SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Small Business: Schedule C and F Expenses

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Small Business: Schedule C and F Expenses (DSBTG10)

OVERVIEW

COURSE DESCRIPTION:	This course examines the various expenses that can be deducted on Schedules C and F. You will become acquainted with the costs that must be capitalized as well as those costs that can be deducted immediately. The course also takes a look at depreciation and Section 179 expenses that can be deducted by sole proprietors and farmers. There is also a discussion on the various employee-related expenses such as wages, payroll taxes, and other employee benefits. In addition, the course covers travel and entertainment expenses and the related reporting requirements. Finally, the course will briefly touch upon retirement plans.
PUBLICATION/REVISION DATE:	December 2010
PREREQUISITE/ADVANCE PREPARATION:	Users of *Small Business Quickfinder Handbook*
CPE CREDIT:	7 QAS Hours, 7 Registry Hours
CTEC CREDIT:	7 Federal CTEC Hours, 0 California Hours
	Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
	Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
CFP® CREDIT:	3 CE Hours – CFP® Credit hours are half the number of CPE credit hours.
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	**December 31, 2011**
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES

Lesson 1: Overview

Completion of this lesson will enable you to:

- Determine hobby versus business expenses and apply the tests for deductibility.
- Identify the cash basis or accrual basis taxpayer and capitalized costs compared to deductible expenses.

Lesson 2: Personal and Business Expenses

Completion of this lesson will enable you to:

- Identify and classify home office expenses.
- Compute automobile expenses using one of the IRS approved methods.

Lesson 3: Depreciation

Completion of this lesson will enable you to:

- Calculate depreciation using the Section 179 expense election and depreciation conventions under MACRS.

Lesson 4: Employee Expenses

Completion of this lesson will enable you to:

- Compute and properly deduct various employee-related expenses.

Lesson 5: Travel and Entertainment

Completion of this lesson will enable you to:

- Determine business expenses that are allowable and those that may be disallowed.

Lesson 6: Common Expenses

Completion of this lesson will enable you to:

- Determine the deductibility of various expenses common to most small business.

Lesson 7: Farming Revenue and Expenses

Completion of this lesson will enable you to:

- Identify the revenue and expense categories unique to a farming operation, including whether or not the farm meets the definition of a business or hobby.

Lesson 8: Retirement Plans

Completion of this lesson will enable you to:

- Identify the deduction limits and qualification rules unique to each type of retirement plan.

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Table of Contents

To enhance your learning experience, the final examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

Lesson 1: Overview

Introduction

This lesson provides an overview of how business expenses are calculated, including issues concerning profit motive, categories of expenses, distinguishing the year in which an expense is reported based on which system of accounting is used, capitalized expenses, and the deduction of start-up costs.

Learning Objectives

Completion of this lesson will enable you to:

- Determine hobby versus business expenses and apply the tests for deductibility.
- Identify the cash basis or accrual basis taxpayer and capitalized costs compared to deductible expenses.

General Introduction

This course is entitled *Small Business Schedule C and F Expenses.* All references are to Internal Revenue Code (IRC) sections; regulations; the 1997 and 1998 Taxpayer Relief Acts; the 1996 Small Business Job Protection Act (1996 Act); the Health Insurance Portability and Accountability Act (HIPAA); the Revenue Reconciliation Act of 1993 (RRA 1993); the American Jobs Creation Act of 2004; Gulf Opportunity Zone and Katrina Emergency Tax Relief Acts of 2005 and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA); the Pension Protection Act of 2006 (PPA); Small Business and Work Opportunity Tax Act of 2007; Economic Stimulus Act of 2008; Emergency Economic Stabilization Act of 2008; Energy Improvement and Extension Act of 2008; the Heroes Act; Fostering Connections to Success and Increasing Adoptions Act of 2008; Heartland, Habitat, Harvest and Horticulture Act of 2008; the 2008 Recovery Act; the American Recovery and Reinvestment Act of 2009; Worker, Homeownership, and Business Assistance Act of 2009; Hiring Incentives to Restore Employment Act of 2010 (HIRE); Patient Protection and Affordable Care Act of 2010; Health Care and Education Reconciliation Act of 2010; Small Business Jobs Act of 2010; committee reports and court cases.

Studies show that taxes from small businesses account for almost half of the taxes the IRS collects annually through its enforcement activities. Generally, approximately 1% of individual tax returns are selected for audit. Approximately 1% of farmers are audited. Individuals reporting unincorporated business activities on Schedule C have an audit rate of slightly under 4%. Audits of individuals reporting no business activities range between 0.5% and 1.5%.

According to the IRS officials interviewed, more small businesses are audited because they experience a higher incidence of compliance problems. The most common problem is employment-tax compliance. The most targeted areas are the self-employed, people who have home offices, cash-intensive businesses, independent contractors, and people who do not file their tax returns.

(**Note:** Tables are available on the IRS website at **www.irs.gov/taxstats**.)

Congress requested that the GAO provide information on the IRS reorganization plans addressing the factors that complicate interactions between small businesses and the IRS. In the study, the GAO noted that small businesses were more likely than other taxpayers to have compliance problems. The complexity of the tax law was the main reason cited for these problems, and small-business owners were not aware of the service the IRS specifically developed for them. Combine those reasons with fund allocations geared toward correcting problems that already occurred rather than preventing problems from happening and one can see that both the small-business owner and the IRS have their work cut out for them.

Profit Motive

A trade or business must have a profit motive in order to generate a deductible expense related to the trade or business; however, the existence of a profit motive does not ensure that a business exists. The test, therefore, becomes one of determining whether the activity is entered into in good faith with the intention of making a profit (*Comm. v. Groetzinger,* 480 U.S. 23 (1987)).

Tests for Deductibility

Expenses incurred in carrying on a trade or business are generally deductible if the business is in operation to create a profit. There are three tests that must be satisfied in order for an expense to be deductible:

1. The expense must be related to the trade or business.
2. The expense must be ordinary and necessary.
3. The expense must be paid or incurred in operating a trade or business.

The following factors are examined in order to prove profit motive (*Seebold v. Comm.,* TC Memo 1988-183):

- Time and effort devoted to the activity by the taxpayer
- The extent the taxpayer is educated concerning the activity
- The manner in which the activity is conducted

Example 1: Brenda is an accountant. She enjoys making crafts in her spare time and has sold some crafts to acquaintances. Brenda makes no effort to sell the crafts. The craft-supply expenses incurred by Brenda are not deductible as business expenses.

Example 2: Winston is a computer consultant. He spends 60 hours a week developing programs and installing them for his clients. He attends seminars in computer programming. He meets with his clients at their places of business, contracts the work, and develops the programs at his office. The expenses incurred by Winston would be deductible as business expenses.

The determination of whether or not an expense is ordinary and necessary is made by examining the facts and circumstances surrounding the expense. An expense is ordinary if it is normal, common, or customary for that particular activity. An expense is necessary if it is appropriate and helpful to the taxpayer's business activity (IRC Sec. 162(a)).

Related to the determination of an ordinary and necessary expense is the determination of reasonableness under the circumstances.

> **Example 3:** If Winston, the computer consultant, must travel from Baltimore, Maryland, to Tampa, Florida, to see a client, then a $250 plane ticket would be reasonable. A $25,000 rent expense incurred in order to rent a yacht to travel from Baltimore to Tampa would not be a reasonable expense.

Hobby versus Business

The taxpayer must be actively engaged in a business in order to deduct expenses. If it is determined that a taxpayer is merely engaged in a hobby, then the expenses are only deductible to the extent of income generated by the activity (IRC Sec. 183).

There is a *presumption* that an activity is engaged in for profit if the activity generates a profit in at least three out of five consecutive tax years, including the current year. (If training, showing, breeding, or racing horses as a business, then the business needs to generate a profit for two out of seven tax years.) The five- and seven-year periods are referred to as "presumption years."

The facts and circumstances of the taxpayer's business activity will ultimately determine whether the business is carried on for profit or not for profit.

A taxpayer may extend the determination that an activity is not carried on for profit by filing Form 5213 within three years after the due date (*not including* extensions) of the tax return for the year in which the activity was first carried on. However, filing this form automatically extends the period of limitations for assessing any income tax deficiency specifically attributable to the activity during any year in the presumption period (i.e., within the five-year or seven-year period). In addition, as a practical matter, it alerts the IRS to a possible hobby issue. Thus, it is rarely used until the taxpayer has been notified that the IRS proposes to disallow deductions related to an alleged hobby activity. If the taxpayer receives a notice from the district director for the proposed disallowance of expenses pertaining to an activity not engaged in for profit, the taxpayer must file Form 5213 within 60 days after the notice is received but no later than the three-year period previously cited. The form may not be used if the taxpayer has been engaged in the activity for more than five years or the breeding, training, showing, racing activity for more than seven years.

Facts and Circumstances

The 3-out-of-5-year test is not the final word, but it changes the status of the IRS and the taxpayer. If the business fails to show a profit in three out of five consecutive years, this results in a rebuttable presumption that the activity is not for profit. This puts the burden of proof on the taxpayer to prove that there is a profit motive in the activity. A profit motive may be proven by the facts and circumstances of the case. Both the IRS and the taxpayer can consider several factors in determining profit motive, including the following:

- Is the activity conducted in a businesslike manner?
- What expertise in the area do the taxpayer and her advisors hold?
- How much time and effort is expended on the activity?

- Are there assets used that may appreciate in value?
- What prior success has the taxpayer had in business activities?
- What is the history of income and loss in the activity?
- What were the profit amounts, if any?
- Does the taxpayer have substantial income from other sources?
- What elements of personal pleasure or recreation are present in the activity?

After looking at the facts and circumstances, the IRS may agree that there is a profit motive and allow the losses. Should the IRS decide that the activity is not for profit, then the taxpayer has the burden of proof to show otherwise. At some point in time, the taxpayer must weigh the cost and expense of arguing the case against the size of the possible tax benefits.

If the activity is determined to be a hobby instead of a trade or business, the expenses related to the activity cannot be reported on Schedule C, Profit or Loss From Business. Instead, they are broken into three categories and can only be deducted in the order and to the extent described in the following list (Reg. 1.183-1(b)):

- **Category 1:** Expenses that would be deductible whether or not incurred in a trade or business (e.g., real estate taxes, mortgage interest, casualty losses). These are deducted in full on the appropriate lines of Schedule A of Form 1040.
- **Category 2:** Operating expenses other than expenses resulting in a basis adjustment (e.g., insurance, utilities, maintenance, supplies, advertising). These are deductible as miscellaneous itemized deductions and only to the extent gross income from the activity exceeds Category 1 deductions.
- **Category 3:** Depreciation and other basis-adjustment expenses (e.g., depreciation and amortization). These are deductible only to the extent gross income from the activity exceeds expenses in Categories 1 and 2 and only as miscellaneous itemized deductions. Where more than one asset is involved, allocate these deductions proportionately between the assets.

Note: A taxpayer with significant hobby expenses may become subject to alternative minimum tax (AMT) because miscellaneous itemized deductions are not deductible for AMT.

If an activity is determined to be a hobby instead of a trade or business, then the expenses in the preceding three groups are deductible to the extent of gross income derived from the activity *only if* the taxpayer itemizes deductions on Schedule A. If the depreciation deductions are limited by gross income, then the allowable deduction is divided proportionally among the assets.

The determination of an activity as a hobby means that the income and deductions cannot be reported on Schedule C, Profit or Loss From Business. The revenue from the activity should be reported as Other Income on the top section of Form 1040, Individual Income Tax. Expenses incurred in the production of the income (limited by the amount of the revenue) must be reported as itemized deductions on Schedule A, Itemized Deductions. Interest and tax expenses are reported in the section for that type of expense. These are the most common, but there are a few others that are deductible whether personal or business, such as casualty losses. Operating expenses, depreciation, and other basis-adjustment expenses that would not be deductible as personal expenses are reported as miscellaneous deductions, subject to the 2% of AGI exclusion.

Cash Basis versus Accrual Basis

There are two common methods of accounting for income and expenses:

1. The cash method
2. The accrual method

The Cash Method: The cash method, also described as the cash receipts and disbursements method, is used by most individuals. Under this method, income is recorded when cash is actually or constructively received, and expenses are generally recorded when cash is actually disbursed. Under a pure cash-basis method of accounting, expenditures for equipment would be expensed in the year the money is disbursed. Consequently, the IRS requires a modified cash basis whereby the expenditures for property and equipment are deducted over several periods in order to more clearly reflect income (depreciation and amortization). Charges to a credit card are considered "cash equivalents" and, therefore, constitute a payment in the year the charge is made (Rev. Rul. 78-39, 1978-1 C.B. 73).

The Accrual Method: Under the accrual method, income is reported when the right to receive it occurs and the amount of the income can be determined. Expenses are recorded when events occur that fix the amount of the item and determine the liability of the taxpayer to pay them.

Note: A taxpayer who owns and operates two small businesses need not use the same method of accounting for both businesses. Different methods may be used as long as each method clearly reports the income of each business.

Prior to the **Job Creation and Worker Assistance Act of 2002 (JCWAA),** accrual-method taxpayers were not required to include in income amounts to be received for the performance of services that will not be collected, based on past experience. This is called the nonaccrual experience (NAE) method. The use of this method was permitted on the condition that the taxpayer would not charge interest or penalty for failure to pay the charge in a timely manner.

Under JCWAA, the nonaccrual experience method is only available for amounts to be received for the performance of qualified services and for other services provided by certain small businesses. Amounts received for all other services are subject to the general rule for income inclusion.

Qualified services are in the fields of health, law, architecture, accounting, engineering, consulting, actuarial sciences, and the performing arts.

Certain small businesses are those with average annual gross receipts not exceeding $5 million.

The taxpayer may not charge interest and may not charge a penalty for failure to timely pay the amount charged. This rule also applied under prior law.

This provision is effective for taxable years ending after March 9, 2002. The change in the taxpayer's method of accounting required as a result of this limitation on the use of the non-accrual experience method is treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. The resultant Section 481(a) adjustment will be taken into account over the lesser of:

- The number of years the taxpayer used the nonaccrual experience, or
- Four years.

Reg. 1.448-2 provides alternative computations or formulas to determine the uncollectible amounts and to include safe harbor methods based on a taxpayer's experience. Rev. Proc. 2008-52 includes procedures for certain automatic changes in accounting method involving the nonaccrual experience method, including a change to a safe harbor NAE method provided in Reg. 1.448-2(f)(1)-(5). Other changes relating to this method of accounting can only be made after advance consent from the Secretary of the Treasury.

Prior to the 2000 tax year, taxpayers who maintained an inventory were required to account for income and expenses on the accrual method. This is no longer the case.

Under Rev. Proc. 2008-52 (2008-36 IRB 587), which was modified by Rev. Proc. 2009-39, taxpayers with average annual gross receipts of $1 million or less who do not regularly use a noncash method for books, records, and reporting purposes, do *not* have to account for inventories and do *not* have to use an accrual method of accounting. The taxpayer has average annual gross receipts of $1 million or less if for each tax year ending after December 16, 1998, the taxpayer's average annual gross receipts for the three-tax-year period ending with the applicable prior tax year does not exceed $1 million.

Under Rev. Proc. 2009-39 and 2008-52 (2008-36 IRB 587), the IRS will permit a qualifying small business to obtain an automatic consent to change its accounting method for nonincidental inventoriable items to the cash method. A qualifying small business may have average annual gross receipts of $10 million or less.

Note: Gross receipts include total sales (net of returns and allowances) and all amounts received for services.

So, what does this mean to our Schedule C filer? If the taxpayer qualifies for exception and does not want to account for inventories, the taxpayer would treat merchandise inventories the same way a cash-method taxpayer would account for them.

A taxpayer qualifying for use of the cash method would follow the automatic change in accounting method procedures outlined in Rev. Proc. 2008-52 and 2009-39. The taxpayer may file a single Form 3115 to change both from the accrual method to the overall cash method and from accounting for inventories. The IRC Sec. 481(a) adjustment for income or loss created by the change of accounting method is generally recognized over a four-year period. The taxpayer may elect, however, to account for the positive or negative adjustment in one year if it is less than $25,000. A positive IRC Sec. 481(a) adjustment would be reported as other income on Schedule C. A negative IRC Sec. 481(a) adjustment would be reported as an other expense on Part V of Schedule C.

A taxpayer generally selects the cash basis of accounting because of its simplicity in practice. In addition, this method of accounting provides a business with the flexibility to recognize or defer income when it would be most advantageous to the taxpayer. The IRS, however, has limited some of the taxpayer's flexibility by modifying the cash basis to require that current-year payments for an expense that extends beyond the tax year be allocated to the year in which the expense applies. The exception to this treatment for prepayments is the 12-month rule.

Key Term: The *12-month rule* states that a taxpayer will generally be allowed a current deduction for prepayments where the payment applies to expenses that will be completely used no later than 12 months after the end of the year in which the payment is made. This rule does not apply to payments that are purely tax-motivated. This rule does not apply to payments that extend beyond a 12-month period from the end of a tax year (Reg. 1.263(a)-4).

Example 4: Angie is a self-employed travel consultant. She rents space in a strip mall at the rate of $500 per month. In 20X1, Angie was unable to pay her rent due to a slow start-up. She had an arrangement with her landlord that she be allowed to double her payments in 20X2, when business would be better, and prepay an additional 12 months' rent of $6,000 in December 20X2 to cover the rent for 20X3. Angie paid $18,000 in rent to her landlord in 20X2. Under the 12-month rule, Angie may deduct $18,000 on her 20X2 tax return.

Example 5: Angie is a self-employed travel consultant. She rents space in a strip mall at the rate of $500 per month. In 20X1, Angie was unable to pay her rent due to a slow start-up. By agreement with the landlord, Angie is required to prepay an additional 18 months' rent, $9,000, in December 20X2 to cover the rent from January 20X3 through June 20X4. Consequently, Angie will pay a total of $21,000 in 20X2. Angie may only deduct $12,000 rent in 20X2. The additional $9,000 rent paid for the period January 20X3 through June 20X4 covers a period longer than 12 months and is, therefore, not deductible in 20X2.

Example 6: Angie is a self-employed travel consultant. Her tax advisor determines she is having a banner year and recommends that she pay all her bills prior to December 31, 20X1. Angie pays her landlord $6,500 on December 1, 20X1, representing rent for the period from December 1, 20X1, through December 31, 20X2. The 12-month because Angie's actions are strictly tax-motivated. This means that she will get no deduction in 20X1 for rent payments for rental periods after December 31, 20X1.

At-risk

A taxpayer's deductible losses generated by various business and investment activities are generally limited to the amount that the taxpayer has at risk with respect to the activity. A taxpayer is "at-risk" for money he invested in the activity, the adjusted basis of other property contributed, and money he borrowed for the activity's use *if* he is personally liable for repayment of the loan or the loan is secured by pledged property not used in the activity. The rules are designed to prevent taxpayers from offsetting trade or business losses from investments in activities that are financed by nonrecourse loans for which they are not personally liable. The at-risk limitation is calculated and reported on Form 6198 (At-Risk Limitations).

Example 7: Bill has an investment of $50,000 (cash and adjusted basis of other property) in a small videotape distribution business. Bill borrowed $25,000 nonrecourse debt to acquire the land and building from which he runs his business. In 2006, Bill incurs a loss of $57,500. Using the simplified calculation of the amount at risk, Bill may deduct $50,000 of the loss in 2006 and carry forward $7,500 to next year to be used in the at-risk calculation of loss deductibility.

Additional discussion of the at-risk limitations is beyond the scope of this course. It is important, however, that the reader understand that while an expense may be deductible, the deduction for business losses in total may be limited.

Capitalized Cost versus Deductible Expenses

Costs that represent an investment in a business must be capitalized instead of deducted (IRC Sec. 263). These expenses are called *capitalized expenses.* The underlying policy for disallowing a current deduction for these expenses is that the cost of an asset that remains productive in a taxpayer's business for a long period of time should be recovered over that period of time.

Capitalized expenses are generally divided into three categories:

1. Costs of going into business
2. Costs of property and equipment
3. Costs of improvements

Start-up and Pre-opening Costs

Expenses incurred in investigating the acquisition or creation of a business, creating a business, and/or anticipating the start of a business are called *start-up expenses* or *pre-opening expenses.* These expenses may include market surveys, advertising, professional fees, travel, repairs, utilities, and wages. They are the same expenses that would normally be deductible once the business is running.

Prior to October 22, 2004, the start-up expenses had to be capitalized as part of the taxpayer's basis in the business. Start-up expenses were not required to include taxes, interest, and research and experimental costs; these are currently deductible under IRC Sec. 195.

An election may be made to expense the first $5,000 of start-up expenses in the year business begins for expenses paid or incurred after October 22, 2004, and before 2010. This amount is reduced if expenses exceed $50,000 by the excess over $50,000. Expenses over $5,000 can be deducted over 180 months beginning with the month the business begins. A taxpayer may elect to amortize start-up expenses in excess of $5,000 (as long as they do not exceed $50,000) over a period of 180 months beginning with the month the business begins (IRC Sec. 195).

2010 Law Change: For tax years beginning in 2010, up to $10,000 of start-up costs can be deduced currently, with the remainder, if any, amortized over 180 months per the Small Business Jobs Act of 2010. The $10,000 deduction limit is reduced by the amount of start-up costs that exceed $60,000. So, no current deduction is allowed (all costs must be amortized) when total start-up costs reach $70,000.

If the amortization election is not made, the expenses remain on the taxpayer's balance sheet until the business operations discontinue. The election must be made not later than the due date for filing the tax return (including extensions) for the taxable year in which the business begins (IRC Sec. 195(d)(1)).

If the business never begins, then the start-up expenses are treated as nondeductible capital expenses or nondeductible personal expenses by the individual.

Start-up expenses must meet two tests (IRC Sec. 195(c)(1)(B)):

1. The expenses would be deductible if they were paid or incurred in the operation of an existing trade or business.

2. The expenses must be paid or incurred prior to the date the taxpayer actually begins business operations.

If a business terminates before the 180 months, the unamortized expenses may be deducted in the business' final year.

Start-up expenses are reported on Form 4562 (Depreciation and Amortization). The amount and nature of the expense, amortization period, and IRC section under which the election is made, in addition to the year's amortization expense, are reported on this form and included with the taxpayer's Form 1040 in the year the election is made.

Business Assets

The costs incurred to acquire assets to be used in a business for more than one year are capitalized expenses. Examples are furniture, equipment, land, buildings, automobiles, and animals. The amount capitalized includes the cost, sales tax, freight, and installation charges. The costs are depreciated over the life of the asset (except in the case of land). Depreciation will be discussed later in the course.

Improvements

The costs incurred to improve an asset used in a business are generally capitalized. An improvement adds to the value of the asset, lengthens the time that the taxpayer can use an asset, or adapts an asset to a different use. The cost of reconditioning, altering, or improving business property to make it suitable for business use is a restoration and is capitalized. The costs of an improvement that stops the deterioration of and adds to the life of an asset are capitalized. Conversely, the cost of replacing a minor part of an asset is a repair and is deductible when the expense is incurred.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Peggy, a full-time data processor, enjoys baking marvelous cinnamon flop desserts. Her close friends ask to buy the desserts for their annual summer cookout. Peggy sells $250 of desserts during the summer and incurs $240 in expenses. Peggy's actions indicate that she is:

   a. Engaged in a trade or business because she's knowledgeable about baking.

   b. Engaged in a trade or business because she made a profit.

   c. Not engaged in a trade or business.

2. Which of the following is **not** a test for deductibility of a trade or business expense?

   a. The expense must be related to the trade or business.

   b. The expense must be ordinary and necessary.

   c. The expense must be the lowest possible cost.

   d. The expense must be paid or incurred in operating a trade or business.

3. Judy is a seamstress and a cash-basis taxpayer. She buys curtain material in December 20X1 (her year-end) and pays for it using a credit card. Judy receives her invoice for the material in January 20X2 and pays the invoice in January 20X3. When is the deduction fixed for tax purposes?

   a. December 20X1.

   b. January 20X2.

   c. January 20X3.

4. Bob's pay periods run from Sunday to Saturday and he pays his employees on the following Friday. The last pay period of the year ends on Saturday, December 31, 20X1. Wages are calculated and the funds are disbursed on Friday, January 6, 20X2. Bob is an accrual-method taxpayer. When does Bob report the wage expense and the employees receive taxable income?

   a. Wage expense reported in 20X1, employees receive taxable income in 20X1.

   b. Wage expense reported in 20X1, employees receive taxable income in 20X2.

   c. Wage expense reported in 20X2, employees receive taxable income in 20X2.

5. Sally owns and operates an income-producing farm. She disburses funds to fix the small hinge on the barn door, buy a new engine for the tractor, paint the wagon, buy nails for fence repair, and construct a wooden fence around the horse barn. Which of the following expenses must Sally capitalize and depreciate? (Hint: more than one answer may apply.)

   a. Fixing the small hinge on the barn door.

   b. Buying a new engine for the tractor.

   c. Buying nails for fence repair.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Peggy, a full-time data processor, enjoys baking marvelous cinnamon flop desserts. Her close friends ask to buy the desserts for their annual summer cookout. Peggy sells $250 of desserts during the summer and incurs $240 in expenses. Peggy's actions indicate that she is: **(Page 2)**

   a. Engaged in a trade or business because she's knowledgeable about baking. [This answer is incorrect. The factors examined in order to prove profit motive are time and effort devoted to the activity by the taxpayer, the extent the taxpayer is educated concerning the activity, and the manner in which the activity is conducted. Peggy does not satisfy these factors.]

   b. Engaged in a trade or business because she made a profit. [This answer is incorrect. Making a profit from an activity does not prove the business has a valid profit motive. Other factors influence the determination of profit motive.]

   c. Not engaged in a trade or business. [This answer is correct. Peggy's actions do not indicate that she is engaged in a trade or business because there is no evidence of intent to make a profit.]

2. Which of the following is **not** a test for deductibility of a trade or business expense? **(Page 2)**

   a. The expense must be related to the trade or business. [This answer is incorrect. Every expense is not a business expense and would not be deductible. Personal expenses are not deductible; therefore, a determination of deductibility is necessary.]

   b. The expense must be ordinary and necessary. [This answer is incorrect. An expense is ordinary if it is one that is common and accepted in that business activity. An expense is necessary if it is appropriate and helpful to the taxpayers business.]

   c. The expense must be the lowest possible cost. [This answer is correct. While the expense must be reasonable, there is no requirement that the item should be at the lowest possible cost. Reasonable covers a lot of different costs.]

   d. The expense must be paid or incurred in operating a trade or business. [This answer is incorrect. Random payments for expenses that could have been business related are not deductible. The expenses must be directly related to operation of a trade of business.]

3. Judy is a seamstress and a cash-basis taxpayer. She buys curtain material in December 20X1 (her year-end) and pays for it using a credit card. Judy receives her invoice for the material in January 20X2 and pays the invoice in January 20X3. When is the deduction fixed for tax purposes? **(Page 5)**

   a. December 20X1. [This answer is correct. Judy may deduct the expense in 20X1. Charges to a credit card are considered *cash equivalents*; therefore, the charge constitutes a payment in 20X1.]

   b. January 20X2. [This answer is incorrect. Even though Judy received her invoice in January 20X2, the expense was fixed and deductible when charged on the credit card.]

   c. January 20X3. [This answer is incorrect. Charges to a credit card are considered *cash equivalents.* Consequently, a charge to a credit card constitutes a payment in the year the charge is incurred as opposed to when the credit card company invoice is paid.]

4. Bob's pay periods run from Sunday to Saturday and he pays his employees on the following Friday. The last pay period of the year ends on Saturday, December 31, 20X1. Wages are calculated and the funds are disbursed on Friday, January 6, 20X2. Bob is an accrual-method taxpayer. When does Bob report the wage expense and the employees receive taxable income? **(Page 5)**

   a. Wage expense reported in 20X1, employees receive taxable income in 20X1. [This answer is incorrect. Since Bob's business accounts for income and expenses on the accrual method, the expense is reported in the year the amount of the expense is fixed and the liability is incurred. However, the employees did not receive the income in 20X1 and would not pay tax on the amount until it is constructively received.]

   b. Wage expense reported in 20X1, employees receive taxable income in 20X2. [This answer is correct. Since Bob's business accounts for income and expenses on the accrual method, the expense is reported in the year the amount of the expense is fixed and the liability is incurred. Consequently, Bob reports wage expense in 20X1. It is important to note that although Bob is on the accrual method and reports the wages as a business expense in 20X1, he would *not* include the wages on the employees' 20X1 W-2 forms because the money was not disbursed to them until 20X2. The employees pay tax on the income in 20X2.]

   c. Wage expense reported in 20X2, employees receive taxable income in 20X2. [This answer is incorrect. Bob's business is on the accrual basis of accounting as opposed to the cash basis.]

5. Sally owns and operates an income-producing farm. She disburses funds to fix the small hinge on the barn door, buy a new engine for the tractor, paint the wagon, buy nails for fence repair, and construct a wooden fence around the horse barn. Which of the following expenses must Sally capitalize and depreciate? **(Page 9)**

   a. Fixing the small hinge on the barn door. [This answer is incorrect. Fixing a small hinge on the barn door represents a minor repair that may be deducted in the current year.]

   b. Buying a new engine for the tractor. [This answer is correct. Buying a new engine for the tractor would significantly lengthen the useful life of the tractor; therefore, it should be capitalized.]

   c. Buying nails for fence repair. [This answer is incorrect. Buying nails for fence repair represents an expense that may be deducted in the current year.]

EXAMINATION FOR CPE CREDIT

Lesson 1

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

1. Ima Healthnut, a multimillionaire, dabbles in a small vitamin distribution business whenever he gets bored with jetting around Europe. Ima takes vitamins and believes everyone should in order to maintain a healthy lifestyle. He really does not care if he makes any money in his endeavors as long as he has improved the health of others. Which of the following statements causes the expenses to be nondeductible?

    a. Ima documents them.

    b. They are not too high.

    c. Ima pays for them out of his business bank account.

    d. Ima has not demonstrated that he is operating a business.

2. Profit motive is **not** determined by examining:

    a. The extent the taxpayer is educated concerning the activity.

    b. The amount of time and effort devoted to the activity by the taxpayer.

    c. The manner in which the activity is conducted.

    d. The other businesses owned by the taxpayer.

3. Nu Bidnessman wants to begin a hand-lotion business reporting on a calendar year. Nu incurs $5,180 in start-up expenses in January 2010. Her business begins in July 2010. Which of the following statements is most accurate?

    a. Nu must capitalize the $5,180 and amortize the start-up expenses over five years.

    b. Nu may elect to write off $5,000 of the start-up expenses in 2010 and then amortize the remaining $180 over 180 months beginning with July 2010.

    c. Nu may elect to write off all of the start-up expenses in 2010.

    d. Nu may amortize the start-up expenses over 180 months beginning in January 2010, when they were incurred.

4. Start-up expenses for a business that never becomes an active trade or business:

   a. May be sold to a family member.

   b. Must be treated as either nondeductible capital expenditures or nondeductible personal expenses by an individual.

   c. May be amortized over a period of 60 months.

   d. Must be expensed up to $5,000, with any amounts in excess of $5,000 amortized over a period of 180 months.

5. A capitalized expense may be deducted over:

   a. 36 months.

   b. Not less than 60 months.

   c. The useful life of the asset.

   d. Not more than 60 months

Lesson 2: Personal and Business Expenses

Introduction

This lesson discusses personal and business expenses including home-office expenses, inventory storage expenses, direct and indirect expenses, business use of an owned vehicle, use of a leased vehicle income exclusion, and limitations to such deductions.

Learning Objectives

Completion of this lesson will enable you to:

- Identify and classify home office expenses.
- Compute automobile expenses using one of the IRS approved methods.

Home Office

Many taxpayers incur expenses that are partly for personal purposes and partly for business purposes. The business portion of the expense may be deducted as a business expense.

> **Example 1:** If a taxpayer borrows money and uses 60% of the loan proceeds to buy office supplies for the business and 40% to have cosmetic surgery, then 60% of the interest paid on the loan will be deductible as a business expense.

Home-office Expenses

If a taxpayer uses a portion of her home for business, the taxpayer may be entitled to deduct a portion of the expenses of using the home for business (IRS Pub. 587). There are requirements that must be met before any home-office expenses may be deducted. The purposes of the requirements are to prohibit taxpayers from deducting personal family expenses as business expenses and to prohibit taxpayers from creating losses from the business use of a home to offset income from other taxable endeavors.

The term “home” includes a house, apartment, condominium, mobile home, boat, or similar property that provides basic living accommodations. It also includes structures on the property, such as an unattached garage, studio, barn, or greenhouse.

Tests: The business portion of the home must be *regularly* and *exclusively* used as:

- The *principal place* of business carried on by the taxpayer, and
- The place where the taxpayer meets or deals with customers, clients, or patients, and
- In the case of a separate structure not attached to the home, the structure must be used exclusively and regularly in connection with the business.

Note: If the taxpayer is an employee, a deduction is allowed only if the home office is maintained for the convenience of the employer.

The home office must be the *principal place of business* for the taxpayer's trade or business. A taxpayer may have more than one trade or business or more than one business location for a single trade or business.

For tax years after 1998, "principal place of business" includes a place of business that is used by the taxpayer for the management or administrative activities of the taxpayer in the trade or business. Therefore, if the taxpayer has no fixed location other than the home in which to conduct substantial administrative or management work, the home-office deduction will be available and the home office will be treated as a principal place of business.

Administrative and managerial activities include the following:

- Maintaining accounting records
- Setting appointments
- Billing
- Writing business correspondence

The following activities will no longer prevent a home office from treatment as a principal place of business (IRS Pub. 587):

- The sole proprietor conducts administrative or managerial activities from locations that are not fixed locations (e.g., hotel rooms, auto).
- The sole proprietor contracts out administrative functions (e.g., billing services).
- The sole proprietor has space to perform administrative or managerial functions outside the home but chooses to perform these activities in the home office.
- The sole proprietor performs nonadministrative and nonmanagerial activities at a fixed business location outside of the home.

Regular use means *on a continuing basis.* Occasional use does not meet the regular-use requirement even if the business portion of the home is used exclusively for the business.

Example 2: Todd uses his study exclusively to prepare tax returns whenever he can get an occasional client. Although Todd does not use the study for any purpose other than to prepare tax returns, he does not use the room on a continuing basis and a home-office deduction would not be available to Todd.

Exclusive use means *only for business.* If the business part of the home is also used for personal purposes, then the exclusive-use test is not met.

Example 3: Todd uses his den to prepare tax returns for clients. Todd also uses his den to play pool and watch football games. Todd may not claim a business deduction for the use of his den.

The storage of inventory in the home and the use of the home as a day-care facility are exceptions to the exclusive-use test.

Inventory-storage expenses may be deducted if five tests are met:

1. The inventory must be used in the trade or business.
2. The trade or business must be the wholesale or retail selling of products.
3. The home must be the only fixed location of the trade or business.
4. The storage space must be used on a regular basis.
5. The space must be separately identifiable.

Note: The 1996 **Small Business Job Protection Act** (1996 Act) clarifies that the present law applies to storage of inventory and/or product samples (IRC Sec. 280A(c)(2), amended by 1996 Act Sec. 1113(a)).

Day-care services are custodial services provided at certain hours of the day for children, elderly individuals, or mentally and physically challenged individuals. The operator of the day-care service must be in compliance with applicable state laws. If the portions of the home used for day-care services are not exclusively used for day-care services, a special allocation formula based on hours of use is employed to calculate the deductible home-office expense. The calculation will be illustrated later in this lesson.

Direct Expenses versus Indirect Expenses

The home office deduction rules cover different kinds of direct and indirect expenses.

The business percentage used to calculate the allowable deduction for expenses for the business use of the home is usually computed as follows: Area used regularly and exclusively for business ÷ Total area of home = Business percentage.

The area is generally measured in square feet.

Direct Expenses: Direct expenses are deductible in full because they benefit only the business portion of the home. Examples include repairs made specifically to the home office, separately billed utilities to the home office, painting the home office, and mortgage interest on a loan taken specifically for the construction of the home office.

Indirect Expenses: Indirect expenses are allocated between business use and personal use because they benefit the upkeep of the entire home. Examples include real estate taxes, mortgage insurance, mortgage interest, utilities, maintenance, insurance, security systems, and depreciation.

Note: The basic monthly service charge for the first telephone line into the taxpayer's home is a nondeductible personal expense. Business long-distance phone calls and a second line used for business are 100% deductible on Schedules C and F, *not subject to the home-office limitations* (IRC Sec. 262(b)). Lawn maintenance is also a nondeductible personal expense.

Day-care Facilities

Day-care facility operators who do not use their homes exclusively for business calculate the business percentage as follows: (Number days used for day care × Hours used for day care per day) ÷ 8,760 hours = Business %.

The 8,760 hours represents the total number of hours available during the year (365 days × 24 hours/day).

Depreciation

The business percentage of the cost (basis) of the home (building, not land) may be deducted as a depreciation expense. Depreciation is defined as the loss in the value of property over the time the property is being used (IRS Pub. 946). Depreciation is also an "allowed or allowable" deduction. Consequently, if a taxpayer does not claim a deduction for depreciation she was *entitled* to deduct, the basis of the property must still be reduced by the amount of the depreciation that would have been allowed. Conversely, if more depreciation is claimed on a tax return than should have been claimed, then the taxpayer must reduce the basis in the home by the allowable depreciation plus the excess depreciation that actually decreases the tax liability for any year.

The home is generally depreciated using the modified accelerated cost recovery system (MACRS). Nonresidential real property is depreciated using the straight-line method over 31.5 years (if placed in service prior to May 13, 1993), 39 years (if placed in service on or after May 13, 1993), or 40 years (if an election is made to depreciate the property over the life used for alternative minimum tax purposes). The amount depreciated is the business portion of the basis of the home (which is normally the purchase price of the property, excluding the price of the land, plus applicable settlement expenses and improvements) minus any casualty losses deducted in earlier tax years *or* the fair market value (FMV) of the home on the date placed in service, whichever is *lower.*

Home-office Deduction Limitations

A home-office deduction may not create or increase a net loss from the business to which it relates; therefore, the deduction for expenses related to the business use of a home may be limited.

The limitation calculation is shown as follows.

Gross income from business activity
Business percentage:
- Mortgage interest
- Real estate taxes
- Casualty or theft losses

Business expenses not attributable to the business use of the home (e.g., salaries, supplies, advertising)

Gross-income limit

The business percentages of mortgage interest, real estate taxes, and casualty or theft losses are not subject to the limitation because these expenses would be deductible elsewhere on the tax return. To the extent that the allocated home-office expenses exceed the gross-income limit, they may not be deducted in the current year but may be carried over to the next year.

Gross income limit
Less: Expenses allocable to home office (e.g., insurance, utilities, repairs)

Expenses available to be carried over to next tax year subject to that year's income limit

Gross income from activity	$	50,000
Business % of mortgage interest, real estate taxes		4,000
Expenses of operation (salaries, supplies, etc.)		43,000
Business % of maintenance, utilities, insurance		2,000
Business % of depreciation		1,500

Calculation:

Gross income from activity	$	50,000
Mortgage interest, real estate taxes		– 4,000
Expenses of operation (salaries, supplies, etc.)		– 43,000
Gross-income limit	$	3,000
Business % of maintenance, utilities, insurance		2,000
Income available to be applied against depreciation	$	1,000
Depreciation		1,500
Expenses available for carryover to next tax year	$	500

Taxpayers operating a business out of the home were at one time hesitant to take advantage of the home-office deduction because of a previously required allocation of gain on the sale of the house between business use and nonbusiness use, in the event the property was sold. The IRC allows a $250,000 gain exclusion for single taxpayers ($500,000 for married filing joint return) on the sale of the taxpayer's principal residence, provided certain conditions are met. At one time, the gain on the sale of the property had to be allocated between the business portion of the property and the personal-use portion. The gain on the business portion was not eligible for the exclusion.

The regulations under IRC Sec. 121 (Reg. Sec. 1.121-1(e)(1)) have now clarified that no allocation of gain on the sale of a residence is required *if* both the residential and nonresidential portions of the property are *within the same dwelling unit.* This rule would apply, for example, if a sole proprietor used a back bedroom of the house as a home office.

Example 4: Ima Success, a single sole proprietor, buys a house in 2006 and uses 20% of the house exclusively for her business operations. She claims depreciation deductions of $2,000 for the period of time she owns the house. Ima sells the house in 2009 and realizes a $15,000 gain on the sale. Ima is able to exclude $13,000 of the gain on the sale of her residence because she is not required to allocate a part of the gain to her 20% business use. The remaining $2,000 (representing the amount of depreciation she claimed on the business portion of the house) will be taxed as an unrecaptured Section 1250 gain.

Let us take this one step further. Suppose Ima was unable to deduct the $2,000 depreciation due to the home-office income limitations on Form 8829. In this situation, the full $15,000 gain will be eligible for the exclusion.

One more step—if Ima had built a small office, in her back yard, that was *not* attached to her dwelling, then the gain on the sale of her property would have to be allocated between the business portion and the personal portion. Only the gain on the personal portion would be eligible for the exclusion.

Motor Vehicles

Expenses related to the use of an automobile are deductible to the extent that the expenses are ordinary and necessary, business-related, and not commuting. An automobile is any four-wheeled vehicle primarily used on public streets, roads, and highways, with an unloaded gross vehicle weight of 6,000 pounds or less. Ambulances, hearses, and vehicles for hire used to transport people or property are not included in this discussion.

Taxpayers may deduct expenses related to the business use of an owned vehicle, using the following methods:

- Standard mileage rate
- Actual auto expenses

The Standard Mileage Rate (SMR)

The SMR is a simplified method to be used in lieu of calculating the costs allocable to the business use of an automobile. It is set by the IRS and may be applied to all miles of business use established through odometer readings.

Tax Year	Standard Mileage Rate
2010	$0.50
2009	$0.55
2008 (7/1/08–12/31/08)	$0.585
2008 (1/1/08–6/30/08)	$0.505 (IR-2007-192; Rev. Proc. 2007-70)
2007	$0.485
2006	$0.445
2005 (9/1/05–12/31/05)	$0.485
2005 (1/1/05–8/31/05)	$0.405
2004	$0.375

The rate includes expenses for gasoline, tires, insurance, maintenance, oil, repairs, depreciation, and license and registration fees. The *business* portion of tolls, parking fees, interest on car loans, and personal property taxes may be deducted in addition to the SMR.

Note: The depreciation component of the SMR is $.21 a mile in 2008, $.19 a mile in 2007, $.17 a mile in 2006 and 2005, and $.16 a mile in 2004. The 2000-2009 SMR for charitable mileage remains unchanged at $.14 per mile. The medical mileage was decreased from $.20 per mile for 2007 to $.19 per mile through June 30, 2008, and $.27 after June 30, 2008. The medical mileage for 2009 is $.24.

The SMR may be used by self-employed individuals who operate only four cars at a time for business (Rev. Proc. 2008-72). It is not available for five or more cars used simultaneously, taxicabs, leased vehicles, or vehicles for which a depreciation calculated using a method other than straight-line or IRC Section 179 deduction (see Lesson 3) was taken in a previous year.

Note: Prior to 2004, a taxpayer could not use the SMR method if he used two cars simultaneously in the business.

The election to use the SMR is made when the automobile is placed in service. The taxpayer may switch from the SMR method to the actual auto-expense method in later years. If the switch is made prior to the time the auto is considered fully depreciated, the taxpayer must determine the estimated useful life of the auto and its depreciable value and must use the straight-line method of depreciation. A switch from the actual-expense method to the SMR method is not allowed unless the taxpayer used the straight-line method when claiming depreciation.

Actual Auto Expenses

A self-employed taxpayer may be able to deduct actual expenses associated with the business use of the automobile. These expenses include oil, gas, personal property taxes, tires, insurance, interest, repairs, licenses, depreciation, rental fees, tolls, and parking fees. It is imperative that the taxpayer maintain detailed, written records substantiating the business use of the automobile (odometer readings) and auto expenses. Once the actual auto-expense method is elected, the taxpayer may not use the SMR to determine deductible auto expenses.

Note: Tax law differentiates the deductibility treatment of interest on auto loans and personal property taxes between an employee and a self-employed individual. A self-employed individual may deduct the business portion of these items on Schedule C and F. An employee may *not* deduct the interest on an auto loan *even if* the auto is used 100% for business. In addition, an employee may only deduct personal property taxes on an auto if the employee itemizes deductions on Schedule A.

Depreciation: The general discussion of depreciation, expensing property according to IRC Section 179, and bonus depreciation is in Lesson 3. The following rules are unique to autos and certain trucks used in business.

The cost of the auto (including sales tax, luxury tax, and improvements) is a capital expense that is recovered over the useful life of the automobile. A taxpayer may claim an IRC Section 179 expense and/or a depreciation expense on the automobile subject to luxury-auto limitations. (This author does not advocate the use of the IRC Section 179 expense election on automobiles due to the luxury-auto limitations. It is more beneficial to elect IRC Section 179 on longer-lived assets that are only subject to the IRC Section 179 limits on qualifying property and income.)

IRC Sec. 280F Limit. Passenger automobiles (with an unloaded gross vehicle weight of 6,000 pounds or less) are considered listed property because they may be used for personal use. As long as the business use of the property remains above 50%, the taxpayer may use MACRS to depreciate the property. Otherwise, an alternative MACRS method must be used. This will be discussed later.

While cars rated at 6,000 pounds *unloaded* gross vehicle weight or less are classified as "luxury vehicles" for tax rules limiting annual depreciation, trucks and vans are defined as "luxury vehicles" using a different standard. The weight applied is "gross vehicle weight" (GVW) instead of "unloaded gross vehicle weight." "Gross vehicle weight" for this purpose is the maximum total weight of a *loaded* vehicle. Consequently, if a van can hold passengers and 1,000 pounds of cargo and its GVW is rated 6,500 pounds by its manufacturer, then the van is not a luxury vehicle. Because certain sport utility vehicles are becoming more popular and SUVs fall under the "truck and van" category, a practitioner should be aware of this tax break.

More on SUVs and Other Heavy Passenger Vehicles. Even though heavy sport utility vehicles may be outside the passenger automobile definition, they are property used as a means of transportation. Therefore, they are still within the definition of "listed property" and are subject to the business usage substantiation rules. These vehicles also remain subject to the ADS straight-line depreciation rules if business usage is 50% or less

There is a $25,000 limit (per vehicle) on the Section 179 deduction on certain heavy passenger vehicles placed in service after October 22, 2004. This limit is not prorated for business use of the vehicle. This limit applies to any four-wheeled vehicle primarily designed to carry passengers over public streets, roads or highways that is not subject to the Section 280F limits and is rated at not more than 14,000 pounds gross vehicle weight. However, the $25,000 limit does not apply to certain exceptions listed in IRC Section 179. Vehicles that fall under these exceptions still qualify for the full Section 179 allowance ($250,000 for 2009), as long as they have gross vehicle weight ratings in excess of 6,000 pounds.

The American Recovery and Reinvestment Act of 2009 (enacted February 17, 2009) increases by $8,000 the first-year depreciation dollar limit for a passenger auto that is "qualified property" meeting the original use and acquisition and placed-in-service requirements through December 31, 2009. The Small Jobs Act of 2010 (enacted September 27, 2010) extends the placed-in-service deadline for the $8,000 increase in the first-year depreciation limit from December 31, 2009, to December 31, 2010.

The maximum first-year depreciation allowance for a light truck or van acquired and placed in service in 2010, and used entirely for business is $11,160.

The Lesson 3 discussion of the restoration of bonus depreciation includes information on autos purchased after a dealer used it as a demonstrator or leased property.

Note: These figures are based on 100% business usage.

Travel expenses are almost always scrutinized in the event a taxpayer's records are requested for audit. It should be recommended to all taxpayers engaging in business, who intend to deduct auto-related expenses, that a mileage log be maintained. By maintaining a log of business mileage and related expenses for each vehicle used in business, the taxpayer will meet the substantiation requirements necessary to support a business-auto deduction.

Leased Vehicles

Sole proprietors may choose to lease their business vehicles. The business percentage of the lease amount would be deductible on Schedule C. IRC Sec. 280F(c)(2) requires that the proprietor include an amount in income to “offset” the deduction for rental of the vehicle. This is called the leased-vehicle income inclusion.

The amount taken into income is determined by consulting a table provided by the IRS. The information needed for the table is as follows:

- The fair market value of the auto on the first day of the lease term
- The year the car was placed in service
- The length of time the leased vehicle has been used in the business
- The business-use percentage

Once the appropriate table is selected, the proprietor pulls the inclusion amount by looking at the FMV line for the auto and the year of service (e.g., first year, second year). The resulting amount may be prorated for the number of days of the lease term included in the tax year. The amount is then multiplied by the business-use percentage.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Marc is a self-employed optometrist who spends 50 hours per week traveling to various optical stores to see patients in their exam rooms and 10 hours per week at his home office completing patient charts and writing referral letters. He hired a part-time office person to work at his home office calling patients, verifying appointments, and typing. Marc must meet which of the following criteria in order to deduct his home office?

    a. He must use the office to meet with patients.

    b. The home office must be his principal place of business.

    c. The home office must be a separate structure from his primary residence.

7. Don is a self-employed optometrist who spends 25 hours per week traveling to various optical stores to see patients and 30 hours per week at his home office completing patient records and writing referral letters. He hired a part-time office person to work at his home office calling patients, verifying appointments, and typing. Under the home-office rules, Don's home-office deduction would most likely be:

    a. Disallowed because Don could perform administrative functions at the optical shops; he just chooses to do them at his home office.

    b. Allowed because Don performs administrative and managerial functions from his home.

    c. Disallowed because his services to his patients are more important than the time-consuming work performed in his home.

    d. Allowed only if Don would start seeing patients in his home in addition to all the administration functions.

8. Which of the following could be classified as direct expenses?

    a. Mortgage insurance.

    b. Mortgage interest on a loan taken specifically to build a home office.

    c. Lawn maintenance for the portion of the lawn directly in front of the home office.

9. Della operates a day-care facility in her home. The total area of her home is 4,000 square feet. The children are in every room of Della's house throughout the day. The area of Della's den, the room in which the children generally spend the most time, is 800 square feet. Della uses her home for day care 13 hours a day for five days a week and 50 weeks a year. What is Della's home-office percentage (rounded to the nearest percent)?

   a. 100%.

   b. 37%.

   c. 20%.

   d. 0%.

10. Rosie is a comedienne. She travels from her office to other locations to perform. She cannot decide what kind of car to buy and calls her trusted CPA to advise her on any auto-related tax benefits she may have. The CPA would be correct in telling her that:

    a. A truck or van with an unloaded GVW of 6,000 pounds would not be considered listed property and therefore the depreciation would not be limited to the luxury-auto limits.

    b. A car with a loaded GVW of 5,000 pounds would not be considered listed property and therefore would not be subject to any depreciation limitations.

    c. A truck or van with a loaded GVW of 6,000 pounds would not be considered listed property and therefore would not be subject to the luxury-auto depreciation limits.

    d. The increased standard mileage rate could be used to calculate business expenses relative to the use of the car only if the car was used for business more than 50% of the time.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

6. Marc is a self-employed optometrist who spends 50 hours per week traveling to various optical stores to see patients in their exam rooms and 10 hours per week at his home office completing patient charts and writing referral letters. He hired a part-time office person to work at his home office calling patients, verifying appointments, and typing. Marc must meet which of the following criteria in order to deduct his home office? **(Page 18)**

   a. He must use the office to meet with patients. [This answer is incorrect. In this particular situation, using the home office to meet with patients is not a requirement. For tax years beginning after 1998, a home office will be respected if used for administrative or management activities, and meets other IRS tests for deductibility.]

   b. The home office must be his principal place of business. [This answer is correct. For tax years beginning after 1998, a home office will be considered a principal place of business if: it is used for administrative or management activities, and there is no other fixed location where the sole proprietor can conduct administrative and management activities.]

   c. The home office must be a separate structure from his primary residence. [This answer is incorrect. In order to deduct expenses related to a home office, a taxpayer is not required to have a separate structure from his primary residence. A taxpayer needs to look at the use, availability of other places to conduct business activities and the function of the space used for business purposes.]

7. Don is a self-employed optometrist who spends 25 hours per week traveling to various optical stores to see patients and 30 hours per week at his home office completing patient records and writing referral letters. He hired a part-time office person to work at his home office calling patients, verifying appointments, and typing. Under the home-office rules, Don's home-office deduction would most likely be: **(Page 18)**

   a. Disallowed because Don could perform administrative functions at the optical shops; he just chooses to do them at his home office. [This answer is incorrect. The fact that the sole proprietor has space to perform administrative or managerial functions outside the home but chooses to perform these activities in the home office will not prevent a home office from being treated as a principal place of business.]

   b. Allowed because Don performs administrative and managerial functions from his home. [This answer is correct. Even though a sole proprietor has space to perform administrative or managerial functions outside the home, it will not preclude a home-office deduction if he chooses to perform these activities in the home office, per IRS Pub. 587.]

c. Disallowed because his services to his patients are more important than the time-consuming work performed in his home. [This answer is incorrect. The nature of the work performed at a fixed business location is not a determining factor in whether or not a home-office deduction will be allowed.]

d. Allowed only if Don would start seeing patients in his home in addition to all the administration functions. [This answer is incorrect. Home office deductions are permissible if any one of three tests is met. The home office need not be a place where Don sees patients if one of the other tests is met.]

8. Which of the following could be classified as direct expenses? **(Page 19)**

a. Mortgage insurance. [This answer is incorrect. Mortgage insurance is an indirect expense. *Indirect expenses* are allocated between business use and personal use because they benefit the upkeep of the entire home.]

b. Mortgage interest on a loan taken specifically to build a home office. [This answer is correct. Mortgage interest on a loan taken specifically to build a home office is an example of a direct expense. Direct expenses are deductible in full.]

c. Lawn maintenance for the portion of the lawn directly in front of the home office. [This answer is incorrect. Lawn maintenance and care is a nondeductible personal expense. It does not matter that the maintenance is on the portion of the lawn directly in front of the home office.]

9. Della operates a day-care facility in her home. The total area of her home is 4,000 square feet. The children are in every room of Della's house throughout the day. The area of Della's den, the room in which the children generally spend the most time, is 800 square feet. Della uses her home for day care 13 hours a day for five days a week and 50 weeks a year. What is Della's home-office percentage (rounded to the nearest percent)? **(Page 20)**

a. 100%. [This answer is incorrect. Della may not claim her house is used 100% for business even though the children are in every room of her home throughout the day.]

b. 37%. [This answer is correct. The percentage is calculated as follows:

- **5 days/week × 50 weeks/year × 13 hours/day = 3,250 hours/year**
- **365 days/year × 24 hours/day = 8,760 hours/year**

3,250 hours ÷ 8,760 hours = 37.1% (rounded: 37%)]

c. 20%. [This answer is incorrect. Day-care operators calculate their business-use percentage based on a formula other than percentage of square feet.]

d. 0%. [This answer is incorrect. Although Della does not use her home exclusively for business, she may claim a percentage of her business use.]

10. Rosie is a comedienne. She travels from her office to other locations to perform. She cannot decide what kind of car to buy and calls her trusted CPA to advise her on any auto-related tax benefits she may have. The CPA would be correct in telling her that: **(Page 24)**

    a. A truck or van with an unloaded GVW of 6,000 pounds would not be considered listed property and therefore the depreciation would not be limited to the luxury-auto limits. [This answer is incorrect. The unloaded GVW has no bearing on the classification of listed property as it relates to trucks and vans.]

    b. A car with a loaded GVW of 5,000 pounds would not be considered listed property and therefore would not be subject to any depreciation limitations. [This answer is incorrect. A vehicle with a loaded GVW of 5,000 pounds would be considered listed property and would be subject to the luxury-auto limits per IRC Sec. 280F.]

    c. A truck or van with a loaded GVW of 6,000 pounds would not be considered listed property and therefore would not be subject to the luxury-auto depreciation limits. [This answer is correct. Trucks and vans with a loaded GVW of 6,000 pounds are *not* considered listed property. The luxury-auto depreciation limits do not apply to these vehicles. There is a Section 179 limit of $25,000 on heavy SUVs placed in service after October 22, 2004.]

    d. The increased standard mileage rate could be used to calculate business expenses relative to the use of the car only if the car was used for business more than 50% of the time. [This answer is incorrect. The standard mileage rate is not affected by the business-use percentage of the vehicle.]

EXAMINATION FOR CPE CREDIT

Lesson 2

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

6. Which of the following statements is one of the tests that must be met in order for inventory-storage expenses for a home-based business to be deductible?

   a. The storage space must be used on a regular basis.

   b. The taxpayer must be able to store the inventory at a location other than the home.

   c. The inventory may be scattered throughout the house as long as the home is the only business location.

   d. The taxpayer must advertise that all inventory is maintained at the address used as the home office.

7. Al operates his greeting-card business from his back-room home office. Al's house measures 7,000 square feet and the office takes up 800 square feet of the house. Al operates the business five days a week, 49 weeks a year, and 10 hours a day. Assuming that Al operates at a profit, what percentage of *indirect* home-office expenses may Al deduct (rounded to the nearest whole number)?

   a. 100%.

   b. 30%.

   c. 11%.

   d. 0%.

8. Cindy operates an interior design business from her home. The table below presents income and expense items related to the business operated from the home.

Gross income	$100,000
Cost of goods sold	80,000
Supplies	15,000
Mortgage interest (business and nonbusiness portion)	10,000
Utilities, etc. (business and nonbusiness portion)	8,000
Depreciation (business and nonbusiness portion)	6,000

   Cindy uses 25% of her home for business. The expenses allocable to Cindy's home office are limited to what amount?

   a. $5,000.

   b. $2,500.

   c. The home-office expenses will not be limited in this situation.

   d. Cindy may not deduct any home-office expenses.

9. The standard-mileage-rate method may be used to calculate auto-related deductions for:

   a. Taxicabs.

   b. Leased vehicles.

   c. Vehicles for which a MACRS depreciation deduction was taken in a previous year

   d. Four cars that are used simultaneously in a business.

10. Dee began leasing a business auto on May 1, 20X1. The lease terminates on April 30, 20X4. The fair market value of the car is $42,100. Dee uses the auto 97% for business. The 20X1 lease-income inclusion table indicates an inclusion amount of $62 for 20X1. How much is the 20X1 lease income inclusion that Dee must report on her Schedule C?

    a. $40.

    b. $42.

    c. $60.

    d. $62.

Lesson 3: Depreciation

Introduction

This lesson discusses depreciation, including issues concerning depreciable basis, the modified accelerated cost recovery system (MACRS), and IRC Section 179.

Learning Objectives

Completion of this lesson will enable you to:

- Calculate depreciation using the IRC Section 179 expense election and depreciation conventions under MACRS.

Basics

Depreciation is a method of recognizing a decline in value of an asset, due either to time or usage, over the period of time that benefits from the use of the asset are measured. At the beginning of tax history, taxpayers were permitted to determine the useful life of the asset. Slowly, the tax code began defining the useful lives of assets over which the taxpayer could deduct the cost of the asset.

The **1971 Revenue Act** gave legal authority to the asset depreciation range (ADR) system. Then the accelerated cost recovery system (ACRS), which was to "simplify" depreciation for the taxpayer, came into existence in 1981. Then MACRS came into being with the **Tax Reform Act of 1986**. Because MACRS is the present depreciation system in place, the focus of the following discussion will be on this system and bonus depreciation on property acquired and placed in service in 2010. MACRS applies to all assets placed in service after 1986 (or after July 31, 1986, if the taxpayer chooses).

Information needed to calculate the depreciation deduction under this method includes the following:

- Taxpayer's basis in the asset
- The class life of the asset
- Classification of the asset as an IRC Sec. 1245 (personal property) or IRC Sec. 1250 (real property) asset
- The depreciation convention (half-year, mid-month, mid-quarter)
- Accelerated versus straight-line election
- IRC Section 179 expense election
- Whether the asset qualifies for 50% bonus depreciation (see the discussion in this lesson.)

As stated in IRC Sec. 167, property may be depreciated only if it is used in a trade or business or held for the production of income. If the property is held for sale (e.g., inventory), it is not depreciable.

The theory behind not depreciating inventory is that the property is likely to be sold at a profit and no decline in value will occur. Property held for personal use is not depreciable.

Basis

The amount that is depreciated is the asset's basis. The basis is normally the cost of the asset. Cost is generally the purchase price of the asset, increased by any liabilities to which the asset is subject. If the asset is constructed by the taxpayer, the basis includes the cost of raw materials and labor, overhead costs allocable to the construction, depreciation of machinery used in the construction process, and carrying charges such as taxes and interest during the construction period.

Under special circumstances, the depreciable basis may be the fair market value (FMV) of the asset. If the asset is converted from personal use to business use, the lower of the FMV or the adjusted basis of the asset at the date the asset is converted is the depreciable basis. If the property is received from a decedent, the FMV at the date of death (or alternate valuation date) is the depreciable basis.

A property's basis may be determined by the basis of property previously held by a taxpayer. If property is involved in an involuntary conversion, then the basis of the replacement property may have a substitute basis. IRC Sec. 1033 provides that a taxpayer shall not recognize a gain on property involuntarily converted if it is replaced by similar property. The taxpayer is required to invest the insurance proceeds to purchase the replacement property and then reduce the cost of the replacement property by the amount of the gain not recognized.

Another example of a substitute basis is like-kind exchange property. IRC Sec. 1031 states that no gain or loss shall be recognized on the exchange of property held in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be used in the trade or business or for investment.

Example 1: Involuntary Conversion. Tim is a private ultrasonographer. His ultrasound equipment is destroyed by an electrical surge. He replaces the equipment with similar ultrasound equipment.

Replacement property			$12,000
Insurance proceeds		$6,000	
Cost of original property	$10,000		
Accumulated depreciation	(5,200)		
Basis	$ 4,800	(4,800)	
Gain		$1,200	(1,200)
Basis replacement property			$10,800

Expense Election

The **Economic Recovery Tax Act of 1981** introduced an election taxpayers could make to expense qualified property placed into service during the tax year. There are limitations on the amount of 179 deduction that can be taken in a given year.

The Section 179 election has an annual dollar limitation of $500,000 for 2010 and 2011 per the Small Business Jobs Act of 2010.

Note: A husband and wife filing a joint tax return are treated as one taxpayer in applying the Section 179 dollar limitation regardless of which spouse placed the property in service.

The depreciable basis of the asset is reduced by the amount of the expense election claimed. The cost of several assets may be combined in order to build up to the annual limitation amount. The following table details the increase in the Section 179 dollar amount:

Tax Years Beginning In:	Maximum Amount	Tax Years Beginning In:	Maximum Amount
1996	$17,500	2004	$102,000
1997	$18,000	2005	$105,000
1998	$18,500	2006	$108,000
1999	$19,000	2007	$125,000
2000	$20,000	2008	$250,000
2001	$24,000	2009	$250,000
2002	$24,000	2010	$500,000
2003	$100,000	2011	$500,000

After 2003 but before 2011, the $400,000 phase-out limit will be annually indexed for inflation. The adjustments will increase in multiples of $10,000, rounded to the nearest multiple of $10,000. For 2010 and 2011, the Small Business Jobs Act of 2010 boosts the phase-out amount to $2,000,000.

Caution: State law may not follow federal tax treatment.

Note: Congress believes the expensing option available under IRC Section 179 assists small businesses by reducing the recordkeeping requirements on expensed property and lowering the cost of capital for tangible property used in a trade or business.

Electing and Revoking an Election to Expense. The expense election must be made as of the first year in which the property is placed in service. With respect to tax years beginning before 2003, the election was irrevocable without the consent of the Commissioner. With respect to tax years beginning after 2002 and before 2012, taxpayers may make or revoke IRC Section 179 elections on amended returns without the consent of the IRS. Once he has revoked, a taxpayer may not change back.

The election is made on the first return for the tax year to which the election applies, including extensions. Before 2003, the election may be made on an amended return only if the amended return is filed by the due date of the original return, including any extensions that have been granted for the original return.

Qualified Property. Property is eligible for the IRC Section 179 expensing election if it is "qualified" property. Qualified property is:

- Used in a trade or business (greater than 50% business use)
- IRC Sec. 1245 tangible property
- Depreciable under IRC Sec. 168

2010 Law Change: The Small Business Jobs Act of 2010 makes the following changes effective for tax years beginning in 2010 and 2011. Assuming all other requirements are met, certain qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property are eligible for Section 179 expensing. The Section 179 election for these types of property is limited to $250,000 per year. Any Section 179 deduction for qualified real property that is unused due to the taxable income limit cannot be carried to a year beginning after 2011. Any carryforward remaining at the end of the tax year beginning in 2011 is treated as placed in service in that 2011 tax year (IRC Sec.179(f)).

The Jobs Growth and Tax Relief Reconciliation Act of 2003 expands IRC Sec. 179 eligibility to include off-the-shelf computer software placed in service in taxable years beginning in 2003. The Small Business Jobs Act of 2010 extends Section 179 expensing for off-the-shelf software to years beginning before 2012. Prior to 2003, this was considered to be intangible property.

The 1996 Act (IRC Sec. 1702(h)(19)) specifically excludes the following property from qualifying as IRC Sec. 179 property: air conditioners, heating units, property used for nontransient lodging, property used outside the United States, and property used by certain tax-exempt organizations and governmental units.

Note: This definition is effective for property placed in service after 1990.

The property may not be inherited property. It may not have a substituted basis as previously discussed. In addition, the property may not be acquired from an individual whose relationship to the taxpayer would bar the taxpayer from recognizing a loss in the transaction (e.g., a related party). Under most circumstances, the property may not be converted from personal use to business use. The property may not be property used for the production of income, such as rental property. It must be property used in a trade or business.

Investment Limitation or Business-income Limitation—IRC Sec. 179

The expense election is subject to two limitations—the investment limitation and the business-income limitation. The investment limitation dictates that the 2010 and 2011 annual dollar limit of $500,000 must be reduced dollar for dollar by the amount by which the cost of all qualified property purchased during the tax year exceeds $2,000,000.

Maximum expense election		$500,000
Qualified property purchased	$2,300,000	
Investment limitation	(2,000,000)	
Excess investment		(300,000)
Maximum allowable Section 179 expense		$200,000

The excess amount may not be carried over to the next year. Unless IRC Section 179 is further amended:

- For tax years 2012 and later, the $100,000 expensing ceiling (increased for inflation) will revert back to the $25,000 ceiling under the pre-2003 Jobs and Growth Act.

Note: The business-income (taxable income) limitation prohibits a taxpayer from electing to expense an amount in excess of income earned in all trades or businesses in which the taxpayer is engaged during the tax year. Income earned in all trades or businesses includes (but is not limited to) the taxpayer's W-2 wages from an employer. It also includes income earned by a spouse if the taxpayers file a joint tax return. The taxable income is calculated before the IRC Section 179 deduction. It does not include net operating loss carryovers or the taxpayer's half of self-employment taxes.

Depreciation Methods

The depreciation methods employed under MACRS are the declining-balance method and the straight-line method. The declining-balance method permits the taxpayer to deduct a greater portion of the depreciation early in the life of the asset, whereas the straight-line method provides a level amount of depreciation during the life of the asset.

Two schedules of depreciation expense of a $10,000, five-year asset are illustrated as follows:

	Declining Balance	Straight Line
Year 1	$ 2,000	$ 2,000
Year 2	3,200	2,000
Year 3	1,920	2,000
Year 4	1,440	2,000
Year 5	1,440	2,000
Total	$10,000	$10,000

IRS Pub. 946 provides tables to assist the preparer in calculating the depreciation.

Depreciation Conventions

After the method of depreciation is selected, the convention is applied in order to properly calculate the depreciation to be deducted for the tax year. There are three conventions:

1. Half-year
2. Mid-month
3. Mid-quarter

Note: These conventions are not elected. There are specific rules that dictate which convention be used. The convention used in the year of acquisition is the same convention used in the year of disposition. The depreciation tables provided by the IRS also include the applicable conventions.

The half-year convention is used for all property except residential rental property, commercial real property, tunnel bores, and railroad grading. (Because most Schedule C and F taxpayers do not have businesses using tunnel bores and railroad grading, those assets will not be discussed.)

As the name implies, an asset using the half-year convention is assumed to be placed in service in the middle of the year. Therefore, the taxpayer deducts half of the year's depreciation in the first year placed in service, no matter when during the year the asset was acquired.

The same asset will receive a half-year depreciation in the year of disposition. If an asset is acquired and disposed of in the same year, no depreciation is allowed.

The mid-month convention is used for residential rental property and nonresidential real property. Property is treated as being placed in service in the middle of the month in which it was placed in service. The property is treated as being disposed of in the middle of the month in the year of disposition.

The mid-quarter convention applies to all property, except residential rental and nonresidential real property, if more than 40% of the aggregate bases of the property are placed in service during the last three months of the tax year. All property placed in service or disposed of during any of the four quarters of the tax year is treated as being placed in service or disposed of during the middle of that quarter.

Note: If the taxpayer was in business only the last three months of the year, the mid-quarter convention would apply to the depreciable assets (except real property) placed in service during that initial period.

It is important to remember the following rules when determining the convention under which to depreciate assets:

- The basis of residential rental property and nonresidential real property is *not* to be included when applying the 40% test.
- The basis of assets for which the taxpayer elects IRC Section 179 is *not* to be included when applying the 40% test.
- The basis of property acquired and disposed of in the same tax year is *not* to be included when applying the 40% test.

The following paragraphs relate to a special first-year additional depreciation bonus, which applied to assets acquired and placed in service after September 11, 2001, and before January 1, 2005. (Tax preparers should be aware bonus depreciation exists because, if initially not handled properly, it could affect the depreciation *allowable* portion of the gain or loss on the asset when disposed.) The 2009 Recovery Act reinstates the availability of the 50% bonus depreciation for new property purchased and placed in service after December 31, 2007, and before January 1, 2010. In addition, the Small Business Jobs Act of 2010 extends the special depreciation provisions for property acquired and placed in service in 2010.

The **Job Creation and Worker Assistance Act of 2002 (JCWAA)**, signed into law on March 9, 2002, included several business economic-stimulus provisions. One provision was an additional 30% first-year depreciation bonus for nonrealty assets acquired and placed in service after September 11, 2001, and before September 11, 2004. JGTRRA extended this date to January 1, 2005, and provided for an *additional first-year depreciation (AFYD)* deduction equal to 50% of the adjusted basis of qualified property. These provisions lapsed; but then in February 2008, the 2008 Stimulus Act was signed and the 50% bonus depreciation was reinstated for qualified assets purchased and placed in service after December 31, 2007, and before January 1, 2009. The 2009 Recovery Act reinstates the availability of the 50% bonus depreciation for new property purchased and placed in service after December 31, 2007, and before January 1, 2010, and now the Small Business Jobs Act of 2010 extends the provision to property placed in service in 2010.

This additional depreciation is allowed for both regular tax and alternative minimum tax (AMT) purposes. A taxpayer may elect not to deduct the additional bonus depreciation for any class of property by attaching a statement to the timely filed tax return.

We will focus on the current provisions.

The AFYD deduction is equal to 50% of the adjusted basis of the qualified property. The adjusted basis is its cost or other basis multiplied by its business-use or investment-use percentage, reduced by amounts expensed under IRC Section 179 and adjusted for items such as the disabled-access credit.

Qualified property for the 50% bonus depreciation is property that:

- Has a recovery period of 20 years or less,
- Is computer software (except for Section 197 software),
- Is qualified leasehold improvement property (IRC Sec. 168(k)(3)), or
- Is water utility property (IRC Sec. 168(e)(5)).

The following is an example of how bonus depreciation is calculated.

Example 2: Iyamso Rich buys a fancy new computer system for $400,000 for his business on March 1, 2010. He wants to take advantage of the Section 179 expense election and the 50% bonus depreciation.

Section 179	$ 250,000
50% bonus depreciation [(400,000 – 250,000) ÷ 2]	75,000
Depreciation {[(400,000 – 250,000) ÷ 2] ÷ 5}	15,000
Total depreciation	$ 340,000

The adjusted basis of qualified property acquired via like-kind exchange or involuntary conversion *is* eligible for the 50% AFYD.

Example 3: Ivana Nuporsh trades in her equipment used in her business for new equipment.

Cost of old equipment	$ 50,000
Accumulated depreciation	26,000
Adjusted basis old equipment	24,000
Cash paid (boot) for new equipment	28,000
Adjusted basis new equipment	$ 52,000

The entire $52,000 is eligible for the 50% AFYD.

Caution: Be sure to check whether or not the taxpayer's state adopts the federal changes in depreciation rules. Several states have not adopted these changes and continue to follow pre-JCWAA depreciation standards. The result is that many taxpayers must maintain book, federal tax, AMT, and state depreciation records.

MACRS

Under general MACRS, the basis of the asset is depreciated over a specific recovery period using a specific convention and a specific method. Generally, the permissible methods under MACRS are the 200% declining-balance method, the 150% declining-balance method, and the straight-line method.

Except in the first and last years of depreciating an asset, the following are true:

- The 200% declining-balance method (DDB or 200 DB) is calculated as follows: (Basis of asset – Accumulated depreciation) ÷ Life of asset × 2 = Depreciation.
- The 150% declining-balance method (150 DB) is calculated as follows: (Basis of asset – Accumulated depreciation) ÷ Life of asset × 1.5 = Depreciation.
- The straight-line method is calculated as follows: (Basis of asset ÷ Life of asset) = Depreciation.

Note: It is common practice to switch to the straight-line method of depreciation at the point in time where the straight-line method would yield a higher deduction than a declining-balance method.

While it is important to understand the mechanics involved in calculating the depreciation of an asset, it is also important to note that tables have been developed to assist individuals in determining the asset lives and the calculation of depreciation.

Example 4: A Double Declining Balance/Half-year Convention Table.

	Life			
Recovery Year	**3-Year**	**5-Year**	**7-Year**	**10-Year**
1	33.33%	20.00%	14.29%	10.00%
2	44.45	32.00	24.49	18.00
3	14.81	19.20	17.49	14.40
4	7.41	11.52	12.49	11.52
5		11.52	8.93	9.22
6		5.76	8.92	7.37
etc.				

For a \$10,000, five-year asset, the depreciation in Year 1 would be \$10,000 × .2 = \$2,000, for Year 2, depreciation would be \$10,000 × .32 = \$3,200, and so on. This, of course, assumes that the taxpayer has elected out of the 50% bonus depreciation in the acquisition year of 2009. The table percentages reflect a switch to straight-line at the mid-life of the asset.

Now that the mechanics of depreciation under MACRS are understood, they must be applied in order to yield the desired results. Taxpayers have several elections that they may make in determining their depreciation deduction.

Regs. 1.1031 and 1.168 provide guidance on how to depreciate like-kind exchange MACRS property. This applies to the basis of property acquired under IRC Sec. 1031 (like-kind exchange) and IRC Sec. 1033 (involuntary conversion). Reg. 1.168(e) splits the property into two pieces—the *carryover* basis portion and the new basis portion.

The carryover basis portion is depreciated as follows. The newly acquired exchange property is depreciated over the remaining recovery period, using the same depreciation method and convention as that of the old property *to the extent the basis of the new exchanged property does not exceed the adjusted basis of the old property*. The excess of the basis of the new property over the adjusted basis of the old property is treated as newly purchased MACRS property. This excess is the new basis portion.

Example 5: Mel trades the copier used in her CPA practice for a newer model. The original cost of the copier was $5,000. Accumulated depreciation on the copier is $1,000. Mel gives up the old model plus $2,000 to acquire the new model. She would depreciate the new model as follows:

Original model adjusted basis	$ 4,000
Cash paid (boot)	2,000
Basis of new model	$ 6,000

Year	Carryover Basis Portion	New Basis Portion	Total
1	$1,600	$400	$2,000
2	960	640	1,600
3	576	384	960
4	576	230	806
5	288	230	518
6	0	116	116
	$4,000	$2,000	$6,000

Note: The IRS regulations explain depreciation calculations after a Section 1031 exchange or a Section 1033 involuntary conversion. The regulations address the following:

1. Depreciation of luxury autos traded or converted
2. How to deal with the time lapse between when the relinquished property was disposed and when the replacement property was acquired
3. How to calculate bonus depreciation for pre-2005 assets

Note: A key provision in the regulation is that a taxpayer may elect to treat the entire basis of the replacement property (both the exchanged basis and the boot) as being placed in service at the time the replacement property is acquired. The election is made by writing “Election Made under Section 1.168-6(i)” at the top of Form 4562. The election must be made by the due date of the return including extensions for the year of the replacement property acquisition. Once made, the election can only be revoked with the IRS’s consent.

Further discussion is beyond the scope of this course, but the reader is encouraged to take a look at the regulations.

Alternate MACRS

An election may be made to recover the cost of the property using a straight-line method of depreciation rather than an accelerated method. This election is irrevocable. The straight-line method election is applied to all assets acquired during the tax year within a particular recovery class. If a taxpayer chooses to use the straight-line method to depreciate a computer in Year 1, the taxpayer must use the straight-line method to depreciate all five-year recovery class assets acquired that year.

The taxpayer may also make an irrevocable election to depreciate 150% declining-balance method assets over a life that is longer than the prescribed recovery period. In practice, this election is generally not seen, but it is important to know that it is available.

50% Bonus Depreciation Extended

Congress previously enacted legislation allowing bonus depreciation following the terrorist attacks of September 11, 2001, but that provision expired December 31, 2004. Under the Economic Stimulus Act of 2008, the 2009 Recovery Act, and the Small Business Act of 2010, bonus depreciation again applies for assets acquired and placed in service during calendar years 2008 through 2010.

Note: The 50% bonus depreciation deduction and the increased Section 179 deduction amount can both apply for a taxpayer. The 50% bonus depreciation deduction is generally available for any cost of 2010 assets not written off with the increased Section 179 deduction.

How It Works. Depreciation is increased for the year in which property is placed in service by an allowance equal to 50% of the adjusted tax basis of the property. To be eligible, the asset must meet three broad criteria (which are explained in more detail following this list):

1. The asset must be qualified property.
2. The original use must commence with the taxpayer after December 31, 2007.
3. The property must be acquired within the applicable time period, generally from January 1, 2009, to December 31, 2010.

Qualified Property. The asset must meet one of four definitions:

1. The asset is eligible Section 168 recovery property with a recovery period of 20 years *or less*.

   Most tangible personal property has a recovery period of 20 years or less. See Rev. Proc. 87-56 (1987-2 CB 674) for a list of general depreciation recovery periods by asset class.

   Real property is generally classified as either residential rental (27.5 year recovery period) or commercial real property (39 year recovery period) and accordingly is ineligible for the 50% bonus depreciation. However, see the later discussion regarding leasehold improvements.

   General purpose buildings used in agriculture, such as machine sheds and shops are 20-year recovery period and qualify for the 50% bonus depreciation.

   Assets with a 20-year or less MACRS recovery period qualify for 50% bonus depreciation, even if the taxpayer elects to depreciate the asset using the alternative depreciation system (ADS) over a life exceeding 20 years (Reg. 1.168(k)-1(b)(2)(i)(A)).

2. The asset is depreciable computer software other than software amortizable under IRC Sec. 197.

3. The property is water utility property defined in IRC Sec. 168(e)(5).

4. It is qualified leasehold improvement property.

Note: The statute states that “qualified property” does not include any property subject to the alternative depreciation system (ADS) under IRC Sec. 168(g), other than where the taxpayer has voluntarily elected ADS.

Caution: Farmers and other growers who produce plants with a more than two-year pre-productive period, such as in the orchard and vineyard industries, are normally subject to Section 263A uniform capitalization (UNICAP) rules, unless they elect out of the UNICAP rules. Those who elect out of the UNICAP provisions under IRC Sec. 263A(d)(3) are forced to use ADS. However, this election out of UNICAP is not considered a voluntary election to use ADS; hence, these orchard and vineyard growers are precluded from using the 50% bonus depreciation on asset purchases (Rev. Proc. 2002-33, IRB No. 2002-20). See IRS Notice 2000-45 (IRB No. 2000-36) for a list of plants with a more than two-year pre-productive period.

Original Use Definition. To qualify, the asset must be new rather than used property. The term “original use” refers to the first use to which the property is put, not to the first use by the particular taxpayer. Capital expenditures to recondition or rebuild acquired or owned property satisfy the original use requirement, but purchases of reconditioned or rebuilt assets do not qualify.

Example 6: New versus Used for 50% Depreciation.

On February 1, 2010, Smithco buys a machine for $20,000 from another company that had previously used this asset. Shortly thereafter, Smithco incurs a capital expenditure of $5,000 to recondition this machine. Regardless of whether the $5,000 amount is added to the basis of the machine or is capitalized as a separate asset, the $5,000 satisfies the “original use” test and is eligible for the 50% bonus depreciation. No part of the $20,000 purchase price of the used machine qualifies for the 50% depreciation allowance.

Demonstrator use by a dealer (e.g., an automobile) does not taint the new status of the inventory item when sold to a buyer, nor does a manufacturer’s retention of an asset for testing prior to sale (Rev. Rul. 78-433). However, if the automobile dealership had leased this new automobile to Customer One for six months prior to the purchase by Customer Two, the revenue producing leasing activity would be considered the first use of the property, and Customer Two would be ineligible for the bonus depreciation upon her subsequent purchase of this vehicle (Rev. Rul. 74-1).

Personal use of an asset by a taxpayer prior to that taxpayer converting it to business use does not taint eligibility. However, if one taxpayer used an asset personally and a second taxpayer subsequently acquires the asset for use in business, the second taxpayer is not the original user (Reg. 1.168(k)-1(b)(3)(ii)).

Example 7: Prior Personal Use of Vehicle.

Mike purchases a new pickup truck in early 2009, and uses it personally early in the year. In June 2010, Mike starts a construction business and converts this pickup to exclusive business use in his home-based construction business. This truck is qualified property for the bonus depreciation, as Mike is considered the original user. If Mike had purchased the truck from another individual who had used it personally, the truck is not qualified property.

Note: The 50% bonus depreciation has its greatest impact on longer-lived depreciable assets, as it accelerates deductions that would otherwise be deferred over many future years into the year of acquisition.

AMT. The 50% bonus depreciation applies for both regular tax and AMT (IRC Sec. 168(k)(2)(F)).

Ordering Rules. Any Section 179 deduction is claimed first, followed by the 50% bonus depreciation, before calculating the regular MACRS depreciation allowance based on the recovery period of the property (Reg. 1.168(k)-1(d)(2)).

Note: State income tax conformity needs to be considered (i.e., has the applicable state adopted the 50% depreciation allowance?). Many states, due to budget restrictions, have not have conformed.

Special Vehicle Limits for 2010. In the case of a passenger automobile that meets the qualified property definition for 50% bonus depreciation, the first-year depreciation limit is increased by $8,000 for 2010. Accordingly, the first-year depreciation limit for vehicles placed in service during 2010 is $11,060 ($3,060 plus $8,000) for automobiles subject to the luxury auto limits and $11,160 ($3,160 plus $8,000) for light trucks or vans (passenger autos built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis) (IRC Sec. 168(k)(2)(F)(i)).

The following chart summarizes the first-year depreciation limits on a luxury auto vehicle, assuming a first-year base limit of $3,060:

	Base Limit	Increase for Bonus Eligibility	Total First Year Limit
Used vehicle	$ 3,060	$ —	$ 3,060
New autos (not trucks or vans)— 50% eligible	3,060	8,000	11,060
New light truck or vans— 50% eligible	3,160	8,000	11,160

The preceding passenger automobile depreciation limits are not applicable to trucks, minivans or sports utility vehicles with a gross vehicle weight rating over 6,000 pounds. Accordingly, many full-size pickup trucks and larger SUVs are exempt from the first-year depreciation caps described above. Assuming that these vehicles are used over 50% for business, the Section 179 deduction is available. If the vehicle is new, the 50% bonus depreciation may also be claimed, to the extent that basis has not been reduced by a Section 179 deduction ($25,000 maximum).

Example 8: Depreciating a Large SUV.

John, who owns a general contracting business, purchases a new Yukon XL for his construction business in December 2010 at a cost of $45,000. This vehicle is used 100% in John's business. Assuming that John has claimed the $500,000 Section 179 deduction for other used assets acquired during 2010 in this business, he may claim a 50% bonus depreciation deduction of $22,500 (50% × $45,000). John's vehicle has a gross vehicle weight rating over 6,000 pounds, and is not subject to the vehicle depreciation limits.

Alternatively, if John had not otherwise used the Section 179 deduction for 2010, he could claim a Section 179 deduction of up to $25,000 for the cost of this vehicle [$25,000 limit per IRC Section 179(b)(6)(A) for SUVs]. The balance of the adjusted basis would qualify for 50% bonus depreciation.

Electing Out of Bonus Depreciation. The bonus depreciation is to occur as a matter of law. Thus, a taxpayer may make an election with respect to any class of property for any taxable year to **not** claim the bonus depreciation. The election, once made, is irrevocable (Reg. 1.168(k)-1(e)(7)).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Ryan bought a sewing machine in 1980 for $550, which he used to mend his clothing. He died in 2010 and left the sewing machine to his brother Jeffrey, a tailor. The value at the date of Ryan's death was $400. Jeffrey found the sewing machine to be in good working order and immediately placed it in service in his tailoring business. What is the depreciable basis of the sewing machine?

    a. $550.

    b. $400.

    c. $0.

12. In 2010, Dr. Bashir purchases medical equipment (five-year property) for $2,005,000. He buys the equipment for use in his private practice on his new medical shuttle, *Tiberian.* Dr. Bashir decides to elect Section 179 expensing for this equipment and elect out of bonus depreciation. His net income before depreciation is $600,000. How much is Dr. Bashir's maximum allowable 2010 Section 179 expense?

    a. $500,000.

    b. $495,000.

    c. $5,000.

    d. $0.

13. Bryan is a counselor and runs his business as a sole proprietorship. He purchases furniture during 2010 totaling $9,000. In addition, he converts his personal-use auto, initially purchased in 2002, to 90% business use. The basis in the auto when purchased was $15,000 (FMV when placed in service = $11,000). Bryan's income from his trade or business before IRC Section 179 election is $5,000. What would Bryan's maximum allowable IRC Section 179 expense be during 2010?

    a. $24,000.

    b. $20,000.

    c. $9,000.

    d. $5,000.

14. Bob places the following into service during 2010:

Furniture	$ 1,000	(acquired October 15, 2010)
Equipment	2,000	(acquired September 15, 2010)
Building	40,000	(acquired September 15, 2010)

Bob returns the equipment on November 1 because it does not work. Bob's business started on September 1, 2010. Which of the following statements is true?

a. Bob must use the mid-quarter convention when calculating depreciation on the furniture.

b. Bob must use the half-year convention when calculating depreciation on all assets placed in service during 2010.

c. Bob would have been required to use the mid-quarter convention on the equipment if he had not returned it.

d. It is a good thing that Bob bought the $40,000 building because it kept him from having to use the mid-quarter convention when depreciating the furniture.

15. Willy Makit has operated his business since 1990. He buys new furniture for his office in November 2009, uses MACRS depreciation, and elects out of claiming bonus depreciation. The furniture, which costs $15,000, is the only new asset placed in service during 2009. The depreciation in the first year of service is $536. Willy makes no special depreciation elections. Willy sells the furniture to Betty Wohnt on November 30, 2010. What is Willy's allowable depreciation on the furniture in 2010?

a. $1,033.

b. $2,066.

c. $3,616.

d. $3,750.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

11. Ryan bought a sewing machine in 1980 for $550, which he used to mend his clothing. He died in 2010 and left the sewing machine to his brother Jeffrey, a tailor. The value at the date of Ryan's death was $400. Jeffrey found the sewing machine to be in good working order and immediately placed it in service in his tailoring business. What is the depreciable basis of the sewing machine? **(Page 34)**

    a. $550. [This answer is incorrect. Value is placed on the property at the decedent's date of death or the alternate valuation date.]

    b. $400. [This answer is correct. Jeffrey's depreciable basis is the FMV at the date of death of his brother ($400).]

    c. $0. [This answer is incorrect. Jeffrey *can* depreciate the asset. He has a date placed in service and a basis for depreciation.]

12. In 2010, Dr. Bashir purchases medical equipment (five-year property) for $2,005,000. He buys the equipment for use in his private practice on his new medical shuttle, *Tiberian.* Dr. Bashir decides to elect Section 179 expensing for this equipment and elect out of bonus depreciation. His net income before depreciation is $600,000. How much is Dr. Bashir's maximum allowable 2010 Section 179 expense? **(Page 36)**

    a. $500,000. [This answer is incorrect. The $500,000 represents the maximum Section 179 expense; however, it is not the maximum allowable expense in Dr. Bashir's case.]

    b. $495,000. [This answer is correct. For 2010, the maximum allowable Section 179 expense deduction is calculated as follows:

Maximum expense election		**$500,000**
Qualified property purchased	**2,005,000**	
Investment limitation	**(2,000,000)**	
Excess		**(5,000)**
Maximum allowable Section 179 expense deduction		**$495,000]**

    c. 5,000. [This answer is incorrect. An amount of $5,000 represents the excess qualified purchases over the investment limitation ($2,005,000 – 2,000,000).]

    d. $0. [This answer is incorrect. Dr. Bashir may make a Section 179 election.]

13. Bryan is a counselor and runs his business as a sole proprietorship. He purchases furniture during 2010 totaling $9,000. In addition, he converts his personal-use auto, initially purchased in 2002, to 90% business use. The basis in the auto when purchased was $15,000 (FMV when placed in service = $11,000). Bryan's income from his trade or business before IRC Section 179 election is $5,000. What would Bryan's maximum allowable IRC Section 179 expense be during 2010? **(Page 37)**

   a. $24,000. [This answer is incorrect. Bryan did not place $24,000 of qualified property into service in 2010.]

   b. $20,000. [This answer is incorrect. Although Bryan placed $20,000 of property into service, not all of the property is qualified property.]

   c. $9,000. [This answer is incorrect. Bryan placed $9,000 of qualified property into service in 2010; however, be sure to check all limitations.]

   d. $5,000. [This answer is correct. The annual dollar limit on IRC Section 179 property is $250,000 in 2010. Bryan placed $20,000 of property into service during 2010; however, only the $9,000 furniture is qualified property. His disbursements meet the annual investment limitation because the cost of the qualified property placed in service during 2010 is less than $2,000,000. His business-income limitation is $5,000. Consequently, Bryan may only elect to expense $5,000. He may carry the remaining $4,000 over to the next year, but he will still be limited to a maximum IRC Section 179 deduction in 2011.]

14. Bob places the following into service during 2010:

Furniture	$ 1,000	(acquired October 15, 2010)
Equipment	2,000	(acquired September 15, 2010)
Building	40,000	(acquired September 15, 2010)

   Bob returns the equipment on November 1 because it does not work. Bob's business started on September 1, 2010. Which of the following statements is true? **(Page 38)**

   a. Bob must use the mid-quarter convention when calculating depreciation on the furniture. [This answer is correct. Bob would be required to use the mid-quarter convention when depreciating the furniture. The equipment would not be included in the determination since it was acquired and disposed of in the same tax year. The building would not be included in the determination because real property basis is not included when applying the 40% test. The furniture was acquired during the last three months of the tax year and its basis represented 100% of the determining assets placed into service during the tax year.]

   b. Bob must use the half-year convention when calculating depreciation on all assets placed in service during 2010. [This answer is incorrect. Residential rental property and nonresidential real property are depreciated using a mid-month convention.]

c. Bob would have been required to use the mid-quarter convention on the equipment if he had not returned it. [This answer is incorrect. Because less than 40% of the bases of the assets would have been placed in service during the last three months of the year if Bob had kept the equipment, he would *not* have been required to use the mid-quarter convention on the equipment.]

d. It is a good thing that Bob bought the $40,000 building because it kept him from having to use the mid-quarter convention when depreciating the furniture. [This answer is incorrect. The basis of residential rental property and nonresidential real property should *not* be included when applying the 40% test for mid-quarter convention]

15. Willy Makit has operated his business since 1990. He buys new furniture for his office in November 2009 and uses MACRS depreciation. The furniture, which costs $15,000, is the only new asset placed in service during 2009. The depreciation in the first year of service is $536. Willy makes no special depreciation elections. Willy sells the furniture to Betty Wohnt on November 30, 2010. What is Willy's allowable depreciation on the furniture in 2010? **(Page 40)**

a. $1,033. [This answer is incorrect. Willy used the mid-quarter convention when the asset was placed in service.]

b. $2,066. [This answer is incorrect. This would have been Willy's depreciation if he held the asset for a complete year.]

c. $3,616. [This answer is correct. Willy's allowable depreciation in 2010 would be calculated as follows: ($15,000 – $536) ÷ 7 × 2 × (3.5 ÷ 4) = $3,616. The depreciable basis is reduced by accumulated depreciation and divided by its recovery period. The result is multiplied by 2 because 200 DB is used, then multiplied by 3.5 ÷ 4 because it was disposed of in the last quarter of 2010 and mid-quarter convention was used when the asset was placed in service.]

d. $3,750. [This answer is incorrect. When calculating the depreciation, be sure to subtract accumulated depreciation from the asset's basis.]

EXAMINATION FOR CPE CREDIT

Lesson 3

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

11. MACRS applies to assets placed in service after:

    a. 1982 (or after July 31, 1982, if the taxpayer chose).

    b. 1985 (or after July 31, 1985, if the taxpayer chose).

    c. 1986 (or after July 31, 1986, if the taxpayer chose).

    d. 1990 (or after July 31, 1990, if the taxpayer chose).

12. An asset's depreciable basis is **not** one of the following:

    a. The cost of the asset.

    b. The purchase price of the asset increased by any liabilities to which the asset is subject.

    c. The cost basis of the decedent if the asset is acquired from a decedent.

    d. The FMV at the date the asset is converted from personal use if lower than adjusted basis.

13. Claudette owns and operates an accounting service. Her Schedule C reports income of $56,000 in 20X1. Claudette's mother also operated an accounting service, but she retires in 20X1 and gives Claudette her air conditioner valued at $500 with an original cost of $2,000. Claudette puts the air conditioner in her bedroom. Now Claudette is well-rested when she sees clients. Which of the following statements is most accurate?

    a. The air conditioner is eligible for the IRC Section 179 expensing election on Claudette's 20X1 Schedule C.

    b. Claudette may elect IRC Section 179 expensing on the air conditioner in the amount of $500.

    c. Claudette may elect IRC Section 179 expensing on the air conditioner in the amount of $2,000.

    d. While Claudette's mother was nice to give her the air conditioner, Claudette may not benefit from an IRC Section 179 expensing election on the unit.

14. Which of the following statements about depreciation conventions is most accurate?

    a. The half-year convention may be used for all property used in a trade or business.

    b. The mid-quarter convention must be used if more than 40% of the cost of all property placed in service during the tax year is placed in service in the last quarter of the year.

    c. The mid-month convention under MACRS treats residential rental property and nonresidential real property as if it was placed in service in the middle of the month.

    d. In a short year, the mid-quarter convention is never used.

15. Phoebe is a masseuse. She depreciates assets using the double declining balance method. In June 2010, Phoebe places $10,000 of seven-year assets into service. These are the only assets placed into service in 2010. How much is Phoebe's depreciation deduction in 2010, assuming no IRC Section 179 election and no bonus depreciation?

    a. $1,000.

    b. $1,429.

    c. $2,000.

    d. $2,449.

Lesson 4: Employee Expenses

Introduction

This lesson discusses employee expenses, including deductible wages, reasonableness of compensation, fringe benefits, qualified moving-expense reimbursements, payroll taxes, employee benefit programs, and the work-opportunity credit.

Learning Objectives

Completion of this lesson will enable you to:

- Compute and properly deduct various employee-related expenses.

Wages and Payroll Taxes

Employee-related expenses are deductible by sole proprietors to the extent the expenses are ordinary and necessary. In this lesson, we will cover employee compensation, payroll taxes, fringe benefits, and common employee-related expenses.

Tests for Deductible Wages

Reasonable compensation paid for personal services rendered in connection with a trade or business is deductible. This statement may be broken down into three *musts*:

1. The compensation *must* be reasonable.
2. The compensation *must* be for services performed.
3. The compensation *must* be paid or incurred.

Reasonable Compensation

Reasonable compensation is that which would be paid for a particular service under similar circumstances. In determining the reasonableness of the compensation, the courts have outlined five factors to be considered:

1. The employee's role in the business
2. The employee's salary compared to salaries of similarly situated employees
3. The condition and character of the business
4. The employee's relationship to the business
5. The business' consistency of paying salaries to all its employees

Comment: Think about it. Is the sole proprietor's son, who provides janitorial services to the business, earning a salary that would normally be paid to highly trained staff? Why is the business having a hard time paying its vendors but no difficulty paying the owner's wife?

If a salary is determined to be excessive because the compensation is deemed unreasonable, then a deduction is still permissible for the reasonable portion of the compensation. Please note, however, that the total amount of the compensation is still considered income to the recipient even if it is not fully deductible by the employer.

Services Rendered

Compensation must be paid in exchange for services rendered. There must be a legal obligation for the services to be rendered and a legal obligation for the payment to be made.

Example 1: Gifts made to employees for the birth of a child would not be deductible as compensation, whereas gifts made to employees for holidays would be deductible because that is common business practice.

Actual Payment Required

Compensation must be actually paid. A cash-basis sole proprietorship will only be permitted to deduct compensation actually paid during the tax year. An accrual-basis sole proprietorship will be permitted to deduct compensation when an obligation to pay exists and when economic performance occurs.

Key Term: *Compensation* is remuneration that may be calculated as an annual salary or an hourly wage. It includes bonuses for services rendered as long as the bonus, when added to other compensation, does not exceed a reasonable amount. Compensation need not be in the form of cash. It may be paid in property. In this case, the amount of compensation is determined by the fair market value of the property exchanged for the service rendered.

Other forms of compensation include vacation allowances, sick pay, tips, overtime, awards, prizes, commissions, fringe benefits, and allowances paid under nonaccountable plans. It also includes loans made to an employee if the employer does not expect the employee to repay the loan.

Fringe Benefits

Compensation may also be in the form of discounts, "free" use of business property, meals, and lodging provided by the employer. These forms of compensation are called "fringe benefits." Fringe benefits, which are small or infrequent or would be too costly to account for, are considered *de minimis* benefits. Examples of these are holiday turkeys, use of a business copy machine, and coffee. *De minimis* fringes are not required to be included in compensation.

Other types of fringe benefits excludible from compensation include the following:

- Employee discounts no greater than 20% of the price of the goods
- No-additional-cost services
- Working-condition fringes

Moving Expenses

Qualified moving-expense reimbursements paid by an employer are deductible by the employer and excludible from the gross income of the employee if the expenses would be deductible if paid by the employee. These are amounts that would be deductible under IRC Sec. 217 if they were directly paid or incurred by the individual. Any amounts paid by the employer that would not be deductible by the individual are still deductible by the employer as compensation and includible by the employee in gross income.

As to the employee, deductible moving expenses include expenses incurred in moving household goods from the former residence to the new residence and traveling and lodging from the former residence to the new residence, but not meals. Of course, this assumes that the employee has met the 50-mile distance test and the 12-month employment requirement.

Payroll Taxes

Employers generally are required to withhold taxes from an employee's compensation. These taxes include federal, state, and local income taxes, social security and Medicare taxes, and in some states, state unemployment taxes. (Because each state is different, this course will only deal with federal tax withholdings.) It is mainly for this reason that an employer is required to have a nine-digit Employer Identification Number (EIN) assigned by the IRS. Each employer obtains an EIN by filing Form SS-4. Each employer should have only one EIN. Employers may also apply for an EIN online by visiting the IRS website at **www.irs.gov/smallbiz**.

Income taxes to be withheld are calculated using a variety of methods outlined in detail in IRS Pub. 15, "Circular E." The author does not feel it is necessary to examine each method. The point is that income taxes are withheld on wages subject to income tax withholding.

Each method of calculation serves to ensure that an employee has a sufficient amount of income tax withheld to satisfy his tax liability at the end of the tax year. The employee guides the employer in calculating the level of withholding by providing marital status and allowance information on a Form W-4 (Employee's Withholding Allowance Certificate). It is on this form that the employee may indicate additional withholding amounts or exemption from withholding.

Note: Income taxes withheld are not deductible by the employer because the employer deducts the gross wage before withholding.

Social security taxes are withheld on social security wages at a rate of 6.2%. The 2010 wage base is $106,800. Medicare taxes are withheld on Medicare wages at a rate of 1.45%. There is no wage base limit for Medicare taxes. The employer is required to withhold this tax on an unlimited amount of wage. The employer is responsible for matching social security taxes and Medicare taxes withheld (employer's portion). The employer is able to deduct the employer's portion on Schedule C or F.

2010 Law Change: The HIRE Act provides an employer payroll tax holiday for new employees. For wages paid for employment during the period from March 19, 2010 through December 31, 2010, the Old Age, Survivors, and Disability Insurance (OASDI) portion of the FICA tax on employers doesn't apply to wages paid to a qualified individual by a qualified employer. A qualified individual is an individual who:

1. Begins employment with a qualified employer any time during the period from February 4, 2010 through December 31, 2010.

2. Certifies that the individual hasn't been employed for more than 40 hours during the 60-day period ending on the date that employment begins with the qualified employer.
3. Isn't employed to replace another employee unless the other employee separated from employment voluntarily or for cause.
4. Isn't related to the qualified employer in a way that would disqualify him for the work opportunity credit under Section 51(i)(1).

The payroll tax holiday applies only to the 6.2% OASDI portion of the employer's tax. It doesn't apply to the 1.45% Medicare portion of the employer's tax or to any part of the employee's tax. It also doesn't apply to the self-employment tax paid by self-employed individuals.

2010 Law Change: The HIRE Act also provides a general business credit increase for retained workers. For tax years ending after March 18, 2010, for each of the taxpayer's retained workers, the Section 38 general business credit is increased by the lesser of:

1. $1,000; or
2. 6.2% of the wages paid to the retained worker during the 52-consecutive-week-period beginning on the date of hire.

A retained worker is any *qualified individual* for payroll tax holiday purposes (see definition above) who:

1. Was employed by the taxpayer on any date during the tax year.
2. Was so employed for at least 52 consecutive weeks.
3. Received wages during the last 26 weeks of the 52-week period that were at least 80% of the wages for the first 26 weeks of that period.

An employer is also responsible for remitting Federal Unemployment (FUTA) taxes. This tax is calculated and remitted quarterly. The FUTA rate is 6.2% of the first $7,000 paid to each employee during the tax year (6% basic rate and a 0.2% temporary surtax). The temporary surtax has been extended through June 2011 by the Worker, Homeownership, and Business Assistance Act of 2009. FUTA is not withheld from an employee's wage. The employer is able to deduct FUTA taxes remitted.

Federal income taxes withheld, social security taxes and Medicare taxes withheld, and the employer's matching portion are reported quarterly on Form 941 (Employer's Quarterly Federal Tax Return). The taxes are deposited on either a monthly or a semiweekly schedule with an authorized financial institution or a federal reserve bank. The employer is notified by the IRS as to whether she is a monthly or a semiweekly depositor. The deposits generally are made with Form 8109 (Federal Tax Deposit Coupon) unless the net tax liability for the quarter is less than $2,500 or payments are made using the accuracy of deposits (98% rule) provision. Employers with less than $2,500 of tax withheld for the monthly deposit period may mail the payment in with the quarterly return.

In a move to simplify payroll reporting requirements, the IRS developed Form 944 (Employer's Annual Federal Tax Return). This form is used by small business employers whose estimated annual employment tax liability is $1,000 or less. The IRS will notify small business employers in writing if they qualify for this new 944 program. The form is filed once a year and takes the place of the quarterly Form 941 filing. The IRS estimates this will affect approximately 950,000 small business employees.

The Electronic Federal Tax Payment System (EFTPS) program, which is sponsored by the U.S. Department of Treasury, permits taxpayers to pay federal tax payments electronically rather than with paper deposit coupons. All taxpayers may elect to remit deposits under EFTPS. Some taxpayers are required to use EFTPS.

Employers enroll in the EFTPS by completing Form 9779 and mailing it to a Treasury financial agent (e.g., Bank of America or First Chicago/Mercantile Services) at least 10 weeks before intending to use EFTPS. Employers not required to enroll may do so voluntarily; or employers may go to the EFTPS website at **www.eftps.gov/eftps/ www.eftps.gov** and enroll online to shorten the process to 15 business days.

If required to use EFTPS, then failure to use it will result in a penalty equal to 10% of the tax deposit. This penalty applies if a timely deposit is made using a paper coupon.

Taxpayers with aggregate federal tax deposits exceeding $200,000 during calendar year 2008 were required to use EFTPS beginning January 2010. The aggregate federal taxes include employment taxes and other federal taxes. Once required to use EFTPS, a taxpayer must continue to use the system even if aggregate federal tax deposits in a calendar year fall below $200,000.

An employer can qualify as a monthly depositor if the aggregate amount of deposits for the previous look-back period (12 months ended June 30) does not exceed $50,000. The monthly depositor must deposit taxes by the 15th day of the following month (Reg. Sec. 31.6302-1(b)(2)(i),(4)).

For those with deposits greater than $50,000 for the year, the employer is called a semiweekly depositor. Such employers must make a deposit within three to five banking days (depending on which day of the week is payday) of the date of the actual payment of the payroll (Reg. Sec. 31.6302-1(c)(2)(ii)).

For larger concerns, if on any day $100,000 of employment taxes accumulate, the taxes must be deposited the next banking day (Reg. Sec. 31.6302-1(c)(3)).

FUTA taxes are reported annually on the IRS-simplified Form 940. This redesigned form replaced both the old Form 940 and old Form 940-EZ. Deposits are made quarterly with Form 8109 if the employer has preprinted forms (Form 8109-B if the employer does not have an EIN) only if the liability for the quarter (in addition to the undeposited amount from any earlier quarter in the tax year) is in excess of $500. If the undeposited amount is less than $500, it is carried over to the next quarter, but not the next year.

Employee Benefit Programs

Employers may cut the costs associated with payrolls by providing alternate forms of deductible compensation. These are known as employee benefit programs:

- Fringe benefit programs (discussed earlier)
- Group-term life insurance
- Self-insuring disability plans
- Health and accident plans

- Dependent-care assistance plans
- Group legal service plans
- Cafeteria plans

A discussion of some of the more common employee benefits follows.

Group-term Life Insurance

The costs associated with group-term life insurance plans are generally deductible by the employer. This benefit cost is excludible by the employee up to the first $50,000 of coverage, the insurance proceeds to beneficiaries are nontaxable, and the cost of the coverage to the employer is less than the cost would be to the employee if the employee would attempt to purchase similar coverage individually. Employers must add the cost of group-term life insurance above the $50,000 limit to the employee’s W-2.

There are requirements that must be met in order to receive the preceding treatment:

- The policy must stipulate that coverage on the employee’s life be carried directly or indirectly by the employer.
- The policy must be provided as compensation for services rendered.
- The policy must be provided to all employees *or* classes of employees. The plan must be nondiscriminatory.

Generally, the group-term life insurance plan must have at least 10 full-time employee participants. A plan may have less than 10 full-time employee participants if it provides protection for the entire year and meets the following requirements:

- There is no requirement to provide the insurance for employees over 65 years old.
- The plan must be provided to all full-time employees.
- The amount of protection must be computed as a uniform percentage of salary or on the basis of coverage brackets where the lowest bracket is at least 10% of the coverage of the highest bracket.
- Evidence of insurability may be a factor that affects eligibility.

Dependent-care Assistance (Outside a Cafeteria Plan)

Employers may provide dependent-care assistance to their employees and deduct the associated costs. The employer may either reimburse employees directly for the dependent-care expenses, contract with a third party to provide the dependent care, or provide the dependent care on the premises. If dependent care is provided on the premises, the employer deducts costs such as depreciation, wages, repairs, and utilities.

Dependent-care expenses include domestic services related to a qualifying individual. They also include care for a dependent under the age of 13, a qualifying child or relative (IRC Sec. 152), or the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than one-half of such taxable year. The expenses are deductible by the employer and excludible by the non-highly-compensated employee up to the lesser of the amount of the earned income of the lower-earning spouse or $5,000 per year ($2,500 in case of married persons filing separate returns). The $5,000 income exclusion authorized by IRC Sec. 129(a) applies only to employer payments or reimbursements of expenses that qualify as dependent care assistance. If an employer reimburses an expense that does not qualify as dependent care assistance, the expense will be additional employee compensation subject to federal income tax withholding (FITW), social security and Medicare (FICA) taxes, and federal unemployment (FUTA) tax. Penalties may also be imposed.

Note: The Fostering Connections to Success and Increasing Adoptions Act of 2008 changed the definition of “qualifying child” for 2009 and subsequent years.

Note: Final regulations clarify which expenses may qualify as employment-related expenses, including nursery school, preschool, after-school care, day camp expenses, and related transportation costs. They address temporary absences and part-time work as it relates to dependent care benefits. There is also a special rule for divorced parents. The final regulations apply to tax years ending after August 14, 2007 (Reg. 1.21-1(I)).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (TRA 2001) provides a tax credit to employers who provide child-care facilities for their employees’ children. The credit is equal to 25% of qualified expenses for employee child-care and 10% of qualified expenses for child-care resource and referral services. The maximum credit is $150,000 per year and is available for taxable years beginning after December 31, 2001.

The qualified dependent-care assistance program (DCAP) must be detailed in a written plan. The plan must meet the following requirements.

1. The DCAP must be a separate written plan of the employer.
2. The DCAP must provide dependent care assistance exclusively to employees.
3. Eligibility for benefits must not discriminate in favor of highly compensated employees or their dependents.
4. Contributions or benefits provided by the DCAP must not discriminate in favor of highly compensated employees or their dependents.
5. Individuals who are shareholders or owners (or their spouses or dependents) owning more than 5% of the stock or of the capital or profits interest in the employer must not receive more than 25% of the amounts paid or incurred by the employer for dependent care assistance during the year.
6. The average benefits provided to non-highly compensated employees must be at least 55% of the average benefits provided to highly compensated employees.
7. The written plan must not require the DCAP to be funded.
8. Reasonable notice of the availability and terms of the program must be provided to eligible employees.
9. Each employee must be furnished, on or before January 31, a statement showing the amounts paid or expenses incurred by the employer in providing dependent care expenses to such employee during the previous calendar year.

However, if any plan would qualify as a dependent care assistance program except for the failure to meet these requirements, then, the plan will still treated as a dependent care assistance program for employees who are not "highly compensated."

Qualified Educational Assistance

The exclusion for expenses incurred by employers under IRC Sec. 127 for educational-assistance programs are fully deductible by the employer and excludible by the employee for amounts paid up to $5,250. The law excluded graduate-level courses beginning after June 30, 1996.

The first $5,250 of qualified educational assistance (including graduate courses) provided during the calendar year under a Section 127 program is exempt compensation for federal income tax (FIT), federal income tax withholding (FITW), social security and Medicare (FICA), and federal unemployment tax (FUTA) purposes.

If more than $5,250 of educational assistance is provided to an employee in a program year and the educational assistance is provided for courses that are job related, the cost of educational assistance in excess of the $5,250 income exclusion cap may qualify for tax-free treatment as a working condition fringe benefit. If the educational assistance is provided for courses that are not job related (i.e., do not qualify for working condition fringe benefit treatment), the proper treatment depends on whether the educational assistance is provided in the form of cash payments or in-kind educational assistance.

Health and Accident Plans

Premiums paid for health and accident plans are deductible by employers, are excludible by employees, and are not subject to federal income tax withholding, social security and Medicare tax withholding, and FUTA. Benefits received by employees under a plan are tax-free to the employee, deductible by the employer, and are not subject to federal income tax withholding, social security and Medicare tax withholding, and FUTA.

2010 Law Change: Effective March 30, 2010, the income exclusion for employer-provided coverage and reimbursements under accident or health plans is expanded to apply to a taxpayer's children who are under age 27 as of the end of the tax year, whether or not they qualify as dependents (IRC Sec. 105(b)). Likewise, the deduction for self-employed medical insurance coverage is expanded to include coverage for the taxpayer's children who are under age 27 as of the end of the year, whether or not they qualify as dependents (IRC Sec. 162(l)).

Cafeteria Plans

2010 Law Change: For tax years beginning after 2010, the Patient Protection and Affordable Care Act (Affordable Care Act) provides that eligible small employers may establish a simple cafeteria plan. A new simple cafeteria plan is available to eligible small employers (any employer with an average of 100 or fewer employees during either of the two preceding years). Under a safe harbor rule, a simple cafeteria plan and the benefits it provides are treated as meeting the nondiscrimination rules that apply to cafeteria plans if the plan satisfies certain minimum eligibility, participation and contribution requirements (IRC Sec. 125(j)).

Employee Meals and Lodging

Meals and Lodging Furnished by Employer. Meals and lodging may be provided to employees as long as this expense is an ordinary and necessary business expense. It must be noted, however, that only 50% of the cost of meals is deductible by the sole proprietor.

The costs of the meals and lodging are generally excluded from employees' incomes if the following three tests are met:

1. The meals and lodging must be provided on the employer's business premises.
2. The meals and lodging must be provided for the employer's convenience.
3. Employees must be required to accept the lodging as a condition of employment.

If employees have the option of accepting additional pay instead of the meals and lodging, then the value of the meals and lodging must be included in the employees' wages. If the value of meals and lodging is included in the employees' wages, then that amount would be subject to Medicare tax, social security (FICA) tax, and FUTA tax.

Work Clothes. Employers may deduct the cost of work clothes provided to employees. If the employees would be responsible for purchasing and deducting the work clothes, they would only be allowed a deduction if the purchase of the clothes was required as a condition of employment and the work clothes were not suitable for wear outside the workplace. Examples include lab coats, work shoes, and painters' jumpsuits. Costs associated with laundering and maintaining the uniforms may also be a deductible expense if the sole proprietor chooses to provide this benefit to his employees.

Small tools provided to employees are deductible and depreciable by sole proprietors as ordinary and necessary business expenses.

Accountable and Nonaccountable Plans

Most employers create an arrangement with their employees for reimbursing expenses. These plans are either accountable plans or nonaccountable plans.

Accountable plans require substantiation of business-related expenses to employers. This type of plan is beneficial to all parties concerned in that the employee is reimbursed for business expenses incurred and does not have to include the reimbursement in wages. Employers have the documentation on record in order to substantiate the business deduction on Schedules C and F.

Note: Because deductions for travel, meals, entertainment, and gifts are generally closely scrutinized in the event of an audit, it is in the employer's interest to require specific substantiation from employees. These requirements include receipts with notations as to the who, what, where, when, and why of the business relationship of the expense.

The IRS has provided for per diem allowances that may be considered to be paid as reimbursement to employees for away-from-home meals and lodging expenses.

Note: Incidental expenses include tips and laundry. They do not include taxi fares and telephone calls.

Self-employed individuals cannot use the per diem method. The IRS has authorized use of the federal M&IE rate as an authorized method; however, the taxpayer is still required to substantiate the time, place, and business purpose of the travel. In other words, the only item the taxpayer is relieved of substantiating is the *amount* of the meals and incidental expenses. A self-employed individual may not use per diem rates for lodging. Documentary evidence must substantiate lodging while traveling.

Under the per diem method, the amount of an employee's reimbursed, optional expenses is equal to the lower of the amount actually paid to the employee or the federal per diem rate for the locality of travel. If the M&IE allowance is used, then lodging costs must be substantiated. If the reimbursement exceeds the federal rate, the excess must be included in the employee's gross wage.

Note: The per diem method may be considered substantiation for an employee's reimbursed expenses only if the employer uses an *accountable plan* arrangement. The amount paid to the employee must be an amount that the employer believes the employee will incur for lodging and meals. The amount paid must either be according to a stated schedule (e.g., a flat rate per day) or the federal per diem rate. The federal rates are updated effective each October 1 to conform to the federal fiscal year.

The following are interesting items to note:

- A full day of travel is considered to be from 12:01 a.m. to midnight.
- The per diem amount must be prorated for partial days of travel based on six-hour segments of a day.
- The sole proprietor is still limited to 50% meals deduction.
- If, therefore, a $45 per diem M&IE allowance is used, the deductible amount is $22.50.

If the employer chooses to provide the employee with a per diem allowance for meals, under an *accountable plan*, the substantiation required from the employee only consists of the time, place, and business purpose of the travel.

Federal per diem rates are published by the IRS annually and generally apply for the year beginning on October 1 and ending on September 30. They are divided into continental United States (CONUS) rates and outside the continental United States (OCONUS) rates, and high-cost localities and low-cost localities.

Per diem rates are adjusted annually and become effective on October 1. You can find these rates on the Internet at **www.gsa.gov/perdiem**.

Nonaccountable plans are plans in which the employer provides the employee an allowance for business expenses expected to be incurred and the employee is not required to furnish any substantiation to the employer in support of the allowance. The employee is not required to return any amounts paid to him that exceed the actual amount paid. This type of allowance must generally be included in the employee's wage and then it is up to the employee to maintain records sufficient to support a deduction for any unreimbursed employee business expenses.

Note: Advances and allowances may be paid under an *accountable plan* and not included in the employee's wage as long as the employee is required to return any amounts in excess of the actual expenses incurred within a reasonable amount of time.

The Work Opportunity Credit

The Work Opportunity Credit (WOTC) is an elective credit that reduces the employer's wage deduction dollar for dollar. The credit is available to employers hiring individuals from one or more of twelve targeted groups. The credit equals 40% of the first $6,000 of qualified first-year wages (25% for employment of less than 400 hours). The $6,000 is increased to $10,000 for employees who are *long-term family assistance recipients* and $12,000 for certain veterans. Wages paid to qualified youth for summer employment are eligible for a $1,200 maximum credit (40% of the first $3,000 of wages). The WOTC is generally effective for individuals who begin work before September 1, 2011.

Members of targeted groups are defined as:

1. Qualified IV-A recipients (i.e., temporary assistance for needy families),
2. Qualified veterans,
3. Qualified ex-felons,
4. Designated community residents,
5. Vocational rehabilitation referrals,
6. Qualified summer youth employees,
7. Qualified food stamp recipients,
8. Qualified Supplemental Security Income (SSI) recipients,
9. Long-term family recipients,
10. Hurricane Katrina employees,
11. Unemployed veterans, and
12. Disconnected youth.

Note: Under the Katrina Emergency Tax Relief Act of 2005 (KETRA), a Hurricane Katrina employee has been treated as a member of a targeted group for purposes of the WOTC. A *Hurricane Katrina employee* is any individual who on August 28, 2005, had a principle residence in the core disaster area and who was hired during the two-year period beginning on August 28, 2005 and ending on August 27, 2007, for a position the principle place of employment of which is located in the core disaster area. The Emergency Economic Stabilization Act of 2008 changed the two-year period to a four-year period beginning August 28, 2005. A list of the declared disaster areas is in the Form 8850 instructions.

The WOTC is calculated differently for the various target groups. One specific treatment of interest to farmers is that an agricultural worker's wages that are subject to social security and Medicare taxes, up to $6,000 per year for that worker, are treated as unemployment insurance wages and qualify as wages for the work opportunity credit. This is true for the entire year if the worker performed agricultural labor during more than one-half of any pay period.

Limitations on the Credit. There are limits under IRC Sec. 51 on which wages can be considered for the credit. Also, the WOTC is one of the credits that comprise the Section 38 general business credit (GBC). However, beginning in 2007, the WOTC is a specified credit that, unlike most other credits, can be used to offset 100% of the alternative minimum tax (AMT).

Health Insurance Tax Credit for Small Employers

This credit was enacted by the Patient Protection and Affordable Care Act as modified by the Health Care and Education Reconciliation Act. For tax years beginning in 2010-2013, qualified small employers can take a credit for up to 35% of the lesser of (1) the amount they contribute to a qualified health arrangement for their employees or (2) the small business benchmark premium (to be determined on a state-by-state basis). Special rules apply to small tax-exempt employers, including a credit rate cap of 25% (IRC Sec. 45R).

A qualified small employer is generally an employer that:

- Employs 25 or fewer full-time equivalent (FTE) employees during its tax year. FTE employees are determined by dividing the total hours worked by all employees (up to 2,080 per employee) by 2,080 (rounded down to the next lowest whole number). Hours worked by seasonal workers are counted only if they work more than 120 days during the tax year.

- Pays average annual wages of less than $50,000 per FTE employee (to compute, divide total wages paid by the number of FTE employees, rounded down to the nearest $1,000).

- Has a qualified health insurance arrangement under which it pays at least 50% of the premiums (on a uniform basis) for all of its employees who enroll in the plan.

The employer’s deduction for premiums paid for employees is reduced by the small employer health insurance credit (IRC Sec. 280C(h)).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. LeeAnn started an applique business in her home. Over the years, the business took off and now two men are working for her, creating designs and sewing. LeeAnn grosses $500,000 a year. LeeAnn pays each of her employees $15,000 per year. LeeAnn's mother answers phones and takes orders. Sometimes, she plays the harmonica to entertain the other employees as they work. LeeAnn pays her mother $150,000 per year. Upon audit, LeeAnn's mother's salary would likely be:

    a. Allowed because LeeAnn can pay her mother whatever she wants.

    b. Partially disallowed because the salary was unreasonable for the services provided.

    c. Disallowed because the services performed are not necessary.

17. Jim sold zippers in Georgia. He learned through the trade grapevine that Joe, the best zipper salesman in central Pennsylvania, was coming out of retirement and would be looking for a sales position. Jim phoned Joe and offered to pay for Joe's entire move if he would consider coming to Georgia to work for Jim's Zuper Zippers. Joe jumped at the opportunity. Jim paid the following:

    - $5,500 directly to the moving company to move Joe's household items
    - $1,000 in travel expenses to search for a new home prior to the move
    - $1,000 in travel and lodging during the move
    - $3,000 in living expenses for the first 30 days after Joe moved into his new home

    How much in employee relocation expenses could Jim deduct on his Schedule C?

    a. $10,500.

    b. $7,500.

    c. $6,500.

    d. $0.

18. Ty owns and operates a lucrative clothing business. He has two employees, each of whom earns $30,000 per year. Which of the following is an **incorrect** statement?

    a. FUTA tax would only be imposed on the first $7,000 of each employee's wages.

    b. The FUTA rate is 6.2%.

    c. The social security rate is 6.2%.

    d. The Medicare wage base is $106,800.

19. Diane provides dependent care in the back room of her gift shop in Booger Holler, North Carolina, for the children of the 20 parents she employs. Which of the following statements is **not** accurate for a qualified dependent care assistance program?

    a. Diane need not notify eligible employees that this benefit is available.

    b. Diane must provide a written statement to the employees that discloses the amount of expenses incurred to provide the benefit.

    c. Diane may not discriminate in providing this benefit to employees.

    d. Not more than 25% of the amounts paid for dependent care may be paid for the care of Diane's children.

20. Erica provides meals and lodging on her farm for her farm manager, Jeb. Jeb's contract did not mention the provision of this fringe benefit, but Erica thought it would be a good idea to have Jeb living on her farm in case an emergency arose that required his attention. Jeb had another house in the city. Which of the following statements is accurate?

    a. Erica must include the value of the lodging in Jeb's wage.

    b. Erica must include the value of the meals and lodging in Jeb's wage.

    c. Erica must include the value of the meals in Jeb's wage, but not the value of the lodging.

    d. Erica need not include the value of the meals or lodging in Jeb's wage.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

16. LeeAnn started an applique business in her home. Over the years, the business took off and now two men are working for her, creating designs and sewing. LeeAnn grosses $500,000 a year. LeeAnn pays each of her employees $15,000 per year. LeeAnn's mother answers phones and takes orders. Sometimes, she plays the harmonica to entertain the other employees as they work. LeeAnn pays her mother $150,000 per year. Upon audit, LeeAnn's mother's salary would likely be: **(Page 53)**

    a. Allowed because LeeAnn can pay her mother whatever she wants. [This answer is incorrect. LeeAnn can pay her mother whatever she wants, but LeeAnn can only take a deduction for reasonable pay.]

    b. Partially disallowed because the salary was unreasonable for the services provided. [This answer is correct. LeeAnn's mother's salary is not reasonable for the services performed. Upon audit, the salary would be determined excessive since her function is apparently less technical than the lower paid services of the individuals designing and sewing for LeeAnn. A deduction is permissible for the reasonable portion of the compensation.]

    c. Disallowed because the services performed are not necessary. [This answer is incorrect. LeeAnn's mother answers the telephones and takes orders; both are necessary services.]

17. Jim sold zippers in Georgia. He learned through the trade grapevine that Joe, the best zipper salesman in central Pennsylvania, was coming out of retirement and would be looking for a sales position. Jim phoned Joe and offered to pay for Joe's entire move if he would consider coming to Georgia to work for Jim's Zuper Zippers. Joe jumped at the opportunity. Jim paid the following:

    - $5,500 directly to the moving company to move Joe's household items
    - $1,000 in travel expenses to search for a new home prior to the move
    - $1,000 in travel and lodging during the move
    - $3,000 in living expenses for the first 30 days after Joe moved into his new home

    How much in employee relocation expenses could Jim deduct on his Schedule C? **(Page 55)**

    a. $10,500. [This answer is correct. Even though Joe can only deduct expenses incurred to move his household items and expenses incurred for travel and lodging during the move, Jim may still deduct the expenses as relocation expenses or compensation.]

    b. $7,500. [This answer is incorrect. Although the living expenses would not be deductible by Joe, these expenses are still deductible by Jim as compensation on Schedule C and includible by Joe in gross income.]

c. $6,500. [This answer is incorrect. Any amounts paid by Jim that would not be deductible by Joe are still deductible by Jim as compensation and includible by Joe in gross income.]

d. $0. [This answer is incorrect. Qualified moving-expense reimbursements paid by an employer are deductible by the employer. The amounts paid by Jim that are not deductible by Joe are still deductible by Jim as compensation and includible by Joe in income.]

18. Ty owns and operates a lucrative clothing business. He has two employees, each of whom earns $30,000 per year. Which of the following is an **incorrect** statement? **(Page 55)**

a. FUTA tax would only be imposed on the first $7,000 of each employee's wages. [This answer is incorrect. The maximum amount of wages per person that is subject to FUTA is $7,000.]

b. The FUTA rate is 6.2%. [This answer is incorrect. The FUTA surtax of 6.2% was extended through June 2011 by the Worker, Homeownership, and Business Assistance Act of 2009.]

c. The social security rate is 6.2%. [This answer is incorrect. Social security taxes are withheld on social security wages at a rate of 6.2%.]

d. The Medicare wage base is $106,800. [This answer is correct. There is no wage base limit for Medicare taxes. The employer is required to withhold this tax on an unlimited amount of wages.]

19. Diane provides dependent care in the back room of her gift shop in Booger Holler, North Carolina, for the children of the 20 parents she employs. Which of the following statements is **not** accurate for a qualified dependent care assistance program? **(Page 59)**

a. Diane need not notify eligible employees that this benefit is available. [This answer is correct. The dependent-care assistance program must be detailed in a written plan. The plan must meet the following requirements: 1) It must not discriminate. 2) Not more than 25% of the amounts paid for dependent care may be provided to owners of the business. 3) A written statement must be provided to the employee by January 31 of each year. The statement must disclose the amount of expense incurred to provide the employee with benefits. 4) Eligible employees must be notified of the benefits available to them. 5) The average benefits provided to nonhighly compensated employees must be at least 55% of the benefits provided to highly compensated employees.]

b. Diane must provide a written statement to the employees that discloses the amount of expenses incurred to provide the benefit. [This answer is incorrect. Under a dependent-care assistance program, a written statement must be provided to the employees by January 31 of each year. The statement discloses the amount of expenses incurred to provide the employee with the benefit.]

c. Diane may not discriminate in providing this benefit to employees. [This answer is incorrect. Under a dependent-care assistance program, the plan must not discriminate. The benefit must be made available to all employees.]

d. Not more than 25% of the amounts paid for dependent care may be paid for the care of Diane's children. [This answer is incorrect. Under a dependent-care assistance program, no more than 25% of the amounts paid for dependent care may be provided to owners of the business.]

20. Erica provides meals and lodging on her farm for her farm manager, Jeb. Jeb's contract did not mention the provision of this fringe benefit, but Erica thought it would be a good idea to have Jeb living on her farm in case an emergency arose that required his attention. Jeb had another house in the city. Which of the following statements is accurate? **(Page 61)**

a. Erica must include the value of the lodging in Jeb's wage. [This answer is correct. Because Jeb is not required to accept lodging on Erica's farm as a condition of employment, the value of the lodging must be included in Jeb's wage.]

b. Erica must include the value of the meals and lodging in Jeb's wage. [This answer is incorrect. The meals are provided on the employer's business premises and for the employer's convenience. The costs would therefore be *excluded* from Jeb's wages.]

c. Erica must include the value of the meals in Jeb's wage, but not the value of the lodging. [This answer is incorrect. Since Erica provided Jeb's meals on the business premises, she need not include their value in Jeb's wage.]

d. Erica need not include the value of the meals or lodging in Jeb's wage. [This answer is incorrect. Because the meals are provided on the employer's business premises and for the employer's convenience, the value of meals is excluded from the employee's wages. The value of lodging may be included in an employee's wages under certain conditions.]

EXAMINATION FOR CPE CREDIT

Lesson 4

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

16. If a salary deducted on a sole proprietor's Schedule C is determined to be excessive:

    a. The employer will receive a refund of payroll taxes remitted on the disallowed portion of the salary.

    b. A deduction is still permissible for the reasonable portion of the salary.

    c. The deduction for the salary will be 100% disallowed.

    d. The employee who received the compensation may file an amended return based on the reasonable compensation.

17. Which of the following must be included as compensation to an employee?

    a. No-additional-cost service.

    b. Meals provided for the employer's convenience on the employer's business premises

    c. Employee discounts greater than 20% of the price of the goods.

    d. Working-condition fringe benefits.

18. Which of the following statements about tax withholdings is accurate?

    a. Medicare is not withheld from an employee's wages.

    b. Social security is withheld from an employee's wages.

    c. Income taxes withheld are deductible as taxes by the employer.

    d. FUTA tax is withheld from an employee's wages.

19. Which of the following statements regarding employee benefit programs is **not** accurate?

    a. Group-term life insurance plans must always have at least 10 full-time employee participants.

    b. Employers providing dependent-care assistance may reimburse employees directly for their dependent-care expenses.

    c. *De minimis* fringe benefits are not required to be included in an employee's gross income.

    d. Premiums paid by an employer for health and accident plans on behalf of an employee are excludible from the employee's wage.

20. Which of the twelve targeted groups authorized under the Work Opportunity Tax Credit is eligible to apply $12,000 of first-year wages in the formula to calculate the credit?

    a. Long-term family recipients.

    b. Qualified summer youth employees.

    c. Certain veterans.

    d. Disconnected youth.

Lesson 5: Travel and Entertainment

Introduction

This lesson discusses travel and entertainment expenses, including requirements, rules concerning allocation, transportation costs, business travel outside the United States for longer than a week, travel on water transportation, conventions on cruise ships, costs of meals, circumstances for deductible entertainment expenses, and substantiation requirements for per diem expenses.

Learning Objectives

Completion of this lesson will enable you to:

- Determine business expenses that are allowable and those that may be disallowed.

Travel, Meals and Entertainment, and Automobile Expenses

Sole proprietors are permitted a deduction for travel away from home as long as the expenses incurred are ordinary, reasonable, and necessary business expenses. These expenses include meals, lodging, and transportation; however, they do not include local transportation expenses that are covered under separate requirements. "Away from home" has been interpreted to mean that the taxpayer must stop for sleep or the travel must be overnight travel. Working a long distance from home but returning home the same day does *not* constitute business travel.

Example 1: An individual may travel from his business site to attend two meetings, have lunch between meetings, and then return home. The meal would not be considered a business meal because the taxpayer was not away from home long enough to require sleep or rest. The meal was just like any meal required by any working individual.

An important issue is the identification of the taxpayer's tax home. Unfortunately, this identification is not a simple one due to the conflicting interpretations by the IRS and circuit courts. The tax home has been identified as the taxpayer's business site (the principal place of business) *and* the taxpayer's personal residence. Some courts have determined that the taxpayer's tax home may be either the taxpayer's business site or the taxpayer's personal residence, depending on the facts and circumstances of the case. Whatever the "tax home" is determined to be, it includes the entire metropolitan area. Consequently, traveling within one's city does not constitute leaving one's tax home.

Some sole proprietors will mix their business trips with trips for pleasure. An example would be an advertising consultant who flies to Acapulco to review the city for a promotional ad for the bureau of tourism. While in Acapulco, the consultant stays a few extra days to lounge by the pool and "experience" the city. This scenario was recognized by the IRS as an area for abuse and it responded by requiring that the trip must be primarily related to the conduct of business.

If a trip is primarily related to personal reasons, then the expenses incurred on the trip would be nondeductible. Consequently, it is important for the taxpayer to document the purpose of the trip, the time spent conducting business activities, and the time spent in pursuit of personal pleasures.

What if a taxpayer travels to a city on business but brings along her spouse? The IRC became very specific about this situation. Travel expenses incurred for a spouse, dependent, or any other individual traveling with a taxpayer are not deductible unless three conditions are met:

1. The person is accompanying the taxpayer for a bona fide business purpose.
2. The person is an employee of the taxpayer.
3. The expense would be deductible by the accompanying person.

See also “Foreign travel and luxury water travel” later in this discussion.

Transportation. Transportation costs are deductible by a sole proprietor as long as the costs are ordinary, necessary, and reasonable expenses incurred in a trade or business. These costs include airfare, bus fare, train fare, cab fare, vehicle expenses, parking fees, and tolls. They are distinguished from travel expenses in that they are incurred by taxpayers who are not away from home.

Rev. Rul. 99-7 redefines “temporary workplace” for purposes of determining the deductibility of transportation between home and a work location outside the home. The revenue ruling states that a workplace is temporary if employment at that location is expected to last, and does last, for one year or less. A workplace is not temporary if employment at that location is expected to last for more than one year. This is the case whether or not the work actually exceeds one year. If the expectation is that employment at a location will last one year or less and then that expectation changes to more than one year, then that workplace is temporary until the date the expectation changes.

What does this mean to a self-employed taxpayer?

Business transportation is:

- Transportation between a person’s residence and a temporary workplace outside the metro area where the person lives and normally works and
- Transportation between a person’s residence and temporary workplace inside the metro area where the person lives and normally works, if:
  - The person has one or more regular work locations away from his residence, and
  - The person’s residence is the person’s principal place of business.

Foreign Travel and Luxury Water Travel

In most circumstances, a taxpayer is required to separate business travel from personal travel. An allocation is then made between the business portion of the travel and the personal portion. Under IRC Sec. 274(c)(2), if the travel is less than one week or the personal portion of the trip is less than 25%, no allocation between business and personal expenses is required. When the trip is outside the United States and is longer than a week, *or* 25% or more of the time away from home on foreign travel is for personal reasons, then a deduction for travel expenses will be limited to the business portion of the trip.

Note: A week is seven consecutive days, including the day of return but not the day of departure.

If the travel to a foreign country is for personal purposes and the taxpayer happens to conduct some business in the foreign country, the taxpayer will still not be permitted to allocate any of the travel expenses to her Schedule C and F. Any other business expenses incurred while in the foreign country would be deductible, but not travel expenses.

Expenses incurred for travel on water transportation (e.g., cruise ship, ocean liner) are deductible but limited to a daily amount equal to twice the highest per diem travel amount allowable to employees of the federal government while on official business away from home within the United States. This rule does not apply to conventions held on a cruise ship.

Conventions held on cruise ships are subject to specific deductibility rules. The deduction is limited to $2,000 per person per year and applies only if:

- The cruise ports are in the United States,
- The convention relates to the taxpayer’s trade or business, and
- The taxpayer reports information specified under IRC Sec. 274(h)(5) on the tax return.

Meals

Meals are deductible business expenses if:

- They are incurred during business discussions with clients and associates,
- They are incurred while on business travel overnight, away from home, and
- They are not extravagant.

IRC Sec. 274 indicates that the sole proprietor must be able to show that the expenses incurred for a meal are:

- Directly related to the active conduct of the taxpayer’s business and
- Preceded or followed by a bona fide business discussion associated with the conduct of the taxpayer’s business.

Note: The deduction for a taxpayer’s expense for his meal while on business travel away from home is not subject to these requirements.

The taxpayer must be able to show that there is a business purpose for the meal expense and there is a reasonable expectation for increased business benefits as a result of incurring the expense.

There are two restrictions that apply to the deductibility of a business meal or business entertainment:

1. The expenses are not deductible if the taxpayer *or an agent of the taxpayer* is not present.
2. The expenses are not deductible to the extent that they are lavish or extravagant.

Example 2: If an attorney representing a taxpayer goes to lunch with a potential client of the taxpayer, the taxpayer is considered to be present at the meal and can deduct the expenses.

Example 3: The taxpayer travels on business and treats himself to a $100 meal at a nice restaurant in Mansfield, Ohio. It is determined that $64 of the expense is considered lavish. The taxpayer would receive a deduction for $36, subject to the 50% disallowance.

The 50% Disallowance Rule

The taxpayer must reduce the deductible amount of a meal or entertainment expense incurred by 50%. This rule applies to meals and entertainment expenses incurred:

- While attending meetings, conventions, receptions, and luncheons,
- While traveling away from home,
- While entertaining clients or associates, or
- In providing meals to employees on the employer's premises for the convenience of the employer.

Note: Expenses related to the meal and entertainment are included as meal and entertainment expenses *before* applying the 50% rule. Examples would be tips at the restaurant and room rental for entertainment.

Exception: As with almost everything in the IRC, there are exceptions to the 50% rule. These are, as they apply to Schedules C and F, as follows:

- Expense for a ticket package for a sporting event:
  - Organized to benefit a tax-exempt organization, to which the net proceeds go; and
  - Worked by volunteers.
- The food and beverage expenses that would not be included in an employee's gross income due to the *de minimis* rule.
- The cost of meals that are included in an employee's gross income.
- Expenses related to holiday parties and summer picnics for all employees.
- Expenses related to providing food in exchange for adequate consideration.

There are other exceptions to the rule; however, those instances are not likely to be encountered by a Schedule C and F filer.

Note: The portion of a business meal or entertainment expense reimbursement that is non-deductible under the 50% disallowance rule is excluded from the employee's income and not subject to withholding and payment of employment taxes. Thus, for example, if an employer reimburses an employee $200 for otherwise deductible meals, the full amount is excluded from the employee's income and exempt from withholding and payment of employment taxes even though the employer's deduction is limited to $100 under the 50% disallowance rule.

Substantiation Requirements

There are very strict substantiation requirements for expenses related to travel, meals, and entertainment. This is probably the one area that is most likely to be examined in the event that a taxpayer is audited because it is an area that has the most probability of being abused. The taxpayer should be able to substantiate the business purpose, time, date, place, and business relationship to the individuals who are entertained.

There is some good news. Beginning with expenses incurred after September 30, 1995, the IRS increased the threshold for *substantiating* travel and entertainment expenses from $25 to $75 (Notice 95-50). Hotel or lodging expenses *must* be substantiated by hotel bills no matter what the amount.

Although the IRS is no longer requiring documentation of these expenses if under $75, it is still requiring the taxpayer to establish the amount of the expense, the business purpose of the expense, the time and place of the expense, and the business relationship to the taxpayer of the individuals who are entertained; the easiest way to do this is to provide a receipt with the proper notations on the back even though it is not a requirement.

Note: The $75 applies to each expenditure. Therefore, the meal is one expenditure. The entertainment following the meal is a separate expenditure.

There have been cases where a taxpayer did not have receipts to support travel and entertainment expenses of $75 or more and the IRS disallowed the *entire* deduction even though there was a timely log entry that would have supported a less-than-$75 deduction.

The best method of substantiating a business expense is to maintain some type of log or diary of the expense. The entries into the diary should be made at the time the expense is incurred. The diary entries need not be extraordinarily detailed if receipts are also maintained that support the diary entry. The taxpayer may merely indicate the travel destination and business purpose of travel to another city in the diary and keep all necessary receipts in an envelope.

Transportation receipts in excess of $75 need not be maintained as long as the costs may be verified by fare schedules and/or mileage rates. Generally, a canceled check only qualifies as documentary evidence if it is attached to a bill that provides the required information. It is necessary to keep hotel receipts because business lodging may be 100% deductible whereas meals included on the hotel bill are only 50% deductible.

Note: The Cohan Rule, which permits individuals to estimate the amount of an expense when records do not exist, does not apply in the case of travel and entertainment expenses. If the taxpayer cannot provide the substantiation because it was destroyed by reasons beyond her control (e.g., fire), the courts *have* allowed the taxpayer to reconstruct the expenditures in a *reasonable manner.*

Entertainment Expenses

Entertainment is any activity that is engaged in for the amusement of the individual involved.

The costs of entertainment are deductible if the costs are:

- Directly related to a taxpayer's business and
- Associated with the active conduct of the taxpayer's business and directly preceded by or followed by a substantial business discussion.

Entertainment costs must be ordinary, necessary, and incurred in the pursuit of the business. Only 50% of entertainment costs paid by the sole proprietor are deductible on Schedule C. The taxpayer must document the cost of the entertainment, the time and place it was incurred, the business relationship to the taxpayer, and the business purpose. These requirements are necessary because there is a degree of personal pleasure involved and a greater chance that the taxpayer may disguise a personal expense as a business expense.

An entertainment expense is considered to be directly related to a taxpayer's business if it occurs during a business discussion and is conducted in a business setting. An active business discussion includes the following:

- There is a specific expectation that the taxpayer will derive a business benefit (greater than just goodwill) from engaging in the entertainment.
- The taxpayer (or his representative) is present and initiates the conduct of business.
- The conduct of business is more important than the entertainment itself.
- The expenses of nonbusiness guests may not be deducted.

Entertainment that does not qualify under the directly related alternative of the business connection requirement may be deductible under the "associated with" tests. The taxpayer may show that there is a business connection for the entertainment expense if the taxpayer can prove the following:

- The entertainment was associated with the active conduct of the taxpayer's trade or business.
- A substantial business discussion preceded or followed the entertainment.

Note: Under these tests, there is no requirement for the taxpayer to spend more time on business than entertainment.

Entertainment facilities are any real or personal property owned, rented, or used by the taxpayer for entertainment. These facilities include swimming pools, boats, tennis courts, bowling alleys, cars, and planes. All of the operating expenses of an entertainment facility are disallowed. These expenses include maintenance and depreciation. In addition, losses on the disposition of the facility are disallowed for the same reasons. Interest and taxes on the facilities, which would be deductible without a business purpose, are not affected by the entertainment facility rules.

Note: Club dues are not permitted as a deductible business expense. These include any amounts paid for membership in a club organized for pleasure or other social activity.

Box seats and season tickets to sporting events and theaters are not considered entertainment facilities. The use of the tickets to each event is looked at to determine if the entertainment activity meets all the requirements of deductibility. It should be noted that the cost of the ticket in excess of the face value of the ticket is not deductible *unless* the event is a charitable sports event as discussed earlier. Also, the cost of a skybox or luxury box is deductible to the extent of the cost of a regular box seat.

Paying a Travel or Mileage Allowance and Substantiation

Employers may opt to pay employees a per diem or daily travel allowance or an automobile mileage allowance regardless of how much employees actually spend. Travel and mileage allowance plans provide the following important advantages over plans reimbursing an employee's actual expenses:

1. **Reduced Substantiation.** Allowance plans eliminate the need for employees to gather documentation and receipts supporting the actual amount spent while on company business. The employer simply reimburses employees at a standard rate without regard to the amount actually spent by the employee. However, employees must still substantiate the other elements of the expense (i.e., dates, location, miles, and business purpose) before the allowance can be treated as made under an accountable plan.

2. **Reduced Employee Compensation and Reporting.** A travel or mileage allowance not exceeding the federal rate is not employee compensation and is exempt from income tax withholding and employment taxes.

3. **Retain Excess Advances.** Employees may retain excess advances (keep the change) for days of travel or business miles substantiated without disqualifying the accountable nature of the allowance plan. In contrast, plans that reimburse actual expenses must require employees to return all excess advances within a reasonable period.

Travel allowance plans are usually structured as one of the following:

1. **Full-allowance Plans.** These plans pay a per diem allowance that is intended to cover lodging, meals, and incidental expenses incurred by employees while in travel status.

2. **Meal and Incidental Expense (M&IE) Plans.** These plans pay a per diem allowance that is intended to cover only meal and incidental expenses incurred by employees while in travel status.

Note: A travel or mileage allowance must be established under an accountable plan (see Lesson 4).

Substantiation Methods. The IRS provides simplified methods of substantiation to use with travel or mileage allowances. Under these simplified methods, known as *deemed substantiation methods*, employees are deemed to have substantiated an amount of expenses equal to the lesser of (1) the actual allowance paid or (2) the amount specified by the IRS. Thus, if the employer's allowance does not exceed the IRS allowance, the amount of the employer's allowance is treated as made under an accountable plan, excluded from the employee's gross income, and exempt from income tax withholding and employment taxes.

If the employer pays an allowance that, in total, exceeds the federal rate, the portion of the allowance not exceeding the federal rate is treated as made under an accountable plan and is deducted by the employer as business expense. (The meals and entertainment portion must be reduced by 50%.) Any portion of the allowance exceeding the federal rate is treated as made under a nonaccountable plan so it is deducted by the employer as compensation. (The 50% disallowance rule is not applicable to the excess allowance since this is employee compensation, not business expense.)

Deemed Substantiation Methods Apply for Mileage Allowance Plans. The following are deemed substantiation methods for mileage allowances (Rev. Proc. 2008-72):

1. Business standard mileage rate.

2. Fixed and variable rate allowance (FAVR).

The business standard mileage rate is the most commonly used method of substantiating an employer's mileage allowance. The IRS typically adjusts this rate prospectively on an annual basis. The business standard mileage rate covers fixed and operating costs of the automobile, including depreciation, lease and rental fees, repairs, tires, gasoline (including taxes), oil, insurance, and registration fees. Parking fees and tolls are not included in the business standard mileage rate.

Deemed Substantiation Methods for Travel Allowance Plans. There are three deemed substantiation methods for travel within the continental United States (CONUS).

1. **Per Diem Method**. The federal government establishes per diem (daily) rates for key cities and localities within the continental United States (CONUS) and then uses these rates to pay a per diem allowance to its employees. Localities within the CONUS are usually revised and published on an annual basis.

2. **High/Low Method**. The IRS classifies certain key cities or localities within the CONUS that have a federal per diem rate exceeding a certain amount for all or part of the calendar year as high-cost localities. All other cities or localities within the CONUS are, by default, classified as low-cost localities.

3. **Meals-only Method**. If the employer pays an employee under a M&IE allowance plan, a special meals-only substantiation method must be used as the benchmark rate against which to compare the company's M&IE allowance. This meals-only substantiation method is based on the M&IE portion of the federal per diem rate. The meals-only substantiation method is specifically designed for when an employee does not incur lodging expenses while in travel status.

Substantiation for Travel Outside the Continental U.S. (OCONUS). Special deemed substantiation method rules apply for employee travel to OCONUS locations. The per diem substantiation method and M&IE-only substantiation methods discussed previously may continue to be used. However, there is no high/low substantiation method for OCONUS travel. Employers paying a per diem allowance for foreign travel must use the per diem substantiation method or meals-only substantiation method (if appropriate) to establish a federal rate for substantiation purposes.

Schedule C and F Filers. An employee related to the employer may use the meals-only per diem allowance method, including the special rules for employees in the transportation industry to substantiate meals and incidental expenses. **However, a related employee (including a sole proprietor and family) may not use the per diem allowance or the high/low substantiation methods to substantiate his or her own expenses.** Instead, the related person must substantiate his or her expenses under the per diem allowance using the normal documentation and written record rules (i.e., actual receipts).

Example 4: Fred operates two restaurants as the sole owner of the LLC that is treated as a disregarded entity for federal income taxes. Fred and his salespersons incur travel costs. The LLC has a per diem allowance plan that pays a travel allowance equal to the federal rate under a deemed substantiation method. All per diem allowance payments to salespersons are deemed substantiated with respect to the amount of the expense and qualify as made under an accountable plan if the other accountable plan requirements are met. However, Fred is considered related to the business because he owns it. Fred must substantiate the amount of the expenses he incurs for travel using the normal rules (actual receipts) for his per diem advances to qualify as made under an accountable plan.

Note: Each year, the IRS issues a revenue procedure explaining the special rules governing travel allowance plans (Rev. Proc. 2009-47 provides the most recent guidance). A separate revenue procedure is issued explaining the rules governing mileage allowance plans (e.g., for 2008, Rev. Proc. 2008-72). See also IRS Pub. 1542 (electronic only) at **www.irs.gov**.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Nancy, an advertising consultant, travels to Baltimore for five days and four nights in order to enjoy the shops at Inner Harbor and dine at her favorite restaurants in Little Italy. During dinner one night at Luchessi's, the restaurant's owner approaches her with a business proposition that she handle the advertising for his restaurant. Nancy arranges to spend two hours with him over lunch the next day to discuss his advertising needs. Nancy spends $200 for airfare to Baltimore, $150 per night at the hotel, $200 for meals, and $10 cab fare to get to Luchessi's for the meeting. Mr. Luchessi provides her with a complimentary lunch on the day they meet to discuss business. What amount may Nancy deduct on her Schedule C in relation to this trip?

    a. $1,010.

    b. $720.

    c. $10.

    d. $0.

22. Dr. Steve's office is in his home. Every day, Dr. Steve sees patients at his home office until 11 a.m. Then he drives five miles to the local hospital to see inpatients until 1 p.m. Then he drives 10 miles to see patients at his satellite office until 5 p.m. Then he drives 15 miles back to his home office to see patients until 8 p.m. How much is Dr. Steve's daily deduction for transportation costs assuming $.50 per mile as the SMR used?

    a. $15.00.

    b. $12.50.

    c. $10.00.

    d. $5.00.

23. Which of the following statements about travel expenses is accurate?

    a. Under IRC Sec. 274(c)(2), if travel is less than one month and the personal portion of the trip is less than 26%, no allocation between business and personal expenses is required.

    b. If a self-employed individual travels to a foreign country and 30% of the time away from home is for personal purposes, then a deduction for travel expenses will be limited to the business portion of the trip.

    c. If a self-employed individual travels to a foreign country on a personal trip and happens to conduct some business while there, the self-employed individual may not allocate a percentage of the travel expenses to her Schedule C.

24. Bryan, a psychologist, travels to Chicago to consult on a particularly interesting case of reactive depression. From this scenario, which of the following statements is accurate?

    a. Bryan should take this opportunity to dine at Chicago's finest, most expensive restaurants because his meals will be 100% deductible as business meals.

    b. Bryan would not be required to keep a receipt for a $68.75 meal with the Chicago psychologist with whom he's consulting.

    c. If Bryan spends one day in Chicago on business and seven more days in Chicago to sightsee, he may still have a valid deduction for 100% of the airfare because he would have incurred that expense anyway.

25. Kathy, a retinal specialist, held a cocktail party in the reception area of her office. Kathy's guests were strictly area optometrists and ophthalmologists. Kathy's staff was on hand to escort the professionals through her set of offices so that they could see her equipment and in-house surgical suite. Which of the following statements is accurate?

    a. Kathy's entertainment occurred in a clear business setting as well as promoted Kathy's practice.

    b. It is apparent that Kathy's significant motive was to make new friends in the eye-care community and her expenses would not be deductible as entertainment expenses.

    c. Because the optometrists and ophthalmologists viewed the party as *free food* and only 50% of them really discussed business with Kathy, she would not be able to deduct the cost of the party as an entertainment expense.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

21. Nancy, an advertising consultant, travels to Baltimore for five days and four nights in order to enjoy the shops at Inner Harbor and dine at her favorite restaurants in Little Italy. During dinner one night at Luchessi's, the restaurant's owner approaches her with a business proposition that she handle the advertising for his restaurant. Nancy arranges to spend two hours with him over lunch the next day to discuss his advertising needs. Nancy spends $200 for airfare to Baltimore, $150 per night at the hotel, $200 for meals, and $10 cab fare to get to Luchessi's for the meeting. Mr. Luchessi provides her with a complimentary lunch on the day they meet to discuss business. What amount may Nancy deduct on her Schedule C in relation to this trip? **(Page 73)**

    a. $1,010. [This answer is incorrect. Because the trip was primarily for pleasure, not all of the expenses incurred are deductible on Schedule C.]

    b. $720. [This answer is incorrect. Nancy took this trip for personal reasons. Only those expenses directly related to business may be deductible.]

    c. $10. [This answer is correct. Nancy's deduction for business-related expenses would be limited to the $10 cab fare. Nancy's trip was primarily for personal purposes. Although Nancy engaged in business while on the trip, no portion of her airfare, lodging, or meals may be allocated to her Schedule C.]

    d. $0. [This answer is incorrect. Nancy did incur some business expenses while she was in Baltimore.]

22. Dr. Steve's office is in his home. Every day, Dr. Steve sees patients at his home office until 11 a.m. Then he drives five miles to the local hospital to see inpatients until 1 p.m. Then he drives 10 miles to see patients at his satellite office until 5 p.m. Then he drives 15 miles back to his home office to see patients until 8 p.m. How much is Dr. Steve's daily deduction for transportation costs assuming $.50 per mile as the SMR used? **(Page 74)**

    a. $15.00. [This answer is correct. Dr. Steve would calculate his deduction for transportation costs as follows: (5 + 10 + 15) × $.50 = $15.00. Because Dr. Steve's main office is in his home, all business transportation costs would be deductible. None would be considered as commuting costs.]

    b. $12.50. [This answer is incorrect. The transportation costs relating to the 10 miles driven to the satellite office and the 15 miles driven from the satellite office to the home office are deductible. However, this is not the only mileage that is deductible.]

    c. $10.00. [This answer is incorrect. The transportation costs relating to the five miles driven to the local hospital and the 15 miles driven from his satellite office to his home office are deductible. However, this is not the only mileage that is deductible.]

    d. $5.00. [This answer is incorrect. The transportation costs relating to the 10 miles driven to his satellite office are deductible. However, this is not the only mileage that is deductible.]

23. Which of the following statements about travel expenses is accurate? **(Page 75)**

    a. Under IRC Sec. 274(c)(2), if travel is less than one month and the personal portion of the trip is less than 26%, no allocation between business and personal expenses is required. [This answer is incorrect. Under IRC Sec. 274(c)(2), if travel is less than one week or the personal portion of the trip is less than 25%, no allocation between business and personal expenses is required.]

    b. If a self-employed individual travels to a foreign country and 30% of the time away from home is for personal purposes, then a deduction for travel expenses will be limited to the business portion of the trip. [This answer is incorrect. If a self-employed individual travels to a foreign country and less than 25% of the time away from home is for personal purposes, travel expenses need not be allocated between personal and business purposes.]

    c. If a self-employed individual travels to a foreign country on a personal trip and happens to conduct some business while there, the self-employed individual may not allocate a percentage of the travel expenses to her Schedule C. [This answer is correct. If the travel to a foreign country is for personal reasons, the taxpayer will not be able to allocate any of the travel expenses to her Schedule C because the primary purpose of the trip was personal. A deduction for travel expense is not allowed when minor business activities occur on a personal trip. Any other business expenses incurred while in the foreign country would be deductible, but not travel expenses.]

24. Bryan, a psychologist, travels to Chicago to consult on a particularly interesting case of reactive depression. From this scenario, which of the following statements is accurate? **(Page 77)**

    a. Bryan should take this opportunity to dine at Chicago's finest, most expensive restaurants because his meals will be 100% deductible as business meals. [This answer is incorrect. The cost of a meal determined to be *lavish* or *extravagant* is not fully deductible, even before applying the disallowance rule.]

    b. Bryan would not be required to keep a receipt for a $68.75 meal with the Chicago psychologist with whom he's consulting. [This answer is correct. Beginning with expenses incurred after September 30, 1995, the IRS increased the threshold for *substantiating* travel and entertainment expenses from $25 to $75 (Notice 95-50).]

    c. If Bryan spends one day in Chicago on business and seven more days in Chicago to sightsee, he may still have a valid deduction for 100% of the airfare because he would have incurred that expense anyway. [This answer is incorrect. It is not apparent from this situation that Bryan went to Chicago for a business purpose. It appears he went to Chicago to do some sightseeing and happened to conduct some business while he was there. None of his airfare would be considered to be deductible as business travel.]

25. Kathy, a retinal specialist, held a cocktail party in the reception area of her office. Kathy's guests were strictly area optometrists and ophthalmologists. Kathy's staff was on hand to escort the professionals through her set of offices so that they could see her equipment and in-house surgical suite. Which of the following statements is accurate? **(Page 78)**

   a. Kathy's entertainment occurred in a clear business setting as well as promoted Kathy's practice. [This answer is correct. Kathy's entertainment did occur in a clear business setting and did promote Kathy's practice. An active business discussion includes the following: 1) There is a specific expectation that the taxpayer will derive a business benefit (greater than just goodwill) from engaging in the entertainment. 2) The taxpayer (or her representative) is present and initiates the conduct of business. 3) The conduct of business is more important than the entertainment itself. 4) The expenses of nonbusiness guests may not be deducted.]

   b. It is apparent that Kathy's significant motive was to make new friends in the eye-care community and her expenses would not be deductible as entertainment expenses. [This answer is incorrect. Kathy's motive was the promotion of her professional practice. She will derive a business benefit from this party.]

   c. Because the optometrists and ophthalmologists viewed the party as *free food* and only 50% of them really discussed business with Kathy, she would not be able to deduct the cost of the party as an entertainment expense. [This answer is incorrect. The fact that Kathy fed her guests well has no bearing on the deductibility of the expenses related to this party.]

EXAMINATION FOR CPE CREDIT

Lesson 5

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

21. Jodi is a head hunter. She specializes in placing brilliant CPAs with accounting departments in major companies. Jodi's husband, Marc, works for her. He answers phones and brings her lunch. Jodi gets a lead on a CPA who would be perfect for the sales tax position at a huge manufacturing plant in town. She travels to Flowery Branch, Georgia, to interview the CPA. Marc accompanies her on the trip because she does not like to leave him at home alone. The following expenses are incurred for Marc:

    - Airfare, $350
    - Meals, $350
    - Sightseeing tour, $100

    How much may Jodi deduct for Marc-related expenses on Schedule C?

    a. $0.

    b. $175.

    c. $350.

    d. $800.

22. A self-employed taxpayer must be able to show, relative to the deduction for meals while on a business trip away from home, that:

    a. The expense for the meal is directly related to the active conduct of the business.

    b. The meal was preceded or followed by a bona fide business discussion.

    c. The expense was incurred during a business discussion with a client.

    d. Do not select this answer choice.

23. The taxpayer must reduce the deductible amount of a meal or entertainment expense incurred by 50%. This rule does not apply to meal and entertainment expenses incurred:

    a. While attending meetings, conventions, receptions, and luncheons.

    b. While traveling away from home.

    c. While entertaining clients or associates.

    d. For a summer picnic for all employees.

24. A self-employed individual must maintain adequate records in order to substantiate travel and entertainment expenses. The self-employed individual need not document which of the following:

    a. Reason for the expense.

    b. Time the expense was incurred.

    c. Place the expense was incurred.

    d. Amount of the non-lodging expense if less than $75.

25. Regarding the per diem method of substantiating business expenses:

    a. The business purpose, time, and place associated with business travel and meals must be substantiated by other evidence.

    b. Self-employed individuals may use the lodging and M&IE rates.

    c. "Full-allowance" plans pay a per diem allowance that is intended to cover only lodging and meals. Incidental expenses are not covered by this allowance.

    d. An employee who is a member of the sole proprietor's family may use the per diem allowance or the high/low substantiation methods to substantiate his or her own expenses.

Lesson 6: Common Expenses

Introduction

This lesson discusses the deductibility of common expenses including advertising, bad debts, gifts, insurance, Archer medical savings accounts, health savings accounts, requirements regarding deductions for education expenses, and legal and professional fees that must first be capitalized before being deducted.

Learning Objectives

Completion of this lesson will enable you to:

- Determine the deductibility of various expenses common to most small business.

Advertising and Promotional Costs

There are several common deductible expenses available to sole proprietors. Disbursements for advertising costs are generally deductible as long as they are reasonable, ordinary, and necessary. They must be related to the taxpayer's business activity and incurred in order to increase sales. In some cases, the advertising and promotional costs may be required to be capitalized, although that is not the norm.

Normally, the expenses are deductible in the year in which they are paid or accrued, depending on the taxpayer's method of accounting for tax purposes. This treatment applies even if the benefits of the advertising extend over a period in excess of one year. Examples of generally deductible advertising expenses include free samples of an existing product line, refreshments, conventional print advertisement, and sports T-shirts imprinted with the taxpayer's business logo.

If the advertising expenses are incurred to acquire property with a useful life in excess of one year, then the amount must be capitalized and depreciated over the useful life of the asset. An example would be a display booth used at shows, conventions, and/or fairs. Signs, cabinets, and awnings are other examples of items that would normally be capitalized and depreciated.

If the advertising consists of samples of a new product that are distributed to potential future users, then the costs associated with creating the samples would be capitalized as business goodwill. The reasoning behind this treatment is that costs were incurred in order to have future users try the new product so that it could be sold in future years. Similarly, advertising expenses incurred to promote a new business must be capitalized as start-up expenses under IRC Sec. 195. See Lesson 1 for a discussion on capitalizing start-up and pre-opening expenses and the opportunity to amortize them over time.

Advertising expenses that are personal expenses will, of course, not be deductible. If the connection of the expenses to the taxpayer's business is too vague, the expenses will not be deductible. If the nature of the expenses is substantially to the personal benefit of the business owner, the expenses will not be deductible.

An advertisement that is political in nature is nondeductible. Advertisements appearing in a political publication are nondeductible if any part of the proceeds directly or indirectly benefit a political party or a political candidate. This is because the amount paid is recharacterized as an indirect political contribution.

Exception: If the advertising is in a political publication associated with nominating candidates for president and vice president of the United States, then the cost of the advertising is considered a deductible trade or business expense if the proceeds go solely to pay the costs of conducting the convention and the expense is reasonable.

Advertising is not deductible if the purpose is to:

- Promote or defeat any type of legislation,
- Influence the general public in matters of public election,
- Intervene or participate in the election of a public official, or
- Communicate with certain executive-branch officials.

These expenses are labeled “lobbying expenses.”

Bad Debts

Debts that arise in the conduct of a person’s trade or business or “the worthlessness of which has been incurred in the taxpayer’s trade or business” are fully deductible as business bad debts. They are deductible at the time when they become partially or totally worthless. A cash-basis taxpayer may deduct business bad debt expenses if he incurred a cash loss or the amount deducted was included in income. Accrual-basis taxpayers may deduct a bad debt if the item deducted was included in income.

Worthlessness of the debt is the key factor in determining if the debt may be classified as a bad debt. The taxpayer has the burden of proof that the debt has no value and that the events causing the debt to have no value occurred in the year in which the taxpayer claims the deduction. It has been held that a debt is worthless when there are grounds for abandoning hope for repayment in the future.

Note: The taxpayer’s belief that there is no hope for recovery is not proof that there is no hope for recovery of the debt. The taxpayer must show that an identifiable event or events occurred to establish that the debt has no value. Because business bad debts are deductible as the debt becomes partially worthless, the taxpayer has greater “flexibility” in determining the time in which to take the deduction.

Events that may indicate a debt is worthless include the financial condition of the debtor and the value of the collateral, if any, securing the debt. The courts recognize that no single event will determine worthlessness; rather, a series of events, which, when viewed in entirety, may determine that a debt has become worthless. An insolvent debtor, even a bankrupt debtor, may have the resources to partially pay a debt.

The taxpayer is required to establish that a worthless debt had value at the beginning of a tax year and had decreased or no value at the end of a tax year in order to claim a deduction. It happens very often that the IRS may agree that a debt is partially worthless but the deduction is disallowed because it is determined that the debt lost its value in the year before or the year after the deduction was claimed.

The courts have interpreted the language of the law to mean that the IRS may use its discretion in determining when a debt becomes partially worthless. It is essential, therefore, that the sole proprietor document the existence of the events leading up to the decision that a debt became partially worthless.

It is important to distinguish between a business bad debt and a nonbusiness bad debt. Business bad debts are deductible on the taxpayer's Schedule C at the time when events indicate that the debt is partially worthless and the debt arose in the conduct of the taxpayer's trade or business or the worthlessness was incurred in the taxpayer's trade or business. Nonbusiness bad debts are deductible on the taxpayer's Schedule D at the time when events indicate that the debt is wholly worthless. The nonbusiness bad debts are treated as short-term capital losses to which limitations apply.

A statement must be attached to the taxpayer's tax return in support of the bad debt deduction. The attachment of the statement applies to both business and nonbusiness bad debt deductions. The statement should include the following:

- Description of the debt (i.e., the amount of the debt, the payment terms)
- Name of the debtor
- Business relationship (and/or family relationship) between the taxpayer and the debtor
- Collection efforts made by the taxpayer
- Reason(s) that led to the determination that the debt was worthless

If a taxpayer claims a deduction for a bad debt and then recovers the debt in a subsequent year, he or she is required to include the recovered debt in income to the extent that the previous year's deduction reduced the amount of the taxpayer's tax.

If the bad debt deduction reduces taxable income but does not reduce the tax (i.e., AMT applies), the payment of the bad debt would *not* be required to be included in income in the year in which it was recovered.

This treatment falls under the tax benefit rule and was clarified by the Tax Reform Act of 1986 (TRA 1986).

Business Gifts, Insurance, Taxes, and Fees

Business Gifts

Gifts to business contacts, customers, and clients are deductible as long as the gifts can be considered ordinary and necessary business gifts. The deductible amount is limited to $25 per person per year. Gifts found to have no connection to an individual's trade or business are not deductible. These would include gifts to parking lot attendants, elevator operators in your building, and mail distributors as long as there is no direct connection to the taxpayer's business. Gifts to the spouse of a business contact are considered deductible because they are indirectly made to the business contact.

Self-employed Health Insurance

Self-employed Health Insurance Deduction. The cost of premiums is not deductible on Schedule C. The self-employed may deduct 100% of premiums paid for himself, a spouse, and children as a deduction for AGI. (Health insurance premiums are generally deductible on Schedule A if the taxpayer itemizes and the medical expenses exceed 7.5% AGI.)

No deduction is permitted if the deduction exceeds the earned income derived from the business in which the plan was established. The deduction is not available to anyone eligible to participate in a subsidized health plan of the spouse. Eligibility is tested each month.

Chief Counsel Advice 200524001 contains answers to questions on the self-employed health insurance deduction. The CCA concludes that a sole proprietor who purchases health insurance in his individual name (as opposed to the name of the business) has established a medical plan for the business and may therefore deduct the insurance costs as self-employed health insurance, but the individual may not aggregate net profits from all his trades or businesses.

Insurance—General

Self-employed individuals may deduct the cost of premiums paid for many types of insurance, including theft, flood, fire, merchandise protection, credit, employee medical, malpractice, auto, performance bonds, business interruption, business overhead, workers' compensation, and use and occupancy insurance. The requirements for deductions are that the policies are maintained in connection with the taxpayer's trade or business and that the expenses are ordinary and necessary business expenses. Life insurance premiums and disability insurance premiums paid for the benefit of the self-employed individual are nondeductible.

Medical Savings Account (MSA). The **Health Reform Act of 1996** established a health care option called the Medical Savings Account (MSA), effective for years beginning after 1996. Subsequent changes have renamed this option as an Archer medical savings account (Archer MSA). This is a tax-favorable way to set aside funds to meet future medical needs. (These are similar to IRA accounts that are used to set aside funds to meet future retirement needs.)

Contributions to an Archer MSA are deductible, subject to limitations, when made. An individual may make contributions to a new Archer MSA through 2007. After December 31, 2007, the individual must have an Archer MSA in place in order to make a contribution to it. Contributions to an Archer MSA must be made in cash (not stock or property). Earnings on the funds in the Archer MSA are not taxed, and distributions to cover qualified medical expenses of the individual eligible to make an Archer MSA contribution are not taxed.

Even though new Archer MSA plans cannot be established after 2007, individuals who had an Archer MSA before 2008 are still able to do all of the following, even after 2007 (IRS Notice 96-53, Q&A-25):

a. Retain unspent money in the Archer MSA, tax-deferred, until withdrawn without penalty beginning at age 65, death, or disability.

b. Continue making or receiving Archer MSA contributions if they continue to meet the eligibility requirements. Generally, an eligible individual is an employee who, on the first day of each month, is covered under a high-deductible health plan meeting all of the requirements, that is established and maintained by a small employer, and who is not covered by any other health plan that is not a high-deductible health plan (IRC Sec. 220(c)(1)).

c. Use tax-free withdrawals from the Archer MSA account to pay for yearly medical expenses.

d. Roll over any balances to a health savings account (HSA).

Self-employed individuals and employees of employers with no more than 50 employees are eligible to participate in Archer MSAs as long as:

- They are only covered by a *high-deductible* health plan (the annual deductible for 2010 must be $2,000–$3,000 for single coverage or $4,050–$6,050 for family coverage); and

- The maximum out-of-pocket expenses, other than premiums, may be no more than $4,050 for single coverage or $7,400 for family coverage.

These amounts are adjusted annually for inflation.

Archer MSA contributions are deductible for AGI. The maximum annual contribution is 65% of the deductible for single coverage or 75% of the deductible for family coverage. The deduction for AGI maximum limitation is determined on a monthly basis and cannot exceed compensation. The contributions must be made by the due date (without extensions) of the individual's tax return. A 6% excise tax is imposed on excess contributions to an Archer MSA for every year they remain in the plan (IRC Sec. 4973). Archer MSA distributions are not taxable if the distributed money is used for the eligible individual's medical expenses. For reimbursement of expenses incurred with respect to tax years beginning after 2010, the Health Care Act provides that Archer MSAs may no longer reimburse for over-the-counter drugs unless the drug is obtained by prescription or is insulin. Distributions from an Archer MSA that are not used for medical expenses are includible in income. These distributions will also be subject to a 15% tax unless they are made due to death or disability, or after age 65. For distributions made after 2010, the Patient Protection and Affordable Care Act (Health Care Act) increases the tax on Archer MSA distributions not used for medical expenses to 20%.

For tax years beginning after 1998, individuals entitled to Medicare benefits are *not* entitled to deductions for an Archer MSA.

An Archer MSA arrangement is an attractive option for "healthy" individuals who normally do not meet their health insurance deductibles. This is because the health insurance premiums on high-deductible policies are generally much lower than low-deductible policies. These individuals would, therefore, spend substantially less on premiums and will have a tendency to shop around for lower cost medical services and more closely examine their medical bills.

In addition, any money contributed to an Archer MSA and not used for medical expenses may be used as retirement benefits. The earnings in the Archer MSA build tax-free. Lastly, the majority of taxpayers cannot deduct their medical expenses on their income tax returns because the expenses are not in excess of 7.5% of AGI, but they can deduct 100% (within limits) of the amounts contributed to an Archer MSA.

After testing the MSAs for several years, Congress has made tax-free medical care available to all individuals (not just the self-employed and small employers) who enroll in high-deductible health plans (HDHP) and deposit tax-deductible amounts in a health savings account (HSA). Contributions to an HSA are tax-deductible, and income earned on HSA funds grows tax-deferred.

Health Savings Account (HSA)

HSAs were designed to replace Archer MSAs. HSAs are targeted to self-employed individuals, small business owners, and employees of small to medium-sized businesses. They allow eligible individuals to make deductible contributions that can later be withdrawn tax-free to reimburse the individual for out-of-pocket medical expenses. An individual may also make HSA contributions to pay for reimbursable medical expenses of the individual's spouse or dependent. Any balances remaining in the account at the end of the year can be carried over to the next year. Employers may also make tax-free contributions to an employee's HSA.

HSAs belong to the individual for whose benefit the account is established. Thus, even if it is employer-funded, the HSA is portable and goes with the individual if they terminate employment with the employer.

An eligible individual can establish an HSA if he or she meets all of the following conditions with regard to any month (IRS Notice 2004-2):

a. Be covered under a high-deductible health plan on the first day of such month.
b. Not be covered by any other health plan that is not a high-deductible health plan (with certain exceptions for plans providing specific limited types of coverage).
c. Not be enrolled in Medicare for such month, which generally occurs at age 65. Individuals remain eligible to establish and contribute to HSAs after becoming entitled to Medicare, provided they do not enroll in Part A, Part B, or Part D. Individuals who enroll in social security will likely be automatically enrolled in Part A, which will make them not eligible for an HSA.
d. Not have received Veterans Administration medical benefits within the past three months, unless the benefits consisted solely of disregarded coverage or preventive care (IRS Notice 2008-59, Q&A 9).
e. Cannot be claimed as a dependent on another person's tax return for the year.

Individuals do not need to have earned income to establish or contribute to an HSA.

A high-deductible health plan for HSA purposes is a plan that satisfies the following requirements for deductibles and out-of-pocket expenses for 2010:

- They are only covered by a high-deductible health plan (the annual deductible for 2010 must be $1,200 and up for single coverage or $2,400 and up for family coverage); and
- The maximum out of pocket expenses, other than premiums, may be no more than $5.950 for single coverage or $11,900 for family coverage.

An employee who is otherwise eligible to establish an HSA may do so without the involvement of their employer. As a result, an employee who is only covered by a high-deductible plan, and who is not enrolled in Medicare, and cannot be claimed as a dependent on another person's tax return, can establish an HSA even if his or her employer is not planning to make any contributions to the account.

For 2010, HSA contributions made by or on behalf of an eligible individual are limited to $3,050 for self-only coverage and $6,150 for family coverage. These limits are adjusted annually for inflation (IRC Sec. 223(g); Rev. Proc. 2009-29).

All HSA contributions made by or on behalf of an individual are aggregated for purposes of applying the limit. The annual limit is decreased by any contributions made to an Archer MSA (IRS Notice 2004-2).

HSA contributions must be made in cash. Contributions may not be made in the form of stock or other property (IRS Notice 2004-2). Rollover contributions need not be in cash.

Catch-up contributions allow an individual who is age 55 or older to make an additional contribution to his or her HSA. An account beneficiary who is 55 or older as of the end of the tax year for which the HSA contribution is made is allowed to make a larger deductible contribution. Specifically, the annual contribution limit that would otherwise apply is increased by $1,000.

The HSA beneficiary (i.e., the individual for whom the account is set up) can take tax-free distributions from an HSA at any time to pay for medical expenses, even if the individual is no longer eligible to make contributions to the HSA account. Furthermore, the HSA beneficiary can take federal-income-tax-free withdrawals to pay for qualified medical expenses of the account beneficiary and his or her spouse or dependents regardless of whether the spouse or dependents are eligible individuals (IRC Sec. 223(f); IRS Notice 2004-50).

Qualified medical expenses are expenses not covered by insurance or otherwise that are for medical care as defined in IRC Sec. 213(d) and include expenses for the diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long-term care expenses.

For reimbursement of expenses incurred with respect to tax years beginning after 2010, the Patient Protection and Affordable Care Act (Health Care Act) provides that HSAs may no longer reimburse for over-the-counter drugs unless the drug is obtained by prescription or is insulin.

For distributions made after 2010, the Health Care Act increases the penalty on HSA distributions not used for medical expenses to 20%.

Medical Savings Account (MSA) Versus Health Savings Account (HSA)		
	MSA	**HSA**
Contribution source	Either individual or employer, not both.	Individual (or on behalf of the individual) and/or employer.
Eligibility	Self-employed and small employers (average under 50 employees) covered under a high-deductible health plan, below Medicare eligibility age and not covered under any other health plan.	Individuals covered under a high-deductible health plan, below Medicare eligibility age, and not covered under any other health plan.

<table>
<tr><th colspan="5">Medical Savings Account (MSA) Versus Health Savings Account (HSA)</th></tr>
<tr><th></th><th colspan="2">MSA</th><th colspan="2">HSA</th></tr>
<tr><td>Deductible
Single:
Family:</td><td>For 2009:
$2,000–$3,000
$4,000–$6,050</td><td>For 2010:
$2,000–$3,000
$4,050–$6,050</td><td>For 2009:
Single: Minimum = $1,150
Family: Minimum = $2,300</td><td>For 2010:
$1,200
$2,400</td></tr>
<tr><td>Contribution levels</td><td colspan="2">Single: 65% of deductible
Family: 75% of deductible</td><td colspan="2">Up to 100% of deductible with a maximum cap determined each year.
For 2009: Single: $3,000 Family: $5,950
For 2010: Single: $3,050 Family: $6,150</td></tr>
<tr><td>Out-of-pocket expense maximum</td><td>For 2009:
Single: $4,000
Family: $7,350</td><td>For 2010:
Single: $4,050
Family: $7,400</td><td>For 2009:
Single: $5,800
Family: $11,600</td><td>For 2010:
Single: $5,950
Family: $11,900</td></tr>
<tr><td>“Catch-up” contribution for older workers?</td><td colspan="2">No</td><td colspan="2">Age 55 or older may contribute more to the account per year. This increased to $1,000 in 2009 and thereafter.</td></tr>
<tr><td>Must employers make comparable contributions?</td><td colspan="2">Yes</td><td colspan="2">Yes, but under HSA legislation, both employers and employees can contribute.</td></tr>
<tr><td>Account earnings</td><td colspan="2">Grow tax-free or deferred</td><td colspan="2">Grow tax-free or deferred</td></tr>
<tr><td>Is money withdrawn for qualified medical expenses taxable?</td><td colspan="2">No</td><td colspan="2">No</td></tr>
<tr><td>If withdrawn funds are not used for qualified medical expenses, is a penalty charged?</td><td colspan="2">Yes, the money is includible in income and a 20% (15% for 2009) penalty applies unless funds are withdrawn due to death, disability, or after age 65.</td><td colspan="2">Yes, the money is includible in income and a 20% (10% for 2009) penalty applies unless funds are withdrawn due to death, disability, or after age 65.</td></tr>
<tr><td>Effective date</td><td colspan="2">Must have been established by December 31, 2007.</td><td colspan="2">Permanent legislation effective January 1, 2004.</td></tr>
</table>

Taxes

A self-employed individual may deduct state, local, and foreign taxes paid or accrued in carrying on a trade or business. Taxes paid or accrued in acquiring property to be used in a trade or business are capitalized as part of the cost of the property. There are taxes which, even if incurred with respect to a trade or business, are not deductible. These include federal income taxes, taxes withheld from employees, estate taxes, gift taxes, excise taxes, and taxes assessed for improvements to property.

Taxes that are not directly connected to the individual's trade or business are only deductible as itemized deductions. These taxes include real property taxes, personal property taxes, and environmental taxes.

Taxes are deductible in the year paid (no matter when they were due) if a cash-basis taxpayer and the year accrued if an accrual-basis taxpayer.

Bribes and Kickbacks

No deduction is allowed for illegal kickbacks or bribes paid (directly or indirectly) to government officials or employees of the government. Payments made to foreign officials to "expedite" administrative actions are not illegal and may be deductible.

Fines and Penalties

Fines and penalties are nondeductible expenses. Amounts paid to settle an actual or potential liability for a fine or penalty are nondeductible. Parking tickets and payments for traffic violations are nondeductible.

Office Expenses

The costs of office supplies consumed or used during the taxable year in a taxpayer's trade or business are deductible on Schedule C. If no physical record of consumption or use is maintained and no inventory record of the items exists, the taxpayer is permitted to deduct the cost of the supplies in the taxable year in which the items are purchased as long as the deduction does not distort the taxpayer's income.

Education Expenses

Expenses for education are deductible as trade or business expenses as long as certain tests are met. In order to be deductible, the expense must meet either of two allowance tests but neither of two disallowance tests.

These are the allowance tests:

1. The expense must be incurred to maintain or improve the skill required by the self-employed individual.
2. The expense must be incurred to meet the requirements of applicable law or regulations imposed as a condition to retain a particular status.

These are the disallowance tests:

1. The expense is required for the individual to meet the minimum educational requirements for qualification in a particular trade or business. Once this requirement is met, the individual is treated to have met the minimum requirement even if the requirement changes later.
2. The expense incurred for training will qualify the individual for a new trade or business.

The following are examples of situations where an individual's additional education would qualify the individual for a new trade or business:

- A chiropractor enrolled in medical school.
- An accountant enrolled in courses to qualify for a CPA certificate.

- A licensed practical nurse enrolled in courses to become a registered nurse.
- A computer operator enrolled in computer programming courses.
- A bookkeeper enrolled in courses to get a degree in accounting.
- An attorney enrolled in courses to become a real estate agent.
- A general building contractor enrolled in courses to become an architect.

Deductible education expenses include the costs of books, tuition, supplies, typing fees, and copying fees. Also included are the costs of tutors, transportation between business and school, and other expenses incidental to the individual's education.

Professional Fees

Accounting fees incurred for services in connection with the production or collection of income are deductible by a self-employed individual. Services provided include audits, tax consultation, cost analyses, compilations and reviews, and preparation of tax returns related to the trade or business. The taxpayer has the burden of proving the portion of the accounting fee allocated to a trade or business is actually business-related.

Fees paid for an appraiser's valuations of business assets in connection with the taxpayer's trade or business are deductible. The fees are deductible for appraisals for audit, borrowing, and income tax purposes.

Actuarial fees are also deductible under IRC Sec. 162.

Legal fees paid to obtain advice with respect to the individual's trade or business are generally deductible. If the legal fees are incurred prior to the start of the individual's business, they must be capitalized as start-up costs. Legal fees incurred in relation to the acquisition of property must be capitalized as part of the cost of the property acquired. Legal fees paid for personal matters are nondeductible.

Legal fees paid to litigate matters arising within the taxpayer's trade or business are deductible under IRC Sec. 162. If the fees are incurred to collect income or resolve matters involving the collection of trade or business income, the fees are deductible. If the fees are incurred to acquire ownership or defend ownership of property, they are not deductible. In this situation, the fees would be capitalized as part of the cost of the property.

Interest, Repairs, and Donations

Interest

Interest is the amount a sole proprietor agrees to pay for the use of money. Interest incurred on trade or business indebtedness is deductible by the sole proprietor. The interest may be deducted if it meets four requirements:

1. It must be interest.
2. The debt must be a true debt.
3. The debt must be an obligation of the taxpayer.
4. The interest must be paid or accrued during the taxable year.

Interest is the amount a sole proprietor agrees to pay for the use of money. Payments may be disguised as interest by the taxpayer. Examples would be payments in the nature of compensation for services performed, gifts, and payments that are part of the sales price of property sold by the lender to the borrower.

The debt must be a valid debt in order for the interest to be deductible. Valid debt is determined by state law and must be enforceable and unconditional. A genuine obligation must be created and must have a business purpose. In other words, it must not be created just to generate interest.

Interest paid for another person may not be deducted by the taxpayer.

Cash-basis taxpayers deduct interest when it is paid. Accrual-basis taxpayers deduct interest when the obligation to pay matures and is fixed. In certain instances, prepaid interest is not deductible by a cash-basis taxpayer in the year in which it is paid. It must be deducted ratably over the life of the loan.

Loan-processing fees or origination fees are treated as interest if they are compensation for the use of money, have an ascertainable amount, and are not payment for specific services performed by the lender in connection with the account. A fee charged instead of specific fees for appraisals, credit reports, and notary may not be deducted as interest expenses.

Commitment fees charged by lenders for the lender's agreement to have funds available for the taxpayer and preserve a firm interest rate for borrowing are not deductible as interest. These fees must be capitalized and amortized over the term of the loan.

Finance charges on credit cards are considered interest. These amounts are deductible by sole proprietors to the extent the amounts are charged on business expenditures. It is clearly advisable that the sole proprietor maintain a specific credit card to be used solely for business purposes in this instance. Otherwise, the proprietor would be required to make an allocation of the interest expense based on a ratio of business expenditures to total expenditures.

Points are generally considered to be prepaid interest and deductible over the life of the loan. This is true unless the points are paid in connection with the acquisition of the taxpayer's personal residence.

Repairs to Business Property

Expenses incurred to repair business property may be deductible by a self-employed individual. Repairs that must be capitalized are repairs made that substantially improve, renovate, add to, or substantially alter business property. Currently deductible repairs do not add to or materially prolong the life of a business asset. They are incidental repairs that maintain the working condition of the property.

Note: The burden of proof rests on the taxpayer to substantiate the time and amount of the repairs made to business property. These types of deductions are those that IRS agents will pay close attention to in the event of an audit.

The deduction for the repair is taken in the year the expense is paid or incurred. This is true even if the amount paid is substantially higher than amounts expended for repairs in previous years. A deduction may not be taken for the amount estimated to be required to repair items in a particular year.

Rents

Amounts paid for the use or possession of property in a trade or business are deductible as rents. The amounts paid will qualify as rent as long as the individual does not have an equity in or take title to the property involved. Payments for property used for both business and personal reasons must be allocated to business use and personal use. The portion paid for the personal use of the property is not deductible as a trade or business expense.

Rent may be paid indirectly.

Example 1: A lessee's rental agreement may state that the lessee may use the lessor's property and pay for all maintenance, utilities, insurance premiums, and repairs.

No rent deduction is permitted where an amount paid is retained to cover repairs that may arise. Only the actual amount paid for the repairs would be deductible as a repair. Only the actual amount paid for the rent would be deductible as rent.

Only a reasonable amount of rent may deducted. This issue generally arises if the business owner and the lessor are related.

Rent is deductible by a cash-basis individual in the year paid as long as the rent is for the year. Prepaid rent cannot be deducted because it is not an ordinary and necessary business expense for that year. Rent paid in advance is deductible to the extent the rented property is used during the tax year. The remaining payment is deducted over the period to which it applies. It is deductible by an accrual-basis individual in the year the rent accrues regardless of when it is paid. Accrual-basis taxpayers would be required to deduct the advance rental payment over the period to which it applies.

Charitable Donations

Charitable donations are not deductible on Schedule C even if paid out of a business account.

Note: Some states permit the deduction of charitable donations as an adjustment to trade or business income reported for federal purposes.

Club Dues

Club dues are nondeductible. Under proposed regulations, however, if an employer pays the club dues of an employee and includes the club dues in the employee's compensation, then the employer may deduct that portion of the club dues included in the employee's wage as compensation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. Julie, a real estate agent, learns from her most recent client, Jacques, that his company will be relocating three families from its Paris location to the new Peachtree City, Georgia, office. Julie quickly books a trip for herself and her family to Paris, in order to learn more about the city so that she can converse knowledgeably with the families about their hometown. She believes that by doing this, she can easily befriend the families and become their real estate agent. Which of the following statements is accurate?

    a. Julie may deduct the entire cost of the trip to Paris as advertising costs since she can now legitimately say that she has first-hand knowledge of the needs of Parisians.

    b. The connection between Julie's family's trip to Paris and Julie's business is too vague. The expenses would not be deductible.

    c. Since Julie is attempting to start a new business—selling homes to foreign people—the cost of her family's trip would be capitalized.

27. Dr. Colin Ahscapy, a gastroenterologist, purchases gifts for the shop owners of the businesses in his building. The doctor spends $1,000 ($100 × 10 shop owners) for the gifts. The doctor receives no referrals from these shop owners. He just thinks they are very nice people. Which of the following statements is accurate?

    a. The doctor may deduct the $1,000 business gifts on his Schedule C.

    b. The doctor may deduct $25 for the business gifts on his Schedule C.

    c. The doctor may deduct $250 for the business gifts on his Schedule C.

    d. The doctor may not deduct anything relative to the gifts on his Schedule C.

28. Les, a self-employed photographer, maintains health insurance through his business. The policy covers Les and his wife, Marcy. In October, Marcy starts the job of her dreams as a computer analyst with an incredible employer. Her employer is willing to pay 100% of the health insurance premiums on the corporate health plan for Marcy and Les. The health insurance coverage begins on October 1, 2010. Les reports self-employment earnings of $25,000 in 2010 and pays $500 per month for health insurance coverage on his plan. What amount may Les deduct as self-employed health insurance before AGI?

    a. $6,000.

    b. $4,500.

    c. $3,150.

    d. $0.

29. Lisa, a traveling nurse, wants to become a physician's assistant. She enrolls in classes at the local hospital. Lisa pays $5,000 per year for classes. Lisa reports $25,000 as earnings from self-employment before any deduction for the costs of education. Which of the following statements is accurate?

    a. Lisa may deduct the costs of education on Schedule C because she is already in the medical field.

    b. Lisa may not deduct the expenses on Schedule C because the courses qualify her for a new profession.

    c. Lisa may deduct the expenses on Schedule C because she must take continuing education courses to maintain her nursing license.

30. Charles, a cash-basis florist, pays a year's worth of rent on October 1. The payment is for November of the current year through October of the following year. How much of the expense can Charles deduct in the current year on his Schedule C?

    a. Charles cannot deduct any of the rent payment.

    b. Charles can deduct two months worth of the rent payment.

    c. Charles can deduct three months worth of the rent payment.

    d. Charles can deduct the entire rent payment.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

26. Julie, a real estate agent, learns from her most recent client, Jacques, that his company will be relocating three families from its Paris location to the new Peachtree City, Georgia, office. Julie quickly books a trip for herself and her family to Paris, in order to learn more about the city so that she can converse knowledgeably with the families about their hometown. She believes that by doing this, she can easily befriend the families and become their real estate agent. Which of the following statements is accurate? **(Page 89)**

    a. Julie may deduct the entire cost of the trip to Paris as advertising costs since she can now legitimately say that she has first-hand knowledge of the needs of Parisians. [This answer is incorrect. Business expenses must be reasonable, ordinary, and necessary in order to be deductible. While Julie's family's presence may have been a comfort to her, their expenses had no relation to the business purpose of the trip and will not be deductible.]

    b. The connection between Julie's family's trip to Paris and Julie's business is too vague. The expenses would not be deductible. [This answer is correct. The connection between Julie's family's trip to Paris and Julie's business is too vague. Julie would be more successful attempting to deduct only the cost of her trip to Paris, but there would most likely be a problem in the area of reasonable, ordinary, and necessary expenses.]

    c. Since Julie is attempting to start a new business—selling homes to foreign people—the cost of her family's trip would be capitalized. [This answer is incorrect. Selling homes to different types of people would not constitute a new business for Julie and the cost of her family's trip still does not have a business purpose. Therefore, the cost of Julie's family's trip would neither qualify as a start-up business expense nor a deductible business expense.]

27. Dr. Colin Ahscapy, a gastroenterologist, purchases gifts for the shop owners of the businesses in his building. The doctor spends $1,000 ($100 × 10 shop owners) for the gifts. The doctor receives no referrals from these shop owners. He just thinks they are very nice people. Which of the following statements is accurate? **(Page 91)**

    a. The doctor may deduct the $1,000 business gifts on his Schedule C. [This answer is incorrect. There are limitations to the amount deductible as gifts on a Schedule C.]

    b. The doctor may deduct $25 for the business gifts on his Schedule C. [This answer is incorrect. If the gifts are deductible, the gift limitation is $25 per person per year, not a total of $25.]

c. The doctor may deduct $250 for the business gifts on his Schedule C. [This answer is incorrect. These gifts do not constitute ordinary and necessary business gifts.]

d. The doctor may not deduct anything relative to the gifts on his Schedule C. [This answer is correct. The doctor may not deduct anything relative to the gifts on his Schedule C. The nature of the gifts is personal. Even if the gifts would constitute business gifts, the deductible cost would be limited to $25 per person per year.]

28. Les, a self-employed photographer, maintains health insurance through his business. The policy covers Les and his wife, Marcy. In October, Marcy starts the job of her dreams as a computer analyst with an incredible employer. Her employer is willing to pay 100% of the health insurance premiums on the corporate health plan for Marcy and Les. The health insurance coverage begins on October 1, 2010. Les reports self-employment earnings of $25,000 in 2010 and pays $500 per month for health insurance coverage on his plan. What amount may Les deduct as self-employed health insurance before AGI? **(Page 92)**

a. $6,000. [This answer is incorrect. The test for eligibility to claim this deduction is made on a monthly basis. Therefore, Les can only claim the deduction from January through September.]

b. $4,500. [This answer is correct. The deduction for self-employed health insurance would be calculated as follows: ($500 × 9) × 100% = $4,500. Once Les becomes eligible to participate in Marcy's subsidized plan, he is no longer eligible for the self-employed health insurance deduction, whether or not he participates.]

c. $3,150. [This answer is incorrect. There is no percentage limitation that applies to the self-employed health insurance deduction. Les may deduct 100% of premiums paid for himself, a spouse and children.]

d. $0. [This answer is incorrect. The test for eligibility to claim this deduction is not made on an annual basis. Therefore, Les may deduct premiums for part of the year.]

29. Lisa, a traveling nurse, wants to become a physician's assistant. She enrolls in classes at the local hospital. Lisa pays $5,000 per year for classes. Lisa reports $25,000 as earnings from self-employment before any deduction for the costs of education. Which of the following statements is accurate? **(Page 97)**

a. Lisa may deduct the costs of education on Schedule C because she is already in the medical field. [This answer is incorrect. Expenses for education are deductible as trade or business expenses as long as certain tests are met. There are two allowance tests and two disallowance tests. Lisa meets the allowance tests, but she also meets one of the disallowance tests.]

b. Lisa may not deduct the expenses on Schedule C because the courses qualify her for a new profession. [This answer is correct. Expenses for education are deductible as trade or business expenses as long as certain tests are met. Lisa meets the allowance tests. Unfortunately, the courses will qualify her for a new profession, so the cost of the courses will be nondeductible.]

c. Lisa may deduct the expenses on Schedule C because she must take continuing education courses to maintain her nursing license. [This answer is incorrect. Expenses for education are deductible as trade or business expenses as long as certain tests are met. There are two allowance tests and two disallowance tests. Enrolling in classes to become a physician's assistant is beyond general continuing education for a nurse and meets one of the disallowance tests.]

30. Charles, a cash-basis florist, pays a year's worth of rent on October 1. The payment is for November of the current year through October of the following year. How much of the expense can Charles deduct in the current year on his Schedule C? **(Page 100)**

a. Charles cannot deduct any of the rent payment. [This answer is incorrect. Amounts paid for the use of property in a trade or business are deductible as rent.]

b. Charles can deduct two months worth of the rent payment. [This answer is correct. Charles can deduct rent for November and December. Rent paid in advance is deductible to the extent the rented property is used during the tax year.]

c. Charles can deduct three months worth of the rent payment. [This answer is incorrect. Charles should not deduct three months of rent expense just because he paid the rent three months before the end of the year. Rent is deductible by a cash-basis individual in the year paid as long as the rent is for the year.]

d. Charles can deduct the entire rent payment. [This answer is incorrect. Charles has ten months of prepaid rent as of the end of the tax year. Prepaid rent cannot be deducted because it is not an ordinary and necessary business expense for that year.]

EXAMINATION FOR CPE CREDIT

Lesson 6

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

26. What qualifies as a deductible advertising expense?

    a. Advertisement to influence the general public in matters of public election.

    b. Advertisement in a political publication associated with nominating candidates for president and vice president of the United States.

    c. Advertisement in a publication for the election of the mayor of a taxpayer's town.

    d. Advertisement to convince the public to vote to build a highway away from the city.

27. Kim, an accrual-basis florist, sells 50 arrangements on credit to Christine for her gift shop. Christine does not charge enough for the arrangements and cannot afford to pay Kim. When the invoice arrives, Kim learns that Christine cannot afford to pay any of her bills and determines Christine's debt is at least partially worthless. Which of the following statements is most accurate?

    a. Kim would be required to establish the debt was worthless in order to claim a bad debt deduction.

    b. Kim's belief that the debt is worthless would be sufficient evidence that the debt was worthless.

    c. The IRS has the burden of proving that the debt is still collectible.

    d. Kim would treat the debt as a short-term capital loss on her tax return.

28. Dr. Dozent Hurt, a neurosurgeon, buys boxes of salmon steaks every year during the holidays for each neurologist who refers patients to him during the year. Dr. Hurt purchased $100 boxes of steaks for 20 neurologists. Dr. Hurt would be entitled to a deduction for gifts totaling how much on his Schedule C?

    a. $2,000.

    b. $1,200.

    c. $500.

    d. $0.

29. Which of the following statements is true as it applies to Archer medical savings accounts (MSAs)?

    a. The number of taxpayers benefiting annually from an Archer MSA contribution is unlimited.

    b. Individual contributions to an Archer MSA are deductible as medical expenses if the contributions are in excess of 7.5% of AGI.

    c. Deductible contributions to an Archer MSA may be made by a self-employed individual as long as that individual is only covered by a high-deductible health plan.

    d. Distributions from an Archer MSA for qualified medical expenses are taxable in the year the medical expense is incurred.

30. Loan-processing fees are **not** treated as interest if:

    a. The fees are compensation for the use of money.

    b. The fees are payment for specific services performed by the lender in connection with the account.

    c. The lender does not specifically call them “interest.”

    d. The fees have an ascertainable amount.

Lesson 7: Farming Revenue and Expenses

Introduction

This lesson discusses farming issues, including determining profit motive and various revenue sources, operating expenses, depreciation of assets used in a farming operation, and reporting requirements.

Learning Objectives

Completion of this lesson will enable you to:

- Identify the revenue and expense categories unique to a farming operation, including whether or not the farm meets the definition of a business or hobby.

Business versus Hobby

Farming activities follow the same requirements as other business entities. They must be profit-motivated. Expenses incurred must be ordinary and necessary expenses incurred in carrying on a trade or business. The expenses incurred must be related to the business of farming (IRC Secs. 162 and 212). If the farming activity is not profit-motivated, the expenses attributable to the activity are deductible under IRC Sec. 183. This section permits the deduction of expenses to the extent of income earned from the activity. The income would be reported on Form 1040, page 1, line 21 as other income and the expenses from the activity would be deductible on Schedule A, but only if you itemize deductions.

Note: The IRS has released an 80-page audit guide on farm-hobby losses to provide guidance to agents (and practitioners) with respect to horse activities and cattle operations. For general information, see IRS Pub. 225, *Farmer's Tax Guide.*

There are nine factors that would be considered in determining a profit motive for a farming activity:

1. The expertise of the taxpayer in the area of farming
2. The manner in which the activity is conducted
3. The effort the taxpayer puts forth in conducting the activity
4. The success of carrying on similar activities
5. The expectation that assets used in the activity may appreciate
6. The taxpayer's history of earnings and losses
7. The amount of profits earned
8. The taxpayer's financial status
9. The element of recreation or personal pleasure derived from conducting the activity

The farmer would be expected to conduct the farming business in a businesslike manner. Accurate and adequate books and records would be expected to be maintained. The farmer would be expected to have a desire to research advances in agricultural procedures.

In addition, there would be an expectation that the farmer would devote substantial time to the activity to ensure that a profit is obtainable.

Farmers are required to report income in the same way as income is reported in any business undertaking. Farmers may be on a cash basis or an accrual basis, just as any other entrepreneur.

Unlike any other business undertaking, farmers can elect to average specified farm income over a three-year period. The farmer may use negative taxable income in the base year calculation.

Revenue Sources and Other Payments

Sales of Livestock and Other Items Bought for Resale

Farmers report on Schedule F income from the sales of livestock held for resale, items bought for resale, produce, grains, and other products. Sales of livestock held for breeding, dairy, sport, and/or draft are reported on Form 4797 (Sales of Business Property) because these animals are normally depreciated by the farmer and, consequently, handled similarly to any other farm asset sold.

Note: Farmers who are forced to sell livestock due to drought conditions in a designated drought area may elect to recognize income in the year after the sale, as long as the farmer can show that the income from the sale would have normally been reported in the following year. The farmer may defer the gain if the livestock is replaced within four years under special rules. The farmer may replace the livestock with other farm property (excluding real property) if due to weather conditions it is not feasible to reinvest in livestock.

Co-op Distributions and Agricultural Program Payments

Farmers receiving patronage dividends from a farm cooperative are taxed on the dividends normally reported to the farmer on Form 1099-PATR (Taxable Distributions Received From Cooperatives).

Similarly, payments by federally subsidized agricultural programs are includible in farmers' incomes and reported on Schedule F.

Commodity Credit Corporation Loans

Under IRC Sec. 77, if a farmer has pledged crop production in order to secure a commodity credit corporation loan (CCC loan), the farmer may elect to report the loan proceeds in the year the proceeds are received, rather than reporting the income in the year the crop is sold. This treatment does not require permission from the IRS; however, once this treatment is elected, it must always be followed unless permission is granted by the IRS to change. Rev. Proc. 2008-52 provides procedures under which a taxpayer may obtain automatic consent of the Service to change the taxpayer's method of accounting for CCC loans from including the loan amount in gross income to treating the loan amount as a loan. The amount of the loan reported as income becomes the basis of the crop sold. The election is made by including the amount of the loan on Schedule F and attaching a statement to the return. The statement must disclose the amount of the loan, the year received, the commodity, and the quantity of the commodity. The election may not be made retroactively. It applies to all loans received during the election year.

If a taxpayer uses cash or CCC certificates to repay a CCC loan, and the loan is repaid when the alternative repayment rate (set by the CCC) is less than the original loan rate, the difference between the original loan amount and the lesser repayment amount is market gain. Regardless of whether a taxpayer repays a CCC loan in cash or uses CCC certificates in repayment of the loan, the market gain is taken into account either as income (if the taxpayer has not made an election under IRC Sec. 77) or as an adjustment to the basis of the commodity (if the taxpayer has made an election under Sec. 77). This rule has been in effect under Notice 2007-63, but it was codified in the Heartland, Habitat, Harvest, and Horticulture Act of 2008 (the Farm Act) that was effective May 22, 2008.

Conservation Reserve Program Payments (CRP)

These are payments the government pays to the taxpayer for conserving and improving soil, water and wildlife resources. The Farm Act (May 2008) provides that CRP payments to retired or disabled individuals who are receiving social security retirement or disability benefit payments are not treated as self-employment income for purposes of the self-employment tax. This is effective for payments made after 2007.

Net Earnings from Self-employment

The Farm Act (May 2008) modified the farm optional method of calculating self-employment tax by increasing and indexing the dollar thresholds so that electing taxpayers may be eligible to secure four credits of social security benefit coverage each tax year. Similar modifications are made to the nonfarm optional method.

2010 Law Change: Previously, self-employed individuals could deduct certain health insurance premiums for income but not self-employment tax purposes.

The Small Business Jobs Act of 2010 was enacted September 27, 2010. For tax years beginning in 2010, self-employed individuals can deduct health insurance premiums for the following individuals for self-employment tax as well as for income tax (IRC Sec. 162(l)(1) and (4)):

- Themselves.
- Their spouses.
- Their dependents.

Their children under age 27 as of year end, regardless of dependency status (effective March 30, 2010).

Crop Insurance Proceeds and Disaster Payments

Crop insurance proceeds are included in income in a manner similar to income from a forced sale of livestock due to drought conditions. The farmer may elect to report the insurance proceeds in the year after the year the crops were damaged if the farmer can show that the income from the sale of the crops would normally have been reported in the following year. To make the election, the farmer attaches a statement to her tax return for the year the crop was damaged.

This tax deferral option also applies to government drought assistance and other relief payments to farmers under USDA programs. Certain government disaster payments, such as for flood and other natural disasters, are also eligible for the crop insurance tax deferral treatment. A farmer who receives multiple crop insurance and government disaster payments attributable to a single farming business must elect to treat these receipts in a consistent manner for a particular tax year, either including all in current income or electing to defer all to the following year.

Farm Loss Limitation

For tax years beginning after 2009, for any year that a taxpayer, other than a C corporation, receives any applicable subsidies [Commodity Credit corporation (CCC) loans and direct or counter-cyclical payments, or payments in lieu of], the Farm Act (2008) provides that farm losses are limited to the greater of (1) $300,000 ($150,000 for a married person filing separately), or (2) the taxpayer's total net farm income for the prior five tax years. Any disallowed loss is carried forward to the next tax year (IRC Sec. 461(j)).

Operating Expenses

Farmers may deduct the ordinary and necessary expenses incurred in operating a farm for profit.

Chemicals. Chemicals applied to crops and farmland are deductible farming expenses. These include herbicides, pesticides, and insect sprays and dust.

Feed Purchased. The cost of feed purchased for livestock used in the farming activity represents an ordinary and necessary farming expense. The cost of feed purchased for livestock consumed by the farmer and his family is not deductible. The "value" of the feed grown by a farmer, including the value of the farmer's labor in producing the feed, is not deductible.

A cash-basis farmer would deduct the cost of the feed (and supplies in general) in the year purchased. Questions are raised, however, when a cash-basis farmer purchases and pays for feed during one taxable year but the feed is consumed by the farmer's livestock in the next taxable year.

There are two limitations applied in resolving this problem:

1. The cost of the feed is not deductible until it is consumed by the livestock unless three conditions are met.
2. The cost of the prepaid farming supplies (including feed) that exceeds 50% of the deductible farming expenses for the taxable year may not be deducted. The excess is deducted in the year consumed.

The three conditions that must be met in order to deduct the cost of feed in the year paid versus the year consumed are as follows:

1. The disbursement must be a payment for the purchase of the feed, not a deposit.

   A payment would not be considered a deposit if a sales contract existed that specified that the seller intended the payment to be nonrefundable. The contract would specify a quantity of feed. There would be no right of substitution.

2. The payment must not be strictly tax-motivated. It must have a business purpose.

   A business-purpose-versus-tax-avoidance distinction is more difficult. The farmer would most likely have a valid business purpose for acquiring the feed.

   Example 1: An advance payment may fix a price at a specific level, ensure preferential treatment in the event of a feed shortage, or ensure that a supply of feed is available at all times. An "investment" farmer would probably have a tax-motivated reason for prepaying for feed.

3. The deduction of the feed payment may not create a distortion of income that is material to the farming operation.

   The material-distortion requirement is perhaps the toughest to overcome. Generally, accounting principles dictate that there must be a matching of income and expenses. The IRS uses this rationale in claiming authority to disallow the deduction for prepaid feed purchased by a cash-basis taxpayer. This authority would permit the IRS to require the farmer to defer the deduction until the feed is consumed in order to avoid a material distortion of income.

Fees for Breeding

Under IRC Sec. 162, a farmer has the option of deducting *or* capitalizing breeding fees. The distinction becomes one of determining whether the cost was connected with raising the livestock versus acquiring the livestock. The distinguishing factor is the risk of loss. If the risk of loss stays with the taxpayer, then the fee is deductible in the year paid. If the risk of loss is with the seller until a future date, then the fee would be considered a cost of acquisition and would need to be capitalized.

Fertilizer and Lime

As long as the benefits of applying fertilizer and lime do not last longer than one year, the costs of purchasing and applying these materials may be deducted in the year paid. If the benefits of applying the fertilizer and lime last longer than one year, the expenses may be classified as capital expenses. IRC Sec. 180 permits a farmer to deduct the costs of purchasing and applying fertilizer and lime in the year paid as long as the taxpayer makes an election to do so.

The election to deduct the costs of purchasing and applying fertilizer and lime in the year paid must be made by the due date, including extensions, of the tax return for the year of the purchase. It is made by deducting the expense on Schedule F and is effective only for the year the deduction is made. It is an irrevocable election unless consent to revoke the election is granted by the IRS.

Note: If the fertilizer and lime purchased in a particular year are not consumed until the next year, the IRC Sec. 464 limitation may be triggered. Consequently, if the prepayment of the fertilizer and lime exceeds 50% of the other deductible farming expenses for the year, then the excess prepaid supplies are deductible in the taxable year in which the supplies are used.

Freight and Trucking

Expenses incurred for freight and trucking in relation to farming activities are deductible in the year paid. If the expenses are incurred in connection with the initial acquisition of livestock or farm machinery, the freight and trucking expenses must be capitalized as acquisition costs.

Gasoline, Fuel, and Oil

Expenses incurred for gasoline, fuel, and oil in relation to farming activities are deductible in the year paid. Note that any expenditures for gasoline, fuel, and oil used in vehicles used for personal use are not deductible.

Insurance

Theft, liability, crop, casualty, fire, and storm insurance premiums and premiums paid on farm assets are deductible as farm expenses. Premiums paid on policies covering farm employees for health, accident, workers' compensation, unemployment, and business overhead are also deductible. The farmer's life and disability insurance premiums would not be deductible items on the Schedule F because the proceeds from life and disability policies are nontaxable.

Note: Some disability policies include a business overhead clause. The portion of the premiums for the business overhead insurance would be deductible.

Premiums paid on policies that cover a period in excess of one year may not be deductible in one year. The taxpayer may be required to spread the deduction for the premiums paid over the period covered. Self-employed farmers may also be eligible for the health insurance deduction that is reported on page 1 of Form 1040. This deduction is 100% of the premiums paid for the health insurance coverage. A self-employed farmer may only be eligible for this deduction if he is not eligible for coverage under an employer-paid plan.

Compensation

Farmers may take a deduction for wages paid to laborers on the farm. This deductible compensation includes amounts paid to provide the laborers with shelter while in the employ of the farmer. Farmers need not include the value of the shelter provided laborers in the laborers' W-2 forms as long as the following conditions are met:

- The shelter is on the farmer's grounds.
- The shelter is furnished for the convenience of the farmer.
- The laborer must accept the lodging as a condition of employment.

The farmer may also be eligible to deduct compensation paid in the form of property. The farmer may pay the farm worker with produce or farm animals. The amount deductible would be the fair market value of the property transferred in exchange for the laborer's services.

A farmer may deduct compensation paid to family members as long as a valid employee-employer relationship exists. Adequate records and contracts, if possible, should be maintained in order to confirm that actual services were performed and payment was transferred in exchange for the services.

Maintenance

Farmers may deduct the cost of repairing and maintaining a working farm. Examples of a repair include fixing the tractor, replacing shingles, or painting a structure. As long as the repair does not substantially lengthen the life of an asset or increase the asset's value, it may be currently deductible.

The cost of applying fertilizer to the land may be a deductible maintenance expense as long as the land is in a "productive state." If the land has not yet been improved or prepared for growing crops, then the costs of preparing the land must be capitalized.

Rents

A reasonable amount paid in exchange for the use of property may be deductible as a farm expense as long as the property used is strictly for farm use. Care should be taken by the farmer to structure the rental agreement as a lease so that it may not be misconstrued as a sale.

Caution: Rent must be paid in cash. It may not be paid in crops or livestock because the cost of the crops and the livestock has already been deducted. The expense will be disallowed for any part of the payment that may be attributed to personal use.

Seeds

The cost of purchasing seeds and young plants is a deductible farm expense. The practice of expensing these costs should be applied consistently by the farmer.

Planting costs associated with planting timber must be capitalized. This treatment applies to orchards and Christmas trees. The costs are recovered through a depletion allowance.

Note: There are also expenses deductible by the farmer that are deductible by any other business form. Review Lesson 6 for a more detailed discussion of these expenses.

Depreciation

Farmers follow the same rules of capitalizing property as many business owners. Depreciation is not permitted for land, inventory, and personal residences on the farm. Items depreciated by farmers include fencing, breeding, and dairy and draft livestock. Farmers are, however, subject to specific rules concerning depreciation.

Immature livestock may not be depreciated until the age it can be worked, milked, or bred. Fruit and nut trees and vines cannot be depreciated until they reach income-production stage.

There are special rules for depreciating assets in a farming operation:

- Farmers generally depreciate assets using the 150% declining-balance method under MACRS, and then switching to straight-line, or they may elect SL over the GDS period or SL over the ADS period.
- Fruit and nut trees and vines are depreciated using the straight-line method over a 10-year life.

- If the uniform capitalization rules are not applied to plants produced in the farming operation, then ADS must be used to depreciate them. Generally, this involves the use of the straight-line method over a longer period of time.

Depreciation Lives for Farm Assets

	GDS	**ADS**
Single-purpose agricultural structures	10	15
Other farm buildings	20	25
Dairy and breeding cattle	5	7
Horses: Breeding and working (<12 years old)	7	10
>12 years old	3	10
Racing horses (>2 years old)	3	12
Goats and sheep: Breeding	5	5
Hogs	3	3
Fences (agricultural)	7	10

GDS = General Depreciation System

ADS = Alternative Depreciation System

(IRS Pub. 946)

The 5-year recovery period for certain machinery and equipment enacted by the Emergency Economic Stabilization Act of 2008 expired at the end of 2009.

The election to use the ADS method is made by entering the depreciation on the ADS line of Form 4562. Once this election is made in a tax year, it cannot be changed. The election applies to all assets within a property class placed in service in that particular year. The election applies to real estate on a property-by-property basis.

Farmers may elect the Section 179 expensing treatment on qualified assets, subject to the limitations discussed in Lesson 3.

Costs of Site-specific Management Actions under the Endangered Species Act of 1973

The Heartland, Habitat, Harvest, and Horticulture Act of 2008 (The Farm Act) includes a conservation provision for taxpayers in the business of farming. Post-2008 expenses related to achieving site-specific management actions under the Endangered Species Act of 1973 are to be deducted, rather than charged to a capital account. This deduction cannot exceed 25% of the farmer's gross income from farming during the tax year. (This treatment is the same as soil or water conservation expenses for land used for farming or for preventing erosion of farm land.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Liz breeds pigs on her pig farm. She acquires 200 breeding pigs for $5,000. After five years, Liz sells these pigs for $2,000 because they have exceeded their estimated useful breeding lives of three years. How would Liz report the sale?

    a. Liz would report $2,000 income on Schedule F.

    b. Liz would report a $3,000 loss on Schedule F.

    c. Liz would treat the $2,000 received as ordinary income flowing from Form 4797.

    d. Liz would report the $3,000 loss on Schedule D as a capital loss.

32. In 20X1, Malcolm purchases enough fertilizer and lime for his farm to benefit his land for 18 months. Which of the following statements is **not** accurate?

    a. Malcolm may elect to deduct the costs of purchasing and applying fertilizer in the year paid.

    b. The expenses may be classified as capital expenses.

    c. Malcolm's election to deduct the fertilizer and lime costs is an irrevocable election.

    d. Malcolm's election to deduct the fertilizer and lime costs in 20X1 must be made no later than April 15, 20X2.

33. Gomer is a farmer and a nurse. Gomer is covered under his employer's group health insurance policy at the hospital. The hospital pays 75% of his premium but requires Gomer to pay 60% of the difference between single-person coverage and married-couple coverage in order for his wife to be covered under his plan. During 2010, Gomer had $750 withheld from his wages for his wife's share of the health insurance. Gomer pays $1,500 for additional health insurance premiums under the plan he maintains for his farm. On their 2010 Form 1040, Gomer may deduct what amount of self-employed health insurance on page 1? (Assume that Gomer's Schedule F reports $10,000 income.)

    a. $2,250.

    b. $1,500.

    c. $750.

    d. $0.

34. Farmers may deduct compensation paid in the form of produce. The amount deductible is the __________ of the produce transferred in exchange for the workers' services.

    a. Cost.

    b. Fair market value.

    c. Future value.

35. Which of the following statements about depreciation, as it applies to farming, is **not** accurate?

    a. Fruit and nut trees and vines are depreciated using 150% declining-balance over 10 years.

    b. Fruit and nut trees and vines cannot be depreciated until they reach the income-producing stage.

    c. Immature livestock may not be depreciated until the age it can be worked, milked, or bred.

    d. The election to use the ADS lives applies to all assets (except real estate) within a property class placed in service in a particular year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

31. Liz breeds pigs on her pig farm. She acquires 200 breeding pigs for $5,000. After five years, Liz sells these pigs for $2,000 because they have exceeded their estimated useful breeding lives of three years. How would Liz report the sale? **(Page 110)**

    a. Liz would report $2,000 income on Schedule F. [This answer is incorrect. These pigs were acquired for breeding and were treated as depreciable assets by Liz.]

    b. Liz would report a $3,000 loss on Schedule F. [This answer is incorrect. These pigs were acquired for breeding and were treated as depreciable assets by Liz; therefore, they would have been fully depreciated at the time they were sold. The sale of depreciable assets are not reported directly on Schedule F.]

    c. Liz would treat the $2,000 received as ordinary income flowing from Form 4797. [This answer is correct. Liz would realize and recognize a $2,000 ordinary gain on Form 4797 when she sold these pigs. The pigs would be fully depreciated at the time of the sale and the income would be ordinary to the extent of the depreciation deducted.]

    d. Liz would report the $3,000 loss on Schedule D as a capital loss. [This answer is incorrect. The pigs were not an investment asset, rather they were assets used in the active conduct of a trade or business. As such, the reporting would not be on Schedule D.]

32. In 20X1, Malcolm purchases enough fertilizer and lime for his farm to benefit his land for 18 months. Which of the following statements is **not** accurate? **(Page 113)**

    a. Malcolm may elect to deduct the costs of purchasing and applying fertilizer in the year paid. [This answer is incorrect. IRC Sec. 180 permits Malcolm to deduct the costs of purchasing and applying fertilizer and lime in the year paid as long as he makes an election to do so. Therefore, this is an accurate statement.]

    b. The expenses may be classified as capital expenses. [This answer is incorrect. The expenses may be classified as capital expenses if the benefits of applying the fertilizer and lime last longer than one year. Since the benefits in this example last 18 months, this is an accurate statement.]

    c. Malcolm's election to deduct the fertilizer and lime costs is an irrevocable election. [This answer is incorrect. The election is an irrevocable election. It cannot be revoked without the consent of the IRS.]

    d. Malcolm's election to deduct the fertilizer and lime costs in 20X1 must be made no later than April 15, 20X2. [This answer is correct. Malcolm's election to deduct the fertilizer and lime costs in 20X1 must be made no later than the due date of his tax return, including extensions.]

33. Gomer is a farmer and a nurse. Gomer is covered under his employer's group health insurance policy at the hospital. The hospital pays 75% of his premium but requires Gomer to pay 60% of the difference between single-person coverage and married-couple coverage in order for his wife to be covered under his plan. During 2010, Gomer had $750 withheld from his wages for his wife's share of the health insurance. Gomer pays $1,500 for additional health insurance premiums under the plan he maintains for his farm. On their 2010 Form 1040, Gomer may deduct what amount of self-employed health insurance on page 1? (Assume that Gomer's Schedule F reports $10,000 income.) **(Page 114)**

    a. $2,250. [This answer is incorrect. Only Gomer's farm portion of the health insurance paid would be eligible for the self-employed health insurance deduction if it can be deducted. The $750 deducted from his wages by his employer is not included.]

    b. $1,500. [This answer is incorrect. Even though farmers are eligible for the self employed health insurance deduction, the rules related to such deduction still apply.]

    c. $750. [This answer is incorrect. The $750 withheld from his wages for his wife's share of the health insurance is not eligible for the self-employed health insurance deduction because this insurance is available to him as an employee.]

    d. $0. [This answer is correct. The amount Gomer paid would *not* be eligible for the deduction since he is eligible for coverage under his employer's plan. It would be deductible on Schedule A, subject to the 7.5% exclusion.]

34. Farmers may deduct compensation paid in the form of produce. The amount deductible is the _______ of the produce transferred in exchange for the workers' services. **(Page 114)**

    a. Cost. [This answer is incorrect. The deductible amount of compensation paid in the form of produce is *not* the cost of the produce. A farmer may take a deduction for compensation paid to employees in the form of produce or farm animals, but not at the farmer's cost of that item.]

    b. Fair market value. [This answer is correct. The amount of compensation paid in the form of produce is the fair market value of the produce transferred in exchange for the workers' services.]

    c. Future value. [This answer is incorrect. It is difficult to determine with certainty the future value of the produce.]

35. Which of the following statements about depreciation, as it applies to farming, is **not** accurate? **(Page 115)**

   a. Fruit and nut trees and vines are depreciated using 150% declining-balance over 10 years. [This answer is correct. Fruit and nut trees and vines are depreciated using the straight-line method over 10 years.]

   b. Fruit and nut trees and vines cannot be depreciated until they reach the income-producing stage. [This answer is incorrect. This is a true statement. Assets cannot be depreciated until they're placed in service. For fruit and nut trees, that period of time is when reach the income-producing stage.]

   c. Immature livestock may not be depreciated until the age it can be worked, milked, or bred. [This answer is incorrect. This is a true statement. Farmers may not depreciate immature livestock until the time at which the livestock contributes to the farming activity.]

   d. The election to use the ADS lives applies to all assets (except real estate) within a property class placed in service in a particular year. [This answer is incorrect. This is a true statement. Once a depreciation election to use the higher ADS lives is made, it must be applied to all assets within the same property class for assets placed in service in a particular year.]

EXAMINATION FOR CPE CREDIT

Lesson 7

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

31. Which of the following statements regarding farming activity is **not** accurate?

    a. Expenses incurred in a farming activity must be ordinary and necessary.

    b. The manner in which the farming activity is conducted is one of the factors considered in determining a profit motive.

    c. If a farmer derives pleasure from the farming activity, he would not be able to deduct the expenses associated with the activity.

    d. If the farming activity was not profit-motivated, then the expenses attributable to the activity would be deductible under IRC Sec. 183.

32. If a farmer has pledged crop production in order to secure a CCC loan and elects to report the loan proceeds in the year the proceeds are received rather than the year the crop is sold:

    a. The amount of the loan reported as income becomes the basis of the crop sold.

    b. The farmer need not apply the election to all CCC loans received during the election year.

    c. The farmer needs to include the amount on Schedule F. No other disclosure is required.

    d. Then the farmer is treating the loan amount as a loan.

33. Robin is looking into breeding her prize sow with Clay's prize hog. Any breeding fees Robin would pay Clay:

    a. May not be capitalized since the payment and the breeding would take place in the same tax year.

    b. Would be capitalized if the risk of loss stayed with Robin and the sow became impregnated.

    c. Would be expensed if the risk of loss is with Clay until a future date but only if the breeding activity was successful.

    d. Would be considered a cost of acquisition and would be capitalized if the risk of loss is with Clay until a future date.

34. Candace employs her son on her income-producing farm, along with two other laborers. Which of the following statements is most accurate?

    a. Candace may not deduct wages paid to her son because a deduction for compensation paid to family members does not exist.

    b. Candace may pay her son in produce. She would deduct the cost of the produce as compensation.

    c. Candace may pay her son in produce. She would deduct the fair market value of the produce as compensation.

    d. Candace may pay her son using produce he likes in order to deduct the cost of the produce as compensation.

35. Gilroy calls a CPA's office with questions concerning expensing versus capitalizing costs of seeds and seedlings. The CPA tells him that:

    a. Planting costs associated with planting timber must be capitalized.

    b. The cost of purchasing seeds and young plants must be capitalized.

    c. He may either expense or capitalize any seeds and timber seedlings as long as he is consistent in the treatment.

    d. Christmas tree orchards must be capitalized, but costs associated with apple tree orchards may be expensed.

Lesson 8: Retirement Plans

Introduction

This lesson discusses retirement plans, including plans available to the self-employed, calculation of taxable compensation, contribution limitations, Education and Roth IRAs, SEP and SARSEP plans, qualified plans, and SIMPLE plans.

Learning Objectives

Completion of this lesson will enable you to:

- Identify the deduction limits and qualification rules unique to each type of retirement plan.

Individual Retirement Account (IRA)

Retirement plans provide sole proprietors with a method of setting aside tax-free money. The different types of plans available to self-employed individuals will be reviewed. Detailed discussions of the more complex top-heavy rules, distribution rules, and combination plan rules are beyond the scope of this course and are available in other course materials.

Retirement plans may take one of several forms:

- Individual Retirement Account (IRA)
- SEP-IRA
- Qualified plan
- SIMPLE

Note: A sole proprietor is generally considered the employer and employee for purposes of participating in a retirement plan. The general rules for each type of plan are varied.

Individual Retirement Accounts

Contributions to Traditional IRAs

An IRA may be established at banks, brokerage firms, and insurance companies. The key is that the IRA must meet Internal Revenue Code requirements. The institution with which an IRA is established must provide an IRA disclosure statement.

An IRA may not be established for or contributed to by individuals who are over 70½ years old even if those individuals are still generating earned income either through wages or self-employment. This age limitation does not apply to Roth IRAs, which will be discussed later in this lesson.

An IRA may be established for a nonworking spouse. This is called a *spousal IRA.*

The **Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)** increases the IRA (and Roth IRA, which is discussed later in this lesson) contribution limits to $5,000 per taxpayer, phased in as follows.

Year	Contribution Limit
2002–2004	$ 3,000
2005–2007	4,000
2008	5,000
After 2008	Adjusted for annual inflation in $500 increments

Individuals aged 50 before the end of each tax year may make *catch-up* contributions under provisions of EGTRRA.

Year	Catch-up	New Limit	Total
2002–2004	$ 500	$ 3,000	$ 3,500
2005	500	4,000	4,500
2006–2007	1,000	4,000	5,000
2008	1,000	5,000	6,000

There are two other types of IRAs (i.e., other than traditional and Roth IRAs)—SIMPLE IRAs and SEP IRAs. These are employer-sponsored retirement accounts, which can also be set up by self-employed individuals. They are subject to different rules than those governing traditional and Roth IRAs.

Maximum Allowable Contributions. Contributions to traditional IRAs can be deductible, partly deductible, or nondeductible. Regardless of how the contribution is treated, the initial step is determining the maximum amount the taxpayer is allowed to contribute.

For 2010, IRA contributions generally can be made up to the lesser of (1) $5,000 ($6,000 if age 50 or older by the end of 2010) or (2) 100% of the individual's compensation. Compensation includes wages, salaries, Schedule C net income and Schedule F net income reduced by the half self-employment tax deduction; other amounts derived from or received for personal services actually rendered; and alimony. For married couples, IRA contributions up to $5,000 ($6,000 if age 50 or older by the end of 2010) can be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount and they file a joint return. Contributions must be made in cash.

Members of the Armed Forces. Those serving in a combat zone can count their nontaxable combat pay as compensation to allow them to make contributions to an IRA. This provision is effective for tax years beginning after December 31, 2003.

2008 Law Change. The Heroes Act (P.L. 110-245 enacted June 17, 2008) included a provision to treat differential pay as compensation for retirement plan purposes and it qualifies as compensation for purposes of the IRA contribution rules. Differential pay is any payment that (1) is made for any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days and (2) represents all or part of the wages that the individual would have received if performing services for the employer.

Note: These contribution limits apply to the combined contributions to all of the taxpayer's traditional and Roth IRAs. Thus, an under age 50 taxpayer who contributes $5,000 to a Roth IRA for 2010 cannot also contribute to a traditional IRA, and vice versa. Allowable contributions can also be split between the two in any fashion.

For the year an individual attains age 70½, and all years thereafter, contributions to traditional IRAs (deductible or nondeductible) are not permitted, even if the individual continues to have earned income. However, such a taxpayer's earned income can still be used by his or her spouse (under age 70½) as the basis for the spouse's IRA contributions (IRS Pub. 590). Taxpayers over age 70½ can still make contributions to Roth IRAs.

Deductible Amount of IRA Contribution. Allowable contributions to traditional IRAs are always fully deductible if the taxpayer (and spouse, if married) is not an "active participant" in an employer-maintained retirement plan. If the taxpayer (or his or her spouse) is an active participant in an employer plan and modified adjusted gross income (AGI) exceeds certain limits (see the following table), the taxpayer cannot deduct the full amount of the IRA contribution and may not be able to deduct any of the contribution.

For married couples, one spouse's participation in an employer plan not only subjects his IRA contribution deduction to phase-out, but it also causes his spouse's contribution deduction to be subject to phase-out. There are two deduction phase-out thresholds for married couples when only one spouse is covered by an employer plan: one for the participant spouse and another for the nonparticipant spouse. Once modified AGI exceeds the upper limit of the phase-out range, no deduction is allowed for affected individuals.

When married people living together file separately and both make IRA contributions, the phase-out computation applies to each spouse's contribution and is based on each spouse's modified AGI.

Modified AGI Limits for Making Deductible Contributions by Active Plan Participants to Traditional IRAs (for Each Participant)

	2009	2010
Married filing joint and Qualifying widower	Between $89,000 and $109,000	Between $89,000 and $109,000
Married taxpayers who are not active plan participants but whose spouse is such a participant	$166,000 and $176,000	$167,000 and $177,000
Married filing separate	$0 and $10,000	$0 and $10,000
Single and Head of household	Between $55,000 and $65,000	Between $56,000 and $66,000

Example 1: Determining Married Couple's Allowable IRA Deduction.

Eddie and Jane Haskel file a joint return and both are under 50 years old. For 2010, each has salary income of $50,000 and their modified AGI is $110,000. Eddie is an active participant in his employer's 401(k) plan. Jane's employer does not offer any retirement plan coverage. Each contributes the maximum allowable amount of $5,000 to a traditional IRA for 2010. How much can they deduct?

Because Eddie is covered by an employer plan, his applicable modified AGI phase-out range is $89,000−$109,000. Jane, on the other hand, is not an active participant in an employer plan, but her spouse (Eddie) is. Thus, the modified AGI phase-out range applicable to her contribution is $167,000−$177,000. Their 2010 modified AGI is $110,000; so Eddie's $5,000 contribution is not deductible, but Jane's $5,000 contribution is.

Nondeductible IRA Contributions. See the Form 8606 and its instructions for filing requirements regarding nondeductible contributions.

A taxpayer who makes nondeductible traditional IRA contributions acquires tax basis in his traditional IRAs. Later distributions from any of the taxpayer's traditional IRAs must be allocated between nontaxable (return of basis) and taxable.

Deadline for Making Contributions. IRA contributions must be made by the due date for filing the taxpayer's return not including extensions (i.e., by April 15, 2011, for 2010 contributions).

Direct Deposit of Federal Income Tax Refunds. A change included in the 2006 Pension Act permits individuals to direct their federal income tax refunds into traditional IRAs, subject to the usual contribution limitation rules. This change took effect starting in 2007. Form 8888 (Direct Deposit of Refund to More Than One Account) is used for this purpose.

Roth IRA

The following are key provisions related to the Roth IRA:

- Contributions to Roth IRAs are subject to the same dollar limitations as contributions to traditional IRAs.
- The total contributions to Roth IRAs and traditional IRAs cannot exceed the maximum annual contribution permitted to an IRA.
- Individuals may continue contributing to a Roth IRA after age 70½.
- The contributions to a Roth IRA are nondeductible.
- Distributions from a Roth IRA of contributed amounts are nontaxable.
- The earnings accumulated within a Roth IRA are nontaxable when distributed unless there is a distribution that is not a qualified distribution.
- The required minimum distribution rules do not apply to the Roth IRA during the owner's lifetime.

A qualified distribution from a Roth IRA is:

- Made after an individual attains the age of 59½,
- Made to a beneficiary or estate of the individual on or after the death of the individual,
- Attributable to the individual becoming disabled, or
- Made to the individual to be used by a first-time home buyer to acquire a principal residence.
- The qualified distribution may not be made within five taxable years from the year the Roth IRA was established.

Note: Contributions to a Coverdell ESA (Education IRA) are *disregarded* when determining the contribution limitations to a Roth IRA because the term "IRA" does not include the Coverdell ESA under IRC Sec. 530.

The 1998 Act adds that contributions to an SEP or SIMPLE plan are *not* taken into account for determining annual contributions to a Roth IRA. Also, an SEP or a SIMPLE plan may not be designated as a Roth IRA. Eligible taxpayers may, therefore, maximize their contributions to an SEP or SIMPLE as well as contribute to a Roth IRA.

Contributions to Roth IRA accounts are phased out as an individual's AGIs reach specific amounts.

	2009	**2010**
Married filing jointly and Qualifying widower	Between $166,000 and $176,000	Between $167,000 and $177,000
Married filing separately	$0 and $10,000	$0 and $10,000
Single and Head of household	Between $105,000 and $120,000	Between $105,000 and $120,000

Mandatory distribution rules do not apply to Roth IRAs.

Individuals may roll contributions into a Roth IRA from a regular IRA as long as the taxpayer's modified AGI does not exceed $100,000 in the year of transfer and as long as the taxpayer is not MFS, in which case conversions are not allowed. For tax years after 2009, rollovers into a Roth IRA will be permitted even if the individual's AGI exceeds $100,000. For conversions from a traditional IRA to a Roth IRA made in 2010, unless the tax payer elects otherwise, the taxable amount will be included ratably in income for 2011 and 2012. Special rules apply if the amount is distributed out of the Roth IRA before 2012. For conversions after 2010, the conversion taxes owed cannot be extended.

Under the Pension Protection Act of 2006 (PPA), individuals are able to roll amounts from the tax-qualified retirement plans, 403(b) annuities, and Sec. 457 government plans directly into a Roth IRA. This provision is effective for distributions made after December 31, 2007. These rollover contributions are treated as distributions not subject to early withdrawal penalties but subject to income tax.

It will be a challenge to tax advisors to determine whether it would be better to rollover funds from a regular IRA account to a Roth IRA or to leave the funds in their present IRA accounts. Individuals and their advisors would be required to examine the individual's marginal tax rate now and in the future. Roth IRAs would most likely benefit those who will be receiving social security benefits while taking IRA withdrawals and those who expect that IRA distributions will cause the individual to exceed the IRC Sec. 86 threshold income levels as they pertain to social security taxable income. It is not known, however, what the marginal tax rates will be 10–40 years from now and if social security will still be in effect.

Simplified Employee Pension (SEP)

Key Term: An *SEP* is a written qualified retirement plan under which an employer contributes to an employee's IRA and has simpler requirements than other qualified plans. Self-employed individuals are treated as employer and employee when discussing SEPs. The IRA is maintained by the employee. A self-employed individual may not deduct contributions to an SEP unless ratable contributions are also made for eligible employees of the self-employed individual.

An SEP allows the employee or sole proprietor many of the same tax advantages of more complicated qualified retirement plans. See the list of advantages in the following discussion of qualified plans.

The SEP must be a written plan executed by the employer (sole proprietor) prior to the latest date for making deductible contributions to the plan. This would be as late as October 15 of the year following the tax year for a calendar-year taxpayer.

The written plan must include the following information:

- The employer's name
- The eligibility requirements
- The formula for allocating the employer's contribution among the employees
- The signature of the responsible official of the employer

It is very easy to establish an SEP. First, the employer executes a plan that establishes the terms of the SEP. The plan outlines the employees' participation and the employer's contributions.

Second, every participating employee completes an IRA agreement. An IRA may be established at banks, brokerage firms, and insurance companies. The IRA agreement outlines the investment and distribution of the SEP contributions deposited into the IRA.

The employer may adopt a model SEP, a prototype SEP, or an individually designed SEP. The model SEP may be initiated using Form 5305-SEP (Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement) unless the self-employed individual maintains any other qualified retirement plans, maintained a defined benefit plan in prior years, uses leased-employee services, or has employees for whom an IRA has not been established. For these discussion purposes, it is only important to know that there are three types of SEPs.

The SEP must be maintained for all qualifying individuals. A qualifying individual is:

- At least 21 years old or older,
- Has worked for the employer for at least three of the immediately preceding five years, and
- Has received at least $550 (2009 and 2010) in compensation.

Note: The employer is not required to impose any of the preceding restrictions. An employer may permit all employees to participate in the SEP.

An employer may not limit participation in an SEP to categories of employees. An employee may not decline participation in an SEP established by the employer. If an employee does not establish an IRA account, the employer may do so on the employee's behalf.

An employee's SEP must be fully vested from the first date of participation. At no time may an employer's contribution to an SEP on behalf of an employee be forfeited or reallocated among employees participating in the plan.

Employer contributions under an SEP are generally deductible by the employer to the extent that they do not exceed 25% of total compensation. However, the contribution must be an ordinary and necessary business expense and, together with other compensation payments to the employee, reasonable compensation for services rendered. The excess of the amount contributed over 25% of total compensation may be carried over and deducted in a future year.

When applying the 25% ceiling on the employer's deduction, the maximum compensation that can be taken into account for any employee is $245,000 in 2009 and 2010.

Employer contributions to an employee's SEP-IRA are excludable from the employee's income to the extent that they do not exceed the lesser of 25% of the employee's compensation or $46,000 for 2008 and $49,000 for 2009 and 2010.

Contributions to an SEP are completely discretionary. The employer may choose to make a contribution to the plan in one year and then choose not to make contributions to the plan for the next three years. The law does not require the employer's SEP contributions to be recurring. (This is in contrast to the rules for profit-sharing plans, which will be examined later in this lesson.)

Taxable compensation for a self-employed person is self-employment income reduced by the deduction for half of the self-employment tax and the deduction for the SEP-IRA. Because the 25% is applied to taxable compensation *after* the deduction of the SEP contribution, the self-employed person calculates the contribution by applying the rate of 20% of taxable compensation *before* the deduction of the SEP contribution. The contribution rate for an SEP need not be 25%. The employer may choose a rate below 25%. Tables are provided (IRS Pub. 560) that indicate the calculation rate for a specific contribution rate (e.g., the contribution rate of 25% has a calculation rate of 20%). If a table is not handy, the calculation rate may be computed as follows: Contribution rate ÷ (1 + Contribution rate) = Calculation rate.

An SEP is an employee benefit plan. Employee benefit plans are required to disclose information to the IRS on Form 5500. An SEP is not required to file a Form 5500 as long as:

- The employer furnishes written notice to employees who are eligible to participate in the SEP (the notice may be a copy of Form 5305-SEP or 5305A-SEP) and
- The employer furnishes written statements to each participant that indicate the amount of the SEP allocation to the employee's IRA. (The written statement may be the contribution amount on the W-2 form.)

An SEP is ideal for a self-employed individual with no employees and easy to administer if the individual has employees. The following are the advantages:

- The administration of the plan is simple.
- The plan can be created after year-end.
- Contributions may be made up to the due date of the income tax return, including extensions.
- There are relatively few reporting requirements.
- The participants direct the investments in the plan.

Qualified Plans

Sole proprietors may establish qualified retirement plans, which are probably the most complicated of all types of retirement plans. (SEPs, as previously discussed, are also qualified plans, but they have less demanding requirements.) Under these plans, the self-employed individual is both the employer and the employee.

The term *Keogh* is now used to refer to any plan that covers at least one self-employed individual and does not refer to a specific type of plan.

Self-employment income includes income from a trade or business. Sole proprietors may carry on a trade or business by working as an independent contractor. Personal services must be rendered in generating self-employment income for plan purposes.

Following are some of the tax advantages available to the employer and the employee under a qualified plan:

1. Contributions made to the plan give rise to a current tax deduction for the employer.
2. Neither the plan nor the employee is taxed currently.
3. Generally, earnings produced by plan assets accumulate in the plan tax-free until distribution.
4. The employee pays tax in the year of distribution, but several tax planning opportunities may be available in that year.

The tax advantages to the employer in the following paragraphs are available only to a retirement plan that is qualified. The general requirements for status as a qualified plan follow.

1. The employer must establish and manage the plan for the exclusive benefit of the employees and their beneficiaries.

2. Contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees.

Qualified plans must also comply with extensive rules regarding participation and coverage of employees. Qualified plans are subject to full reporting and disclosure requirements. This is done on Form 5500. Fiduciary rules also apply.

The minimum participation rules apply only to defined benefit (DB) plans (see the information on DB plans later in this lesson). Typically, in a small business, employees are not excluded from participating. Thus, the minimum participation rules are usually satisfied. The minimum coverage rules require that a qualified plan benefit a broad range of employees and not discriminate in favor of highly compensated employees (HCEs).

A plan can have minimum age and/or service requirements. However, in general, a qualified plan cannot exclude an otherwise eligible employee from participation by requiring him or her to complete a period of service extending beyond the later of:

1. The date on which the employee reaches age 21; or

2. The date on which the employee completes one year of service, which generally is a 12-consecutive-month period during which the employee works at least 1,000 hours. However, a plan may require an employee to complete two years of service before becoming eligible to participate in the plan if the employee will be 100% vested after completing that service requirement. This exception does not apply to 401(k) features.

Specific vesting rules apply to each plan type.

A sole proprietor may either adopt an IRS-approved prototype or a master plan offered by an organization or have a plan written that conforms to the qualification requirements outlined in the Internal Revenue Code. Once the plan is established, the employer then sets up a trust or custodial account for the funds or buys annuity contracts or face-amount certificates from an insurance company.

Qualified plans must have been established by the last day of the employer's taxable year for which the plan is adopted (December 31 for calendar-year taxpayers) in order to take a deduction for the contribution. Contributions to the plan must be made by the due date of the income tax return, including extensions.

There are two types of qualified plans:

1. Defined contribution plans

2. Defined benefit plans

Defined contribution plans provide a separate account for each individual participating in the plan. Benefits are provided to each participant in the plan based on the amount contributed to the plan. Each participant's account is affected by income, expenses, and forfeitures of other accounts within the plan.

Defined contribution plans include money-purchase pension plans and profit-sharing plans.

A money-purchase pension plan has minimum fixed (mandatory) contributions that are not based on the employer's profits. These plans are precluded from containing a 401(k) feature. The maximum contribution to a money pension plan is 25% of compensation.

A profit-sharing plan is one under which a percentage of the employer's profits is contributed to the plan and shared among the participants in the plan. If a formula does not exist in order to determine the amount of profits to be shared, then the employer is obligated to make "systematic and substantial" contributions. Contributions to the plan are discretionary, but must be recurring. Forfeitures in this type of plan may be allocated among remaining participants or may reduce the amount of the employer contribution. The maximum deductible contribution under this type of plan is 25% of compensation. Loans may be made to certain participants from the plan under specific guidelines.

Generally, defined contribution plans sponsored by single employers are subject to several limits that are interrelated and require careful consideration in determining the employer deduction limit.

Employer Deduction Limits. The limitation on the amount that can be deducted depends on the type of plan:

1. **Money Purchase Plans.** The contribution deduction limit is 25% of total compensation (limited to $245,000 of compensation per participant for 2009 and 2010 for all employees.

2. **Profit-sharing and Stock Bonus Plans**. In general, an employer may deduct contributions of up to 25% of total participant compensation (limited to $245,000 of compensation per participant for 2009 and 2010 to a profit-sharing plan.

The definition for compensation used for a self-employed individual is the net self-employment (SE) income earned in the trade or business for which the plan is established. Net SE income is calculated after (a) the deduction for half of self-employment tax and (b) a reduction for the self-employed participant's deductible contribution to the plan. This latter reduction requires the use of a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income). For example, a deduction of 25% for a self-employed person would equal 20% of earned income after the reduction.

If the self-employed individual has a net loss from the trade or business, then she may not make a contribution for herself. However, if she has employees and suffers a net loss from the trade or business, the sole proprietor may still be required to make a contribution for any employees based on their compensation.

Plan contributions exceeding these limitations may be carried over and deducted in later years, subject to the applicable limitations. However, nondeductible contributions are subject to a nondeductible 10% excise tax the employer must pay each year the excess exists.

The Annual Addition Limit. The annual addition limit is the amount of contributions that can be added to an individual participant's plan account. This limit includes the employer and employee contribution as well as reallocated forfeitures allocated to the account of the participant. This limit is the lesser of 100% of compensation or $49,000 for 2009 and 2010.

Employee Deferral Limit. This limit applies to employee deferrals (e.g., a 401(k) plan) on a per-individual basis with respect to a calendar year. These deferrals are included in the annual addition limit (item 2) but not in the employer deduction limit (item 1). No participant may make a salary deferral of more than $16,500 in 2008 and 2009 (plus a $5,500 catch-up contribution if age 50 or over by the calendar year-end). This limit applies on an aggregate basis to all plans in which the employee participates.

Since deduction limits for profit-sharing plans have increased to the limit for money-purchase plans, many businesses are discontinuing their money-purchase plans. The exceptions are small businesses that use their money-purchase plans as a type of "forced savings" program.

Defined benefit plans provide for contributions to be made to provide the participants with a specific, determinable benefit. An employer can contribute and deduct an amount necessary to satisfy the annual minimum funding standard. Besides the amount necessary to satisfy the minimum funding standard, an employer with a defined benefit plan may be able to contribute and deduct additional amounts. Limits on this additional contribution are actuarially determined.

Because of the mandatory contributions, defined benefit plans are seldom used anymore. For this reason, the author will not go into detail on these plans. The limitation for an annual benefit in a defined benefit plan is $195,000 for 2009 and 2010.

SIMPLE Plans

SIMPLE IRAs. A savings incentive match plan for employees (SIMPLE IRA plan) is a written salary reduction arrangement under which an eligible employee can elect to have the employer make contributions to a SIMPLE IRA rather than receiving that amount in cash.

An advantage of SIMPLE IRA plans is that they are easier to operate than Keogh plans (see "Qualified Plans"). SIMPLE IRA plans do not have to meet the nondiscrimination requirements, minimum participation and minimum coverage rules, vesting rules, or the top-heavy rules applicable to qualified plans. Also, Form 5500 is not required and fiduciary liabilities are limited.

SIMPLE IRAs are available to employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year. Self-employed individuals are also eligible to participate in a SIMPLE IRA plan. The employer may not currently maintain any other qualified retirement plans while using a SIMPLE IRA plan. SIMPLE IRA plans must be maintained on a calendar-year basis. So, employer eligibility is determined on a calendar-year basis.

If an employer establishes a SIMPLE IRA plan, all employees who received at least $5,000 in compensation from the employer during any two prior tax years (whether or not consecutive) and who are reasonably expected to receive at least $5,000 in compensation during the current year must be eligible to participate in the plan for the year. The employer can provide more liberal participation requirements than these, but not more restrictive ones. For example, an employer could allow employees to begin participating as soon as they are employed. This enables employers, including self-employed individuals, to establish SIMPLE IRA plans in their first year of existence without regard to any compensation requirement for prior years.

SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. Employer contributions must be made under one of two formulas:

1. **Matching Contribution Formula.** Employers must generally match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year. However, in two out of every five years, the employer has the option of electing a matching percentage as low as 1% of each eligible employee's compensation. For purposes of the matching contribution, compensation is not limited.

2. **Nonelective Contribution Formula.** In lieu of making matching contributions, the employer may contribute 2% of compensation for each eligible employee having at least $5,000 of compensation during the calendar year. "Compensation" of each eligible participant is limited to $245,000 for 2009 and 2010).

Note: Under IRC Sec. 404(a)(8)(C), a self-employed individual's deduction for contributions to a pension, profit-sharing, and/or stock bonus retirement plan cannot exceed his earned income from the business. However, IRC Sec. 404(m), which allows the deduction for the SIMPLE IRA plan contribution, contains no such limitation. Therefore, while not entirely clear, it appears the combined deduction the self-employed individual can claim for contributions to the SIMPLE IRA plan (elective deferral plus employer match) can exceed the net income from the business.

An employer can generally establish a SIMPLE IRA plan effective on any date between January 1 and October 1 of the year. However, if an employer previously maintained a SIMPLE IRA plan, a new one can be established effective only on January 1. A new employer that comes into existence after October 1 can establish a SIMPLE IRA plan effective between October 1 and December 31 if the plan is established as soon as administratively feasible after the employer comes into existence.

The IRS provides a model agreement for most employers that may be used to adopt a SIMPLE IRA plan, but it is not required. Prototype plans (developed by financial institutions, such as banks, savings and loan associations, or regulated investment companies) and individually designed plans can be adopted.

SIMPLE 401(k) Plans. SIMPLE 401(k) plans are also available to the same employers who can establish SIMPLE IRA plans. A SIMPLE 401(k) plan is a qualified plan (profit-sharing plan) and is subject to the same requirements as Keogh plans. (See "Qualified Plans" in this lesson, including the definition of compensation.) The main advantage of SIMPLE 401(k) plans over typical 401(k) plans is that they are subject to simplified nondiscrimination tests and they are not subject to the top-heavy rules.

SIMPLE 401(k) plans are seldom the best plan for an employer. They are subject to the same filing requirements as the regular 401(k) plans (Form 5500), and the contribution limits are much lower. An employer must make either a 2% nondiscretionary contribution for all eligible participants or a 100% match up to 3% of compensation. These plans are also subject to the 100% of compensation annual addition limit discussed in “Qualified Plans.” Employee deferrals are limited to $11,500 for 2009 and 2010. A SIMPLE 401(k) plan generally is advantageous only for an employer with a small number of employees and a business owner who is not highly paid.

Employers are required to notify employees of their rights under the SIMPLE plan within 60 days prior to the beginning of the plan year or suffer a $50-per-day penalty. Eligible employees may elect to participate in a SIMPLE plan each year. This election must be made within a 60-day period before the beginning of each year (or within 60 days before first becoming eligible to participate in the plan). This election is to participate in the plan or modify an existing election.

Note: Participants in SIMPLE plans are “active participants” for purposes of the IRA deduction phase-out rules. Employee elective contributions are wages for employment tax purposes.

Tax Credits for Retirement Plans

Two tax credits are available for retirement plans: (a) certain plan participants are eligible for a credit for contributions they make to retirement plans and (b) businesses establishing new retirement plans are eligible for a credit for certain plan expenses.

Retirement Savings Contributions Credit. Eligible participants are entitled to a nonrefundable tax credit (that can offset both regular and alternative minimum tax) for contributions (or elective deferrals) made to a 401(k), 403(b), governmental 457, or SIMPLE plan; a SARSEP; or a traditional or Roth IRA. Voluntary after-tax employee contributions made to a qualified plan are also eligible for the credit. The credit (which is called “saver’s credit”) is claimed on the participant’s individual income tax return (i.e., Form 1040), and is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. Eligible participants include anyone over age 17 at the end of the applicable year who is not a full-time student or claimed as a dependent on another taxpayer’s return.

The maximum annual contribution eligible for the credit is $2,000. This amount is reduced by certain distributions received from qualified plans or IRAs during the year, the two years prior to the year the credit is claimed, or the period after that year until the due date of the return for that year. The credit rate for 2009 and 2010 is determined by the taxpayer’s modified adjusted gross income according to the following table.

Year	Joint Filers	Heads of Household	Single Filers and Married Filing Separately	Credit Rate
2010	$0–$33,500	$0–25,125	$0–16,750	50%
	$33,501–$36,000	$25,126–$27,000	$16,751–$18,000	20%
	$36,001–$55,500	$27,001–$41,625	$18,001–$27,750	10%
	Over $55,000	Over $41,625	Over $27,750	0%

Year	Joint Filers	Heads of Household	Single Filers and Married Filing Separately	Credit Rate
2009	$0–$33,000	$0–24,750	$0–16,500	50%
	$33,001–$36,000	$24,751–$27,000	$16,501–$18,000	20%
	$36,001–$55,500	$27,001–$41,625	$18,001–$27,750	10%
	Over $55,500	Over $41,625	Over $27,750	0%

Credit for New Retirement Plan Expenses. Certain small employers that establish a new qualified defined benefit or defined contribution plan (including a 401(k) plan), a SIMPLE plan, or SEP can claim a nonrefundable income tax credit for administrative and retirement-education expenses (IRC Sec. 45E). The credit applies to 50% of the first $1,000 of qualified expenses for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000. For an employer to be eligible for the credit, the plan must cover at least one nonhighly compensated employee. In addition, if credit is for cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who have been with the employer at least three months.

The 50% of qualifying expenses offset by the credit are not deductible; however, the other 50% of such expenses (along with other expenses above the $1,000 limit) remain deductible.

Rollovers

TRA 2001 makes available increased rollover options for individuals in retirement plans. It provides for rollover distributions from one type of qualified plan to any other qualified plans. Distributions from an IRA may be rolled into a qualified retirement plan. All rollovers must be directly from one plan trustee to the other plan trustee.

The last key provision is that after-tax contribution rollovers may be accepted by the qualified plan unless that plan is willing to maintain a separate accounting of those funds. This provision is effective for distributions after December 31, 2001.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Karen and Dan, a married couple, each have their own business in 2010. Karen's compensation base for IRA purposes is $68,000. Dan's compensation base for IRA purposes is $200. Karen and Dan are less than 50 years old. They may contribute a maximum of how much to IRAs?

    a. Karen may contribute $4,000 to her IRA and Dan may contribute $200 to his IRA any time prior to April 15, 2011.

    b. Karen may contribute $5,000 to her IRA and $5,000 to a spousal IRA set up for Dan any time prior to April 15, 2011.

    c. Karen may contribute $5,000 to a spousal IRA and Dan may contribute $200 to his IRA any time prior to the extended due date of their 2010 tax return.

    d. Karen may contribute $5,000 to her IRA and $5,000 to an IRA established for Dan any time prior to the extended due date of their 2010 tax return.

37. Barbara is a 45-year-old self-employed golf instructor and her husband, 48-year-old Kurt, is employed as a salesman with a large insurance company. Barbara is not an active participant in any retirement plan. Kurt is an active participant in his employer's 401(k) plan. The couple's 2010 AGI is $48,000. Barbara's Schedule C net income is $20,000. Which of the following statements is most accurate?

    a. Barbara may make a deductible contribution of $5,000 to her IRA. Kurt may make a deductible contribution of $5,000 to his IRA.

    b. Barbara may make a deductible contribution of $5,000 to her IRA. Barbara may also make a nondeductible contribution of $5,000 to her Roth IRA.

    c. Barbara may make a nondeductible contribution of $5,000 to her Roth IRA. Kurt may make a deductible contribution of $5,000 to his Roth IRA.

    d. Barbara may make a nondeductible contribution of $5,000 to her IRA. Kurt may not contribute to any IRA.

38. Josie, a 45-year-old self-employed manicurist, was married to Frank, a 46-year-old employee at a local wire company. Frank was eligible to participate in the company's retirement plan. The couple's 2010 joint adjusted gross income before IRA deductions, but after the deduction for half of Josie's self-employment tax deduction, was $96,000. Josie's Schedule C net earnings totaled $5,000. Josie and Frank each contribute $5,000to their respective IRAs. They may deduct how much on their 2010 Form 1040?

    a. $10,000.

    b. $8,250.

    c. $5,000.

    d. $0.

39. Which of the following is **not** accurate about a defined benefit plan?

    a. An employer can contribute and deduct an actuarially calculated amount necessary to satisfy the annual minimum funding standard.

    b. The contribution amount is calculated as a percentage of the employee's compensation.

    c. Defined benefit plans are no longer commonly used because of the mandatory contributions.

40. Beth, a 40-year-old self-employed whirligig designer, is considering setting up a SIMPLE plan. She is mainly attracted to the easy administration of the plan. Beth has one employee, who earns $8,000 per year. Beth's 2010 Schedule C net income is $230,000. Which of the following statements is most accurate?

    a. Beth may not contribute any money to her SIMPLE plan if her employee elects not to participate.

    b. Beth's employee's elective contribution to his SIMPLE plan may not exceed $240 (3% of $8,000).

    c. If Beth's employee elects to defer $240 into his SIMPLE plan, Beth must contribute at least $240 (3%) to his plan.

    d. Beth's employee may elect to defer $8,000 of his compensation into his SIMPLE plan.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

36. Karen and Dan, a married couple, each have their own business in 2010. Karen's compensation base for IRA purposes is $68,000. Dan's compensation base for IRA purposes is $200. Karen and Dan are less than 50 years old. They may contribute a maximum of how much to IRAs? **(Page 126)**

    a. Karen may contribute $4,000 to her IRA and Dan may contribute $200 to his IRA any time prior to April 15, 2011. [This answer is incorrect. While Karen and Dan have each contributed the allowable amounts based on their calculated compensations, they have not contributed the maximum allowable amounts.]

    b. Karen may contribute $5,000 to her IRA and $5,000 to a spousal IRA set up for Dan any time prior to April 15, 2011. [This answer is correct. Dan may choose to be treated as having no compensation. Karen may contribute $5,000 to her IRA *and* may set up a spousal IRA for Dan and contribute $5,000 to it.]

    c. Karen may contribute $5,000 to a spousal IRA and Dan may contribute $200 to his IRA any time prior to the extended due date of their 2010 tax return. [This answer is incorrect. If a spousal IRA is set up for Dan and a contribution made to it, then he may not make an additional contribution to his IRA. Also, there is a time limit for making contributions to an IRA.]

    d. Karen may contribute $5,000 to her IRA and $5,000 to an IRA established for Dan any time prior to the extended due date of their 2010 tax return. [This answer is incorrect. There is a time limit for making contributions to an IRA and it does not include the extension.]

37. Barbara is a 45-year-old self-employed golf instructor and her husband, 48-year-old Kurt, is employed as a salesman with a large insurance company. Barbara is not an active participant in any retirement plan. Kurt is an active participant in his employer's 401(k) plan. The couple's 2010 AGI is $48,000. Barbara's Schedule C net income is $20,000. Which of the following statements is most accurate? **(Page 127)**

    a. Barbara may make a deductible contribution of $5,000 to her IRA. Kurt may make a deductible contribution of $5,000 to his IRA. [This answer is correct. Barbara may make a deductible contribution of $5,000 to her IRA. Kurt may make a deductible contribution of $5,000 to his IRA because their AGI is below $167,000.]

    b. Barbara may make a deductible contribution of $5,000 to her IRA. Barbara may also make a nondeductible contribution of $5,000 to her Roth IRA. [This answer is incorrect. Barbara has a limit of $5,000 to contribute to any IRA. She may contribute to both types of IRAs, but she may not contribute in excess of $5,000 total.]

c. Barbara may make a nondeductible contribution of $5,000 to her Roth IRA. Kurt may make a deductible contribution of $5,000 to his Roth IRA. [This answer is incorrect. Contributions to a Roth IRA are always nondeductible.]

d. Barbara may make a nondeductible contribution of $5,000 to her IRA. Kurt may not contribute to any IRA. [This answer is incorrect. Barbara may make a deductible contribution to her IRA. Kurt is eligible to contribute to a Roth IRA. Kurt is also eligible to make a fully deductible contribution to his regular IRA due to the couple's AGI level.]

38. Josie, a 45-year-old self-employed manicurist, was married to Frank, a 46-year-old employee at a local wire company. Frank was eligible to participate in the company's retirement plan. The couple's 2010 joint adjusted gross income before IRA deductions, but after the deduction for half of Josie's self-employment tax deduction, was $96,000. Josie's Schedule C net earnings totaled $5,000. Josie and Frank each contribute $5,000 to their respective IRAs. They may deduct how much on their 2010 Form 1040? **(Page 128)**

a. $10,000. [This answer is incorrect. Josie and Frank may contribute $10,000 total to their IRAs; however, the deduction for their contributions is limited.]

b. $8,250. [This answer is correct. Josie and Frank would calculate their deductible IRA contributions as follows:

Josie's contribution		**$5,000**
Frank's contribution		**$5,000**
Maximum joint AGI	**$109,000**	
Their AGI	**96,000**	
Difference	**$13,000**	
Divided by $20,000		**× .65**
Josie's deductible		**$5,000**
Frank's deductible		**3,250**
Total deduction		**$ 8,250**

c. $5,000. [This answer is incorrect. Frank is permitted to make a deductible IRA contribution even if he participates in an employer-provided retirement plan as long as his joint income level is below a specific amount.]

d. $0. [This answer is incorrect. Josie and Frank are permitted to make deductible IRA contributions even if Frank participates in an employer-provided retirement plan as long as their joint income level is below a specific amount.]

39. Which of the following is **not** accurate about a defined benefit plan? **(Page 135)**

a. An employer can contribute and deduct an actuarially calculated amount necessary to satisfy the annual minimum funding standard. [This answer is incorrect. This is because the statement is true. A contribution to satisfy the minimum funding standard is deductible.]

b. The contribution amount is calculated as a percentage of the employee's compensation. [This answer is correct. Defined benefit plan contributions are calculated actuarially to be the amount necessary to satisfy the annual minimum funding standard. The annual contribution is not based on a percentage of the employee's compensation.]

c. Defined benefit plans are no longer commonly used because of the mandatory contributions. [This answer is incorrect. Defined benefit plans fell out of favor during the 1980's. This can be attributed to many factors, including the expense of making mandatory annual contributions to a defined benefit plan and the need to perform annual actuarial computations, which can be expensive.]

40. Beth, a 40-year-old self-employed whirligig designer, is considering setting up a SIMPLE plan. She is mainly attracted to the easy administration of the plan. Beth has one employee, who earns $8,000 per year. Beth's 2010 Schedule C net income is $230,000. Which of the following statements is most accurate? **(Page 137)**

a. Beth may not contribute any money to her SIMPLE plan if her employee elects not to participate. [This answer is incorrect. There is no rule that states Beth may not participate in her SIMPLE plan if her employee chooses not to participate.]

b. Beth's employee's elective contribution to his SIMPLE plan may not exceed $240 (3% of $8,000). [This answer is incorrect. Beth's employee's elective contribution may exceed 3% of his compensation.]

c. If Beth's employee elects to defer $240 into his SIMPLE plan, Beth must contribute at least $240 (3%) to his plan. [This answer is incorrect. Beth must make a contribution to her employee's SIMPLE plan each year; however, she may choose from a variety of contribution formulas.]

d. Beth's employee may elect to defer $8,000 of his compensation into his SIMPLE plan. [This answer is correct. Beth's employee may elect to defer $8,000 into his SIMPLE plan. He would not be limited to a percentage of his salary.]

EXAMINATION FOR CPE CREDIT

Lesson 8

Determine the best answer for each question below, then log onto our Online Grading Center at **cl.thomsonreuters.com** to record your answers.

36. Roth IRAs differ from regular IRAs in which of the following ways?

    a. A contribution to a Roth IRA is nondeductible, whereas a contribution to a regular IRA may be deductible or nondeductible.

    b. An individual may contribute to both a Roth IRA and a traditional IRA after reaching the age of 70½.

    c. Distributions from a Roth IRA are always nontaxable, whereas distributions from a regular IRA are always taxable.

    d. A spouse's active participation in an employer-provided retirement plan affects the ability to contribution to a Roth IRA but not a traditional IRA.

37. Which of the following statements about SEP plans is most accurate?

    a. An SEP plan must be executed by December 31 and contributions to the plan must be made by April 15.

    b. An SEP plan must be executed by April 15 and contributions to the plan must be made by April 15.

    c. An SEP plan must be executed by April 15 and contributions to the plan must be made by the extended due date of the tax return.

    d. An SEP plan must be executed by and contributed to by the extended due date of the tax return for the applicable tax year.

38. For IRA purposes, taxable compensation for a self-employed individual is equal to net taxable earnings from the self-employed individual's trade or business:

    a. Reduced by the deduction for half of the self-employment tax. No other compensation of the individual is taken into consideration.

    b. Reduced by the deduction for half of the self-employment tax and any deductions made on the self-employed's behalf for contributions to a retirement plan. No other compensation of the individual is taken into consideration.

    c. Reduced by the deduction for half of the self-employment tax and any deductions for contributions to a retirement plan. Other taxpayer compensation is considered such as W-2 wages, alimony received under separate maintenance, and commissions.

    d. Not reduced by any amount and not increased by any other income of the taxpayer.

39. A money-purchase pension plan:

    a. Has fixed contribution based on the employer's profits.

    b. Requires a plan contribution of 12% of the employees' compensation.

    c. Is a defined contribution plan.

    d. Is a defined benefit plan.

40. Which of the following statements is true as it applies to SIMPLE plans?

    a. Self-employed taxpayers may establish a SIMPLE plan.

    b. SIMPLE plan requirements are the same as requirements established for other qualified plans.

    c. An eligible employer must contribute at least 3% of all employees' compensation to a SIMPLE plan once it is established.

    d. The maximum contribution an employee may make to a SIMPLE plan in 2010 is $15,000.

Glossary

Accelerated Cost Recovery System (ACRS) – A depreciation method specified in the tax law that is applied to assets acquired after 1980 and through 1986. It was replaced by modified ACRS (MACRS). It prescribed asset lives and rates of depreciation for classes of assets.

Established by the Economic Recovery Tax Act of 1981 (ERTA 1981) and changed by the Tax Reform Act of 1986 (TRA 1986), ACRS ignores concepts of useful life and residual value and specifies “cost recovery periods” for various classes of assets that are used as the useful life. It also specifies the percentage of cost allocated to each year. ACRS ignores residual value and provides for rapid recovery of the acquisition cost of operational assets with the public-interest objective of encouraging capital expenditures to modernize existing plant assets.

Accountable Plan – Must satisfy three conditions:

1. Expenses must have a definite connection to the business.
2. Expenses must be substantiated (or deemed substantiated through per diem rules).
3. Excess amounts given to the employee through the expense allowance must be returned to the employer. These reimbursements are not included in the employee’s W-2 and are not subject to withholding or FICA.

Adjusted Gross Income (AGI) – Gross income minus allowed business deductions and other deductions allowed as adjustments to income “above the line,” such as business expenses, expenses of producing rent and royalty income, capital loss deduction, educator expenses, contributions to retirement plans (Keogh, IRA), deduction for education-related interest, tuition and fees deduction, allowed Archer medical savings account deduction, health savings accounts, moving expenses, one-half of self-employment tax, self-employed health insurance, interest forfeited on premature withdrawals, domestic production activities deduction, and alimony. AGI is used as a standard for limiting the amount recognized for certain itemized deductions, such as medical expenses, casualty losses, and charitable contributions, and for the child and dependent care credit, and the phase-out of other tax benefits, such as the child tax credit and personal exemptions.

Alternate Valuation – For federal estate tax purposes, the general rule states that property includible in the decedent’s gross estate must be valued at fair market value as of the date of the decedent’s death. The alternate valuation is an exception to the general rule, which allows the property in the gross estate to be valued as of the date *six* months after the decedent’s death.

The executor may only elect the alternate valuation if the election decreases the value of the decedent’s gross estate, the estate tax, and the generation-skipping transfer tax imposed on the property.

If property has been distributed, sold, exchanged, or otherwise disposed of within the six months, the property is valued as of the date of ownership change.

Alternative Depreciation System (ADS) – Applies to nonlisted property and uses the *applicable* recovery period, depreciation method, and convention.

The following types of property are subject to ADS depreciation rules:

- Tangible personal property used outside the United States
- Property used for tax-exempt purposes (by a tax-exempt group)
- Property financed by tax-exempt bonds
- Imported property that the president of the United States has signed an executive order regarding
- Farm equipment or property placed in service during the year in which an election was made under IRC Sec. 263A(d)(3)

There are also exceptions to other types of property which can be depreciated using ADS if an election is made. This method is similar to but separate from the elections available under the general depreciation methods (MACRS) to elect to use 150% DB or straight-line depreciation over the MACRS lives.

Away from Home – A tax home is the location of the principal place of business. When an employee or business owner is absent from the principal place, or main office of a business, for a temporary assignment he is "away from home." IRS rulings in 1992 defined *temporary* as a term less than one year. Any period longer than one year is considered indefinite and the tax home changes. Away-from-home expenses can be calculated on actual expenses or based on the IRS per diem rate. Per diem can be prorated for periods of less than 24 hours if time spent is longer than an ordinary work day.

Basis Adjustment – A change in the valuation of the adjusted basis of an asset used for determining the asset's gain or loss for tax purposes or used for determining the amount of allowable depreciation, depletion, or amortization.

The original basis of a partnership interest acquired by a contribution of property, including money, is the money a partner contributed plus the adjusted basis of any property he contributed. If the property contribution results in taxable income to the partner, this income will generally be included in the basis of his interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is also treated as a contribution of money to the partnership by the partner.

Adjustments to basis. The original basis of an interest is increased by:

- Additional contributions to the partnership,
- The partner's distributive share of both taxable and nontaxable partnership income, and
- The partner's distributive share of the excess of the deductions for depletion over the basis of the depletable property.

The original basis of an interest is decreased (but never below zero) by:

- The amount of money and the adjusted basis of property distributed to the partner by the partnership,
- The partner's distributive share of the partnership losses (including capital losses),
- The partner's distributive share of nondeductible partnership expenses that are not capital expenditures,

- The amount of the partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner, and
- The partner's share of any IRC Section 179 expenses, even if the partner cannot deduct the entire amount on his individual income tax return.

Optional basis adjustments can be made if an election under IRC Sec. 754 is in effect.

Example: If a partner's interest in a partnership is sold, exchanged, or transferred, under IRC Sec. 743, a basis adjustment may be available to the purchasing partner to allow him to step-up or step-down the basis of the partnership assets to reflect the purchase price of the partnership interest and equalize the inside basis of the assets with the outside basis of the partner's interest.

Capitalization – To capitalize a cost is to record it as an asset and defer its recognition as an expense to future periods. The asset can be tangible (e.g., inventory or fixed assets) or intangible (e.g., securities, organization, or rearrangement costs) or can represent the right to receive services in the future (e.g., a prepaid expense, such as prepaid rent, insurance, subscriptions, or any service paid for in advance of receipt of the service). Assets are subject to an assessment of recoverability by the enterprise, such as the benefits to be derived and the periods benefited.

Accounting issues involve determination of the following:

- The valuation of the asset (the deferred cost), which usually equals the cash outlay or the market price of the asset (right to service) acquired
- The periods that will be benefited by the asset
- The appropriate method of amortization of the deferred cost

Cash Equivalents – Negotiable, highly liquid items that are the equivalent of cash in value and availability (e.g., checks, bank drafts, cashier's checks, certified checks, and money orders) and, in a broader sense, any short-term, highly liquid investment, such as commercial paper, Treasury notes, and marketable equity securities. Cash equivalents are classified as current assets.

Class Life – The period, specified by the alternative depreciation system (ADS), over which a taxpayer may take depreciation deductions for the alternative minimum tax (AMT) system for tax years prior to 1999.

The class life is generally defined as the asset depreciation range (ADR) midpoint life and is specified for many assets in Rev. Proc. 87-56 and Rev. Proc. 88-22.

Contributions – Gifts to qualified charitable organizations as opposed to gifts to private individuals. Such contributions are generally deductible.

Contributions are also money placed in a retirement fund such as an individual retirement arrangement or an employer-maintained retirement plan.

Coverdell Education Savings Account – After 2002, individuals may establish Coverdell education savings accounts (ESAs, previously called education IRAs) and, subject to an adjusted gross income (AGI)-based phase-out, may make nondeductible contributions of as much as $2,000 each year ($500 for 2011) for each account beneficiary under the age of 18. Contributions to these accounts accumulate earnings free of income tax, and distributions are tax-free up to the amount paid for qualified higher education expenses during that year. A contribution can be made to a Coverdell ESA in a tax year that a contribution is made to an IRC Sec. 529 qualified state tuition program for the same beneficiary. The proceeds from a Coverdell ESA may now fund expenses of elementary and secondary (K–12) education.

Credits – Amounts deducted from tentative tax to compute income tax payable, such as the credit for the elderly or the disabled, the credit for child and dependent care, the foreign tax credit, the general business credit, the earned income credit, the adoption credit, the Hope credit for higher education, and the Lifetime Learning credit.

Decedent – The deceased individual whose estate is being administered.

Depletion – In accounting, depletion is the systematic and rational allocation of the cost of a natural (wasting) resource (e.g., timber, minerals, oil, gas, coal) against revenue earned as the resource is extracted and sold. The depletion method is usually based on units of production:

Depletion per unit = capitalized costs ÷ total estimated units economically recoverable

Depletion per unit is revised as the denominator estimate changes. This is a change in the engineering reserves estimate that is accounted for prospectively:

Depletion expense = depletion rate × units extracted, current year

In oil and gas tax accounting, for federal income tax purposes, depletion is computed on each individual unit of property. The allowable depletion on each property is the higher of cost depletion or percentage depletion.

The *tax cost depletion* is determined through multiplication of the remaining tax basis by a fraction consisting of the current production as the numerator and the current production plus the estimated future production as the denominator.

For federal income tax purposes, *percentage depletion* is the lesser of a percentage of gross income or 100% of the net income from the property before depletion. The general rule is that 15% will be applied to the gross income in making this comparison. The deduction for percentage depletion cannot exceed 65% of the taxable income of the taxpayer before the deduction for depletion under the independent-producer exemption. Percentage depletion is available only to producers not classified as either refiners or retailers (i.e., independent producers and royalty owners). Furthermore, percentage depletion is allowable only on a depletable quantity of up to 1,000 barrels equivalent per day.

Note: The Working Families Tax Relief Act of 2004 (the Family Act) temporarily suspended the 100% net income from the property limitation that applies when computing allowable depletion if the property has marginal production for tax years through 2005. The Tax Relief and Health Care Act of 2006 further suspended the taxable income limit for such property through 2007. Thus, for marginal production properties, the allowable depletion was not limited to the net income from the property for 2007. The Energy Improvement and Extension Act of 2008 extended the suspension for tax years beginning in 2009, but not for years beginning in 2008 (IRC Sec. 613A(c)(6)(H)).

Election – An affirmative choice subject to a particular tax law provision. Elections often require the filing of a specific statement or form.

Example: The election to roll over capital gain into a small business investment company is made on a separate statement attached to the return.

In other cases, an election is made by simply taking a position on a tax return.

Example: The election out of the installment method of reporting is made by simply reporting all gain on the return for the year of the installment sale.

Estate Tax – Excise taxes levied on the transfer of a person's property on that person's death. There are federal estate taxes and state estate taxes. The amount of the federal estate tax is determined by applying the relevant tax rates to the taxable estate.

Excise Tax – A type of *ad valorem* (according to value) tax or *in rem* (on the physical units) tax levied by various levels of government on specified goods or services.

An excise tax can also be in the form of a one-time fee, as for a type of seller's license.

There are several different federal excise taxes that can be triggered by excess contributions to or insufficient withdrawals from pension plans.

Sales tax is a general (broadly applied) excise tax.

In general, excise taxes on tobacco, gasoline, and spirits are not deductible for individual income tax.

Expenses for Education – Expenses that are paid by an individual to maintain or improve skills in his existing trade or business or to meet the requirements of law necessary to retain an established employment status or level of income.

In the case of an employee, the expenses are deductible as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income limitation and the phase-out of itemized deductions.

In the case of a self-employed taxpayer, the expenses are deductible on Schedule C as ordinary and necessary business expenses in arriving at adjusted gross income.

Except in the case of teachers, deductible educational expenses do not include those expenses that qualify the taxpayer for a new occupation or position, even though such education may be expressly required by the taxpayer's employer or applicable law (IRC Sec. 162).

Extension – An automatic four-month time allowance granted to individual taxpayers for preparation and filing in the appropriate IRS center the tax return required for the prior year. Corporate extensions are for six months. The initial partnership extension is for three months. This extension is secured by filing the appropriate application (Form 4868 for individuals, Form 7004 for corporations, and Form 8736 for partnerships) and payment of any remaining tax liability calculated at the extension date.

As a general rule, corporate and individual extensions of time are not granted for more than six months beyond the original due date of the tax return.

Federal Insurance Contribution Act (FICA) – Federal legislation that:

- Provides for and administers social insurance (retirement, survivor's, and disability insurance) and elderly medical assistance (Medicare),
- Is a payroll tax, and
- Is financed by employee and employer matching contributions based on a prescribed percentage of income up to a specified amount.

The federal government responded to the need for old-age support by creating Federal Old-Age, Survivors, and Disability Insurance (OASDI), a national program of social insurance provided for in the Social Security Act of 1935. The program's objective was to cover all gainfully employed persons, including the self-employed, and excluding certain groups, such as persons employed by the U.S. government. Legislation has added all new employees of the U.S. government to FICA coverage.

Federal Unemployment Tax Act (FUTA) – Federal legislation that:

- Provides temporary economic security for workers who lose their jobs by being laid off (quitting is *not* covered immediately) and who meet minimum requirements,
- Is a form of insurance,
- Is organized and administered by the various states at federal instigation, and
- Is financed by employer contribution only. The federal rate is 6.2% on the first $7,000 paid to each employee, reduced by up to 5.4% of state unemployment tax (SUTA) paid.

Its purpose is to compensate unemployed workers for the period of time that is presumably needed to find a new job. The fund accumulates in periods of economic prosperity and is depleted in periods of economic recession, and is designed to act as a stabilizer of consumer consumption by supporting consumption during recessions.

FUTA means Federal Unemployment Tax Act while SUTA stands for state unemployment tax acts (a generic term used to apply to the provisions of the unemployment tax acts of the various states).

Form 1040 – Federal income tax return (form) for use by individuals for filing their annual income tax report. Form 1040 is also known as the individual "long form." This form is used when deductions are itemized, the taxpayer has capital gains or losses to report, or other schedules need to be attached.

The simplest federal income tax return for individuals, known as a "short form," is Form 1040-EZ. This form is used only by individuals in low income brackets who have no itemized deductions or other unusual items to report.

Half-year Convention – Only half of a year's depreciation is allowed in the year the asset is placed in service and in the year of disposition (IRC Secs. 168(d)(1) and 168(d)(4)(A)).

Under MACRS, the half-year convention is applied to all "personal property" (property other than residential rental property and nonresidential real property) in the year of acquisition and in the year of disposition, unless the mid-quarter convention is required for that tax year.

Home-office Expenses – Employment- and business-related expenses attributable to the use of a residence as the principal place of business. The office expense is allowed only if the portion of the residence is exclusively used on a regular basis as the taxpayer's principal place of business or as a place of business that is used by patients, clients, or customers.

Effective for tax years beginning after 1998, a home office qualifies as the principal place of business if:

- It is used by the taxpayer to conduct administrative or management activities of a trade or business and
- There is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

If the expenses are employment-related, the use must be for the convenience of the employer as opposed to being merely appropriate and helpful.

Involuntary Conversion – An involuntary conversion is the receipt of money or other property as reimbursement for the loss or destruction of property through theft, casualty, or condemnation. Any gain realized on an involuntary conversion can, at the taxpayer's election, be considered nonrecognizable for federal income tax purposes if the owner reinvests the proceeds within a prescribed period of time in similar property.

Investment Limitation – A provision of the tax law that allows the taxpayer to elect to expense up to a certain amount of tangible depreciable personal property placed in service during the year. The basis of the asset(s) is reduced by the amount so expensed. There are two restrictions: The amount expensed cannot exceed the taxpayer's aggregate taxable income from trade or business activities (excess is carried forward indefinitely), and the ceiling amount is reduced dollar-for-dollar for personal property acquisitions in excess of $500,000 (2010 and 2011). For 2010 and 2011, the qualifying property phase-out threshold is $2 million. Qualified Section 179 property must be acquired by purchase for use in the active conduct of a trade or business.

Lease Term – The fixed, noncancelable time period from the beginning to the end of the lease *plus* all periods, if any, covered by:

- A bargain renewal option,
- A penalty for failure to renew the lease such that renewal is reasonably assured,
- An ordinary renewal option during which the lessee guarantees the lessor's debt related to the leased property,
- An ordinary renewal option preceding the effective date of a bargain renewal option, or
- Renewals and extensions at the lessor's option.

The lease term never extends beyond the point in time when a bargain purchase option is exercisable. It is used in capitalization criteria and used as the amortization period when the basis for capitalization is either the 75% of economic life or the 90% fair value criterion (SFAS 98.22(a)).

Lessee – The party that receives the use of an asset in exchange for periodic rental payments. A lessee must apply accounting standards that apply to the lessee, even if different from those used by the lessor. A lessee must use the lower of the lessee's incremental borrowing rate *or* the discount rate used by the lessor, if known (the lessor's implicit interest rate).

A lessee's basic approach to accounting for a capital lease is to record, at the date of inception, an asset and a liability for the present value of all future rents required in the lease agreement:

$$\begin{array}{c}\text{Value of lease asset}\\ \text{and related liability}\end{array} = \text{Periodic lease payments} \times \begin{array}{c}\text{Present value of annuity}\\ \text{of } n \text{ at } i \text{ rate of interest}\end{array}$$

The recorded value of the asset (and liability) should not exceed the fair value of the asset at lease inception.

Listed Property – A term developed by the Internal Revenue Service (IRS) to handle property that can be used for business purposes but also has frequent personal usage by individuals. The following items are included among listed property (IRC Sec. 280F(d); Reg. Sec. 1.280F-6(b)(1)):

- Passenger automobiles weighing 6,000 pounds or less
- Other transportation equipment, except that used substantially for hire
- Any property used for entertainment, recreation, or amusement purposes
- Any computer or peripheral equipment (unless located at a regular place of business and owned by the owner of that business)
- Any other property specified in the IRS regulations

For tax years beginning after 2009, cell phones are no longer included as listed property.

Such listed property must be listed separately on Form 4562 (Depreciation Expense), the percent of business use must be indicated, and straight-line depreciation must be utilized when business use is 50% or less.

Malpractice – Professional misconduct or unreasonable lack of skill. It is the failure of one rendering professional services to exercise that degree of skill and learning commonly applied under all the circumstances in the community by the average prudent reputable member of the profession, with the result of injury, loss, or damage to the recipient of those services or to those entitled to rely upon the professional.

Marginal Tax Rate – The percentage of tax paid on the last dollar of taxable income. It is the highest percentage paid.

Mid-quarter Convention – Applied to all property (other than residential rental property and nonresidential real property) placed in service if more than 40% of the aggregate basis of all property placed in service during the year is placed in service during the last three months of the year. For tax years beginning after March 31, 1988, property placed in service and disposed of during the same tax year is not included in the 40% test.

Modified Accelerated Cost Recovery System (MACRS) – A depreciation method specified in the tax law applied to assets acquired after 1986. MACRS replaced ACRS (accelerated cost recovery system) and prescribes asset lives and rates of depreciation for classes of assets.

Money-purchase Pension Plan – A type of defined contribution plan in which contributions to the plan, rather than benefits under the plan, are determined by a formula, usually based on compensation. Each participant accumulates contributions in his own account.

Moving Expenses – Deductible moving expenses must be related to a change in job location. Expenses of moving household goods and personal effects, as well as travel (not including meals) from the former residence to the new residence, are moving expenses deductible as an adjustment in determining adjusted gross income (AGI), if the new place of employment is at least 50 miles farther from the old residence than the old place of employment.

The taxpayer must maintain full-time employment at least 39 weeks during the subsequent 12 months. For a self-employed individual, she must work 78 weeks out of 24 months, and at least 39 of the 78 weeks must be in the first 12 months (IRC Sec. 217 and Sec. 62).

Ordinary and Necessary – An ordinary expense is one commonly incurred in the regular course of a taxpayer's business, trade, or profession. An expense is necessary if it is appropriate and beneficial (though not necessarily essential) to the business.

Business expenses must be both ordinary and necessary to qualify as tax-deductible. Proof that an expense is ordinary and necessary may be required to support a deduction.

Ordinary and necessary is one of four requirements that business expenses must meet in order to be tax-deductible:

1. The expenses must be ordinary and necessary.
2. The expenses must be related to the carrying on of the trade, business, or income-producing activity.
3. The expenses must be reasonable in amount.
4. The expenses must be incurred or paid.

Phase-out Rules – The gradual elimination of credits, deductions, and personal exemptions for the personal taxpayer as the reported taxable income of the taxpayer increases.

Profit-sharing Plan – Established and maintained by an employer to provide for the participation in the profits by the employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants (Reg. Sec. 1.401-1(b)(1)(ii)).

Some plans make annual cash distributions resulting in current taxable income. Other plans make deferred income contributions to individual accounts. The pool of funds is invested in stocks, bonds, and other investments until withdrawn. A distribution from the fund is a taxable event.

Qualified Retirement Plan (or Qualified Plans) – Defined in IRC Sec. 4974(c) to be any of the following:

- A plan described in IRC Sec. 401(a) that includes a trust exempt from tax under IRC Sec. 501(a)
- An annuity plan described in IRC Sec. 403(a)
- An annuity contract described in IRC Sec. 403(b)
- An IRA (individual retirement account) described in IRC Sec. 408(a)
- An IRA annuity described in IRC Sec. 408(b)

To be qualified, the plan must follow the rules established by the IRS. When the plan is qualified under the IRS rules, the employer receives an immediate deduction for contributions to the plan, the income from the plan assets is not taxable, and the employee is taxed on the income only upon distribution from the plan.

Employee Retirement Income Security Act (ERISA) requirements for a qualified employee benefits plan

A qualified plan must meet at least *one* of three requirements:

1. The plan benefits at least 70% of employees who are not highly compensated.
2. The plan benefits a percentage of non–highly compensated employees that is at least 70% of the percentage of highly compensated employees benefiting under the plan.
3. The plan meets the “average benefits test.” Under the average benefits test, both of the following conditions must exist:
    - The plan must benefit employees qualifying under a classification set up by the employer that does not discriminate in favor of highly compensated employees.
    - The average benefit percentage for non–highly compensated employees must be at least 70% of the average benefit percentage for highly compensated employees.

Note: The definition of *highly compensated employee* is based on salary, ownership, and officer rank and is contained in IRC Sec. 414(q).

- A qualified plan should cover a minimum of the lesser of 40% of all employees or 50 employees.
- A qualified plan cannot discriminate in favor of highly compensated employees. Within IRC Sec. 401(a)(4), there are safe-harbor standards that can be used to satisfy this requirement.
- The participation standard requires that an employee become a participant in the plan no later than six months after the employee attains the age of 21 and has completed one year of service (generally 1,000 hours in 12 months).

Reasonable Compensation – If the compensation paid to an employee exceeds the amount the IRS deems to be "reasonable," the deduction for the compensation will be disallowed.

The amount of compensation that is considered "reasonable" is based on the facts and circumstances of the situation and determining what would be paid for like services by a like business under like circumstances (Reg. Sec. 1.162-7).

All compensation is considered, regardless of form. Thus, the value of perquisites, fringe benefits, retirement benefits, and deferred compensation is combined with cash compensation for this determination.

The IRS most commonly challenges compensation of owner-employees of closely held corporations. The excess compensation is usually treated as constructive dividends (i.e., nondeductible to the corporation and taxable to the owner-employee).

Recovery Period – The time period to which an asset is assigned for purposes of computing cost recovery deductions under the accelerated and modified accelerated cost recovery systems. The assigned life is based on the asset depreciation life system.

Regulations – The Secretary of the Treasury publishes interpretations of the law in the form of regulations. They do not have the force and effect of law except in those cases in which the law on a particular subject calls for rules on that subject to be expounded through regulations.

Many regulations are first issued in proposed form, with a designated time period in which practitioners and other interested parties can provide written or oral comments. Because proposed regulations are simply "invitations to comment," courts have consistently held that they lack any authoritative weight. Taxpayers must be careful when taking a tax-filing position that contradicts a proposed regulation, however, because the regulation could be issued in temporary or final form without material changes.

A final regulation is the final stage in the process of issuance of regulations after the comments have been received and considered. After release as a final regulation, the regulation has the force of law, subject to the right to challenge an interpretive regulation.

Residential Rental Property – A building or structure that derives at least 80% of its gross rental income from dwelling units. The term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure but does not include a hotel, motel, or other establishment where more than one-half of the units are used on a transient basis (IRC Sec. 168(e)(2)(A)).

Roth IRA (Individual Retirement Account) – Similar to a traditional IRA with a few exceptions. Contributions to a Roth IRA are always nondeductible, do not depend on whether the taxpayer or spouse is an active participant in a company-sponsored qualified retirement plan, and may be made after the taxpayer attains the age of 70½. In addition, qualified distributions are nontaxable. (Funds must be held in the IRA for five years prior to the initial distribution for the funds to be nontaxable.) Accounts may be passed to beneficiaries at death and remain nontaxable for income tax purposes.

For all years before 2002, contributions were limited to $2,000 per year. The limit on annual contributions for 2009 and 2010 are as follows:

Year	Amount
2009	$5,000
2010	$5,000

The act also allows an additional catch-up contribution to be made by taxpayers aged 50 and older:

Year	Amount
2009	$1,000
2010	$1,000

A participant who will attain the age of 50 before the end of a calendar year is deemed to be aged 50 as of January 1 of that year. The catch-up contribution can be made on any day of that year.

Self-employment Tax – A provision for social security (old-age, survivor's, and disability insurance) and Medicare (hospital insurance) for self-employed individuals. The social security portion is double the rate for employed individuals based on amounts of net earnings indexed for inflation. The Medicare portion is double the rate for the employed on unlimited amounts of net earnings. The estimated self-employed tax must be paid quarterly with the estimated income tax.

SIMPLE Plan – A savings incentive match plan for employees (SIMPLE) became available in taxable year 1997. An employer with 100 or fewer employees is able to adopt this new type of retirement savings plan for employees. The new plan is "simple" to maintain, has higher limits, and is available to a larger number of "small employers." In general, a SIMPLE plan can be either an IRA (individual retirement account) or a 401(k). For an IRA SIMPLE plan, individual IRA accounts are set up for employees. For a 401(k) SIMPLE plan, individual 401(k) accounts are set up for the employees.

Sole Proprietorship – A business form of one person conducting business as an individual. It is not a legal, taxable entity separate from the owner. The owner is personally liable for the debts of the proprietorship. It is governed by the laws of contracts and agency. The owner may hire employees or agents (or independent contractors). (Contrast to partnership and corporation.)

Special Allocation – Because IRC Sec. 704(a) allows the partners to choose how to allocate income and deductions, the partnership agreement may provide different allocation ratios for sharing items of income, gain, deduction, losses, and credits among the individual partners. When an allocation ratio differs from the partner's profit- and loss-sharing ratio, or when it differs from a partner's relative capital contribution, it is referred to as a *special allocation.*

Example: The partnership agreement may stipulate that partners A and B share equally in profits and losses, except that partner A would be *specially allocated* 100% of the depreciation on a building owned by the partnership. In this case, the partnership's ordinary income would be computed exclusive of depreciation on the building. Partner A would report on his tax return 50% of partnership income as well as *all* of the depreciation on the building.

If a partnership agreement is silent and does not provide for a special allocation, or if a special allocation is made and the allocation lacks *substantial economic effect,* a partner's distributive share of profit or loss can be redetermined by the IRS in accordance with the *partner's interest in the partnership.*

Standard Mileage Rate – For 2010, the standard mileage rate is 50 cents per mile for business miles driven.

To use the standard mileage rate, the following rules apply:

- The taxpayer must own the automobile and not use it for hire (e.g., as a taxi).
- The taxpayer may take neither accelerated depreciation nor additional first-year depreciation on the automobile (*Siragusa v. Comm.,* TC Memo 1980-68*).*

Additional mileage rates are available in 2010 for moving-expense deductions and itemized deductions:

- Job-related moving: 16.5 cents per mile
- Medical expense: 16.5 cents per mile
- Charitable activities: 14 cents per mile

  This rate is set by statute, not the IRS.

Straight-line Method – A method of allocation such that a constant dollar amount is recognized as revenue or expense each period. The straight-line method is used for depreciation, leases, and so forth.

Example: An asset costing $100,000, with a salvage value of $5,000, to be depreciated over 10 years by the straight-line method of depreciation, would be depreciated at $9,500 per year (($100,000 – $5,000) ÷ 10).

Tax Benefit Rule – It makes possible an allowable deduction in one year that leads to a state tax refund or reduction in tax liability in the future.

If during Year A, a tax benefit is realized through utilizing state income taxes paid, a medical expense deduction in excess of 7.5% of adjusted gross income (AGI), a casualty-loss deduction, or other deductions of this type, which reduce tax liability, the state income tax refund or any reimbursements for other expenses allowed must be included in income in Year B.

Tax Home – The taxpayer's principal place of business, regardless of where the taxpayer's family lives. If there are two business locations where the taxpayer commonly works, the tax home is the principal location. If there is no fixed business location, the tax home is the taxpayer's regular residence. A tax home is important because travel expenses are deductible only if the taxpayer is away from the tax home.

Taxable Income – The amount of income on which the taxpayer owes tax under current tax law. For individuals, it is adjusted gross income (AGI) minus personal exemptions and all allowable deductions (usually the larger of the standard deduction or itemized deductions). For a business, it is the excess of taxable revenues over tax-deductible business expenses for the period.

Traditional IRA – Beginning in 1998, an IRA that permits either a deductible or nondeductible contribution is referred to as a traditional IRA or IRA.

Units-of-production – A depreciation method based on the assumption that useful life decreases with production output rather than with the passage of time. The output can be measured as units of output or machine hours used. Depreciation expense varies with production. A proportionate part of cost is allocated to each unit of production.

The computation is: rate per unit = (cost – residual value) ÷ useful life (in units).

Depreciation expense = rate per unit × units of output, current year

The advantages of this method are that it is simple and uses actual output. The disadvantage is that depreciation expense varies each year.

Useful Life – The measurement of the benefit derived from the use of an operational asset, which may be measured in terms of time, units of production, or time of production (machine hours).

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Testing Instructions for Examination for CPE Credit

Small Business: Schedule C and F Expenses (DSBTG10)

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