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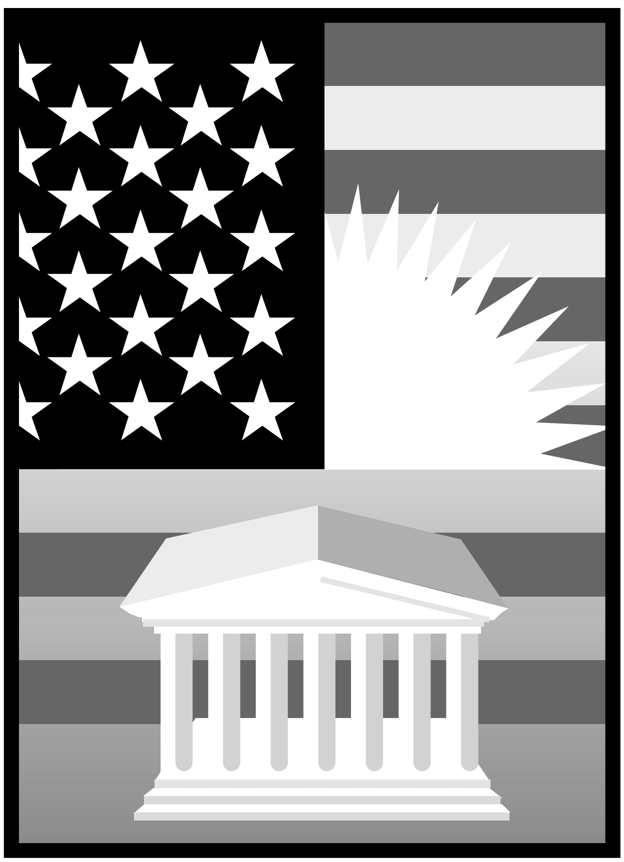
Business Expenses

For use in preparing

1999 Returns



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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.

Important Changes for 1999

The following items highlight some changes in the tax law for 1999.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1999 is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile for business miles driven after March 31. See chapter 16.

Health insurance deduction for the self-employed. For 1999, this deduction increases to 60% of the amount you paid for health insurance for yourself and your family. After 2001, the deduction will increase again. See chapter 10.

Business use of your home. You may be able to deduct expenses for your home office even if it is not where you perform your most important business activities or spend most of your business time. See chapter 1.

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.

Important Changes for 2000

The following items highlight some changes in the tax law for 2000.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2000 is 32.5 cents per mile for each business mile.

Meal expense deduction subject to "hours of service" limits. For 2000, this deduction increases to 60% of the reimbursed meals your employees consume while they are subject to the Department of Transportation's "hours of service" limits. See chapter 16.

Taxable income limit for certain percentage depletion. For tax years beginning after 1999, percentage depletion on the marginal production of oil or natural gas is limited to taxable income from the property figured without the depletion deduction. See chapter 13.

1. Deducting Business Expenses

Introduction

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

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

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

See chapter 17 for information about getting publications and forms.

What Can Be Deducted?

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

It is important to separate business expenses from the following.

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

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

Cost of Goods Sold

If your business manufactures products or purchases them for resale, some of your expenses are for the products you sell. You use these expenses to figure the cost of the goods you sold during the year. You deduct these costs from your gross receipts to figure your gross profit for the year. You must maintain inventories to be able to determine your cost of goods sold. If you use an expense to figure 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 in your inventory, including the cost of having them shipped to you.
- The cost of storing the products you sell.
- Direct labor costs (including contributions to pension or annuity plans) for workers who produce the products.
- Factory overhead expenses.

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

For more information, see the following.

- Cost of goods sold—chapter 6 of Publication 334.
- Inventories—Publication 538.
- Uniform capitalization rules—section 1.263A of the 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 a method of depreciation, amortization, or depletion. These methods allow you to deduct part of your cost each year over a number of years. In this way you are able to "recover" your capital expense. See *Amortization* (chapter 12) and *Depletion* (chapter 13) in this publication. For information on depreciation, see Publication 946.

Going Into Business

The costs of getting started in business, before you actually begin business operations, are capital expenses. 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 12 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 amounts paid to replace parts of a machine that only keep it in a normal operating condition like repairs. However, if your equipment has a major overhaul, capitalize and depreciate the expense.

Capital or Deductible Expenses

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

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

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

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

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

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

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

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

Personal Expenses

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

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

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

The business use of your home must meet specific requirements before you can take any of these expenses as business deductions.

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

1) Your use of the business part of your home must be:
   a) Exclusive,
   b) Regular,
   c) For your trade or business, AND

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, or
   c) A separate structure (not attached to your home) you use in connection with your trade or business.

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

1) For the storage of inventory or product samples.

2) As a day-care facility.

Beginning in 1999, your home office will qualify as your principal place of business if you meet the following requirements.

1) You use the office exclusively and regularly for administrative or management activities of your trade or business.

2) You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

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 1999, the standard mileage rate is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile after March 31.

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 Be Deducted?

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

Recovery of amount deducted. If you recover part of an expense in the same tax year for which you 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 an amount equal to 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. Deductions from passive activities generally can only offset your income from passive activities. You cannot deduct any excess deductions against your other income. In addition, you can take passive activity credits only from tax on net passive income. Any excess loss or credits are carried over to later years. For more information, see Publication 925.

Net operating loss. If your deductions are more than your income for the year, you may have a "net operating loss." You can use a net operating loss to lower your taxes in other years. See Publication 536 for more information. See Publication 542 for information about net operating losses of corporations.

When Can an Expense Be Deducted?

When an expense can be deducted 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 deduct business expenses in the tax year you actually paid them, even if you incur them in an earlier year.

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

Economic performance rule. Under an accrual method, you generally cannot deduct or capitalize business expenses 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 as the property is used. If your expense is for property or services you provide to others, economic performance occurs as you provide the property or services.

Example. Your tax year is the calendar year. In December 1999, 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 2000. If you use an accrual method of accounting, deduct the $150 on your tax return for 1999 because all events that set the amount of liability and economic performance occurred in that year. If you use the cash method of accounting, you can deduct the expenses on your 2000 return.

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

Example. In 1999, you sign a 10-year lease and immediately pay your rent for the first 3 years. Even though you paid the rent for 1999, 2000, and 2001, you can deduct only the rent for 1999 on your current tax return. You can deduct on your 2000 and 2001 tax returns the rent for those years.

Contested liabilities. 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 persons. 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 persons and the person you owe uses the cash method of accounting, you must pay the expense before you can deduct it. The deduction by an accrual method payer is allowed when the corresponding amount is includible in income by the related cash method payee. See *Related Persons* in Publication 538.

Not-for-Profit Activities

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

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

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

Limit on Deductions and Losses

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

Category 1. Deductions you can take for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses, belong in this category. Deduct them on the appropriate lines of Schedule A (Form 1040). You can only deduct a casualty loss on property you own for personal use to the extent it is more than $100 and all these losses exceed 10% of your adjusted gross income. See Publication 547 for more information on casualty losses. For the limits that apply to mortgage interest, see Publication 936.

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

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

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

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

Gross income		$3,200
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 adds the remaining $1,600 (the total of categories (2) and (3)) to her other miscellaneous deductions on Schedule A (Form 1040) that are subject to the 2%-of-adjusted-gross-income limit.

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

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

Presumption of Profit

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

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

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

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

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

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

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. Chapters 3, 4, and 5 provide additional information about the treatment of certain benefits you furnish to employees.

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,* and Publication 15–A, *Employer's Supplemental Tax Guide.* For information about deducting employment taxes paid on your employees' wages, see chapter 9.

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

- *Empowerment zone employment credit.*
- *Indian employment 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 Empowerment Zones and Other Distressed Communities.

Topics

This chapter discusses:

- Tests for deductibility
- Kinds of payments

Useful Items

You may want to see:

Form (and Instructions)

- ☐ **W–2** Wage and Tax Statement
- ☐ **1099–MISC** Miscellaneous Income

See chapter 17 for information about getting publications and forms.

Tests for Deductibility

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 under *What Can Be Deducted?* and *When Can an Expense Be Deducted?* in chapter 1.

In addition, the pay must meet both of 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 by the employee-shareholder, 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 amount of gross and net income of the business, as well as with distributions to shareholders if the business is a corporation.
- Your policy regarding pay for all of your employees.
- The history of pay for each employee.

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

Test 2—For Services Performed

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

Kinds of Payments

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. However, if you give property to an employee as an employee achievement award, your deduction may be limited.

Employee achievement awards. Your deduction for the cost of employee achievement awards given to any one employee during the tax year is subject to the following limits.

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

Include the cost that is not more than the above limits on the "Other deductions" line of your tax return or business schedule.

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

- It is given 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 achievement award if either of the following applies.

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

Safety achievement award. An award will not qualify as a safety achievement award if it is given to either of the following.

1) A manager, administrator, clerical employee, or other professional employee.
2) More than 10% of the employees during the year, excluding those listed in (1).

Qualified plan award. This is an employee achievement award that you awarded as part of an established written plan or program that does not favor highly compensated employees as to eligibility or benefits. See *Exclusion of Certain Fringe Benefits* in chapter 4 for the definition of a highly compensated employee.

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

Exclusion from employee's wages. If the cost of employee achievement awards you give an employee is not more than the limits, you can exclude the awards from the employee's wages.

If the awards cost more than the amount you can deduct, include in the employee's wages the ***larger*** of the following amounts.

- The part of the cost of the awards you cannot deduct (up to the awards' fair market value).
- The amount by which the fair market value of the awards is more than the amount you can deduct.

Do not include the remaining value of the awards in the employee's wages.

Bonuses

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

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

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

Education Expenses

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

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

Employee Benefit Programs

You can generally deduct amounts you spend on employee benefit programs as a business expense. Employee benefit programs include the following.

- Accident and health plans (including medical savings accounts).
- Adoption assistance.
- Cafeteria plans.
- Dependent care assistance.
- Educational assistance.
- Group-term life insurance coverage.
- Welfare benefit funds.

Claim your deduction for these programs on the "employee benefit programs" line of your tax return or business schedule. However, 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.).

For more information about employee benefit programs, see chapter 5. Also, see *Fringe Benefits* and *Meals and Lodging,* later in this chapter.

Group-term life insurance. You cannot deduct the cost of group-term life insurance if you are directly or indirectly the beneficiary of the policy.

Limit on deduction for welfare benefit funds. Your deduction for the cost of employee benefit programs provided under a welfare benefit fund is limited to the fund's qualified cost for the tax year. However, if your contributions to the fund are more than its qualified cost, you can carry the excess over to the next tax year.

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.

Qualified cost. Generally, this 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.

Fringe Benefits

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

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

Include your deduction for fringe benefits 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.

For more information about fringe benefits, see chapter 4. Also, see *Employee Benefit Programs,* earlier, and *Meals and Lodging,* later, in this chapter.

Loans or Advances

You generally can deduct as employee pay a loan or advance you make to an employee that you do not expect the employee to repay if it is for personal services actually performed. The total must be reasonable when you add the loan or advance to the employee's other pay, and it must meet the tests for deductibility, discussed earlier. However, if the employee performs no services, treat the amount you advanced to the employee as a loan, which you cannot deduct.

Below-market interest rate loans. On certain loans you make to an employee or 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 8 for more information.

Meals and Lodging

You can usually deduct the cost of furnishing meals and lodging to your employees. However, you can generally deduct only 50% of your costs of furnishing meals.

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 costs of furnishing lodging to an employee as expenses for utilities, linen service, salaries, depreciation, etc.

For more information about meals and lodging furnished to employees, see chapter 3.

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

- Meals that qualify as a de minimis fringe benefit, as discussed in chapter 4.
- Meals whose value you must include in an employee's wages. For more information, see chapter 3.
- 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 must furnish to crew members of a commercial vessel under a federal law. This includes crew members of commercial vessels operating on the Great Lakes, the Saint Lawrence Seaway, or any U.S. inland waterway if meals would be required under federal law had the vessel been operated at sea. This does not include meals you furnish on vessels primarily providing luxury water transportation.
- 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.

Property

If you transfer property (including your company's stock) to an employee as payment for services, you can deduct it as wages. The amount you can deduct, and the amount you must include in the employee's wages, is its fair market value on the date of the transfer minus any amount the employee paid for the property. You treat the deductible amount as received in exchange for the 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.

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

You can claim the deduction only for your tax year in which the employee includes the property's value in income. The employee is deemed to have included the value in income if you report it on Form W–2 in a timely manner.

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,*** include it in your employee's wages and deduct it as wages on your tax return or business schedule.

See *Travel, Meals, and Entertainment* in chapter 16 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 compensation. However, your deduction is limited to amounts not compensated by insurance or other means.

Vacation Pay

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

You can ordinarily 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.

However, you can deduct vacation pay in your tax year in which the employee earns it if it is vested by the end of that year and the employee actually receives it within 2½ months after the end of that year. Generally, vacation pay is vested if it is payable under an oral or written vacation pay plan that you told your employees about before the tax year and its amount and your liability for it are certain.

3. Meals and Lodging Furnished to Employees

Important Reminder

Meals furnished on your business premises. If you furnish meals to employees on your business premises and more than half of these employees are furnished the meals for your convenience, then all the meals are considered furnished for your convenience. See *Test 2—For Your Convenience* under *Exclusion From Employee Wages.* This means that you can exclude the value of all the meals from the employees' wages.

Introduction

If you furnish meals or lodging to an employee, or to anyone else in connection with the employee's services, you must generally include the value in the employee's wages. You determine the value using the rules explained in chapter 4.

This chapter explains a special rule that allows you to exclude the value of meals and lodging from an employee's wages if you meet certain tests. See chapter 4 for information on excluding the value of certain meals as a de minimis fringe benefit.

For information about deducting the cost of meals and lodging furnished to an employee, see chapter 2.

Exclusion From Employee Wages

You can exclude from an employee's wages the value of meals and lodging you, or a third party on your behalf, furnish to the employee or the employee's spouse or dependents if you meet all the following tests.

- ***Test 1.*** You furnish the meals or lodging ***on your business premises.***
- ***Test 2.*** You furnish the meals or lodging ***for your convenience.***
- ***Test 3.*** In the case of lodging (but not meals), you require your employee to accept the lodging on your business premises ***as a condition of his or her employment.***

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

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

Test 1—On Your Business Premises

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

Test 2—For Your Convenience

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

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

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

Meals you furnish to promote goodwill, boost morale, or attract prospective employees. These meals are considered furnished in your business for pay reasons. They are not furnished for your convenience unless you also have a substantial nonpay business reason for furnishing the meals.

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

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

If you furnish meals for which you charge the employees a flat amount whether or not they eat the meals, do not include the flat amount you charge in your employees' wages. Whether the value of the meals is wages depends on whether you meet *Tests 1* and *2.* If you do not meet both of these tests, you must include the value of the meals in your employees' wages whether it is more or less than the amount you charged. If no evidence indicates otherwise, the value of the meals is the amount you charged for them.

Test 3—Lodging Required as a Condition of Employment

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

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

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

Examples

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

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

Example 2 (Meals on nonworkdays). The facts are the same as in *Example 1,* except that you also allow Carol to have meals on your business premises without charge on her days off. You must include the value of these meals in her wages.

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

Example 4 (Meals). A hospital maintains a cafeteria on its premises where all of its 230 employees may get meals at no charge during their working hours. The hospital furnishes meals to have 120 employees available for emergencies. Each of these employees is at times called upon to perform services during the meal period. Although the hospital does not require these employees to remain on the premises, they rarely leave the hospital during their meal period. Since the hospital furnishes meals to its employees to have more than half of them available for emergency calls during meal periods, the hospital does not include the value of these meals in the wages of any of its employees.

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

4. Fringe Benefits

Important Change for 1999

Vehicle cents-per-mile rule. The standard mileage rate you can use under the vehicle cents-per-mile rule to value the personal use of a car, van, pickup, or panel truck you provide to an employee in 1999 is 32½ cents a mile for all personal miles driven before April 1. The rate is 31 cents a mile for personal miles driven after March 31. See *Vehicle Cents-Per-Mile Rule.*

Important Reminders

Meals furnished to employees. If the value of meals you provide at your eating facility for employees can be excluded from their wages because you furnish them for your convenience, your revenue from the meals is considered to equal the facility's direct operating costs for them. This means that you may be able to treat the meals as a de minimis fringe benefit and deduct all of their cost. See *De Minimis (Minimal) Fringe.*

Qualified transportation fringe benefits in place of pay. You can exclude qualified transportation fringe benefits from an employee's wages even if you provide them in place of pay. See *Qualified Transportation Fringe.*

Introduction

If you provide a fringe benefit to an employee, you must generally include the value in the employee's wages. This chapter explains the valuation rules for fringe benefits that you include in an employee's wages. However, it does not cover all the exceptions to these rules, or the rules that apply to the use of an aircraft. For more information, see section 1.61–21 of the regulations.

This chapter also discusses some special rules that allow you to exclude the value of certain fringe benefits from an employee's wages. See chapters 3 and 5 for information on excluding the value of certain other benefits from wages.

For information about deducting the cost of fringe benefits, see chapter 2.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **15** Circular E, Employer's Tax Guide
- ☐ **15–A** Employer's Supplemental Tax Guide

Form (and Instructions)

- ☐ **W–2** Wage and Tax Statement
- ☐ **1099–MISC** Miscellaneous Income

See chapter 17 for information about getting publications and forms.

General Information

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

Examples of fringe benefits you may provide include the following items.

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

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

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

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

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

Including benefits in pay. Unless the law says otherwise, you must include the value of fringe benefits in the recipient's pay.

If the recipient of a taxable fringe benefit is your employee, the benefit is subject to employment taxes and must be reported on Form W–2. However, you can use special rules to withhold, deposit, and report the employment taxes. See Publication 15 and Publication 15–A for more information.

If the recipient of a taxable fringe benefit is not your employee, the benefit is not subject to employment taxes. However, you may have to report it on Form 1099–MISC and you may have to withhold income tax under the backup withholding rules. See the *Instructions for Forms 1099, 1098, 5498, and W–2G* for more information.

General Valuation Rule

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

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

However, you and the employee may use special rules to value certain fringe benefits. (See *Special Valuation Rules,* later.)

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

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

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

Employer-provided vehicles. In general, the value of an employer-provided vehicle is the amount the employee would have to pay a third party to lease the same or a similar vehicle on the same or comparable terms in the same geographic area where the employee uses the vehicle. A comparable lease term would be the amount of time the vehicle is available for the employee's use, such as a 1-year period.

Do not determine the value by multiplying a cents-per-mile rate times the number of miles driven unless the employee can prove the vehicle could have been leased on a cents-per-mile basis. (However, see *Vehicle Cents-Per-Mile Rule,* later.)

Special Valuation Rules

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

- Automobile lease rule.
- Commuting rule.
- Employer-operated eating facility rule.
- Unsafe conditions commuting rule.
- Vehicle cents-per-mile rule.

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

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

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

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

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

Automobile Lease Rule

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

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

Benefits excluded for business use. If the employee uses the automobile for business, he or she may qualify to exclude part of the lease value as a working condition fringe benefit. You can reduce the amount of the lease value by the working condition fringe and include the net amount in the employee's wages, or you can choose to include the entire lease value. See *Vehicle-allocation rules* under *Working Condition Fringe,* later.

Annual Lease Value

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

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

Annual Lease Value Table

(1) Automobile Fair Market Value	(2) Annual Lease Value
$0 to 999	$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600

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

For vehicles with an FMV of more than $59,999, the annual lease value equals (.25 × the FMV of the automobile) + $500.

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

If you have 20 or more automobiles, see section 1.61–21(d)(5)(v) of the regulations. See section 1.61–21(d)(2)(ii) of the regulations if you and the employee own or lease the automobile together.

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

Neither the amount the employee considers to be the value of the fringe benefit nor your cost for either buying or leasing the automobile determines its FMV. However, see *Safe-harbor value,* next.

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

For an automobile you lease, you can use any of the following as the safe-harbor value.

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

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

3) The retail value of the automobile reported by a nationally recognized pricing source if that retail value is reasonable for that automobile.

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

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

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

If you have 20 or more automobiles, see section 1.61–21(d)(3)(ii)(D) of the regulations.

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

Consistency rules. If you adopt the automobile lease rule for an automobile, the following rules apply.

1) You must adopt it by the first day you make the automobile available to any employee for personal use. However, the following exceptions apply.

   a) If you adopt the commuting rule when you first make the automobile available to any employee for personal use, you can change to the automobile lease rule on the first day for which you do not use the commuting rule.

   b) If you adopt the vehicle cents-per-mile rule when you first make the automobile available to any employee for personal use, you can change to the automobile lease rule on the first day on which the automobile no longer qualifies for that rule.

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

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

4) The employee can use the automobile lease rule only if the employee uses the rule beginning with the first day on which the automobile is made available to the employee for personal use (and the employer does not use the commuting rule).

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

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

Using the special accounting rule. If you use the special accounting rule for fringe benefits discussed in Publication 15–A, you can figure the annual lease value for each later 4-year period at the beginning of the special accounting period that starts immediately before the January 1 date described in the previous paragraph.

For example, assume that you use the special accounting rule and that, beginning on November 1, 1998, the special accounting period is November 1 to October 31. You elected to use the automobile lease valuation rule as of January 1, 1999. You can refigure the annual lease value on November 1, 2002, rather than on January 1, 2003.

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

However, if you use the special accounting rule for fringe benefits discussed in Publication 15–A, you can refigure the annual lease value (based on the FMV of the automobile) at the beginning of the special accounting period in which the transfer occurs. If you do not refigure the annual lease value, the employee cannot refigure it.

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

If you provide an automobile continuously for at least 30 days, but the period covers 2 calendar years (2 special accounting periods if you are using the special accounting rule for fringe benefits discussed in Publication 15–A), you can use the prorated annual lease value or the daily lease value.

If you have 20 or more automobiles, see section 1.61–21(d)(6) of the regulations.

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

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

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

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

Commuting Rule

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

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

You can use this special rule to figure commuting value if all the following requirements are met.

1) You own or lease the vehicle and provide it to one or more employees for use in your trade or business.
2) For bona fide noncompensatory business reasons, you require the employee to commute in the vehicle.
3) You establish a written policy under which you do not allow the employee to use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home).
4) The employee does not use the vehicle for personal purposes, other than commuting and de minimis personal use.
5) If this vehicle is an automobile, the employee who must use it for commuting is not a ***control employee*** (defined later).

Personal use of a vehicle is all use that is not for your trade or business.

An employer-provided vehicle generally used each workday to carry at least three employees to and from work in an employer-sponsored commuting pool meets requirements (1) and (2) above.

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

Control employees. A control employee of a ***nongovernment employer*** for 1999 is any employee who:

1) Was a board- or shareholder-appointed, confirmed, or elected officer of the employer whose pay for the year was $70,000 or more,
2) Was a director of the employer,
3) Received pay for the year of $145,000 or more from the employer, or
4) Owned a 1% or more equity, capital, or profits interest in the employer.

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

A control employee of a ***government employer*** for 1999 is any:

1) Elected official, or
2) Employee whose pay was at least $110,700 for the year (the pay of a federal government employee at Executive Level V).

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

Instead of using the above definitions, you can choose to treat all of your highly compensated employees as control employees. For the definition of a highly compensated employee, see *Exclusion of Certain Fringe Benefits,* later.

Employer-Operated Eating Facility Rule

You can use this rule to determine the value of taxable meals you provide at an employer-operated eating facility for employees. For situations in which you do not have to include the value of meals in an employee's wages, see chapter 3 and the discussion under *De Minimis (Minimal) Fringe,* later.

Under this rule, you first figure the ***total meal value*** of meals provided at the facility. Then you use that value to figure the value for each employee under either of the following two methods.

1) The ***individual meal subsidy*** method.
2) The ***allocated total meal subsidy*** method.

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

1) You own or lease the facility.
2) You operate the facility. You are considered to operate the eating facility if you have a contract with another to operate it.
3) The facility is on or near your business premises.
4) You provide meals (food, drinks, and related services) at the facility during, or immediately before or after, the employee's workday.

Total meal value. The total meal value is 150% of the ***direct operating costs*** of the eating facility. This total meal value is considered the value of all meals provided at that facility for employees during the calendar year.

Direct operating costs. The direct operating costs of an eating facility are the costs of food and drinks and the cost of labor for employees performing services relating to the facility primarily on the eating facility premises. For example, the labor costs for cooks, waiters, and waitresses are included in direct operating costs. If an employee performs the services both on and off premises, include only the labor costs for the services performed on premises.

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

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

CAUTION **Meal charge required.** *You can use the individual meal subsidy method only if there is a charge for each meal and the price charged each employee is the same for any given meal.*

Allocated total meal subsidy method. Under this method, you figure the value of meals provided to a particular employee by allocating the ***total meal subsidy*** among the employees in any manner reasonable under the circumstances. It is presumed reasonable for you to allocate the total meal subsidy on a per-employee basis if you can show that you provided each employee with approximately the same number of meals at the facility.

Total meal subsidy. This is the total meal value (explained earlier) minus the gross receipts of the facility.

Unsafe Conditions Commuting Rule

Under this rule, the value of the commuting use of ***transportation*** you provide each employee solely because of ***unsafe conditions*** is $1.50 per one-way commute (that is, from home to work or from work to home).

You can use this special rule to figure commuting value if all the following requirements are met.

1) The employee would ordinarily walk or use public transportation for commuting.
2) You establish a written policy under which you do not allow the employee to use the transportation for personal purposes other than commuting because of unsafe conditions.
3) The employee does not use the transportation for personal purposes other than commuting because of unsafe conditions.
4) The employee is a ***qualified employee.***

This special valuation rule applies on a trip-by-trip basis. If the requirements are not met for any trip, use the FMV of the transportation to determine the amount to include in the employee's wages.

Transportation. This rule applies to transportation of a qualified employee to or from work by any motorized wheeled vehicle (including an automobile) manufactured for use on public streets, roads, and highways. You or the employee must buy the transportation from a party that is not related to you. If the employee buys it, you must reimburse the employee for its cost (for example, cabfare) under a bona fide reimbursement arrangement.

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

Qualified employee. A qualified employee for 1999 is one who meets the following requirements.

1) Performed services during the year.
2) Was paid on an hourly basis.
3) Was not claimed under section 213(a)(1) of the Fair Labor Standards Act of 1938 (as amended) to be exempt from the minimum wage and maximum hour provisions.
4) Was within a classification for which you actually paid, or specified in writing you would pay, overtime pay of at least one and one-half times the regular rate provided in section 207 of the 1938 Act.
5) Received pay of not more than $70,000 during the year.

However, the employee will not be considered a qualified employee if you do not comply with the recordkeeping requirements concerning the employee's wages, hours, and other conditions and practices of employment under section 211(c) of the 1938 Act and the related regulations.

Vehicle Cents-Per-Mile Rule

Under this rule, you determine the value of a vehicle you provide to an employee for personal use by multiplying the standard mileage rate by the total miles the employee drives the vehicle for personal purposes. For 1999, the rate is $32\frac{1}{2}$ cents a mile for all personal miles driven before April 1. The rate is 31 cents a mile for personal miles driven after March 31.

You can use the vehicle cents-per-mile rule if either of the following requirements is met.

1) You reasonably expect the vehicle to be regularly used in your trade or business throughout the calendar year (or for a shorter period during which you own or lease it).
2) The vehicle meets the mileage rule requirements discussed later.

When you cannot use the cents-per-mile rule. *You cannot use the vehicle cents-per-mile rule for an automobile first made available to an employee for personal use in 1999 if the FMV of the automobile is more than $15,500. If you and the employee own or lease the automobile together, see section 1.61–21(e)(1)(iii) of the regulations.*

Apply the standard mileage rate only to personal miles. Disregard business miles. For example, if the employee drove 20,000 personal miles and 35,000 business miles in the last 9 months of 1999, the personal use value of the vehicle for those months is $6,200 (20,000 × .31).

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

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

Regular use in your business. Determine whether a vehicle is regularly used in your trade or business on the basis of all the facts and circumstances. A vehicle is regularly used in your trade or business if it meets any of the following safe-harbor conditions.

1) At least 50% of the vehicle's total annual mileage is for your trade or business.
2) You sponsor a commuting pool that generally uses the vehicle each workday to drive at least 3 employees to and from work.

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

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

1) The vehicle is actually driven at least 10,000 miles during the year.
2) The vehicle is used during the year primarily by employees.

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

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

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

For special rules that apply to fuel you provide for miles driven outside the United States, Canada, and Mexico, see section 1.61–21(e)(3)(ii)(B) of the regulations.

The FMV of any other service you provide for a vehicle is not included in the cents-per-mile rate. Use the general valuation rule to value these services.

Consistency rules. If you adopt the cents-per-mile rule for an automobile, the following rules apply.

1) You must adopt it by the first day you make the automobile available to any employee for personal use. However, if you adopt the commuting rule when you first make the automobile available to any employee for personal use, you can change to the cents-per-mile rule on the first day for which you do not use the commuting rule.
2) You must use the rule for all later years in which you make the automobile available to any employee and the automobile qualifies, except that you can use the commuting rule for any year during which use of the automobile qualifies. However, if the vehicle does not qualify for the cents-per-mile rule during a later year, you can adopt for that year and thereafter any other special rule for which the vehicle then qualifies.
3) You must continue to use the rule if you provide a replacement automobile to the employee and your primary reason for the replacement is to reduce federal taxes.
4) The employee can use the vehicle cents-per-mile rule only if the employee uses the rule beginning with the first day on which the automobile is made available to the employee for personal use (and the employer does not use the commuting rule).

Exclusion of Certain Fringe Benefits

Special rules allow you to exclude certain fringe benefits you provide to an employee from the employee's wages. You can exclude under these rules all of the following fringe benefits.

- A de minimis (minimal) fringe.
- A no-additional-cost service.
- An on-premises athletic facility.
- A qualified employee discount.
- A qualified moving expense reimbursement.
- A qualified transportation fringe.
- A working condition fringe.

TIP *These are not the only employee benefits you can exclude from an employee's wages. For example, you can also exclude certain meals and lodging you provide for your convenience and certain benefits you provide through employee ben-*

efit programs. For more information, see chapters 3 and 5.

Except for the exclusions for de minimis fringe benefits and qualified moving expense reimbursements, the above exclusions do not apply if the tax treatment of the fringe benefit is provided by another tax rule. For example, these exclusions do not apply to employer-provided dependent care assistance or tuition reductions, the tax treatments of which are covered by other rules. However, if another tax rule excludes a benefit from wages and the exclusion is a limited amount of the benefit's cost, an exclusion under the fringe benefit rules may apply to the rest of the cost.

The value of fringe benefits you properly exclude from an employee's wages is not subject to income tax withholding or social security, Medicare, or federal unemployment (FUTA) tax. You do not report it as wages on Form W–2.

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

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

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

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

Highly compensated employee. A highly compensated employee for 2000 is an employee who:

1) Was a 5% owner at any time during the year or the preceding year, or
2) Received more than $85,000 in pay for the preceding year.

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

De Minimis (Minimal) Fringe

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

Examples of de minimis fringes include the following.

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

TIP *If food or beverages you furnish employees qualify as a de minimis fringe benefit, you can deduct their full cost. The 50% limit on deductions for the cost of meals does not apply. See* Deduction limit on meals *under* Meals and Lodging *in chapter 2.*

Employer-operated eating facility. The value of meals you provide to employees at an eating facility operated by you is a de minimis fringe benefit only if the annual revenue from the facility equals or exceeds the direct operating costs of the facility. For the nondiscrimination requirements, see *Nondiscrimination rules,* earlier. For definitions of an employer-operated eating facility and direct operating costs, see *Employer-Operated Eating Facility Rule,* earlier.

Meals furnished for your convenience. If the value of the meals furnished at your eating facility for employees can be excluded from the employees' wages under the rules explained in chapter 3, your revenue from the meals is considered to equal the facility's direct operating costs for them.

No-Additional-Cost Service

If you provide an employee with the same service you offer to customers in the ordinary course of the ***line of business*** in which the employee performs substantial services, this service may be a no-additional-cost service. Do not include the value of the service in the employee's wages if you do not incur any substantial additional costs to provide the service to the employee. (But see *Nondiscrimination rules,* earlier, if the employee is highly compensated.) To determine additional costs include lost revenue, but do not reduce the costs you incur by any amount the employee paid for this service.

Generally, no-additional-cost services are excess capacity services, such as airline, bus, or train tickets; hotel rooms; or telephone services provided free or at a reduced price to employees working in those lines of business.

Generally, an employer's ***line of business*** is determined by the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. For more information, see section 1.132–4 of the regulations.

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

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

Employee. For this fringe benefit, “employee” includes any of the following persons.

1) An individual currently employed by you.
2) An individual who stopped working for you as an employee because of retirement or disability.
3) A surviving spouse of an individual who died while working for you as an employee or who stopped working for you as an employee because of retirement or disability.
4) Partner who performs services for a partnership.

Treat services you provide to the spouse or dependent child of an employee as provided to the employee. For this fringe benefit, “dependent child” means any son, stepson, daughter, or stepdaughter who is a dependent of the employee, or both of whose parents have died and who has not reached age 25. Treat a child of divorced parents as a dependent of both parents.

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

On-Premises Athletic Facilities

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

For this purpose, the term “employee” includes the same individuals included as employees for no-additional-cost services (described earlier).

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

Qualified Employee Discount

Do not include in an employee's wages the value of a qualified employee discount. A qualified employee discount is a price reduction you give an employee on certain property or services you offer to customers in the ordinary course of the line of business in which the employee performs substantial services. For the rules on line of business, see *No-Additional-Cost Service,* earlier. If the employee is highly compensated, see *Nondiscrimination rules,* earlier.

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

1) For a discount on property, your ***gross profit percentage*** times the price you charge customers for the property.

2) For a discount on services, 20% of the price you charge customers for the service.

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

The term "employee" includes the same individuals listed earlier under *No-Additional-Cost Service.* For special rules concerning employees of a leased section of a department store, see section 1.132–3(d) of the regulations.

Qualified Moving Expense Reimbursements

You can exclude from an employee's wages any qualified moving expense reimbursement. This is any amount you give the employee, directly or indirectly (including services furnished in kind), as a payment for, or a reimbursement of, expenses that would be deductible as moving expenses if your employee paid or incurred them. You should make the reimbursements under rules similar to those described in chapter 16 for reimbursements of expenses for travel, meals, and entertainment under accountable plans.

Deductible moving expenses. Deductible moving expenses include only the reasonable expenses of:

1) Moving household goods and personal effects from the former home to the new home, and

2) Traveling (including lodging) from the former home to the new home.

CAUTION: *Deductible moving expenses do not include any expenses for meals.*

For more information on deductible moving expenses, see Publication 521, *Moving Expenses.*

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

Where to report reimbursements. Report any qualified moving expense reimbursements you paid directly to an employee in 1999 in box 13 of the employee's 1999 Form W–2. Use code "P" to identify the reimbursements. Do not report any qualified moving expense reimbursements you paid to a third party on behalf of the employee or services that you furnished in kind to an employee.

Include any nonqualified moving expense reimbursements with your employee's wages in box 1.

Qualified Transportation Fringe

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

1) A ride in a commuter highway vehicle between the employee's home and work place.

2) A transit pass.

3) Qualified parking.

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

Benefit provided in place of pay. You can exclude qualified transportation fringe benefits from an employee's wages even if you provide them in place of pay.

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

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

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

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

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

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

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

Exclusion Limits

For 2000, you may exclude from the wages of each employee up to:

1) $65 per month for combined commuter highway vehicle transportation and transit passes, and

2) $175 per month for qualified parking.

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

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

Example 2. Each month, you provide qualified parking valued at $180 to Travis Ramon. He does not pay you for any part of the parking. Because the value of the parking exceeds the limit, for each month you provide this parking you must include $5 in his wages for income and employment tax purposes.

Example 3. You provide qualified parking with a fair market value of $200 per month to your employees, but you charge the employees $25 per month. The value of the parking exceeds the limit by $25. You reduce that excess benefit by the amount your employees paid ($25). Do not include any amount in your employees' wages.

More Information

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

Working Condition Fringe

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

For this fringe benefit, **employee** includes any of the following persons.

1) An individual currently employed by you.
2) A partner who performs services for a partnership.
3) A director of your company.
4) An independent contractor who performs services for you.

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

Vehicle-allocation rules. Generally, for an employer-provided vehicle, the amount you can exclude as a working condition fringe is the amount that would be allowable as a deductible business expense if paid by the employee. That is, if the employee uses the car for business, as well as for personal use, the value of the working condition fringe is the portion determined to be for business use of the vehicle. See *Business use of your car* under *Personal Expenses* in chapter 1. Also, see the special rules for certain demonstrator cars and qualified nonpersonal-use vehicles, discussed later.

However, instead of excluding the value of the working condition fringe related to the deductible car expense, you may include the entire annual lease value in an employee recipient's wages. The employee can then claim any deductible business car expense as an itemized deduction on his or her personal income tax return. This option is available only if you use the automobile lease rule (discussed under *Special Valuation Rules,* earlier) to value the fringe benefit.

Educational assistance. If you pay the cost of an employee's education, you may be able to exclude the cost from the employee's wages under the tax rules that apply to employer-provided educational assistance programs. Costs you cannot exclude under those rules may be excluded only if they qualify as a working condition fringe. To qualify as a working condition fringe, the cost of the education must be a job-related expense that would be deductible by the employee if he or she paid it. For more information on educational assistance programs, see chapter 5. For more information on deductible education expenses, see Publication 508, *Tax Benefits for Work-Related Education.*

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

You cannot exclude the value of services that do not qualify as a working condition fringe because the employee can choose to receive cash or taxable benefits in place of the services. If you maintain a severance plan and permit employees to get outplacement services with reduced severance pay, include in the employee's wages the difference between the unreduced severance and the reduced severance payments.

Demonstrator cars. All of the use of a demonstrator car by your full-time auto salesperson generally qualifies as a working condition fringe if the use is primarily to facilitate the services the salesperson provided for you and there are substantial restrictions on personal use. For more information and the definition of “full-time auto salesperson,” see section 1.132–5(o) of the regulations.

Qualified Nonpersonal-Use Vehicles

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

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

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

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

Law enforcement officer. A law enforcement officer is a full-time employee of a governmental unit that is responsible for preventing or investigating crimes involving injury to persons or property (including catching or detaining persons for these crimes). The law must allow the employee to take all of the following actions.

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

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

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

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

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

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

1) Permanent shelving that fills most of the cargo area.

2) An open cargo area and the van always carries merchandise, material, or equipment used in your trade, business, or function.

Items Not Excludable

The following are examples of items you cannot exclude from an employee's wages as working condition fringe benefits.

1) A service or property offered through a flexible spending account. A flexible spending account is an agreement that gives employees over a time period a certain amount of unspecified noncash benefits with a predetermined cash value.

2) Any item for which the employee does not have the necessary substantiation to deduct as a trade, business, or depreciation expense.

3) Expenses the employee can deduct under sections of the Internal Revenue Code other than for trade or business expenses or depreciation.

4) A physical examination program, even if mandatory for some or all employees.

5) A cash payment you made to the employee unless you require the employee to do all of the following.

   a) Use the money for expenses for a specific or prearranged activity that are deductible as trade, business, or depreciation expenses.

   b) Verify that he or she used the money for these expenses.

   c) Return any unused money to you.

5. Employee Benefit Programs

Introduction

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

You can generally exclude a limited amount of the cost of benefits you provide to an employee through certain employee benefit programs from the employee's wages as you withhold, pay, and report employment taxes. This chapter explains how to figure the amount you can exclude from your employee's wages. See chapters 3 and 4 for information on excluding certain other benefits from wages. See chapter 2 for information about deducting the costs of employee benefit programs.

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

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

See chapter 17 for information about getting publications and forms.

Accident and Health Plans

This section provides basic tax information about accident and health plans.

Accident or health plan. This is an arrangement that provides benefits for your employees, their spouses, and their dependents in the event of personal injury or sickness. The benefits can be paid directly by you, through insurance, or through a trust or fund that provides benefits directly or through insurance.

Accident and health benefits include the following items.

- Contributions to the cost of accident or health insurance.
- Contributions to a separate trust or fund that provides accident or health benefits directly or through insurance.
- Contributions to medical savings accounts.
- Payments or reimbursements of medical expenses.
- Payments for specific injuries or illnesses (such as the loss of the use of an arm or leg).
- Payments that replace or supplement wages during an absence from work due to illness or injury.

Special rules apply to accident or health plans that include coverage under a group health plan or contributions to an employee's medical savings account. These rules are explained later.

Exclusion from wages. You can generally exclude benefits you provide to an employee under an accident or health plan from the employee's wages as you withhold, pay, and report employment taxes. However, you cannot exclude payments you make under a self-insured plan as a continuation of an employee's wages during his or her absence from work (sick pay). Treat these payments as wages.

Self-insured plans that favor highly compensated individuals. If your plan is a self-insured plan and it favors highly compensated individuals, you must include all or part of the amounts you pay to these individuals in their wages.

A self-insured plan is a plan that reimburses your employees for medical expenses not covered by an accident or health insurance policy.

A highly compensated individual (for this purpose) is any of the following.

1) One of the five highest paid officers.

2) A shareholder who owns (directly or indirectly) more than 10% in value of the employer's stock.

3) Among the highest paid 25% of all employees, other than those who can be excluded from the plan.

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

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

If your accident or health plan includes coverage under a group health plan, you may be subject to various excise taxes if the group health plan does not meet certain requirements.

Coverage requirements. A tax equal to 25% of your group health plan expenses may apply if the plan discriminates against beneficiaries with end-stage renal disease or because of age or disability. For more information, see section 5000 of the Internal Revenue Code.

Continuation-of-coverage requirements. A tax of up to $100 per beneficiary may apply for each day the plan does not allow qualified beneficiaries who would otherwise lose coverage because of certain events to choose continuation coverage under the plan. This tax does not apply if you normally employ fewer than 20 employees.

For more information, see section 4980B of the Internal Revenue Code and the related regulations.

Other requirements. A tax of up to $100 per beneficiary may apply for each day the plan does not meet requirements that do all the following.

- Increase portability by limiting the circumstances under which the plan can deny coverage for preexisting conditions.
- Ensure accessibility by barring the plan from using an individual's health status to deny coverage.
- Guarantee renewability under a multi-employer plan by limiting the circumstances under which the plan can deny

an employer continued access to coverage.

- Ensure an acceptable level of postpartum care by obligating the plan to pay for a minimum hospital stay for mothers and newborns following childbirth if the plan otherwise provides benefits for hospital stays in connection with childbirth.
- Increase parity for mental health benefits by preventing the plan from placing lower limits on those benefits than on the plan's medical and surgical benefits.

This tax does not generally apply if the plan has fewer than two participants who are current employees or if your plan is insured and you normally employ no more than 50 employees. For more information, see section 4980D and chapter 100 of the Internal Revenue Code.

Medical savings accounts. If your health plan for your employees has a higher annual deductible than typical health plans, your employees may be able to set up medical savings accounts (MSAs) to set aside money for medical expenses not reimbursable by the plan. Generally, your employees can set up MSAs only if you have 50 or fewer employees and your high-deductible health plan has a limit on the annual out-of-pocket expenses that an employee must pay for covered expenses.

If you contribute to an employee's MSA, treat your contribution as accident or health plan benefits up to the maximum annual contribution allowed for that employee. Generally, this is 75% (65% for self-only coverage) of the health plan's annual deductible, limited to the amount of the employee's wages.

You may be subject to an excise tax if you make a contribution to an employee's MSA during any calendar year and do not make comparable contributions for all comparable participating employees for each coverage period during that year. The tax is 35% of the total amount you contributed to MSAs that year.

For more information, see Publication 969, *Medical Savings Accounts (MSAs).*

Adoption Assistance

You can exclude payments or reimbursements you make under an adoption assistance program for an employee's qualified adoption expenses from the employee's wages. The payments are not subject to income tax withholding. However, they are subject to other employment taxes. For more information, see Publication 968, *Tax Benefits for Adoption.*

Cafeteria Plans

This section provides basic tax information about cafeteria plans.

Cafeteria plan. A cafeteria plan is a written plan that allows your employees to choose between receiving cash or certain qualified benefits.

Generally, a cafeteria plan does not include any plan that offers a benefit that defers pay. However, a cafeteria plan can include a qualified 401(k) plan as a benefit. Also, certain life insurance plans maintained by educational institutions can be offered as a benefit even though they defer pay.

The fact that your employee can choose between cash and qualified benefits does not make the qualified benefits your employee chooses to receive taxable to the employee.

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

Exclusion from wages. You can generally exclude the cost of providing qualified benefits to an employee under a cafeteria plan from the employee's wages as you withhold, pay, and report employment taxes. However, certain group-term life insurance coverage (discussed later) is subject to social security and Medicare taxes. Also, adoption benefits are subject to social security, Medicare, and federal unemployment taxes.

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

A highly compensated employee (for this purpose) is any of the following.

1) An officer.
2) A shareholder who owns more than 5% of the voting power or value of all classes of the employer's stock.
3) An employee who is highly compensated based on the facts and circumstances.
4) A spouse or dependent of a person described in (1), (2), or (3).

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

A key employee during 2000 is generally an employee who is any of the following.

1) An officer having, for any year listed below, annual pay of more than the listed amount.
   a) 1996 — $60,000
   b) 1997 — $62,500
   c) 1998 — $65,000
   d) 1999 — $65,000
   e) 2000 — $67,500
2) A person who, for 2000 or any of the 4 preceding years, was any of the following.
   a) One of the 10 employees having annual pay of more than $30,000 and owning the largest interests in your business.
   b) A 5% owner of your business.
   c) A 1% owner of your business whose annual pay was more than $150,000.

To determine ownership in (2) above, treat your employee as owning both his or her own interest and any related person's interest. The term **related person** includes the employee's spouse, children, grandchildren, and parents. It also includes any corporations, partnerships, estates, or trusts in which the employee has at least a 5% interest.

More information. For more information about cafeteria plans, see section 125 of the Internal Revenue Code and the related regulations.

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

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

You will need these records to file Form 5500 after the end of the plan year.

Form 5500. If you maintain a cafeteria plan, you must file information about the plan each year by the last day of the 7th month after the plan year ends. Use Form 5500 and Schedule F (Form 5500). See the form instructions for information on extensions of time to file.

Dependent Care Assistance

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

Dependent care assistance program. A dependent care assistance program is a separate written plan that provides dependent care assistance only to your employees. However, the plan will not be treated as a dependent care assistance program for assistance provided to a highly compensated employee unless certain tests are met. See *Assistance provided to a highly compensated employee,* later.

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

1) They allow the employee to work, and
2) They are for a qualifying person's care.

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

Exclusion from wages. You can exclude a limited amount of benefits you provide to an employee under a dependent care assistance program from the employee's wages if you reasonably believe that the employee can exclude the benefits from gross income. The amount you exclude is not subject to employment taxes.

An employee can generally exclude from gross income up to $5,000 of benefits received under a dependent care assistance program each year. This limit is reduced to $2,500 for married employees filing separate returns.

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

1) The employee, or
2) The employee's spouse.

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

Assistance provided to a highly compensated employee. Dependent care assistance provided to a highly compensated employee (as defined in chapter 4 under *Exclusion of Certain Fringe Benefits)* is treated as provided under a dependent care assistance program and can be excluded from the employee's wages only if the following tests are met.

1) The benefits provided under the program do not favor highly compensated employees.
2) The program benefits employees who qualify under rules set up by you that do not favor highly compensated employees. To determine whether your program meets this test, do not consider the following.
   a) Employees who are under age 21 and have not completed 1 year of service.
   b) Employees excluded from your program who are covered by a collective bargaining agreement, if there is evidence that dependent care assistance was a subject of good-faith bargaining.
3) The program does not provide more than 25% of its benefits during the year for shareholders or owners. A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.
4) You give reasonable notice of the program to eligible employees.
5) By January 31, you provide each employee with a Form W–2 showing the amount of dependent care assistance (if furnished in kind, its fair market value) provided to the employee during the preceding year.
6) The average benefits provided to your employees who are not highly compensated is at least 55% of the average benefits provided to your highly compensated employees under all your dependent care programs. To determine whether your programs meet this test, do not consider the following.
   a) Employees who are under age 21 and have not completed 1 year of service.
   b) Employees excluded from your program who are covered by a collective bargaining agreement if there is evidence that dependent care assistance was a subject of good-faith bargaining.
   c) If you provide the benefits through a salary reduction agreement, employees whose pay is less than $25,000 before the reduction.

If all of these tests are not met, you must include the dependent care assistance provided to each highly compensated employee in his or her wages.

Educational Assistance

This section provides basic tax information about educational assistance programs.

Educational assistance program. An educational assistance program is a separate written plan that provides educational assistance only to your employees. The program qualifies only if all of the following tests are met.

1) The program benefits employees who qualify under rules set up by you that do not favor highly compensated employees (as defined in chapter 4 under *Exclusion of Certain Fringe Benefits*). To determine whether your program meets this test, do not consider employees excluded from your program who are covered by a collective bargaining agreement if there is evidence that educational assistance was a subject of good-faith bargaining.
2) The program does not provide more than 5% of its benefits during the year for shareholders or owners. A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.
3) The program does not allow employees to choose to receive cash or other benefits that must be included in gross income instead of educational assistance.
4) You give reasonable notice of the program to eligible employees.

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

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

1) Has a reasonable relationship to your business, or
2) Is required as part of a degree program.

Education expenses do not include the cost of tools or supplies (other than textbooks) that your employee is allowed to keep at the end of the course. Nor do they include the cost of lodging, meals, or transportation.

Exclusion from wages. You can exclude a limited amount of benefits you provide to an employee under an educational assistance program from the employee's wages as you withhold, pay, and report employment taxes.

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

Assistance over the limit. If you provide an employee with more than $5,250 of educational assistance during the year, you may be able to exclude part or all of the excess as a working condition fringe benefit. See chapter 4.

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

CAUTION *As this publication was being prepared for print, Congress was considering legislation that would extend the expiration date of the educational assistance exclusion. For more information about this and other important tax changes, see Publication 553,* Highlights of 1999 Tax Changes.

Group-Term Life Insurance Coverage

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

Group-Term Life Insurance

This is life insurance that meets all the following conditions.

1) It provides a general death benefit that is not included in income.
2) You provide it to a group of employees.
3) It provides an amount of insurance to each employee based on a formula that prevents individual selection. This formula must use factors such as the employee's age, years of service, pay, or position.
4) You provide it under a policy you carry directly or indirectly. Even if you do not pay any of the policy's cost, you are considered to carry it if you arrange for payment of its cost by your employees and charge at least one employee less than, and at least one other employee more than, the cost of his or her insurance. Determine the cost of the insurance, for this purpose, as explained under *Group-Term Life Insurance* in Publication 15–A.

Employee. For this purpose, an employee is one of the following.

1) A person who works for you whose legal

relationship to you is that of an employee.

2) A full-time life insurance agent.

3) A person who was formerly your employee.

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

Life insurance that includes permanent benefits is group-term life insurance only if it meets certain conditions. For more information, see section 1.79–1 of the regulations.

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

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

Exceptions. Even if you do not meet the 10-employee rule, two exceptions allow you to treat insurance as group-term life insurance.

Under the first exception, you do not have to meet the 10-employee rule if all the following conditions are met.

1) If evidence that the employee is insurable is required, it is limited to a medical questionnaire (completed by the employee) that does not require a physical.

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

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

Under the second exception, you do not have to meet the 10-employee rule if all the following conditions are met.

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

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

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

To apply either exception, do not consider employees who were denied insurance for ***any*** of the following reasons.

1) They were 65 or older.

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

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

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

Policy covering employee's spouse or dependent. A policy that provides insurance on the life of your employee's spouse or dependent is not group-term life insurance. However, you may be able to exclude the cost of this insurance from your employee's wages as a de minimis fringe benefit. See chapter 4.

Exclusion From Wages

You can generally exclude group-term life insurance coverage you provide to an employee from the employee's wages as you withhold income tax and pay federal unemployment tax. In addition, you can exclude a limited amount of coverage for other employment tax and reporting purposes.

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

Coverage over the limit. If you provide an employee with more than $50,000 of coverage at any time during the year, you must include in the employee's wages the cost of insurance that is more than the cost of $50,000 of coverage, reduced by any amount the employee pays toward the insurance. Figure the cost of the insurance as explained under *Group-Term Life Insurance* in Publication 15–A.

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

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

Key employee. A key employee during 2000 is an employee or former employee who is one of the following.

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

   a) 1996 — $60,000

   b) 1997 — $62,500

   c) 1998 — $65,000

   d) 1999 — $65,000

   e) 2000 — $67,500

2) A person who, for 2000 or any of the 4 preceding years, was any of the following.

   a) One of the 10 employees having annual pay of more than $30,000 and owning the largest interests in your business.

   b) A 5% owner of your business.

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

To determine ownership in (2) above, treat your employee as owning both his or her own interest and any related person's interest. The term “related person” includes the employee's spouse, children, grandchildren, and parents. It also includes any corporations, partnerships, estates, or trusts in which the employee has at least a 5% interest.

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

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

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

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

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

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

When applying this test do not consider employees who meet the following requirements.

1) Have not completed 3 years of service.

2) Are part time or seasonal.

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

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

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

6. Retirement Plans

Important Reminder

Contributions to a SEP-IRA or a SIMPLE IRA. A SEP-IRA or a SIMPLE IRA *cannot* be designated as a Roth IRA. Contributions to a SEP-IRA or a SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA. For information about Roth IRAs, see Publication 590.

Introduction

This chapter discusses retirement plans that 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 participating in a retirement plan.

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 in later years.

Under some 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 later years.

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

Topics

This chapter discusses:

- Simplified employee pensions (SEPs)
- SIMPLE retirement plans
- Qualified plans
- Individual retirement arrangements (IRAs)

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

- ☐ **W–2** Wage and Tax Statement
- ☐ **5305–SEP** Simplified Employee Pension–Individual Retirement Accounts Contribution Agreement
- ☐ **5305A–SEP** Salary Reduction and Other Elective Simplified Employee Pension–Individual Retirement Accounts Contribution Agreement
- ☐ **5304–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (Not subject to the Designated Financial Institution Rules)
- ☐ **5305–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (for Use With a Designated Financial Institution)
- ☐ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

See chapter 21 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. But some 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).

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 in setting up your SEP.

Contribution Limits

Contributions you make for a year to a common-law employee's SEP-IRA are limited to the lesser of $30,000 or 15% 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 compensation of an employee that is over $160,000 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 an account are limited to the lesser of $30,000 or 25% of the participant's compensation. When you figure this limit, your contributions to all of the plans must be added. Because a SEP is considered a defined contribution plan for purposes of this limit, your contributions to a SEP must be added to your contributions to defined contribution plans.

Reporting on Form W–2. Do not include SEP contributions on Form W–2 unless there are contributions under a salary reduction arrangement.

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when you figure your maximum deductible contribution. See *Deduction of contributions for yourself,* later.

Deduction Limits

The most you can deduct for employer contributions for common-law employees is 15% of the compensation paid to them during the year from the business that has the plan.

Deduction of contributions for yourself. When figuring the deduction for employer contributions made to your own SEP-IRA, compensation is your net earnings from self-employment 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 the *Rate Worksheet for Self-Employed* shown under *Qualified Plan* to figure the rate.

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

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

Employee contributions. Employees can also make contributions of up to $2,000 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 SEP can include a salary reduction (elective deferral) arrangement. Under the arrangement, employees can choose to have you contribute part of their pay to their SEP-IRAs. The income tax on the contribution is deferred. This choice is called an elective deferral, which remains tax free until distributed (withdrawn).

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

- At least 50% of your eligible employees choose the salary reduction arrangement.
- You had 25 or fewer eligible employees (or employees who would have been eli-

gible 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 non-highly 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 salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1999 is limited to the lesser of $10,000 or 15% of the participant'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.

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 unemployment (FUTA) tax purposes.

Reporting SEP Contributions on Form W–2

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

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

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

If his employer chooses to treat deferrals as compensation under the salary reduction arrangement, Jim's deferral amount 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 $3,913.05 ($30,000 x 13.0435%).

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

For more information on SEPs, see Publication 560.

SIMPLE Retirement Plan

A SIMPLE plan (Savings Incentive Match Plan for Employees) is a written salary reduction arrangement that allows a small business (an employer with 100 or fewer employees) to make elective contributions to a SIMPLE retirement account on behalf of each eligible employee. An eligible employer (defined later) is generally not allowed to maintain another retirement plan.

Setting Up a SIMPLE Plan

If an employer has 100 or fewer employees who were paid at least $5,000 by the employer in the preceding year, the employer may be able to set up a SIMPLE retirement plan on behalf of eligible employees. The plan can be either of the following.

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

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

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

Definitions

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

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

Qualified salary reduction arrangement. This is an arrangement that allows an eligible employee to choose, during the 60-day period before the beginning of any year, to have the employer make contributions (elective deferrals) to a SIMPLE retirement account on his or her behalf. An eligible employee may also stop making elective deferrals at any time during the year. The employer must match the employee's contributions or make nonelective contributions. No other types of contributions are allowed under a qualified salary reduction arrangement.

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

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

Compensation. Compensation is the total wages required to be reported on Form W–2 plus elective deferrals. For a self-employed individual, compensation is net earnings from self-employment. It does not include any contribution made to the SIMPLE plan.

TIP *Any SIMPLE elective deferrals made for an employee under a salary reduction arrangement are included in wages on the employee's Form W–2 for social security and Medicare tax purposes only.*

Contribution Limits

Contributions include employee elective deferrals and employer contributions. The employer must satisfy one of two contribution formulas: the matching contribution formula or a 2% nonelective contribution. No other contributions can be made to the SIMPLE plan. These contributions, which are deductible by the employer, must be made timely.

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

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

CAUTION *If the employer chooses a matching contribution of less than 3%, the percentage cannot be less than 1%. The employer must notify the employee of the lower percentage within a reasonable time before the 60-day election period for the calendar year. A percentage of less than 3% cannot be chosen for more than 2 years during a 5-year period.*

Nonelective contributions. In place of the dollar-for-dollar matching contributions, the employer can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee. Only $160,000 of the employee's compensation can be taken into account when figuring the contribution limit.

CAUTION *An employer who chooses the 2% contribution formula, must timely notify the employee (within the 60-day election period described earlier).*

Time limits for contributing funds. The employer must make the contribution to the SIMPLE account within 30 days after the end of the month for which the payments to the employee were deferred. The employer's matching contributions must be made by the due date of the tax return, including extensions, for the year.

Distributions (Withdrawals)

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

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

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

More information. This chapter does not cover all the rules and exceptions that apply to a SIMPLE IRA or a SIMPLE 401(k) plan. See Publication 560 for additional information on excludable employees, reporting and disclosure requirements, and other rules. See Form 5304–SIMPLE or Form 5305–SIMPLE and their instructions, also.

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

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 HR–10 plan.

You, or you and your employees can make contributions to the plan. If your plan meets the qualification requirements, you can generally 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 assets until they are distributed to them. However, certain loans made from qualified employer 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 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 some or all of your IRA contributions. See Publication 590.

Kinds of Qualified Plans

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

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 ***three types*** of defined contribution plans: profit-sharing, stock bonus, 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 contributions made to the plan among the participating employees and for distributing the funds in the plan.

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

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

Defined Benefit Plan

This is any plan that is not defined contribution plan. In general, a qualified defined benefit plan must provide for set benefits and your contributions to the plan are based on actuarial assumptions. Generally, you will need continuing professional help to administer a defined benefit plan.

Plan Approval

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

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

A request for a determination, opinion, or ruling letter can be complex. You may need professional help to complete the request. Also, the IRS charges a fee for issuing these letters. Attach Form 8717, *User Fee for Employee Plan Determination Letter Request,* to your application.

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

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

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

Deduction Limit

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

CAUTION *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.*

Defined contribution plans. The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. Your deduction for contributions to a profit-sharing plan cannot be more than ***15%*** of the compensation from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this limit in figuring the deduction for contributions you make for your own account. See *Deduction of contributions for yourself,* later.

Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is generally limited to ***25%*** of the compensation from the business paid during the year to a participating common-law employee. You must reduce this limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. An actuary must figure the deduction for contributions to a defined benefit plan since 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 $30,000 or 13.0435% (15% reduced as discussed below) of your net earnings from the trade or business that has the plan. If the plan is a money purchase plan, the deduction is limited to the lesser of $30,000 or 20% (25% reduced as discussed below) of your net earnings.

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

Your net earnings are your business gross income minus the allowable deductions from that business. Allowable deductions include contributions to the plan for your common-law employees and your other business expenses.

If you are a partner other than a limited partner, your net earnings include your distributive share of the partnership income or loss (other than separately computed items such as capital gains and losses) and any guaranteed payments you receive from the partnership. If you are a limited partner, your net earnings include only guaranteed payments you receive for services rendered to or for the partnership. For more information, see *Partners* under *Who Must Pay Self-Employment Tax* in Publication 533.

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

Adjustments. You must reduce your net earnings by the deduction for one-half of your self-employment tax. Also, net earnings must be reduced by the deduction for contributions you make for yourself. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. You must reduce net earnings by your deduction for contributions for yourself. The deduction and the net earnings depend on each other. You can make the adjustment to your net earnings indirectly by reducing the contribution rate called for in the plan and using the reduced rate to figure your maximum deduction for contributions for yourself.

Annual compensation limit. You generally cannot take into account more than $160,000 of your compensation in figuring your contribution to a defined contribution plan.

Figuring Your Deduction

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

Rate Worksheet for Self-Employed

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

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

Deduction Worksheet for Self-Employed

Step 1 Enter the self-employed rate shown on line 3 above	______
Step 2 Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065)	______
Step 3 Enter your deduction for self-employment tax from line 27, Form 1040	______
Step 4 Subtract step 3 from step 2 and enter the result	______
Step 5 Multiply step 4 by step 1 and enter the result	______
Step 6 Multiply $160,000 by your plan contribution rate. Enter the result, but not more than $30,000	______
Step 7 Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 29, Form 1040	______

Example. You are a self-employed farmer and you have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation (defined earlier) and 10½% of your common-law employees' compensation. Your net earnings from line 36, Schedule F (Form 1040) are $200,000. In figuring this amount, you deducted your common-law employees' pay of $100,000 and contributions for them of $10,500 (10½% x $100,000). You figure your self-employed rate and maximum deduction for contributions on behalf of yourself as follows.

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (10½% = .105)	0.105
2) Rate in line 1 plus 1 (.105 + 1 = 1.105)	1.105
3) Self-employed rate as a decimal rounded to at least 3 decimal places (line 1 ÷ line 2)	0.0950

Deduction Worksheet for Self-Employed

Step 1 Enter the self-employed rate shown on line 3 above	0.0950
Step 2 Enter your net earnings (net profit) from line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065)	$200,000
Step 3 Enter your deduction for self-employment tax from line 27, Form 1040	7,180
Step 4 Subtract step 3 from step 2 and enter the result	192,820
Step 5 Multiply step 4 by step 1 and enter the result	18,318
Step 6 Multiply $160,000 by your plan contribution rate. Enter the result but not more than $30,000	16,800
Step 7 Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 29, Form 1040	$ 16,800

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

More information. See Publication 560 for more information 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 Arrangements (IRAs)

An individual retirement arrangement (IRA) is a personal savings plan that allows you to set aside money for your retirement or for certain education expenses. You do not have to set up IRAs for your employees or make contributions for them. 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 some 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.

7.

Rent Expense

Introduction

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

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

Topics

This chapter discusses:

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

Useful Items

You may want to see:

Publication

- ☐ **334** Tax Guide for Small Business
- ☐ **538** Accounting Periods and Methods
- ☐ **946** How To Depreciate Property

See chapter 17 for information about getting publications and forms.

Rent

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

Unreasonable rent. You cannot take a rental deduction for rents that are unreasonable. Ordinarily, the issue of reasonableness of the rent will not arise unless you and the lessor are related. Rent paid to a **related person** is reasonable if it is the same amount you would pay to a stranger for use of the same property. A percentage rental is reasonable if the rental paid is reasonable. For some examples of persons that may be considered related, see *Related Persons* in chapter 15.

Rent on your home. If you rent rather than own a home and use part of your home as your place of business, you may be able to deduct the rent you pay for that part. You must meet the requirements for business use of your home. For more information, see *Qualifying for a Deduction* in Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers).*

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

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

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

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

Whether the agreement is a conditional sales contract depends on the ***intent of the parties.*** Determine intent based on the facts and circumstances that exist when you make the agreement.

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

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

Leveraged leases. Leveraged lease transactions may be considered leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually the lease 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. The following revenue procedures contain the guidelines the IRS will use to determine if a leveraged lease is a lease for federal income tax purposes.

- Revenue Procedure 75–21, in Cumulative Bulletin 1975–1.
- Revenue Procedure 75–28, in Cumulative Bulletin 1975–1.
- Revenue Procedure 76–30, in Cumulative Bulletin 1976–2.
- Revenue Procedure 79–48, in Cumulative Bulletin 1979–2.

In general, the revenue procedures provide that, for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction to be a valid lease if all the factors in the revenue procedures are met, including the following.

- The lessor must maintain a minimum unconditional “at risk” equity investment in the property (at least 20%) 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 79–48.
- The lessee may not lend any money to the lessor to buy the property or guarantee the loan used to buy the property.
- The lessor must 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. See Publication 1375 and Revenue Procedure 2000–1 for more information. Revenue Procedure 2000–1 is in Internal Revenue Bulletin No. 2000–1.

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 member of the lessee group. See Revenue Procedure 76–30 for examples of limited-use property and property that is not limited-use property.

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

- Any rents are payable after the close of the calendar year following the calendar year the use occurs.
- Rents increase during the lease.

Generally, if these conditions exist, you must accrue rents for the periods to which the rents are allocated under the lease. If a lease only contains a rent payment schedule, the rents payable for a period during the lease are the rents allocated to that period. If the lease allocates any rent to a calendar year that is not payable until after the close of the succeeding calendar year, only the present value of that rent should be accrued and interest on the unpaid rent accrues until the rent is paid. For certain leases designed to achieve tax avoidance, the IRS may require the parties to accrue rent and interest on rent using the constant rental method.

Taxes on Leased Property

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

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

Accrual method. If you use an accrual method of accounting, you can deduct taxes as additional rent for the tax year in which you can determine all of 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. 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. This means that property owners become liable for real estate taxes for a year on January 1 of that year, but do not have to pay them until July 1 of the next year.

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

If, according to the terms of the lease, Oak is liable for the real estate taxes when the owner of the property becomes liable for them, Oak will deduct the real estate taxes as rent on its tax return for the earlier year. This is the year in which Oak's liability under the lease becomes fixed.

Cost of Getting a Lease

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

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

The cost of getting a lease is not subject to the amortization rules that apply to section 197 intangibles discussed in chapter 12.

Option to renew. The term of the lease for amortization includes all renewal options if less than 75% of the cost of getting the lease is for the term remaining on the purchase date. Treat as renewal options any period for which the lessee and lessor reasonably expect the lease to be renewed. In determining the term of the lease remaining on the purchase date, do not include any period for which the lessee may choose to renew, extend, or continue the lease. Allocate the lease cost to the original term and any option term based on the facts and circumstances. Make the allocation using a present value computation. For more information, see section 1.178–1(b)(5) of the regulations.

Example 1. You paid $10,000 to get a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, you paid $7,000 for the original lease and $3,000 for the renewal options. Because $7,000 is less than 75% of the total cost of the lease of $10,000 (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. Assume the same facts as in Example 1, except that the amount that applies to the original lease is $8,000. You can amortize the entire $10,000 over the 20-year remaining life of the original lease. The $8,000 cost of getting the original lease was not less than 75% of the total cost of the lease (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 that you pay to get a lease on property you use in your business are capital costs. You must amortize these costs over the term of the lease.

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

Improvements by Lessee

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

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

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

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 as discussed earlier.

Capitalizing Rent Expenses

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

Generally, you are subject to the uniform capitalization rules if you do any of the following.

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

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

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

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

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

8. Interest

Introduction

This chapter discusses the tax treatment of business interest expenses.

What are business interest expenses? These are amounts charged for the use of money that 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** Supplemental Income and Loss

☐ **Sch K–1 (Form 1065)** Partner's Share of Income, Credits, Deductions, etc.

☐ **Sch K–1 (Form 1120S)** Shareholder's Share of Income, Credits, Deductions, etc.

☐ **1098** Mortgage Interest Statement

☐ **3115** Application for Change in Accounting Method

☐ **4952** Investment Interest Expense Deduction

☐ **8582** Passive Activity Loss Limitations

See chapter 17 for information about getting 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 amount of 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 pays the loan proceeds to a third party, the allocation of the loan is still based on your use of the funds. This applies if you pay for property, services, or anything else by incurring a loan, or if you take property subject to a debt.

Proceeds deposited in borrower's account. Treat loan proceeds deposited in an account as property held for investment. It does not matter whether the account pays interest. Any interest you pay on the loan is investment interest expense. If you withdraw the proceeds of the loan, you must reallocate the loan based on the use of the funds.

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

Under the interest allocation rules, the entire $100,000 loan is treated as property held for investment for the period 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.

- 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.

Edith treats the $600 used for personal purposes as made from the remaining $200 proceeds of Loan C and $400 of unborrowed funds. Note that for the periods during which loan proceeds are held in the account, they are treated as property held for investment.

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

Amounts paid within 30 days. If 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 of the interest charged on the part of 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 some other 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 some other use.

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

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

Continuous borrowings. 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 items 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 acquisitions. A debt-financed acquisition is the use of loan proceeds to purchase an interest in a partnership or S corporation or to make a contribution to the capital of one.

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 purchase 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 purchase an interest in a partnership for $20,000 using borrowed funds. The partnership's only assets include machinery used in its business valued at $60,000 and stocks valued at $15,000. You allocate the loan proceeds based on the value of the assets. Therefore, 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 deductible 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 (i).

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 (g).

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 (i). 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 and shareholders separately. This is because the loan proceeds and the interest expense must be allocated depending on how the partner or shareholder uses the proceeds.

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 entity'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 amount of the other expenditures minus 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 will take the interest into account in figuring the net rental income or loss reported on Schedule K–1.

More information. For more information on allocating and reporting these interest expenses, see Notice 88–37 in Cumulative Bulletin 1988–1. Also see Notice 89–35 in Cumulative Bulletin 1989–1.

Interest You Can Deduct

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

- You are legally liable for that debt.
- Both you and the lender intend that the debt be repaid.
- 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.

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

Original issue discount. Original issue discount (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.

Stated interest, in general, is qualified stated interest if it 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, 1999, you took out a $100,000 discounted loan and received $98,500 in proceeds. The loan will mature on January 1, 2009 (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, 2000. 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 1999, 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 in the following steps.

1) Determine the issue price of the loan. Generally, this is the amount of the proceeds of the loan. If you paid points on the loan (as discussed next), the issue price generally is the amount of the proceeds reduced by the amount of 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, you start with the ***adjusted issue price*** in step (1) above. 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 (YTM)*** 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 YTM 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.

Qualified stated interest (QSI) generally is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a single fixed rate.

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 1999, you can deduct $93 [($98,500 × .102467) − $10,000]. For 2000, 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 same 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 same 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 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 purchases. 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

Some interest payments cannot be deducted. In addition, certain other expenses that may seem to be interest are not, and you cannot deduct them as interest.

You cannot currently deduct interest that must be capitalized and (except for corporations) you generally cannot deduct personal interest.

Interest paid with funds borrowed from same 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 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 must capitalize them under the uniform capitalization rules. For more information on uniform capitalization rules, see section 1.263A–8 through 1.263A–15 of the regulations.

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. For contracts issued before June 9, 1997, you generally cannot deduct interest paid or accrued on a debt incurred with respect to any life insurance, annuity, or endowment contract covering someone who is or was an employee, officer, or someone financially interested in your business unless that person is a ***key person.***

For contracts issued or considered issued after June 8, 1997, you generally cannot deduct interest with respect to any life insurance, annuity, or endowment contract that covers any individual unless that individual is a ***key person.***

If the policy or contract covers a key person, you can deduct the interest 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.

Pre-June 21, 1986 contracts. With a few exceptions, otherwise allowable interest (not in excess of the maximum rates set by law) paid or accrued on debt with respect to contracts purchased before June 21, 1986, can be deducted no matter when the debt was incurred.

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 rules 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 the amount of 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. Interest related to property that you acquire in any manner other than by producing it is not capitalized.

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 the property. Treat the property produced for you under a contract as produced by you up to the amount you pay or incur for the property.

Capitalized interest. Treat capitalized interest as a cost of the property produced. You recover the interest when you sell or use the property, or dispose of it under the rules that apply to such transactions. 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 in a partnership or a shareholder in an S corporation, 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. You must provide the required information in an attachment to the Schedule K–1 to properly capitalize interest for this purpose.

Additional information. The procedures for applying the uniform capitalization rules are beyond the scope of this publication. For more information, see section 1.263A–8 through 1.263A–15 of the regulations and Notice 88–99 (as amended by Announcement 89–72). Notice 88–99 is in Cumulative Bulletin 1988–2. Announcement 89–72 is in Cumulative Bulletin 1989–1.

When To Deduct Interest

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

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

Prepaid interest. Under the cash method, you generally cannot deduct any interest paid before the year it is due. Interest paid in advance can be deducted only in the tax year in which it is due.

Discounted loans. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you cannot deduct it when you get the loan.

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 income if the deduction for the interest reduced your tax. You should include in income only the amount of the interest deduction that reduced your tax.

Accrual method. You can deduct only interest that has accrued during the tax year.

Prepaid interest. Under the accrual method, you generally cannot deduct any interest paid before it is due. Instead, deduct it in the year in which it is due.

Discounted loans. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you cannot deduct it when you get the loan. 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 persons. If you use the accrual method, you cannot deduct interest owed to a related person who uses the cash method until payment is made and the interest is includible in the gross income of that person. The relationship is determined as of the end of the tax year for which the interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ceases to exist before the interest is includible in the gross income of that person. See *Related Persons* in Publication 538.

Below-Market Loans

If you receive a below-market 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* and *Treatment of term 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 below-market loan generally is treated as an arm's-length transaction in which you, the borrower, are treated as having received both of the following.

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

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 amount of 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.

TIP *Applicable federal rates are published by the IRS each month in the* Internal Revenue Bulletin. *You can also contact an Internal Revenue Service office to get these rates.*

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 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 certain loans on days on which the total amount of 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 gift 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 previously has been 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 of 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 qualified continuing care facilities. 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 1999, this exception applies only to the part of the total outstanding amount of all loans from the lender (or lender's spouse) that does not exceed $137,000.

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

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

1) The individual and/or the individual's spouse must be entitled to use the facility for the rest of their life or lives.
2) The residential use must begin in a separate, independent living unit provided by the continuing care facility and continue until the individual (or individual's spouse) is incapable of living independently. The facility must provide various “personal care” services to the resident such as maintenance of the residential unit, meals, and daily aid and supervision relating to routine medical needs.
3) The facility must 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* 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.

9.

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

See chapter 17 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, the accrual date for federal income tax purposes is the original accrual date. Use the original accrual date for all future years as well.

Example. Your state imposes a tax on intangible and tangible personal property used in a trade or business conducted in the state. This tax is assessed and becomes a lien as of July 1. In 1999, the state, by legislative action, changes the assessment and lien dates from July 1, 2000, to December 31, 1999, for property tax year 2000. Because December 31 is earlier than the original accrual date, the tax for federal income tax purposes accrues on July 1, 2000.

Uniform capitalization rules. Uniform capitalization rules apply to certain taxpayers who produce real or tangible personal property for use in a trade or business or for sale to customers. They also apply to taxpayers who acquire property for resale. Under these rules, you may have to either include in inventory costs or capitalize certain expenses related to the property, such as taxes. For more information, see Publication 551.

Carrying charges. Carrying charges include taxes you pay to carry or develop real estate or to carry, transport, or install personal property. You can choose to capitalize carrying charges not subject to the uniform capitalization rules if they are otherwise deductible. For more information, see chapter 11.

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

TIP *You must include any interest you receive with state or local tax refunds in income.*

Real Estate Taxes

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

If you use an accrual method of accounting, you generally cannot accrue real estate taxes until you pay them to the government authority. You can, however, choose to ratably accrue the taxes during the year. See *Election to ratably accrue,* later.

Taxes for local benefits. Generally, you cannot deduct taxes charged for local benefits and improvements that tend to increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, and public parking facilities. You should increase the basis of your property by the amount of the assessment.

You can deduct taxes for these local benefits only if the taxes are for maintenance, repairs, or interest charges related to those benefits. If ***part*** of the tax is for maintenance, repairs, or interest, you 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. City X, to improve downtown commercial business, converted a downtown business area street into an enclosed pedestrian mall. The city assessed the full cost of construction, financed with 10-year bonds, against the affected properties. The city is paying the principal and interest with the annual payments made by the property owners.

The assessments for construction costs are not deductible as taxes or as business expenses, but are depreciable capital expenses. The part of the payments 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 during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and seller must divide the real estate taxes according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each owned the property. Treat the seller as paying the taxes up to but not including the date of sale. Treat the buyer as paying the taxes beginning with the date of sale. For this purpose, disregard the accrual or lien dates under local law. You can usually find this information on the settlement statement you received at closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting and the buyer of your property is personally liable for the tax, you are considered to have paid your part of the tax at the time of the sale. This lets you deduct the part of the tax to the date of sale even though you did not pay it. You must also include the amount of that tax in the selling price of the property.

If you (the seller) use an accrual method and have not chosen to ratably accrue real estate taxes, you are considered to have accrued your part of the tax on the date you sell the property.

Example. Al Green, a calendar year accrual method taxpayer, owns real estate in X County. He has not chosen to ratably accrue property taxes. November 30 of each year is the assessment and lien date. He sold the property on June 30, 1999. 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 1999.

Election to ratably accrue. If you use an accrual method, you can choose to accrue real estate tax that is related to a definite period ratably over that period.

Example. John Smith is a calendar year taxpayer who uses an accrual method. His real estate taxes for the real property tax year, July 1, 1999, to June 30, 2000, amount to $1,200. July 1 is the assessment and lien date.

If John chooses to ratably accrue the taxes, $600 will accrue in 1999 ($1,200 × 6/12, July 1–December 31) and the balance will accrue in 2000.

Separate elections. You can make an election for each separate trade or business and for nonbusiness activities if you account for them separately. Once you elect to ratably accrue real estate taxes, you must use that method unless you get permission from the IRS to change from that method. See *Revoking the election,* later.

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

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

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

If you make the election 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 election is to be effective. For more information, see the instructions for Form 3115.

Revoking the election. To revoke an election to ratably accrue real estate taxes, file Form 3115 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 income taxes imposed on the corporation or partnership as business expenses. An individual can deduct state 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.*

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.

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.

CAUTION *Do not deduct state and local sales taxes imposed on the buyer that you must collect and pay over to the state or local government. Do not include these taxes in gross receipts or sales.*

Self-employment tax. You can deduct one-half of your self-employment tax as a business expense in figuring your adjusted gross income. This 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 27, 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.

10. Insurance

Important Change for 1999

Health insurance deduction for the self-employed. For 1999, this deduction increases to 60% of the amount you paid for health insurance for yourself and your family. After 2001, the deduction will increase again. See *Health Insurance Deduction for the Self-Employed.*

Introduction

You generally can deduct the ordinary and necessary cost of insurance as a business expense if it is for your trade, business, or profession. However, you may have to capitalize certain insurance costs under the uniform capitalization rules. For more information, see *Capitalizing Premiums,* later.

Topics

This chapter discusses:

- Deductible premiums
- Nondeductible premiums
- Capitalizing premiums
- When to deduct premiums

Useful Items

You may want to see:

Publication

- ☐ **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 17 for information about getting publications and forms.

Deductible Premiums

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

1) Fire, theft, flood, or similar insurance.
2) Credit insurance on losses from unpaid debts.
3) Group hospitalization and medical insurance for employees, including long-term care insurance.
   a) If a partnership pays accident and health insurance premiums for its partners, it can deduct them as guaranteed payments made to the partners.
   b) If an S corporation pays accident and health insurance premiums for its shareholder-employees, it can deduct the premiums.

   For more details, see *Accident and Health Plans* in chapter 5.
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 can deduct these amounts as guaranteed payments to the partners.
   b) If an S corporation pays the workers' compensation premiums for its shareholder-employees, it can deduct these amounts.
7) Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered taxes under state law.
8) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness.
9) Car and other vehicle insurance. This insurance covers vehicles used in your business for liability, damages, and other losses. If you operate a vehicle partly for personal use, you can deduct only the part of your insurance premiums that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums.
10) Life insurance covering your officers and employees if you are not directly or indirectly a beneficiary under the contract.
11) Use and occupancy and business interruption insurance. This insurance pays you for lost profits if your business is shut down due to a fire or other cause.

Health Insurance Deduction for the Self-Employed

You can deduct 60% of the amount paid during 1999 for medical insurance and qualified long-term care insurance for yourself and your family if you are one of the following.

- A self-employed individual.
- A general partner (or a limited partner receiving guaranteed payments) in a partnership.
- A shareholder owning more than 2% of the outstanding stock of an S corporation.

You are allowed this deduction whether you paid the premiums yourself or your partnership or S corporation paid them and you included the premium amounts in your gross income. Take this deduction on line 28 of Form 1040.

Percentage increases after 2001. For tax years beginning after 2001, the deductible percentage of your health insurance premiums gradually increases. The increases are shown in the following table.

For Tax Years Beginning in:	Deductible Percentage
1999 through 2001	60%
2002	70%
After 2002	100%

Long-term care insurance. If you pay the premiums on a qualified long-term care insurance contract for yourself, your spouse, or your dependents, you can include those premiums when figuring your deduction. But you can include only the lesser of the following amounts.

1) The amount you pay.
2) The amount shown below.
   a) Age 40 or less — $210
   b) Age 41 to 50 — $400
   c) Age 51 to 60 — $800
   d) Age 61 to 70 — $2,120
   e) Age 71 and above — $2,660

Use your age at the end of the tax year.

Long-term care insurance contract. A long-term care insurance contract is any insurance contract that only provides coverage of qualified long-term care services. The contract must 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 as collateral for a loan, 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, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
- An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

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

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

Limits. You cannot deduct an amount more than your net earnings from the trade or business in which the medical insurance plan or long-term care insurance plan is established. If the business in which the insurance plan is established is an S corporation, you cannot deduct more than your wages from the S corporation.

Other coverage. You cannot take the deduction for any month if you were eligible to participate in any employer (including your spouse's) subsidized health plan at any time during that month. This rule is applied separately to plans that provide long-term care insurance and plans that do not provide long-term care insurance. However, any medical insurance payments not deductible on line 28

Table 10-1. **Self-Employed Health Insurance Deduction Worksheet** (Keep for your records.)

1a)	Enter total payments made during the tax year for health insurance for yourself, your spouse, and your dependents. (***Do not include*** payments for coverage for any month during which you were eligible to participate in a health plan subsidized by your or your spouse's employer. Also, do not include payments for long-term care insurance.)	1a)
1b)	For long-term care insurance coverage, enter the ***lesser*** of: A) Total payments made, or B) $210—if age 40 or less $400—if age 41 to 50 $800—if age 51 to 60 $2,120—if age 61 to 70 $2,660—if age 71 or older (***Do not include*** payments for any month during which you were eligible to participate in a long-term care insurance plan subsidized by your or your spouse's employer.)	1b)
1c)	Add the total of lines 1a) and 1b)	1c)
2)	Percentage used to figure deduction for 1999	2) .60
3)	Multiply the amount on line 1c) by the percentage on line 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 27, 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 29, attributable to the same trade or business in which the health 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 health 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 28. (***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.

of Form 1040 can be included as part of your medical expenses on Schedule A (Form 1040) if you itemize your deductions.

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

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

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

- You have 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 long-term care insurance to figure the deduction.

CAUTION *If you have more than one health plan during the year and each plan is established under a different business, you must use separate worksheets (in this chapter) to figure each plan's net earnings limit. Include your insurance payments under that plan on line 1 of the separate worksheet and your net profit (or wages) from that business on line 4 (or line 11).*

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 you set up for self-insurance. This applies even if you cannot get business insurance coverage for certain business risks. However, your actual losses may be deductible. See Publication 547.

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

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

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

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

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

Capitalizing Premiums

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for production or resale activities. Include these costs in the basis of property you produce or 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.

When the uniform capitalization rules apply. You must use the uniform capitalization rules if, in your trade or business or activity carried on for profit, you do any of the following.

- Produce real property or tangible personal property for use in the business or activity.
- Produce real property or tangible personal property for sale to customers.
- Acquire property for resale. However, you generally do not have to use the uniform capitalization rules for personal property acquired for resale if your average annual gross receipts are not more than $10,000,000 for the 3 prior tax years.

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

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

When To Deduct Premiums

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

Cash method. If you use the cash method of accounting, you must generally deduct insurance premiums in the tax year in which you actually pay them, even if you incurred them in an earlier year.

Accrual method. If you use an accrual method of accounting, you cannot deduct insurance premiums before the tax year in which you incur a liability for them, even if you paid them in an earlier year. For more information about accrual methods of accounting, see chapter 1.

Cash or accrual method prepayments. You cannot deduct in one year the entire premium for an insurance policy that covers more than one year. You can deduct only the part of the premium that applies to that year. For each later tax year, you can deduct the part that applies to that tax year.

Example. You operate a business and file your returns on a calendar-year basis. You bought a fire insurance policy on your building effective October 1, 1999, and paid a premium of $1,200 for 2 years of coverage. On your 1999 return, you can deduct only the part of the total premium that applies to the 3 months of coverage in 1999. For 2000 and 2001, you can deduct the part of the premium that applies to each of those years. Since the total policy premium is $1,200 for 2 years, the yearly rate is $600 and the monthly rate is $50. For the 3-month period in 1999, you can deduct $150; for 2000, you can deduct $600; and for the 9-month period in 2001, you can deduct $450.

If you use the cash method of accounting and you pay the $1,200 premium in January 2000, you cannot deduct any amount on your 1999 return. However, you can deduct $750 (the $150 that applies to 1999 plus the $600 that applies to 2000) on your return for 2000.

Dividends received. If you receive dividends from business insurance and you deducted the premiums in prior years, part of the dividends are income. For more information, see *Tax Benefit Rule* in Publication 525.

11. Costs You Can Deduct or Capitalize

Introduction

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

You generally deduct a cost (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.

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

For more information on alternative minimum tax, see the instructions for Form 6251, Alternative Minimum Tax—Individuals *or 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
- Costs of removing barriers to the disabled and the elderly

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 17 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 more information on capitalization of interest, see chapter 8.) You can choose to capitalize carrying charges not subject to the uniform capitalization rules, but only if they are otherwise deductible.

You can choose to capitalize carrying charges separately for each project you have and for each type of carrying charge. For unimproved and unproductive real property, your choice is good for only 1 year. You must decide whether to capitalize carrying charges each year the property remains unimproved and unproductive. For other property, your choice to capitalize carrying charges remains in effect until construction, development, or installation is completed (or, for personal property, the date you first use it, if later).

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

For information on amortizing these costs, see *Research and Experimental Costs* in chapter 12.

Research and experimental costs defined. Research and experimental costs are reasonable costs you incur in your trade or business for activities intended to provide information to help eliminate uncertainty about the development or improvement of a product. Uncertainty exists if the information available to you does not establish how to

If you:	Then:
Deduct research and experimental costs as a current business expense,	Deduct all research and experimental costs for the year of choice and all later years.
Do not deduct research and experimental costs as a current business expense,	Amortize them over at least 60 months, starting with the month you first receive an economic benefit from the research.

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. Neither the nature of the product or improvement being developed nor the level of technological advancement matters when making this determination.

The costs of obtaining a patent, including attorneys' fees in making and perfecting a patent application, are research and experimental costs.

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

- Formula
- Invention
- Patent
- Pilot model
- Process
- Technique
- Similar property

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

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

- 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. Generally, you can only make the choice to deduct these costs in the first year you incur research and experimental costs.

You choose to deduct research and experimental costs, rather than capitalize them, by deducting them on your tax return for the year in which you first have research and experimental costs.

Intangible Drilling Costs

The costs of developing ***oil, gas, or geothermal wells*** are ordinarily capital expenses. You can usually recover them through depreciation or depletion. However, you can choose to deduct as current business expenses certain drilling and development costs for wells 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, geothermal steam, or geothermal hot water.

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

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

If you do not choose to deduct your intangible drilling and development costs currently, you can choose to deduct them over the 60-month period beginning with the month they were paid or incurred.

Amounts paid to a contractor that must be capitalized. Amounts paid to a contractor must be capitalized if they are either of the following.

- Amounts properly allocable to the cost of depreciable property.
- Amounts paid only out of production or proceeds from production if the amount is depletable income to the recipient.

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

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

Nonproductive well. If you capitalize your intangible drilling and development costs, you have another option if the well is nonproductive. You can deduct the intangible drilling and development costs 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 in one year all of the intangible drilling and development costs paid or incurred for an oil, gas, or geothermal well located outside the United States. However, you can choose to include the costs in the adjusted basis of the well to figure depletion. If you do not make this choice, you can deduct the costs over the 10-year period beginning with the tax year in which you paid or incurred them. These rules do not apply to a nonproductive well.

Exploration Costs

The costs of determining the existence, location, extent, or quality of any mineral deposit are ordinarily capital expenses 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 an amended income tax return for the tax year you paid or incurred the costs. 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% and amortize them over the 60-month period starting with the month the exploration costs are paid or incurred. The 30% the corporation capitalizes cannot be added to its basis in the property for purposes of figuring cost depletion. However, the amount amortized is treated as additional depreciation and is subject to recapture as ordinary income on a disposition of the property. See *Section 1250 Property* under *Depreciation Recapture* in chapter 3 of Publication 544.

These rules also apply to the deduction of development costs for corporations. See *Development Costs,* later.

Recapture of exploration expenses. When your mine reaches the producing stage, you must recapture any exploration costs you chose to deduct. 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 amount of depletion you would have deducted equals the amount of deducted exploration costs.

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 amount of depletion you would have deducted equals the amount of your deducted exploration costs.

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

Foreign exploration costs. If you pay or incur exploration costs for a mine or other natural deposit located outside the United States, you cannot deduct all of the costs in the current year. You can choose to include the costs (other than for an oil, gas, or geothermal well) in the adjusted basis of the mineral property to figure cost depletion. (Cost depletion is discussed in chapter 13.) 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 of depreciable property.

You can choose to treat development costs as deferred expenses and deduct them ratably as the units of produced ores or minerals related to the expenses are sold. This choice applies each tax year to expenses paid or incurred in that year. Once made, the choice is binding for the year and cannot be revoked for any reason.

How to make the choice. The choice to deduct development costs ratably as the ores or minerals are sold must be made for each mine or other natural deposit by a clear indication on your return or by a statement filed with the IRS office where you file your return. 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 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 publishers circulation list.

Other treatment of circulation costs. If a publisher does not want to currently deduct circulation costs, the publisher 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.

Costs of Removing Barriers to the Disabled and the Elderly

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

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

You cannot deduct any costs that you paid or incurred to completely renovate or build a new facility or public transportation vehicle, or to replace depreciable property 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 them.

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

A partnership must be able to show that any amount added back to basis was not deducted by the 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 shares of the partnership's costs in full.

Example. John Duke's distributive share of ABC partnership's deductible expenses for the removal of architectural barriers was $20,000. John had $10,000 of similar expenses in his sole proprietorship. He chose to deduct $5,000 of them. John allocated the remaining $10,000 of the $15,000 limit to his share of ABC's expenses. John can capitalize the excess $5,000 of his own expenses. Also, if ABC can show that John could not deduct $10,000 of his share of the partnership's expenses because of how John applied the limit, ABC can add $10,000 to the basis of its property.

Qualification standards. You must meet the following specific standards for improved access for the disabled or the elderly to deduct your costs as a current expense.

Grading. The ground must be graded to the level of a normal entrance to make the facility accessible to people with physical disabilities.

Walks.

1) A public walk must be at least 48 inches wide and cannot slope more than 5%. A fairly long walk of maximum or near maximum steepness must have level areas at regular intervals. A walk or driveway must have a nonslip surface.

2) A walk must have a continuing common surface and must not have steps or sudden changes in level.

3) Where a walk crosses another walk, a driveway, or a parking lot, they must blend to a common level. However, this does not require the removal of curbs 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 at the top or bottom of the walk, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the

platform, the platform must be at least 3 feet deep and 5 feet wide. The platform must extend at least 1 foot past the opening side of any doorway.

Parking lots.

1) At least one parking space close to a facility must be set aside and marked for use by persons with disabilities.
2) A parking space must be open on one side to allow room for a person in a wheelchair or on braces or crutches to get in and out of a car onto a level surface suitable for wheeling and walking.
3) A 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 go 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 extend at least 1 foot past the top and bottom of the ramp. However, this does mean that a handrail extension which 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, the platform must be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform, the platform must be at least 3 feet deep and 5 feet wide. The platform must extend at least 1 foot past the opening side of any doorway.
5) A ramp must have level platforms no farther than 30 feet apart and at any turn.
6) A curb ramp with a nonslip surface must be provided at an intersection. The curb ramp must not be less than 4 feet wide and must not 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 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 which 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 the dial and the headset can be reached by a person in a wheelchair.
2) A public telephone must be equipped for a person who is hearing impaired and 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 used by a visually impaired person, such as a door leading to a loading platform, boiler room, stage, or fire escape, must be identifiable by touch.

Warning signals.

1) An audible warning signal must be accompanied by a simultaneous visual signal for the benefit of those who are hearing impaired.

2) A visual warning signal must be accompanied by a simultaneous audible signal for the benefit of persons who are visually impaired.

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.

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 clear signs that indicate that seats in the front of the bus are priority seats for persons who have a disability or are elderly. The signs must encourage other passengers to make these seats available to those who have priority.

5) Handrails and stanchions must be provided in the entrance to the bus so that passengers who have a disability or are elderly can grasp them from outside the bus and use them while boarding and paying the fare. This system must include a rail across the front of the bus interior 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 from the eyes of entering and exiting passengers.

9) The fare box must be located as far forward as practical and must not block traffic in the vestibule.

Rapid and light rail vehicles.

1) Passenger doorways on the vehicle sides must have clear openings at least 32 inches wide.

2) Audible or visual warning signals must be provided to alert passengers of closing doors.

3) Handrails and stanchions must permit safe boarding, moving around, sitting and standing assistance, and getting off by persons who have a disability or are elderly. On a level-entry vehicle, handrails, stanchions, and seats must be located to allow a wheelchair user to enter the vehicle and position the wheelchair in a location that does not block the movement of other passengers. On a vehicle with steps 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 and use them from outside the vehicle while boarding.

4) Floors must have nonslip surfaces. Step edges on a light rail vehicle must have a band of bright contrasting color running the full width of the step.

5) A stepwell next to the driver must have, when the door is open, at least 2 foot-candles of light measured on the step tread. Other stepwells must have, at all times, at least 2 foot-candles of light measured on the step tread.

6) Doorways on a light rail vehicle must have outside lighting that provides at least 1 foot-candle of light on the street surface for a distance of 3 feet from the bottom step edge. This lighting must be below window level and must be shielded from the eyes of entering and exiting passengers.

Other barrier removals. To be deductible, expenses of removing any barrier not covered by the above standards must meet 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 take the disabled access credit. If you make this choice, you must reduce the amount you deduct or capitalize by the amount of the credit.

For more information, see Form 8826.

12. Amortization

Introduction

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.

Topics

This chapter discusses:

- Amortizing costs of section 197 intangibles

- Amortizing costs of going into business
- Amortizing reforestation costs
- Amortizing costs of pollution control facilities
- Amortizing costs of research and experimentation
- Amortizing bond premiums
- Amortizing the cost of getting a lease

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 17 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 choose to amortize your costs by completing Part VI of Form 4562 in the year in which you make the choice.

For later years, do not report your deduction for amortization on Form 4562 unless you must file the form for another reason. You must file Form 4562 in any of the following situations.

- You start claiming amortization this tax year.
- You claim depreciation on property placed in service this year.
- You claim a section 179 deduction.
- You claim a deduction for any vehicle reported on a form other than Schedule C (Form 1040) or Schedule C–EZ (Form 1040).
- You claim depreciation on any vehicle or other listed property (regardless of when it was placed in service).
- You claim depreciation on a return for a corporation (other than an S corporation).

Other forms to use. If you do not have to file Form 4562, claim amortization directly on the "Other expenses" line of Schedule C (Form 1040) or the "Other deductions" line of Form 1065 or Form 1120.

Bond premium amortization. You do not use Form 4562 to report bond premium amortization. How you report this amortization depends on when you get the bond. For information on how to report bond premium amortization, see Publication 550.

Section 197 Intangibles

You must amortize over 15 years the capitalized costs of "section 197 intangibles" you acquired after August 10, 1993. Section 197 intangibles are defined later. You must amortize these costs if you hold the section 197 intangibles in connection with your trade or business or in an activity engaged in for the production of income. Your deduction each year is the part of the adjusted basis (for purposes of determining gain) of the intangible amortized ratably over a 15-year period, beginning with the month acquired. You are not allowed any other depreciation or amortization deduction for a section 197 intangible.

Section 197 Intangibles Defined

The following assets are section 197 intangibles.

1) Goodwill.
2) Going concern value.
3) Workforce in place, including its composition and the terms and conditions (contractual or otherwise) of its employment.
4) Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers.
5) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item.
6) A customer-based intangible.
7) A supplier-based intangible.
8) Any item similar to items (3) through (7).
9) A license, permit, or other right granted by a governmental unit or agency (including renewals).
10) A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business.
11) A franchise, trademark, or trade name (including renewals).

CAUTION *You cannot amortize any of the intangibles listed in items (1) through (8) that you created unless you created them in connection with the acquisition of assets constituting a trade or business or a substantial part of a trade or business.*

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

Going concern value. Going concern value is the additional value of a trade or business that attaches to property because the property is an integral part of a going concern. It includes value based on the ability of a business to continue to function and generate income even though there is a change in ownership.

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

For example, you must amortize the part of the purchase price of a trade or 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 as part of the acquisition of a trade or business.

Business books and records, etc. This includes the cost of technical manuals, training manuals or programs, data files, and accounting or inventory control systems. It also includes the cost of customer lists, subscription lists, insurance expirations, patient or client files, and lists of newspaper, magazine, radio, or television advertisers.

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

Customer-based intangible. A customer-based intangible is the composition of market, market share, and any other value resulting from the future provision of goods or services because of relationships with customers in the ordinary course of business. You must amortize the part (if any) of the purchase price of a trade or business that is for the following intangibles.

- Customer base.
- Circulation base.
- Undeveloped market or market growth.
- Insurance in force.
- Mortgage servicing contracts.
- Investment management contracts.
- Any other relationship with customers that involves the future provision of goods or services.

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

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

For example, you must amortize the part of the purchase price of a trade or business that is based on the existence of any of the following.

- 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. Any license, permit, or other right granted by a governmental unit or an agency or instrumentality of a governmental unit is a section

197 intangible. For example, you must amortize the capitalized costs of acquiring (including issuing or renewing) a liquor license, a taxicab medallion or license, or a television or radio broadcasting license.

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

If you pay or incur an amount under a covenant not to compete (or similar arrangement) after the year in which you entered into the covenant (or similar arrangement), you must amortize that amount over the months remaining in the 15-year amortization period.

You cannot amortize amounts paid under a covenant not to compete (or similar arrangement) that represent additional consideration for the purchase of stock in a corporation. You must add the amounts to the basis of the acquired stock.

Franchise, trademark, or trade name. A franchise, trademark, or trade name is a section 197 intangible. You can deduct amounts paid or incurred on the transfer, sale, or other disposition of a franchise, trademark, or trade name if all of the following apply to the amounts.

- They are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name.
- They are part of a series of payments payable at least annually throughout the term of the transfer agreement.
- They are part of a series of payments that are substantially equal in amount or payable under a fixed formula.

You must amortize any other amount, whether fixed or contingent that you paid or incurred because of the transfer of a franchise, trademark, or trade name.

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, or similar financial contract.
3) Any interest in land.
4) Most computer software (see *Computer software defined,* later).
5) Any of the following ***not*** acquired in connection with the acquisition of a trade or business or a substantial part of a trade or business.
   a) An interest in a film, sound recording, videotape, book, or similar property.
   b) A right to receive tangible property or services under a contract or granted by a governmental agency.
   c) An interest in a patent or copyright.
   d) A right under a contract (or a right granted by a governmental agency) if the right:
      i) Has a fixed life of less than 15 years, or
      ii) Is of a fixed amount that, except for the section 197 intangible provisions, would be recoverable under a method similar to the unit-of-production method of cost recovery.
6) An interest under either of the following.
   a) An existing lease or sublease of tangible property, or
   b) A debt that was in existence when the interest was acquired.
7) A professional sports franchise and any item acquired in connection with the franchise.
8) A right to service residential mortgages unless the right is acquired in the acquisition of a trade or business or a substantial part of a trade or business.
9) Certain transaction costs under a corporate organization or reorganization in which any part of a gain or loss is not recognized.

Computer software. Section 197 intangibles do not include computer software that is:

1) Readily available for purchase by the general public,
2) Subject to a nonexclusive license, and
3) Not substantially changed.

Software that is not acquired in the acquisition of a substantial part of a business is not a section 197 intangible.

If you are allowed to depreciate any computer software that is not a section 197 intangible, use the straight line method with a useful life of 36 months. For more information on depreciation of computer software, see Publication 946.

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

Costs associated with nonsection 197 intangibles. Amounts you take into account in determining the cost of nonsection 197 property are not considered section 197 intangibles. These amounts are added to the basis of the property. For example, none of the costs of acquiring real property held for the production of rental income are considered goodwill, going concern value, or any other section 197 intangible.

Anti-Churning Rules

Anti-churning rules prevent you from converting section 197 intangibles that do not qualify for amortization into property that would qualify for amortization.

You cannot use 15-year amortization for goodwill, going concern value, or any other intangible for which you cannot claim a depreciation deduction and for which an amortization deduction is only allowable under section 197 if:

1) You acquired the goodwill, going concern value, or other intangible after August 10, 1993, and
2) Any of the following conditions apply.
   a) You or a related person (defined later) held or used the intangible at any time from July 25, 1991, through August 10, 1993.
   b) You acquired the intangible from a person who held the intangible at any time from July 25, 1991, through August 10, 1993, and as part of the transaction, the user does not change.
   c) You grant the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time from July 25, 1991, through August 10, 1993.

Exception. The anti-churning rules do not apply to an intangible acquired from a decedent if the property's basis is stepped up to fair market value.

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

- Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- An individual and a corporation when the individual owns, directly or indirectly, more than 20% in 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 subsection (a)(4) and (e)(3)(C) of section 1563.
- A trust fiduciary and a corporation when the trust or grantor of the trust owns, directly or indirectly, more than 20% in value of the corporation's outstanding stock.
- A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- A tax-exempt educational or charitable organization and a person who directly or indirectly controls the organization, or a member of that person's family.
- A corporation and a partnership if the same persons own more than 20% in value of the outstanding stock of the corporation and more than 20% of the capital or profits interest in the partnership.
- Two S corporations if the same persons own more than 20% in value of the outstanding stock of each corporation.
- Two corporations, one of which is an S corporation, if the same persons own more than 20% in value of the outstanding stock of each corporation.

- Two partnerships if the same persons own, directly or indirectly, more than 20% of the capital or the profits interests in both partnerships.
- A person and a partnership when the person owns, directly or indirectly, more than 20% of the capital or profits interests in the partnership.

Treat these persons as related to you if the relationship exists immediately before or immediately after you acquire the intangible.

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

Rule 1. Stock or a partnership interest owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. (However, for a partnership interest owned by or for a C corporation, this applies only to shareholders who own, directly or indirectly, 5% or more in value of the stock of the corporation.)

Rule 2. An individual is considered as owning the stock owned directly or indirectly by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning (other than by applying rule 2) any stock in a corporation is considered to own the stock owned directly or indirectly by or for his or her partner.

Rule 4. For purposes of applying rule 1, 2, or 3, treat stock or a partnership interest constructively owned by a person under rule 1 as actually owned by that person. Do not treat stock or a partnership interest 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 or partnership interest.

Exception. An exception to the anti-churning rules applies if you acquire an intangible from a person related to you by more than 20%, but not more than 50%, under both of the following conditions.

- The seller recognizes gain on the disposition of the intangible.
- The seller pays income tax on the gain at the highest tax rate.

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

Note. If the income tax on the gain (figured without regard to this rule) is less than the tax on the gain at the highest rate, the seller reports the difference as additional tax under this exception on Form 1040, line 40 (or the appropriate line of other income tax returns). On the dotted line next to line 40, the seller should write “197.”

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

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

Incorrect Amount of Amortization Deducted

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

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

Amended Return

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

- To correct a mathematical error made in any year.
- To correct a posting error made in any year.
- To correct the amount of amortization for section 197 intangibles for which you have not adopted a method of accounting. See *Changing Your Accounting Method,* later.

If you did not deduct the correct amount of amortization for the section 197 intangible on two or more consecutively filed tax returns, you have adopted a method of accounting for that property. If you have adopted a method of accounting, you cannot change the method by filing amended returns.

If an amended return is allowed, you must file it by the later of 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.
- 2 years from the time you paid your tax for that year.

A return filed early is considered filed on the due date.

Changing Your Accounting Method

If you did not deduct the correct amount of amortization for the section 197 intangible on any two or more consecutively filed tax returns, you have adopted a method of accounting for that property. You can claim the correct amount of amortization only by changing your method of accounting for amortization. By changing your method of accounting, you will 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 Cumulative Bulletin 1997–1, gives general instructions for getting approval. Cumulative Bulletins are available at many libraries and IRS offices. You do not need IRS approval to correct any mathematical or posting error. See *Amended Return,* earlier.

Automatic approval. You may be able to obtain automatic approval from the IRS to change your method of accounting if you meet all the following conditions.

- The property is amortizable under section 197 of the Internal Revenue Code.
- It is property for which, under your present accounting method, you deducted less than or more than the amount of amortization allowable in at least the 2 years immediately preceding the year of change.
- You owned the property 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 98–60 and section 2.01 of its Appendix, which is in Internal Revenue Bulletin No. 1998–51, has instructions for getting automatic approval and lists exceptions to the automatic approval procedures.

Exceptions. You generally cannot use the automatic approval procedure under 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.

Also, see the exceptions listed in section 2.01(2)(b) of the Appendix of Revenue Procedure 98–60.

Disposition of Section 197 Intangibles

A section 197 intangible is treated as depreciable property used in your trade or business. If you dispose of property held for more than 1 year, any gain on the disposition, up to the amount of allowable amortization, is ordinary income (section 1245 gain). Any remaining gain, or loss, is a section 1231 gain or loss. If you held the property 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. If you acquire more than one section 197 intangible in a transaction (or series of related transactions) and later dispose of one of them or if one of them becomes worthless, you cannot deduct any loss on the intangible. Instead, increase the adjusted basis of each remaining amortizable section 197 intangible by the 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 the remaining intangible on the date of the disposition.
- The denominator is the total adjusted basis of all remaining amortizable section 197 intangibles on the date of the disposition.

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

Nonrecognition transfers. If you dispose of one section 197 intangible and acquire another in a nonrecognition transfer, treat the part of the adjusted basis of the acquired intangible that is not more than the adjusted basis of the transferred intangible as if it were the transferred section 197 intangible. You continue to amortize this part of the adjusted basis over the remaining amortization period of the transferred section 197 intangible. Nonrecognition transfers include transfers to a corporation, partnership contributions and distributions, like-kind exchanges, and involuntary conversions.

Example. You own a section 197 intangible you have amortized for 4 full years. It has a remaining unamortized basis of $30,000. You exchange the asset plus $10,000 for a like-kind section 197 intangible. The nonrecognition provisions of like-kind exchanges apply. You amortize $30,000 of the basis of the acquired section 197 intangible over the 11 years remaining in the original 15-year amortization period for the transferred asset and the other $10,000 of adjusted basis over 15 years.

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. 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 before the trade or business begins in anticipation of the activity becoming an active trade or business.

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

1) 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).
2) It is a cost you pay or incur before the day your active trade or business begins.

Start-up costs can ***include*** costs for the following items.

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

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 costs incurred in the course of a general search for or preliminary investigation of the business. Costs you incur in the attempt to purchase a specific business are capital expenses and you cannot amortize them.

Investigative costs. Investigative costs are the costs that help you decide whether to purchase a business and which business to purchase.

Example. In June, you hired an accounting firm to assist you in the potential purchase of XYZ. They researched XYZ's industry and analyzed the financial projections of XYZ. In September, you hired a law firm to prepare and submit 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 only deduct these deferred start-up costs 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 of the following tests.

- It is for the creation of the corporation.
- It is chargeable to a capital account.
- You could amortize the cost over the life of the corporation if the corporation had a fixed life.

You must have incurred the cost before the end of the first tax year in which the corporation was in business. A corporation using the cash method of accounting 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.

- Costs of temporary directors.
- The cost of organizational meetings.
- State incorporation fees.
- 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).

Costs you cannot amortize. The following costs are not organizational costs. You must capitalize these costs.

- 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

Partnership organizational costs are the direct costs of creating a partnership.

Qualifying costs. You can amortize an organizational cost only if it meets all of 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.
- You could amortize the cost over the life of the partnership if the partnership had a fixed 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.

Costs you cannot amortize. You cannot amortize costs connected with any of the following activities.

- Acquiring assets for the partnership or transferring assets to the partnership.
- Admitting or removing partners, other than at the time the partnership is first organized.
- Making a contract concerning the operation of the partnership trade or business (including a contract between a partner and the partnership).
- Syndication fees.

Syndication fees are costs for issuing and marketing interests in the partnership (such as commissions, professional fees, and printing costs). You must capitalize syndication fees. You cannot depreciate or amortize them.

How To Amortize

You deduct start-up and organizational costs in equal amounts over a period of 60 months or more. You can choose a period for start-up costs that is different from the period you choose for organizational costs, as long as both are 60 months or more. 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 each month.

CAUTION *A partnership using the cash method of accounting cannot deduct a 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 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 costs. 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). 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.

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 the month you acquired the business).
- 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 that 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 choose to amortize your start-up costs.

Organizational costs. If you choose to amortize your organizational costs, complete Part VI of From 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 active business began (or the month you acquired the business).
- The number of months in your amortization period (not less than 60).

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, provided you list the dates the first and last costs were incurred. If you use the cash method of accounting, you must also list the total amount of these costs that were paid by the end of the tax year.*

Amended return. After a partnership makes the choice to amortize organizational costs, it can file an amended return to include additional organizational costs.

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.

TIP *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 succeed in acquiring an interest in the partnership.*

Reforestation Costs

You can choose to amortize part of your qualified timber property reforestation costs. These are the direct costs of planting or seeding for forestation or reforestation.

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 can be a woodlot or other site that you own or lease. The property qualifies only if it meets all of the following requirements.

1) It is located in the United States.
2) 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.
3) 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.

Annual limit. Each year, you can choose to amortize up to $10,000 of qualified costs you pay or incur during the tax year. If you are married and file a separate return, the annual limit is $5,000. You cannot carry over or carry back qualifying costs over the annual limit. The annual limit applies to costs you pay or incur during a tax year on all of your qualified timber property.

If you pay or incur more than $10,000 in costs for more than one piece of timber property, you can divide the annual limit among any of the properties in any manner you wish.

For example, if you incurred $10,000 of qualifying costs on each of four qualified timber properties last year, you can divide $2,500 to each property, $5,000 to two properties, 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. The $10,000 annual limit applies to a partnership or an S corporation and to each partner or shareholder. A partnership or S corporation makes the choice to amortize its qualified costs and allocates the costs (limited to $10,000) among the partners or shareholders.

A partner or shareholder is also subject to the annual limit of $10,000 ($5,000, if married and filing a separate return) regardless of the source of the costs. For example, if you are a partner in two or more partnerships that choose to amortize qualified costs, your total share of partnership amortizable basis cannot be more than $10,000 on a joint return ($5,000 if married and filing a separate return). ***Amortizable basis*** is the part of the basis of qualified property that is from reforestation costs.

Estates. Estates can choose to amortize up to $10,000 of qualified reforestation costs paid or incurred in each tax year. Any amortizable basis acquired by an estate is divided between the estate and the income beneficiary based on the income of the estate allocable to each. The amortizable basis distributed from an estate to a beneficiary is taken into account in determining the beneficiary's annual limit.

Life tenant and remainderman. If one person holds the property for life with the remainder going to another person, the life tenant is entitled to the full amortization (up to the annual limit) for reforestation costs made by the life tenant. Any remainder interest in the property is ignored for amortization purposes.

Amortization period. You can amortize qualified reforestation costs over a period of 84 months. The 84-month period starts on the first day of the first month of the second half of the tax year you incur the costs (July 1st for a calendar year taxpayer). 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 qualified reforestation costs of $8,400. His monthly deduction ($100) is figured by dividing $8,400 by 84 months. Since it was the first year of the 84-month period, he can deduct only $600 ($100 × 6 months).

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

Recapture. If you dispose of qualified timber property within 10 years after the tax year you create an amortizable basis in the property, report any gain as ordinary income up to the amount of the amortization you took.

Investment credit. Reforestation costs eligible to be amortized qualify for the investment credit, whether or not they are amortized. See the instructions for Form 3468 for information on the investment credit.

How to make the choice. To choose to amortize qualified 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. If you file Schedule C or F (Form 1040) for the activity in which you incurred reforestation costs, include your amortization deduction on the line for “Other Expenses.” If you do not file Schedule C or F, include your amortization deduction in the total on line 32 of Form 1040. Enter the amount and “RFST” (for reforestation) on the dotted line next to line 32.

Revocation. You must get IRS approval to revoke your choice to amortize 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.

New identifiable treatment facility. A new identifiable treatment facility is tangible depreciable property that is identifiable as a treatment facility. This 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 research. For a definition of “research and experimental costs” and information on deducting them as current business expenses, see chapter 11.

Optional write-off method. Rather than 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 both of the following apply.

- 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.

Bond Premium

Bond premium is the amount by which your basis in a bond right after you get it is more than the total of all amounts payable on the bond after you get it (other than payments of qualified stated interest).

The term "bond," as used in this discussion, means any interest-bearing bond, debenture, note, or certificate or other evidence of debt issued by a corporation or a government or political subdivision of a government. The term does ***not*** include any obligation listed below.

- Your stock in trade.
- Property that would properly be included in your inventory if on hand at the close of the tax year.
- Property held by you primarily for sale to customers in the ordinary course of your trade or business.

Tax-exempt bonds. If the bond yields tax-exempt interest, you must amortize the premium. You cannot deduct the amortizable premium in figuring your taxable income. However, each year you must reduce your basis in the bond by the amortization for the year.

Taxable bonds. You can choose to amortize the premium on taxable bonds. This generally means that each year, over the life of the bond, you use part of the premium to reduce the amount of interest includible in your income. If you make this choice, you must reduce your basis in the bond by the amortization for the year. The premium on the bond is part of your basis in the bond.

Inflation-indexed instruments. An inflation-indexed debt instrument is generally a debt instrument on which the payments are adjusted for inflation and deflation (such as Treasury Inflation-Indexed Securities). Determine the premium on an inflation-indexed debt instrument as of the date you acquire the instrument by assuming that there will be no inflation or deflation over the remaining term of the instrument. Allocate the premium over the remaining term of the instrument by making the same assumption. Reduce the instrument's interest income for the tax year by the premium allocable to the tax year. Use any excess premium allocable to the tax year to offset the original issue discount on the instrument for the year.

Basis adjustment. If you are required to amortize bond premium, or choose to do so, you must decrease the basis of the bond by the amortizable bond premium. The result is the adjusted basis you use to figure gain or loss on the sale or redemption of the bond.

More information. For more information on how to figure and report bond premium, see Publication 550.

Cost of 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 includes all renewal options (and any other period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost of getting the lease is attributable to the term of the lease remaining on the acquisition date. The term of the lease remaining on the acquisition date does not include any period for which the lease may later be renewed, extended, or continued under an option exercisable by the lessee.

Enter your deduction in Part VI of Form 4562 if you must file that form, or on the appropriate line of your tax return.

13. Depletion

Important Reminders

Temporary suspension of taxable income limit for certain percentage depletion. For tax years beginning after 1997 and before 2000, 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 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.

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 of the following apply.

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

A contractual relationship you have that allows you an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest. 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 mineral properties separately or as a group. See section 614 of the Internal Revenue Code for rules on how to treat separate properties.

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 a small 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 in the property's natural deposit.
- The number of units sold during the tax year.

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

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

2) The residual value of land and improvements at the end of operations.

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 two items.

1) The number of units of mineral remaining at the end of the year (including units recovered but not sold).

2) The number of units 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 using the most accurate and reliable information you can obtain.

Number of units sold. The number of units sold during the tax year is one of the following.

- The units sold for which you receive payment during your tax year (regardless of the year of sale), if you use the cash method of accounting.
- The units sold based on your inventories, if you use the accrual method of accounting.

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

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.

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

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

A bonus payment includes a bonus for either a mineral lease or an oil and gas lease.

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

$$\frac{\text{Number of units sold in the tax year}}{\text{Recoverable units from the property}} \times \text{Bonus Payments}$$

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.

CAUTION *For tax years beginning after 1997 and before 2000, 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.*

When figuring your taxable income from the property for purposes of the taxable income limit consider the following rules.

- 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 determine the amount of ordinary gain allocable to the property.

Oil and Gas Wells

Generally, only small producers and royalty owners can claim percentage depletion for any oil or gas well. However, if you are ***not*** a small producer or royalty owner, you may be able to claim percentage depletion for the following items.

- Natural gas sold under a fixed contract.
- Natural gas from geopressured brine.

For information on the depletion deduction for these items, see *Natural Gas Wells,* later.

Small Producers

If you are a small producer, 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 and retailers, as explained next, 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 of any one of the following interests.

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

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

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

1) You sell oil or natural gas or their by-products directly or through a related person 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 of 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 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.

Sales through a related person. You are considered to be selling through a related person if any sale by the related person produces gross income from which you may benefit because of your direct or indirect ownership interest in the person.

You are ***not*** considered to be selling through a related person who is a retailer if all of the following apply.

- 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.

Transfers. 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.

Figuring percentage depletion. Generally, as a small producer 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 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.

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

You have a part interest in property, for example, if you have a net profits interest. To figure the share of production for your net profits interest, you must determine your percentage participation (as measured by the net profits) in the gross revenue from the property. To figure this percentage, you divide the income you receive for your net profits interest by the gross revenue from the property.

Example. John Oak owns oil property in which Paul Elm owns a 20% net profits interest. During the year, the property produced 10,000 barrels of oil, which John sold for $200,000. John had expenses of $90,000 attributable to the property. The property generated a net profit of $110,000. Paul received income of $22,000 ($110,000 $\times$ .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 $\times$ 11%).

Depletable oil or natural gas quantity. Generally, your depletable oil quantity is 1,000 barrels and your depletable natural gas quantity is 6,000 cubic feet multiplied by the number of barrels of your depletable oil quantity that you choose to apply. If you claim depletion on both oil and natural gas, you must reduce your depletable oil quantity by the number of barrels you use to figure your depletable natural gas quantity. If you are involved in marginal production, see section 613A(c) of the Internal Revenue Code to figure your depletable oil or natural gas quantity.

You must allocate the depletable oil or gas quantity among the following 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 person* in chapter 15 except that item (1) in that discussion includes only an individual, his or her spouse, and minor children.

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, and one member's share of the group's depletable quantity will reduce the other members' share of the group's depletable quantity. Under this rule, a controlled group of corporations is defined in section 1563(a), except that “more than 50%” is substituted for “at least 80%” in that definition.

Gross income from oil and gas property. For purposes of percentage depletion, gross income from oil and gas property is the amount you receive from the sale of the oil or gas in the immediate vicinity of the well. If you do not sell the oil or gas on the property, but manufacture or convert it into a refined product before sale or transport it before sale, the gross income from the property is the representative market or field price (RMFP) of the oil or gas, before conversion or transportation.

If 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 a small producer 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.
- 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 2000, 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 to 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 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.

The 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.

RECORDS 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 he or she takes 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. Deduct oil and gas depletion for a partnership or S corporation interest on Schedule E (Form 1040). The instructions for Schedule E explain where to report your income and deductions 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. For partnership tax years beginning after 1997, 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 limits on the amount of production and taxable income. 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 partners. An electing large partnership does not figure the depletion allowance of its disqualified partners. The disqualified partners must figure it themselves, as explained earlier.

All of the following are disqualified partners.

- Refiners who cannot claim percentage depletion (discussed under *Small Producers,* earlier).
- Retailers who cannot claim percentage depletion (discussed under *Small Producers,* 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 natural gas 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%. Natural gas sold under a fixed contract is domestic natural gas sold by the producer under a contract provided that the price cannot be adjusted to reflect any increase in the seller's tax liability because of the repeal of percentage depletion for gas. 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%. Qualified natural gas from geopressured brine is natural gas 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. The percentage of your gross income from a natural deposit that you can deduct as depletion depends on the type of deposit.

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

DEPOSITS	PERCENT
Sulphur, uranium, and, if from deposits in the United States, asbestos, lead ore, zinc ore, nickel ore, and mica	22
Gold, silver, copper, iron ore, and certain oil shale, if from deposits in the United States	15
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 deposits 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 mining. 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 of 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 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 that are included as mining depend on the ore or mineral mined. To qualify as mining, the treatment processes must be applied by the mine owner or operator. For a listing of treatment processes considered as mining, see section 613(c)(4) of the Internal Revenue Code and the related regulations.

Transportation of more than 50 miles. If the 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 transportation that is authorized is included in the computation of gross income from mining.

If you wish to include transportation of more than 50 miles in the computation of gross income from mining, file an application in duplicate 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: Assistant Chief Counsel,
Passthroughs and Special Industries

Disposal of coal or iron ore. You cannot take a depletion deduction on coal (including lignite) or iron ore mined in the United States that you disposed of after holding it for more than 1 year if you retained an economic interest in it. 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 15).
- 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 a geothermal steam well in the same way as for oil and gas wells. See *Gross income from oil and gas property,* earlier, under *Oil and Gas Wells.*

Lessor's Gross Income

A lessor's gross income from the property that qualifies for percentage depletion usually is the total of the royalties received from the lease. However, for purposes of 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 received upon the grant of rights and advanced royalties are payments a lessee makes to a lessor for the lease or for minerals, gas, or oil to be extracted from leased property. Both types of payments are made before production. If you are the lessor, your income from bonuses and advanced royalties is subject to an allowance for depletion.

Figuring cost or percentage depletion on bonuses and advanced royalties. To figure cost depletion on a bonus, multiply your adjusted basis in the property by a fraction, the numerator 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 units for which the advanced royalty is received as the units sold.

To figure percentage depletion (for other than gas, oil, or geothermal property), any bonus or advanced royalty payments are part of your gross income from the property.

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 or cutting of timber, include in income the depletion deduction you took. Also increase your adjusted basis in the property to restore the depletion deduction you previously subtracted.

For advanced royalties, include in income the depletion claimed on minerals for which the advanced royalties were paid if the minerals were not produced before lease termination. Increase your adjusted basis in the property by the amount you include in income.

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

Timber

The term “timber property” means your economic interest in standing timber in each tract or block representing a separate timber account.

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.

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.

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.

2) Add to the amount determined in (1) the cost of any units acquired during the year and any additions to capital.

3) Figure the number of units to take into account by adding the number of units acquired during the year to the number of units on hand in the account at the beginning of the year and then adding (or subtracting) any correction to the estimate of the number of units remaining in the account.

4) Divide the result of (2) by the result of (3). This is your depletion unit.

Example. You bought a timber tract for $160,000 and the land was worth as much as the timber. Your basis for the timber is $80,000. Based on an estimated one million board feet (1,000 MBF) of standing timber, you figure your depletion unit to be $80 per MBF ($80,000 divided by 1,000). If you cut 500 MBF of timber, your depletion allowance would be $40,000 (500 MBF multiplied by $80).

When to claim depletion. Claim your depletion allowance as a deduction in the year of sale or other disposition of the products cut from the timber, unless you 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 that 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 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 to report on the cutting. You generally report the gain as long-term capital gain. The fair market value then becomes your basis for figuring your ordinary gain or loss on the sale or other disposition of the products cut from the timber. For more information, see *Timber* in chapter 2 of Publication 544, *Sales and Other Dispositions of Assets.*.

Form T. Attach Form T, *Forest Activities Schedules,* 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.

14. 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 bad debts and nonbusiness bad debts.

Generally, a business bad debt is one that comes from operating your trade or business. You can deduct business bad debts as an expense on your business tax return.

All other bad debts are nonbusiness bad debts and deductible as short-term capital losses on Schedule D (Form 1040). For more information on nonbusiness bad debts, see Publication 550, *Investment Income and Expenses.*

Topics

This chapter discusses:

- Definition of business bad debts
- How to treat business bad debts
- Where to deduct business bad debts

Useful Items

You may want to see:

Publication

- ☐ **525** Taxable and Nontaxable Income
- ☐ **536** Net Operating Losses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses
- ☐ **556** Examination of Returns, Appeal Rights, and Claims for Refund

See chapter 17 for information about getting publications and forms.

Defined

A business bad debt is a loss from the worthlessness of a debt that was either of the following.

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

The bad debts of a corporation are always business bad debts.

A debt is closely related to your trade or business if your primary motive for incurring the debt is a business reason.

Example. John Smith, an advertising agent, made loans to certain clients to keep their business. His main reason for making these loans was to help his business. One of these clients later went bankrupt and could not repay him. Since John's business was the main reason for making the loan, the debt was a business debt and he can take a business bad debt deduction.

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 that the amount owed will be paid.

It is not necessary to go to court if you can show that a judgement 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.

Debts from sales or services. Business bad debts are mainly the result of credit sales to customers. They can also be the result of loans to suppliers, clients, employees, or distributors. Goods and services customers have not paid for are shown in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. Accounts or notes receivable valued at fair market value at the time of the transaction are deductible only at that fair market value, even though the value may be less than face value.

You can take a bad debt deduction for these accounts and notes receivable only if the amount owed you was included in your gross income for the year the deduction is claimed or for a prior year. This applies to amounts owed you from all sources of taxable income, such as sales, services, rents, and interest.

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

Accrual method taxpayers. Accrual method taxpayers normally report income as they earn it. They can take a bad debt deduction for an uncollectible receivable if they have included the uncollectible amount in income.

Cash method taxpayers. Cash method taxpayers normally report income when they receive payment. They cannot take a bad debt deduction for amounts owed to them that they have not received and cannot collect because they never included those amounts in income.

Debts from a former business. If you sell your business but keep its accounts receivable, these debts are business debts since they arose in your trade or business. If an account becomes worthless, the loss is a business bad debt. These accounts would also be business debts if sold to the new owner of the business.

If you sell your business to one person and sell your accounts receivable to someone else, the character of the debts as business or nonbusiness is based on the activities of the new holder of these debts. 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 debt of a business acquired from a decedent is determined in the same way as a debt sold by a business. If you are in a trade or business, 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.

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

Debts of political parties. If a political party (or other organization that accepts contributions or spends money to influence elections) owes you money and the debt becomes worthless, you cannot take a bad debt deduction unless you use an accrual method of accounting and meet all the following tests.

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

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

Debts of an insolvent partner. If your business partnership breaks up and one of your former partners is insolvent and cannot pay any of the partnership's debts, you may have to pay more than your share of the partnership's debts. If you pay any part of the insolvent partner's share of the debts, you can take a bad debt deduction.

Business loan guarantee. If you guarantee a debt that becomes worthless, 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 that 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.

Consider any guarantee you make to protect or improve your job as closely related to your trade or business as an employee.

Example. Bob Zayne owns the Zayne Dress Company. He guaranteed payment of a $20,000 note for Elegant Fashions, a dress outlet. Elegant Fashions is one of Zayne's largest clients. Elegant Fashions later filed for bankruptcy and defaulted on the loan. Mr. Zayne made full payment to the bank. He can take a business bad debt deduction, since his guarantee was made in the course of his trade or business for a good faith business purpose. He was motivated by the desire to retain one of his better clients and keep a sales outlet.

Deductible in the year paid. You can deduct a payment you make on a loan you guaranteed in the year of payment unless you have rights against the borrower.

Rights against a borrower. When you make payment on a loan you guaranteed, you may have the right to take the place of the lender. The debt is then owed to you. If you have this right, or some other right to demand payment from the borrower, you cannot take a bad debt deduction until these rights become partly or totally worthless.

Bankruptcy claim. You can deduct as a bad debt only the difference between the amount owed to you by a bankrupt entity and the amount you received from the distribution of its assets.

Sale of mortgaged property. If mortgaged or pledged property is sold for less than the debt, the unpaid, uncollectible balance of the debt after the sale is a bad debt. If the debt represents capital or an amount you previously included in income, you can deduct it as a bad debt in the year it becomes totally worthless or in the year you charged it off as partially worthless.

Recovery of bad debt. If you deduct a bad debt and later recover (collect) all or part of it, you may have to include all or part of the recovery in gross income. The amount you include is limited to the amount you actually deducted. 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.

Example. In 1998, the Willow Corporation had gross income of $158,000, a bad debt deduction of $3,500, and other allowable deductions of $49,437. The corporation reported on the accrual method of accounting and used the specific charge-off method for bad debts. The entire bad debt deduction reduced the tax on the 1998 corporate return. In 1999, the corporation recovers part of the $3,500 deducted in 1998. It must include the part recovered in income for 1999 as “Other income” on its corporate return.

Net operating loss (NOL) carryover. If a bad debt deduction increases an NOL carryover that has not expired before the beginning of the tax year in which the recovery takes place, you treat the deduction as having reduced your tax. A bad debt deduction that contributes to a net operating loss helps lower taxes in the year to which you carry the net operating loss.

See Publication 536 for more information about net operating losses.

More information. See *Recoveries* in Publication 525 for more information on recovered amounts.

Property received for debt. If you receive property in partial settlement of a debt, reduce the debt by the fair market value of the property received. You can deduct the remaining debt as a bad debt in the year you determine it is worthless.

If you later sell the property, any gain on the sale is due to the appreciation of the property after it was used to partially settle the debt. You must include any gain from the sale in gross income. The gain is not a recovery of a bad debt. For information on the sale of an asset, see Publication 544.

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.

Specific Charge-Off Method

If you use the specific charge-off method, you can deduct specific business bad debts that become either partly or totally worthless during the tax year.

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

Deduction disallowed. You can generally take a partial bad debt deduction only in the year you make the charge-off on your books. If the Internal Revenue Service (IRS) does not allow your deduction and the debt becomes partly worthless in a later tax year, you can deduct the amount you charge-off in that year plus the amount charged off in the earlier year. The charge-off in the earlier year, unless reversed on your books, fulfills the charge-off requirement for the later year.

Totally worthless debts. Deduct a totally worthless debt only in the tax year it becomes totally worthless. Do not include any amount deducted in an earlier tax year when the debt was only partly worthless.

You do not have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. However, you may want to do so. If 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 partially 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.

However, see Publication 556 for information on suspending the time period for filing a claim when you are physically or mentally unable to handle your financial affairs.

Use one of the following forms to file a claim for a credit or refund.

If you are an:	File:
Individual	Form 1040X
Corporation	Form 1120X
S corporation	Form 1120S (check box F(4))
Partnership	Form 1065 (check box G(4))

For more information about filing a claim, see Publication 556.

Nonaccrual-Experience Method

If you use an accrual method of accounting and qualify under the rules explained in this section, you can use the nonaccrual-experience method of accounting for bad debts. Under this method, you do not accrue income that you expect to be uncollectible.

If you determine, based on your experience, that certain amounts (accounts receivable) are uncollectible, do not include them in your gross income for the tax year.

Amounts must be for performing services. You can use the nonaccrual-experience method only for amounts earned by performing services that you would otherwise include in income. You cannot use this method for amounts owed to you from activities such as lending money, selling goods, or acquiring receivables or other rights to receive payments.

Interest or penalty charged. Generally, you cannot use the nonaccrual-experience method for amounts due on which you charge interest or a late payment penalty. However, do not treat a discount offered for early payment as the charging of interest or a penalty if both of 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.

How to apply this method. You can apply the nonaccrual-experience method under either of the following systems.

- Separate receivable system.
- Periodic system.

Under the separate receivable system, apply the nonaccrual-experience method separately to each account receivable. Under the periodic system, apply the nonaccrual-experience method to total qualified accounts receivable at the end of your tax year.

Treat each system as a separate method of accounting. You generally cannot change from one system to the other without IRS approval.

Generally, you also need IRS approval to change to either system under the nonaccrual-experience method from a different accounting method.

For more information on the separate receivable system, see section 1.448–2T of the regulations. For more information on the periodic system, see Notice 88–51 in Cumulative Bulletin 1988–1.

Where To Deduct

Use the following guide to find where to deduct your business bad debts.

If you are a:	Then deduct your bad debt on:
Sole Proprietor	Line 9 of Schedule C (Form 1040) **or** Line 2 of Schedule C–EZ (Form 1040)
Farmer	Line 34 of Schedule F (Form 1040)
Corporation	Line 15 or Form 1120 **or** Line 15 of Form 1120–A **or** Line 10 of Form 1120S
Partnership	Line 12 of Form 1065

15. Electric and Clean-Fuel Vehicles

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 17 for information about getting publications and forms.

Deductions for Clean-Fuel Vehicle and Refueling Property

You are allowed a limited deduction for the cost of clean-fuel vehicle property. You are also allowed a limited deduction for the cost of 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 a property's cost that you claim as a section 179 deduction.

Nonqualifying property. You cannot claim these deductions for 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.

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.

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 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.*

Motor vehicle defined. A motor vehicle is any vehicle that has four or more wheels and is manufactured primarily for use on public streets, roads, and highways. It does not include a vehicle operated exclusively on a rail or rails.

Qualified property. For your property to qualify for the deduction:

1) It must be acquired for your own use and not for resale,
2) Its original use must begin with you, and
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.

However, see *Nonqualifying property*, earlier.

Deduction limit. The maximum deduction you can claim for qualified clean-fuel vehicle property with respect to any motor vehicle is:

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, or
3) $2,000 for a vehicle not included in (1) or (2).

Deduction for Clean-Fuel Vehicle Refueling Property

For your property to qualify for this deduction:

1) It must be depreciable property, and
2) Its original use must begin with you.

However, see *Nonqualifying property*, 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 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.

For the definition of a motor vehicle, see *Deduction for Clean-Fuel Vehicle Property*, earlier.

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 portions of the property's cost) that you are using as a basis for the deduction.*

Related persons. For this purpose, related persons include the following persons.

1) An individual and his or her brothers and sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
2) An individual and a corporation when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
3) Two corporations that are members of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
4) A grantor and a fiduciary of 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 when the trust or a grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.

9) A person and a tax-exempt educational or charitable organization that is controlled directly or indirectly by that person or by members of the family of that person.

10) A corporation and a partnership if the same 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 owning, directly or indirectly, more than 50% of the capital or profits interest in the partnership.

13) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital or profits interest in both partnerships.

14) An executor of an estate and a beneficiary of the estate, except in the case of a sale or exchange 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 vehicles and refueling property depends on the use of the property and the kind of income tax return you file.

Nonbusiness use of clean-fuel vehicle property by individuals. Individuals can claim the deduction for the nonbusiness use of clean-fuel vehicle property by including the deduction in the total on line 32 of Form 1040. Also, enter the amount of your deduction and "Clean-Fuel" on the dotted line next to line 32. If you use the vehicle partly for business, see the next two discussions.

Business use by employees. Employees who use clean-fuel vehicle property for business, or partly for business and partly for nonbusiness purposes, should include the entire deduction in the total on line 32 of Form 1040. Also, enter the amount of your deduction and "Clean-Fuel" on the dotted line next to line 32.

Business use by sole proprietors. Individuals who operate a business as a sole proprietor must claim their deduction for the business use of clean-fuel vehicles and clean-fuel vehicle refueling property on the *Other expenses* line of either Schedule C (Form 1040) or Schedule F (Form 1040). If clean-fuel vehicle property is used partly for nonbusiness purposes, claim the nonbusiness part of the deduction as explained earlier under *Nonbusiness use of clean-fuel vehicle property by individuals.*

Partnerships. Partnerships claim the deduction for the business use of clean-fuel vehicle and clean-fuel vehicle refueling property on line 20 of Form 1065.

S corporations. S corporations claim the deduction for the business use of clean-fuel vehicle and clean-fuel vehicle refueling property on line 19 of Form 1120S.

Other corporations. Corporations claim the deduction for the business use of clean-fuel vehicle and clean-fuel vehicle refueling property on line 26 of Form 1120 (line 22 of Form 1120–A).

Recapture of the Deductions

If the property ceases to qualify, you may have to recapture the deduction. You recapture the deduction by including it, or a 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:

1) Is modified so that it can no longer be propelled by a clean-burning fuel,

2) Ceases to be a qualified clean-fuel vehicle property (for example, by failing to meet emissions standards), or

3) Is used—

   a) Predominantly outside the United States,

   b) Predominantly to furnish lodging or in connection with the furnishing of lodging,

   c) By certain tax-exempt organizations, or

   d) By governmental units or foreign persons or entities.

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 used in a manner described above, you are subject to the recapture rules. In other sales or dispositions (including a disposition by reason of an accident or other casualty), the recapture rules do not apply.

If the vehicle was subject to depreciation, the deduction (minus any recapture) is considered depreciation when figuring the part of the gain that is ordinary income. See Publication 544 for more information on dispositions of depreciable property.

Recapture amount. Figure your recapture amount by multiplying the deduction by a recapture percentage. The percentages are as follows.

- 100% if the recapture date is within the first full year after the date the vehicle was placed in service.
- $66\frac{2}{3}\%$ if the recapture date is within the second full year after the date the vehicle was placed in service.
- $33\frac{1}{3}\%$ 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.

Nonbusiness use by individuals. Include the amount on line 21 of Form 1040.

Business use by employees. Include the amount on line 21 of Form 1040.

Business use by sole proprietors. Include the amount on the *Other income* line of either Schedule C (Form 1040) or Schedule F (Form 1040).

Partnerships and corporations (including S corporations). Include the amount on the *Other income* line of the form you file.

Clean-Fuel Vehicle Refueling Property

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:

1) Ceases to be a clean-fuel vehicle refueling property (for example, by being converted to store and dispense gasoline),

2) Is no longer used 50% or more in your trade or business, or

3) Is used—

   a) Predominantly outside the United States,

   b) Predominantly to furnish lodging or in connection with the furnishing of lodging,

   c) By certain tax-exempt organizations, or

   d) By governmental units or foreign persons or entities.

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 used in a manner described above, you are subject to the recapture rules. In other sales or dispositions, the recapture rules do not apply.

The deduction (minus any recapture amount) is considered depreciation when figuring the part of the gain that is ordinary income upon its disposition. See Publication 544 for more information on dispositions of depreciable property.

Recapture amount. Figure your recapture amount by multiplying the deduction you claimed by the following fraction.

$$\frac{\text{Total recovery period for the property} - \text{Recovery years before the recapture year}}{\text{Total recovery period for the property}}$$

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) or (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 refueling property depends on how you claimed the deduction for that property.

Business use by sole proprietors. Include the amount on the *Other income* line of either Schedule C (Form 1040) or Schedule F (Form 1040).

Partnerships and corporations (including S corporations). Include the amount on the *Other income* line of the form you file.

Basis Adjustments

You must reduce the basis of your clean-fuel vehicle or clean-fuel vehicle refueling property by the amount of the deduction claimed. If, in a later year, you must recapture part or all of the deduction, increase the basis of the property by the amount recaptured. If the property is depreciable property, you can recover this additional basis over the property's remaining recovery period beginning with the tax year of recapture.

If you were using the percentage tables to figure your depreciation on the property, you will not be able to continue to do so. See Publication 946 for information on figuring your depreciation without the tables.

Electric Vehicle Credit

You can choose to claim a tax credit for a qualified electric vehicle you place in service during the year. You can make this choice regardless of whether the property is used in a trade or business.

Qualified Electric Vehicle

A vehicle is a qualified electric vehicle if it meets all of the following requirements.

1) It has at least four wheels and is manufactured primarily for use on public streets, roads, and highways.
2) It is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current.
3) You were the first person to use it.
4) You acquired it for your own use and not for resale.

Generally, an electric vehicle is not qualified if it:

1) Has ever been used as a nonelectric vehicle,
2) Is operated exclusively on a rail or rails, or
3) Is used—
   a) Predominantly outside the United States,
   b) Predominantly to furnish lodging or in connection with the furnishing of lodging,
   c) By certain tax-exempt organizations, or
   d) By governmental units or foreign persons or entities.

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 amount of credit you can take, complete Form 8834 and attach it to your tax return.

How To Claim the Credit

You must complete and attach Form 8834 to your tax return to claim the electric vehicle credit. Enter your credit on your tax return as discussed next.

Individuals. Individuals claim the credit by entering the amount from line 19 of Form 8834 on line 47 of Form 1040. Check box "d" and specify Form 8834.

Partnerships. Partnerships enter the amount from line 19 of Form 8834 on line 13 of Schedule K (Form 1065). The partnership then allocates the credit to the partners on line 13 of Schedule K–1 (Form 1065). See the instructions for Form 1065.

S corporations. S corporations enter the amount from line 19 of Form 8834 on line 13 of Schedule K (Form 1120S). The S corporation then allocates the credit to the shareholders on line 13 of Schedule K–1 (Form 1120S). See the instructions for Form 1120S.

Other corporations. Corporations other than S corporations claim the credit by entering the amount from line 19 of Form 8834 in the total for line 4c of Schedule J (Form 1120) and checking the Form 8834 box to the left of the entry. See the instructions for Form 1120.

Recapture of the Credit

The electric vehicle credit is subject to recapture if, within 3 years after the date you place the vehicle in service, it ceases to qualify for the electric vehicle credit. You recapture the credit by adding it, or a part of it, to your income tax.

The vehicle ceases to qualify if it:

1) Is modified so that it is no longer primarily powered by electricity, or
2) Is used—
   a) Predominantly outside the United States,
   b) Predominantly to furnish lodging or in connection with the furnishing of lodging,
   c) By certain tax-exempt organizations, or
   d) By governmental units or foreign persons or entities.

Sales or other dispositions. If you sell or dispose of the vehicle within 3 years after the date you place it in service and know or have reason to know that it will be used in a manner described above, you are subject to the recapture rules. In other sales or dispositions, the recapture rules do not apply.

If the vehicle was subject to depreciation, the credit (minus any recapture amount) is considered depreciation when figuring the part of the gain that is ordinary income. See Publication 544 for more information on dispositions of depreciable property.

Recapture amount. Figure your recapture amount by multiplying the credit by a recapture percentage. The percentages are as follows.

- 100% if the recapture date is within the first full year after the date the vehicle was placed in service.
- 66$\frac{2}{3}$% if the recapture date is within the second full year after the date the vehicle was placed in service.
- 33$\frac{1}{3}$% 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. How you report the recapture amount of the electric vehicle credit depends on how the credit was claimed.

Individuals. Include the amount on line 56 of Form 1040. Write "QEVCR" on the dotted line next to line 56.

Partnerships. Include on line 25 of Schedule K–1 (Form 1065) the information a partner needs to figure the recapture of the credit.

S corporations. Include on line 23 of Schedule K–1 (Form 1120S) the information a shareholder needs to figure the recapture of the credit.

Other corporations. Include the amount on line 8 of Schedule J (Form 1120), or line 5 of Part I (Form 1120–A). Write "QEV recapture" on the dotted line next to that entry space.

Basis 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.

16. Other Expenses

Important Change for 1999

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1999 is 32½ cents a mile for all business miles driven before April 1. The rate is 31 cents a mile for business miles driven after March 31. See chapter 5.

Important Changes for 2000

Meal expense deduction subject to "hours of service" limits. For 2000, this deduction increases to 60% 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.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 2000 is 32.5 cents per mile for each business mile.

Introduction

This chapter covers some 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)

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **529** Miscellaneous Deductions
- ☐ **542** Corporations
- ☐ **946** How To Depreciate Property
- ☐ **1542** Per Diem Rates

Form (and Instructions)

- ☐ **Sch A** (Form 1040) Itemized Deductions
- ☐ **1099–MISC** Miscellaneous Income
- ☐ **6069** Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction

See chapter 17 for information about getting forms and publications.

Travel, Meals, and Entertainment

To be deductible, expenses incurred for travel, meals, and entertainment must be ordinary and necessary expenses of carrying on your trade or business. Generally, you also must show that entertainment expenses (including meals) are directly related to, or associated with, the conduct of your trade or business.

The following discussion explains how you deduct any reimbursements or allowances you make for these expenses incurred by your employees. If you are self-employed and incur these expenses yourself, see Publication 463 for information on how you can deduct them.

Reimbursements

How you deduct a reimbursement or allowance arrangement (including per diem allowances, discussed later) for travel, meals, and entertainment expenses incurred by your employees depends on whether you have an accountable plan or a nonaccountable plan. A ***reimbursement or allowance arrangement*** is a system by which you 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 and deduct them as wages. See Table 16–1, *Reporting Reimbursements.*

Accountable Plans

To be an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all of the following rules.

1) They must have paid or incurred deductible expenses while performing services as your employees.
2) They must adequately account to you for these expenses within a reasonable period of time.
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.

TIP ***Reasonable period of time.*** *A reasonable period of time depends on the facts and circumstances. Generally, you can consider the period reasonable if your employees adequately account for the expenses within 60 days after they pay or incur them and if they return any excess reimbursement within 120 days after they pay or incur the expense. Also, the period is considered reasonable if you give your employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days of the statement. An advance made to an employee within 30 days of the time he or she has an expense is considered made within a reasonable period.*

If any expenses reimbursed under this arrangement are not substantiated, or are an excess reimbursement that is not returned within a reasonable period of time by an employee, you cannot treat these expenses as reimbursed under an accountable plan. Instead, treat the reimbursed expenses as paid under a nonaccountable plan, discussed later.

How to deduct. You can take a deduction for travel, meals, and entertainment if you reimburse your employees for these expenses under an accountable plan. The amount you 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 deductions" line of Form 1120 or Form 1120–A. If you file any other income tax return, such as a partnership or S corporation return, deduct the reimbursement on the appropriate line of the return as provided in the instructions for that return.

Table 16-1. **Reporting Reimbursements**

If the type of reimbursement (or other expense allowance) arrangement is under:	Then the employer reports on Form W-2:
An accountable plan with:	
Actual expense reimbursement: Adequate accounting made and excess returned	No amount.
Actual expense reimbursement: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1.
Per diem or mileage allowance up to the federal rate: Adequate accounting and excess returned	No amount.
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting up to the federal rate only and excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 13—it is not reported in box 1.
A nonaccountable plan with:	
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.
No reimbursement plan	The entire amount as wages in box 1.

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.

Car allowance. Your employee is considered to have accounted to you for car expenses that do not exceed the ***standard mileage rate.*** For 1999, the standard mileage rate is 32.5 cents for all business miles incurred for the period January 1 to March 31. For the period April 1 to December 31, 1999, the standard rate is 31 cents per mile for each business mile. The standard mileage rate is considered to be the federal rate. If the car allowance you pay is equal to or less than the standard mileage rate, see *Allowance LESS than or EQUAL to the federal rate,* later. If the car allowance you pay is more than the standard mileage rate, see *Allowance MORE than the federal rate,* later.

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 98–63 in Internal Revenue Bulletin No. 1998–52. You can read Revenue Procedure 98–63 at many public libraries.

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. The ***federal rate*** can be figured using any one of the following methods.

1) The regular federal per diem rate.
2) The standard meal allowance.
3) The high-low method.

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. Publication 1542 lists the rates in the continental U.S.

The federal rates for meal and incidental expenses are the same as those rates discussed under *Standard Meal Allowance* in chapter 1 in Publication 463.

Standard meal allowance. For an allowance for meal expenses only, the ***federal rate*** is the standard meal allowance (see chapter 1 in Publication 463). You may pay an allowance for meal 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 1999 is $185 for certain locations. All other areas have a per diem amount of $115. The areas eligible for the $185 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 amount of 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 part of the employee's pay. Deduct the allowance as travel expenses (including meals that may be subject to the 50% limit, discussed later). See *How to deduct* under *Accountable Plans,* 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 13 (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 allowance amount that is more than the federal rate in box 1 (and in boxes 3 and 5 if they apply) of the employee's Form W–2. Deduct it as wages subject to income tax withholding, social security, Medicare, and federal unemployment taxes. This part of the allowance is treated as reimbursed under a nonaccountable plan as explained later under *Nonaccountable Plans.*

Meals and Entertainment

Under an accountable plan, you can generally deduct only 50% of any otherwise deductible business-related meal and entertainment expenses that you reimburse your employees. The deduction limit applies even if you reimburse them for 100% of the expenses.

Application of the 50% limit. The 50% deduction limit applies to reimbursements you make to your employees for expenses they incur while traveling away from home on business and for entertaining business customers at your place of business, a restaurant, or other location. It applies to attending a business convention or reception, business meeting, or business luncheon at a club. The deduction limit may also apply to meals you furnish on your premises to your employees (discussed in chapter 3).

Related expenses. Taxes and tips relating to a meal or entertainment activity that you reimburse to your employee under an accountable plan are included in the amount that is subject to the 50% limit. Reimbursements you make for expenses, such as cover charges for admission to a nightclub, rent paid for a room to hold a dinner or cocktail party, or the amount you pay for parking at a sports arena, are all subject to the 50% limit. However, the cost of transportation to and from a business meal or entertainment activity that is otherwise allowable is not subject to the 50% limit.

How to apply the 50% limit. If you provide your employees with a per diem allowance (discussed earlier) only for meal and incidental expenses, the amount treated as an expense for food and beverages is the lesser of the following.

- The per diem allowance.
- The federal meal and incidental expense rate (M & IE).

If you provide your employee with a per diem allowance that covers lodging, meals, and incidental expenses, you must treat an amount equal to the federal M & IE rate for the area of travel as an expense for food and beverages. If you use the high-low method, the federal M & IE rate is treated as $42 for a high-cost locality and $34 for any other locality. If the per diem allowance you provide for a full day of travel is less than the federal per diem rate for the area of travel, you can treat 40% of the per diem allowance as the amount for food and beverages.

Drilling rigs. The 50% limit does not apply to the food or beverages an employer provides on an oil or gas platform or drilling rig located offshore or in Alaska. This exception also applies to food and beverages provided by an employer at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

Meal expenses when subject to "hours of service" limits. You can deduct 55% 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. The percentage increases to 60% for 2000.

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 chapter 4 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 chapter 4, 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. The definition of a highly compensated employee is the same as the one given in chapter 4 under *Exclusion of Certain Fringe Benefits,* with the following exceptions.

- An employee owning less than a 10% interest in your business is not considered a shareholder or other owner.
- An employee is treated as owning any interest owned by a family member. Family members include brothers, sisters, a spouse, ancestors, and lineal descendants.

These expenses are not subject to the 50% limit. For example, the expenses for food, beverages, and entertainment for a company-wide picnic are not subject to the 50% limit.

Nonaccountable Plans

A nonaccountable plan is an arrangement that does not meet the requirements for an accountable plan. All amounts paid, or treated as paid, under a nonaccountable plan are reported as wages on Form W–2. The payments are subject to income tax withholding, social security, Medicare, and federal unemployment taxes. You can deduct the reimbursement as compensation or wages only to the extent it meets the deductibility tests for employees' pay in chapter 2. Deduct the allowable amount as compensation or wages on the appropriate line of your income tax return, as provided in its instructions.

Other Reimbursed Expenses

You may provide meals and entertainment expenses to individuals 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 separate *Instructions for Forms 1099, 1098, 5498, and W–2G.* These expenses are not subject to the 50% limit.

Director, stockholder, or employee meetings. You can deduct entertainment expenses directly related to business meetings of your employees, partners, stockholders, agents, or directors. You can provide some minor social activities, but the main purpose of the meeting must be your company's business. These expenses are subject to the 50% limit.

Trade association meetings. You can deduct expenses directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, and trade and professional associations. These expenses are subject to the 50% limit.

Sale of meals or entertainment. You can deduct the cost of providing meals, entertainment, goods and services, or use of facilities that you sell to the public. For example, if you run a nightclub, your expense for the entertainment you furnish to your customers, such as a floor show, is a business expense. These expenses are not subject to the 50% limit.

Advertising to promote goodwill. You can deduct the cost of providing meals, entertainment, or recreational facilities to the general public as a means of advertising or promoting goodwill in the community. For example, the expense of sponsoring a television or radio show is deductible. You can also deduct the expense of distributing free food and beverages to the general public. These expenses are not subject to the 50% limit.

Charitable sports event. The 50% limit does not apply to the expenses covered by a package deal that includes a ticket to a charitable sports event 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 "good will" advertising to keep your name before the public if it relates to business you reasonably expect to gain in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross, to buy U.S. Saving Bonds, or to participate in similar causes is usually deductible.

Foreign expenses. You cannot deduct the costs of advertising on foreign radio and television (including cable) where the advertising is primarily for a market in the United States. However, this rule only applies to advertising expenses in countries that deny a deduction for advertising on a United States broadcast primarily for that country's market.

Anticipated liabilities. Anticipated liabilities or reserves for anticipated liabilities are not deductible. For example, assume you sold 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 return, include them when figuring if you must file an information return, Form 1099–MISC. For more information about when to file Form 1099–MISC, see the separate *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Car and truck expenses. You can deduct the cost of operating a car, truck, or other vehicle in your business. These costs include gas, oil, repairs, license tags, insurance, and depreciation. Only the expenses for business use are deductible. Traveling between your home and your place of business is 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 is given at the beginning of this chapter. 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 that 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 inventory is not included in your opening inventory, the inventory's basis is zero and you cannot claim a charitable contribution deduction. Treat the inventory'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 that an S corporation) can deduct its basis in the property plus ½ of the gain that would have been realized if the property had been sold at its fair market value on the date of contributions. 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 1999 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 1999. 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 1999 for $400 (not part of the opening inventory). The $400 is included as part of the cost of goods sold for 1999 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, athletic clubs, luncheon clubs, sporting clubs, airline clubs, and hotel clubs.

Exception. Unless a main purpose is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities, the following organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose.

- 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 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) that are 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 law or regulations for keeping your pay, status, or job.

You ***cannot*** deduct education expenses you incur to meet the minimum requirements of your present trade or business, or those that qualify you for a new trade or business. This is true even if the education maintains or improves skills presently required in your business.

Example 1. Dr. Carter, who is a psychiatrist, begins a program of study at an accredited psychoanalytic institute to qualify as a psychoanalyst. She can deduct the cost of the program because the study maintains or improves skills required in her profession and does not qualify her for a new one.

Example 2. Herb Jones owns a repair shop for electronic equipment. The bulk of the business is television repairs, but occasionally he fixes tape decks and disc players. To keep up with the latest technical changes, he takes a special course to learn how to repair disc players. Since the course maintains and improves skills required in his trade, he can deduct its cost.

Example 3. Peter Green, an architect in New York, decided to take a special 2-week course in Los Angeles on the latest building techniques. While there, he spent an extra 8 weeks on personal activities. The time he spent on personal activities indicates his main reason for going to Los Angeles was to take a vacation. He can deduct his education expenses and meals and lodging for the 2 weeks he attended the course. He cannot deduct his round trip transportation expense to Los Angeles or any of the expenses for the 8 weeks spent on personal activities.

Environmental cleanup costs. You can deduct certain costs to clean up land and to treat groundwater that you contaminated with hazardous waste from your business operations. You can deduct the costs you incur to restore your land and groundwater to the same physical condition that existed prior to contamination. You cannot deduct costs for the construction of groundwater treatment facilities. You must capitalize those costs and you can recover them through depreciation.

Franchise, trademark, trade name. If you buy a franchise, trademark, or trade name, you can deduct the amount you pay or incur for the transfer as a business expense only if the payments are part of a series of payments that are:

1) Contingent on productivity, use, or disposition of the item,
2) Payable at least annually for the entire term of the transfer agreement, and
3) Substantially equal in amount (or payable under a fixed formula).

When determining the term of the transfer agreement, include all renewal options and any other period for which you and the transferor 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 for the transfer that are not described in (1) through (3) under *Franchise, trademark, trade name,* above must be charged to a capital account. These are "section 197 intangibles" and are amortized over 15 years. See chapter 12 for more information on amortization.

You can also elect to apply this same treatment to any franchise, trademark, or trade name acquired after July 25, 1991. This election is binding and cannot be revoked without consent from the IRS.

Property acquired before August 11, 1993. For a transfer not treated as a sale or exchange of a capital asset, you can deduct a lump-sum payment of an agreed upon principal amount ratably over the shorter of 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.

CAUTION *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 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 at a gain, you must recapture as ordinary income the payments you deducted as:

- A lump-sum or serial payment of a principal amount not treated as a sale or exchange of an asset,
- An amortized payment deducted over 25 years, or
- The amortization claimed on section 197 intangibles.

For more information about dispositions of franchises, trademarks, and trade names, see chapter 2 in Publication 544.

Interview expense allowances. Reimbursements you make to job candidates for transportation or other expenses related to interviews for possible employment are not wages. They are not subject to social security and Medicare taxes (FICA), federal unemployment taxes (FUTA), or the withholding of income tax. 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 is 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 12 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 income tax regulations.

You cannot take a charitable deduction or business expense for amounts paid to an organization described in section 170(c) of the Internal Revenue Code if both of the following apply.

- The organization conducts lobbying activities on matters of direct financial interest to your business.
- A principal purpose of your contribution is to avoid the rules discussed earlier that prohibit a business deduction for lobbying expenses.

If a tax-exempt organization, other than a section 501(c)(3) organization, provides you with a notice on the portion of dues that are allocable to nondeductible lobbying and political expenses, you cannot deduct that portion of the dues.

Covered executive branch official. For purposes of this discussion, a covered executive branch official includes 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 items (a) or (b) above.

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).

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.

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.

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 and 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 also 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.

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 the value or usefulness of property 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.

TIP *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 that you added to the ***cost of goods sold*** as a separate business expense.

Repayments (claim of right). If you had to repay an amount that you included in your income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount repaid from your income in the year in which you repay 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 that you previously reported as a capital gain, deduct the repayment as a capital loss.

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. If you reported it as wages, unemployment compensation, or other nonbusiness ordinary income, enter it on line 22 of Schedule A (Form 1040). If you reported it as a capital gain, deduct it on Schedule D (Form 1040).

Repayment—over $3,000. If the amount you repaid was more than $3,000, you can take a deduction for the amount repaid (Method 1) or you can take a credit against your tax (Method 2). Figure your tax under both methods and use the method that results in less tax.

Method 1. Figure your tax for 1999 claiming a deduction for the repaid amount.

Method 2. Follow these steps.

1) Figure your tax for 1999 ***without*** deducting the repaid amount.
2) Refigure your tax from the earlier year without including in income the amount you repaid in 1999.
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 1999 figured without the deduction (step 1).

If the amount from method 1 is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. For example, if you reported it as self-employment income, deduct it as a business deduction on Schedule C or Schedule C–EZ (Form 1040). If you reported it as wages, deduct it as an itemized deduction on line 27 of Schedule A (Form 1040).

If using method 2 results in less tax, claim the credit on line 63 of Form 1040, and write “I.R.C. 1341” next to line 63.

Example. For 1998 you filed a return and reported your income on the cash method. In 1999 you repaid $5,000 included in your 1998 gross income under a claim of right. Your filing status in 1999 and 1998 is single. Your income and tax for both years are as follows:

	1998 With Income	1998 Without Income
Taxable Income	$15,000	$10,000
Tax Liability	$ 2,254	$ 1,504
	1999 Without Deduction	**1999 With Deduction**
Taxable Income	$49,950	$44,950
Tax Liability	$10,646	$ 9,246

Your tax under method (1) is $9,246. Your tax under method (2) is $9,896, figured as follows:

Tax previously determined for 1998	$ 2,254
Less: Tax as refigured	– 1,504
Decrease in 1998 tax	$ 750
Regular tax liability for 1999	$10,646
Less: Decrease in 1998 tax	– 750
Refigured tax for 1999	**$ 9,896**

Because you pay less tax under method (1), you should take a deduction for the repayment in 1999.

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 payment deducted. If you use the cash method, you can take the deduction for the tax year in which you actually make the repayment. If you use any other accounting method, you can deduct the repayment 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 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 of 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. If you have an office in your home, even though you are in business, you cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home.

17. How To Get More Information

You can 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.

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.

Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can select:

- *Frequently Asked Tax Questions* (located under *Taxpayer Help & Ed)* to find answers to questions you may have.

- *Forms & Pubs* to download forms and publications or search for forms and publications by topic or keyword.
- *Fill-in Forms* (located under *Forms & Pubs)* to enter information while the form is displayed and then print the completed form.
- *Tax Info For You* to view Internal Revenue Bulletins published in the last few years.
- *Tax Regs in English* to search regulations and the Internal Revenue Code (under *United States Code (USC)).*
- *Digital Dispatch* and *IRS Local News Net* (both located under *Tax Info For Business)* to receive our electronic newsletters on hot tax issues and news.
- *Small Business Corner* (located under *Tax Info For Business)* to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov.**

TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703–368–9694.** 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.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.**
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Walk-in. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Also, some libraries and IRS offices have:

- An extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.
- The Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

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. Find 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. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1–877–233–6767** or on the Internet at **www.irs.gov/cdorders.** The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide,* is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1–800–829–3676.**

Help with unresolved tax problems. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your ***Taxpayer Advocate.***

The Taxpayer Advocate 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's toll-free number: **1–877–777–4778.**
- Call the IRS toll-free number: **1–800–829–1040.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

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Tax Publications for Business Taxpayers

See *How To Get More Information* 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)
- **225** Farmer's Tax Guide
- **334** Tax Guide for Small Business
- **509** Tax Calendars for 2000
- **553** Highlights of 1999 Tax Changes
- **595** Tax Highlights for Commercial Fishermen
- **910** Guide to Free Tax Services

Employer's Guides

- **15** Circular E, Employer's Tax Guide
- **15-A** Employer's Supplemental Tax Guide
- **51** Circular A, Agricultural Employer's Tax Guide
- **80** Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
- **179** Circular PR Guía Contributiva Federal Para Patronos Puertorriqueños
- **926** Household Employer's Tax Guide

Specialized Publications

- **378** Fuel Tax Credits and Refunds
- **463** Travel, Entertainment, Gift, and Car Expenses
- **505** Tax Withholding and Estimated Tax
- **510** Excise Taxes for 2000
- **515** Withholding of Tax on Nonresident Aliens and Foreign Corporations
- **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
- **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 Keogh Plans)
- **561** Determining the Value of Donated Property
- **583** Starting a Business and Keeping Records
- **587** Business Use of Your Home (Including Use by Day-Care Providers)
- **594** Understanding the Collection Process
- **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 Empowerment Zones and Other 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 More Information* 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 numbers 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
940EZ 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. Partnership Return of 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 Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*	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