent is not unreasonable just because it is figured as a percentage of gross sales. For examples of related persons, see *Related Persons* in chapter 12.

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

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

Example 1. You leased a building for 5 years beginning July 1. Your rent is $12,000 per year. You paid the first year's rent ($12,000) on June 30. You can deduct only $6,000 ($^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 ($3 \times$ $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.

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

Lease or purchase. There may be instances in which you must determine whether your payments are for rent or for the purchase of the property. You must first determine whether your agreement is a lease or a conditional sales contract. Payments made under a conditional sales contract are not deductible as rent expense.

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

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after you make a stated amount of required payments.

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

Leveraged leases. Leveraged lease transactions may not be considered leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually the lease term covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender.

If you plan to take part in what appears to be a leveraged lease, you may want to get an advance ruling. Revenue Procedure 2001–28 in Internal Revenue Bulletin 2001–19 contains the guidelines the IRS will use to determine if a leveraged lease is a lease for federal income tax purposes. Revenue Procedure 2001–29 in the same Internal Revenue Bulletin provides the information required to be furnished in a request for an advance ruling on a leveraged lease transaction.

In general, Revenue Procedure 2001–28 provides that, for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction to be a valid lease if all the factors in the revenue procedure are met, including the following.

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

The IRS may charge you a user fee for issuing a tax ruling. For more information, see Revenue Procedure 2004–1, in Internal Revenue Bulletin No. 2004–1, or Publication 1375, which is a reprint of Revenue Procedure 2004–1.

Leveraged leases of limited-use property. The IRS will not issue advance rulings on leveraged leases of so-called limited-use property. Limited-use property is property not expected to be either useful to or usable by a lessor at the end of the lease term except for continued leasing or transfer to a lessee. See Revenue Procedure 2001–28 for examples of limited-use property and property that is not limited-use property.

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

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

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

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

Taxes on Leased Property

If you lease business property, you can deduct as additional rent any taxes 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 all the following.

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

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

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

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

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

Cost of Getting a Lease

You may either enter into a new lease with the lessor of the property or get an existing lease from another lessee. Very often when you get an existing lease from another lessee, you must pay the previous lessee money to get the lease, besides having to pay the rent on the lease.

If you get an existing lease on property or equipment for your business, you generally 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 an existing lease of tangible property is not subject to the amortization rules for section 197 intangibles discussed in chapter 9.

Option to renew. The term of the lease for amortization includes all renewal options plus any other period for which you and the lessor reasonably expect the lease to be renewed. However, this applies only if less than 75% of the cost of getting the lease is for the term remaining on the purchase date (not including any period for which you 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. In some cases, it may be appropriate to make the allocation using a present value computation. For more information, see section 1.178–1(b)(5) of the 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 $10,000 cost of the lease (or $7,500), 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. The facts are the same as in *Example 1*, except that you paid $8,000 for the original lease and $2,000 for the renewal options. 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 (or $7,500).

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 (12 × $50) that you will pay during each of the first 5 years as rent.

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

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

Improvements by Lessee

If you add buildings or make other permanent improvements to leased property, depreciate the cost of the improvements using the modified accelerated cost recovery system (MACRS). Depreciate the property over its appropriate 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 in the improvements at that time.

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

Assignment of a lease. If a long-term lessee who makes permanent improvements to land later assigns all lease rights to you for money 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 over the recovery period of the property as discussed earlier, without regard to the lease term.

Capitalizing Rent Expenses

Under the uniform capitalization rules, you have to capitalize the direct costs and part of the indirect costs for production or resale activities.

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

Generally, you are subject to the uniform capitalization rules if you do any of the following in the course of a trade or business or an activity carried on for profit.

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

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.

5. Interest

Introduction

This chapter discusses the tax treatment of business interest expense. Business interest expense is an amount charged for the use of money you borrowed for business activities.

Topics

This chapter discusses:

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

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 (Form 1040)** 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 14 for information about getting publications and forms.

Allocation of Interest

The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, investment, or passive activities. If you use the proceeds of a loan for more

than one type of expense, you must make an allocation to determine the interest for each use of the loan's proceeds.

Allocate your interest expense to the following categories.

- Trade or business interest
- Passive activity interest
- Investment interest
- Portfolio interest
- Personal interest

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

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

Secured loan. The allocation of loan proceeds and the related interest is not generally 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.

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

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

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

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

Proceeds deposited in borrower's account. Treat loan proceeds deposited in an account as property held for investment. It does not matter whether the account pays interest. 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 from January 4 through March 31. From April 1 through August 31, Connie must treat $20,000 of the loan as used in the passive activity and $80,000 of the loan as property held for investment. From September 1 through December 31, she must treat $40,000 of the loan as used for personal purposes, $20,000 as used in the passive activity, and $40,000 as property held for investment.

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

- Any unborrowed amounts held in the same account.
- Any amounts deposited after these 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. She treats the $600 used for personal purposes as made from the remaining $200 proceeds of Loan C and $400 of unborrowed funds.

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

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

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

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

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

Example. Frank gets a loan of $1,000 on August 4 and receives the proceeds in cash. Frank deposits $1,500 in an account on August 18 and on August 28 writes a check on the account for a passive activity expense. Also, Frank deposits his paycheck, deposits other loan proceeds, and pays his bills during the same period. Regardless of these other transactions, Frank can treat $1,000 of the deposit he made on August 18 as being paid on August 4 from the loan proceeds. In addition, Frank can treat the passive activity expense he paid on August 28 as made from the $1,000 loan proceeds treated as deposited in the account.

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

- The first day of that month.
- The date the loan proceeds are deposited in the account.

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

Interest on a 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. You borrowed $20,000 and used the proceeds of this loan to open a new savings account. When the account had earned interest of $867, you withdrew $20,000 for personal purposes. You can treat the withdrawal as coming first from the interest earned on the account, $867, and then from the loan proceeds, $19,133 ($20,000 – $867). All the interest charged on the loan from the time it was deposited in the account until the time of the withdrawal is investment interest expense. The interest charged on the part of the proceeds used for personal purposes ($19,133) from the time you withdrew it until you either repay it or reallocate it to another use is personal interest expense. The interest charged on the loan proceeds you left in the

account ($867) continues to be investment interest expense until you either repay it or reallocate it to another use.

Loan repayment. When you repay any part of a loan allocated to more than one use, treat it as being repaid in the following order.

1) Personal use.
2) Investments and passive activities (other than those included in (3)).
3) Passive activities in connection with a rental real estate activity in which you actively participate.
4) Former passive activities.
5) Trade or business use and expenses for certain low-income housing projects.

Line of credit (continuous borrowings). The following rules apply if you have a line of credit or similar arrangement.

1) Treat all borrowed funds on which interest accrues at the same fixed or variable rate as a single loan.
2) Treat borrowed funds or parts of borrowed funds on which interest accrues at different fixed or variable rates as different loans. Treat these loans as repaid in the order shown on the loan agreement.

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

Partnerships and S Corporations

The following rules apply to the allocation of interest expense in connection with debt-financed acquisitions of interests in partnerships and S corporations. These rules also apply to the allocation of interest expense in connection with debt-financed distributions from partnerships and S corporations.

CAUTION *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 acquisition. A debt-financed acquisition is the use of loan proceeds to buy an interest in, or to make a contribution to the capital of, a partnership or S corporation.

You must allocate the loan proceeds and the related interest expense among all the assets of the entity. You can use any reasonable method. If you buy an interest in a partnership or S corporation (other than by way of a contribution to capital), 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 a partnership or S corporation, 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 a partnership or S corporation as a contribution to capital to the extent the entity receives any proceeds of the purchase.

Example. You buy 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, you allocate $16,000 of the loan proceeds ($60,000/$75,000 × $20,000) and the interest expense on that part to trade or business use. You allocate the remaining $4,000 ($15,000/$75,000 × $20,000) and the interest on that part 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 share of deductible partnership or S corporation interest expense on either 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 partnership or S corporation in column (a) and the amount in column (h).

For interest allocated to passive activity use, enter the interest on **Form 8582** as a deduction from the passive activity of the partnership or S corporation. 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 (f).

For interest allocated to 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 partnership or S corporation in column (a) and the amount in column (h). Carry the balance of the deductible amount to line 13, Schedule A (Form 1040).

Any interest allocated to proceeds used for personal purposes is generally not deductible.

Debt-financed distribution. A debt-financed distribution occurs when a partnership or S corporation borrows funds and allocates those funds to distributions made to partners or shareholders. The distributed loan proceeds and related interest expense must be reported to the partners or 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.

This treatment of debt-financed distributions follows the general allocation rules discussed earlier. For example, if a shareholder uses distributed loan proceeds to invest in a passive activity, that shareholder's portion of the S corporation's interest expense on the loan proceeds is allocated to a passive activity use.

Optional allocation method. The partnership or S corporation 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 difference between the other expenditures and 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 allocation 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 allocation 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 takes 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 in Cumulative Bulletin 1988–1. Also see Notice 89–35 in Cumulative Bulletin 1989–1.

Interest You Can Deduct

You can generally deduct as a business expense 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 the following requirements.

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

Partial liability. If you are liable for part of a business debt, you can deduct only your share of the total interest paid or accrued.

Example. You and your brother borrow money. You are liable for 50% of the note. You use your half of the loan in your business, and you make one-half of the loan payments. You can deduct your half of the total interest payments as a business deduction.

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

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. If the property mortgaged is business or income-producing property, you can amortize the costs over the life of the mortgage.

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.

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

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

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

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

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

If the OID is de minimis, you can choose one of the following ways to figure the amount you can deduct each year.

- On a constant-yield basis over the term of the loan.
- On a straight-line basis over the term of the loan.
- In proportion to stated interest payments.
- In its entirety at maturity of the loan.

You make this choice by deducting the OID in a manner consistent with the method chosen on your timely filed tax return for the tax year in which the loan is issued.

Example. On January 1, 2003, you took out a $100,000 discounted loan and received $98,500 in proceeds. The loan will mature on January 1, 2013 (a 10-year term), and the $100,000 principal is payable on that date. Interest of $10,000 is payable on January 1 of each year, beginning January 1, 2004. The $1,500 OID on the loan is de minimis because it is less than $2,500 ($100,000 × .0025 × 10). You choose to deduct the OID on a straight-line basis over the term of the loan. Beginning in 2003, you can deduct $150 each year for 10 years.

Constant-yield method. If the OID is not de minimis, you must use the constant-yield method to figure how much you can deduct each year. You figure your deduction for the first year using the following steps.

1) Determine the ***issue price*** of the loan. Generally, this equals the proceeds of the loan. If you paid points on the loan (as discussed later), the issue price generally is the difference between the proceeds and the points.
2) Multiply the result in (1) by the yield to maturity.
3) Subtract any qualified stated interest payments from the result in (2). This is the OID you can deduct in the first year.

To figure your deduction in any subsequent year, follow the above steps, except determine the ***adjusted issue price*** in step (1). To get the adjusted issue price, add to the issue price any OID previously deducted. Then follow steps (2) and (3) above.

The ***yield to maturity*** is generally shown in the literature you receive from your lender. If you do not have this information, consult your lender or tax advisor. In general, the yield to maturity is the discount rate that, when used in computing the present value of all principal and interest payments, produces an amount equal to the principal amount of the loan.

Example. The facts are the same as in the previous example, except that you deduct the OID on a constant yield basis over the term of the loan. The yield to maturity on your loan is 10.2467%, compounded annually. For 2003, you can deduct $93 [($98,500 × .102467) – $10,000]. For 2004, you can deduct $103 [($98,593 × .102467) – $10,000].

Loan or mortgage ends. If your loan or mortgage ends, you may be able to deduct any remaining OID in the tax year in which the loan or mortgage ends. A loan or mortgage may end due to a refinancing, prepayment, foreclosure, or similar event.

CAUTION *If you refinance with the original lender, you generally cannot deduct the remaining OID in the year in which the refinancing occurs, but you may be able to deduct it over the term of the new mortgage or loan. See* Interest paid with funds borrowed from original lender *under* Interest You Cannot Deduct, *later.*

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.

Because points are prepaid interest, you cannot deduct the full amount in the year paid. (For an exception for points paid on your home mortgage, see Publication 936.) Instead, the points reduce the issue price of the loan and result in original issue discount, deductible as explained in the preceding discussion.

Partial payments on a nontax debt. If you make partial payments on a debt (other than a debt owed the IRS), the payments are applied, in general, first to interest and any remainder to principal. You can deduct only the interest. This rule does not apply when it can be inferred that the borrower and lender understood that a different allocation of the payments would be made.

Installment purchase. If you make an installment purchase of business property, the contract between you and the seller generally provides for the payment of interest. If no interest or a low rate of interest is charged under the contract, a portion of the stated principal amount payable under the contract may be recharacterized as interest (unstated interest). The amount recharacterized as 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

Certain 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.

You cannot currently deduct interest that must be capitalized, and you generally cannot deduct personal interest.

Interest paid with funds borrowed from original lender. If you use the cash method of accounting, you cannot deduct interest you pay with funds borrowed 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 a payment on the new loan, you first apply the payment to interest and then to the principal. 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. You cannot currently deduct interest you are required to capitalize under the uniform capitalization rules. See *Capitalization of Interest,* later. In addition, 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 this interest to the basis of the property.

Commitment fees or standby charges. Fees you incur to have business funds available on a standby basis, but not for the actual use of the funds, are not deductible as interest payments. 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 generally must capitalize them under the uniform capitalization rules. See *Capitalization of Interest,* later.

Interest on income tax. Interest charged on income tax assessed on your individual income tax return is not a business deduction even though the tax due is related to income from your trade or business. Treat this interest as a business deduction only in figuring a net operating loss deduction.

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

Interest on loans with respect to life insurance policies. You generally cannot deduct interest on a debt incurred with respect to any life insurance, annuity, or endowment contract 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 on up to $50,000 of debt for that person. However, the deduction for any month cannot be more than the interest figured using Moody's Corporate Bond Yield Average-Monthly Average Corporates (Moody's rate) for that month.

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

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

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

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

Capitalization of Interest

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

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

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

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

Carrying charges. Carrying charges include taxes you pay to carry or develop real estate or to carry, transport, or install personal property. You can choose to capitalize carrying charges not subject to the uniform capitalization rules if they are otherwise deductible. For more information, see chapter 8.

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

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

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

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

When To Deduct Interest

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

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

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

Discounted loan. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you cannot deduct it when you get the loan. For more information, see *Original issue discount (OID)* under *Interest You Can Deduct,* earlier.

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

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

Prepaid interest. You generally cannot deduct any interest paid before it is due. Instead, deduct it in the year in which it is due.

Discounted loan. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you cannot deduct it when you get the loan. For more information, see *Original issue discount (OID)* under *Interest You Can Deduct,* earlier.

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

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 person. If you use an accrual method, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. 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.

Below-Market Loans

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

A ***below-market loan*** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A gift or demand loan that is a below-market loan generally is considered an arm's-length

transaction in which you, the borrower, are considered as having received both the following.

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

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

For any period, ***forgone interest*** is:

1) The interest that would be payable for that period if interest accrued on the loan 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. Internal Revenue Bulletins are available on the IRS web site at **www.irs.gov**. *You can also contact an IRS office to get these rates.*

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

1) Gift loans (below-market loans where the forgone interest is in the nature of a gift).
2) Compensation-related loans (below-market loans between an employer and an employee or between an independent contractor and a person for whom the contractor provides services).
3) Corporation-shareholder loans.
4) Tax avoidance loans (below-market loans where the avoidance of federal tax is one of the main purposes of the interest arrangement).
5) Loans to qualified continuing care facilities under a continuing care contract (made after October 11, 1985).

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

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

Limit on forgone interest for gift loans of $100,000 or less. For gift loans between individuals, forgone interest treated as transferred back to the lender is limited to the borrower's net investment income for the year. This limit applies if the outstanding loans between the lender and borrower total $100,000 or less. If the 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 any federal tax is one of the main purposes of the interest arrangement.

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

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

1) Gift loans between individuals if the loan is not directly used to buy or carry income-producing assets.
2) Compensation-related loans or corporation-shareholder loans if the avoidance of any federal tax is not a principal purpose of the interest arrangement.

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

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

1) Loans made available by lenders to the general public on the same terms and conditions that 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.
5) Any other loan if the taxpayer can show that the interest arrangement has no significant effect on the federal tax liability of the lender or the borrower. Whether an interest arrangement has a significant effect on the federal tax liability of the lender or the borrower will be determined by all the facts and circumstances. Consider all the following factors.
   a) Whether items of income and deduction generated by the loan offset each other.
   b) The amount of the items.
   c) The cost of complying with the below-market loan provisions if they were to apply.
   d) Any reasons, other than taxes, for structuring the transaction as a below-market loan.

Exception for certain loans to a qualified continuing care facility. The below-market interest rules do not apply to a loan made to a qualified continuing care facility under a continuing care contract if the lender (or lender's spouse) is age 65 or older by the end of the calendar year. For 2003, this exception applies only to the part of the total outstanding loans from the lender (or lender's spouse) that does not exceed $151,000.

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

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

1) The individual and/or the individual's spouse must be entitled to use the facility for the rest of their life or lives.
2) The residential use must begin in a 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 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.

Sale or exchange of property. Different rules generally apply to a loan connected with the sale or exchange of property. If the loan does not provide adequate stated interest, part of the principal payment may be considered interest. However, there are exceptions that may require you to apply the below-market interest rate rules to these loans. See *Unstated Interest and Original Issue Discount (OID)* in Publication 537.

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

6.

Taxes

Introduction

You can deduct various federal, state, local, and foreign taxes directly attributable to your trade or business as business expenses.

CAUTION *You cannot deduct federal income taxes, estate and gift taxes, or state inheritance, legacy, and succession taxes.*

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ❑ **15** Circular E, Employer's Tax Guide
- ❑ **378** Fuel Tax Credits and Refunds
- ❑ **533** Self-Employment Tax
- ❑ **538** Accounting Periods and Methods
- ❑ **551** Basis of Assets

Form (and Instructions)

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

See chapter 14 for information about getting publications and forms.

When To Deduct Taxes

Generally, you can only deduct taxes in the year you pay them. This applies whether you use the cash method or an accrual method of accounting.

Under 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 a date for accruing taxes that is earlier than the date it originally required. However, if you use an accrual method, and can deduct the tax before you pay it, use the original accrual date for the year of change and all future years to determine when you can deduct the tax.

Example. Your state imposes a tax on personal property used in a trade or business conducted in the state. This tax is assessed and becomes a lien as of July 1 (accrual date). In 2003, the state changed the assessment and lien dates from July 1, 2004, to December 31, 2003, for property tax year 2004. Use the original accrual date (July 1, 2004) to determine when you can deduct the tax. You must also use the July 1 accrual date for all future years to determine when you can deduct the tax.

Uniform capitalization rules. Uniform capitalization rules apply to certain taxpayers who produce real property or tangible personal property for use in a trade or business or for sale to customers. They also apply to taxpayers who acquire property for resale. Under these rules, you either include certain costs in inventory or capitalize certain expenses related to the property, such as taxes. For more information, see 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 8.

Refunds of taxes. If you receive a refund for any taxes you deducted in an earlier year, include the refund in income to the extent the deduction reduced your federal income tax in the earlier year. For more information, see *Recovery of amount deducted* in chapter 1.

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

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real estate levied for the general public welfare. The taxing authority must base the taxes on the assessed value of the real estate and charge them uniformly against 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, 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 *Choosing 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 must be able to show how much of the tax is for these expenses to claim a deduction for that part of the tax.

Example. X City, 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 used 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, 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. 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 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 up to (but not including) 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 for the current real property tax year, which is the calendar year. He sold the property on June 30, 2003. 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 2003.

Choosing to ratably accrue. If you use an accrual method, you can choose to accrue real estate tax 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, 2003, to June 30, 2004, are $1,200. July 1 is the assessment and lien date.

If John chooses to ratably accrue the taxes, $600 will accrue in 2003 ($1,200 × 6/12, July 1–December 31) and the balance will accrue in 2004.

Separate choices. You can choose to ratably accrue the taxes 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. See *Changing,* later.

Making the choice. If you choose to ratably accrue the taxes for the first year in which you incur real estate taxes, attach a statement to your income tax return for that year. The statement should show all the following items.

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

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

If you choose to ratably accrue for a year after the first year in which you incur real estate taxes, file **Form 3115.** Generally, you must file this form during the tax year for which the choice is to be effective. For more information, see the instructions for Form 3115.

Changing. To change your choice to ratably accrue real estate taxes, file Form 3115 during the tax year for which the change is requested.

Income Taxes

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

Federal income taxes. You cannot deduct federal income taxes.

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

However, an individual can deduct a state tax on gross income (as distinguished from net income) directly attributable to a trade or business as a business expense.

Accrual of contested income taxes. If you use an accrual method, can deduct taxes before you pay them, and contest a state or local income tax liability, a special rule applies. Under this special rule, you must accrue and deduct any contested amount 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 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.* For information on the foreign tax credit, see Publication 514, *Foreign Tax Credit for Individuals.*

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 employment taxes from your own funds. These include your share of social security and Medicare taxes as an employer, 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 employment 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.

Unemployment fund taxes. As an employer, you may have to make payments to a state unemployment compensation fund or to a state disability benefit fund. Deduct these payments as taxes.

Other Taxes

The following are other taxes you can deduct if you incur them in the ordinary course of your trade or business.

Excise taxes. You can deduct as a business expense all excise taxes that are ordinary and necessary expenses of carrying on your trade or business. However, see *Fuel taxes,* later.

Franchise taxes. You can deduct corporate franchise taxes as a business expense.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that you use in your 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.

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 deduction only affects your income tax. It does not affect your net earnings from self-employment or your self-employment tax.

To deduct the tax, enter on Form 1040, line 28, the amount shown on the *Deduction for one-half of self-employment tax* line of Schedule SE (Form 1040).

For more information on self-employment tax, see Publication 533.

7.

Insurance

Important Change for 2003

Self-employed health insurance deduction. Beginning in 2003, the self-employed health insurance deduction percentage increases to 100%. See *Self-Employed Health Insurance Deduction.*

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 *Capitalized Premiums,* later.

Topics

This chapter discusses:

- Deductible premiums
- Nondeductible premiums
- Capitalized premiums
- When to deduct premiums

Useful Items

You may want to see:

Publication

❑ **15–B** Employer's Tax Guide to Fringe Benefits

❑ **525** Taxable and Nontaxable Income

❑ **538** Accounting Periods and Methods

❑ **547** Casualties, Disasters, and Thefts

Form (and Instructions)

❑ **1040** U.S. Individual Income Tax Return

See chapter 14 for information about getting publications and forms.

Deductible Premiums

You generally can deduct premiums you pay for the following kinds of insurance related to your trade or business.

1) Fire, theft, flood, or similar insurance.
2) Credit insurance that covers losses from business bad debts.
3) Group hospitalization and medical insurance for employees, including long-term care insurance.
   a) If a partnership pays accident and health insurance premiums for its partners, it generally can deduct them as guaranteed payments to partners.
   b) If an S corporation pays accident and health insurance premiums for its 2% shareholder-employees, it generally can deduct them, but must also include them in the shareholder's wages subject to federal income tax withholding. See Publication 15–B.
4) Liability insurance.
5) Malpractice insurance that covers your personal liability for professional negligence resulting in injury or damage to patients or clients.
6) Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.
   a) If a partnership pays workers' compensation premiums for its partners, it generally can deduct them as guaranteed payments to partners.
   b) If an S corporation pays workers' compensation premiums for its 2% shareholder-employees, it generally can deduct them, but must also include them in the shareholder's wages.
7) Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.
8) Overhead insurance that pays for business overhead expenses you have during long periods of disability caused by your injury or sickness.
9) Car and other vehicle insurance that covers vehicles used in your business for liability, damages, and other losses. If you operate a vehicle partly for personal use, deduct only the part of the insurance premium that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums.
10) Life insurance covering your officers and employees if you are not directly or indirectly a beneficiary under the contract.
11) Business interruption insurance that pays for lost profits if your business is shut down due to a fire or other cause.

Self-Employed Health Insurance Deduction

You may be able to deduct 100% of the amount paid for medical and dental insurance and qualified long-term care insurance for you, your spouse, and your dependents if you are one of the following.

- A self-employed individual with a net profit reported on Schedule C, C–EZ, or F.
- A partner with net earnings from self-employment reported on line 15a of Schedule K–1 (Form 1065).
- A shareholder owning more than 2% of the outstanding stock of an S corporation with wages from the corporation reported on Form W–2.

The insurance plan must be established under your business. You may be allowed this deduction whether you paid the premiums yourself or your partnership or S corporation paid them and you included the premium amounts in your gross income. Take the deduction on line 29 of Form 1040.

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

1) The amount paid for that person.
2) The amount shown below. (Use the person's age at the end of the year.)
   a) Age 40 or younger–$250
   b) Age 41 to 50–$470
   c) Age 51 to 60–$940
   d) Age 61 to 70–$2,510
   e) Age 71 or older–$3,130

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

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

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

- Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and
- Maintenance or personal care services.

The services must be 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.

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

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

Benefits received. For information on excluding benefits you receive from a long-term

Worksheet 7–A. **Self-Employed Health Insurance Deduction Worksheet** *(Keep for your records.)*

1.	Enter total payments made during the year for health insurance coverage established under your business for you, your spouse, and your dependents. (***Do not include*** payments for any month you were eligible to participate in a health plan subsidized by your or your spouse's employer or any amount you claim on line 4 of Form 8885. Also, do not include payments for qualified long-term care insurance.)	**1.**
2.	For coverage under a qualified long-term care insurance contract, enter for each person covered the ***smaller*** of the following amounts. a) Total payments made for that person during the year. b) The amount shown below. (Use the person's age at the end of the year.) $250—if that person is age 40 or younger $470—if age 41 to 50 $940—if age 51 to 60 $2,510—if age 61 to 70 $3,130—if age 71 or older (***Do not include*** payments for any month you were eligible to participate in a long-term care insurance plan subsidized by your or your spouse's employer.) If more than one person is covered, figure separately the amount to enter for each person. Then enter the total of those amounts	**2.**
3.	Add the total of lines 1 and 2	**3.**
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.)	**4.**
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.)	**5.**
6.	Divide line 4 by line 5	**6.**
7.	Multiply Form 1040, line 28, by the percentage on line 6	**7.**
8.	Subtract line 7 from line 4	**8.**
9.	Enter the amount, if any, from Form 1040, line 30, attributable to the same trade or business in which the insurance plan is established	**9.**
10.	Subtract line 9 from line 8	**10.**
11.	Enter your wages from an S corporation in which you are a more-than-2% shareholder and in which the insurance plan is established	**11.**
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	**12.**
13.	Subtract line 12 from line 10 or 11, whichever applies	**13.**
14.	Compare the amounts on lines 3 and 13 above. Enter the ***smaller*** of the two amounts here and on Form 1040, line 29. (***Do not include*** this amount when figuring a medical expense deduction on Schedule A (Form 1040).)	**14.**

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

care contract from gross income, see Publication 525.

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

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

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

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

- You had more than one source of income subject to self-employment tax.
- You file Form 2555 or Form 2555–EZ (relating to foreign earned income).
- You are using amounts paid for qualified long-term care insurance to figure the deduction.

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

Health coverage tax credit. You may be able to take this credit ***only*** if you were an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, or Pension Benefit Guaranty Corporation pension recipient. Use **Form 8885,** *Health Coverage Tax Credit,* to figure the amount, if any, of your health insurance credit.

More than one health plan and business. If you have more than one health plan during the year and each plan is established under a different business, you must use separate worksheets (*Worksheet 7–A*) to figure each plan's net earnings limit. Include the premium you paid under each plan on line 1 or line 2 of that separate worksheet and your net profit (or wages) from that business on line 4 (or line 11). For a plan that provides long-term care insurance, the total of the amounts entered for each person on line 2 of all worksheets cannot be more than the appropriate limit shown on line 2 for that person.

Nondeductible Premiums

You cannot deduct premiums on the following kinds of insurance.

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

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

3) ***Certain life insurance and annuities.***

   a) For contracts issued ***before June 9, 1997,*** you cannot deduct the premiums on a life insurance policy covering you, an employee, or any person with a financial interest in your business if you are directly or indirectly a beneficiary of the policy. You are included among possible beneficiaries of the policy if the policy owner is obligated to repay a loan from you using the proceeds of the policy. A person has a financial interest in your business if the person is an owner or part owner of the business or has lent money to the business.

   b) For contracts issued ***after June 8, 1997,*** you generally cannot deduct the premiums on any life insurance policy, endowment contract, or annuity contract if you are directly or indirectly a beneficiary. The disallowance applies without regard to whom the policy covers.

c) ***Partners.*** If, as a partner in a partnership, you take out an insurance policy on your own life and name your partners as beneficiaries to induce them to retain their investments in the partnership, you are considered a beneficiary. You cannot deduct the insurance premiums.

4) ***Insurance to secure a loan.*** If you take out a policy on your life or on the life of another person with a financial interest in your business to get or protect a business loan, you cannot deduct the premiums as a business expense. Nor can you deduct the premiums as interest on business loans or as an expense of financing loans. In the event of death, the proceeds of the policy are not taxed as income even if they are used to liquidate the debt.

Capitalized Premiums

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

Indirect costs include premiums for insurance on your plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

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

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

However, these rules do not apply to the following property.

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

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

When To Deduct Premiums

You can usually deduct insurance premiums in the tax year to which they apply.

Cash method. If you use the cash method of accounting, you generally deduct insurance premiums in the tax year you actually paid them, even if you incurred them in an earlier year. However, see *Prepayment,* later.

Accrual method. If you use an accrual method of accounting, you cannot deduct insurance premiums before the tax year in which you incur a liability for them. In addition, you cannot deduct insurance premiums before the tax year in which you actually pay them (unless the exception for recurring items applies). For more information about accrual methods of accounting, see chapter 1. For information about the exception for recurring items, see Publication 538.

Prepayment. You cannot deduct expenses in advance, even if you pay them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

Expenses such as insurance are generally allocable to a period of time. You can deduct insurance expenses for the year to which they are allocable.

Example. In 2003, you signed a 3-year insurance contract. Even though you paid the premiums for 2003, 2004, and 2005 when you signed the contract, you can only deduct the premium for 2003 on your 2003 tax return. You can deduct in 2004 and 2005 the premium allocable to those years.

Dividends received. If you receive dividends from business insurance and you deducted the premiums in prior years, at least part of the dividends generally are income. For more information, see *Recovery of amount deducted* in chapter 1.

8. Costs You Can Deduct or Capitalize

Important Reminder

Qualified environmental cleanup (remediation) costs. The deduction for qualified environmental cleanup (remediation) costs has been extended to include costs you pay or incur before 2004. After December 31, 2003, these costs must be capitalized. For more information see *Environmental Cleanup Costs*, later.

Introduction

This chapter discusses two ways of treating certain costs—deduction or capitalization.

You generally deduct a cost as a current business expense by subtracting it from your income in either the year you incur it or the year you pay it.

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

A partnership, corporation, estate, or trust makes the choice to deduct or capitalize the costs discussed in this chapter except for exploration costs for mineral deposits. 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 discussed in this chapter, other than carrying charges and the costs of removing architectural barriers and retired assets.*

For more information on the alternative minimum tax, see the instructions for one of the following forms.

- *Form 6251,* Alternative Minimum Tax—Individuals.
- *Form 4626,* Alternative Minimum Tax—Corporations.

Topics

This chapter discusses:

- Carrying charges
- Research and experimental costs
- Intangible drilling costs
- Exploration costs
- Development costs
- Circulation costs
- Environmental cleanup costs
- Retired asset removal costs
- Barrier removal costs

Useful Items

You may want to see:

Publication

❑ **544** Sales and Other Dispositions of Assets

Form (and Instructions)

❑ **3468** Investment Credit

❑ **8826** Disabled Access Credit

See chapter 14 for information about getting publications and forms.

Carrying Charges

Carrying charges include the taxes and interest you pay to carry or develop real property or to carry, transport, or install personal property. Certain carrying charges must be capitalized under the uniform capitalization rules. (For information on capitalization of interest, see chapter 5.) 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 1 year. You must decide whether to capitalize carrying charges each year the property remains unimproved and unproductive. For other real property, your choice to capitalize carrying charges remains in effect until construction or development is completed. For personal property, your choice is effective until the date you install or first use it, whichever is 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. However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100–2" on the statement. File the amended return at the same address you filed the original return.

Research and Experimental Costs

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

If you meet certain requirements, you may choose to defer and amortize research and experimental costs. For information on choosing to defer and amortize these costs, see *Research and Experimental Costs* in chapter 9.

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

The costs of obtaining a patent, including attorneys' fees paid or incurred in making and perfecting a patent application, are research and experimental costs. However, costs paid or incurred to obtain ***another's*** patent are not research and experimental costs. For more information on the treatment of costs paid or incurred to obtain another's patent, see *Section 197 Intangibles* in chapter 9.

Product. The term "product" includes any of the following items.

- Formula.
- Invention.
- Patent.
- Pilot model.
- Process.
- Technique.
- Property similar to the items listed above.

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

Costs not included. Research and experimental costs do not include expenses for any of the following activities.

- Advertising or promotions.
- Consumer surveys.
- Efficiency surveys.
- Management studies.
- Quality control testing.
- Research in connection with literary, historical, or similar projects.
- The acquisition of another's patent, model, production, or process.

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

Research credit. If you pay or incur qualified research expenses, you may be able to take the research credit. For more information about the research credit, see the instructions to Form 6765, *Credit for Increasing Research Activities*.

IF you . . .	THEN . . .
choose to deduct research and experimental costs as a current business expense	deduct all research and experimental costs in the first year you pay or incur the costs and all later years.
do not deduct research and experimental costs as a current business expense	if you meet the requirements, amortize them over at least 60 months, starting with the month you first receive an economic benefit from the research. See *Research and Experimental Costs* in chapter 9.

Intangible Drilling Costs

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

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

You can also choose to deduct the cost of drilling exploratory bore holes to determine the location and delineation of offshore hydrocarbon deposits if the shaft is capable of conducting hydrocarbons to the surface on completion. It does not matter whether there is any intent to produce hydrocarbons.

If you do not choose to deduct your IDCs as a current business expense, you can choose to deduct them over the 60-month period beginning with the month they were paid or incurred.

Amounts paid to contractor that must be capitalized. Amounts paid to a contractor must be capitalized if they are either:

- Amounts properly allocable to the cost of depreciable property, or
- Amounts paid only out of production or proceeds from production if these amounts are depletable income to the recipient.

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

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

you filed the original return or within 2 years after the date you paid the tax, whichever is later.

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

Nonproductive well. If you capitalize your IDCs, you have another option if the well is nonproductive. You can deduct the IDCs of the nonproductive well as an ordinary loss. You must indicate and clearly state your choice on your tax return for the 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 as a current business expense all the IDCs paid or incurred for an oil, gas, or geothermal well located outside the United States. However, you can choose to include the costs in the adjusted basis of the well to figure depletion or depreciation. 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 are ordinarily capital expenditures if the costs lead to the development of a mine. You recover these costs through depletion as the mineral is removed from the ground. However, you can choose to deduct domestic exploration costs paid or incurred before the development stage began (except those for oil, gas, and geothermal wells).

How to make the choice. You choose to deduct exploration costs by taking the deduction on your income tax return, or on an amended income tax return, for the first tax year for which you wish to deduct the costs paid or incurred during the tax year. 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 the tax year you make this choice and all later tax years.

Partnerships. Each partner, not the partnership, chooses whether to capitalize or to deduct that partner's share of exploration costs.

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% of costs and amortize them over the 60-month period starting with the month the exploration costs are paid or incurred. A corporation may also elect to capitalize and amortize mining exploration costs over a 10–year period. For more information on this method of amortization, see section 59(e) of the Internal Revenue Code.

The 30% the corporation capitalizes cannot be added to its basis in the property to figure 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 *Section 1250 Property* under *Depreciation Recapture* in chapter 3 of Publication 544.

These rules also apply to the deduction of development costs by 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. 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. Your choice must be clearly indicated on the return. Increase your adjusted basis in the mine by the amount included in income. Generally, you must choose this recapture method by the due date (including extensions) of your return. However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Make the choice on your amended return and write "Filed pursuant to section 301.9100–2" on the form where you are including the income. File the amended return at the same address you filed the original return.

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

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

Generally, if you dispose of the mine before you have fully recaptured the exploration costs you deducted, recapture the balance by treating all or part of your gain as ordinary income.

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

Foreign exploration costs. If you pay or incur exploration costs for a mine or other natural deposit located outside the United States, you cannot deduct all the costs in the current year. You can 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. (Cost depletion is discussed in chapter 10.) 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.

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 for you by a contractor. Also, development costs include depreciation on improvements used in the development of ores or minerals. They do not include costs for the acquisition or improvement of depreciable property.

Instead of deducting development costs in the year paid or incurred, you can choose to treat them as deferred expenses and deduct them ratably as the units of produced ores or minerals benefited by 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. Generally, you must make the choice by the due date of the return (including extensions). However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the choice on your amended return and write "Filed pursuant to section 301.9100–2." File the amended return at the same address you filed the original return.

Foreign development costs. The rules discussed earlier for foreign exploration costs apply to foreign development costs.

Reduced corporate deductions for development costs. The rules discussed earlier for reduced corporate deductions for exploration costs also apply to corporate deductions for development costs.

Circulation Costs

A publisher can deduct as a current business expense the costs of establishing, maintaining, or 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 normally would be capitalized.

This rule does not apply to the following costs that ***must*** be capitalized.

- The purchase of land or depreciable property.
- The acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical, including the purchase of another publisher's list of subscribers.

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

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

How to make the choice. 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.

Environmental Cleanup Costs

Environmental cleanup (remediation) costs are generally capital expenditures. However, you can choose to deduct these costs as a current business expense if certain requirements (discussed later) are met. This special tax treatment is generally available for qualified environmental cleanup costs you pay or incur before January 1, 2004.

Qualified environmental cleanup costs. Qualified environmental cleanup costs are generally costs you pay or incur to abate or control hazardous substances at a qualified contaminated site.

Hazardous substance. Hazardous substances are defined in section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 and certain substances are designated as hazardous in section 102 of the Act. Substances are not hazardous if a removal or remedial action is prohibited under sections 104 and 104(a)(3) of the Act.

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

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

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

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

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

When and how to choose. You choose to deduct environmental cleanup costs by taking the deduction on the income tax return (filed by the due date including extensions) for the taxable year in which the costs are paid or incurred. The costs are deducted differently depending on the type of business entity involved.

Individuals. Deduct the environmental cleanup costs on the "Other Expenses" line of Schedule C, E, or F (Form 1040). If the schedule requires you to separately identify each expense included in "Other Expenses" write "Section 198 Election" on the line next to the environmental cleanup costs.

All other entities. All other taxpayers (including S corporations, partnerships, and trusts) deduct the environmental cleanup costs on the "Other Deductions" line of the appropriate federal income tax return. On a schedule attached to the return that separately identifies each expense included in "Other Deductions" write "Section 198 Election" on the line next to the amount for environmental cleanup costs.

More than one environmental cleanup cost. If, for any taxable year, you pay or incur more than one environmental cleanup cost, you can choose to deduct one or more of such expenditures for that year. You can choose to deduct one expenditure and choose to capitalize another expenditure (whether or not they are of the same type or paid or incurred with respect to the same qualified contaminated site). A choice to deduct an expenditure for one year has no effect on other years. You must make a separate choice for each year in which you intend to deduct qualified environmental cleanup costs.

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

Costs to clean up land. For more information on costs you can deduct for the environmental cleanup of land, see *Environmental cleanup costs* in chapter 13.

More information. For more information about the environmental cleanup cost deduction, see section 198 of the Internal Revenue Code.

Retired Asset Removal Costs

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

Barrier Removal Costs

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

A facility is all or any part of buildings, structures, equipment, roads, walks, parking lots, or similar real or personal property. A public transportation vehicle is a vehicle, such as a bus or railroad car, that provides transportation service to the public (including service for your customers, even if you are not in the business of providing transportation services).

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

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

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

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

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

Qualification standards. You can deduct your costs as a current expense only if the barrier removal meets one or more of the following specific standards for improved access for the disabled or the elderly.

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 that 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 toward the walk, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform or toward the walk, the platform must be at least 3 feet deep and 5 feet wide. A platform must extend at least 1 foot past the opening side of any doorway.

Parking lots.

1) At least one accessible 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 parking space marked for use by persons with disabilities, when 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 wheel or walk behind parked cars.

Ramps.

1) A ramp must not rise more than 1 inch in 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 must extend at least 1 foot past the top and bottom of the ramp. However, this does mean that a handrail extension that is itself a hazard is required.
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 or toward the ramp, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform or toward the ramp, the platform must be at least 3 feet deep and 5 feet wide. A platform must extend at least 1 foot past the opening side of any doorway.
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 rise more than 1 inch in each foot of length. The two surfaces must blend smoothly.

Entrances. A building must have at least one main entrance that 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 of at least 32 inches 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 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 high, measured from 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 mean that a handrail extension that is itself a hazard is required.
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 of the type discussed previously.

Toilet rooms.

1) A toilet room must have enough space for persons in wheelchairs 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 a person in a wheelchair can reach the dial and the headset.
2) A public telephone must be equipped for a person who is hearing impaired and it must be 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 above the finished floor.
2) A door that might prove dangerous if a visually impaired person used 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 hearing impaired persons.
2) A visual warning signal must be accompanied by a simultaneous audible signal for the benefit of visually impaired persons.

Hazards. Hanging signs, ceiling lights, and similar objects and fixtures must be at least 7 feet above 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 at wheelchair-accessible entrances to public transportation vehicles. This symbol is the outline drawing of a person in a wheelchair and is shown in the following illustration.

Rail facilities.

1) A rail facility must have a fare control area with 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 mean that a wheelchair-securing device that is itself a barrier or hazard is required.
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. The steps at the front and rear doors must be at least 12 inches deep.
4) The bus must have clearly legible 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 having priority who wish to use them.
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 that passengers can 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 to protect 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 who have a disability or are elderly 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 that must be used in boarding, handrails and stanchions must be provided in the entrance so that persons who have a disability or are elderly can grasp them from outside the vehicle and use them 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 to protect 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 all three of the following tests.

1) The removed barrier must be a substantial barrier to access or use of a facility or public transportation vehicle by persons who have a disability or are elderly.
2) The removed barrier must have been a barrier for at least one major group of persons who have a disability or are elderly

(such as people who are blind, deaf, or wheelchair users).

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

How to make the 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. 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.

For your choice to be valid, you generally must file your return by its due date, including extensions. However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the choice on your amended return and write "Filed pursuant to section 301.9100–2." File the amended return at the same address you filed the original return. Your choice is irrevocable after the due date, including extensions, of your return.

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

For more information about the disabled access credit, see Form 8826.

9.

Amortization

Introduction

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

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

Topics

This chapter discusses:

- How to deduct amortization
- Amortizing costs of going into business
- Amortizing costs of getting a lease
- Amortizing costs of section 197 intangibles
- Amortizing reforestation costs
- Amortizing costs of pollution control facilities
- Amortizing costs of research and experimentation

Useful Items

You may want to see:

Publication

- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **550** Investment Income and Expenses
- ❑ **946** How To Depreciate Property

Form (and Instructions)

- ❑ **3468** Investment Credit
- ❑ **4562** Depreciation and Amortization
- ❑ **6251** Alternative Minimum Tax—Individuals

See chapter 14 for information about getting publications and forms.

How To Deduct Amortization

The purpose of this section is to explain how you deduct amortization.

Form 4562. You deduct amortization that begins during the current year by completing Part VI of Form 4562 and attaching it to your current year's return.

For a later year, with respect to an item you elect to amortize, you do not report your deduction for amortization on Form 4562 unless you begin to amortize a different amortizable item in that later year. In that case, you must list on the Form 4562 not only the item you are beginning to amortize in the later year, but any items you had previously begun to amortize and are still amortizing. For example, if you began amortizing a lease in 2002, and a second lease in 2003, you would show the second lease on line 42 of Form 4562, and the first on line 43. If you had not added the second lease in 2003, you would follow the instructions in *Other forms to use,* next.

Other forms to use. If you do not have to report amortization on Form 4562 for years after the year the amortization begins, claim amortization directly on the "Other expenses" line of Schedule C or F (Form 1040) or the "Other deductions" line of Form 1065, 1120, 1120-A, or 1120-S. However, if you are amortizing reforestation costs, see *Where to report* under *Reforestation Costs,* later.

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 choose to amortize certain costs for setting up your business over a period of 60 months or more. The cost must qualify as one of the following.

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

Business Start-Up Costs

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit and for the production of income in anticipation of the activity becoming an active trade or business.

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

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

Start-up costs include costs for the following items.

- An analysis or survey of potential markets, products, labor supply, transportation facilities, etc.
- Advertisements for the opening of the business.
- Salaries and wages for employees who are being trained and their instructors.
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers.
- Salaries and fees for executives and consultants, or for similar professional services.

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

Purchasing an active trade or business. Amortizable start-up costs for purchasing an active trade or business include only investigative costs incurred in the course of a general search for or preliminary investigation of the business. These are the costs that help you decide whether to purchase a new business and which active business to purchase. Costs you incur in an attempt to purchase a specific business are capital expenses that you cannot amortize.

Example. In June, you hired an accounting firm and a law firm to assist you in the potential

purchase of XYZ. They researched XYZ's industry and analyzed the financial projections of XYZ. In September, the law firm prepared and submitted a letter of intent to XYZ. The letter stated that a binding commitment would result only after a purchase agreement was signed. The law firm and accounting firm continued to provide services including a review of XYZ's books and records and the preparation of a purchase agreement. In October, you signed a purchase agreement with XYZ.

The costs to investigate the business before submitting the letter of intent to XYZ are amortizable investigative costs. The costs for services after that time relate to the attempt to purchase the business and must be capitalized.

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

Costs of Organizing a Corporation

The costs of organizing a corporation are the direct costs of creating the corporation.

Qualifying costs. You can amortize an organizational cost only if it meets all the following tests.

- It is for the creation of the corporation.
- It is chargeable to a capital account.
- It could be amortized over the life of the corporation if the corporation had a fixed life.
- It is incurred before the end of the first tax year in which the corporation is in business. A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

The following are examples of organizational costs.

- The cost of temporary directors.
- The cost of organizational meetings.
- State incorporation fees.
- The cost of accounting services for setting up the corporation.
- The cost of legal services (such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings).

Nonqualifying costs. The following costs are not organizational costs. They are capital expenses that you cannot amortize.

- Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs.
- Costs associated with the transfer of assets to the corporation.

Costs of Organizing a Partnership

The costs of organizing a partnership are the direct costs of creating the partnership.

Qualifying costs. You can amortize an organizational cost only if it meets all the following tests.

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

Organizational costs include the following fees.

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

Nonqualifying costs. The following costs cannot be amortized.

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

Liquidation of partnership. If a partnership is liquidated before the end of the amortization period, the unamortized amount of qualifying organizational costs can be deducted in the partnership's final tax year. However, these costs can be deducted only to the extent they qualify as a loss from a business.

How To Amortize

You deduct start-up and organizational costs in equal amounts over a period of 60 months or more. You can choose a period for start-up costs that is different from the period you choose for organizational costs, as long as both are not less than 60 months. Once you choose 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 for each month.

Cash method partnership. A partnership using the cash method of accounting cannot deduct an organizational cost it has not paid by the end of the tax year. However, any cost the partnership could have deducted as an organizational cost in an earlier tax year (if it had been paid that 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.

How To Make the Choice

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

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

Once you make the choice to amortize start-up or organizational costs, you cannot revoke it.

Corporations and partnerships. If your business is organized as a corporation or partnership, only your corporation or partnership can choose to amortize its start-up or organizational costs. A shareholder or partner cannot make this choice. 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.

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

Start-up costs. If you choose to amortize your start-up costs, complete Part VI of Form 4562 and prepare a separate statement that contains the following information.

- A description of the business to which the start-up costs relate.
- A description of each start-up cost incurred.
- The month your active business began (or was acquired).

- The number of months in your amortization period (not less than 60).

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

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

Organizational costs. If you choose to amortize your corporation's or partnership's organizational costs, complete Part VI of Form 4562 and prepare a separate statement that contains the following information.

- A description of each cost.
- The amount of each cost.
- The date each cost was incurred.
- The month your corporation or partnership began active business (or acquired the business).
- The number of months in your amortization period (not less than 60).

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

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

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

Getting a Lease

If you get a lease for business property, you recover the cost by amortizing it over the term of the lease. The term of the lease for amortization purposes generally includes all renewal options (and any other period for which you and the lessor reasonably expect the lease to be renewed). However, renewal periods are not included if 75% or more of the cost of getting the lease is for the term of the lease remaining on the acquisition date (not including any period for which you may choose to renew, extend, or continue the lease).

Enter your deduction in Part VI of Form 4562 if you are deducting amortization that begins during the current year, or on the appropriate line of your tax return.

For more information on the costs of getting a lease, see *Cost of Getting a Lease* in chapter 4.

Section 197 Intangibles

You must generally amortize over 15 years the capitalized costs of "section 197 intangibles" you acquired after August 10, 1993. 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.

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

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

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

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

If you pay or incur an amount that increases the basis of an amortizable section 197 intangible after the 15-year period begins, amortize it over the remainder of the 15-year period beginning with the month the basis increase occurs.

You are not allowed any other depreciation or amortization deduction for an amortizable section 197 intangible.

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

Section 197 Intangibles Defined

The following assets are section 197 intangibles.

1) Goodwill.
2) Going concern value.
3) Workforce in place.
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 issuances and renewals).
10) A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business.
11) A franchise, trademark, or trade name (including renewals).
12) A contract for the use of, or a term interest in, any item in this list.

CAUTION *You cannot amortize any of the intangibles listed in items (1) through (8) that you created (rather than acquired) 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. This is the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor.

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

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

For example, you must amortize the part of the purchase price of a business that is for the existence of a highly skilled workforce. Also, you must amortize the cost of acquiring an existing employment contract or relationship with employees or consultants.

Business books and records, etc. This includes the intangible value 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, and television advertisers.

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

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

- A customer base.
- A circulation base.
- An undeveloped market or market growth.
- Insurance in force.
- A mortgage servicing contract.
- An investment management contract.
- Any other relationship with customers involving 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 a trade or business are not section 197 intangibles.

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

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

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

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

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

An arrangement that requires the former owner to perform services (or to provide property or the use of property) is not similar to a covenant not to compete to the extent the amount paid under the arrangement represents reasonable compensation for those services or for that property or its use.

Franchise, trademark, or trade name. A franchise, trademark, or trade name is a section 197 intangible. You must amortize its purchase or renewal costs, other than certain contingent payments that you can deduct currently. For information on currently deductible contingent payments, see *Franchise, trademark, trade name* under *Miscellaneous Expenses* in chapter 13.

Contract for the use of, or a term interest in, a section 197 intangible. Section 197 intangibles include any right under a license, contract, or other arrangement providing for the use of any section 197 intangible. It also includes any term interest in any section 197 intangible, whether the interest is outright or in trust.

Assets That Are Not Section 197 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, interest rate swap, or similar financial contract.
3) Any interest in land.
4) Most computer software. (See *Computer software,* later.)
5) Any of the following assets ***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, video tape, book, or similar property.
   b) A right to receive tangible property or services under a contract or from a governmental agency.
   c) An interest in a patent or copyright.
   d) Certain rights that have a fixed duration or amount. (See *Rights of fixed duration or amount,* later.)
6) An interest under either of the following.
   a) An existing lease or sublease of tangible property.
   b) A debt that was in existence when the interest was acquired.
7) A professional sports franchise or any item acquired in connection with the franchise.
8) A right to service residential mortgages unless the right is acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business.
9) Certain transaction costs incurred by parties to a corporate organization or reorganization in which any part of a gain or loss is not recognized.

Intangible property that is not amortizable under the rules for section 197 intangibles can be depreciated if it meets certain requirements. You generally must use the straight line method over its useful life. For certain intangibles, the depreciation period is specified in the law and regulations. For example, the depreciation period for computer software that is not a section 197 intangible is 36 months.

For more information on depreciating intangible property, see *Intangible Property* under *Can You Use MACRS To Depreciate Your Property?* in chapter 1 of Publication 946.

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

1) Software that meets all the following requirements.
   a) It is (or has been) readily available for purchase by the general public.
   b) It is subject to a nonexclusive license.
   c) It has not been substantially modified. This requirement is considered met if the cost of all modifications is not more than the greater of 25% of the price of the publicly available unmodified software or $2,000.
2) Software that is not acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business.

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

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

- Has a fixed life of less than 15 years, or
- Is of a fixed amount that, except for the rules for section 197 intangibles, would be recovered under a method similar to the unit-of-production method of cost recovery.

However, this does not apply to the following intangibles.

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

Anti-Churning Rules

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

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

1) You or a related person (defined later) held or used the intangible at any time from July 25, 1991, through August 10, 1993.
2) You acquired the intangible from a person who held it at any time during the period in

(1) and, as part of the transaction, the user did not change.

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

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

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

Related person. For purposes of the anti-churning rules, the following are related persons.

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

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

- In the case of a single transaction, immediately before or immediately after the transaction in which the intangible was acquired.
- In the case of a series of related transactions (or a series of transactions that comprise a qualified stock purchase under section 338(d)(3) of the Internal Revenue Code), immediately before the earliest transaction or immediately after the last transaction.

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

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock directly or indirectly owned by or for 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 directly or indirectly owned by or for his or her partner.

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

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

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

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

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

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

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

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

Incorrect Amount of Amortization Deducted

If you did not deduct the correct 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 amortization. See *Changing Your Accounting Method,* later.

Basis adjustment. If you could have deducted amortization but you did not take the deduction, you must reduce the basis of the section 197 intangible by the amortization you were entitled to deduct. If you deducted more amortization than you should have, you must reduce your basis by the correct amortization plus any of the excess for which you received a tax benefit.

Amended Return

If you did not deduct the correct amortization, you can file an amended return to make any of the following corrections.

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

You have adopted a method of accounting for a section 197 intangible if you did not deduct the correct amortization for the intangible on ***two or more*** consecutively filed tax returns for reasons other than a mathematical or posting error. You

cannot file amended returns to correct the amount of amortization.

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

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

Changing Your Accounting Method

If you cannot correct your amortization deductions for a section 197 intangible by filing amended returns, you can claim the correct amount only by changing your method of accounting for the intangible. You will then be able to take into account any unclaimed or excess amortization from years before the year of change.

Approval required. You must get IRS approval to change your method of accounting. File Form 3115, *Application for Change in Accounting Method,* to request a change to a permissible method of accounting for amortization. Revenue Procedure 97–27, which is in Internal Revenue Bulletin 1997–21, gives general instructions for getting approval. You do not need IRS approval to correct any mathematical or posting error. See *Amended Return,* earlier.

Automatic approval. You may be able to get automatic approval from the IRS to change your method of accounting for a section 197 intangible if you meet both the following conditions.

- You did not deduct amortization or you deducted the incorrect amount of amortization for the intangible in at least the 2 years immediately preceding the year of change.
- You owned the intangible at the beginning of the year of change.

File Form 3115 to request a change to a permissible method of accounting for amortization. Revenue Procedure 2002–9 and section 2.01 of its Appendix, which is in Internal Revenue Bulletin No. 2002–3, have instructions for getting automatic approval and list exceptions to the automatic approval procedures.

Exceptions. You generally cannot use the automatic approval procedure in any of the following situations.

- You (your federal income tax return) are under examination.
- You are before a federal court or an appeals office for any income tax issue and the method of accounting to be changed is an issue under consideration by the federal court or appeals office.
- You changed the same method of accounting (with or without obtaining IRS approval) during the last 5 years (including the year of change).
- You filed a Form 3115 to change the same method of accounting during the last 5 years (including the year of change), but did not make the change because the Form 3115 was withdrawn, not perfected, denied, or not granted.

See the other exceptions listed in section 4.02 and section 2.01(2)(c) of the Appendix of Revenue Procedure 2002–9. See also the modifications made to section 4.02 by Revenue Procedure 2002–19 in Internal Revenue Bulletin No. 2002–13 and Revenue Procedure 2002–54 in Internal Revenue Bulletin No. 2002–35.

Disposition of Section 197 Intangibles

A section 197 intangible is treated as depreciable property used in your trade or business. If you held the intangible for more than 1 year, any gain on its disposition, up to the amount of allowable amortization, is ordinary income (section 1245 gain). Any remaining gain, or any loss, is a section 1231 gain or loss. If you held the intangible 1 year or less, any gain or loss on its disposition is an ordinary gain or loss. For more information on ordinary or capital gain or loss on business property, see chapter 3 in Publication 544.

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

- The numerator is the adjusted basis of each remaining intangible on the date of the disposition.
- The denominator is the total adjusted bases of all remaining amortizable section 197 intangibles on the date of the disposition.

Covenant not to compete. A covenant not to compete, or similar arrangement, is not considered disposed of or worthless before you dispose of your entire interest in the trade or business for which you entered into the covenant.

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

In a like-kind exchange or involuntary conversion of a section 197 intangible, you must continue to amortize the part of your adjusted basis in the acquired intangible that is not more than your adjusted basis in the exchanged or converted intangible over the remaining amortization period of the exchanged or converted intangible. Amortize over a new 15-year period the part of your adjusted basis in the acquired intangible that is more than your adjusted basis in the exchanged or converted intangible.

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 $40,000 adjusted basis of the acquired intangible over the 11 years remaining in the original 15-year amortization period for the transferred asset. You amortize the other $10,000 of adjusted basis over a new 15-year period.

Reforestation Costs

You can choose to amortize a limited amount of reforestation costs for qualified timber property over a period of 84 months. Reforestation costs are the direct costs of planting or seeding for forestation or reforestation.

The choice to amortize reforestation costs incurred by a partnership, S corporation, or estate must be made by the partnership, corporation, or estate. A partner, shareholder, or beneficiary cannot make that choice.

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

Qualifying costs. Qualifying costs include only those costs you must capitalize and include in the adjusted basis of the property. They include costs for the following items.

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

Costs you can deduct currently are not qualifying costs.

If the government reimburses you for reforestation costs under a cost-sharing program, you can amortize these costs only if you include the reimbursement in your income.

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

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

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

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

Example. Last year (a full 12-month tax year), John Jones incurred qualifying reforestation costs of $8,400. His monthly amortization 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).

Annual limit. Each year, you can choose to amortize up to $10,000 ($5,000 if you are married filing separately) of qualifying costs you pay or incur during the tax year. You cannot carry over or carry back qualifying costs over the annual limit. The annual limit applies to qualifying costs for all your qualified timber property.

If your qualifying costs are more than $10,000 for more than one piece of qualified timber property, you can divide the annual limit among any of the properties in any manner you wish.

Example. You incurred $10,000 of qualifying costs 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, or you can divide the $10,000 among some or all of the properties in any other manner.

Partnerships and S corporations. A partnership or S corporation can choose to amortize up to $10,000 of qualifying reforestation costs each tax year. A partner's or shareholder's share of these amortizable costs is figured under the general rules for allocating items of income, loss, deductions, etc., of a partnership or S corporation.

The partner or shareholder is also subject to the annual limit of $10,000 ($5,000 if married filing separately) on qualifying costs. This limit applies to all the partner's or shareholder's qualifying costs, regardless of their source.

Example. You are single and a partner in two partnerships, both of which incurred qualifying reforestation costs of more than $10,000 for the year. Each partnership chose to amortize these costs up to the $10,000 annual limit. Your share of that $10,000 is $6,000 for one partnership and $8,000 for the other. Although your qualifying costs total $14,000, the amount you can amortize is limited to $10,000.

Estates. Estates can choose to amortize up to $10,000 of qualifying reforestation costs each tax year. These amortizable costs are divided between the estate and the income beneficiary based on the income of the estate allocable to each. The amortizable cost allocated to the beneficiary is subject to the beneficiary's annual limit.

Maximum annual amortization deduction. The maximum annual amortization deduction for costs incurred in any tax year is $1,428.57 ($10,000 ÷ 7), or $714.29 ($5,000 ÷ 7) if married filing separately. The maximum deduction in the first and last tax year of the 84-month amortization period is one half of the maximum annual deduction, or $714.29 ($357.15 if married filing separately).

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 qualifying reforestation costs incurred by the life tenant. Any remainder interest in the property is ignored for amortization purposes.

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

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

How to make the choice. To choose to amortize qualifying reforestation costs, enter your deduction in Part VI of Form 4562 and attach a statement that contains the following information.

- A description of the costs and the dates you incurred them.
- A description of the type of timber being grown and the purpose for which it is grown.

Attach a separate statement for each property for which you amortize reforestation costs.

Generally, you must make the choice on a timely filed return (including extensions) for the tax year in which you incurred the costs. However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach Form 4562 and the statement to the amended return and write "Filed pursuant to section 301.9100–2" on Form 4562. File the amended return at the same address you filed the original return.

Where to report. The following chart shows where to report your amortization deduction for qualifying reforestation costs after you enter it on Form 4562.

If you file . . .	The deduction goes on . . .
Schedule C (Form 1040)	Line 27
Schedule F (Form 1040)	Line 34
Form 1120	Line 26
Form 1120-A	Line 22
Form 1120S	Schedules K and K-1
Form 1065	Schedules K and K-1
None of the above	Line 33 of Form 1040 (identify as "RFST")

You cannot report your amortization deduction on Schedule C-EZ (Form 1040).

Partner or shareholder. If you are a partner in a partnership or a shareholder in an S corporation, see the instructions for Schedule K-1 (Form 1065 or Form 1120S) for information on where to report any allocated amortization for qualifying reforestation costs. However, if you have qualifying reforestation costs from other sources, your total deduction may be limited. See *Annual limit,* earlier.

Estate. If the estate does not file Schedule C or F for the activity in which the qualifying reforestation costs were incurred, include the amortization deduction on line 15a of Form 1041.

Revoking the choice. You must get IRS approval to revoke your choice to amortize qualifying reforestation costs. Your application to revoke the choice must include your name, address, the years for which your choice was in effect, and your reason for revoking it. You, or your duly authorized representative, 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 choice is to end.

Send the application to:

Commissioner of Internal Revenue
Washington, DC 20224

Pollution Control Facilities

You can choose to amortize over 60 months the cost of a certified pollution control facility.

Certified pollution control facility. A certified pollution control facility is a new identifiable treatment facility used in connection with a plant or other property in operation before 1976, 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. Also, it must not significantly change the nature of the manufacturing or production process or facility.

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

TIP *You can claim a special depreciation allowance on a certified pollution control facility that is qualified property even if you elect to amortize its cost. You must reduce its cost (amortizable basis) by the amount of any special allowance you claim. Full discussion of the special depreciation allowance and what property qualifies for it is in Chapter 3 of Publication 946.*

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

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

More information. For more information on the amortization of pollution control facilities, see section 169 of the Internal Revenue Code and the related regulations.

Research and Experimental Costs

You can amortize your research and experimental costs, deduct them as current business expenses, or write them off over a 10-year period. 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 expenditures. For a definition of "research and experimental costs" and information on deducting them as current business expenses, see chapter 8.

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

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 you meet both the following requirements.

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

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

Your choice is binding for the year it is made and for all later years unless you get IRS approval to change to a different method.

More information. For more information on amortizing research and development costs, see section 174 of the Internal Revenue Code and the related regulations.

10.

Depletion

Important Reminder

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

For more information on alternative minimum tax, see the following sources.

If you are:	See:
An individual	The instructions for Form 6251, *Alternative Minimum Tax—Individuals.*
A corporation	Form 4626, *Alternative Minimum Tax—Corporations.*
An estate or trust	Form 1041, *U.S. Income Tax Return for Estates and Trusts,* and its instructions.

Introduction

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

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

Topics

This chapter discusses:

- Who can claim depletion?
- Mineral property
- Timber

Who Can Claim Depletion?

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

You have an economic interest if both the following apply.

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

A contractual relationship that allows you an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest. A production payment carved out of, or retained on the sale of, mineral property is not an economic interest.

Mineral Property

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 two or more separate interests as one property or as separate properties. See section 614 of the Internal Revenue Code and the related regulations for rules on how to treat separate mineral interests.

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.
- Percentage depletion.

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

Cost Depletion

To figure cost depletion you must first determine the following.

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

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

1) Amounts recoverable through:

   a) Depreciation deductions,

b) Deferred expenses (including deferred exploration and development costs), and

c) Deductions other than depletion.

2) The residual value of land and improvements at the end of operations.

3) The cost or value of land acquired for purposes other than mineral production.

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

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

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

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

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

IF you use ...	THEN the units sold during the year are ...
The cash method of accounting	The units sold for which you receive payment during the tax year (regardless of the year of sale).
An accrual method of accounting	The units sold based on your inventories.

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

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

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

Percentage Depletion

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

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

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

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

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

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

$$\frac{\text{No. of units sold in the tax year}}{\text{Recoverable units from the property}} \times \text{Bonus Payments}$$

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

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

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

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

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

- Do not deduct any net operating loss deduction from the gross income from the property.
- Corporations do not deduct charitable contributions from the gross income from the property.
- If, during the year, you dispose of an item of section 1245 property that was used in connection with mineral property, reduce any allowable deduction for mining expenses by the part of any gain you must report as ordinary income that is allocable to the mineral property. See section 1.613–5(b)(1) of the regulations for information on how to figure the ordinary gain allocable to the property.

For tax years beginning after 1997 and before 2004, percentage depletion on the marginal production of oil or natural gas is not limited to taxable income from the property figured without the depletion deduction.

Oil and Gas Wells

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

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

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

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

Independent Producers and Royalty Owners

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

Refiners who cannot claim percentage depletion. You cannot claim percentage depletion if you or a related person refine crude oil and you and the related person refined more than 50,000 barrels on any day during the tax year.

Related person. You and another person are related persons if either of you holds a significant ownership interest in the other person 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 in any one of the following.

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

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

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

1) You sell oil or natural gas or their by-products directly or through a related person in any of the following situations.
   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.
   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 by all retail outlets taken into account in (1) are more than $5 million for the tax year.

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

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

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

Sales through a related person. You are considered to be selling through a related person if any sale by the related person produces gross income from which you may benefit because of your direct or indirect ownership interest in the person.

You are ***not*** considered to be selling through a related person who is a retailer if all the following apply.

- You do not have a significant ownership interest in the retailer.
- You sell your production to persons who are not related to either you or the retailer.
- The retailer does not buy oil or natural gas from your customers or persons related to your customers.
- 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.
- 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 a definition of the term "transfer," see section 1.613A–7(n) of the regulations. For a definition of the term "interest in proven oil or gas property," see section 1.613A–7(p) of the regulations.

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

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

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

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

You have a partial interest in the production from a property if you have a net profits interest in the property. To figure the share of production for your net profits interest, you must first determine your percentage participation (as measured by the net profits) in the gross revenue from the property. To figure this percentage, you divide the income you receive for your net profits interest by the gross revenue from the property. Then multiply the total production from the property by your percentage participation to figure your share of the production.

Example. John Oak owns oil property in which Paul Elm owns a 20% net profits interest. During the year, the property produced 10,000 barrels of oil, which John sold for $200,000. John had expenses of $90,000 attributable to the property. The property generated a net profit of $110,000 ($200,000 − $90,000). Paul received income of $22,000 ($110,000 × .20) 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. Your depletable natural gas quantity is 6,000 cubic feet multiplied by the number of barrels of your depletable oil quantity that you choose to apply. If you claim depletion on both oil and natural gas, you must reduce your depletable oil quantity (1,000 barrels) by the number of barrels you use to figure your depletable natural gas quantity. If you have production from marginal wells, see section 613A(c)(6) of the Internal Revenue Code to figure your depletable oil or natural gas quantity.

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

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

- 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).
- You and your spouse and minor children.

For purposes of this allocation, a related person is anyone mentioned under *Related persons* in chapter 12 except that item (1) in that discussion includes only an individual, his or her spouse, and minor children.

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

Gross income from the property. For purposes of percentage depletion, gross income from the property (in the case of oil and gas wells) is the amount you receive from the sale of the oil or gas in the immediate vicinity of the well. If you do not sell the oil or gas on the property, but manufacture or convert it into a refined product before sale or transport it before sale, the gross income from the property is the representative market or field price (RMFP) of the oil or gas, before conversion or transportation.

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.

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

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

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

- Your taxable income from the property figured without the deduction for depletion. For a definition of taxable income from the property, see *Taxable income limit*, earlier, under *Mineral Property.*
- 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.

Temporary suspension of taxable income limit for marginal production. For tax years beginning after 1997 and before 2004, percentage depletion on the marginal production of oil or natural gas is not limited to taxable income from the property figured without the depletion deduction. For information on marginal production, see section 613A(c)(6) of the Internal Revenue Code.

Partnerships and S Corporations

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

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

Each partner's share of the adjusted basis of the oil or gas property generally is figured according to that partner's interest in partnership capital. However, in some cases, it is figured according to the partner's interest in partnership income.

The partnership or S corporation adjusts the partner's or shareholder's share of the adjusted basis of the oil and gas property for any capital expenditures made for the property and for any change in partnership or S corporation interests.

Each partner or shareholder must separately keep records of his or her share of the adjusted basis in each oil and gas property of the partnership or S corporation. The partner or shareholder must reduce his or her adjusted basis by the depletion allowed or allowable on the property each year. The partner or shareholder must use that reduced adjusted basis to figure cost depletion or his or her gain or loss if the partnership or S corporation disposes of the property.

Reporting the deduction. Information that you, as a partner or shareholder, use to figure your depletion deduction on oil and gas properties is reported by the partnership or S corporation on line 25 of Schedule K-1 (Form 1065) or on line 23 of Schedule K-1 (Form 1120S). Deduct oil and gas depletion for your partnership or S corporation interest on line 20 of Schedule E (Form 1040). The depletion deducted on Schedule E is included in figuring income or loss from rental real estate or royalty properties. The instructions for Schedule E explain where to report this income or loss and whether you need to file either of the following forms.

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

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

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

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

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

All the following are disqualified persons.

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

Natural Gas Wells

You can use percentage depletion for a well that produces natural gas either sold under a fixed contract or produced from geopressured brine.

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

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

- Produced from a well you began to drill after September 1978 and before 1984.
- Determined in accordance with section 503 of the Natural Gas Policy Act of 1978 to be produced from 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. For a natural deposit, the percentage of your gross income from the property that you can deduct as depletion depends on the type of deposit.

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

DEPOSITS	RATE
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%
Borax, granite, limestone, marble, mollusk shells, potash, slate, soapstone, and carbon dioxide produced from a well	14%
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%

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

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

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

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

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

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

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

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

Transportation of more than 50 miles. If the IRS finds that the ore or mineral must be transported more than 50 miles to plants or mills to be treated because of physical and other requirements, the additional authorized transportation is considered mining and included in the computation of gross income from mining.

If you wish to include transportation of more than 50 miles in the computation of gross income from mining, file an application in duplicate with the IRS. Include on the application the facts concerning the physical and other requirements which prevented the construction and operation of the plant within 50 miles of the point of extraction. Send this application to:

Internal Revenue Service
Washington, DC 20224
Attention: Associate Chief Counsel, Pass-throughs and Special Industries

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

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

Treat any gain on the disposition as a capital gain.

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

- A related person (as listed in chapter 12).
- 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. For percentage depletion purposes, a geothermal deposit is not considered a gas well.

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

Lessor's Gross Income

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

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

Figuring cost depletion. To figure cost depletion on a bonus, multiply your adjusted basis in the property by a fraction, the numerator of which is the bonus and the denominator of which is the total bonus and royalties expected to be received. To figure cost depletion on advanced royalties, use the computation explained earlier under *Cost Depletion,* treating the number of units for which the advanced royalty is received as the number of units sold.

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

Terminating the lease. If you receive a bonus on a lease that expires, terminates, or is abandoned before you derive any income from the extraction of mineral, include in income for the year of expiration, termination, or abandonment, the depletion deduction you took. Also increase your adjusted basis in the property to restore the depletion deduction you previously subtracted.

For advanced royalties, include in income for the year of lease termination, the depletion claimed on minerals for which the advanced royalties were paid if the minerals were not produced before 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 either abandoning the lease, beginning development operations, or obtaining production.

Timber

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

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

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

Timber units. When you acquire timber property, you must make an estimate of the quantity of marketable timber that exists on the property. You measure the timber using board feet, log scale, cords, or other units. If you later determine that you have more or less units of timber, you must adjust the original estimate.

The term "timber property" means your economic interest in standing timber in each tract or block representing a separate timber account.

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

1) Determine your cost or adjusted basis of the timber on hand at the beginning of the year. Adjusted basis is defined under *Cost Depletion* in the discussion on *Mineral Property.*
2) Add to the amount determined in (1) the cost of any timber units acquired during the year and any additions to capital.
3) Figure the number of timber units to take into account by adding the number of timber units acquired during the year to the number of timber 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 timber units remaining in the account.
4) Divide the result of (2) by the result of (3). This is your depletion unit.

Example. You bought a timber tract for $160,000 and the land was worth as much as the timber. Your basis for the timber is $80,000. Based on an estimated one million board feet (1,000 MBF) of standing timber, you figure your depletion unit to be $80 per MBF ($80,000 ÷ 1,000). If you cut 500 MBF of timber, your depletion allowance would be $40,000 (500 MBF × $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 choose 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 you sell the timber products.

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

Choosing to treat the cutting of timber as a sale or exchange. You can choose, under certain circumstances, to treat the cutting of timber held for more than 1 year as a sale or exchange. You must make the choice on your income tax return for the tax year to which it applies. If you make this choice, subtract the adjusted basis for depletion from the fair market value of the timber on the first day of the tax year in which you cut it to figure the gain or loss on the cutting. You generally report the gain as long-term 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. For more information, see *Timber* in chapter 2 of Publication 544, *Sales and Other Dispositions of Assets.*

Form T. Attach Form T (Timber), *Forest Activities Schedule,* to your income tax return if you are claiming a deduction for timber depletion or choosing to treat the cutting of timber as a sale or exchange.

11.

Business Bad Debts

Introduction

If someone owes you money you cannot collect, you have a bad debt. There are two kinds of bad debts—business and nonbusiness. This chapter covers business bad debts.

Generally, a business bad debt is one that comes from operating your trade or business. You can deduct business bad debts on your business tax return.

All other bad debts are nonbusiness bad debts and are deductible only as short-term capital losses on Schedule D (Form 1040). For more information on nonbusiness bad debts, see Publication 550.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

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

See chapter 14 for information about getting publications and forms.

Business Bad Debt Defined

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

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

A debt is closely related to your trade or business if your primary motive for incurring the debt is business related.

The bad debts of a corporation are always business bad debts.

Credit sales. Business bad debts are mainly the result of credit sales to customers. Goods and services customers have not paid for are recorded in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these receivables, the uncollectible part is a business bad debt.

Accounts or notes receivable valued at fair market value when received are deductible only at that value, even though the fair market value may be less than face value. If you bought an account receivable for less than its face value, the amount you can deduct if it becomes worthless is the amount you paid for it.

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

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

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

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

Debts from a former business. If you sell your business but keep its receivables, these debts are business debts since they arose out of your trade or business. If one of these debts later becomes worthless, the loss is still a business bad debt. These debts 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 receivables to someone else, the activities of the new holder of the debts determine whether they are business or nonbusiness debts for that person. A loss from the debts is a business bad debt to the new holder if that person acquired the debts in his or her trade or business or if the debts were closely related to the new holder's trade or business when they became worthless. Otherwise, a loss from these debts is a nonbusiness bad debt.

Debt acquired from a decedent. The character of a loss from debts of a business acquired from a decedent is determined in the same way as debts sold by a business. If you are in a trade or business, a loss from the debts is a business bad debt if the debts were closely related to your trade or business when they became worthless.

Otherwise, a loss from these debts is a nonbusiness bad debt.

Example 1. In 2002, Arnie died leaving his business, including the accounts receivable, to his son Carl. Certain receivables become worthless in 2003. Carl can deduct the loss as a business bad debt because the debt was closely related to his business when it became worthless.

Example 2. In 2002, Charlie died leaving his business to his son George, but leaving the receivables to his daughter Diane. The receivables become worthless in 2003. Diane is not engaged in any trade or business during 2002 or 2003. Therefore, Diane's loss is a nonbusiness bad debt even though the original debt was incurred in a business.

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

Types of Business Bad Debts

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

Loans to clients and suppliers. If you make a loan to a client, supplier, employee, or distributor for a business reason and it becomes worthless, you have a business bad debt.

Example. John Smith, an advertising agent, made loans to certain clients to keep their business. One of these clients went bankrupt and could not repay him. Since the main reason for making the loan was business related, the debt was a business debt and John can take a business bad debt deduction.

Debts of political parties. If a political party (or other organization that accepts contributions or spends money to influence elections) owes you money and the debt becomes worthless, you can take a bad debt deduction only if you use an accrual method of accounting ***and*** meet all the following tests.

1) The debt arose from the sale of goods or services in the ordinary course of your trade or business.
2) More than 30% of your receivables accrued in the year of the sale were from sales to political parties.
3) You made substantial 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. If you pay any part of the insolvent partner's share of the debts, you can take a bad debt deduction for the amount you pay.

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

- You made the guarantee in the course of your trade or business.
- You have a legal duty to pay the debt.
- You made the guarantee before the debt became worthless. You meet this requirement if you reasonably expected you would not have to pay the debt without full reimbursement from the issuer.
- You receive reasonable consideration for making the guarantee. You meet this requirement if you made the guarantee in accord with normal business practice or for a good faith business purpose.

Example. Jane Zayne owns the Zayne Dress Company. She 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. Ms. Zayne made full payment to the bank. She can take a business bad debt deduction, since her guarantee was made in the course of her trade or business for a good faith business purpose. She was motivated by the desire to retain one of her better clients and keep a sales outlet.

Employee. Any guarantee you make to protect or improve your job is closely related to your trade or business as an employee.

Deductible in the year paid. If you make a payment on a loan you guaranteed, you can deduct it in the year paid, unless you have rights against the borrower.

Rights against a borrower. When you make payment on a loan you guaranteed, you may have the right to take the place of the lender. The debt is then owed to you. If you have this right, or some other right to demand payment from the borrower, you cannot take a bad debt deduction until these rights become partly or totally worthless.

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

Bankruptcy claim. If a person who owes you money becomes bankrupt, the amount you can deduct as a bad debt is the amount owed to you minus the amount you receive from distribution of the bankrupt person's assets.

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

When Debt Is Worthless

You do not have to wait until a debt is due to determine whether it is worthless. A debt becomes worthless when there is no longer any chance the amount owed will be paid.

It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You must only show that you have taken reasonable steps to collect the debt. Bankruptcy of your debtor is generally good evidence of the worthlessness of at least a part of an unsecured and unpreferred debt.

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 if and when it becomes worthless.

If you later sell the property, any gain on the sale is due to the appreciation of the property. It is not a recovery of a bad debt. For information on the sale of an asset, see Publication 544.

Example. Patti owed Margaret $5,000. In partial satisfaction of the debt, Patti gave Margaret property worth $2,000. Margaret deducted the remaining $3,000 as a bad debt but did not get a tax benefit from the deduction as she had no taxable income. Margaret later sold the property for a $1,000 gain. Even though Margaret did not get a tax benefit from the earlier bad debt deduction, she must include the $1,000 gain in her income. It is not a recovery of her bad debt.

How To Treat

There are two ways to treat business bad debts.

- The specific charge-off method.
- The nonaccrual-experience method.

Generally, you must use the specific charge-off method. However, you can use the nonaccrual-experience method if you meet the requirements discussed later under *Nonaccrual-Experience Method*.

Specific Charge-Off Method

If you use the specific charge-off method, you can deduct specific business bad debts that become either partly or totally worthless during the tax year.

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

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

Deduction disallowed. You can generally take a partial bad debt deduction only in the year you make the charge-off on your books. If, under audit, the IRS does not allow your deduction and the debt becomes partly worthless in a later tax year, you can deduct the amount you charge off in that year plus the disallowed amount charged-off in the earlier year. The charge off in the earlier year, unless reversed on your books,

fulfills the charge-off requirement for the later year.

Totally worthless debts. If a debt becomes totally worthless, you can deduct the entire amount, except 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.

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

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

If the claim is for a partly worthless bad debt, you must file the claim by the later of the following dates.

- 3 years from the date you filed your original return.
- 2 years from the date you paid the tax.

You may have longer to file the claim if you were physically or mentally unable to handle your financial affairs for a time. For details and more information about filing a claim, see Publication 556.

Use one of the following forms to file a claim.

Table 11–1. **Forms Used To File a Claim**

IF you filed as a...	THEN file...
Sole proprietor or farmer	Form 1040X
Corporation	Form 1120X
S corporation	Form 1120S (check box F(5))
Partnership	Form 1065 (check box G(5))

Nonaccrual-Experience Method

If you use an accrual method of accounting and qualify under the rules explained in this section, you can use the nonaccrual-experience method for bad debts. Under this method, you do not accrue service related income you expect to be uncollectible.

You generally can use the nonaccrual-experience method for accounts receivables for services you performed only if:

- The services are provided in the fields of accounting, actuarial science, architecture, consulting, engineering, health, law, or the performing arts, **or**
- You meet the $5 million gross receipts test for all prior years.

Service related income. You can use the nonaccrual-experience method only for amounts earned by performing services. You cannot use this method for amounts owed to you from activities such as lending money, selling goods, or acquiring receivables or other rights to receive payment.

Gross receipts test. You meet the gross receipts test if your average annual gross receipts for the 3 prior tax years does not exceed $5,000,000.

Interest or penalty charged. Generally, you cannot use the nonaccrual-experience method for amounts due on which you charge interest or a late payment penalty. However, do not treat a discount offered for early payment as the charging of interest or a penalty if both the following apply.

- You otherwise accrue the full amount due as gross income at the time you provide the services.
- You treat the discount allowed for early payment as an adjustment to gross income in the year of payment.

Methods available. You can use any of the following nonaccrual-experience methods.

- 6-year moving average method.
- Actual experience method.
- Modified Black Motor method.
- Modified 6-year moving average method.
- Alternative nonaccrual-experience method.

Apply the nonaccrual-experience method separately to each account receivable.

You generally cannot change from one method to another without IRS approval. You may be able to obtain automatic consent to change your method of accounting. See section 1.448–2T(g) of the regulations for more information on obtaining consent to change to a nonaccrual-experience method or to change from one method to another.

For more information about the nonaccrual-experience method, including the $5 million gross receipts test, see section 448(d)(5) of the Internal Revenue Code and section 1.448–2T of the regulations.

Recovery

If you deduct a bad debt on your tax return and later recover (collect) all or part of it, you may have to include all or part of the recovery in gross income. The amount you include is limited to the amount you actually deducted. However, you can exclude the amount deducted that did not reduce your tax. Report the recovery as "Other income" on the appropriate business form or schedule.

See *Recoveries* in Publication 525 for more information.

Net operating loss (NOL) carryover. If a bad debt deduction increases an NOL carryover that has not expired before the beginning of the tax year in which the recovery takes place, you treat the deduction as having reduced your tax. A bad debt deduction that contributes to a net operating loss helps lower taxes in the year to which you carry the net operating loss.

More information. See Publication 536 for more information about net operating losses.

Where To Deduct

Use the following table to find where to deduct your business bad debts.

Table 11–2. **Where To Deduct a Bad Debt**

IF you file as a...	THEN deduct your bad debt on...
Sole proprietor	Line 27 of Schedule C (Form 1040)
Farmer	Line 34 of Schedule F (Form 1040)
Corporation	Line 15 of Form 1120 or Form 1120–A
S corporation	Line 10 of Form 1120S
Partnership	Line 12 of Form 1065

12.

Electric and Clean-Fuel Vehicles

Important Reminder

Maximum clean-fuel vehicle deduction. The maximum clean-fuel vehicle deduction and qualified electric vehicle credit were scheduled to be 25% lower for 2002 and both were scheduled to be phased out completely by 2005. The full deduction and credit are now allowed for qualified property placed in service in 2002 and 2003. The phaseout of the deduction and the credit will begin in 2004, and no deduction or credit will be allowed for property placed in service after 2006. See chapter 12.

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 in a trade or business. However, you can take a deduction for clean-fuel vehicle refueling property only 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 14 for information about getting publications and forms.

Definitions

The following definitions apply throughout this chapter.

Clean-burning fuels. The following are clean-burning fuels.

1) Natural gas.
2) Liquefied natural gas.
3) Liquefied petroleum gas.
4) Hydrogen.
5) Electricity.
6) Any other fuel that is at least 85% alcohol (any kind) or ether.

Motor vehicle. 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.

Nonqualifying property. This is property used in the following ways.

1) Predominantly outside the United States.
2) Predominantly to furnish lodging or in connection with the furnishing of lodging.
3) By certain tax-exempt organizations.
4) By governmental units or foreign persons or entities.

Deductions for Clean-Fuel Vehicle and Refueling Property

You are allowed a limited deduction for the cost of clean-fuel vehicle property and clean-fuel vehicle refueling property. These deductions are allowed only in the tax year you place the property in service.

You cannot claim these deductions for the part of the property's cost you claim as a section 179 deduction. For information on the section 179 deduction, see Publication 946.

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 either of the following kinds of property.

1) A motor vehicle (defined earlier) 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 the part attributable to:
   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 that may be 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 electric vehicle credit, discussed later.*

Qualified property. Your property must meet the following requirements 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) Either—
   a) The motor vehicle of which it is a part must satisfy any federal or state emissions standards that apply to each fuel by which the vehicle is designed to be propelled, or
   b) It must satisfy any federal and state emissions certification, testing, and warranty requirements that apply.
4) It cannot be nonqualifying property, defined earlier.

Deduction limit. The maximum deduction you can claim for qualified clean-fuel vehicle property with respect to any motor vehicle is one of the following.

1) $50,000 for a truck or van with a gross vehicle weight rating over 26,000 pounds or 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.
3) $2,000 for a vehicle not included in (1) or (2).

Deduction for Clean-Fuel Vehicle Refueling Property

Your property must meet the following requirements to qualify for this deduction.

1) It must be depreciable property.
2) Its original use must begin with you.
3) It cannot be nonqualifying property, defined earlier.

Clean-fuel vehicle refueling property. Clean-fuel vehicle refueling property is any property (other than a building or its structural components) used to do either of the following.

1) Store or dispense a clean-burning fuel (defined earlier) 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.
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 motor vehicle propelled by electricity. It includes low-voltage recharging equipment, 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 *If the deduction limit applies, you must specify on your tax return the property (and the portion of the property's cost) you are using as a basis for the deduction.*

Related persons. For this purpose, the following are considered related persons.

1) An individual and his or her brothers and sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
2) An individual and a corporation if the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
3) Two corporations that are members of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
4) A grantor and a fiduciary of any trust.
5) Fiduciaries of two separate trusts if the same person is a grantor of both trusts.
6) A fiduciary and a beneficiary of the same trust.
7) A fiduciary and a beneficiary of two separate trusts if the same person is a grantor of both trusts.
8) A fiduciary of a trust and a corporation if the trust or a grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
9) A person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by that person or by members of the family of that person.
10) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
11) Two S corporations or an S corporation and a regular corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
12) A partnership and a person if the person, directly or indirectly owns, more than 50% of the capital or profits interests 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.
14) An executor of an estate and a beneficiary of the estate unless the sale or exchange is in satisfaction of a pecuniary bequest.

To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, see *Ownership of stock* under *Related Persons* in Publication 538.

How To Claim the Deductions

How you claim the deductions for clean-fuel vehicle property and clean-fuel vehicle refueling property depends on the use of the property and the kind of income tax return you file.

Deduction for nonbusiness clean-fuel vehicle property by individuals. Individuals can claim the deduction for clean-fuel vehicle property used for nonbusiness purposes by including the deduction in the total on line 33 of Form 1040. Also, enter the amount of your deduction and "Clean-Fuel" on the dotted line next to line 33. If you use the vehicle partly for business, see the next two discussions.

Deduction for business clean-fuel vehicle property by employees. Employees who use clean-fuel vehicle property for business, or partly for business and partly for nonbusiness purposes, should include the entire deduction in the total on line 33 of Form 1040. Also, enter the amount of your deduction and "Clean-Fuel" on the dotted line next to line 33.

Sole proprietors. Sole proprietors must claim deductions for clean-fuel vehicle property and clean-fuel vehicle refueling property used for business 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 *Deduction for nonbusiness clean-fuel vehicle property by individuals.*

Partnerships. Partnerships claim the deductions for clean-fuel vehicle property and clean-fuel vehicle refueling property on line 20 of Form 1065.

S corporations. S corporations claim the deductions for clean-fuel vehicle property and clean-fuel vehicle refueling property on line 19 of Form 1120S.

C corporations. C corporations claim the deductions for clean-fuel vehicle property 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 ceases to qualify, you may have to recapture the deduction. You recapture the deduction by including it, or part of it, in your income.

Clean-Fuel Vehicle Property

You must recapture the deduction for clean-fuel vehicle property if the property ceases to qualify within 3 years after the date you placed it in service. The property will cease to qualify if it is changed in any of the following ways.

1) It is modified so that it can no longer be propelled by a clean-burning fuel.
2) It ceases to be a qualified clean-fuel vehicle property (for example, by failing to meet emissions standards).
3) It becomes nonqualifying property, defined earlier.

Sales or other dispositions. If you sell or otherwise dispose of the vehicle within 3 years after the date you placed it in service and know or have reason to know that it will be changed in any of the ways described above, you are subject to the recapture rules. In other 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 any gain from the disposition 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 the following percentage.

- 100% if the recapture date is within the first full year after the date the vehicle was placed in service.
- 66⅔% if the recapture date is within the second full year after the date the vehicle was placed in service.
- 33⅓% if the recapture date is within the third full year after the date the vehicle was placed in service.

Recapture date. The recapture date is generally the date of the event that causes the recapture. However, the recapture date for an event described in item (3), earlier, is the first day of the recapture year in which the event occurs.

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.

Deducted by individuals as nonbusiness-use property. Include the amount on line 21 of Form 1040.

Deducted by employees as business-use property. Include the amount on line 21 of Form 1040.

Deducted by sole proprietors as business-use property. 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

You must recapture the deduction for clean-fuel vehicle refueling property if the property ceases to qualify at any time before the end of its depreciation recovery period. The property will cease to qualify if it is changed in any of the following ways.

1) It ceases to be a clean-fuel vehicle refueling property (for example, by being converted to store and dispense gasoline).
2) It is no longer used 50% or more in your trade or business.
3) It becomes nonqualifying property, defined earlier.

Sales or other dispositions. If you sell or otherwise dispose of the property before the end of its recovery period and know or have reason to know that it will be changed in any of the ways described above, you are subject to the recapture rules. In other dispositions (including a disposition by reason of an accident or other casualty), the recapture rules do not apply.

The deduction (minus any recapture amount) is considered depreciation when figuring the part of any gain from the disposition 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 you claimed by the following fraction.

Total recovery period for the property	−	Recovery years before the recapture year
Total recovery period for the property		

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.

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 Adjustments

You must reduce the basis of your clean-fuel vehicle property or clean-fuel vehicle refueling property by 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 this additional basis over the property's remaining recovery period beginning with the tax year of recapture.

CAUTION *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 the following requirements.

1) It is a motor vehicle (defined earlier) powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current.
2) You were the first person to use it.
3) You acquired it for your own use and not for resale.
4) It has never been used as a nonelectric vehicle.
5) It is not nonqualifying property, defined earlier.

Amount of the Credit

The credit is generally 10% of the cost of each qualified electric 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, see 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 credit limit, 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 20 of Form 8834 on line 52 of Form 1040. Check box "c" and specify Form 8834.

Partnerships. Partnerships enter the amount from line 20 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 20 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.

C corporations. C corporations claim the credit by entering the amount from line 20 of Form 8834 in the total for line 6c of Schedule J (Form 1120), checking the "Other" box and entering "8834" in the space provided. 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. You recapture the credit by adding it, or part of it, to your income tax for the year in which the recapture event occurs.

The vehicle will cease to qualify if it is changed in either of the following ways.

1) It is modified so that it is no longer primarily powered by electricity.
2) It becomes nonqualifying property, defined earlier.

Sales or other dispositions. If you sell or otherwise dispose of the vehicle within 3 years after the date you placed it in service and know or have reason to know that it will be changed in either of the ways described above, you are subject to the recapture rules. In other 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 credit (minus any recapture amount) is considered depreciation when figuring the part of any gain from the disposition that is ordinary income. See Publication 544 for more information on dispositions of depreciable property.

Recapture amount. Figure your recapture amount by multiplying the credit by the following percentage.

- 100% if the recapture date is within the first full year after the date the vehicle was placed in service.
- 66⅔% if the recapture date is within the second full year after the date the vehicle was placed in service.
- 33⅓% if the recapture date is within the third full year after the date the vehicle was placed in service.

Recapture date. The recapture date is generally the date of the event that causes the recapture. However, the recapture date for an event described in item (2), earlier, is the first day of the recapture year in which the event occurs.

How to report. Report the recapture amount as follows.

Individuals. Include the amount on line 60 of Form 1040. Write "QEVCR" on the dotted line next to line 60.

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.

C corporations. Include the amount on line 10 of Schedule J (Form 1120), or line 5 of Part I (Form 1120–A). Check the box for "Other" and attach the required schedule. See the instructions for Form 1120.

Basis Adjustments

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.

13.

Other Expenses

Important Change for 2003

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2003 is 36 cents a mile for all business miles. For more information, see *Car and truck expenses*, under *Miscellaneous Expenses*.

Important Changes for 2004

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2004 is 37.5 cents a mile for all business miles.

Meal expense deduction subject to "hours of service" limits. In 2004, this deduction increases to 70% of the reimbursed meals your employees consume while they are subject to the Department of Transportation's "hours of service" limits. For more information, see *Meal expenses when subject to "hours of service" limits*, later.

Introduction

This chapter covers expenses you as a business owner may have that are not explained in earlier chapters of this publication.

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)
- Other miscellaneous expenses

Table 13–1. **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 made and excess returned	No amount.
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting made up to the federal rate only and excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.
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.

Useful Items

You may want to see:

Publication

- ❑ **15–B** Employer's Tax Guide to Fringe Benefits
- ❑ **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
- ❑ **Sch C (Form 1040)** Profit or Loss from Business
- ❑ **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 14 for information about getting publications and forms.

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 pay advances, reimbursements, and charges for your employees' business expenses and they substantiate their expenses to you so you can substantiate your deduction of the advance, reimbursement, or charge. 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, *Wage and Tax Statement,* and deduct them as wages. See *Table 13–1*.

Accountable Plans

To be an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all the following requirements.

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.
3) They must return any excess reimbursement or allowance within a reasonable period of time.

An arrangement under which you advance money to employees is treated as meeting (3) above only if the following requirements are also met.

- The advance is reasonably calculated not to exceed the amount of anticipated expenses.
- You make the advance within a reasonable period of time.

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.

Adequate accounting. Your employees must adequately account to you for their expenses. They must give you documentary evidence of their travel, mileage, and other employee business expenses. This evidence should include items such as receipts, along with either a statement of expenses, an account book, a diary, or a similar record in which the employee entered each expense at or near the time the expense was incurred.

Excess reimbursement or allowance. An excess reimbursement or allowance is any amount you pay to an employee that is more than the business-related expenses for which the employee adequately accounted. The employee must return any excess reimbursement or other expense allowance to you within a reasonable period of time.

Reasonable period of time. A reasonable period of time depends on the facts and circumstances. Generally, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

1) You give an advance within 30 days of the time the employee has the expense.
2) Your employees adequately account for their expenses within 60 days after the expenses were paid or incurred.
3) Your employees return any excess reimbursement within 120 days after the expense was paid or incurred.
4) You give a periodic statement (at least quarterly) to your employees that asks them to either return or adequately account for outstanding advances ***and*** they comply within 120 days of the statement.

How to deduct. You can take a deduction for travel, meals, and entertainment expenses if you reimburse your employees for these expenses under an accountable plan. The amount you deduct 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 decutions* line of Form 1120, *U.S. Corporation Income Tax Return,* or Form 1120–A, *U.S. Corporation Short-Form Income Tax Return.* 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 and Car Allowances

You may reimburse your employees under an accountable plan based on travel days, miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you for the amount of the expense that does not exceed the rates established by the federal government. Your employee must actually substantiate to you the other elements of the expense, such as time, place, and business purpose.

Federal rate. The federal rate can be figured using any one of the following methods.

1) For per diem amounts:
   a) The regular federal per diem rate.
   b) The standard meal allowance.
   c) The high-low rate.
2) For car expenses:
   a) The standard mileage rate.
   b) A fixed and variable rate (FAVR).

Car allowance. Your employee is considered to have accounted to you for car expenses that do not exceed the ***standard mileage rate.*** For 2003, the standard mileage rate is 36 cents per mile for each business mile.

You can choose to reimburse your employees using a fixed and variable rate (FAVR) allowance. This is an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover your employees' variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your employees' fixed costs (such as depreciation, insurance, etc.). For information on using a FAVR allowance, see Revenue Procedure 2002-61 in Internal Revenue Bulletin 2002-39. You can read Revenue Procedure 2002-61 at many public libraries or online at **www.irs.gov**.

Per diem allowance. If your employee actually substantiates to you the other elements (discussed earlier) of the expenses reimbursed using the per diem allowance, how you report and deduct the allowance depends on whether the allowance is for lodging and meal expenses or for meal expenses only and whether the allowance is more than the federal rate.

Regular federal per diem rate. The regular federal per diem rate is the highest amount the federal government will pay to its employees 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 United States.

Internet access. Per diem rates are available on the Internet. If you have a computer and a modem, you can access per diem rates at **www.policyworks.gov/perdiem.**

Standard meal allowance. The ***federal rate*** for meal and incidental expense (M & IE) is the standard meal allowance. You may pay an allowance for meal and incidental expenses only if, for example, you reimburse actual lodging expenses or do not reimburse lodging expenses because there are none.

High-low method. This is a simplified method of computing the federal per diem rate for lodging and meal expenses for traveling within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel during 2003 is $204 ($45 for M & IE) for certain high-cost locations. All other areas have a per diem amount of $125 ($35 for M & IE). The high-cost locations eligible for the $204 per diem amount under the high-low method are listed in Publication 1542.

Reporting per diem and car allowances. The following paragraphs explain how to report per diem and car allowances. The manner in which you report them depends on how the allowance compares to the federal rate.

Allowance LESS than or EQUAL to the federal rate. If your allowance for the employee is less than or equal to the appropriate federal rate, that allowance is not included as part of the employee's pay in box 1 of the employee's Form W–2. Deduct the allowance as travel expenses (including meals that may be subject to the 50% limit, discussed later). See *How to deduct* under *Accountable Plans,* earlier.

Allowance MORE than the federal rate. If your employee's allowance is more than the appropriate federal rate, you must report the allowance as two separate items.

You include the allowance amount up to the federal rate in box 12 (code L) of the employee's Form W–2. Deduct it as travel expenses (as explained above). This part of the allowance is treated as reimbursed under an accountable plan.

You include the amount that is more than the federal rate in box 1 (and in boxes 3 and 5 if they apply) of the employee's Form W–2. Deduct it as wages subject to income tax withholding, social security, Medicare, and federal unemployment taxes. This part of the allowance is treated as reimbursed under a nonaccountable plan as explained later under *Nonaccountable Plans.*

Meals and Entertainment

Under an accountable plan, you can generally deduct only 50% of any otherwise deductible business-related meal and entertainment expenses you reimburse your employees. The deduction limit applies even if you reimburse them for 100% of the expenses.

Application of the 50% limit. The 50% deduction limit applies to reimbursements you make to your employees for expenses they incur for meals while traveling away from home on business and for entertaining business customers at your place of business, a restaurant, or another location. It applies to expenses incurred at a business convention or reception, business meeting, or business luncheon at a club. The deduction limit may also apply to meals you furnish on your premises to your employees (discussed in chapter 2).

Related expenses. Taxes and tips relating to a meal or entertainment activity you reimburse to your employee under an accountable plan are included in the amount subject to the 50% limit. Reimbursements you make for expenses, such as cover charges for admission to a nightclub, rent paid for a room to hold a dinner or cocktail party, or the amount you pay for parking at a sports arena, are all subject to the 50% limit. However, the cost of transportation to and from an otherwise allowable business meal or a business-related entertainment activity is not subject to the 50% limit.

Amount subject to 50% limit. If you provide your employees with a per diem allowance (discussed earlier) only for meal and incidental expenses, the amount treated as an expense for food and beverages is the lesser of the following.

- The per diem allowance.
- The federal rate for M & IE.

If you provide your employees with a per diem allowance that covers lodging, meals, and incidental expenses, you must treat an amount equal to the federal M & IE rate for the area of travel as an expense for food and beverages. If the per diem allowance you provide is less than the federal per diem rate for the area of travel, you can treat 40% of the per diem allowance as the amount for food and beverages.

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 food and beverages provided by an employer at a support camp that is near and integral to an oil or gas platform or drilling rig located in Alaska.

Meal expenses when subject to "hours of service" limits. You can deduct 65% of the reimbursed meals your employees consume while away from their tax home on business during or incident to any period subject to the Department of Transportation's hours of service limits.

Individuals subject to the Department of Transportation's hours of service limits include the following.

- Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.
- Interstate truck operators and bus drivers who are under Department of Transportation regulations.
- Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.
- Certain merchant mariners who are under Coast Guard regulations.

De minimis (minimal) fringe benefit. The 50% limit does not apply to an expense for food or beverage that is excluded from the gross income of an employee because it is a de minimis fringe benefit. See Publication 15–B for additional information on de minimis fringe benefits.

Company cafeteria or executive dining room. 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 in Publication 15–B, or unless they are compensation to your employees and you treat them as provided under a nonaccountable plan, as discussed later.

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.

For this purpose, a highly compensated employee is an employee who meets either of the following requirements.

1) Owned a 10% or more interest in the business during the year or the preceding year. An employee is treated as owning any interest owned by his or her brother, sister, spouse, ancestors, and lineal descendants.
2) Received more than $90,000 in pay for the preceding year. You may choose to include only employees who were also in the top 20% of employees when ranked by pay for the preceding year.

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 to individuals who are not 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 *General 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 include business leagues, chambers of commerce, real estate boards, and trade and professional associations. Meal and entertainment 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 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 if the event meets certain conditions. See *Entertainment tickets* in chapter 2 of Publication 463 for a list of the conditions a charitable sports event must meet.

Miscellaneous Expenses

In addition to travel, meal, and entertainment expenses, there are other expenses you can deduct. This section briefly covers some of these expenses (listed in alphabetical order).

Advertising expenses. You generally 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.

You can usually deduct as a business expense the cost of institutional or goodwill 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. Savings 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 1-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 deduct it, 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) under *Bribes and kickbacks.*

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 income tax return, you may have to report them on an information return, Form 1099–MISC. For more information about when to file Form 1099–MISC, see the *General Instructions for Forms 1099, 1098, 5498, and W–2G.*

Car and truck expenses. You can deduct the costs 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 usually 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 the cost of operating your car, van, pickup, or panel truck in 2003 is 36 cents a mile for all business miles. 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 (other than S corporations) can deduct charitable contributions on their income tax returns. See *Charitable Contributions* in Publication 542 for more information. Sole proprietors, partners in a partnership, or shareholders in an S corporation may be able to deduct charitable contributions made by their business on Schedule A (Form 1040).

Example. You paid $15 to a local church for a half-page ad in a program for a concert it is sponsoring. The purpose of the ad was to encourage readers to buy your products. Since your payment is not a contribution, you cannot deduct it as such. However, you can deduct it as an advertising expense.

Inventory. If you contribute inventory (property you sell in the course of your business), the amount you can claim as a contribution deduction is the smaller of its fair market value on the day you contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that you would otherwise include in your opening inventory for the year of the contribution. You must remove the amount of your contribution deduction from your opening inventory. It is not part of the cost of goods sold.

If the cost of donated property is not included in your opening inventory, the property's basis is zero and you cannot claim a charitable contribution deduction. Treat the property's cost as you would ordinarily treat it under your method of accounting. For example, include the purchase price of inventory bought and donated in the same year in the cost of goods sold for that year.

A corporation (other than an S corporation) can deduct its basis in the property plus one-half of the gain that would have been realized if the property had been sold at its fair market value on the date of contribution. But the deduction cannot be more than twice the property's basis. For more information on the charitable contribution of property by a corporation, see section 170(e)(3) of the Internal Revenue Code.

Example 1. You own an auto repair shop and in 2003 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 2003. Your charitable contribution is $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 2003 for $400 (not part of the opening inven-

tory). The $400 is included as part of the cost of goods sold for 2003 but not in figuring the basis of the property. Your charitable contribution is $0.

Club dues and membership fees. 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, golf and athletic clubs, hotel clubs, sporting clubs, airline clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Exception. None of the following organizations will be treated as a club organized for business, pleasure, recreation, or other social purpose unless one of the main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

- Boards of trade.
- Business leagues.
- Chambers of commerce.
- Civic or public service organizations.
- Professional organizations such as bar associations and medical associations.
- Real estate boards.
- Trade associations.

Damages recovered. Special rules apply to compensation you receive for damages sustained as a result of patent infringement, breach of contract or fiduciary duty, or antitrust violations. You must include this compensation in your income. However, you may be able to take a ***special deduction.*** The deduction applies only to amounts recovered for actual injury, not any additional amount. The deduction is the smaller of the following.

- The amount you received or accrued for damages in the tax year reduced by the amount you paid or incurred in the year to recover that amount.
- Your losses from the injury you have not deducted.

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 that extends substantially beyond the year it is placed in service, 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 may be able to elect to deduct a limited amount of the cost of certain depreciable property in the year you place it in service in your business. This deduction is known as the ***section 179 deduction***.

For information on depreciation and the section 179 deduction, see Publication 946.

Donations to business organizations. You can deduct donations to business organizations as business expenses if all the following conditions are met.

- The donation relates directly to your trade or business.
- You reasonably expect a financial return in line with your donation.
- The donation is not a nondeductible lobbying expense as discussed later under *Lobbying expenses.*

For example, a donation 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 own education expenses (including certain related travel) related to your trade or business. You must be able to show the education maintains or improves skills required in your trade or business, or it is required by your employer, or 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. For more information on education expenses, see Publication 970.

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.

Environmental cleanup costs. You can deduct certain costs to clean up land and to treat groundwater 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. For more information, see *Environmental cleanup costs*, in chapter 8.

Franchise, trademark, trade name. If you buy a franchise, trademark, or trade name, you can deduct the amount you pay or incur as a business expense only if your payments are part of a series of payments that are:

1) Contingent on productivity, use, or disposition of the item,
2) Payable at least annually for the entire term of the transfer agreement, and
3) Substantially equal in amount (or payable under a fixed formula).

When determining the term of the transfer agreement, include all renewal options and any other period for which you and the transferrer reasonably expect the agreement to be renewed.

A franchise includes an agreement that gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area.

Property acquired after August 10, 1993 (or after July 25, 1991, if elected). Any amounts you pay or incur 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 9 for more information on amortization.

You can elect to apply this treatment to any franchise, trademark, or trade name acquired after July 25, 1991. This election is binding and cannot be revoked without approval of 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 the following.

- 10 years.
- The period of the transfer 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 either of the following.

- The period of the transfer agreement.
- A period of more than 10 years, regardless of the period of the agreement.

The above business deductions do not apply to transfers after October 2, 1989, and before August 11, 1993, if the principal 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 choose to 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 discussed earlier for annual and substantially equal payments do not apply.

Disposition of franchise, trademark, or trade name. If you transfer, sell, or otherwise dispose of a franchise, trademark, or trade name, you must recapture as ordinary income (up to any gain realized) the payments you deducted as any of the following.

- A lump-sum or serial payment of a principal amount not treated as a sale or exchange of a capital asset.
- An amortized payment deducted over 25 years.
- The amortization claimed on section 197 intangibles.

For more information about dispositions of franchises, trademarks, and trade names, see chapter 2 in Publication 544.

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 either of the following.

- A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed.
- A physical or mental impairment that substantially limits one or more of your major life activities.

You can deduct the expense as a business expense if all the following apply.

- Your work clearly requires the expense for you to satisfactorily perform the work.
- The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities.
- Their treatment is not specifically provided for under other tax law provisions.

Example. You are blind. You must use a reader to do your work, both at and away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as a business expense.

Interview expense allowances. Reimbursements you make to job candidates for transportation or other expenses related to interviews for possible employment are not wages. You can deduct the reimbursements as a business expense. However, expenses for food, beverages, and entertainment are subject to the 50% limit discussed earlier under *Meals and Entertainment.*

Legal and professional fees. 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 may be deductible on Schedule A (Form 1040) if you itemize 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 9 for more information.

Lobbying expenses. Generally, you cannot deduct lobbying expenses. Lobbying expenses include amounts paid or incurred for any of the following activities.

- Influencing legislation.
- Participating in or intervening in any political campaign for, or against, any candidate for public office.
- Attempting to influence the general public, or segments of the public, about elections, legislative matters, or referendums.
- Communicating directly with covered executive branch officials (defined later) in any attempt to influence the official actions or positions of those officials.
- Researching, preparing, planning, or coordinating any of the preceding activities.

Your expenses for influencing legislation and communicating directly with a covered executive branch official include a portion of your labor costs and general and administrative costs of your business. For information on making this allocation, see section 1.162-28 of the regulations.

You cannot take a charitable or business expense deduction for amounts paid to an organization if both the following apply.

- The organization conducts lobbying activities on matters of direct financial interest to your business.
- A principal purpose of your contribution is to avoid the rules discussed earlier that prohibit a business deduction for lobbying expenses.

If a tax-exempt organization, other than a section 501(c)(3) organization, provides you with a notice on the part of dues that is allocable to nondeductible lobbying and political expenses, you cannot deduct that part of the dues.

Covered executive branch official. For purposes of this discussion, a covered executive branch official is any of the following.

1) The President.
2) The Vice President.
3) Any officer or employee of the White House Office of the Executive Office of the President and the two most senior level officers of each of the other agencies in the Executive Office.
4) Any individual who:
   a) Is serving in a position in Level I of the Executive Schedule under section 5312 of title 5, United States Code,
   b) Has been designated by the President as having Cabinet-level status, or
   c) Is an immediate deputy of an individual listed in item (a) or (b).

Exceptions to denial of deduction. The general denial of the deduction does not apply to the following.

- Expenses of appearing before, or communicating with, any local council or similar governing body concerning its legislation (local legislation) if the legislation is of direct interest to you or to you and an organization of which you are a member. An Indian tribal government is treated as a local council or similar governing body.
- Any in-house expenses for influencing legislation and communicating directly with a covered executive branch official if those expenses for the tax year do not exceed $2,000 (excluding overhead expenses).
- Expenses incurred by taxpayers engaged in the trade or business of lobbying (professional lobbyists) on behalf of another person (but does apply to payments by the other person to the lobbyist for lobbying activities).

Moving machinery. Generally, the cost of moving 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, resumé assistance, skills assessment, etc.

The costs of outplacement services may cover more than one deduction category. For example, deduct as a utilities expense the cost of telephone calls made under this service and deduct as rental expense the cost of renting machinery and equipment for this service.

For information on whether the value of outplacement services is includable in your employees' income, see Publication 15–B.

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 the following amounts.

- Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.

- Paid as a penalty imposed by federal, state, or local law in a civil action, including certain additions to tax and additional amounts and assessable penalties imposed by the Internal Revenue Code.
- Paid in settlement of actual or possible liability for a fine or penalty, whether civil or criminal.
- Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Examples of nondeductible penalties and fines include the following.

- Fines for violating city housing codes.
- Fines paid by truckers for violating state maximum highway weight laws.
- Fines for violating air quality laws.
- Civil penalties for violating federal laws regarding mining safety standards and discharges into navigable waters.

A fine or penalty does not include any of the following.

- 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.
- Court costs or stenographic and printing charges.
- 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 cannot deduct indirect political contributions and costs of taking part in political activities as business expenses. Examples of nondeductible expenses include the following.

- Advertising in a convention program of a political party, or in any other publication if any of the proceeds from the publication are for, or intended for, the use of a political party or candidate.
- Admission to a dinner or program (including, but not limited to, galas, dances, film presentations, parties, and sporting events) if any of the proceeds from the function are for, or intended for, the use of a political party or candidate.
- Admission to an inaugural ball, gala, parade, concert, or similar event if identified with a political party or candidate.

Removal costs. You can deduct the cost of retiring and removing a depreciable asset in connection with the installation or production of a replacement asset. However, you must capitalize the cost of removing a component of a depreciable asset if the replacement adds to the value or usefulness of the asset or significantly increases its useful life.

Repairs. The cost of repairing or improving property used in your trade or business is either a deductible or capital expense. You can deduct repairs that keep your property in a normal efficient operating condition, but that do ***not*** add to its value or usefulness or appreciably lengthen its life. If the repairs add to the value or usefulness of your property or significantly increase its life, you must capitalize them. Although you cannot deduct capital expenses as current expenses, you can usually deduct them over a period of time as depreciation.

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 the following.

- 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 you added to the ***cost of goods sold*** as a separate business expense.

Repayments. If you had to repay an amount you included in your income in an earlier year, you may be able to deduct the amount repaid for the year in which you repaid it. Or, if the amount you repaid is more than $3,000, you may be able to take a credit against your tax for the year in which you repaid it.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount you previously reported as a capital gain, deduct the repayment as a capital loss on Schedule D (Form 1040). If you reported it as self-employment income, deduct it as a business deduction on Schedule C or Schedule C–EZ (Form 1040) or Schedule F (Form 1040).

If you reported the amount as wages, unemployment compensation, or other nonbusiness ordinary income, enter it on line 22 of Schedule A (Form 1040). However, if the repayment is over $3,000 and Method 1 (discussed later) applies, deduct it on line 27 of Schedule A (Form 1040).

Repayment—$3,000 or less. If the amount you repaid was $3,000 or less, deduct it from your income in the year you repaid it.

Repayment—over $3,000. If the amount you repaid was more than $3,000, you can deduct the repayment, as described earlier. However, you can instead choose to take a tax credit for the year of repayment if you included the income under a ***claim of right.*** This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and use the method that results in less tax.

Method 1. Figure your tax for 2003 claiming a deduction for the repaid amount.

Method 2. Figure your tax for 2003 claiming a credit for the prepaid amount. Follow these steps.

1) Figure your tax for 2003 ***without*** deducting the repaid amount.
2) Refigure your tax from the earlier year without including in income the amount you repaid in 2003.
3) Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
4) Subtract the answer in (3) from the tax for 2003 figured without the deduction (step 1).

If Method 1 results in less tax, deduct the amount repaid as discussed earlier under *Type of deduction.*

If Method 2 results in less tax, claim the credit on line 67 of Form 1040, and write "I.R.C. 1341" next to line 67.

Example. For 2002, you filed a return and reported your income on the cash method. In 2003, you repaid $5,000 included in your 2002 gross income under a claim of right. Your filing status in 2003 and 2002 is single. Your income and tax for both years are as follows:

	2002 With Income	2002 Without Income
Taxable Income	$15,000	$10,000
Tax	$ 1,954	$ 1,204

	2003 Without Deduction	2003 With Deduction
Taxable Income	$49,950	$44,950
Tax	$9,304	$ 8,054

Your tax under Method 1 is $8,054. Your tax under Method 2 is $8,554, figured as follows:

Tax previously determined for 2002	$ 1,954
Less: Tax as refigured	– 1,204
Decrease in 2002 tax	$ 750
Regular tax liability for 2003	$9,304
Less: Decrease in 2002 tax	– 750
Refigured tax for 2003	**$ 8,554**

Because you pay less tax under Method 1, you should take a deduction for the repayment in 2003.

Repayment does not apply. This discussion does not apply to the following.

- Deductions for bad debts.
- Deductions from sales to customers, such as returns and allowances, and similar items.
- Deductions for legal and other expenses of contesting the repayment.

Year of deduction (or credit). If you use the cash method of accounting, you can take the deduction (or credit, if applicable) for the tax year in which you actually make the repayment. If you use any other accounting method, you can deduct the repayment or claim a credit for it only for the tax year in which it is a proper deduction under your accounting method. For example, if you use an accrual method, you are entitled to

the deduction or credit in the tax year in which the obligation for the repayment accrues.

Subscriptions. You can deduct as a business expense subscriptions to professional, technical, and trade journals that deal with your business field.

Supplies and materials. Unless you have deducted the cost in any earlier year, you generally can deduct the cost of materials and supplies actually consumed and used during the tax year.

If you keep incidental materials and supplies on hand, you can deduct the cost of the incidental materials and supplies you bought during the tax year if all the following requirements are met.

- You do not keep a record of when they are used.
- You do not take an inventory of the amount on hand at the beginning and end of the tax year.
- This method does not distort your income.

You can also deduct the cost of books, professional instruments, equipment, etc., if you normally use them up within a year. However, if the usefulness of these items extends substantially beyond the year they are placed in service, you generally must recover their costs through depreciation. See *Depreciation,* earlier.

Utilities. Your business expenses for heat, lights, power, and telephone service are deductible. However, any part due to personal use is not deductible.

Telephone. You cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home, even though you have an office in your home. However, charges for business long-distance phone calls on that line, as well as the cost of a second line into your home used exclusively for business, are deductible business expenses.

14.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at **1–877–777–4778.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.
- Visit the web site at **www.irs.gov/advocate**.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services.* It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at **www.irs.gov** to:

- ***E-file.*** Access commercial tax preparation and *e-file* services available for free to eligible taxpayers.
- Check the amount of advance child tax credit payments you received in 2003.
- Check the status of your 2003 refund. Click on "Where's My Refund." Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- See answers to frequently asked tax questions.
- Search publications online by topic or keyword.
- Figure your withholding allowances using our Form W-4 calculator.
- Send us comments or request help by email.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

You can also reach us using File Transfer Protocol at **ftp.irs.gov**.

Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703–368–9694** from your fax machine. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call **703–487–4608.**

Long-distance charges may apply.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.**
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax or account questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2003 refund, call **1–800–829–4477** for automated refund information and follow the recorded instructions or call **1–800–829–1954**. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the

Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Use the address that applies to your part of the country.

- **Western part of U.S.:**
  Western Area Distribution Center
  Rancho Cordova, CA 95743–0001
- **Central part of U.S.:**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702–8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261–5074

CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) on the Internet at **www.irs.gov/cdorders** for $22 (no handling fee) or call **1–877–233–6767** toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide,* is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling **1–800–829–3676** or by visiting the website at **www.irs.gov/smallbiz**.

To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

■

Tax Publications for Business Taxpayers

See *How To Get Tax Help* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

1 Your Rights as a Taxpayer
17 Your Federal Income Tax (For Individuals)
334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
509 Tax Calendars for 2004
553 Highlights of 2003 Tax Changes
910 Guide to Free Tax Services

Employer's Guides

15 Circular E, Employer's Tax Guide
15-A Employer's Supplemental Tax Guide
15-B Employer's Tax Guide to Fringe Benefits
51 Circular A, Agricultural Employer's Tax Guide
80 Circular SS, Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands
179 Circular PR Guía Contributiva Federal Para Patronos Puertorriqueños
926 Household Employer's Tax Guide

Specialized Publications

225 Farmer's Tax Guide
378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
505 Tax Withholding and Estimated Tax
510 Excise Taxes for 2004
515 Withholding of Tax on Nonresident Aliens and Foreign Entities
517 Social Security and Other Information for Members of the Clergy and Religious Workers
527 Residential Rental Property
533 Self-Employment Tax
534 Depreciating Property Placed in Service Before 1987
535 Business Expenses
536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
537 Installment Sales
538 Accounting Periods and Methods
541 Partnerships
542 Corporations
544 Sales and Other Dispositions of Assets
551 Basis of Assets
556 Examination of Returns, Appeal Rights, and Claims for Refund
560 Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
561 Determining the Value of Donated Property
583 Starting a Business and Keeping Records
587 Business Use of Your Home (Including Use by Daycare Providers)
594 The IRS Collection Process
595 Tax Highlights for Commercial Fishermen
597 Information on the United States-Canada Income Tax Treaty
598 Tax on Unrelated Business Income of Exempt Organizations
686 Certification for Reduced Tax Rates in Tax Treaty Countries
901 U.S. Tax Treaties
908 Bankruptcy Tax Guide
911 Direct Sellers
925 Passive Activity and At-Risk Rules
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
954 Tax Incentives for Distressed Communities
1544 Reporting Cash Payments of Over $10,000
1546 The Taxpayer Advocate Service of the IRS

Spanish Language Publications

1SP Derechos del Contribuyente
579SP Cómo Preparar la Declaración de Impuesto Federal
594SP Comprendiendo el Proceso de Cobro
850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get Tax Help* for a variety of ways to get forms, including by computer, fax, phone, and mail. Items with an asterisk are available by fax. For these orders only, use the catalog number when ordering.

Form Number and Title	Catalog Number
W-2 Wage and Tax Statement	10134
W-4 Employee's Withholding Allowance Certificate*	10220
940 Employer's Annual Federal Unemployment (FUTA) Tax Return*	11234
940-EZ Employer's Annual Federal Unemployment (FUTA) Tax Return*	10983
941 Employer's Quarterly Federal Tax Return	17001
1040 U.S. Individual Income Tax Return*	11320
Sch A & B Itemized Deductions & Interest and Ordinary Dividends*	11330
Sch C Profit or Loss From Business*	11334
Sch C-EZ Net Profit From Business*	14374
Sch D Capital Gains and Losses*	11338
Sch D-1 Continuation Sheet for Schedule D*	10424
Sch E Supplemental Income and Loss*	11344
Sch F Profit or Loss From Farming*	11346
Sch H Household Employment Taxes*	12187
Sch J Farm Income Averaging*	25513
Sch R Credit for the Elderly or the Disabled*	11359
Sch SE Self-Employment Tax*	11358
1040-ES Estimated Tax for Individuals*	11340
1040X Amended U.S. Individual Income Tax Return*	11360
1065 U.S. Return of Partnership Income	11390
Sch D Capital Gains and Losses	11393
Sch K-1 Partner's Share of Income, Credits, Deductions, etc.	11394
1120 U.S. Corporation Income Tax Return	11450
1120-A U.S. Corporation Short-Form Income Tax Return	11456
1120S U.S. Income Tax Return for an S Corporation	11510
Sch D Capital Gains and Losses and Built-In Gains	11516
Sch K-1 Shareholder's Share of Income, Credits, Deductions, etc.	11520
2106 Employee Business Expenses*	11700
2106-EZ Unreimbursed Employee Business Expenses*	20604
2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts*	11744
2441 Child and Dependent Care Expenses*	11862
2848 Power of Attorney and Declaration of Representative*	11980
3800 General Business Credit	12392
3903 Moving Expenses*	12490
4562 Depreciation and Amortization*	12906
4797 Sales of Business Property*	13086
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*	13141
5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*	13329
6252 Installment Sale Income*	13601
8283 Noncash Charitable Contributions*	62299
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business*	62133
8582 Passive Activity Loss Limitations*	63704
8606 Nondeductible IRAs*	63966
8822 Change of Address*	12081
8829 Expenses for Business Use of Your Home*	13232