2019 FEDERAL TAX UPDATE FOR BUSINESS RETURNS

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BUSINESS RETURNS

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ACCOUNTING PERIODS AND METHODS (§446 / §468/ §263A / §280E)

Accounting Methods - General Rules

Taxpayers may compute taxable income using any permissible method as long as that method is applied consistently and clearly reflects income. Overall methods of accounting for income and expenses include cash, accrual, other specifically permitted methods (usually for specific items), or a combination of these called a hybrid method (§446). The method used on the taxpayer's first return usually establishes the accounting method for that business. After that, the consent of the Secretary is normally required to change an accounting method (as discussed later).

The cash method. The cash method requires the reporting of income when it is received and deducting the expenses when the items are paid.

> **Warning**. Constructive receipt is an audit issue. This is why the auditor looks at bank deposits immediately after year-end.
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> **Tax practitioner planning**. Even for a cash basis taxpayer, expenses paid in advance can be deducted only in the year to which they apply.

When taxpayers are required to use the accrual method. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use the accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts per year exceed $26 million (2019). An exception to this $26 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation

(1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $25 million.

The accrual method. An accrual method taxpayer generally must recognize income when ***all the events*** have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method is required if you sell "products." A taxpayer whose business uses inventories must use the accrual method for purchases and sales. Inventories must be used in all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor (§1.446-1(a)(4)(I)).

> **Tax practitioner planning**. Accrual basis taxpayers must use the cash basis for deducting business expenses to a related cash-basis taxpayer.

Different accounting methods may be used for multiple business operations. For ease in compliance, the accrual method may be limited to sales and purchases of product only, rather than all income and expenses in businesses. This is called the hybrid method. Also, taxpayers may use one accounting method to compute income and deductions of one business and a different method for the income and deductions of another business (§1.446-1(c)(1)(iv)(b)). This flexibility is particularly helpful to the business whose main source of income is from the performance of services but also sells product.

Change of Accounting Methods

If the business does not strictly follow one of these acceptable methods (for example, the business uses the cash method on inventory, or uses an unacceptable accounting method combination), the business must request to change accounting methods. As strange as this may sound, a taxpayer may not change from an incorrect accounting method to a correct accounting method without the IRS's permission! A Form 3115 must be filed with the IRS.

New. **Accounting Method - Use of Cash Basis Available to More Businesses (§446)**

The cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $26 million for the three prior taxable-year period (was $5 million pre TCJA) to use the cash method. Farming C corporations (and farming partnerships with a C corporation partner) that meet the $26 million gross receipts test may use the cash method of accounting.

> **Tax practitioner planning**. Qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the $26 million gross receipts test, so long as the use of the cash method clearly reflects income.

***New*. Accounting Method - Inventories (§471(a) and new §471(c))**

Taxpayers that meet the $26 million (2019)gross receipts test (was $10 million in 2017) may use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories effective for tax years beginning after Dec. 31, 2017. In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer (§471).

> **Tax practitioner planning**. A deduction is generally permitted for the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations (§1.162-3(a)(1)).
>
> **Example**. Retail, Inc. has gross receipts in its prior three years of $4,000,000 and therefore is not required to use the accrual method of accounting even though the sale of merchandise is an income-producing factor. Retail, Inc. buys $100,000 of merchandise at its calendar year end. It may not include the purchase in its cost of goods sold but rather must include the purchase as incidental materials and supplies on its balance sheet. The $100,000 is deductible when the merchandise is sold.

***New*. Accounting Method - UNICAP (new §263A(i))**

The exception for small taxpayers from the uniform capitalization rules has been expanded to include any producer or reseller that meets the $26 million (2019) gross receipts test (was $10 million) effective for tax years beginning after Dec. 31, 2017. The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer's gross receipts.

***New*. Change of Accounting Method (§481)**

Taxpayers eligible to use the cash method, certain taxpayers exempt from the requirement to keep inventories, and the exception from the uniform capitalization rules has been expanded for purposes of §481 effective for tax years beginning after Dec. 31, 2017. Application of the exception for small construction contracts from the requirement to use the percentage-of-completion method is applied on a cutoff basis for all similarly classified contracts (hence there is no adjustment under §481(a) for contracts entered into before Jan. 1, 2018).

> **Example**. MRI, Inc. failed the $5 million gross receipts test in 2015 and properly converted its method of accounting to accrual basis. Since MRI, Inc. has gross receipts of less than $25 million in its three prior years, it may change its accounting method (back) to cash basis for 2018.
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> **Tax practitioner planning**. A Form 3115 is required to change accounting methods.

Small Businesses Get Automatic Consent for Accounting Method Change (Rev. Proc. 2018-40, IR 2018-160)

The IRS will provide automatic consent to a small business taxpayer's application to change to the cash method of accounting. Eligible small business taxpayers, as defined by TCJA, are generally those with

average annual gross earnings of $26 million or less in the prior three-year period (2019). The automatic consent changes include:

- a change to the cash method of accounting;
- exemption from UNICAP;
- certain changes to inventory items;
- a change from the percentage-of-completion method for long-term construction contracts; and
- exemption from UNICAP for home construction contracts.

Section 481(a) Adjustment

When changing a method of accounting different from the preceding taxable year, adjustments solely by reason of these changes must be taken into account in order to prevent amounts from being duplicated or omitted. Section 481 provides the mechanics of making a change in accounting method and offers some relief as to when the adjustment to taxable income resulting from the accounting method change should be made.

One-year negative and four-year positive §481(a) adjustment. If the automatic IRS consent is available to the taxpayer, a four-year positive §481(a) adjustment and a one-year negative §481(a) adjustment is allowed. However, if a positive adjustment is less than $50,000 a taxpayer may elect to take a positive adjustment into account in a single tax year. The IRS will not be so generous if they initiate the change.

> **Tax practitioner planning.** Taxpayers should generally use the four-year spread for positive adjustments (for example, increases to taxable income) and the 100% *de minimis* rule for negative adjustments (for example, decreases to taxable income).

If a taxpayer terminates the business, any remaining balance of a §481(a) adjustment must be taken into taxable income in the tax year of the termination, and the four-year spread ceases.

The All Events Test - §451; §461

Even under the accrual method, when cash is received, it's taxable income. Under the accrual method, income is to be included for the taxable year when ***all events have occurred*** that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (§1.446-1(c)(1)(ii), §1.451-1(a)). Typically, all events that fix the right to receive income have occurred upon the earliest of when the income is (1) actually or constructively received, (2) due, or (3) earned by performance. In contrast, amounts properly characterized as loans, deposits, or trust funds are not includable upon receipt (*Comm. v. Indianapolis Power & Light Co*., (SCt) 90-1 USTC ¶50,007).

For expenses, the all events test has separate prongs, each of which must be satisfied before accrual of an expense is proper.

Accrual method deductibility of liabilities are limited (§461). Under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal tax purposes, in the taxable year in which:

1. All the events have occurred that establish the fact of the liability,
2. The amount of the liability must be capable of being determined "with reasonable accuracy," and

3. Economic performance has occurred with respect to the liability (§1.461-1(a)(2)(i)); §1.446-1(c)(1)(ii)).

Definition of "economic performance" involving rebates and refunds. If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to whom the liability is owed (§1.461-4(g)(3)).

Nonetheless, "certain recurring items" are subject to a more relaxed version of the "all events" test. Notwithstanding the general rule that "the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs" (§461(h)(1)), an item shall be treated as incurred during any taxable year if:

1. the all events test with respect to such item is met during such taxable year (determined without regard to [§461(h)(1)]), economic performance with respect to such item occurs within the shorter of—
   a) a reasonable period after the close of such taxable year, 12 or
   b) 8½ months after the close of such taxable year,
2. such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of paragraph 1 are met, and either:
   a) such item is not a material item, or
   b) the accrual of such item in the taxable year in which the requirements of paragraph 1 are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs (§461(h)(3)(A)).

For purposes of the "recurring item" exception, "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy" (§461(h)(4)).

***New*. Rules for Taxable Year of Inclusion (§451)**

An accrual method taxpayer subject to the all events test for an item of gross income is to recognize such income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement or another financial statement under rules specified by the Secretary, but an exception for taxpayers without an applicable or other specified financial statement is available effective for tax years beginning after Dec. 31, 2017.

> **Tax practitioner planning.** An applicable financial statement is generally one required to be filed by the tax payer to the SEC or an audited financial statement of the taxpayer which is used for credit purposes, reporting to shareholders, partners, or other proprietors, or to beneficiaries, or any other substantial nontax purpose.

The rules associated with when an item is realized for Federal income tax purposes were not revised and, accordingly, do not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.

Example - Purchase to lease or lease to purchase. The recharacterization of a transaction from sale to lease, or vice versa, is not required to conform to how the transaction is reported on the taxpayer's applicable financial statement.

Example - Mark to market. The recognition of gain or loss from securities that are marked to market for financial reporting purposes is not required if the gain or loss from such investments is not realized for Federal income tax purposes.

Example - Using equity method of accounting. As a further example, income from investments in corporations or partnerships that are accounted for under the equity method for financial reporting purposes will not result in the recognition of income for Federal income tax purposes until such time that the Federal income tax realization event has occurred (e.g., when the taxpayer receives a dividend from the corporation in which it owns less than a controlling interest or when the taxpayer receives its allocable share of income, deductions, gains, and losses on its Schedule K-1 from the partnership).

Transactions costs. Generally, a taxpayer is required to capitalize an amount paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction (§1.263(a)-5(a)). But when a regulatory agency approves a merger subject to certain conditions, the costs of activities undertaken in satisfaction of the regulatory agency's conditions are not per se required to be capitalized as amounts paid to facilitate a transaction. In this case, the IRS did not have sufficient information to determine whether the taxpayer incurred the costs at issue solely on account of the merger. The costs at issue appeared to be in the nature of annual operating or investment expenses and not analogous to deal costs paid to service providers who assist with financing, investigating, documenting, or otherwise administratively facilitating the transfer of property. Three of the four costs were commonly and frequently required by regulators and were annually incurred by companies as part of their ordinary and recurring business operations. In addition, the fact that one of the companies previously made annual donations in the same amount as its commitment to make future donations suggested a continuation of prior business practice. The fourth cost appeared to be, at least in part, in exchange for intangible property.

Also See.

- CCA 201713010, where cost of activities undertaken in satisfaction of conditions in approved merger were not required to be capitalized.
- *Giant Eagle, Inc. v. Comm.*, (CA-3) 14-3961; 2016-1 USTC ¶50,274, where whenever the supermarket's customers purchased $50 of groceries, they received a 10¢-per-gallon discount at the supermarket's gas station. The supermarket properly deducted $3.4 million of discounts in the year before the gas was purchased by their customers.

Section 460 - Long-Term Contracts Generally

Long-term contracts generally recognize income and expenses throughout the contract using the percentage of completion method (§460(a)). Generally, taxpayers who receive income from long-term contracts must account for that income using the percentage of completion method, which essentially requires the taxpayer to recognize income and expenses throughout the duration of a contract (§460(a) & (b); *Tutor-Saliba Corp. v. Comm.*, 115 TC 1 (2000)). One exception to this general rule is home construction contracts (§460(e)(1)(A), (6)(A)). There are several acceptable methods of accounting for home construction

contracts (and other contracts exempt from the percentage-of-completion method of accounting), one of which is the completed-contract method (CCM) of accounting (§1.460-4(c)(1)).

> **Tax practitioner planning.** Under the percentage-of-completion method of accounting, a taxpayer must generally recognize as income a portion of the contract price in each taxable year covered by the long-term contract (§1.460-4(b)(1)). By contrast, under the CCM, a taxpayer generally does not recognize any income from a long-term contract until the contract is complete. A contractor using the CCM takes into account in the contract's completion year the gross contract price and all allocable contract costs incurred by the completion year (§1.460-4(d)(1)). The CCM is often more favorable to taxpayers because it generally defers the taxation of income relative to the percentage-of-completion method.

Long-term contracts defined. A long-term contract is "any contract for the manufacture, building, installation, or construction of property if such contact is not completed within the taxable year in which such contract is entered into" (§460(f)(1)). The statute does not define "completion" for this purpose, but does note it will be determined on a contract-by-contract basis (§1.460-1(f)). The regulations clarify that a contract is complete upon the earlier when one of the two following tests are met: (1) the use and 95% completion test; or (2) the final completion and acceptance test (§1.460-1(c)(3)(i)).

(1) the use and 95% completion test. Under the first test, the contract is deemed completed upon the use of the subject matter of the contract by the customer for its intended purpose (other than for testing) ***and*** at least 95% of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer.

(2) the final completion and acceptance test. Under the second test, the contract is completed upon final completion and acceptance of the subject matter of the contract. "Final completion and acceptance" of the subject matter of a contract is a question of fact and all relevant facts and circumstances are considered.

Secondary items. A further wrinkle to determining when a taxpayer completes a contract is the role of secondary items. Taxpayers are to apply the tests to determine when a contract is completed under the completed contract method "without regard to whether one or more secondary items have been used or finally completed and accepted." In applying the 95% completion test, taxpayers "must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract" (§1.460-1(c)(3)(ii)).

***New*. Section 460(e) - Small Construction Contract Exception Expanded**

The exception for small construction contracts from the requirement to use the percentage-of-completion method has been expanded. Contracts within this exception are those contracts for the construction or improvement of real property if the contract:

1. is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract, and
2. is performed by a taxpayer that (for the taxable year in which the contract was entered into) meets the $25 million gross receipts test (was $10 million).

The percentage-of-completion method change applies to contracts entered into after Dec. 31, 2017, in taxable years ending after such date.

A small construction contract. 80% of estimated total contract costs attributable to 1-4 unit dwellings and "directly related to"real property "site" improvements**.** An exception exists from the requirement to use the percentage completed method of accounting for ***home construction contracts***. Qualified taxpayers may instead account for income from home construction contracts under the completed contract method (§460(e)). A "home construction contract" is any construction contract if 80% of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities that are "building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property" with respect to: (1) dwelling units contained in buildings containing four or fewer dwelling units, ***and (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units***" (§460(e)(6)(A)).

IRS Audit Hit List - Land Developers Not Permitted to Use Completed Contract Method (CCM) (LB&I Compliance Issues, Updated Jun. 28, 2018

The IRS believes that large land developers that construct in residential communities may be improperly using the Completed Contract Method (CCM) of accounting. A developer, whose average annual gross receipts exceed $26 million in 2019 (was $10 prior in 2017), may only use the CCM under a home construction contract. In some cases, developers are improperly deferring all gain until the entire development is completed. LB&I will provide training for revenue agents assigned to work this issue. The treatment stream includes development of a practice unit, issuance of soft letters, and follow-up with issue based examinations when warranted.

Also See.

- *Shea Homes, Inc. v. Comm.*, (CA-9); 2016-2 USTC ¶50,391; No. 14-72161; affirming 142 TC No. 3) , where homebuilder was allowed by the court to use the completed contract method based on costs of entire housing development, a planned community.

GAINS

***New*. Certain Self-created Property Not Qualified for LTCG Treatment (§1221)**

Patent, invention, model or design. A patent, invention, model or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) is excluded from the definition of a "capital asset" and will not receive long-term capital gain treatment. Effective for dispositions after Dec. 31, 2017.

Musical compositions. An exception applies under prior law and new law for a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created. The exception also applies to a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction. If the taxpayer elects, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income (§1221(b)(3)).

***New*. Repeal of Rollover of Publicly Traded Securities Gain into Specialized Small Business Investment Companies (§1044 repealed)**

The election to roll over tax-free capital gain realized on the sale of publicly-traded securities was repealed after Dec. 31, 2017. Under prior law, a corporation or individual could elect to roll over tax-free any capital gain realized on the sale of publicly-traded securities to the extent of the taxpayer's cost of purchasing common stock or a partnership interest in a specialized small business investment company within 60 days of the sale. The amount of gain that an individual could elect to roll over for a taxable year was limited to (1) $50,000 or (2) $500,000 reduced by the gain previously excluded. For corporations, these limits were $250,000 and $1 million, respectively.

***New*. Opportunity Zones - Gain Deferral (new §1400Z-1, §1400Z-2)**

An Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.

The temporary deferral of inclusion in gross income is available for net §1231 capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in a qualified opportunity fund ("QOF"). The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

Qualified opportunity zones. Each population census tract in each US possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on Dec. 22, 2017. The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation. Governors (and the Mayor of DC) submitted nominations for a limited number of opportunity zones to the Secretary of Treasury for certification and designation following the guidelines in Rev. Proc. 2018-16. A list of the approved zones can be found on the US Department of the Treasury's CDFI Fund website at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

IRS help on Opportunity Zones. The IRS has posted a list of FAQs that may help a client understand this new provision. For a current list of Opportunity Zones see Opportunity Zone Resources.

Tax incentives. Two main tax incentives encourage investment in qualified opportunity zones:

> **Incentive #1 — Deferral of gain**. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (qualified opportunity zone stock, qualified opportunity zone partnership interest, and qualified opportunity zone business property) that holds at least 90% of its assets in qualified opportunity zone property.
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> *Basis adjustment*. If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis is increased by 10% of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis is increased by an additional 5% of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or Dec. 31, 2026. Only taxpayers who rollover

capital gains of non-zone assets before Dec. 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations.

Percent of deferred gain. The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10% of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional 5% of the deferred gain.

Incentive #2 — Exclusion of gain on Zone investment. Second, it excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer, the basis of such investment in the hands of the taxpayer is the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

Warning. This provision expires before ten years. Thus, the original gain is deferred until the earlier of the sale of the Fund or Dec. 31, 2026.

Tax practitioner planning. There is neither a gain deferral available with respect to any sale or exchange nor an exclusion available for investments in qualified opportunity zones made after Dec. 31, 2026. Also, keep in mind that there are risks involved, namely the poor performance of the QOF itself or that capital gain rates are increased during the deferral period.

Example. In Jan. 2019, Steve sells his Microsoft stock and realizes a $50,000 gain. Within 180 days of year end, he invests the $50,000 gain in a qualified California Opportunity Zone Fund. On the day he invests, his basis in the Fund is zero (because he has invested money on which he has not paid tax). In June 2026, he sells his interest in the Fund, and receives a check for $100,000. Steve must recognize $42,500 of the gain on the Microsoft stock sale from seven years earlier (since Steve held his investment for more than seven years and his basis is increased by 15% of the $50,000 deferred gain). In addition Steve must recognize his gain on the sale of the Fund of the $50,000.

IRS Guidance

Proposed Regulations REG-115420-18, were released on October 19, 2018. These proposed rules addressed the type of gains that may be deferred by investors, the time by which corresponding amounts must be invested in QOFs, and the manner in which investors may elect to defer specified gains. They also provided guidance to QOFs, including rules for self-certification, valuation of QOF assets, and guidance on qualified opportunity zone businesses.

A second set of Proposed Regulations REG-120186-18 were released April 17, 2019 which provided additional guidance relating to gains that may be deferred as a result of a taxpayer's investment in a qualified opportunity fund (QOF), as well as special rules for an investment in a QOF held by a taxpayer for at least 10 years. The proposed regulations also update portions of the October 2018 proposed regulations to address various issues that needed clarification.

Guidance to Investors
Net §1231 Gain – Only net §1231 capital gains qualify for the deferral which means a full year of information must be available in order to net losses with gains. It is important to note that if any capital gain is subject to recapture, that amount will not qualify for deferral.

> **Example:** If a taxpayer had §1231 gains of $100,000 and §1231 losses of $30,000 in 2019, only $70,000 of capital gain would be available for deferral. Instead, if taxpayer had §1231 gains of $100,000 and §1231 losses of $110,000 in 2019, no capital gain would be available for deferral.

Timing of investment - Because the capital gain income from section 1231 property is determined as of the last day of the taxable year, the proposed regulations provide that the 180-day period for investing such capital gain income from §1231 property in a QOF begins on the last day of the taxable year of the entity or individual.

Pass-Through Entities – A partnership, S Corporation or LLC that holds an investment in a QOF can either net its own §1231 gains and losses to determine what is eligible for deferral, or, it can pass the gain to its partner who would make the calculation at the partner level.

Amount of investment – A taxpayer does not have to invest the entire proceeds from the sale that generated the eligible capital gain, only that portion of the gain they want to defer. If more than the eligible gain is invested, there would be two investments, one that gets the tax benefits and one that follows the normal tax rules on capital gain.

Becoming a Qualified Opportunity Fund
To set up a QOF, an eligible corporation or partnership self-certifies by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return. Eligible entities include a C Corporations, S Corporations, partnerships and LLCs.

A QOF must hold at least 90% of its assets in qualified opportunity zone property ("QOZP") which is either:
- qualified opportunity zone business property ("QOZBP"), or
- qualified opportunity zone stock or partnership interest.

The QOZBP must be used in a "trade or business" within the meaning of §162.

> **Warning:** This would seem to preclude triple-net-leases.

QOZBP is property:
- purchased after 12/31/2017 from an unrelated party, and
- the original use of the property in the QOZ begins with the QOF or QOZB, or
- the QOF or QOZB "substantially improves" the property.

REPORTING CASH TRANSACTIONS

Cash Payment Reporting Helps Combat Money Laundering (FS-2019-1, IRS Form 8300 Reference Guide)

Federal law requires a person to report cash transactions of more than $10,000 by filing IRS Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business. By law, a "person" is an individual, company, corporation, partnership, association, trust or estate. For example, dealers in jewelry, furniture, boats, aircraft or automobiles; pawnbrokers; attorneys; real estate brokers; insurance companies and travel agencies are among those who typically need to file Form 8300. A tax-exempt organization doesn't have to file Form 8300 for a charitable cash contribution.

Reporting cash payments. A person must file Form 8300 if they receive cash of more than $10,000 from the same payer or agent:

- In one lump sum.
- In two or more related payments within 24 hours.
- As part of a single transaction or two or more related transactions within 12 months.

Examples of reporting situations:

Automobile dealerships. If a husband and wife purchased two cars at one time from the same dealer, and the dealer received a total of $10,200 in cash, the dealer can view the transaction as a single transaction or two related transactions. Either way, it calls for only one Form 8300.

> **Example**. A dealership doesn't file Form 8300 if a customer pays with a $7,000 wire transfer and a $4,000 cashier check. A wire transfer is not cash.
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> **Example**. A customer purchases a car for $9,000 cash. Within 12 months, the customer pays the dealership cash of $1,500 for accessories for that car. The dealer doesn't need to file Form 8300, unless they knew or had reason to know the transactions were connected.

Taxi company. Weekly lease payments in cash from a taxi driver to a taxi company within 12 months is considered the same transaction. The taxi company needs to file Form 8300 when the total amount exceeds $10,000. Then, if the company receives more than $10,000 cash in additional payments from the driver within 12 months, the company must file another Form 8300.

Landlords. Landlords need to file Form 8300 once they've received more than $10,000 in cash for a lease during the year. But a person not in the trade or business of managing or leasing real property, such as someone who leases their vacation home for part of the year, doesn't need to report a cash receipt of more than $10,000.

Bail-bonding agent. A bail-bonding agent must file Form 8300 when they receive more than $10,000 in cash from a person. This applies to payments from persons who have been arrested or anticipate arrest. The agent needs to file the form even though they haven't provided a service when they received the cash.

Colleges and universities. Colleges and universities must file Form 8300, if they receive more than $10,000 in cash in one or more transactions within 12 months.

Home builders. Home builders and contractors need to file Form 8300 if they receive cash of more than $10,000 for building, renovating or remodeling.

When to file Form 8300. A business must file Form 8300 within 15 days after the date the business received the cash. If a business receives later payments toward a single transaction or two or more related transactions, the business should file Form 8300 when the total amount paid exceeds $10,000. Each time payments aggregate more than $10,000, the business must file another Form 8300.

How to file. A person can file Form 8300 electronically using the Financial Crimes Enforcement Network's BSA E-Filing System (IR-2019-20). Filers will receive an electronic acknowledgment of each submission. To file Form 8300 electronically, a business must set up an account with the Financial Crimes Enforcement Network's BSA E-Filing System. For more information, interested businesses can call the BSA E-Filing Help Desk at 866-346-9478 or email them at BSAEFilingHelp@fincen.gov.

Those who prefer to mail Form 8300 can send it to IRS, Federal Building, P.O. Box 32621, Detroit, MI 48232. Filers can confirm the IRS received the form by sending it via certified mail with return receipt requested or calling the Detroit Federal Building at 866-270-0733.

Informing customers about Form 8300 filing. The business must give a customer written notice by Jan. 31 of the year following the transaction that it filed Form 8300 to report the customer's cash transaction. A business may voluntarily file Form 8300 to report a suspicious transaction below $10,000. The law prohibits a business from informing a customer that it marked the suspicious transaction box on the form.

> **Tax practitioner planning**. Cash businesses are a particular target of the IRS in its Form 8300 enforcement efforts. As you can guess, the cannabis industry is attracting a lot of attention from the IRS.

TAXING MEDICAL CANNABIS

Reporting of Illegal Income and Expenses

Section 162 ordinary and necessary business expense provisions even apply to illegal trades or businesses. Ordinary and necessary business expenses for the operation of an illegal trade or business are generally deductible, even if the payments of the expense or certain acts by employees of the business are illegal (§162(a)). In *Comm. v. Sullivan*, (SCt, 58-1 USTC 9368, 356 US 27), the Supreme Court held that rents and salaries paid by a bookmaker were deductible as ordinary and necessary business expenses.

In rendering its decision in *Sullivan*, the court noted that deductions are a "matter of grace" and Congress can, of course, disallow them as it chooses. At times, the policy to disallow expenses in connection with certain condemned activities is clear. However, in the case of rents and employee wages, the court found if it enforced as federal policy, the disallowance of the deductions, it would come close to making this type of business taxable on the basis of its gross receipts, while all other businesses would be taxable on the basis

of net income. If that choice is to be made, Congress should do it. And, in fact, Congress has done just that when it comes to certain expenses associated with illegal activities.

Taxing a Medical Cannabis Business—Trafficking in Drugs

Though a medical cannabis business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. Section 61(a) defines "gross income" broadly using 15 examples of items that are includible in gross income. Consistent with the Sixteenth Amendment, §61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. "Gains derived from dealings in property" means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year (§1.61-3(a)).

In 1982, Congress enacted §280E. Section 280E reads as follows:

> *No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by federal law or the law of any State in which such trade or business is conducted.*

When Congress enacted §280E in 1982, the Senate Report stated that the cost of goods sold is not affected by §280E. The COGS is computed under §263A(a) just like for any other producer or retailer. The courts have consistently applied this provision allowing a deduction for cost of goods sold, but disallowing any other expenses (*McHan v. Comm.*, TCM 2006-84; *Peyton v. Comm.*, TCM 2003-146; *Franklin v. Comm.*, TCM 1993-184; *Vasta v. Comm.*, TCM 1989-531).

Despite its legalization in 31 states (and the District of Columbia) for medical use and in nine states (and the District of Columbia) for recreational use, cannabis is still classified as a federal "controlled substance" under schedule I of the CSA. Although still illegal federally, the Justice Department has declined, to date, to enforce §841 when a person or company buys or sells cannabis in accordance with state law. In 2015 and 2016, Congress reinforced this arrangement by defunding the Justice Department's prosecution of the exchange of medical cannabis where it is legal under state law. The Court of Appeals commented: but while "today prosecutors will almost always overlook federal cannabis distribution crimes in Colorado," it does not mean the "tax man" is willing to turn a blind eye. In *The Green Solution Retail, Inc. v. USA*, (CA-10),No. 16-1281, May 2, 2017, the Court of Appeals held that Green Solution was not entitled to enjoin the IRS from obtaining information related to its initial findings that it was dispensing cannabis in violation of the Controlled Substances Act.

How a Taxpayer "Trafficking" in Medical Cannabis Computes COGS (CCA 201504011)

When §280E was enacted in 1982, "inventoriable cost" meant a cost that was capitalized to inventories under §471 (as those regulations existed before the enactment of §263A). The specific regulations are §1.471-3(b) in the case of a reseller of property, and §1.471-3(c)and §1.471-11 in the case of a producer of property.

Applying §471 rules to cannabis resellers and producers. A cannabis reseller using an inventory method would have capitalized the invoice price of the cannabis purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the cannabis. Similarly, a cannabis producer using an inventory method would have capitalized direct material costs (cannabis seeds or plants), direct labor costs (for example, planting; cultivating; harvesting; sorting), Category 1 indirect costs (§1.471-11(c)(2)(i)), and possibly Category 3 indirect costs (§1.471-11(c)(2)(iii)).

Applying §263A rules to cannabis resellers and producers. Section 263A increased the types of costs that are inventoriable compared to the rules under §471, but did not revolutionize inventory costing. A reseller still is required to treat the acquisition costs of property as inventoriable. Now, a reseller also is required to capitalize purchasing, handling, and storage expenses. In addition, both resellers and producers are required to capitalize a portion of their service costs, such as the costs associated with their payroll, legal, and personnel functions. Thus, under §263A, resellers and producers of property are required to treat some deductions as inventoriable costs.

What about other costs? Nothing in §263A allows a business to capitalize otherwise nondeductible costs into inventory. Thus, for example, a cannabis producer would be permitted to include in its inventory wages, rents, and repair expenses attributable to its production activities, but would not be permitted to include wages, rents, or repair expenses attributable to its general business activities or its marketing activities.

"Pleading the Fifth" to Avoid Self-incrimination Does Not Avoid § 280E Limitations (*Neil and Andrea Feinberg v. Comm*., CA-10, 2019-1 ustc 50,161, Feb. 26, 2019)

Taxpayer operated THC, an LLC licensed by Colorado to operate two medical marijuana dispensaries. During audit the IRS reclassified expenses THC deducted as Cost of Goods Sold ("COGS"). Under §280E, a taxpayer can only deduct COGS when engaged in unlawful trafficking of controlled substances. As a result, the IRS adjustment increased the taxpayer's taxable income.

The IRS argued taxpayers did not meet their burden of proof to show the IRS's determination that THC unlawfully trafficked in controlled substances was incorrect. Taxpayer responded that placing the burden on them would violate their Fifth Amendment privilege against self-incrimination.

The court pointed out that in order to meet the burden that §280E does not apply, the Taxpayer would be required to introduce evidence to prove THC was not unlawfully trafficking in a controlled substance which is not incriminating. As a result, §280E precluded the deduction of the Taxpayers' business expenses, and the tax court properly rejected their challenge to the deficiency.

Even Reasonable Wage Paid to S Corporation Owner-employee Disallowed for Cannabis Business (*Jesse and Desa Ploughman v. Comm*., TCM 2018-85)

Palisades, also known as Colorado Alternative Health Care LTD, is an S corporation. Jesse and Desa Ploughman were the sole owners of Palisades and also served as its officers during the years in issue, 2010, 2011 and 2012. Colorado licensed Palisades to grow and sell medical cannabis. During 2010-2012, Palisades

paid and deducted wages paid to Mr. Ploughman. The Ploughmans reported the wages on their individual tax returns. Both the IRS and the taxpayers agreed that the wages were not part of cost of goods sold. Thus, the IRS disallowed the wage deduction under §280E.

Wage money doubled taxed. The Ploughman's argued that the IRS's treatment of Mr. Ploughman's wage income as an expense subject to §280E caused the same income to be taxed twice, once as wages, and a second time as S corporation income. They contend that this results in the disallowed officer wages attributable to trafficking being included in Palisades' earnings, which flow through to the taxpayers without any deduction for the wages. The Ploughmans complained that a discriminatory treatment results because an S corporation is required to pay a reasonable wage as a salary to its officers, and other entities are not subject to this reasonable wage requirement.

No help for S corporation owner. Section 1366(a) provides that income, losses, deductions, and credits of an S corporation are passed through pro rata to its shareholders on their individual tax returns. Thus Palisades' income passes through to the Ploughmans, and they must report it on their individual tax returns. Separately, and in addition to Palisades' passthrough income, the Ploughman must report the wage compensation they received as officers of Palisades as a part of their gross income on their individual returns (§61(a)). If Palisades had paid wages to a third party, the wages would have been taxable to the recipient whether or not they were deductible by the business.

Is an S corporation the right entity choice? The court commented in its decision that "to the extent that the Ploughmans believe they received disparate tax treatment as a result of organizing their cannabis business as an S corporation, they were free to operate as any business entity and in other trades. The Ploughmans chose to operate Palisades as an S corporation in the cannabis business. They are responsible for the tax consequences of their decision. See *Higgins v.Smith*, 308 U.S. 473, 477 (1940)."

Medical Cannabis Dispensary Expenses Not Deductible (*Canna Care, Inc. a CA not-for-profit Corp. v. Comm.*, TCM 2016-206, affirmed by CA-9, 16-70265, July 25, 2017)

California and federal law. In 1996, California voters approved the Compassionate Use Act of 1996 (CUA) to ensure that seriously ill Californians had the right to obtain and use cannabis for medical purposes. In 2003, the Medical Cannabis Program Act was approved to promote uniform and consistent application of the CUA, clarify the scope of its application, and enhance patients' and caregivers' access to medical cannabis through collective, cooperative cultivation projects. The federal Controlled Substances Act (CSA), however, *still* classifies cannabis as a schedule I controlled substance, and cannabis is a controlled substance within the meaning of §280E (*CHAMP, Inc. v. Comm.*, 128 TC No. 14 (2007)).

***Canna Care* facts.** Bryan and Lanette Davies are the parents of six children. After much prayer, Bryan was convinced that God wanted him to open a medical cannabis dispensary to solve his family's (including school tuition) financial woes. Canna is a mutual benefit corporation, and, pursuant to California law, is prohibited from distributing cannabis for profit. Bryan, Lanette and an acquaintance, Jeff Cowen, were Canna's officers and directors. The IRS determined deficiencies in Canna's federal income tax of $229,473, $304,090, and $339,604 for 2006, 2007, and 2008, respectively.

Three factors used to disallow operating expenses. The issue was whether the IRS properly disallowed deductions for Canna's operating expenses pursuant to §280E. The application of §280E rests on the presence of three key elements: (1) a controlled substance; (2) trafficking; and (3) trade or business.

***Canna* found to be a business trafficking in a controlled substance - expenses disallowed by the Tax Court and the 9th Circuit Court of Appeals.** Canna's numerous arguments as to why cannabis should no longer be considered a schedule I controlled substance were rejected by the courts. "Cannabis was a schedule I controlled substance during the years at issue." The Court of Appeals for the Ninth Circuit stated: "[T]he only question Congress allows us to ask is whether cannabis is a controlled substance 'prohibited by federal law." "If Congress now thinks that the policy embodied in §280E is unwise as applied to medical cannabis sold in conformance with state law, it can change the statute. We may not (*Martin Olive v. Comm.,* 139 TC No. 19 (2012), aff'd by 9th Cir. , 139 TC 19, No. 13-70510 (2015). Canna then argued that its actions could not be considered "trafficking" for purposes of §280E because its activities were not illegal under California law. The court held that Canna regularly bought and sold cannabis, an activity that constituted trafficking within the meaning of §280E even when permitted by State law (*CHAMP, Inc. v. Comm.*, 128 TC No. 14 at 182 (2007)). Even though CA law prohibits the distribution of cannabis for profit, there was no doubt, in the court's opinion that Bryan incorporated Canna, Inc. "to produce income. " (Bryan) admitted "that he entered into the medical cannabis business in order to cure his family's financial difficulties. (Bryan) and the other shareholders received wages well in excess of those paid to (Canna's) other employees, and the payment of such wages would not have been possible if (Canna) had not had income." "Whether (Canna) was operated in accordance with California law's restrictions on profiting from the distribution of cannabis is not an issue before (the court), and it does not affect (the court's) finding that (Canna, Inc.) was engaged in the business of distributing cannabis for purposes of §280E." "(The courts held) that §280E prohibits (Canna) from deducting *any* amounts paid or incurred during the years at issue in connection with its trade or business that (the IRS) disallowed."

> **Tax practitioner planning.** This is certainly not the last word on the subject, as the IRS, the courts, and to a lesser extent, Congress, struggle with how to deal with this whole industry, which is still "sorta" illegal under federal law, but legal under state law. Certainly more cases and developments will be coming, as cannabis sales continue to become "legitimized."

EFTPS Deposit Issues

EFTPS deposit issues arise because of unallowed bank accounts (SBSE-04-0615-0045, "Interim Guidance on the Failure to Deposit Penalty under §6656 for Taxpayers Unable to get a Bank Account" (June 9, 2015) and SBSE-20-0615-1045, "FTD Penalty Relief for Unbanked Taxpayers" (June 17, 2015)). Cannabis dealers, in states that allow medical and recreational cannabis use, can have difficulty making electronic deposits because, under federal law, no bank, credit union or financial-services company may knowingly accept business accounts with those dealers.

Interim guidance. The IRS has issued interim guidance that allows taxpayers who are unable to get a bank account, or make other arrangements for depositing their tax deposit obligations electronically, to obtain an abatement of the failure to deposit penalty if they follow certain procedures. This provision provides relief

to taxpayers who legally sell cannabis under state law and are not able to get a bank account because of federal law issues.

The Electronic Federal Tax Payment System (EFTPS) must be used to deposit payroll taxes. Subject to limited exceptions, the following are required to be deposited via electronic funds transfer (EFT) through the EFTPS: FICA and FUTA taxes, withheld income taxes, and corporate income and estimated taxes (§6302(h), §31.6302-1(h)(2)(iii), §31.6302-1(h)(3)). There is a penalty for failure to deposit taxes electronically when required through EFTPS, but it will not be imposed if the taxpayer proves that the failure to deposit electronically was due to reasonable cause and not willful neglect (§6656(a)).

IRS issues interim relief. For taxpayers who are timely in meeting their tax deposit obligations, the IRS will not impose, or abate, the failure to deposit penalty if taxpayers can show they made reasonable efforts but were unable to get a bank account during the period at issue.

Establishing reasonable cause. In order to establish reasonable cause, the taxpayer must include a signed statement that explains the taxpayer's attempts to get a bank account and may include any corroborating documentation (denied account application(s), correspondence from banks, etc.). The signed statement does not have to be in a particular format, but should clearly identify the taxpayer's name, address, and taxpayer identification number. The taxpayer should include corroborating documentation establishing at least one attempt to obtain a bank account and may use the same documentation for up to 24 months. The taxpayer should make continued efforts to obtain a bank account.

Reasonable cause for failure to deposit by EFT applies for 24 months after the taxpayer establishes reasonable cause by showing inability to obtain banking services. The guidance is effective June 9, 2015.

GROSS INCOME

Gross Income (§61) vs. Gift (§102)

Compensation for services is included in gross income for federal income tax purposes (§61(a)(1)). But, gross income does not include amounts acquired by gift (§102(a)). Whether a payment is a gift under §102(a) or gross income under §61(a) is a factual question. The Supreme Court has held that distinguishing a gift from taxable income "does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases." The Supreme Court concluded that the transferor's intent is the most critical consideration and there must be an objective inquiry into the transferor's intent. Generally, the transfer must be made from a "'detached and disinterested generosity' * * * 'out of affection, respect, admiration, charity, or like impulses.'" We must make "an objective inquiry as to whether what is called a gift amounts to it in reality. * * * It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter" (*Comm. v. Duberstein*, 363 US 278 (1960)).

New. Cash Employee Achievement Awards Are Taxable

"Tangible personal property" may be considered a deductible employee achievement award, but cannot include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring

only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. Employee achievement awards that are deductible by an employer (or would be deductible but for the fact that the employer is a tax-exempt organization) are excludible from an employee's gross income beginning after Dec. 31, 2017.

> **Tax practitioner planning**. The Conference Committee Report specifically says no inference is intended that this is a change from present law and guidance. In other words, Congress believes that these rules do, or should, apply under old and new law.

Crowdfunding Campaigns Often Result in Taxable Income

> A Pew Research survey reports that nearly a quarter of the US population earns money from the shared economy.

Are Funds Collected Through a Crowdfunding Site Taxable Income?

Everything is taxable. Section 61(a) provides the general rule that gross income includes all income from whatever source derived. Gross income includes all accessions to wealth, whether realized in the form of cash, property, or other economic benefit. However, some benefits that a taxpayer receives are excluded from income, either because they do not meet the definition of gross income or because a specific exclusion exists.

Unless it is a loan, contributed capital, or a gift. In general, money received without an offsetting liability (such as a repayment obligation), that is neither a capital contribution to an entity in exchange for a capital interest in the entity nor a gift, is includible in income. That means crowdfunding revenues are generally includible in income if they are not (1) loans that must be repaid; (2) capital contributed to an entity in exchange for an equity interest in the entity; or (3) gifts made out of detached generosity and without any "quid pro quo." So. . .what is crowdfunding? A loan? A capital contribution? A gift? Or is it reward-based in that the backer will receive something in exchange for the money contributed?

Project funding. On websites such as kickstarter.com and indiegogo.com, "creators" of a fundraising campaign seek "backers" to finance their projects. Projects include creating films, games, art, design, and a variety of inventions. Since Kickstarter's launch in 2009, more than $2 billion has been pledged by more than 10 million people, funding more than 100,000 projects. Reward-based crowd funding is likely to be taxable income to the campaign creator.

> **Example**. Vern is the inventor of a new generation charger for iPhones. He creates a Kickstarter campaign to manufacture and market his invention and raises $100,000. Each backer will receive a charger in return for their contribution. The $100,000 is taxable income as it is considered proceeds from the sale of product. As a practical matter, Vern is likely to have business expenses to offset some or all of the crowd funding income.

Personal funding. Other sites, such as gofundme.com or causes.com, feature fund raisers for personal or charitable endeavors. Gofundme shows current campaigns running to help fire victims, evicted families, individuals with medical tragedies, and fund raising for the family of a Baton Rouge police officer killed in a July shooting. Funds received from donation-based crowd funding are likely to be considered nontaxable gifts.

> **Example**. Stephanie creates a Gofundme campaign to help with medical and living expenses for her critically ill daughter. The campaign raises $22,000. The money raised is not taxable as it is given in "disinterested generosity" and is considered a gift.

Form 1099-K problems. Reward-based and donation-based crowd funding use third-party payment processing for collecting money. Both PayPal and Amazon Payments provide these services for crowdfunders and both companies comply with the US Patriot Act data-collection requirements. A campaigner who collects over $20,000 and has 200 transactions in a year will receive a Form 1099-K, Payment Card and Third Party Network Transactions, reporting unadjusted gross revenues.

> **Tax practitioner planning.** Both Vern and Stephanie will receive Forms 1099-K from the third-party processors. Although the funds that Stephanie received from the crowd funding effort went entirely to her daughter, Stephanie will receive the Form 1099-K since she is the creator of the campaign. The IRS has not provided guidance for reporting the Form 1099-K when the proceeds reported are gifts and not taxable.

IRS Opens Shared Economy Tax Center on Its Website

In recognition of the boom in the sharing economy, the IRS is beginning to address the tax issues involved. If your client (or client's child) is considering earning a little extra from Uber, Task Rabbit or Airbnb, refer your client to the IRS website for general tax information or use the information on the site to develop a firm letter on taxing the "gig" economy.

What is sharing economy? The sharing economy can be described as "collaborative consumption" or a "peer-to-peer market" that links a willing provider to a consumer of goods or services (coordinated through a community-based online service). Typically, there are three parties involved in a sharing economy transaction often referred to as service providers (the freelancers who provide the goods or services), service recipients (the consumers of such good or services), and service coordinators (the third-party platforms that facilitates the transactions).

Rentals. If a taxpayer rents out her or his home, apartment or other dwelling but also lives in it during the year, special rules generally apply (see Publication 527, Residential Rental Property (Including Rental of Vacation Homes). Taxpayers can use the Interactive Tax Assistant Tool, Is My Residential Rental Income Taxable and/or Are My Expenses Deductible? to determine if their residential rental income is taxable.

> **Also See**. "Six things that taxpayers should know about the sharing economy" from Tax Tip 2019-46 issued Apr. 23, 2019.

***New*. Repeal of Deduction for Local Lobbying Expenses (§162(e))**

The exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments has been repealed effective on Dec. 22, 2017. Thus the general disallowance rules applicable to lobbying and political expenditures will also apply to costs incurred related to such local legislation. Expenses paid or incurred in connection with lobbying and political activities (such as research for, or preparation, planning, or coordination of, any previously described activity) also are not deductible. Under prior law, an exception to the general rule for a deduction was allowed for ordinary and necessary expenses incurred in connection with any "local legislation" (§162(e)(5)(c)).

A deduction is denied for amounts paid or incurred in connection with (1) influencing legislation, (2) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or (4) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official (§162(e)).

***New*. Denial of Deductions for Fines and Penalties (§162(f) and new §6050X)**

Any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law is denied effective on Dec. 22, 2017 (§162(f)). In addition, TCJA disallows any deduction for investigation costs.

> **Tax practitioner planning.** The disallowance applies to governmental enforcement actions including securities, employment, environmental, Foreign Corrupt Practices Act, white collar, health-care, government contracts, gaming, and any other regulatory claims. The new law can also apply to a whistleblower action brought by a private party under a state or federal false claims act or private attorney general act.

Except for restitution. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid. No deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

Government must be complainant. This applies only when a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the

violation or potential violation of any law. An exception also applies to any amount paid or incurred as taxes due.

> **Tax practitioner planning**. This change does not apply to payments made by one private party to another in a lawsuit between private parties because a judge, or jury acting in the capacity as a court, directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause the payment to be made "at the direction of a government".

Government agency reporting required. Government agencies (or entities treated as such agencies under the provision) are required to report to the IRS, and to the taxpayer, the amount of each settlement agreement or order entered into where the aggregate amount required to be paid, or incurred to or at the direction of the government, is at least $600. The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

***New*. Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection with Sexual Harassment or Sexual Abuse (new §162(q))**

No deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement and made after Dec. 22, 2017. In addition, this new provision disallows a deduction for attorney fees related to the settlement of sexual harassment claims that include a nondisclosure agreement. An amount paid to settle a sexual harassment claim can be subject to this disallowance rule, even if a portion of the settlement amounts are attributable to future wages due to the claimant. Is an NDA worth the loss of the tax deduction?

> **Tax practitioner planning**. The new law could also be interpreted as prohibiting the recipients of settlement payments from deducting the cost of their legal fees. It's not likely that Congress meant the victims to be limited in their deductions.

How Do State Tax Credit Programs Apply to §162(a) Business Deductions?

Under the proposed regulations, a taxpayer who makes a transfer to a §170(c)charity must reduce his or her contribution deduction by the amount of any state tax credits received (PR § 1.170A-1(h)(3)(i)). In IR-2018-178, the IRS clarified that "business taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses." See also IRS State and Local Income Tax FAQ.

> **Tax practitioner planning.** Secretary Mnuchin assured businesses that the proposed regulations had "no impact on federal tax benefits for business-related donations to school choice programs."

Ordinary and Necessary Business Expense vs. Personal Expense

To qualify as a deduction allowable under §162, an expenditure must satisfy a five-part test: it must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be

necessary, and (5) be ordinary (*Comm. v. Lincoln Savings and Loan Association*, 403 US 345, 352 (1971)). Thus, personal expenditures incurred outside of a taxpayer's trade or business are not deductible under §162. Even though a particular taxpayer may incur an expense, the expense may qualify as ***ordinary and necessary if it is appropriate and helpful*** in carrying on that business, is ***commonly and frequently incurred*** in the type of business conducted by the taxpayer, and is not a capital expenditure.

General Principles Governing Substantiation of *All* Deductions.

Deductions are a matter of legislative grace, and a taxpayer is required to maintain records sufficient to substantiate expenses underlying deductions claimed on his or her return (§6001; §1.6001-1(a); *New Colonial Ice Co. v. Helvering,* 292 US 435, 440 (1934)).

The *Cohan* Rule

Approximating a business expense. If the taxpayer is able to establish that she or he paid or incurred a deductible expense but is unable to substantiate the precise amount, the court generally may approximate the deductible amount, but only if the taxpayer presents sufficient evidence to establish a rational basis for making the estimate (*Cohan v. Comm.*, 39 F.2d 540, 543-544 (2d Cir. 1930); *Vanicek v. Comm.*, 85 TC 731, 742-743 (1985)).

Requirements to use the *Cohan* rule. To qualify for the estimation treatment under *Cohan*, the taxpayer must establish that she or he is entitled to some deduction. As *Cohan* puts it: "Absolute certainty in such matters is usually impossible and is not necessary," but a court "should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making" (*Cohan v. Comm.,* 39 F.2d at 543-544). Otherwise an allowance would amount to unguided largesse (*Williams v. US*, 245 F.2d 559, (5th Cir. (1957)). The *Cohan* rule, however, is superseded—that is, estimates are not permitted—for certain expenses specified in §274, such as travel (including meals and lodging), entertainment, and "listed property" expenses (including passenger automobiles) [§274(d), §280F(d)(4)(A)(i); §1.274-5T(a); Boyd v. Comm., 122 TC 18, at 305 (2004)]. Instead, these types of expenses are subject to the strict §274(d) substantiation rules (§1.274-5T(a); *James A. Venuto v. Comm.*, TCM 2017-123).

No "shoebox" records allowed! If the presentation of the taxpayer's expenses is tantamount to the "shoebox method" of substantiating them, the court will not sort through the voluminous evidence to decide whether the taxpayer substantiated each and every expense he claimed (*Terry Gene Akey v. Comm., pro se.*, TCM 2015-227, *Willie Lewis v. Comm. pro se*, TCM 2017-117).

Court Allows Some Deduction Using Cohan Rule (*Ames Ray v. Comm.*, TCM 2019-36)

Although Ames Ray did not establish the amount of losses related to the legal expenses of her business, the court allowed a portion of Ms. Ray's funds management losses under the Cohan rule. *"When the Court applies the Cohan rule, the taxpayer must introduce sufficient evidence to permit us to conclude that the taxpayer paid or incurred a deductible expense in at least the amount allowed. In estimating amounts*

allowable pursuant to the Cohan rule, we bear heavily upon the taxpayer who failed to maintain the required records and to substantiate deductions as the Code requires."

> **Tax practitioner planning.** In other words, work hard on the story of why the client should have these deductions even though the records are scanty.

"Cohan" Not Good Enough to Substantiate Deduction (*Daniel Imperato v. Comm.*, TCM 2018-126)

Daniel Imperto operated a consulting business in which he provided management, scientific, and technical consulting. He deducted a commission expense of $20,000 for 2009. He bears the burden of substantiating the amount and the business purpose of the expense. The Court may estimate such an expense where the record provides a basis to make the estimate. *Cohan v. Comm.*, 2 ustc ¶489], 39 F.2d 540, 543-544 (2d Cir. 1930). Imperto did not present any testimony or other evidence to substantiate the amount or business purpose of the commission expense or provide a basis for us to estimate the amount of the expense. Nor did he establish that he incurred the expense. Accordingly, the court ruled that he was not entitled to the deduction.

S Corporation Allowed Certain Unsubstantiated Business Expenses Using *Cohan* Rule (*Alan and Carol Brookes v. Comm.*, TCM 2017-146)

A "bad records" case allowed an "estimated" amount approximated by the court. Alan and Carol Brookes each owned half of Brookes Financial, an S corporation, which carried on two lines of business, Alan's business and financial consulting activities, which included tax preparation services, and Carol's art business. The IRS questioned what a financial services business was doing in the art business; the court held the S corporation was clearly, and actively, involved in two businesses. But, the court noted that the Brookes' exhibits provided little help explaining or supporting their deductions for 2010 - 2012, the three years at issue. The Brookes provided corporate "Profit & Loss Statement[s]," and a "Cash Flow" statement, but these documents merely listed total expenses in various categories. Brookes Financial also provided itemized lists of expenses for each year, but the itemized lists were generally not supported by receipts or other documentation demonstrating that the expenses were actually paid or that the expenses had a business purpose. The amounts in the itemized lists were generally lower than those appearing on the profit and loss or cashflow statements (and lower than the amounts appearing on Brookes Financial's 1120-S returns). These numerous discrepancies between the itemized lists, the profit and loss or cashflow statements, and the deductions claimed on Brookes Financial's returns were never explained anywhere. The Brookes' also provided credit card statements for personal credit cards, with handwritten notes in the margins indicating that certain expenses were business expenses. In the court's opinion, the Brookes did not provide any meaningful explanation of how all these various documents fit together as substantiation for their deductions.

The court used the *Cohan* rules. The court did, however, review the Brookes' poorly organized evidence and estimated the amounts of certain deductible expenses under the *Cohan* rule (which the IRS didn't allow). "While it is true that 'a court should allow the taxpayer some deductions if the taxpayer proves he is entitled to the deduction but cannot establish the full amount claimed' . . . 'the *Cohan* rule does not 'require that such latitude be employed.'"

Allowing husband's financial services "division" to deduct wife's art advertising, rent, gallery fees and art supplies. After determining that the S corporation was actively involved in both Alan's financial services and Carol's artwork/sales, the court allowed additional deductions for **advertising art** in 2012 as the Brookes' provided receipts showing information sufficient to determine the date of purchase, amount paid, and business purpose claimed. The court also allowed added $6,300 of deductions per year for estimated **rent** paid. The documentation provided to substantiate rent paid for the art studio was inconsistent and not properly substantiated, but after reviewing the Brookes' testimony as a whole in conjunction with the documents provided, the court was satisfied that Brookes Financial did rent an art studio for $6,300. In addition, the court allowed the **gallery fees** deductions claimed by Brookes Financial for the three years at issue. Lastly, the court estimated, and allowed, **art supplies**, in excess of the amount allowed by the IRS, of at least $3,000, $10,000, and $7,000 for 2010, 2011, and 2012, respectively.

Also see.

- *Andrew and Sara Berry v. Comm.*, TCM 2018-143), where the taxpayers failed to provide a reasonable evidentiary basis for an estimate. Taxpayers provided undated and unsigned invoices, including one that was purportedly signed by the vendor, but after his death.
- *Mohammad M. Zarrinnegar and Mary M. Dini v. Comm.*, TCM 2017-034; Mohammad M. Zarrinnegar testified that many of the dental practice receipts for the three years at issue had become unreadable because the ink had faded on account of water damage or the passage of time. As an alternative, he offered credit card statements at trial to substantiate these expenses. Lack of receipts, confusing accounting techniques, and vague testimony gave the court no excuse to estimate.
- *Nvard Balyan v. Comm.*, TCM 2017-140, Nvard Balyan, a registered nurse in California, in 2014, the year at issue, provided consulting services to two hospice care providers as an independent contractor. The IRS disallowed these Schedule C deductions for lack of substantiation. The court ruled "it cannot even apply the *Cohan* rule as it relates to the Sch. C expenses not subject to the §274(d) strict substantiation rules because there (was) no foundation...for estimating the respective amounts."
- *Stephen Drah v. Comm.*, TCM 2017-149, FedEx Ground courier created C corp which was not respected by IRS, as were most of his expenses. No records mean no expenses for either the courier as an independent contractor or his C corp. Steve was even disallowed use of §179 or §168(k) on his leased vehicle - the 2009 Workhorse P42 truck. (Come on Steve, is it owned or leased?). Worse, with questionable records, the delivery van's repair and maintenance expenses were rejected. Why didn't the court allow Steve to use the *Cohan rule? Because the dummy never brought up the argument in court!*
- *Ivan Levine v. Comm., pro se,* TCS 2017-60, a retired CPA was an investment adviser representative (his financial services business), working with two broker-dealers who paid him commissions that they reported on Forms W-2. He also operated a marketing consulting business which he reported on Sch. C. He used his home office as the principal place of business for both business activities. Ivan claimed, and the IRS disallowed for lack of substantiation, the following 2011 expenses related to his financial services business: (1) advertising; (2) car and truck expenses (no log); (3) depreciation of a passenger automobile (he also used mileage); (4) insurance (other than health); (5) legal and professional services; (6) office expenses; (7) supplies; (8) utilities and internet services; and (9) other expenses for tolls, cellular phone use, and software. The IRS conceded that Ivan could

deduct $863 for insurance (other than health), $3,409 for legal and professional services and the court allowed $120 for advertising. Even though he attached Form 8829 to his Sch. C, Ivan lost his home office deduction because he couldn't convince the court of the space used exclusively for his marketing consulting business.

DISALLOWANCE OF CERTAIN ENTERTAINMENT EXPENSES

***New*. Entertainment Expenses (§274; §162)**

No (as in 0%) entertainment, amusement and/or recreation business expenses are deductible after Dec. 31, 2017. 50% of business entertainment, amusement, or recreation expenses were deductible prior to 2018. Tax reform provides that no deduction is allowed with respect to:

1. An activity generally considered to be entertainment, amusement or recreation,
2. Membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or
3. A facility or portion thereof used in connection with any of the above items.

In general, the term "entertainment" means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family.

The term "entertainment" does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (a) supper money provided by an employer to his employee working overtime, (b) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. On the other hand, the providing of a hotel room or an automobile by an employer to his employee who is on vacation would constitute entertainment of the employee (§1.274-2(b)(1)(i)).

Can entertainment be classified as marketing? An objective test is used to determine whether an activity is generally considered entertainment regardless of whether it can also be described otherwise, and/or relates to the taxpayer alone. This test precludes arguments such as that "entertainment" means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test, the taxpayer's trade or business is considered (§1.274-2(b)(1)(ii)).

> **Example**. Although attending a theatrical performance would generally be considered entertainment, it would not be so for the professional theater critic attending in his or her professional capacity.
>
> **Example**. If a manufacturer of dresses conducts a fashion show to introduce his or her products to a group of store buyers, the show would not generally be considered entertainment.

Example. If an appliance distributor conducts a fashion show for the spouses of retailer customers, the fashion show would generally be considered entertainment.

When is entertainment really a gift? An expenditure is deemed to be for a gift, rather than entertainment, if it is:

1. An expenditure for packaged food or beverages transferred directly or indirectly to another person intended for consumption at a later time.
2. An expenditure for tickets of admission to a place of entertainment transferred to another person (§1.274-2(b)(1)(iii)).

Example. Curt gives a pair of Giants baseball tickets to his investor clients. Curt is limited to a $25 gift deduction.

50% of Meal and Entertainment Expenses (§274(n))

Deductions for any meals (food and beverages) are limited to 50% of such allowable expenses even if they are incurred while traveling away from home (§274(n)).

Tax practitioner planning. Advise clients that they need to change their bookkeeping to distinguish between meals and entertainment.

80% of business meals deductible for transportation workers. Individuals may deduct 80% of the cost of their food and beverages while away from home during, or incident to, a period of duty subject to the hours-of-service limitations of the Department of Transportation. For 2018 through 2025, employees can no longer deduct employee business expenses, only self employed individuals.

100% Deductible Meals

These are 100% deductible meals:

1. Reimbursed expenses - the self-employed independent contractor
2. Reimbursed expenses - employee (§274(e)(2))
3. The "HoneyBaked" Ham - De minimis (§274(n)(2)(B))
4. The company party (§274(e)(4))
5. Items available to public (§274(e)(7); LTR 94140040; LTR9641005)
6. Items sold to customers (§274(e)(8))
7. Charitable fund raising (§274(n)(2)(c))
8. Expenses for food or beverages required by any federal law to be provided to crew members of commercial vessels or expenses for food or beverages provided to crew members of a commercial vessel that is operating on the Great Lakes, the Saint Lawrence Seaway, or any inland waterway of the United States and which would be required by federal law to provide food and beverage if the commercial vessels were operated at sea (§274(n)(2)(E)(i & ii))

9. Expenses for food or beverages provided at certain oil or gas platforms or drilling rigs and support camps (§274(n)(2)(E)(iii))

***New*. Meals for the Convenience of the Employer Not Deductible (new §274(o))**

The 50% limitation applies to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer for amounts incurred and paid after Dec. 31, 2017 and until Dec. 31, 2025. Amounts incurred and paid after Dec. 31, 2025 are not deductible.

Employer Provided Meals Were Taxable Income to Employees (TAM 201903017)

The value of meals and snacks that the Taxpayer provided to its employees in their offices were includable in employees' income and subject to employment taxes. The value of meals furnished to the Taxpayer's employees is excludable from gross income under §119 as furnished for the convenience of the employer, if the Taxpayer's stated business reasons for furnishing the meals include:

a) protecting confidential and proprietary information, including intellectual property by providing a secure environment for business discussions on business premises;
b) fostering collaboration and innovation-by encouraging employees to stay on the Taxpayer's business premises;
c) protecting employees due to unsafe conditions surrounding the Taxpayer's business premises;
d) providing healthy eating options for employees to improve employee health;
e) because, given the Taxpayer's particular location and situation, employees cannot secure a meal within a reasonable meal period;
f) providing meals where the demands of the employees' job functions allow them to take only a short meal break but the Taxpayer can only provide limited substantiation for this policy; or
g) providing meals so that employees are available to handle emergency outages that regularly occur?

In addition, to exclude meals, the Taxpayer must show that at least half of all employees are furnished meals for the convenience of the employer (§119(b)(4)) and the meals must be provided in "an eating facility" (not at the employee's desk) (§132(e)(2)). The TAM found the Taxpayer unable to verify the necessity of providing meals as enumerated in §119 and §132.

Snacks are not includable. Determining the value of items consumed by each employee of snacks that come in small, sometimes difficult to quantify portions and are stored in open-access areas is administratively impractical given the low value of each snack portion, even if the employer offers the snacks on a continual basis. "Therefore, the value of the snacks the Taxpayer furnishes to its employees is excludable from gross income as a de minimis fringe benefit under §132(e)(1)."

Tax practitioner planning. This is good news for tax offices.

LISTED PROPERTY

***New*. What is Listed Property? (§280F(d)(4): §1.280F-6(b))**

The term "listed property" means—

1. *Any passenger automobile* which is defined as any 4-wheeled vehicle manufactured primarily for use on public streets, roads, and highways, and rated at 6,000 pounds gross vehicle weight or less, with the exception of:
   a) Ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,
   b) Taxi: vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, or
   c) Truck or van that is a qualified nonpersonal use vehicle (see §1.274-5T(k)); (§1.280F-6(c)(1)-(3); §280F(d)(4)(A)(i)).
2. Any other *property used as a means of transportation* including trucks, buses, trains, boats, airplanes, motorcycles, and any other vehicles for transporting persons or goods (§280F(d)(4)(A)(ii));
   a) but not any qualified nonpersonal use vehicle (as defined in §274(i) and §1.274-5(k)) [§1.280F-6(b)(1)(ii), -6(b)(2)].
3. Any *property generally used for entertainment, recreation, or amusement purposes* including property such as photographic, phonographic, communication, and video recording equipment (§280F(d)(4)(A)(iii)).
4. ***New*. Computer or peripheral equipment has been deleted from the listed property list and no longer is subject to the "daily log" substantiation requirements effective Jan. 1, 2018**:
   a) Any *computer or peripheral equipment.*
      i. The term "computer or peripheral equipment" does not include any equipment which is an integral part of other property which is not a computer, typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and equipment of a kind used primarily for amusement or entertainment of the user. (§168(I)(2)(B), -(I)(2)(B)(iv) (I)-(III)).
      ii. The term "listed property" does not include any computer (including peripheral equipment) used exclusively at a regular business establishment or a qualified (§280A(c)(1)) office-in-home (§1.280F-6(b)(1)(iv), -6(b)(5); §168(I)(2)(B)).

Example. Holly buys a new laptop uses in her home office and at her client's office. If she purchased the laptop in 2017, she was not allowed a depreciation deduction (or §179 expensing amount) related to her laptop unless she maintained a log book on its use during the year. If she purchases the laptop in2019, she is no longer required to provide the IRS auditor a log book to get the deduction. She instead must show the reasonableness of her business use of the laptop.

Substantiation of Listed Property: Autos, Etc. (§280F(d)(4))

Documentation required to substantiate the business use of listed property must include:

1. **Amount**
   a. **Expenditures** - The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, cost of capital improvements, lease payments, cost of maintenance and repairs, or other expenditures or uses.
   b. **Uses** - The amount of each business-investment use (as defined in §1.280F-6(d)(3)) based on the appropriate measure *(for example, mileage for automobiles)* and the total use of the listed property for the taxable year.
2. **Time** - The date of each expenditure or use.
3. **Business or Investment Purpose -** The business purpose for each expenditure or use (§1.274-5T(b)(6)).

The Strict Substantiation Rules of Listed Property

Detailed log with receipts. Section 274(d) imposes strict substantiation requirements for certain expenses such as vehicle expenses (§1.274-5T(a)). To substantiate by adequate records, the taxpayer must provide:

1. an account book, a log, or a similar record and
2. documentary evidence, which together are sufficient to establish *each element* with respect to an expenditure (§1.274-5T(c)(2)(I)).

"Guesstimates" or "testimony only" not sufficient. §274(d) contemplates that no deduction or credit shall be allowed on the basis of mere approximations or unsupported testimony of the taxpayer.

The Alternative Recordkeeping Option

If log is not contemporaneous, "other sufficient credible evidence" required. Although a contemporaneous log is not required, corroborative evidence to support a taxpayer's reconstruction "of the elements * * * of the expenditure or use must have a high degree of probative value to elevate such statement" to the level of credibility of a contemporaneous record (§1.274-5T(c)(1)). If a taxpayer fails to substantially comply with the adequate records requirement with respect to any element of an expenditure or use, the taxpayer MUST then establish such elements by "other sufficient evidence" backed up with "other corroborative evidence."

What is meant by "other sufficient evidence corroborating the taxpayer's own statement?"

1. ***Other sufficient evidence*** is the taxpayer's own statement, whether written or oral, containing specific information in detail as to such element and other corroborative evidence sufficient to establish such element (§1.274-5T(c)(3)(I)).

2. ***Other corroborative evidence*** must be direct evidence (a written statement or oral testimony of witness) if the element is the cost, amount, time, place, or date of an expenditure or use (§1.274-5T(c)(3)(I)).

Substantiation in exceptional circumstances. The substantiation requirements do not have to be met in those exceptional circumstances where it is simply impossible to meet these requirements and other "highly probative" evidence is available (§1.274-5T(c)(4)).

Sampling may be used under certain circumstances. If a taxpayer maintains an adequate record of part of the taxable year, he or she may possibly be permitted to use such partial records to substantiate the business/investment use of listed property for the entire year if he or she demonstrates that the period covered by the adequate record is representative of the use (§1.274-5T(c)(3)(ii)(A)). This sampling may be as small as 25% of the entire year.

> ***Example - Auto log filled in for only three months:*** Leah, a sole proprietor, operates an interior decorating business out of her home. Leah uses an automobile for local business travel to visit the homes or offices of clients, to meet with suppliers and other subcontractors, and to pick up and deliver certain items to clients when feasible. There is no other business use of the automobile but Leah and other members of her family also use the automobile for personal purposes. Leah maintains adequate records for the first three months of the year that indicate that 75% of the use of the automobile was in Leah's business. Invoices from subcontractors and paid bills indicate that Leah's business continued at approximately the same rate for the remainder of the year. If other circumstances do not change (for example, Leah does not obtain a second car for exclusive use in her business), the determination that the business/investment use of the automobile for the taxable year is 75% is based on sufficient corroborative evidence (§1.274-5T(c)(3)(ii)(c)).
>
> ***Example - Auto log filled in one week a month:*** The facts are the same as in the previous example, except that Leah maintains adequate records during the first week of every month, which indicate that 75% of the use of the automobile is in Leah's business. The invoices from Leah's business indicate that Leah's business continued at the same rate during the subsequent weeks of each month so that Leah's weekly records are representative of each month's business use of the automobile. Thus, the determination that the business/investment use of the automobile for the taxable year is 75% is based on sufficient corroborative evidence (§1.274-5T(c)(3)(ii)(c)).

Loss of records beyond the taxpayer's control. If the taxpayer's records are destroyed due to fire, flood, earthquake, or other casualty, the taxpayer may reconstruct the expenses using a reasonable method (§1.274-5T(c)(5)).

Telephone, Cell Phone, and Internet Expenses

Telephone expenses with respect to the first telephone ***line*** in a personal residence are nondeductible personal expenses (§262(b)). All substantiated business long-distance calls, call-waiting, call-forwarding, mail box, cellular telephone, and beeper expenses are deductible as would a business second telephone line, dedicated fax lines, and Internet lines. Telephones, including cellular, used mainly for personal use with only an occasion business use will be disallowed (*D.D. Lanier,* 11 TCM 439).

Cell Phones Are Not Listed Property

Because cell phones are not listed property, the burdensome substantiation requirements of §274(d)(4) do not apply. In addition, the IRS ruled that the personal use portion of the value of an employer-provided cell phone is a non-taxable de minimis fringe benefit to the employee if the "noncompensatory business purpose" rule ("I need to get hold of you outside of business hours") of Notice 2011-72 is met.

> **Tax practitioner alert**. Some tax professionals are reporting that IRS examiners are requiring taxpayers to have two cell phones in order to deduct one as a business expense. Reportedly, the IRS is relying on §262(a), which disallows the deduction for the first telephone *line* into a home regardless of how it is used. The author believes that the IRS is wrong taking this position. There is no such requirement for cellular telephones. Cell phones don't have *lines*.

Stock Broker/Real Estate Professional's Denied Cell Phone Expenses as She Didn't Allocate between Business and Personal Usage by Minutes (*Patricia Windham v. Comm.*, TCM 2017-68)

The IRS agreed that Patricia Windham, a stock broker and landlord, paid $592 in cell phone expenses evidenced by her cell phone bills. Even though Patricia testified that she used her cell phone for her brokerage work, for her rental real estate activities, and for the charities for which she volunteered, strangely, she offered no testimony or other evidence delineating how many cell phone minutes were used for business calls, charity calls, or personal calls. Worse, the Tax Court pointed out, as she provided no evidentiary basis to allow the court to apply the *Cohan* rule to her cell phone expenses, her entire cell phone expenses for the year were disallowed.

> **Tax practitioner planning.** Patricia, who was represented by counsel, didn't introduce the *Cohan* defense supported by cell phone minutes! Why?

Also see.

- *Joseph Dwight and Dona De Primavera Jackson, pro sese v. Comm.*, TCS 2016-11, where 90% of mechanic's cell phone bills were deductible. A mechanic who worked for several employers, and operated a small-engine repair business on the side, was not entitled to unsubstantiated deductions. However, as cellular phones are no longer included in the definition of listed property in §280F(d)(4), and, therefore, are no longer subject to the strict substantiation requirements of §274(d), the court allowed Joe to deduct approximately 90% of his estimated cell phone expenses (an amount based solely on his credible testimony).
- *Ronald G. Ezzell, Jr., pro se., v. Comm.*, TCS 2015-52, where 80% of cell phone was deductible.
- *Sam D. Kilpatrick, pro se v. Comm.*, TCM 2016-166, where a CPA's cell phone deduction was denied because his evidence was the words "I guess!" Sam's exact testimony was "I would say 70-30. That's strictly a guess." The court was not " . . . persuaded of the veracity of (Sam's) guess." Furthermore, the court added "even if strict substantiation did not govern this expense, the record does not give us a reasonable basis for making a *Cohan* estimate." Accordingly, the court denied Sam's entire cell phone deduction.

Tax practitioner planning. This is an unreasonably harsh result, although understandable.

Internet is Not Listed Property

Why Was CPA's Home Internet Deduction Limited to 9% of Annual Charges? (*Sam D. Kilpatrick, pro se v. Comm.*, TCM 2016-166)

Internet is a utility expense, not a computer expense, so reasonable estimate (per *Cohan)* should be allowed. The IRS only allowed $144 of Sam Kilpatrick's $1,523 business-expense deduction for internet-expense deduction. Sam admitted that he used the internet in his home both for personal purposes and for his CPA business and estimated it to be 50/50. The court conceded that an estimate of a taxpayer's deductible internet-service expenses is allowed if there was a reasonable basis for making such an estimate. The problem was the court did not find Sam's testimony "credible evidence of the percentage of home internet use for business versus personal purposes" and agreed with the IRS's $144 limitation.

> **Tax practitioner planning.** Nine percent ($144/$1523) of the annual internet expense is a tough result. Other courts have allowed 75% to 80% (see below) with no better records than Sam had. Perhaps the court held this CPA to a higher standard.

Also see.

- *Ronald G. Ezzell, Jr., pro se., v. Comm.*, TCS 2015-52, where 80% of bundled package for internet/cable charge was deductible.
- *James E. Kaminski, pro se v. Comm.*, TCS 2015-7, where 75% business use of Internet charges allowed as a reasonable estimate. The court has previously characterized Internet access expenses as utility expenses (*Verma, pro se v. Comm.*, TCM 2001-132), where strict substantiation, therefore, did not apply.

Taxpayers Had Contemporaneous Records for Miles Driven (*Huirong Zhu and Tina Zhou v. Comm.*, TSCO 2019-6)

Tina Zhou managed 11 investment properties that the couple owned. During 2013 Ms. Zhou drove two cars—a Toyota Camry and a Toyota Sienna— and showed a schedule by property totaling 14,676 miles driven to manage nine of them. Ms. Zhou collected rents, carried out evictions, made minor repairs (including drywall repairs), and coordinated hiring workers for large repairs as part of managing the properties. Sometimes Ms. Zhou would visit more than one property during a trip. Other times she would travel from their home in Mountain House, California, to one property, return home, and later, in the same day, visit another property.

Log book maintained. Two or three times a week Ms. Zhou logged her travel, including the purpose and time spent for the trip, with respect to managing the investment properties. She used a computer program to calculate the miles between their home and the investment property or properties. When the IRS examiner asked her for documentation of the miles Ms. Zhou drove, she consolidated the various contemporaneous

logs into one log. On the Schedule E filed with their 2013 tax return, they claimed total auto and travel expenses of $14,416 for 11 properties.

Court allows standard mileage rate for miles driven. The taxpayers proved to the court's satisfaction that Ms. Zhou maintained contemporaneous records of the miles she drove to and from the various investment properties. The log that consolidated the various records met the requirements of §274. The Court agreed that Ms. Zhou proved that she drove 14,676 miles in connection with managing their investment properties. Applying the standard mileage rate for 2013, 56.5¢, the Court allowed $8,292 for auto and travel expenses with respect to their investment properties for 2013.

> **Note**. The case does not explain how the taxpayers came up with a $14,416 deduction.

See Also.

- *Jesus and Juanita Rodriquez v. Comm.*, TCSO 2019-4, where logs were created in anticipation of trial, and thus didn't meet the contemporaneous requirements of §274.
- *Daniel Imperato v. Comm.*, TCM 2018-126, where no log book equaled no auto deduction.

S Corporation Shareholder/employee Auto Expenses Not Deductible (*Andrew and Sara Berry v. Comm.*, TCM 2018-143)

In 2011 Andrew Berry owned 50% of Phoenix, an S corporation. Phoenix built and remodeled homes in San Luis Obispo County, California. Phoenix claimed a deduction of $26,641 for the use of a passenger vehicle. Andrew and Sara also deducted automobile expenses of $12,525 on their Schedule C related to their sales efforts for Phoenix.

No log book. Phoenix did not provide a log pertaining to the use of the passenger vehicle or other evidence showing the business use of the vehicle. Phoenix did not meet the requirements of §274(d) and therefore was not entitled to deduct car and truck expenses of $26,641. In support of Andrew's Schedule C auto expenses, Andrew provided his 2011 bank statement, on which he circled some of the entries and labeled them as "fuel" or "truck". He provided no evidence to show that these were business expenses or any evidence to meet the requirements of §274(d). Accordingly, the court sustained the IRS disallowance of deductions for these expenses.

Unreimbursed S corporation expenses. If Andrew had properly substantiated his auto expenses, they would have been employee business expenses, not Schedule C expenses. Employee business expenses are not deductible for 2018 through 2025, whether there are records or not.

AUTOMOBILE EXPENSES

The 2019 Standard Mileage Rate for Business Driving 58¢

The IRS provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred of operating a passenger automobile. In

addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate. For qualification rules, see Rev. Proc. 2010-51.

	2018	**2019**
Business	54.5¢	**58¢**
Moving	18¢ military only	**20¢ military only**
Medical	18¢	**20¢**
Charity	14¢	**14¢**

2019 deemed depreciation per business mile is 26¢. To compute the basis of a vehicle when the standard mileage has been used (generally when the vehicle is sold), the depreciation component of the standard mileage rate is 26¢ per mile.

Year	Amount
2019	26¢
2017 & 2018	25¢
2015 & 2016	24¢
2014	22¢
2012 & 2013	23¢

Luxury Auto Depreciation Limits (§280F)

The 2018 (effective after Dec. 31, 2017) maximum amount of allowable depreciation for passenger automobiles, if the additional first-year depreciation deduction under §168(k) is not claimed, is:

***2019 Luxury auto depreciation numbers have not been released at our publishing date.		
Passenger Auto	Placed in service 2018	**Placed in service 2019**
Year One	$10,000	
Year Two	$16,000	
Year Three	$9,600	
Year Four	$5,760	
Year Five and thereafter	$5,760	
Five year total	$47,120	

Example. Ben bought a *used* BMW sedan in 2017 for $50,000. His 2017 depreciation was limited to $3,160. If he buys the BMW sedan in 2018, his depreciation is limited to $10,000, plus bonus depreciation of $8,000.

When business use is less than 100%. If business use is less than 100%, the maximum depreciation deduction is reduced by the percentage of personal use (§280F(a)(2)). For example, if business use is 90%, depreciation is limited to 90% of each amount in the chart.

Autos on a truck chassis with GVW in excess of 6,000 excluded. Applicable automobiles include passenger cars weighing 6,000 gross vehicle weight (GVW) or less, which are manufactured primarily for use on public streets, roads, and highways. Therefore, light vans or trucks may be included whereas many full-sized pickups and large vans are excluded. Vehicles that by design or nature are not considered passenger cars (for example, taxicabs, ambulances, and hearses) are also not subject to these depreciation limitations (§280F(d)(5)).

Heavy SUVs. Heavy SUVs (i.e., those that are rated at more than 6,000 pounds gross (loaded) vehicle weight) are also exempt from the luxury-auto limitations because they don't meet the specific definition of a passenger auto (see §280F(d)(5) for definition.) But, certain heavy SUVs may not elect to §179 expense more than $25,500 (2019) of their cost (§179(b)(6)). The balance of the heavy SUV's cost may be depreciated as five-year MACRS property. For this purpose, a sport utility vehicle is defined to ***exclude*** any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Tax practitioner planning. The GVW is listed on a metal plate on the inside of the driver's door.

One table for autos and a separate table for trucks and vans. There are two sets of annual depreciation dollar limits for non-electric vehicles, one for passenger autos that are not trucks or vans and are subject to the §280F luxury-auto limits (i.e., rated at 6,000 pounds unloaded gross vehicle weight or less) and one for light trucks or vans (passenger autos built on a truck chassis, including minivans and SUVs built on a truck chassis). Light trucks or vans are subject to the §280F luxury-auto limits if they are rated at 6,000 pounds (loaded) vehicle weight or less (§280F(d)(5)(A)).

Leased Vehicle Inclusion Amount - In General (Rev. Proc. 2018-25)

To prevent avoidance of the personal use and luxury car limitations that apply to owned cars, a parallel system of limitations has been put in place for leased vehicles. Under this system, a taxpayer who leases a luxury car for business may be required to include an additional amount within his or her gross income in order to offset the deduction for the rental expense. The inclusion amount is calculated using annual tables provided by the IRS. The inclusion amount, based on the cost of the vehicle, generally applies to vehicles with a fair market value in excess of the following:

The lease term began in:	**And the vehicle's FMV on the 1st day of the lease exceeded:**
2017 Passenger autos	$19,000
2018 Passenger autos	$50,000

Inclusion amount - calculation. Section 1.280F-7T provides that if a taxpayer leases a passenger automobile, the taxpayer must include in gross income an inclusion amount determined for each taxable year during which the taxpayer leases the automobile.

Calculation. For the appropriate range of fair market values and the table in §1.280F-7T, select the dollar amount from the column for the taxable year in which the automobile is used under the lease (but for the last taxable year during any lease that does not begin and end in the same taxable year, use the dollar amount for the preceding year).

1. Multiply the inclusion amount by a fraction equal to the number of days the car is leased during the year divided by 365.
2. Multiply the product in #1 by the car's percentage of business and investment use during the year.

TRANSPORTATION BENEFITS DEDUCTION

Qualified Transportation Fringe Benefits (§132; §1.132-1, 5, 9)

Excluded from gross income is the value of any qualified transportation fringe benefit provided by an employer to an employee to the extent that it does not exceed the applicable statutory monthly limit (§132).

Qualified parking and transit passes. Prior to 2018, there were three categories of qualified transportation fringes for purposes of determining the amount that is excludable from gross income: (1) qualified parking, (2) transportation in a commuter highway vehicle (for example, VanPool) and transit passes, and (3) a qualified bicycle commuting reimbursement fringe benefit. Commuters can receive both the transit and parking benefits monthly; that would be up to $530 per month.

Monthly	2018	**2019**
Parking	$260	**$265**
Transit pass	$260	**$265**
Bicycling	$0	**-0-**

***New*. Parking and Transit Passes are Not Deductible, but Still Qualify as a Tax-Free Fringe Benefit (§132)**

The expenses associated with providing any qualified transportation fringe to employees are not deductible, and except as necessary for ensuring the safety of an employee, neither are any expenses incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment unless the employer treats the benefits as taxable W-2 wages. This started for amounts paid or incurred after Dec. 31, 2017 (§132(f)(1),(5)).

Example. Karen provides her employees with monthly CalTrain passes of $200. Beginning in 2018, the amount that Karen pays for transportation benefits passes is not deductible, although the CalTrain passes continue to be a tax-free fringe benefit to her employees.

Parking benefit includes costs of ownership. Clearly, the cost of providing parking to employees in a downtown, high rise office building includes the monthly lease costs paid by the business. But wonder if the business owns its parking lot? Ownership costs are not deductible and they may include depreciation, maintenance, security, utilities, snow removal and similar costs.

***New*. Exclusion for Bicycling is Gone (§132)**

The exclusion from gross income and wages for qualified bicycle commuting reimbursements does not apply to taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

2018-2019 Federal Lodging and Meal Per Diems

For fiscal year 2018-19, the per diem options available for (1) employee reimbursements and deductions and (2) self-employed deductions have been released (GSA Per Diem Rates Look-Up; GSA Per Diem Files; GSA 2018 Highlights; GSA FY 2018 M&IE Breakdown). The new rates are effective through Sept. 30, 2019.

Meals/Lodging Per Diem Rates	FY 2017- 18 (Notice 2017-54)	FY 2018-19 (Notice 2018-84)
Meals, Lodging, and Incidentals	**$144 to $498**	**$149 to $501**
High/Low M&IE Rate	**$191/$284**	**$195/$287**
Transportation Meal Flat Rate	$63 (CONUS)	**$66 (CONUS)**
Incidental Expenses only	$5	**$5**

The meals per diem deduction is available to the self-employed but not lodging per diem deductions. Self-employed individuals who wish to deduct per diem on her or his business returns, may use the meal and incidental rate to substantiate travel meals but cannot use any federal per diem method containing lodging. Methods containing the lodging per diem are available exclusively to businesses (employers, its agents or a third party) reimbursing employees for travel away-from-home expenses. Therefore, to deduct lodging on a personal return, the self-employed must have actual receipts (Rev. Proc. 2010-39, §1). Self-employed individuals may always use actual allowable expenses, instead of per diems, to compute the deductible costs of business lodging, meals, and incidental expenses paid while traveling away from home as long as they maintain adequate records (or other sufficient evidence).

The requirements to use the per diem option. Per diem reimbursement is not taxable wages to the employee as long as the employee and employer follow three basic rules.

1. ***Major misunderstanding! "Adequate accounting" to the employer is required.*** The employee must timely substantiate to the employer "the elements necessary to determine the amount of the allowance (for example, the number of miles driven or the number of days away from home, and the

time, place, and business purpose of the travel)" [Rev. Proc. 2011-47; §7.01]. The per diem must be paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer (Rev. Proc. 2011-47, §3.01). If the employee does not timely substantiate to the employer, the per diem becomes taxable income and expenses are not deductible on Form 2106 (*B.J. Baugh*, TCM 1996-70; *R. L. Evans pro se v. Comm.,* TCM 2010-7).

2. ***Per diem cannot be more than the IRS-specified rates.*** The employee may only receive or deduct a per diem amount at or below the "IRS-specified standard rates" as enumerated in the previous chart. Any excess per diem creates W-2 income. The IRS-specified per diem rates are updated every Oct. 1, not Jan. 1. But, businesses may choose either the prior year rate or the current year rate for the last three months of the year.
3. ***Any per diem not substantiated mut be returned.*** The employee must be required to return any portion of such an allowance which relates to days, miles, or travel not substantiated.

Tax practitioner planning. "Cut and paste" the above three requirements to create a written "accountable plan" for each of your business clients with employees.

Tax practitioner planning. The General Services Administration final regulations define incidental expenses under the Federal Travel Regulations §300-3.1 to include only fees and tips given to porters, baggage carriers, hotel staff, and staff on ships. Transportation between places of lodging or business and places where meals are taken, and the mailing cost of filing travel vouchers and paying employer-sponsored charge card billings, are not included in incidental expenses. Accordingly, taxpayers using the per diem rates may separately deduct or be reimbursed for transportation and mailing expenses.

Per diem rates available on the Internet. ***Domestic*** per diem rates can be found at "www.gsa.gov." GSA's per diem mobile app is also available and allows travelers to look up federal government per diem rates by city/state and ZIP code in locations throughout the United States and its territories. For ***foreign*** per diem rates go here. Converting foreign dollars to US dollars for expense purposes can be done at Oanda.com.

Outside the continental United States (OCONUS). The rates for non-foreign localities outside the continental United States are established by the Secretary of Defense (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States). The Secretary of State establishes rates for foreign localities. The rates are published in the Per Diem Supplement to the Standardized Regulations (Government Civilians, Foreign Areas) and are updated monthly. The rates can be found on the Department of Defense website.

How to Treat Per Diem's Paid Under Accountable Plan or Under a Nonaccountable Plan

When are per diem allowances includable in W-2 income? The treatment of payments received by an employee subject to the employer's employee business expense reimbursement plan depends upon whether the plan is an accountable plan or a nonaccountable plan. If the expenses are reimbursed by the employer pursuant to an accountable plan, then the reimbursed amount is excluded from gross income and is not

considered wages or other compensation (§1.62-2(c)(4)). But if the reimbursement is not made under an accountable plan, then the amount of the reimbursement is treated as wages and is includable in the employee's gross income (§1.62-2(c)(5)).

To qualify as an accountable plan, the plan must: (1) have a business connection; (2) require substantiation of expenses; and (3) require the return of amounts exceeding expenses incurred (§1.62-2(d), (e), and (f)).

Insurance Adjuster's Per Diem Paid Under a Nonaccountable Plan Reportable on W-2 (*Gary Patrick Johnson v. Comm., pro se*, TCS 2017-71)

Employer included per diem in employee's W-2. Gary Patrick Johnson was employed as an insurance adjuster for Pilot Catastrophe Services, Inc. (Pilot). As reported on his Form W-2, Gary's wages from Pilot for 2013 amounted to $131,884, which included a total of $42,812 per diem travel allowances for lodging, meals, and incidental expenses he paid or incurred in connection with his employment. Gary argued that Pilot should not have treated the per diem allowances as includable in his taxable income.

Employee was entitled to the per diem allowances regardless of whether he paid or incurred any qualifying expense relating to the allowances *or* whether he could substantiate that expense. Consequently, the court held, the per diem allowances were not paid to Gary pursuant to an accountable plan. "It follows that the per diem allowances (were) properly includable, and were in fact included, in (Gary's) 2013 income." The court's conclusion on this point, of course, was supported by the fact that Pilot obviously considered the reimbursement plan a nonaccountable plan as the company treated the reimbursements as wages.

> **Tax practitioner planning.** Planning is important considering the suspension of the employee business expense deduction. To have converted the taxable reimbursement to non-taxable, all the employee needs to do is fill in an expense report and simply put the daily per diem into the "amount" column!

Concierge CFO Not Away From Home (*Michael and Miriam Mercado Brown v. Comm.*, TCM 2019-30)

Michael Brown is an independent contractor carrying on as a "concierge CFO." Brown has had clients for his CFO business since at least 1998. At times, he has had as many as three clients simultaneously. Brown, his wife and children live in a suburb of Atlanta.

In 2012, Brown entered into a three-year contract with American Furniture Rental (AFR) and was required to work four days a week in Pennsauken, New Jersey. He returned to his home in Atlanta, Georgia, for the rest of the week. AFR was the sole source of business income reported by Brown for the period beginning when he went to work for AFR and extending through 2013. The IRS disallowed Brown's deductions of traveling expenses between Atlanta and Pennsauken for years 2012 and 2013.

Not "away from home." A taxpayer's "home", for purposes of §162(a)(2), generally means the

vicinity of his principal place of employment rather than his personal residence *(Mitchell v. Comm.,* 74 T.C. 578, 581 (1980); *Zbylut v. Comm.*, TCM 2008-44). A temporary work site might have provided a deduction for Brown. But Brown's work was not temporary. It was instead "indefinite" as his contract was for three years. The travel expenses were disallowed since Brown's "home" for the years at issue was New Jersey.

SECTION 163 INTEREST

***New*. Limitations on Business Interest Deductions (§163(j), REG-106089-18(Dec. 28, 2018)**

TCJA added new §163(j). This new rule generally limits the amount of a taxpayer's business interest deduction to the sum of:

1. The taxpayer's business interest income;
2. 30% of the taxpayer's adjusted taxable income; and
3. The floor plan financing interest of the taxpayer.

Any business interest expense in excess of this threshold is carried forward indefinitely. There is a special carryforward rule for partnerships.

> **Note**. The limitation generally does not apply to small businesses (other than tax shelters), regulated public utilities, and electing farming or real property trades or businesses.

Floor plan financing. Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness.

- Floor plan financing indebtedness means indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired. Motor vehicle means a motor vehicle that is: any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; a boat; or farm machinery or equipment.
- Once a taxpayer takes floor plan financing interest into account in calculating its business interest limitation, the taxpayer may not claim bonus depreciation under §168(k) for property placed in service during such year and subsequent years.
- The taxpayer can choose not to take floor plan financing into account in computing its business interest limitation, in which case the taxpayer may claim bonus depreciation (if floor plan financing was not taken into account in a prior year).

Prior-law and earnings stripping. Prior-law §163(j) limited a corporation's interest deduction in circumstances that indicated the corporation was paying interest to related parties to reduce US taxable income. Generally, the rule applied to a corporation with a high debt-to-equity ratio making large interest payments (relative to adjusted taxable income) to related parties not subject to US tax (e.g., a foreign affiliate). Adjusted taxable income for purposes of prior-law §163(j) was defined to roughly approximate earnings before interest, tax, depreciation, or amortization ("EBITDA"). Because of its focus on reductions in the US tax base, this rule was often referred to as addressing "earnings stripping."

New-law applies more broadly. TCJA replaced prior-law §163(j) which has broader application. The new rule:

1. Applies to business interest expense of all taxpayers (not just corporations) regardless of debt-to-equity ratio and regardless of status of the lender (i.e., related or unrelated);
2. Retains old §163(j)'s focus on the relationship between interest payments and an adjusted taxable income; and
3. Addresses debt financing generally, and does not focus primarily on scenarios reflecting the potential for earnings stripping.

The limitation applies at the taxpayer level. For example, the limitation applies at the consolidated tax return filing level, because the consolidated group is a single taxpayer. For partnerships and S corporations, the limitation applies at the entity level.

Adjusted taxable income. Adjusted taxable income ("ATI") means the taxable income of the taxpayer computed without regard to:

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- Any business interest or business interest income;
- The amount of any net operating loss deduction;
- The amount of any deduction allowed under §199A.

EBITDA and EBIT. For taxable years beginning before Jan. 1, 2022, ATI is computed without regard to any deduction allowable for depreciation, amortization, or depletion. This definition of ATI generally corresponds with the financial accounting concept of EBITDA. For taxable years beginning on or after Jan. 1, 2022, ATI is computed with regard to deductions for depreciation, amortization, and depletion. This definition of ATI generally corresponds with the financial accounting concept of earnings before interest and taxes, or EBIT.

> **Note**. As a result, for taxpayers with such deductions, the limitation becomes more stringent in taxable years beginning on or after Jan. 1, 2022.

Carryforward rules. For taxpayers other than partnerships, the amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. The business interest carried forward is added to any business interest in the succeeding year and then subjected to the limitation for that year.

- For corporations, this carryforward is subject to limitation by §382 (change of ownership and carryforward tax attributes).
- For partnerships and S corporations, the limitation applies at the entity level. Any business interest in excess of the entity's limitation is allocated to the owners in the same manner as the owner's distributive share of the entity's interest expense.

Special carryforward rules for partnerships. In the case of a partnership, the general entity-level carryforward rule does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to the partners.

> (1) In the current year, without regard to carryovers, the ability to deduct partnership business interest is limited by partnership business interest income, partnership ATI, and partnership floor plan financing;
> (2) Any interest that is not deductible in the current year does not carry forward at the partnership level, but rather is allocated to the partners, where future potential deductions depend on future amounts allocated from the partnership that generated the carryforward; and (3) A partner's ability to deduct a carryforward in the future may depend not only on business interest income allocated to the partner by the partnership that generated the carryforward, but also on other activities of the partner or entities the partner owns.

Exceptions- small business. Section 163(j) does not apply to any taxpayer (other than a tax shelter) for which the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $26 million (for 2019) .

> **Note**. The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

BUT §163(j) applies to a tax shelter. The small business exception does not apply to tax shelters. Tax shelters are defined in §448(d)(3) and 461(i)(3). §461(i)(3) provides that the term "tax shelter" means:

1. any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,
2. any syndicate (within the meaning of §1256(e)(3)(B)), and
3. any tax shelter (as defined in §6662(d)(2)(C)(ii)).

Syndicate for this purpose is defined as any partnership or other entity (other than a C corporation) if more than 35% of the losses of the entity during the tax year are allocable to limited partners or limited entrepreneurs. The meaning of "limited entrepreneur" is provided in §461(k)(4) as a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of that enterprise. Thus, an LLC that allocates losses to members more than 35% of which are not active in the management is a tax shelter and subject to §163(j).

Elections- real property and farming. At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (i.e., any electing real property trade or business[1]) is not treated as a trade or

[1]Real property trade or business uses the definition in §469(c)(7)(C).

business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.

- An electing real property trade or business is required to use the alternative depreciation system ("ADS," a slower system of cost recovery than might otherwise be available) to depreciate any of its nonresidential real property, residential rental property, qualified improvement property, qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property.

Similarly, at the taxpayer's election, any farming business[2] or any business engaged in the trade or business of a specified agricultural or horticultural cooperative, is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to any such trade or business.

- Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products, but not contract harvesting or buying and selling animals or farm products raised by another farmer.
- An electing farming business is required to use ADS to depreciate any property with a recovery period of 10 years or more.

Form 8990

Use Form 8990 to to figure the amount of business interest expense you can deduct
and the amount to carryforward to the next year. A taxpayer with business interest expense; a disallowed business interest expense carryforward; or, current year or prior year excess business interest expense, generally must file Form 8990, unless an exclusion from filing applies. A pass-through entity allocating excess taxable income or excess business interest income to its owners (that is, a pass-through entity that is not a small business taxpayer) must file Form 8990. Instructions are here.

IRS Issues FAQs Regarding §163(j) (Basic Questions and Answers, Mar. 8, 2019)

IRS has provided on its website the answers to 17 basic questions about the limitation on the deduction for business interest expense, also known as the "section 163(j) limitation."

IRS Issues Guidance on Business Interest Expense Limitations (Notice 2018-28)

Notice 2018-28 clarifies the treatment of interest disallowed and carried forward under §163(j) prior to the TCJA enactment. The notice describes aspects of the regulations that the Treasury Department and the IRS intend to issue, including rules addressing the calculation of the business interest expense limitation at the

[2]Farming business uses the definition in §263A(e)(4).

level of a consolidated group of corporations and other rules to clarify certain aspects of the law as it applies to corporations. Finally, the notice makes it clear that partners in partnerships and S corporation shareholders cannot interpret newly amended §163(j) to inappropriately "double count" the business interest income of a partnership or S corporation.

SECTION 166 BAD DEBT - BUSINESS BAD DEBT DEDUCTION

Requirements for a Bad Debt Deduction

A deduction is allowed for any debt that becomes worthless within the taxable year (§166(a)(1)). The inability to collect money due to a breach of contract *may* allow the taxpayer a bad debt deduction. But prior to taking the deduction, the taxpayer must determine if the debt is:

1. Actually worthless?
2. Genuinely a "bona fide" debt?
3. Factually a capital contribution?
4. A business bad debt?
5. A nonbusiness bad debt?

Additionally, the above questions cannot be circumvented by calling a bad debt deduction a loss under §165.

Worthlessness of debt. Whether a debt actually becomes worthless, in whole or in part, is a question of fact, but actual worthlessness is a condition that must be present for a bad debt deduction. A debt is considered worthless when there are reasonable grounds for abandoning hope that the debt will be repaid and there is no longer any chance of the debt being collected. The decision must be made in the exercise of sound business judgment (*Andrew v. Comm.,* 54 TC 239, 248 (1970)). It is not necessary to wait until a debt became due to determine whether it is worthless if the facts show that actual worthlessness existed before the due date (§1.166-2). Worthlessness is generally evidenced by an insolvent debtor not timely servicing the debt and refusing to pay any part of the debt in the future, declaring bankruptcy, or simply disappearing. Legal action is not required to enforce payment where the surrounding facts and circumstances indicate that, in all probability, the action would not result in an enforceable judgment in favor of the lender (§1.166-2(b)).

Bona fide debt. A bona fide debt is a debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money (§1.166-1(c)). The loan must be made with the understanding that it is to be repaid. Whether a debtor-creditor relationship exists depends on all the facts and circumstances, and generally no one fact is determinative. An essential question is whether there is a good-faith intent on the part of the recipient of the funds to make repayment, and a good-faith intent of the person advancing the funds to enforce repayment (*Fisher v. Comm.*, 54 T. C. 905 (1970)).

Bona fide debt vs. capital contribution. There are no uniform standards to resolve the debt-equity issue; each case depends upon its individual facts and the courts have not always been in agreement on the legal framework within which this factual issue is to be determined. Most have agreed that the bottom line is whether the parties in fact intended the advances to create debt rather than equity, in the case of a corporate recipient, or a gift in the case of an individual recipient. But in determining that intent some courts have

relied heavily on the formal documentation, or objective manifestation, of the intent of the parties (*Byerlite Corporation v. Williams*, 61-1 USTC ¶9138], 286 F. 2d 285 (6th Cir. 1960)); while others have given greater weight to the subjective manifestations of intent to find what was really in the minds of the parties in light of the substantive economic realities of the transaction (*Matter of Uneco, Inc.*, 532 F. 2d 1204 (8th Cir. 1976)). In *Chester I. Johnson*, consolidated with *Hubbard & Johnson Lumber Co.* (36 TCM 1780, TCM 1977-436), the court determined that advances made by a corporation to another corporation were in part loans because, when they were first made, there were a reasonable expectation of repayment, the sums were treated as accounts receivable and the receiving corporation recognized the obligation to repay the amounts. However, once it was apparent that the receiving corporation would not be successful, the advanced sums were nondeductible contributions to capital because it was unreasonable to make unsecured loans.

Bona fide debt vs. gift. A loan to a friend or relative solely for reasons other than to make a profit is not a "bona fide" debt (maybe it's a gift) and, therefore, no bad debt deduction of any kind is allowed. Intrafamily transfers are especially subject to close scrutiny and may be presumed to be gifts. The presumption may be rebutted by an affirmative showing that, at the time of the transaction, there was a real expectation of repayment and a real intent to enforce the collection of the asserted debt (*Estate of Van Anda v. Comm.*, 192 F.2d 391 (2d Cir. 1951)). The absence of loan formalities, loans to relatives make the taxpayer's burden of proof very difficult.

Factors used to determine bona-fide. Some of the factors considered when determining whether there is a debtor-creditor relationship with a reasonable expectation of repayment are whether:

1. there is a note or other evidence of indebtedness,
2. interest is charged,
3. there is a fixed schedule for repayment,
4. security or collateral is requested,
5. there is any written loan agreement,
6. a demand for repayment has been made,
7. the parties' records reflect the transaction as a loan,
8. repayments have been made, and
9. the borrower was solvent at the time of the loan (*Hunt v. Comm.*, TC Memo. 1989-335).

Business bad debt deduction. A business debt is "a debt created or acquired * * * in connection with a trade or business of the taxpayer" or "a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business" (§166(d)(2)). To be eligible to deduct a loss as a business bad debt, a taxpayer must show that he was engaged in a trade or business and that the debt was proximately related to his trade or business (§1.166-5(b); *Putoma Corp. v. Comm.* 66 TC 652, 673 (1976), aff'd [79-2 USTC ¶9557], 601 F.2d 734 (5th Cir. 1979)). To be engaged in a trade or business, the taxpayer must participate in the activity with continuity and regularity, and his primary purpose for engaging in the activity must be for income or profit (*Comm. v. Groetzinger*, 87-1 USTC ¶9191, 480 US 23, 35 (1987)). The management of one's investments, no matter how extensive, is not a "trade or business" (*Whipple v. Comm.*, 63-1 USTC ¶9466, 373 US 193, 200 (1963)).

> **Tax practitioner planning.** For a nonbusiness bad debt held by a taxpayer other than a corporation, §166(a)(1) does not apply, and the taxpayer is allowed a short-term capital loss (limited to $3,000

per year and reportable on Sch. B to allow the IRS to quickly identify this deduction) for the taxable year in which the debt becomes completely worthless (§166(d)(1); §1.166-5(a)(2)).

Evidence Didn't Show Debtor-creditor Relationship (*Terry and Dorothy Yaryan v. Comm.*, TCM 2018-129)

Terry and Dorothy Aryan invested $400,000 in a joint venture with Prime Realty Inc., a Colorado home builder. The joint venture agreement provided that the Yaryan's funds would be used to purchase building lots and that Prime would finance construction of "spec" homes. For 2004-06 the Yaryans reported profits from the joint venture's real estate transactions on their jointly filed Forms 1040. For each of these years they reported the profits as "Other income" on line 21 of the Form 1040. For 2004-07 the Yaryans did not file Schedules C. And then the housing bubble burst, and the losses started to pile up for the Yaryans.

Theft loss. For 2011 Yaryan deducted $573,398 for a "fraudulent theft loss" on Schedule A of their Form 1040. They detailed the loss on Form 4684, Section B, Business and Income-Producing Property. On the Form 4684 they reported losses for four building projects, and they identified the losses collectively as the "Prime Realty-Olson Fraud theft". When the Yaryans agreed with the IRS that they didn't qualify for a theft loss, they tried for a business bad debt deduction on amended returns.

Or maybe a business bad debt. The Yaryans claimed bad debt deductions on their amended 2010 and 2011 returns. Prime issued the Yaryans a promissory note which stated that it was secured by a deed of trust. A genuine debtor-creditor relationship must be accompanied by "more than the existence of corporate paper encrusted with the appropriate nomenclature captions." *Tyler v. Tomlinson* [69-2 ustc ¶9559], 414 F.2d 844, 850 (5th Cir. 1969). The Yaryans did not receive promissory notes from Prime for the advances paid after the land purchases, including the payments advanced for landscaping expenses, construction loan interest, and property taxes. Mr. Yaryan testified that he began to suspect that Prime was broke. His failure to obtain or request formal promissory notes or other security under these circumstances indicated to the court that these payments were not intended to be bona fide debt.

Insolvent debtor. Advances made to an insolvent debtor generally do not create debts for tax purposes but are characterized as capital contributions or gifts. See *Dixie Dairies Corp. v. Comm.*, 74 T.C. at 496-497. The chance that the Yaryans's continued advances would be repaid was far more speculative than any third-party creditor would accept. See *Fin Hay Realty Co.*, 398 F.2d at 697. The best the Yaryans can do is a capital loss to the extent that there was a completed transaction.

Financial Advisor Denied Business Bad-Debt Deduction (*Jason Scheurer v. Comm., pro se.*, TCM 2017-36)

Loan made to long-time friend's business. When Jason Scheurer, a financial advisor, was not repaid funds (claiming over $197,000 advanced but he only substantiating $19,800 in court) made to a business of his long-time friend (and best man at his friend's wedding), Kevin Zinn, Jason claimed, in 2011, on his late-filed 2009 Form 4797, Sale of Business Property, a business bad-debt deduction. After receiving a notice of deficiency in 2014, Jason filed a delinquent Form 1065 for 2009, essentially claiming a similar amount. The

issue in front of the court was if he was entitled to claim either a business bad-debt deduction (discussed next) or a partnership loss deduction (which is discussed in the partnership chapter).

Not in the trade or business of lending. Business bad-debt deduction denied because financial planner was not in the trade or business of lending money, knew friend was a deadbeat, and didn't even ask for a signed note. The court concluded that Jason failed to show that the advances, to the extent substantiated, were business bad debts. A loss is deductible as a business bad debt only if the taxpayer is in a "business" and the debt in question is proximately related to that business (*US v. Generes*, 72-1 USTC ¶9259, 405 US 93, 96 (1972)); *Todd A. Dagres v. Comm.,* No. 15523-08, 136 TC 263, 282 (2011)).

THE OFFICE-IN-HOME REQUIREMENTS - §280A

Primer on Office in Home Rules: Strict Rules Prevent Abuse (Form 8829 - Expenses for Business Use of Your Home)

General rule. No deduction is allowed with respect to the use of a dwelling unit used by an individual or an S corporation during the taxable year as a residence (§280A(a)).

Exception for interest, taxes, casualty losses, etc. The general rule does not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity) [§280A(b)].

Tax practitioner planning. Home office is business debt, not home acquisition debt.

Exclusive and regular. To deduct expenses related to the business use of part of the home, the taxpayer must meet specific requirements. Even then the deduction may be limited. For home office expenses to qualify for a deduction, the portion of the home that is used for business must:

1. be used *exclusively*, (however, exceptions exist, see: *James A. & Joan H. Soholt v. Comm.*, TCS 2007-49, where a few personal papers in the home office didn't disqualify the home office deduction),
2. on a *regular* basis,
3. in connection with a *trade or business*, AND

in ***one*** of the following ways:

4. as the *principal place of business* for any of the taxpayer's trade or business, or
5. as a place of business for meeting or dealing with patients, clients, or customers in the ordinary course of business, or
6. in connection with the taxpayer's trade or business if the taxpayer is using a separate structure that is not attached to the dwelling (§280A(c)(1)).

No other fixed location. A home office qualifies as the taxpayer's "principal place of business" IF *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* (§280A(c)(1)). This means that outside salespersons and real estate agents will often be able to deduct an office in their home.

> **Tax practitioner planning.** Miscellaneous itemized deductions have been suspended after Dec. 31, 2017 and before Jan. 1, 2026. Therefore, an employee cannot deduct home office expenses.

The meaning of "home." The term home includes a house, apartment, condominium, mobile home, or boat. It also includes structures on the property, such as an unattached garage, studio, barn, or greenhouse. However, it does not include any part of the property ***used exclusively*** as a hotel or inn (§1.280A-1(c)(2)).

Use the square-footage method because room-by-room allocation is no longer permitted. According to the instructions of Form 8829, the room-by-room method is available only if "the rooms in the house are all about the same size" (that is, each bathroom is the same size as the living room, etc.), which is a ridiculous requirement. Edward Andrews claimed a deduction based on the ratio of rooms in the house, but the court determined that the home-office expenses should more reasonably be allocated on a square-footage basis (*E. W. Andrews v. Comm.*, 60 TCM 277, TCM 1990-391; CA-1 91-1 USTC ¶50,211; *Abhimanyu Swain, pro se, v. Comm.*, TCM 1996-22, (CA-4), No. 96-1170, 96-2 USTC ¶50,480).

Employee renting office-in-home to employer doesn't work. Section 280A specifically disallows the deduction of any expenses incurred when an employee rents a personal residence to his employer for business purposes (*Leslie A. and Betsy M. Roy v. Comm.,* TCM 1998-125). Therefore, a home office deduction is even barred when an employee leases a portion of his or her home to the employer at fair market value. This rule also extends to an independent contractor who attempts to lease to the party for whom he or she perform services (for example, a real estate agent should not lease office space located at home to his or her broker/owner) (§280A(c)(6)).

> **Tax practitioner planning.** IR-2017-96 is a plain language explanation of the home office deduction for providing quick information to a client's query on his or her home office, EXCEPT before using this IRS information release be sure to note that employees cannot take a home office deduction for 2018 through 2025.

Regular and Exclusive Use Required (*Clifton and Judith Gibbs v. Comm*., CA-4, 2019-1 ¶50,180 (Mar. 18, 2019)

Section 280A(c)(1)(A) allows a taxpayer to deduct expenses for the business use of his residence, but only to the extent the expenses are allocable to a portion of the residence which is exclusively used on a regular basis as the principal place of business for a trade or business of the taxpayer. Mr. Gibbs gave very general testimony about having a home office, but he provided no floor plan or other information to establish a portion of the house used exclusively for business, and he provided no information about the expenses incurred to maintain his residence. He proved no deductible home office expense.

Storage Space Denied Even Though Dwelling Unit Was "Principle Place of Business" (*Mohammad Najafpir v. Comm., pro se*, TCM 2018-103)

Business location didn't have space to store smog check reports for three years so he stored them in his apartment garage four doors away. Mohammad Najafpir (Najafpir) owned AA+ Smog Check a smog inspection station in Burlingame, CA with a slogan "Smog and a Smile." Najafpir lived in a one-bedroom apartment four doors down the street from AA+. His rent of $1,450 per month entitled him to the use of his apartment, as well as shared laundry facilities and one-half of a shared two-car garage that was attached to the apartment building. Najafpir did not park his car in the garage but instead used the space as business storage. As an owner of a smog check business, Najafpir was required by the State of California to keep certain invoices and records regarding smog checks for at least three years. Invoices must be kept on location for purposes of immediate inspection. AA+ had no formal office or storage space, and Burlingame area real estate was expensive. Given the proximity and availability of his garage, Najafpir used it as storage for his business records, including the State- mandated smog inspection invoices. In addition to these business records, Najafpir also stored business-related items such as backup air compressors, printers, monitors for the smog machine, and various parts such as oil filters and wipers. He stored no personal items of note or value in the garage, save for some pencils and stationery.

Because invoices weren't inventory or product samples, he loses his home office deduction. Can this be correct? Judge's opinion: Generally deductions "for otherwise allowable expenses with respect to the use of an individual taxpayer's home are prohibited." This prohibition, however, does not apply to space allocable within a "dwelling unit which is used on a regular basis as a storage unit for the inventory or product samples of the taxpayer held for use in the taxpayer's trade or business of selling products at retail or wholesale, but only if the dwelling unit is the sole fixed location of such trade or business" (§280A(a); §280A(c)(2)). Najafpir argued "he is entitled to these deductions because the garage was used to store business records. (Najafpir) was required to maintain these records by the State of California, and his garage was the most convenient and inexpensive place to do so." The judge concluded Najafpir "does not fit within the exception of §280A(c)(2), nor does he qualify for any other exceptions to §280A(a). (Najafpir) is not in the trade or business of selling products at retail or wholesale, and his business records and invoices do not constitute inventory. Therefore, (Najafpir) is not entitled to a deduction for his claimed home office expenses..."

Also see.

- *Daniel Imperato v. Comm.*, TCM 2018-126,where the taxpayer deducted expenses allocable to 37.5% and 50% of his residence for 2008 and 2009, respectively, but did not maintain records to establish the business use, and the payment of the expenses. Imperato failed to produce any records to substantiate the amounts of his mortgage interest, real estate taxes, utilities, or management fees.
- *Andrew and Sara Berry v. Comm.*, TCM 2018-143), where Andrew did not provide any evidence to show that a portion of his residence was exclusively used for business or how he calculated that a portion of his residence was used for business.
- *Steven Edward and Stacy Suzanne Ellison v. Comm.*, TCM 2017-134, Steven and Stacy failed to produce any credible testimony or introduce credible documentary evidence to substantiate that they

used a portion of their dwelling unit "regularly and exclusively" for business purposes. Accordingly, the court held that they were not entitled to home office expense deductions for the tax years at issue.

- *Dreck Spurlock Wilson v. Comm.*, TCS 2017-25), where taxpayer failed to prove dining room was either "portion of home used" or "portion used exclusively".

Can We Deduct an Office-in-home for Managing a Real Estate Rental Reported on Schedule E? (*Patricia Windham v. Comm.*, TCM 2017-68)

If a business - Yes! If an investment - No! Aren't all rentals a good investment? Patricia Windham owned 12 rental properties and was allowed by the court to have a home office where she completed administrative tasks associated with her rental properties. The court allowed Patricia's rental to be treated as a trade or business (home office allowed) and not an investment (home office never allowed). The court also ruled in *John M. Rodriquez v. Comm.* TCM 2009-22 (1) that John conducted a rental real-estate business in his home office, (2) and was allowed a home office deduction on Schedule E.

> **Tax practitioner planning.** Deducting an office-in-home on a Sch. E looks weird, but is permitted – as long as the Sch. E is referred to as a "business," not an "investment." Most importantly, no SE tax is due even when the rentals reported on Sch. E are referred to as a "business."

Home Office Safe Harbor Alternative (Rev. Proc. 2013-13)

The IRS allows an optional safe harbor method for home office users to calculate their deductible home office expenses. The safe harbor method is an alternative to the calculation, allocation, and substantiation of actual expenses currently required under §280A. The safe harbor is elective and the election is made annually by simply using the safe harbor calculation.

Five dollars multiplied times maximum of 300 square feet allowed. Under the safe harbor method, qualifying taxpayers calculate the home office deduction by multiplying the square footage of the portion of the home used for business (300 square feet maximum) times the $5 prescribed rate (IRS may update the prescribed rate periodically). The maximum deduction allowed under the safe harbor method is $1,500 (300 sq. ft. x $5).

> **Tax practitioner planning.** All other home office requirements apply (for example, exclusive use, principal place of business, etc.).

How do we start and stop home office depreciation? Taxpayers who use the safe harbor method for a taxable year and use actual expenses for any subsequent taxable year must calculate the depreciation deduction allowable in subsequent years using the appropriate 39-year life. A taxpayer computes depreciation in a year subsequent to using the safe harbor method by multiplying the remaining adjusted home office depreciable basis by 39 years.

Limited double dipping allowed. Taxpayers who itemize deductions and use the safe harbor method may deduct expenses related to her or his home that were otherwise deductible (for example, mortgage interest,

property taxes, and casualty losses). Additionally, taxpayers who use the safe harbor method are not required to recapture any depreciation upon the sale of the residence.

Home office deduction cannot create a deductible loss under safe harbor or actual method, but excess actual home office deductions may be carried forward. The deduction computed using the safe harbor method cannot exceed the gross income derived from the qualified business use of the home for the taxable year reduced by the business deductions unrelated to the qualified business use of the home. Any amount in excess of this gross income limitation is disallowed and **may not** be carried over to future years unless the actual expense method is used to calculate the deduction. Also, taxpayers who use the safe harbor method may not deduct any carry forward home office deductions from a prior year where the taxpayer used actual expenses. Such deductions are carried forward to the next succeeding taxable year in which the taxpayer deducts actual home office expenses.

Minimizing the impact on property taxes and mortgage interest. The Schedule A tax deduction is limited to $10,000. It also limits the home mortgage interest deduction to a loan of $750,000 (the prior law $1,000,000 debt limit is grandfathered for loans originating before Dec. 15, 2017). If part of the house is used for a qualifying home office, a percentage of property tax and mortgage interest is deductible on the Form 8829. Perhaps, this allocation will help avoid some of the negative impact.

> **Example**. John uses 20% of his home regularly and exclusively as the principal place of business for his consulting business. He gets no benefit for the property taxes he pays because his state income tax exceeds the $10,000 limit. His home acquisition debt is $900,000 (exceeding the $750,000 limit by $150,000). John avoids some of the negative impact to his Schedule A deductions as he is able to claim 20% of his property tax and mortgage interest as a home office expense on his Schedule C.

DEDUCTION - §162: REPAIR VS. IMPROVEMENTS

Deductible Repair or a Depreciable Improvement?

In recent years, much debate has focused on the extent to which taxpayers are required to capitalize as an improvement amounts paid to restore property to its former working condition; that is the extent to which, amounts paid to restore or improve property are depreciable capital expenditures (under §263(a)) or deductible ordinary-and-necessary repair-and-maintenance expenses (§162). There has been controversy, for example, regarding what tests to apply for determining capitalization or expensing, how to apply the tests, and the appropriate "unit of property" with respect to which to apply the tests.

What Kind of Property Is Depreciable?

Generally, depreciable property is:

1. a capital expenditure in depreciable property;
2. used in a trade or business or held for the production of income; and

3. has a definite useful life of more than one year (§167 & §168).

Requirement 1: Capital expenditures in property. Capital expenditures include the acquisition costs of property as well as subsequent improvements that increase the property's value or prolong its useful life.

Requirement 2: Property used in a trade or business or for the production of income. Depreciation is allowed only for property that is used in a trade or business or that is held for the production of income (§167(a)). Therefore, personal property, such as a personal residence or personal automobile, may not be depreciated.

Requirement 3: Useful life of more than one year. The useful life of an asset is the period over which the asset is reasonably expected to be useful in a trade or business or for the production of income. In order to be depreciable, an asset must have a useful life of more than one year. If the life is one year or less, it is to be expensed in the year placed into service (normally the year of acquisition).

TANGIBLE PROPERTY FINAL REGULATIONS

Capitalization of Tangible Assets - Final Regulations (§1.263(a)-1(h); Capitalization of Tangible Property)

Taxpayers may deduct ordinary and necessary expenses incurred in a trade or business activity, including the costs of certain materials, supplies, repairs, and maintenance (§162). However, the costs of acquiring, producing, and improving tangible property, *regardless of the size or the amount the costs incurred*, must be capitalized (§263(a)). Taxpayers must determine whether expenditures related to tangible property are currently deductible business expenses or non-deductible capital expenditures.

Prior to the date the final tangible property regulations were issued, taxpayer decisions were guided by decades of often conflicting case law and administrative rulings on specific factual situations. The final tangible property regulations attempt to combine the case law and other authorities into a framework that helps taxpayers determine whether certain costs are currently deductible or must be capitalized. The final regulations apply to anyone who pays or incurs amounts to acquire, produce, or improve tangible real or personal property, including, but not limited to, corporations, S corporations, partnerships, LLCs, and individuals who file Form 1040 with Schedule C, E, or F. The regulations are most significant for those that regularly incur large capital expenditures (for example, electric utilities, telecommunications companies, and businesses with substantial real estate holdings) and are *mandatory for years beginning on or after Jan. 1, 2014*.

Rules for Determining Whether an Expenditure Is a Deductible Repair or a Capital Improvement

How to treat the acquisition, production, and improvement of all tangible property (for example, when to capitalize amounts paid to sell, acquire, produce, or improve tangible property). This includes general rules for capital expenditures, amounts paid for the acquisition or production of tangible property, and amounts paid for the improvement of tangible property (§1.263(a)-1, -2, & -3). The regulations also provide

significant changes related to the definition of units of property and restorations and allow for industry-specific repair allowance methods to be released by the IRS in the future.

Amounts Paid to Improve Tangible Property (§1.263(a)-3)

Improvements must be capitalized. The final tangible property regulations created a two-step process used to determine whether or not an expenditure must be capitalized as an improvement or must be deductible as a repair.

Step One - Determine the Proper Unit of Property (§1.263(a)-3(e)(1))

For buildings - The unit of property is generally the entire building including its structural components. However, for these purposes only, the improvement analysis applies to the building structure and each of the key building systems. The key building systems are the plumbing system, electrical system, HVAC system, elevator system, escalator system, fire protection and alarm system, gas distribution system, and security system. Lessees of portions of buildings apply the analysis to the portion of the building structure and portion of each building system subject to the lease. Lessors of an entire building apply the improvement rules to the entire building structure and each of the key building systems (§1.263(a)-3(e)(2)).

> **Example - Work performed on building's HVAC system must be capitalized.** Janet must treat her office building and its structural components as a single unit of property. Janet pays for work performed on the roof-mounted HVAC units. The HVAC system is comprised of ten roof-mounted units that service different parts of the building. Even though the roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, the amount Janet paid for work on the roof-mounted units results in an improvement to the building's HVAC system. If the payment results in an improvement to the building structure ***or*** any designated building system, they must be capitalized and depreciated (not deducted as a repair) (§1.263(a)-3(e)(6), Exp. 1).
>
> **Tax practitioner planning.** Although the HVAC must be capitalized in this example, TCJA amended §179 to allow expensing for HVACs on nonresidential buildings.
>
> **Example -Work performed on one elevator is an improvement to the entire building system and must be capitalized.** Larry's retail business building contains two elevator banks, each containing three elevators. All of the elevators, including all their components, comprise a building system. Therefore, if an amount paid for work on the elevators results in an improvement to the entire elevator system, Larry must treat these amounts as an improvement to the building (§1.263(a)-3(e)(6), Exp. 2).

For non-buildings - The unit of property is, and the analysis applies to, all components that are functionally interdependent. Components of property are functionally interdependent if the taxpayer cannot place in service one component of property without placing in service another component of property.

The Court of Appeals concluded in *FedEx Corp. v. US*, (412 F.3d 617 (6th Cir. 2005)) that the aircraft, and not the aircraft engine, was the appropriate unit of property. *Smith v. Comm.*, (300 F.3d 1023 (9th Cir. 2002)), concluded that an aluminum reduction cell, rather than the entire cell line, was the appropriate unit of property; *Ingram Industries, Inc. v. Comm.*, TCM 2000-323, concluded that a towboat, and not the towboat engine, was the appropriate unit of property; in *LaSalle Trucking Co. v. Comm.*, TCM 1963- 274, the court concluded that truck engines, tanks, and cabs were each separate units of property (which is probably wrong in light of the final tangible property regulations).

For plant property, for example, manufacturing plant, generation plant, etc. The unit of property is, and the analysis applies to, each component or group of components within the plant that performs a discrete and major function or operation.

For network assets, for example, railroad track, oil and gas pipelines, etc. The particular facts and circumstances or industry guidance from the US Dept of Treasury and the IRS determines the unit of property and the application of the improvement analysis.

Step Two - Determine if There Is an Improvement to the Unit of Property (§1.263(a)-3(d)(1)-(3))

Businesses must determine if there was an improvement to any "unit of property," or in the case of a building, the building structure or any key building system, identified in Step 1. A unit of tangible property was improved only if the amounts paid were:

1. For a betterment to the unit of property; or
2. To restore the unit of property; or
3. To adapt the unit of property to a new or different use.

#1. Definition of a betterment (a.k.a. an improvement) (§1.263(a)-3(j))

A betterment consists of amounts paid to fix a material condition or material defect that existed before the acquisition or arose during production of the unit of property; or amounts paid for a material addition, including a physical enlargement, expansion, extension, or addition of a major component, to the property or a material increase in capacity, including additional cubic or linear space of the unit of property; or amounts paid that are reasonably expected to materially increase productivity, efficiency, strength, quality, or output of the unit of property where applicable.

Betterment examples from the regs. (§1.263(a)-3(j)).

- Remediation costs to replace underground gasoline storage tanks unknown at time of purchase was a land improvement that must be capitalized (§1.263(a)-3(j)(3), Exp. 1).
- Cleanup of asbestos in an existing building need not be capitalized (§1.263(a)-3(j)(3), Exp. 2).
- Expenditures made to fix a defect existing prior to purchase of a Zamboni, but the defect wasn't material under the facts and circumstances, was deductible (§1.263(a)-3(j)(3), Exp. 4).
- Repairing pre-existing conditions two years after acquisition must be capitalized as an improvement if aware of condition prior to acquisition (§1.263(a)-3(j)(3), Exp. 5).

- Building refreshment and limited improvements by nationwide chain of retail stores was not an improvement (only kept buildings in efficient operating condition) (§1.263(a)-3(j)(3), Exp. 6, 7).
- Relocating and reinstalling manufacturing equipment at another site resulting in increased capacity was an improvement that must be capitalized (§1.2623(a)-3(j)(3), Exp. 10).
- City requirement to earthquake-proof front of hotel by adding expansion bolts creates an improvement that must be capitalized; the new requirement that the hotel meet new safety standards to continue operating was not relevant (§1.263(a)-3(j)(4), Exp. 11).
- Maintenance expenses must be capitalized when incurred simultaneously with a material capacity increase. Harbor had a channel that was originally 20 feet deep but erosion reduced depth to 18 feet. Bringing it back to 20 feet deep need not be capitalized. But, dredging channel to 25 feet is a material upgrade and 100% of the dredging costs must be capitalized; no proration is allowed. (§1.263(a)-3(j)(3), Exp. 15, 16, 17).
- Adding new insulation that reduces annual power costs by 50% was an improvement (§1.263(a)-3(j)(3), Exp. 21).
- Adding a second electrical panel with additional circuits and adding wiring and outlets throughout the building constituted an improvement (§1.263(a)-3(j)(3), Exp. 23).
- Replacing roof membrane was a repair, not an improvement (§1.263(a)-3(j)(3), Exp. 13).

***#2. Amounts to restore a unit of property* (§1.263(a)-3(k)).** A taxpayer must capitalize amounts paid to restore a unit of real or personal property when:

- **Replacing major component or substantial structural part of property:** When the amount resulted in the replacement of a part or a combination of parts that comprised a major component or a substantial structural part of a unit of property (§1.263(a)-3(k)(1));
- **Deducted loss: Replacing component of property adjusted for loss of component**: When the amount was for the replacement of a component of a unit of property and the taxpayer had properly deducted a loss for that component (other than a casualty loss under §1.165-7);
- **Sale or exchange: Replacing component of property adjusted by sale**: When the amount was for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- **Casualty loss: Repairing property adjusted for casualty loss**: When the amount was for the repair of damage to a unit of property for which the taxpayer had properly taken a basis adjustment as a result of a casualty loss under §165, or relating to a casualty event described in §165;
- **Deterioration to state of disrepair: Restoring deteriorated property:** When the amount returned the unit of property to its ordinarily efficient operating condition if the property had deteriorated to a state of disrepair and was no longer functional for its intended use;
- **Rebuilding to like-new condition:** When the amount resulted in the rebuilding of the unit of property to a like-new condition after the end of its class life. Property was rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications.

Examples of "expensing vs. depreciating" from the Regs. (§1.263(a)-3(k)).

- Replacement of major component or substantial structural part of roof must be capitalized (§1.263(a)-3(k)(7), Exp. 14).
- Replacing one of three furnaces in the HVAC system was not an improvement and the cost could be expensed (§1.263(a)-3(k)(7), Exp. 16).
- Replacing the only chiller in an HVAC system was an improvement and must be capitalized (§1.263(a)-3(k)(7), Exp. 17).
- Replacing three of the ten roof-mounted HVAC units was an expense (§1.263(a)-3(k)(7), Exp. 18).
- Replacing the entire sprinkler or electrical system was an improvement, but replacing 30% of the wiring was a repair (§1.263(a)-3(k)(7), Exp. 19, 20 & 21).
- Replacing all the toilets and sinks in retail building was an improvement and must be capitalized, but replacing eight of 20 sinks (40%) was a repair (§1.263(a)-3(k)(7), Exp. 22 & 23).
- Updating a hotel two floors at a time, or all floors over three years, was an improvement (§1.263(a)-3(k)(7), Exp. 24).
- Replacing 100 of 300 exterior windows (33%) was a repair unless the 300 windows comprised a significant portion of the building's exterior. But, replacing 200 of the 300 exterior windows (67%) was an improvement that must be capitalized (§1.263(a)-3(k)(7), Exp. 25, 26 & 27).
- Replacing wood flooring in the hotel lobby was not an improvement, but replacing the floors in all the public areas was an improvement that must be capitalized (§1.263(a)-3(k)(7), Exp. 28 & 29).

***#3. Adapting the unit of property to a new or different use* (§1.263(a)- 3(l)).** An amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the ordinary use of the unit of property at the time the asset was originally placed it in service.

Adapting use examples in the Regs.(§1.263(a)- 3(l))

- Converting a manufacturing building into a showroom created a new or different use (§1.263(a)-3(l)(3), Exp. 1).
- Cleaning up land after closing down manufacturing operations to prepare it for sale was not a new or different use; regrading the land so that it can be used for residential purposes was a new or different use, and the costs would have to capitalized (§1.263(a)-3(l)(3) Exp. 4).
- Converting three retail spaces into one larger space for an existing tenant did not create a new or different use (§1.263(a)-3(l)(3) Exp. 2).
- Repainting the interior walls and refinishing the hardwood floors to prepare the building for sale did not constitute a new or different use (§1.263(a)-3(l)(3) Exp. 3).

$2,500/$5,000 DE MINIMIS EXPENSE SAFE HARBOR ELECTION

De Minimis Expensing Safe Harbor Election (§1.263(a)-1(f))

Taxpayers may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted for financial accounting purposes or in keeping with the taxpayer's books and records. The maximum amount that may be elected is either $5,000 or $2,500, depending on whether or not the taxpayer has an "applicable financial statement." This de minimis safe harbor election eliminates the need for taxpayers to determine whether or not a tangible property small-dollar

expenditure is properly deductible or capitalizable. If the de minimis safe harbor is elected, taxpayers don't have to capitalize the cost of qualifying de minimis acquisitions or improvements.

The invoice rule: transaction and other additional costs. The de minimis safe harbor is determined at the invoice or item level. A taxpayer electing to apply the de minimis safe harbor is not required to include in the cost of the tangible property the additional costs of acquiring or producing such property if these costs are not included in the same invoice as the tangible property. However, the taxpayer must include in the cost of such property all additional costs (for example, delivery fees, installation services, or similar costs) if these additional costs are included on the same invoice with the tangible property. If the invoice includes amounts paid for multiple tangible properties and such invoice includes additional invoice costs related to these multiple properties, then the taxpayer must allocate the additional invoice costs to each property using a reasonable method. Reasonable allocation methods include, but are not limited to, specific identification, a pro rata allocation, or a weighted average method based on the property's relative cost (§1.263(a)-1(f)(3)).

An Election Is Required to Use the De Minimis Safe Harbor (§1.263(a)-1(f)(5))

Election must be timely made, in proper format, and attached to tax return. A taxpayer may annually elect to expense immediately amounts paid for the acquisition or production of a unit of property or of any material or supply. The election is made by including a statement on the taxpayer's timely filed original federal tax return (including extensions) and is irrevocable. The statement must be titled "Section 1.263(a)-1(f) de minimis safe harbor election." If elected, the de minimis safe harbor must be applied to all amounts paid in the taxable year for tangible property that meet the requirements of the de minimis safe harbor, including amounts paid for materials and supplies that meet the requirements. The election may not be made by filing an application for change in accounting method.

If the de minimis safe harbor is used, that does not mean the business must capitalize all expenses that exceed the $2,500 or $5,000 limitations. The safe harbor doesn't require the capitalization of all amounts paid for tangible property in excess of the applicable limitation. If an amount doesn't qualify under the de minimis safe harbor, the business treats the amount under the normal rules that apply (that is, currently deductible if paid for incidental materials and supplies or for repair and maintenance). This treatment is proper regardless of whether the amount exceeds the applicable de mininis safe harbor limitation. The de minimis safe harbor is simply an administrative convenience that generally allows the election to deduct small-dollar expenditures for the acquisition or production of property that otherwise must be capitalized under the general rules.

$2,500 De Minimis Expensing Election Doesn't Require an Applicable Financial Statement (§1.263(a)-1(f)(1)(ii))

$2,500 per invoice for businesses without AFS. Businesses without applicable financial statements may rely on the de minimis safe harbor only if the amount paid for property does not exceed $2,500 per invoice, or per item as substantiated by the invoice as long as:

- ***Accounting policy:*** it establishes at the beginning of the tax year accounting procedures expensing for non-tax purposes de minimis items:

- costing less than a certain dollar amount, or
- items with an economic life of 12 months or less,
- ***Book/tax consistency***: it recognizes the de minimis costs as expenses on its books and records, and
- ***De minimis amount:*** the amount paid for the property does not exceed $2,500 per invoice (or per item as substantiated by the invoice) or other amount as determined by the IRS.

If the cost exceeds $2,500 per invoice (or item), then no portion of the cost of the property will fall within the de minimis safe harbor.

For the $2,500 de minimis safe harbor election, a written accounting policy is not required. However, the expensing amounts on the books and records for the taxable year must be in accordance with a consistent accounting procedure or policy existing at the beginning of the taxable year. It is advisable that the taxpayer writes a capitalization policy as soon as possible.

Optional Sample Language - $2,500 per Invoice Expense Accounting Policy

For taxable years beginning _____, 2019 and later, the general capitalization policy is that all equipment and other fixed assets costing no more than $2,500 per invoice (or per item as substantiated by the invoice) will be treated as an expense for both book and tax purposes. This accounting policy is intended to comply with the IRS de minimis safe-harbor provisions at §1.263(a)(1)(f).

Accounting policy expensing amounts above $2,500 may be used as long as income is being clearly reflected. If the business doesn't have an AFS but does have an accounting policy of deducting the costs of acquiring or improving tangible property ***less*** than a specified dollar amount but that amount exceeds the de minimis safe harbor ceiling of $2,500, the business may deduct these amounts for federal tax purposes, as long as this reporting policy clearly reflects income. For example, a business could have an accounting policy to expense amounts under $4,000, but its expensing amount would not be protected by the safe harbor. Rather, the taxpayer would have to convince the IRS or the court, that the expensed amount was reasonable and that it did not distort reported income.

Tax practitioner planning. In effect, the audit protection provision means that when preparing *any* tax return, the $2,500 de minimis expensing election may be used. Notify your clients so that they can adjust their year-end bookkeeping accordingly.

Tax practitioner planning. For taxpayers *with* an applicable financial statement, the de minimis or small-dollar threshold is $5,000.

Tax practitioner warning. Check county personal property tax rules as most jurisdictions do not have a de minimis provision. Separate records may need to be maintained for the annual personal property tax reports.

Tax practitioner planning. Save time and money by asking property managers to retitle repair and improvement accounts in their monthly and year end reports to owners so that expenditures under $2,500 are clearly differentiated from those over $2,500.

$5,000 De Minimis Election Requires an Applicable Financial Statement (§1.263(a)-1(f)(1)(i))

What is an applicable financial statement? The de minimis safe harbor thresholds and qualifications are different depending on whether or not a taxpayer has an "applicable financial statement." An applicable financial statement is a financial statement that is (1) filed with the SEC (the 10-K or Annual Statement to Shareholders); (2) certified audited by an independent CPA and is used to obtain credit, report to owners, or other non-tax purpose; ***or*** (3) provided to any federal or state agency (other than the IRS) (§1.263(a)-1(f)(4)).

$5,000 per invoice for businesses with AFS. Businesses with applicable financial statements (AFS) may rely on the de minimis safe harbor only if the amount paid for property did not exceed $5,000 per invoice, or per item as substantiated by the invoice, as long as:

1. **Written policy:** it established at the beginning of the tax year **written** accounting expensing procedures for non-tax purposes de minimis items:
   a. costing less than a certain dollar amount, or
   b. items with an economic life of 12 months or less,
2. **Book/tax consistency:** it recognized the de minimis costs as expenses on its AFS, and
3. **De minimis amount:** the amount paid for the property did not exceed $5,000 per invoice (or per item as substantiated by the invoice) or other amount as determined by the IRS.

Sample Language - $5,000 per Invoice Expense Accounting Policy

For taxable years beginning _____, 2019 and later, the general capitalization policy is that all equipment and other fixed assets costing no more than $5,000 per invoice (or per item as substantiated by the invoice) will be treate8d as an expense for both book and tax purposes. This accounting policy is intended to comply with the IRS de minimis safe-harbor provisions at §1.263(a)(1)(f).

SIMPLIFIED ALTERNATIVES TO REPAIR REGULATIONS

Simplifying Alternatives to an Analysis under the Facts and Circumstances Test

For taxpayers that didn't meet requirements the $5,000/$2,500 de minimis expense election requirements, and have expenses that don't meet the definition of materials and supplies, the IRS has provided additional alternatives that would allow a taxpayer to avoid using facts and circumstances analysis to determine if an expenditure must be capitalized or may be expensed immediately:

1. "Eligible building" safe harbor election for small taxpayers (§1.263(a)-3(h)).
2. Safe harbor accounting method for routine maintenance (§1.263(a)-3(i)).
3. Election to capitalize repair and maintenance costs (§1.163(a)-3(n)).
4. Election to capitalize rotable parts (§1.162-3(e)).

"Eligible Building" Safe Harbor Election for Small Taxpayers (§1.263(a)-3(h))

A business is not required to capitalize an improvement, and, therefore, may deduct, the costs of work performed on owned or leased buildings, for example, repairs, maintenance, improvements, or similar costs that fall into the safe harbor election for small taxpayers. The requirements of the safe harbor election for small taxpayers are:

Average annual gross receipts less than $10 million; and

1. Owns or leases building property with an unadjusted basis of less than $1 million; and
2. The total amount paid during the taxable year for repairs, maintenance, improvements, or similar activities performed on such building property doesn't exceed the lesser of:
   a. 2% of the unadjusted basis of the eligible building property; or
   b. $10,000; and
3. An election is made to use the safe harbor for each taxable year in which qualifying amounts are incurred.

The election is made by attaching a statement to the income tax return for the taxable year.

Only taxpayers with average annual gross receipts <$ 10 million for prior three years qualify. The term qualifying taxpayer means a taxpayer whose average annual gross receipts for the three preceding taxable years were less than or equal to $10,000,000. If a taxpayer has been in existence for less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence. In the case of taxable years of less than 12 months, the gross receipts shall be annualized (§1.263(a)-3(h)(3)).

Application with other safe harbor provisions. Amounts paid for repairs, maintenance, improvements, and similar activities performed on eligible building property include those amounts not capitalized under the de minimis safe harbor election (see above) and those amounts deemed not to improve property under the safe harbor for routine maintenance.

Safe harbor exceeded. If total amounts paid by a qualifying taxpayer during the taxable year for repairs, maintenance, improvements, and similar activities performed on an eligible building exceeded the safe harbor limitations, then the safe harbor election is not available for that eligible building, and the taxpayer must apply the general improvement rules to determine whether amounts were for deductible building repairs or depreciable building improvements.

Only buildings with unadjusted bases of <$1 million eligible. The term "eligible building property" refers to each unit of property (leased building or portion of building) that has an unadjusted basis of $1,000,0000 or less. The unadjusted basis of eligible building property leased to the taxpayer is the total amount of (undiscounted) rent paid or expected to be paid by the lessee under the lease for the entire term of the lease, including renewal periods if all the facts and circumstances in existence during the taxable year in which the lease is entered indicate a reasonable expectancy of renewal (§1.263(a)-3(h)(4)).

Example - Safe harbor applied building-by-building. Dave, a qualifying taxpayer, owned two multi-family rental properties, one in California and one in Illinois. In 2019, each property had an unadjusted basis of $300,000. Dave paid $5,000 and $7,000 for improvements in 2019 on the California and Illinois buildings, respectively. The $5,000 Dave paid on the California property did not exceed the lesser of $6,000 (2% of the building's $300,000 unadjusted basis) or $10,000, so he may elect to currently deduct the improvement amounts on his 2019 tax return. However, the $7,000 Dave paid to improve his Illinois property exceeded the $6,000 threshold, so he is not eligible to make the election for the Illinois property. Instead, Dave must analyze the $7,000 he spent on the Illinois property and properly classify the amounts as improvements or repairs (§1.263(a)-3(h)(10), Exp. 3).

Tax practitioner planning. To determine the unadjusted basis of the building, total all of the 27½-year assets (or 39-year assets on a commercial building) on the building's depreciation schedule.

Tax practitioner planning. The $2,500 de minimis election can be used for personal property purchased during the year for a rental or business operation.

Tax practitioner planning. Advise the client to have separate bookkeeping categories for building improvements, personal property purchases, and service costs (pool, janitorial, yard, etc. services.)

Time and manner of election. The election is made annually by attaching a statement to the taxpayer's timely filed original federal tax return (including extensions) for the taxable year in which qualifying amounts are paid. The statement must be titled, "§1.263(a)-3(h) Safe Harbor Election for Small Taxpayers" and include the taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election. The election may not be made through the filing of an application for change in accounting method or, before obtaining the IRS's consent to make a late election, by filing an amended federal tax return. The election is irrevocable.

PARTIAL DISPOSITIONS

Partial Disposition Loss Allowed (§1.168(i)-8; Rev. Proc. 2014-54; FAA 20154601F)

Building owners may write off adjusted cost off a component when it is replaced. Taxpayers who replace a portion of a building or building system may write off the disposed property's remaining original basis at the time the item is replaced. These rules may be used to write off the apportioned net tax basis of any part of a building including siding, windows, roofs, HVAC systems, elevators, etc.

Example. Doug replaces an elevator in a retail building he owns. Doug makes the "partial disposition" election for the elevator. Doug reports the disposition of the old elevator on Form 4797 as a loss in the amount of any remaining basis of the old elevator.

Safe harbor provided to compute the partial disposition loss. Taxpayers may use any reasonable method to compute the amount of the cost basis and accumulated depreciation of the disposed asset and the related loss. The regulations also provide three safe harbor methods that may be used to calculate the loss:

1. ***PPI method.*** Taxpayers discount current year replacement costs back to the year the building was acquired using the Producer Price Index for finished goods or Producer Price Index for final demand to inflation adjust the amount. This method is only available if the replacement isn't an improvement or "adaption" of an asset to a new or different use.
2. ***Replacement cost method.*** Replacement cost of the disposed of asset divided by the replacement cost of the entire asset.
3. ***Cost seg. study or analysis method.*** Taxpayers may prepare a study that allocated the cost of the entire asset to its components (for example, a cost segregation study).

Audit Techniques Guide on Cost Segregation, Updated Feb. 26, 2019

Cost segregation is the process of examining all the physical components of a property, reclassifying them based on their life expectancy and often reclassifying (27.5 or 39-year depreciable life) real property to personal property (5 to 15 year depreciable life) [*AmeriSouth v. Comm.,* TCM 2012-67)]. A cost segregation study often defends the amounts being reclassified.

The Audit Techniques Guide on Cost Segregation has been updated by the IRS. Several chapters were reorganized, expanded, and updated and special topics, including uniform capitalization and change of accounting method, were added.

> **Tax practitioner planning**. If a client is considering a cost segregation study, this ATG is required reading, if not for the client, then, for the client's tax advisors.
>
> **Tax practitioner planning**. A cost segregation study is even more important now that partial disposition losses are allowed. The study helps confirm the adjusted basis of the disposed property.
>
> **Tax practitioner planning.** Preparers should also be alert to review depreciation schedules for assets that are completely depreciated. Removing such depreciated assets via the partial disposition rules eliminates the corresponding depreciation recapture upon sale of the building. The result is a conversion of gains on the sale of the building from unrecaptured depreciation gain (maximum tax rate 25%) to capital gains (maximum tax rate 20%).

Calculating the Partial Disposition Loss

> **Example.** KHS paid $100,000 to replace the plumbing in its commercial building. KHS estimated the cost to rebuild the entire building would be $1,000,000. The net tax basis of building is $656,450. The deductible loss on disposition of the old plumbing is $65,645 (($100,000÷$1,000,000) x $656,450).

Claiming the Partial Disposition Loss on the Tax Return

To claim a partial disposition loss on the current tax return, divide the original building into two smaller sub-assets and then "sell" the component that was replaced.

> **Example**. The KHS depreciation schedule shows the building with an original cost basis of $800,000 and accumulated depreciation of $143,500. Divide the building into two assets and then use your tax software to sell the old plumbing with a zero sales price. This will result in a $65,645 ordinary loss showing on the Form 4797.

	Original Cost	Acc. Depreciation	Remaining Basis
Building (remaining)	$720,000	$129,195	$590,805
Old plumbing	$80,000	$14,355	$65,645
Totals	$800,000	$143,550	$656,450
New plumbing	$100,000	-0-	-0-

Section 469 warning! The passive loss rules apply to this partial disposition loss. Only in a complete disposition is the loss deductible. Otherwise, it is suspended and used in a year when there is passive income or at the complete disposition of the property.

No double dipping allowed. The partial disposition election is only allowed for items that are replaced with improvements that are capitalized. If the taxpayer treated the expenditure as a repair expense on its tax return, the partial disposition rules will not apply.

> **Example.** KaBro spent $50,000 to replace the rubber roof membrane on its commercial building, but did not make any repairs or improvement to the actual roof structure. KaBro deducted the entire $50,000 as a repair expense on its tax return. KaBro cannot not take an additional deduction for the partial disposition of the replaced roof membrane.
>
> **Variation.** Assume the same facts as above except when KaBro removed its existing roof membrane it found that there was damage to the underlying structural components of the roof. KaBro spent $150,000 to not only replace the roof membrane, but also to completely rebuild the underlying roof structure. KaBro capitalized the entire project and elected to utilize the partial disposition rules to expense the old roof structure and roof membrane.
>
> **Variation**. Assume the same facts as above except KaBro expensed the new roof under the expanded §179 rules. Kabro cannot use the partial disposition rules for the old roof.

Timely election required. Taxpayers generally must make a partial disposition election on their timely filed, original tax return (including extensions).

No formal election required. The partial disposition rules are elective, and taxpayers make the election by simply deducting the loss on the return. Taxpayers making the election create a separate line on the depreciation schedule as of the beginning of the year of disposition. The new line includes a pro rata portion of the building's original cost and accumulated depreciation. The new line item is then depreciated normally in the year of acquisition and the remaining basis of the asset disposed of is written off on Form 4797.

Late partial disposition election allowed if IRS auditor capitalizes repairs. The regulations provide some degree of "audit insurance" for taxpayers who deduct too much in repairs expense. If, under audit, the IRS disallows a portion of a taxpayer's repair deductions, the taxpayer may file Form 3115, Change in Accounting Method, and deduct the partial disposition loss as a §481(a) adjustment. While the deduction would not be allowed in the year the IRS audit adjustment was made, it would be allowed in the year for which Form 3115 was filed. This change is an automatic accounting method (may be filed by the extended due of the return.) See Rev. Proc. 2014-54 for additional partial disposition accounting method change guidance.

DEPRECIATION/MACRS §167 & §168

Apportionment of Basis (§1.167(a)-5).

If depreciable property and nondepreciable property such as real property with improvements are bought for a lump sum, the cost must be apportioned between the land and the improvements (§1.167(a)-5)). In making this allocation, §1.167(a)-5 provides "(i)n the case of the acquisition . . . of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time." The relevant inquiry is the respective fair market values of the depreciable and nondepreciable property at the time of acquisition (*Weis v. Comm.*, 94 TC 473 (1990) No. 26336-88; No. 27526-88; No. 27526-88; No. 27527-88; No. 30233-88; No. 30235-88; *Randolph Bldg. Corp. v. Comm.*, 67 TC 804, 807 (1977)).

> **Tax practitioner warning.** If part of the purchase price is allocated to personal property, such as furniture and fixtures, be careful of the new §1031 rules. §1031 no longer allows an exchange of personal property.

Boat and RV Depreciation Expenses Denied; Personal Home Not Converted to Income Producing Property (*Carlos and Pamela Langston v. Comm.*, TCM 2019-19)

Carlos and Pamela Langston owned Port Carlos Marina in Ketchum, Oklahoma and a private residence referred to as the "75th Place" property. The court pointed out that Mr. Langston holds a bachelor's degree in accounting and a Juris Doctorate from the University of Tulsa. Mrs. Langston is a partner in a mid-sized law firm and is the named attorney on at least two tax court cases.

Boat and RV. In 2011 the Langstons bought a Meridian 580 boat for $245,920 and a Raptor RV for $69,092. In 2012 the Langstons deducted depreciation expenses on their Schedule C of $139,996 for the Meridian 580 and $30,7089 for the Raptor RC. In 2013, deductions for the boat and RV were $36,421 and 10,234.

Note. Their tax preparer was not provided documentation of the business use of either vehicle. The court pointed out that the preparer held a bachelor's degree in accounting, a master's degree in taxation, and a juris doctor degree from the University of Tulsa.

75th Place residence. Taxpayers purchased the 75th Place property in 1997 and lived there until 2005 when renovations were undertaken and completed in 2010. In 2011 the taxpayer was notified they would lose their homeowner insurance unless the home was occupied. The house was vacant so Mr. Langston rented it to a fraternity brother at a rent below fair market value. In 2013, the property was sold for $540,000. On their 2013 return they claimed a Form 4797 loss deduction of $436, 633 relating to the sale of 75th Place. The loss was computed by using the original 1997 purchase price plus additions to arrive at a basis of $1,027,415. The acquisition date on the Form 4797 was in 2011, the date it was converted to income producing property and had an estimated fair market value of just below the sale price.
Under audit the boat and RV expenses were disallowed for not being ordinary and necessary for a trade or business. The loss deduction on the sale of the 75th Place property was disallowed because it was their primary residence.

Meridian 580 boat and Raptor RV not used for business. The Langstons argued both the boat and the RV were used as offices for Port Carlos Marina where they were stored. The only evidence provided was the testimony of the Langstons and the marina general manager. In 2014, an IRS revenue agent toured the Meridian 580 and Raptor RV and found no signage identifying the vehicles as an office nor were there any logs to indicate how they were used which is required for listed property. In addition, upon inspection the Agent noted numerous personal items, suitcases, clothing and a pot on the stove that gave the impression neither was used as a sales office. The court agreed with the IRS and disallowed the deduction.

75th Place property not converted from personal to business. The court focused on whether the former personal residence was converted to income-producing property. Taxpayers lived in the property for eight years before moving out. Moving out of personal residence can sometime be evidence of intent to convert. However, in this case, the conversion to business use was not until 7 years after they moved out of the property which is a strong indication there was no intent to convert at that time. The rental of the property at below market value was solely for insurance persons and not a factor that would indicate a profit motive. Based on this, the court agreed the property was not converted to income-producing purposes.

Accuracy related penalties apply. The accuracy-related penalty will not apply where a taxpayer establishes that he or she had reasonable cause and acted in good faith. A taxpayer who relied on the advice of an independent, competent professional as to the tax treatment of an item might escape these penalties. The court repeated that the preparer is a qualified professional and that the Langstons are well-educated, sophisticated individuals. The preparer testified that she relied on oral and implied information from the Langstons without documentation. Langstons have failed to prove they provided accurate and credible information to their preparer and therefore they cannot avail themselves of a good faith and reasonable cause penalty defense. Further, the Court finds that because the Langstons knew they had not provided necessary and accurate information to Ms. Burch, their reliance upon her was unreasonable and not in good faith. Accuracy-related penalties of $60,894 were assessed along with a tax deficiency of $305,297.

§179 EXPENSING

***New!* §179 Amount Increased for Tax Years Beginning after Dec. 31, 2017**

The maximum amount a taxpayer may expense under §179 has been increased to $1,020,000, and the phase-out threshold amount has been increased to $2,550,000, beginning in 2019.

§179 Expensing Options			
Year	2017	2018	**2019**
Maximum §179 deduction	$510,000	$1,000,000	**$1,020,000**
Maximum annual property before phase-out	$2,030,000	$2,500,000	**$2,550,000**

Tax practitioner planning. The maximum annual qualifying property amount did not increase proportionally to the increase in the maximum § 179 deduction.

***New*. Property qualifying for §179 includes personal property in lodging facilities.** The definition of §179 property was expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging including beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let (§1.48-1(h)).

***New*. Non-residential real property qualified.** The definition of qualified real property eligible for §179 expensing has been expanded to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:

- roofs;
- heating,
- ventilation, and air-conditioning property;
- fire protection and alarm systems; and
- security systems.

***New! Qualified* improvement property definition changed**. The separate rules for restaurant improvements, retail property improvements and leasehold improvements are gone. They've been consolidated into a "qualified improvement property" category. Qualified improvement property qualifies for §179 expensing.

***New!* Restaurant property.** Restaurant property placed in service after Dec. 31, 2017 does not meet the definition of "qualified improvement property". Qualified improvement property only includes improvements to the interior of an existing property. Thus, restaurant property does not qualify for bonus depreciation and §179 property. It's recovery period is 39 years.

No double dipping allowed. The repair regs' partial disposition election is only allowed for items that are replaced with improvements that are capitalized. If the taxpayer treated the expenditure as a repair expense on its tax return, the partial disposition rules do not apply.

> **Example #1.** KaBro spent $150,000 to replace the roof on its commercial building. If KaBro capitalizes the new roof, KaBro may elect to utilize the partial disposition rules to expense the old roof.
>
> **Example # 1A**. Assume the same facts as above except KaBro expensed the new roof under the expanded §179 rules. Kabro cannot use the partial disposition rules for the old roof.

§179 elections may be made on amended returns without IRS pre-approval. A taxpayer may make a §179 election with respect to any §179 property without the IRS's consent on an amended federal tax return for the taxable year in which the taxpayer places in service the §179 property. Because the IRS hasn't updated the §1.179-5(c)regulations for this provision, taxpayers may rely on Rev. Proc. 2017-33, Sec. 3 .02.

General rules when using §179. The expensing election is limited to the amount of taxable income from all of the taxpayer's active trades or businesses. Taxable income is computed without the §179 deduction, without any net operating loss carrybacks or carryforwards, and without deducting one-half of self-employment (§1.179-2(c)(1)). The net income, and losses, from all actively conducted businesses of the taxpayer (i.e., all Schedules Cs, Fs and K-1s) are aggregated for purposes of this income limitation (§1.179-2(c)(1)). The "net income definition" includes a partner's share of income from a partnership (or shareholder's share of income from an S corporation) as long as the partner/shareholder is active (§1.179-2(c)(2); -2(c)(6)(ii)). Also aggregated are §1231 gains (or losses) from the sale of business assets and interest income from working capital (§1.179-2(c)(1)). Section 179 deductions that are disallowed because of the income limitation may be carried forward indefinitely, subject to the annual limitations for total §179 expense and for maximum assets purchases (§1.179-3(a)). The taxpayer may choose the properties for which the cost will be carried forward, as well as the portion of each property's cost to be carried forward.

> **Tax practitioner planning.** A taxpayer can include wages and salaries of the taxpayer (and spouse), even if the earned wages are not from the business deducting the §179 property (§1.179-2(c)(6)(iv)).
>
> **Tax practitioner planning.** Vehicles for which a §179 deduction has been claimed must maintain business use greater than 50% or be subject to §179 recapture. Such recapture is reported on Form 4797 in the year that business use drops to 50% or below and the recaptured amount is reported as other income on the schedule where the depreciation was originally taken (such as Sch. C). An amended return is not required (*Michael Birdsill v. Comm.*, TCS 2008-55).

Also see:

- *Tulane Meredith Peterson, pro se v. Comm.,* TCM 2015-1, The IRS successfully disallowed 100% of the depreciation expense, §179 expense, and airplane-related expenses of the attorney's $332,000 Cessna (including those deemed substantiated, 18%) on the grounds that none of these costs were ordinary and necessary expenses.

BONUS DEPRECIATION (§168(k))

General Requirements

To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction. It does not apply to property received as a gift or from a decedent. In the case of trade-ins, like-kind exchanges, or involuntary conversions, bonus depreciation applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property. It does not apply to property acquired in a nontaxable exchange such as a reorganization, to property acquired from a member of the taxpayer's family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in §267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer. It does not apply, for example, if one member of an affiliated group of corporations purchases property from another member, or if an individual who controls a corporation purchases property from that corporation.

***New!* §168(k) Bonus Depreciation Increased to 100% (§168(k); §1.168(k); Rev. Proc. 2017-33)**

***§New! 168*(k) has been extended and modified through 2026 (through 2027 for longer production period property and certain aircraft).** The 50% allowance is increased to 100% for property placed in service after Sep. 27, 2017, and before Jan. 1, 2023 (Jan. 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after Sep. 27, 2017, and before Jan. 1, 2023.

> **Tax practitioner planning**. For a taxpayer's first taxable year ending after Sep. 27, 2017, the taxpayer may elect to apply a 50% allowance instead of the 100% allowance.

§168(k) Bonus Depreciation Chart						
1-1-15 to 9-26-17	**9-27-17 to 12-31-22**	1-1-23 to 12-31-23	1-1-24 to 12-31-24	1-1-25 to 12-31-25	1-1-26 to 12-31-26	After 12-31-26
50%	**100%**	80%	60%	40%	20%	-0-
New property	New or used property					N/A

> **Tax practitioner planning**. The taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year (§168(k)(7)). For the definition of a class of property (§1.168(k)-1(e)(2)). The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS (§168(k)(2)(D)(i)).

New! **New or used property**. The requirement that the original use of qualified property must commence with the taxpayer has been eliminated. Thus, bonus depreciation applies to purchases of used as well as new items.

New! **Film, TV and live theater qualifies.** The definition of qualified property eligible for the additional first year depreciation allowance has been expanded to include qualified film, television and live theatrical productions placed in service after Sep. 27, 2017, and before Jan. 1, 2027, for which a deduction otherwise would have been allowable under §181 without regard to the dollar limitation or termination of such section. A production is considered placed in service at the time of initial release, broadcast, or live staged performance (i.e., at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).

New! **Qualified improvement property category no longer qualifies for bonus depreciation**. Qualified leasehold improvements, retail improvements and restaurant improvements were moved to qualified improvement property. Tax writers intended to give these qualified real property improvements a 15-year recovery period and to make them eligible for bonus depreciation. Because of an apparent drafting error, the statute does not include the 15-year life. Thus, restaurant improvements, retail property improvements and leasehold improvements are depreciated over 39 years.

New! **AMT credits can't be accelerated**. The election to accelerate AMT credits in lieu of bonus depreciation has been repealed.

Section 168(k) Proposed Regs Released (REG-104397-18)

The proposed regulations update existing regulations in §1.168(k)-1 by providing a new section at §1.168(k)-2 for property acquired and placed in service after Sep. 27, 2017. Clarifications include:

Property acquired before Jan. 1, 2018. The proposed regulations provide that qualified property for purposes of the 100% bonus rules includes "qualified leasehold improvement property as defined in §168(e)(6) as in effect on the day before amendment" by the Tax Cuts and Jobs Act, or Jan. 1, 2018. Because the 15-year life was in place before Jan. 1, 2018, qualified restaurant property, qualified retail property improvement property and qualified leasehold improvement property placed in service after Sep. 27, 2017 and before Dec. 31, 2017 are all eligible for 100% bonus depreciation (PR §1.168(k)-2(b)(2)).

QRP, QRIP, or QLIP acquired before 9/28/2017 and placed in service after 9/27/2017	QRP, QRIP, or QLIP acquired after 9/27/2017 and placed in service on or before 12/31/2017	QRP, QRIP, or QLIP acquired after 9/27/2017 and placed in service after 12/31/2017
50% bonus depreciation	100% bonus depreciation	Not eligible for bonus depreciation without technical correction from 39-year to 15-year recovery period

Used property. The proposed regulations provide that the acquisition of used property is eligible for bonus depreciation deduction if such acquisition meets the following requirements (PR §1.168(k)-2(b)(3)):

a) the property was not used by the taxpayer or a predecessor at any time prior to the acquisition;
b) the acquisition of the property meets the related party and carryover basis requirements of §179(d)(2) and §1.179-4(c)(1), or (c)(2); and
c) the acquisition of the property meets the cost requirements of §179(d)(3) and §1.179-4(d).

Series of related transactions. In the case of a "series of related transactions": (1) the property is treated as directly transferred from the original transferor to the ultimate transferee; and (2) the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series. For example, if Jack sells property to an unrelated party, and subsequently the unrelated party sells the property to Jack's daughter, the property does not qualify for bonus depreciation because of the related party rule (PR §1.168(k)-2(b)(3)(iii)(c)).

Leaseback property. A lessee who leases an asset and acquires such asset at the end of the lease term will not be treated as having used the asset prior to its acquisition for purposes of the above rules. The lessee's depreciable interest in the improvements it has made to leased property does not taint the overall bonus eligibility of the leased property (of which those improvements are a part) that is subsequently acquired (PR §1.168(k)-2(b)(3)(iii)(B)).

Syndication transaction. For new or used property, the proposed regulations provide that if (1) a lessor has a depreciable interest in the property and the lessor and any predecessor did not previously have a depreciable interest in the property, (2) the property is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and (3) the user (lessee) of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, then the purchaser of the property in the last sale during the three-month period is considered the taxpayer that acquired the property and the taxpayer that originally placed the property in service, but not earlier than the date of the last sale (PR §1.168(k)-2(b)(3)(v)).

§734(b) adjustment. Because a §734(b) basis adjustment is made to the basis of partnership property (i.e., non-partner specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment, a §734(b) basis adjustment fails the original use clause in §168(k)(2)(A)(ii) and also fails the used property requirement in §168(k)(2)(E)(ii)(I). The proposed regulations therefore provide that §734(b) basis adjustments are not eligible for the additional first year depreciation deduction (PR §1.168(k)-2(b)(3)(iv)(A) and (c)).

§743(b) adjustment. §743(b)(1) provides that, in the case of a transfer of a partnership interest, either by sale or exchange or as a result of the death of a partner, a partnership that has a §754 election in effect, will increase the adjusted basis of partnership property by the excess of the transferee's basis in the transferred partnership interest over the transferee's share of the adjusted basis of partnership's property. Because a § 743(b) basis adjustment is a partner specific basis adjustment to partnership property, the proposed regulations provide that, in determining whether a §743(b) basis adjustment meets the used property acquisition requirements, each partner is treated as having owned and used the partner's proportionate share of partnership property. In the case of a transfer of a partnership interest, §168(k)(2)(E)(ii)(I) will be satisfied

if the partner acquiring the interest, or a predecessor of such partner, has not used the portion of the partnership property to which the §743(b) basis adjustment relates at any time prior to the acquisition (that is, the transferee has not used the transferor's portion of partnership property prior to the acquisition), notwithstanding the fact that the partnership itself has previously used the property (PR §1.168(k)-2(b)(3)(iv)(D)).

- The transferee partner's basis in the transferred partnership interest may not be determined in whole or in part by reference to the transferor's adjusted basis.
- The same result will apply regardless of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another. The transferee's existing interest in the underlying partnership property is distinct from the interest being transferred.

Contributed property. The proposed regulations provide a special rule for qualified property that is placed in service in a taxable year and then contributed to a partnership under §721(a) in the same taxable year. The proposed regulations provide that, in this situation, the additional first year depreciation deduction with respect to the contributed property is allocated under the general rules of §1.168(d)-1(b)(7)(ii) based on the number of months that each held the qualified property in service in 2018 (PR §1.168(k)-2(f)(1)(iii)).

Like kind exchange. With respect to like-kind exchanges and involuntary conversions, the proposed regs provides that the exchanged basis and excess basis, if any, of the replacement property is eligible for the additional first year depreciation deduction if the replacement property is qualified property. The proposed regulations retain this rule if the replacement property also meets the original use requirement. Pursuant to §168(k)(2)(E)(ii)(II) and its cross-reference to §179(d)(3), the proposed regulations also provide that only the excess basis, if any, of the replacement property is eligible for the additional first year depreciation deduction if the replacement property is qualified property and also meets the used property acquisition requirements (PR §1.168(k)-2(f)(5)).

HOBBY LOSSES (ACTIVITIES NOT ENGAGED IN FOR PROFIT) - §183

Hobby Loss Rules (§183: Activities Not Engaged in for Profit (ATG))

Must be engaged in for profit. Taxpayers are generally allowed to deduct expenses that are incurred in a trade or business (§162) or for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income (§212). For expenses to be deductible under §162 or §212, taxpayers must engage in or carry on an activity to which the expenses relate with an ***actual and honest objective of making a profit*** (*Samuel Keanini v. Comm*., USTC No. 46,354, 94 TC 41 (Jan. 30, 1990); *Maurice C, Dreicer v. Comm*., USTC No. 38,948, 78 TC 642 (Apr. 19, 1982)). Taxpayers bear the burden of proving that they are engaged in the activity with an actual and honest objective of realizing a profit and must devote time to the business in the honest belief that the business will sometime in the future become profitable.

If no profit motive, hobby rules restrict deductions (§183(b)). When taxpayers are engaged in an activity with an ***actual and honest objective of making a profit***, expenses incurred in a §162 trade or business or a

§212 activity for the production of income are deductible even if such expenses exceed income from the activity. But, if no profit motive exists, the §183(b) hobby rules allow deductions only to the extent of gross income unless the deductions would have been allowed anyway (for example, mortgage interest and property taxes deductible on Schedule A). Gross income under §183 includes the total of all gains from the sale, exchange, or other disposition of property and all other gross receipts derived from such activity (§1.183-1(e)).

> **Tax practitioner planning.** Activities conducted in S corporations and partnerships are subject to the §183 loss limitations but not activities conducted in C corporations. On the other hand, the §469 passive loss limitation rules apply to all closely-held entities, including C corporations.

IRS factors used to determine profit motive. Whether or not an activity is presumed to be operated for profit requires an analysis of the facts and circumstances of each case. Neither the Code nor the Regulations provide an absolute definition. As a result, deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine nonexclusive factors contained in §1.183-2(b). These factors are as follows:

1. The manner in which the taxpayer carried on the activity.
2. The expertise of the taxpayer or his or her advisers.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the assets used in the activity may appreciate in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.
6. The taxpayer's history of income or loss with respect to the activity.
7. The amount of occasional profits, if any, which are earned.
8. The financial status of the taxpayer.
9. Elements of personal pleasure or recreation.

No single factor controls and the factors do not have equal weight, meaning the mere fact that the majority of factors indicate a profit objective exists (or vice versa) is not conclusive. For example, if five factors say the activity is not for profit, but four are on the profit side, the activity still could be determined to be engaged in for profit. On occasion, other factors may be also be considered.

Existence of Profit Motive Presumed If Activity Profitable for at Least Three of Past Five Years (§183(d))

The "presumption" tests (§183(d)). It is presumed that activities that are profitable for at least three of the past five tax years have the requisite profit objective (two of the last seven years for activities that consist primarily of breeding, showing, training, or racing horses), and the IRS has the burden of proving otherwise.

Taxpayer Must Be Given Sufficient Time to Prove Existence of Profit Motive (§183(e))

Want to stall an IRS audit until year 4? Submit Form 5213 (§183(e)). Section 183(e) allows the taxpayer to postpone the determination of whether the activity is engaged in for profit. The taxpayer must file Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is

Engaged in for Profit, to make this election. Form 5213 allows the taxpayer to postpone the determination of whether the activity has a profit motive until at least the close of the activity's fourth tax year. The form must be filed within three years after the due date, determined without extension, for the activity's first tax return or within 60 days of receiving a notice of IRS examination disallowance on issues pertaining to hobby loss.

Statute of limitations extended. Generally, 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. The extension also applies to partners or shareholders in the activity. The period is extended until two years after the due date for filing the return (determined without extensions) for the last tax year in the presumption period.

> **Tax practitioner planning.** ***Gross receipts*** from a "hobby activity" are reported on 2019 Form 1040, Schedule 1, "Other income" Line 21. ***Expenses*** from the same "hobby activity" are not deductible in 2019. In 2017 expenses from a "hobby activity" were deductible as a miscellaneous itemized deduction subject to the 2% "haircut". Ouch!

Texas Part-time Rancher Wins Big (*Finis Welch and Linda Waite v. Comm*, TCM 2019-229)

Finis Welch was audited on his 2007, 2008, 2009 and 2010 tax returns. The IRS found his ranching operation to be a hobby and came up with almost $5 million of tax deficiencies. Dr. Welch, with a Ph.D. in Economics from the University of Chicago, took his arguments to tax court.

Over the past 25 years, Dr. Welch's Center Ranch grew from 130 acres to 8,700 acres. Dr. Welch's original intent was to grow hay as a cash crop and to raise some cattle on the first 130 acres he had purchased. Center Ranch is now a multi-operational, 8,700-acre ranch with 25 full-time employees who receive annual salaries ranging from $25,000 to $115,000. Gross receipts for each of the years at issue exceeded $1.5 million.

Three B's. The tax court analyzed each of the nine factors in §1.183-1(d) in its decision, but the three "B's" were emphasized.

1. Books and records were maintained;
2. Bank accounts were business only; and
3. Business plan was modified regularly.

Court says only for this case. The court found Dr. Welch was engaged in Center Ranch as a for profit activity during the years at issue. "*In so holding, the Court is not declaring Center Ranch a for-profit activity ad infinitum. If Center Ranch's future losses cannot be reined in, petitioner may again find his profit motives before this Court*."

Yacht Charter Operation Not a For-profit Activity (*Charles and Rhoda Steiner v. Comm.*, TCM 2019-25)

Charles Steiner is a highly successful businessman and a CPA. In 1973 he acquired an electrical supply business. He was the chief executive officer, and the business grew to have nearly 1,000 employees and

several hundred million dollars of revenue. Mr. Steiner acquired other companies including a communications company and a telephone recovery company.

Triumphant Lady. In 2001 the Steiners purchased the Triumphant Lady, a 155-foot motor yacht, for $4,650,000. They used it for diving, and they planned to sail around the world. The Triumphant Lady had a full-time captain and crew. In 2006 the Steiners undertook a $10,839,000 refit of the Triumphant Lady that was completed in 2009. Until 2009 the Steiners used the Triumphant Lady exclusively for personal purposes. This changed in 2009 after John Weller, a yacht broker, approached them about making the Triumphant Lady available for a specific charter. The Steiners retained International Yacht Collection (IYC) as the exclusive agent to charter the Triumphant Lady and secured a charter through Mr. Weller's contact from May 2-10, 2009.

No business plan. The Steiners did not have a formal business plan. There was no evidence that they consulted charter industry experts about the profit potential other than charter brokerage companies that would earn a commission upon charter. Between 2010 and 2012 the Steiners secured only one charter for the Triumphant Lady, a week-long charter for $150,000. The charter activity never produced a profit. The Steiners listed the Triumphant Lady for sale with an asking price of $15.95 million, and it sold in January 2012 for $4,455,000. They did not expect the yacht to appreciate in value.

Charter activity only to offset personal costs. After reviewing the nine factors in §1.183-2(b), the court found that the evidence did not show that the Steiners operated the charter activity with a profit objective within the meaning of §183(c). Rather, it appears that their primary objective was to partially offset the significant fixed costs of maintaining the yacht so that it could be sold after they stopped using it for personal purposes. The Steiners' objective was to offset their significant income with these fixed costs.

A Loser! Real Estate Developer's Horse-Raising Activity Not-for-Profit (*Cecilia M. Hylton v. Comm.*, No. 17-1776 (CA-4 May 7, 2018)

Very successful real estate developer. Cecilia Hylton (Cecilia) is president of the Hylton Group, a successful real estate group founded by her father, Cecil, which owned at least five strip malls, over 1,000 apartment units in northern Virginia, as well as building contractors and other entities involved in real property development. Cecilia's brothers managed the financial side of these companies. Having started at the age of 15, Cecilia normally worked at the Hylton Group's offices 10 hours every Wednesday. Cecilia and her brothers controlled trusts holding the Hylton Group companies. Cecilia also owed Hylton Quarter Horses (HQH), which breeds, trains, shows, and sells quarter horses.

Quarter horse ranch reported gross income of $1.3 million, claimed losses of $17.4 million. From 1998 to 2014 (17 years) Cecilia owned and operated HQH claiming losses of $17,378,825 while reporting gross income of $1,279,326. Over the same period, she received $89,097,917 in non-HQH income.

Ranch not operated in a businesslike manner. Along with 17 years of straight losses, the court found that operating in a non-businesslike manner was illustrated by Cecilia's purchase of two "nicely appointed" motor coaches in 2006 for $1.8 million, one year after she identified an impending economic downturn in the quarter horse industry.

Ranch operated primarily for personal pleasure or recreation. There was no question that Cecilia was a quarter horse enthusiast who enjoyed horse-related activities since she was 12 years old. The court concluded that Cecilia had a passion for quarter horses along with ample financial resources to own and operate a quarter horse activity to further her personal pleasure regardless of the consistent large losses. The court held that Cecilia's ownership and operation of HQH was not engaged in for profit.

A Winner (sort of). Unprofitable Cattle Ranching Was a Business (*Shane and Robin Robison v. Comm.*, TCM 2018-88)

In 1999 Shane and Robin Robison purchased a 410-acre ranch in a remote area of southern Utah. The cost of the Ranch was approximately $2 million. In 2000 and 2009 the Robisons acquired additional acreage near and surrounding the property, increasing the total property to more than 500 acres. In 2000 the Robisons formed Robison Ranch, LLC (Robison Ranch). Shane Robison has a family background in ranching and farming, although neither Mr. nor Mrs. Robison had ever previously operated a ranch.

Ranch is a big loser. From 2000 to 2015 Robison Ranch reported over $9 million in losses on its Federal income tax returns. For the years under audit (2010 through 2014), The Robisons claimed Robison Ranch's loss deductions for the years in issue on their Schedules E in the respective amounts of $657,356, $640,769, $606,633, $493,194, and $420,798.

It's not a hobby. After weighing the relevant factors, the court concluded that the Robisons engaged in their ranching activity for the years under audit with the requisite profit objective. The Robison's activities cannot be characterized as a "hobby" during those years. The Robison's efforts to reduce Robison Ranch's expenses and the resulting decrease in the Robison's net losses during the years under audit were the most persuasive to the court.

Passive activity rules apply. The annual log the Robisons provided for each tax year reported hours assigned to activities years after the fact, in preparation for trial, and based solely on their judgment and experience as to how much time the activities must have taken them. The evidence before the court did not establish that during the years at issue the majority of hours the Robisons spent were hours spent in a capacity other than as investors. After the hours attributable to investor types of activities are subtracted, and in the light of the fact that Robison Ranch employed a full-time ranch manager, the Robisons did not spend the required 500 hours on the Robison Ranch activity, nor were they engaged on a regular, continuous, and substantial basis, as required under §469 and the related regulations.

EXCESS BUSINESS LOSSES (§461)

***New*! Excess Business Losses of a Taxpayer, Other than a C Corporation, Are Not Allowed for Taxable Years Beginning after Dec. 31, 2017 and Before Jan. 1, 2026.**

Excess business losses are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years. An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without

regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for the 2019 taxable year is $255,000 ($510,000 MFJ). The threshold amount is indexed for inflation.

4. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level.
5. The provision applies after the application of the passive loss rules.
6. During the period that excess business losses are disallowed, the limit on excess farm losses of noncorporate taxpayers will not apply (§461(l)(1)(A)).

Example. Larry, a single individual, owns and operates a restaurant. The 2019 gross receipts are $500,000 and the expenses are $900,000, resulting in a $400,000 loss. Larry is limited to a $255,000 loss on his 2019 tax return. The excess is carried over to 2019 and is added to any other NOL that he has for that year. Because of TCJA, any NOL carryover, including the excess loss from 2019, is limited to 80% of his 2020 taxable income.

NET OPERATING LOSS - §172

Net Operating Loss Deduction (§172)

New! **The NOL deduction is limited to 80% (was 100%) of taxable income** (determined without regard to the deduction) for losses arising in taxable years ending after 12/31/2017. Carryovers to other years are adjusted to take into account this limitation and may be carried forward indefinitely.

New! **Farmers have a two-year NOL carryback in the case of certain losses** effective for tax years beginning after Dec. 31, 2017.

Drafting error. The Conference Committee Report says the new law is effective for years *beginning* after Dec. 31, 2017. The statute says *ending* after Dec. 31, 2017. The law as currently written allows calendar year filers to carryback their 2017 net operating losses, but fiscal year filers are prohibited from carrying back their 2017 NOLs.

Example. John incurs a 2017 NOL. He may carryback the NOL to 2015 and 2016. Any remaining NOL may be carried forward for 20 years to 2037. If John incurs the NOL in 2019, he may not carryback the NOL (thus, forgoing any tax refunds that may have provided much needed cash in his losing business). John is only allowed a carryforward of his 2019 NOL and the 2019 NOL can only be used against 80% of his 2020 taxable income.

The carryback period for a "qualified farming loss" is two years. Only the farming loss portion of the NOL can be carried back two years. A farming loss is the smaller of:

7. The amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses were taken into account, or
8. The NOL for the tax year.

Farming business. A farming business is a trade or business involving cultivation of land, raising or harvesting of any agricultural or horticultural commodity, operating a nursery or sod farm, raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. The raising, shearing, feeding, caring for, training, and management of animals is also considered a farming business.

A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by someone else. It also does not include a business which merely buys or sells plants or animals are grown or raised by someone else.

Waiving the farming carryback. The taxpayer can choose to figure the carryback period for a farming loss without regard to the special carryback rule. To make this choice, attach to the income tax return filed by the due date (including extensions) a statement that the taxpayer is choosing to treat any farming losses without regard to the special carryback rule.

> **Tax practitioner planning**. If the return is filed by the original due date, this election can be made on an amended return filed up to six months after the due date of the return (excluding extensions). Attach a statement to the amended return and write "Filed pursuant to §301.9100-2" at the top of the statement. Once made, this choice is irrevocable.

What if New Deductions Are Found in the Carryback Year?

Generally, the portion of an NOL that is carried to another year is the excess, if any, of the amount of the NOL over the sum of the taxable income for each of the prior taxable years to which the loss may be carried (§172(b)(2); FAA 20123905F). For these purposes, "taxable income" means correct taxable income, even if the applicable period of limitations expired on any allowable adjustments (*Springfield St. Ry. Co. v. US*, 312 F.2d 754, 759 (Ct. Cl. 1963) [stating "deductions which were allowable if taken, but are now barred by the statute of limitations, still have to be considered when applying a carryback loss"].

Missed deduction allowed before applying NOL to closed year. In FAA 20123905F, the taxpayer incurred an NOL in 2004 that was carried back to 2003, and then forward to 2005. When the NOL carryback was prepared, the taxpayer determined that a deductible ESOP dividend payment was not deducted on the originally filed 2003 tax return. The statute of limitations, however, had already closed for 2003. The IRS Field Attorney advised that the taxpayer's 2003 income is reduced by the ESOP dividend payment before determining the amount of the NOL that would be used in 2003 and subsequently carried forward to 2005. The result was the NOL deduction in 2005 was increased by the amount of the missed ESOP dividend payment.

Statute Closes Three Years after NOL Is Used, Not Three Years after NOL Is Generated

A taxpayer claiming an NOL deduction for a taxable year must file with the tax return for that year a concise statement setting forth the amount of the NOL deduction claimed and all material and pertinent facts, including a detailed schedule showing the computation of the NOL deduction (§1.172-1(c)). Taxpayers bear the burden of establishing both the actual existence of an NOL and the amount of such NOL that may be

carried to the year(s) at issue and are required to keep such permanent records as are sufficient to substantiate the amount and the purpose of any deductions (§6001; *Higbee v. Comm.*, 116 TC 438; *Hradesky v. Comm.*, 540 F.2d 821 (5th Cir. 1976); §1.6001-1(a)). The courts have applied this rule to NOL carryforwards (*Philip Lehman and Sara Merrick v. Comm.*, TCM 2010-74; *Allan & Judy N. Green v. Comm.*, TCM 2003-244).

Loss Year Tax Returns Not Enough to Verify NOL Carryforward (*Robert De Sylva v. Comm.*, TCM 2018-65)

The only evidence offered by Robert De Sylva to substantiate a $50,000 NOL carryforward loss claimed on his 2012 tax return consisted of unfiled Federal income tax returns for 2009-11 that De Sylva prepared. The mere introduction into evidence of these returns, even if they had been filed, is inadequate to sustain De Sylva's burden of proof with respect to the claimed NOL deduction. See *Moore v. Comm.*, 8 BTA 749, 754 (1927); see also *Lawinger v. Comm.*,, 103 T.C. 428, 438 (1994) ("Tax returns do not establish the truth of the facts stated therein."). Accordingly, De Sylva was not entitled to an NOL carryover in any amount for 2012.

Return Didn't Include "Concise Statement" Setting Forth NOL (*Martha Smith and George Lakner, et al. v. Comm.*, TCM 2018-127)

On line 21 of their 2007-2011 returns, captioned "Other Income," Martha Smith and George Lakner claimed "net operating loss carryovers" in the following amounts: 2007—$85,258, 2008—$99,383, 2009—$162,030, 2010 —$219,855, 2011—$250,773.

Statement required. A taxpayer may generally deduct, as an NOL for a taxable year, an amount equal to the sum of the NOL carryovers and carrybacks to that year §172(a). A taxpayer claiming an NOL deduction must file with his return "a concise statement setting forth the amount of the * * * [NOL] deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the * * * [NOL] deduction." §1.172-1(c). Smith and Lakner bear the burden of establishing both the existence of NOLs for prior years and the NOL amounts that may properly be carried forward to the years at issue. See Rule 142(a); *Keith v. Comm.*, [Dec. 54,169], 115 T.C. 605, 621 (2000).

Tax practitioner planning. Any NOLs generated in 2019 may not be carried back.

No statement attached. The $85,258 NOL deduction Smith and Lakner claimed for 2007 allegedly represented the carryforward of losses Smith and Lakner had incurred in 2004-2006. Smith and Lakner did not attach to their 2007 return the explanatory statement required by the regulations. They offered no evidence that they had sustained bona fide losses during 2004-2006, apart from submitting copies of the tax returns on which they reported those losses. Merely claiming a loss does not substantiate it. See *Coburn v. Comm.*, TCM 2014-113 ("A tax-payer's return is merely a statement of the taxpayer's position and cannot be used to substantiate a deduction."); see also *Gould v. Comm.*, [Dec. 59,263], 139 T.C. 418, 447 (2012), aff'd, 552 F. App'x 250 (4th Cir. 2014).

IRS audit wiped out other NOL carryforwards. The NOL carryforward deductions Smith and Lakner claimed for 2008-2011 resulted from the $85,258 NOL carryforward from 2004-2006 (to which they were

not entitled) and the negative AGI they reported for 2007-2010 (in the aggregate amount of $623,955). As a result of the adjustments requiring inclusion of unreported income and disallowing Smith and Lakner' claimed Schedule C loss deductions, Smith and Lakner will have substantial positive AGI for each year at issue. Because they have no operating losses to carry forward, the IRS properly disallowed all of their claimed NOL deductions.

Theft Deduction Denied, Therefore NOLs Not Deductible (*James N. and Lillian Gaunt v. Comm.*, TCM 2018-78)

James and Lillian Gaunt's 2009 and 2010 amended returns claimed NOL deductions of $113,393 and $18,128, respectively. Although the Gaunts did not attach to their amended returns a statement describing the NOL deductions, they explained in their post-trial brief that the NOL deductions originated from the theft loss they claimed for 2010. Because the Gaunts were not entitled to a theft loss deduction, they were not entitled to a corresponding NOL deduction.

> **Tax practitioner planning**. Keep as much back-up as possible in the client's tax file if there is a large NOL. Warn the client of the record retention requirements with an NOL carryback or NOL carryover. The following listed cases are evidence that the IRS is examining all NOL carryforwards!

Also see.

- *Barry Leonard Bulakites v. Comm., pro se.*, TCM 2017-79, where neither the tax return reporting the original NOL, nor the accounting records supporting the original NOL were submitted to the IRS, or the court, by the taxpayer.

RESEARCH AND EXPERIMENTAL EXPENSES (§174)

Research and Experimental Expenses

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business (§174(a) and (e)). Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months (§174(b)).

> **Tax practitioner planning**. §174 amounts are excluded from the definition of "start-up expenditures" under §195.

***New*. Amounts Defined as Specified Research or Experimental Expenditures Are Required to Be Capitalized and Amortized Ratably over a Five-year Period**, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred, after Dec. 31, 2021.

Including software development. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

But not depreciable or depletable property. Specified research or experimental expenditures do not include expenditures for land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

Must continue to deduct retired, abandoned, or disposed property (but it's not on the balance sheet any more). In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

10-year amortization eliminated. As part of the repeal of the alternative minimum tax, taxpayers may no longer elect to amortize their research or experimental expenditures over a period of 10 years.

File change in accounting method Form 3115 before Jan. 2, 2022. This is a change in the taxpayer's method of accounting for purposes of §481, initiated by the taxpayer, and made with the consent of the Secretary. The change is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after Dec. 31, 2021. Hence there is no adjustment under §481(a) for research or experimental expenditures paid or incurred in taxable years beginning before Jan. 1, 2022.

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. Taxpayers may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business (§174(a) and (e)). Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months (§174(b)). Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years (§174(f)(2) and §59(e)).

> **Tax practitioner planning**. §174 amounts are excluded from the definition of "start-up expenditures" under §195.

START-UP EXPENSES - §195

Deducting Start-Up Expenses

Background. Except as otherwise provided in §195, no deduction is allowed for "start-up expenditures." However, start-up expenditures may, at the election of the taxpayer, be treated as "deferred expenses" beginning in the month the "active trade or business begins" (§195(b)). Under §195(c)(1)(A), a "start-up expenditure" includes any amount paid or incurred in connection with:

1. Investigating the creation or acquisition of an active trade or business;
2. Actually creating an active trade or business; or
3. Any activity engaged in for profit and for the production of income *before* the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

Start-up expenses deductible only after the activity has risen to the level of a trade or business. Finally, the expenses are "start-up expenditures" only if they would be allowable as a deduction for the taxable year in which paid or incurred if they were paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in §195(c)(1)(B)).

> **Tax practitioner planning.** Section 195 is not intended to change the coverage of §248 or §709, which respectively provide for the amortization or deduction of corporate and partnership organizational expenditures.

Business operations with respect to the activity must have actually commenced. Although a taxpayer may be committed to entering into a business and invest considerable time and money in preparing to do so, the activity will not constitute a trade or business for §162(a) purposes until the business is actually functioning and performing the activities for which it was organized. "Until that time, expenses related to that activity are not 'ordinary and necessary' expenses currently deductible under §162 . . . but rather are 'start-up' or 'pre-opening' expenses" (*Thomas J. Woody v. Comm.*, TCM 2009-93).

First-Year Start-Up Expense Deduction Allowed up to $5,000

Fifteen-year amortization for intangibles but $5,000 first year deduction available if cumulative costs do not exceed $50,000. A taxpayer is allowed to elect to deduct up to $5,000 of start-up expenditures in the tax year the trade or business begins. The $5,000 deduction is reduced (but not below zero) dollar for dollar by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000. Start-up expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period consistent with the amortization period for §197 intangibles.

Amortization starts the month that the active conduct of the business begins. This occurs by applying the "going concern" test, that is, when the business begins to function as a going concern and performs those activities for which it was organized. For existing businesses, expenses in connection with the expansion of the business are not considered start-up expenses.

> **Example**. Vern paid his attorney $23,000 to form and write the operating agreement for his new LLC, which began business October 2019. Vern is entitled to expense the first $5,000 of these start-up expenses. The remaining $18,000 of legal fees is amortized over 15 years.

Election to Amortize Organization or Start-up Expenses

Formal written election is not required. The IRS allows a "deemed" election to expense and amortize start up and organizational expenses. Acknowledging that most businesses choose to expense and amortize these kinds of expenses, the IRS no longer requires a formal written election (TD 9411, NPRM REG-164965-04).

The "deemed" election is made by reporting it on a timely filed return. Taxpayers may even choose to forgo the deemed election by clearly electing to capitalize its start-up expenditures on a ***timely filed*** federal income tax return (including extensions). An election either to deduct start-up expenditures or to capitalize start-up expenditures is irrevocable and applies to all start-up expenditures of the taxpayer that are related to the active trade or business.

Boat Business Had Not Yet Commenced (*Robert De Sylva v. Comm.*, TCM 2018-65)

Robert De Sylva has a degree in electrical engineering from UCLA, which he received in the 1990s. Since graduating from UCLA, De Sylva has performed patent application drafting and review services.

In Dec. 2004 De Sylva, without any prior boating experience, purchased a 1974 70-foot Tait boat. De Sylva chose this boat because he believed the structure and size of its deck could be modified to support a landing pad for helicopters (helipad). De Sylva believed that this modification would be unique for a boat this size; and because he had a helicopter pilot's license and also knew owners of helicopter companies, he could both use the boat personally and make money renting it out to companies and high-net-worth individuals. Notwithstanding the proposed modification, at the time of purchase the boat needed a fair number of repairs to bring it up to a condition in which it could be rented.

Was De Sylva in business? On the Schedule C for his boat rental business, De Sylva reported gross receipts of $5,400 and total expenses of $84,217. IRS disallowed the Schedule C loss contending that De Sylva's boat rental activity was not a going concern during 2012; in other words, that De Sylva was not engaged in the active conduct of a trade or business on the basis that De Sylva's boat rental activity had not actually commenced.

Business had not yet commenced. During 2012 De Sylva did not rent out the boat to anyone. Since his purchase of the boat in 2004, the boat has been unusable and never in any condition to be rented. Consequently, De Sylva has never had any contracts or agreements for rental of the boat or marketed the boat as available for charter or rental. Accordingly, even though De Sylva made a decision in 2004 to enter into a boat rental business by purchasing the boat and he has strived over a considerable period to repair it so that it can be rented out, the court held that De Sylva had yet to commence the boat rental activity and be engaged "in carrying on any trade or business" within the meaning of §162(a). See §195(a) and (b)(1) (a taxpayer may not deduct startup expenses for a year that predates the start of an active trade or business).

Engineer, whose full-time W-2 job was building underwater cameras, lights, and sonar units, attempted to build a webcast (on the side) to compete with Angie's List and attempted (again on the side) to develop a device to keep away Stingrays. Yeah, that sounds similar to his prior job! Prior to and during 2013 and 2014, the years at issue, Samuel Carrick was employed by Remote Ocean Systems (ROS), building underwater equipment such as cameras, lights, thrusters, control devices, and integrative sonar. During the years at issue, Sam also began exploring two businesses, Local Bidz, a webcast similar to Angie's List, Yelp, and eBay which would permit people to bid on hiring contractors for products and repairs and Stingray Away, researching and developing a device to prevent surfers and swimmers from being injured by stingrays. At Local Bidz, Sam's time was spent accumulating data and developing software and the website, but he

abandoned the project prior to reaching the operations level. Simultaneously, in 2013 and 2014, Sam continued the research and development of the anti-stingray devices.

Preparatory expenses are deducible *only* after the business commences. The general rule of §162(a) provides that a deduction is allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." "It was clear to (the court) that (Sam) was not "carrying on" a trade or business in 2013 or 2014 when the expenditures for the Local Bidz and Stingray Away activities were made. Carrying on a trade or business requires more than preparatory work such as initial research or solicitation of potential customers; a business must have actually commenced. Expenses paid after a decision has been made to start a business, but before the business commences, are generally not deductible as ordinary and necessary business expenses. These preparatory expenses are capital expenditures." "Neither activity had reached the point of actually commencing. There was neither sales activity nor evidence of the offering of products or services to the public. (Sam) was still in the very early stages of research and development in each of these activities." The court concluded that Sam was not "carrying on" a trade or business in 2013 or 2014.

Also see.

- *Timothy John and Dianne Elizabeth Crissey v. Comm., pro sese*, TCS 2017-44, where a start-up consultant was not allowed to deduct current business expenses. After reporting no income in 2012, and performing only research into the field, the consulting business tapered off and ended before the beginning of 2013.
- *Samuel Joseph Carrick v. Comm., pro se.*, TCS 2017-56, where costs to develop two new businesses were non-deductible start-up expenses and not current deductible business expenses.

PRODUCTION ACTIVITY DEDUCTION (§199)

Repeal of Production Activity Deduction

The deduction for income attributable to domestic production activities has been repealed effective Jan. 1, 2018.

FARM TOPICS

Farm Property (§168 (b))

New! Recovery period for any machinery or equipment. The recovery period for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business has been shortened from 7 to 5 years *if the original use commenced* with the taxpayer and was placed in service after Dec. 31, 2017.

***New!* Required use of 150% DB repealed.** The required use of the 150% declining balance method for property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property) has been repealed effective Jan.

1, 2018. The 150% declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150% declining balance method.

"Farming business." The term farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. That includes operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals) and the processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products (§263A(e)(4)).

> **Tax practitioner planning**. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.

Replanting Citrus Lost by Casualty (§263A)

***New!* Cost of replanting paid after Dec. 22, 2017.** The special rule for costs incurred by persons other than the taxpayer in connection with replanting an edible crop for human consumption following loss or damage due to casualty has been modified with respect to replanting costs paid or incurred after Dec. 22, 2017, but no later than Dec. 22, 2027, applies to citrus plants lost or damaged due to casualty. Such replanting costs may also be deducted by a person other than the taxpayer if:

1. The taxpayer has an equity interest of not less than 50% in the replanted citrus plants at all times during the taxable year in which the replanting costs are paid or incurred and such other person holds any part of the remaining equity interest, or
2. Such other person acquires all of the taxpayer's equity interest in the land on which the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

OTHER BUSINESS CREDITS §38 - 45R

Orphan Drug Credit Reduced (§45C)

***New*! Orphan drug credit reduced to 25%.** The §45C business tax credit is 25% (was 50%) for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs" for tax years beginning after Dec. 31, 2017. Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the FDA but before the drug has been approved for sale by the FDA (§45C(b)). A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug §45C(d)).

Tax practitioner planning. Amounts included in computing the credit under this section are excluded from the computation of the research credit under §41 (§45C(c)).

Rehabilitation Credit (§47)

New! **The 10% credit for pre-1936 buildings has been repealed.** But, the 20% credit for qualified rehabilitation expenditures with respect to a certified historic structure is allowed for a taxable year during the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service. But, the amount is the ratable share equal to 20% of the qualified rehabilitation expenditures for the building paid or incurred after Dec. 31, 2017.

24 month and 60 month transition rule. In the case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building) with respect to any building owned or leased by the taxpayer at all times on and after Jan. 1, 2018, the 24-month period or the 60-month period under the rule for phased rehabilitation (§47(c)(1)(C)(i), (ii)), is to begin not later than the end of the 180-day period beginning on Dec. 22, 2017, and to such expenditures paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends.

Method of Allocation Between R&D and Operational Expenses (§1.41-2)(d)(1); FAA 20171601F)

Follow the regulations. The Chief Counsel Advise determined that the taxpayer's method of allocating in-house research expense was not correct. Taxpayer should have followed the method provided in §1.41-2)d)(1).

For Small Business Startups, Option for Claiming Research Credit against Payroll Tax Liability Instead of Income Tax Liability (IR-2017-93; Notice 2017-23)

Use current research credit against the small businesses *payroll or income* tax liability (you choose!). Eligible small businesses can take advantage of an option enabling them to apply part or all of their research credit against their payroll tax liability, instead of their income tax liability. Notice 2017-23 provided guidance. This option is available to any eligible small business filing its federal tax return.

Tax practitioner planning. This topic is covered *extensively* in the payroll chapter 7.

Election to Accelerate AMT Credit in Lieu of Bonus Depreciation Is Repealed

The election to claim unused AMT credits in lieu of bonus depreciation was repealed by TCJA for tax years beginning after Dec. 31, 2017.

***New*. WOTC Extended Through Dec. 31, 2019 by PATH Act (Work Opportunity Tax Credit §51; WOC Page; Form 8850)**

The PATH Act retroactively allowed eligible employers to claim the Work Opportunity Tax Credit (WOTC) for all targeted group employee categories, including qualified veterans and long-term unemployed

recipients, that were in effect prior to the enactment of the PATH Act, if the individual began or begins work for the employer after Dec. 31, 2014 and before Jan. 1, 2020.

New targeted group - qualified long-term unemployment recipient (hired on or after Jan. 1, 2016). The PATH Act expanded the targeted groups of individuals to include qualified long-term unemployment recipients. A qualified long-term unemployment recipient is any individual who on the day before the individual began work for the employer, or, if earlier, the day the individual completed Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, in a period of unemployment that was (i) not less than 27 weeks and (ii) includes a period (which may be less than 27 weeks) in which the individual received unemployment compensation under state or federal law.

Pre-screening and certification. An employer must obtain certification that an individual is a member of the targeted group, before the employer may claim the credit. An eligible employer must file Form 8850 with their respective state workforce agency within 28 days after the eligible worker began work (see "transitional relief" above). Employers should contact their individual state workforce agency with any specific processing questions for Form 8850.

Limitations on the credits. The credit is limited to the amount of the business income tax liability or social security tax owed. A taxable business may apply the credit against its business income tax liability, and the normal carryback and carryforward rules apply. See the instructions for Form 3800, General Business Credit, for more details. For qualified tax-exempt organizations, the credit is limited to the amount of employer social security tax owed on wages paid to all employees for the period the credit is claimed.

Unemployed veterans.

Claiming the credit. Qualified tax-exempt organizations will claim the credit on Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans, as a credit against the employer's share of Social Security tax. The credit will not affect the employer's Social Security tax liability reported on the organization's employment tax return.

Taxable employers. After the required certification is secured, taxable employers claim the tax credit as a general business credit on Form 3800 against their income tax by filing the following:

- Form 5884 (with instructions)
- Form 3800 (with instructions)
- The business's related income tax return and instructions (i.e., Forms 1040, 1041, 1120, etc.)

Tax-exempt employers. Qualified tax-exempt organizations described in §501(c)and exempt from taxation under §501(a), may claim the credit for qualified veterans who begin work on or after Dec. 31, 2014, and before Jan. 1, 2020. After the required certification (Form 8850) is secured, tax-exempt employers claim the credit against the employer social security tax by separately filing Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans (PDF). File Form 5884-C after filing the related employment tax return for the period that the credit is claimed. The IRS recommends that qualified tax-exempt employers do not reduce their required deposits in anticipation of any credit.

Qualified veteran. A qualified veteran is a veteran certified as any of the following:

- A member of a family receiving assistance under the Supplemental Nutrition Assistance Program (SNAP) (food stamps) for at least three months during the first year of employment.
- Unemployed for a period totaling at least four weeks (whether or not consecutive) but less than six months in the one-year period prior to the date of hire.
- Unemployed for a period or periods totaling at least six months (whether or not consecutive) in the one-year period ending on the date of hire.
- Entitled to compensation for a service-connected disability and hired not more than one year after being discharged or released from active duty in the US Armed Forces.
- Entitled to compensation for a service-connected disability and unemployed for a period totaling at least six months (whether or not consecutive) in the one-year period that ended on the date of hire.

See IRS Notice 2012-13 for more detailed information.

UNDERSTANDING ACA's EMPLOYER MANDATE

Obamacare Replace and Repeal

President Trump and the Republican-controlled Congress promised to repeal and replace Obamacare (the Affordable Care Act, or ACA). Their first tries failed, but certainly changes are on the horizon. For the moment, ACA is the law of the land and employers must continue to obey ACA.

What Would it Mean If the Employer Mandate Is Repealed?

Applicable large employers (ALEs) would no longer have to offer health insurance. Some would withdraw coverage. (State insurance commissioners might have something to say about withdrawing benefits.) This would reduce costs for ALEs — especially important to the 50 to 250 employee-range employer.

Insurance offered would not have to provide minimum essential coverage and, thus, the employer could provide a "skinnier" plan, leaving the employee to pay more in co-pays and deductibles.

Insurance offered would not have to be affordable. This could lead to de facto discrimination as only those with higher income would be able to pay their share of premiums.

Many compliance costs would be reduced. However, the proposed (and failed) ACA replacement legislation still required applicable large employers (ALEs) to continue to issue Forms 1095-C.

Tax practitioner planning. We will keep you informed.

ACA's Employer Mandate Provides Two Incentives for Employers to Provide Insurance Benefits

The ACA provides two incentives for employers to expand health coverage for their employees. The ACA *encourages* qualified businesses with fewer than 25 employees to provide health coverage by providing a tax credit of up to 50% of the health insurance premiums for two years. ACA *imposes* a shared responsibility payment (penalty) on a large employer that fails to offer qualified health coverage to 95% of its full-time employees.

Employer Benefits and Burdens in ACA for 2019			
1-10 employees (FTEs)	**11-24 employees (FTEs)**	**25 to 49 employees (FTEs)**	**50 or more employees (FTEs)**
Business credit is available to subsidize 50% of the cost of the health insurance premiums paid by employers if employee wages average less than $27,100 (2019). Employer must pay 50% or more of insurance to qualify for credit. This credit is available for only two consecutive years. The requirement that insurance must be purchased from SHOP was eliminated for 2018.	A phased out business credit is available to subsidize a portion of the cost of the health insurance premiums paid by the employer if employee (wages average less than $54,200 (2019)). This credit is available for only two consecutive years. The requirement that insurance must be purchased from SHOP was eliminated in 2018.	Employer is not required to offer health insurance to employees, although employees are required to carry minimum essential health coverage.	Employer must offer affordable basic insurance or be subject to a "shared responsibility" penalty. If employee's required contribution for the employer- provided insurance is so expensive for a low wage employee that employee cannot participate, employee may receive credit from the exchange.

HOW ACA IMPACTS HRAs AND SELF-EMPLOYED HEALTH INSURANCE DEDUCTIONS (§35; §105, §106 & §125)

Self-Employed Health Insurance Deduction (§162(l))

Self-employed may deduct health insurance "above-the-line." The deduction for self-employed health insurance includes premium payments for the self-employed taxpayer, the taxpayer's spouse, dependents, and any children who are not 27 by the end of the taxable year. The definition of "insurance premiums" includes Medicare premiums (CCA 201228037; Pub 535). One hundred percent of these health insurance premiums are deductible "above-the-line" (before AGI) with the following limitations:

- Deduction is limited to that business's earned income. The income from two businesses cannot be aggregated for income limits, although each business could pay different specific health insurance plans (CCA 200524001).
- Deduction is limited when taxpayer is ***eligible*** to participate in a subsidized health plan maintained by his or her employer ***or the spouse's employer*** (§162(l)(2)(A) & (B)).

- The deduction isn't available for self-employment tax purposes (§162(l)(4)).
- Self-employed taxpayers who receive a premium assistance credit through the Marketplace may only deduct the net premiums paid (Rev. Proc. 2014-41).

Premium Assistance Credits Reduce the Self-Employed Health Insurance Deduction

A taxpayer is allowed a self-employed health insurance deduction for specified premiums not to exceed an amount equal to the lesser of:

1. The specified premiums less the premium tax credit attributable to the specified premiums; and
2. The sum of the specified premiums not paid through advance credit payments plus any advance credit repayments required under §36B(f)(2)(A) [T.D. 9683, NPRM REG-104579-13; TR §1.162(l)-1T; §1.36B-4T(a)(3)(iii); Rev. Proc. 2014-41].

ACA Eliminated Health Reimbursement Plans (Medical Expense Reimbursement Plans) For Most Small Employers (Notice 2013-54; Notice 2015-87; T.D. 9745)

ACA market reforms terminated many stand alone HRAs. Notice 2013-54 specifically provides that a group health plan may not establish ***any*** annual limit on the dollar amount of benefits for any individual. Because HRAs are considered a group health plan, and therefore subject to the ACA market reforms, and as HRAs without an annual dollar limit are impractical for employers, essentially the ACA market reforms eliminated HRAs as a viable tax-free fringe benefit[3]. As discussed below, beginning in 2017, Congress attempted to "cure" this dilemma with the 21st Century Cures Act.

Congress "Cures" Small Employer Health Insurance Dilemma Beginning in 2017 (21st Century Cures Act)

The 21st Century Cures Act was signed into law on Dec. 13, 2016. The legislation provides for an exception from group health plan requirements for qualified small employer health reimbursement arrangements. Beginning in 2017, a small employer may reimburse employees for individual health insurance premiums without fear of the onerous $100 per day per employee penalty assessed for violation of health care reform.

Plan requirements. To qualify as "a qualified small employer health reimbursement arrangement" the plan must meet certain requirements.

1. The plan must be provided on the same terms to all employees. Some employees may be excluded from the plan:
   - employees who have not completed 90 days of service,
   - employees who have not attained age 25,
   - part time (less than 30 hours a week) or seasonal employees, or

[3] In some cases, HRAs may be integrated with a group health plan.

- employees subject to collective bargaining.

2. The plan must be funded solely by the employer and no salary reduction contributions may be made under the arrangement.
3. The plan must provide, after the employee provides proof of minimum essential coverage, for the payment of, or the reimbursement of, medical expenses (as defined in §213(d)) of an eligible employee or the employee's eligible family members.
4. The plan must provide that payments and reimbursements for any year be no more than $5,150 (2019) for an eligible employee and $10,450 (2019) if the arrangement provides payment or reimbursement for family members.

    - In the case of an individual who is not covered for the entire year, the limitations are prorated. For example, an employee who is covered for nine months of the 2019 plan year, may have payments and reimbursements of no more than $3,862 (9/12 of $5,150).

Small employer. An eligible employer is one that is not an applicable large employer (ALE) under §4980H(c)(2). Thus, the employer may offer a qualified small employer health reimbursement arrangement if it has less than 50 full time and full time equivalent employees. An eligible employer may not offer a group health plan to any of its employees.

Tax-free fringe benefit. A qualified small employer health reimbursement arrangement payment or reimbursement is not excluded from gross income if for the month in which such medical care is provided and the individual did not have minimum essential health coverage.

Premium tax credit. For an employee who is provided a qualified small employer health reimbursement arrangement for any coverage month, the premium tax credit for that month will be reduced.

Other rules.

- The eligible employee must receive proper and timely notice of the plan availability (§9831(d)(4)(A) and Notice 2017-67 for details.)
- The total amount of the permitted benefit must be reported on the employee's Form W-2.
- The transition relief provided in Notice 2015-17 is extended for any plan year beginning on or before Dec. 31, 2016.

Example. Sharon had three full-time employees working in her tax practice. She did not provide a group health plan. With proper notice to her employees, Sharon established a qualified small employer health reimbursement arrangement effective Jan. 1, 2019 to reimburse up to $5,150 (or a lesser amount if she wishes) of §213(d) medical expenses.

Action item. Small business clients should be advised that Congress, in a rare bipartisan effort, granted relief to the small business that wants to help employees with insurance premiums and out of pocket medical expenses without going through the trouble or expense of adopting a group health plan.

Small businesses with HRAs are required to file Form 1095-B. In the instructions covering 1095-B, Health Coverage; and 1095-C, Employer-Provided Health Insurance Offer and Coverage, providers are not required to report coverage that is supplemental to other minimum essential coverage, such as Medicare or TRICARE supplemental coverage or an individual having coverage in more than one plan or program provided by the same plan sponsor (as plan sponsors are only required to report one type of minimum essential coverage). But, coverage is not provided by the same plan sponsor if they are not reported by the same reporting entity. Therefore, an insured group health plan and a self-insured health reimbursement arrangement (HRA) covering the employees of the same employer are not supplemental and both the insurance company and the employer must separately report, even if the employer is not an ALE (as the HRA is considered to be a self-insured plan).

Rules for Employers Not Qualifying Under the 21st Century Cures Act

ALEs, those with 50 or more full-time (and FTE) employees, are not eligible employers for the 21st Century Cures Act relief. But, as discussed below, certain one participant HRAs are exempt from ACA market reform. The following rules apply to these two employers.

ACA says individual policy premiums cannot be reimbursed by the employer. Under IRS Notice 2013-54, employer reimbursements of employee individual health insurance premiums are employer payment plans (EPPs). EPPs are considered group health plans subject to the ACA market reforms. By definition, an EPP that only pays for individual policy premiums has annual limits and, therefore, is not ACA compliant. Employers may not reimburse employees for premiums paid for individual health insurance policies. This prohibition applies whether the insurance is purchased from the Marketplace (with or without a premium assistance credit) or directly from an insurance company.

HRAs (1) for one participant, (2) that provide exempt benefits, or (3) that are for retirees only, are exempt from ACA market reforms (Notice 2015-87, Q&A-1, -5). The market reforms required by ACA do not apply to group health plans that:

1. have fewer than two participants who are current employees on the first day of the plan year;
2. only provide excepted benefits such as accident-only coverage, disability income, certain dental and vision benefits, certain health FSAs, etc.; and
3. group health plans that are limited to retirees only.

The Penalty (Tax) for Noncompliance (§4980D; Q&A#54)

ACA makes old penalty newly relevant. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) included §4980D, a provision that imposed an onerous excise tax on non-compliant employer provided group health plans (for example, restricted employee participation based on the employee's health status, claims experience, genetic information, etc.). When originally enacted, §4980D went largely unnoticed outside the insurance industry. Notice 2013-54 brought to light that employers who offer group health plans that are not ACA compliant are subject to the excise tax imposed by §4980D.

Section 4980D excise tax can be as much as $100 per day per participant (Form 8928; Form 8928 Instructions). Employers who offer non-ACA compliant HRAs, EPPs or any other non-ACA compliant health coverage must complete Form 8928 and pay an excise tax.

1. For employers who knowingly and intentionally offer non-ACA compliant health plans, EPPs or HRAs, the excise tax is $100 per day, per employee ($36,500 per employee per year).
2. For employers who offer non-ACA compliant health plans, EPPs, or HRAs, but the failure to comply (1) was not discovered despite the employer exercising reasonable diligence; or (2) was discovered, corrected, and was due to reasonable cause, no excise tax is due. If the correction was made after the employer was notified of an income tax examination and the failure continued during the examination period, the excise tax is the lesser of $2,500 per employee ($15,000 per employee if the violations are deemed "more than de minimis") or 10% of the amount of benefits paid under the non-ACA compliant plan. The maximum penalty in such circumstances is $500,000.
3. For employers who can establish that (assuming reasonable diligence) they did not know, or would not have known, that the failure occurred, no excise tax is due.
4. For employers who can establish the failure to comply was due to reasonable cause and was corrected during the 30-day period beginning on the first date anyone liable for the tax knew that the failure existed, no excise tax is due.

S Corporation Medical Insurance After ACA (IRS Update)

ACA says that only group health plan benefits may be provided to an employee. No reimbursement or payment of individual premiums is allowed (see Cure Act exception above.) How does the ACA restriction apply to the S corporation owner's insurance rules?

Notice 2015-17 transition relief. Notice 2015-17 provided transition relief for S corporations that sponsor employer payment plans covering 2% shareholders. Until additional guidance provides otherwise, S corporations and shareholders may continue to rely on Notice 2008-1 with regard to the tax treatment of 2% shareholder-employee and their healthcare arrangements for all federal income and employment tax purposes.

Notice 2008-1 provides that health insurance premiums paid on behalf of a greater than 2% S corporation shareholder-employee are deductible by the S corporation and reportable as wages on the shareholder-employee's Form W-2, subject to income tax withholding, but not FICA or Medicare. A 2% shareholder-employee is eligible for the self-employed medical insurance deduction, unless the shareholder or the shareholder's spouse was eligible to participate in any subsidized health care plan.

> **Tax practitioner planning.** To the extent that a 2% shareholder is allowed both the above-the-line deduction and the premium tax credit, Rev. Proc. 2014-41 provides guidance on computing the deduction and the credit.

ACA FOR LARGE EMPLOYERS

The Employer Mandate Applies Only to Large Employers

The employer shared responsibility payment and the employer information reporting for offers of minimum essential coverage apply only to applicable large employers (ALEs). To be an ALE, the business must have had an average of at least 50 full-time employees – including full-time-equivalent employees – during the preceding calendar year. So, for example, the business must use information about the size of its workforce during 2018 to determine if its organization is an ALE for 2019.

What You Need to Know to Help Your Client Comply with the Employer Mandate

In order to fully understand the ACA Employer Mandate, tax professionals must have answers to the following questions:

1. Who is a "large employer"?
2. What is a "full-time" employee?
3. What is a "full-time equivalent" for purposes of determining who is a large employer?
4. Which employees must be offered coverage to avoid penalties?
5. What is "adequate" and "affordable" coverage?
6. How are the penalties for non-compliance calculated?

WHO IS A LARGE EMPLOYER?

Entities with 50+ Full-Time and FTE Employees (T.D. 9655; Treasury Fact Sheet, Final Regs)

Who is an applicable large employer (ALE)? Generally, a qualified employer employing an average of at least 50 full-time (including any seasonal employees) and full-time equivalent (FTE) employees ***for each month*** during the ***preceding calendar year*** is an ALE. ALEs must offer full-time employees minimum essential health coverage or owe an "Employer Shared Responsibility" penalty payment under §4980H.

> **Tax practitioner planning.** A controlled group or affiliated service group must be aggregated into single activity as the §414 business aggregation rules apply.

WHO IS A FULL-TIME EMPLOYEE WHEN DETERMINING LARGE EMPLOYER STATUS?

Employees That Employer Must Count as "Full-Time" Based on Employee's "Hours of Service"

Number of employees determine if: (1) the employer mandate applied to the business; and (2) the employer mandate penalty was owed by the business. An employer's number of full-time employees matters both for purposes of whether the employer mandate ***provisions apply*** to an employer ***and*** whether the employer mandate ***penalty payment is owed*** by an employer (and the amount of that payment) [Preamble VI].

An employer identifies *all* its full-time employees by "hours of service." An employer identifies its full-time employees based on each employee's "hours of service," ***including*** employees who are not compensated on an hourly basis.

> **Tax practitioner planning.** Payments while on paid disability are included in an employee's "hour of service"(Notice 2015-87, Q&A-14).

Measurement methods. Two measurement methods: the "monthly measurement method" and the "look-back measurement method," may be used when determining whether an employee has sufficient hours of service to be a full-time employee. Under the ***"monthly measurement method,"*** an employer determined each employee's status as a full-time employee by counting the employee's hours of service for each month. The other method is the ***"look-back measurement method"*** under which an employer determined the status of an employee as a full-time employee during a future period (referred to as the stability period), based upon the hours of service of the employee in a prior period (referred to as the measurement period) (§54.4980H-3(a); Preamble VII.A; Q&A #15).

Common law standards determine employer and employee status (Independent Contractor (Self-employed) or Employee?). Under common law standards, an employment relationship exists if a worker is subject to the will and control of the entity not only as to what shall be done but how it shall be done. In contrast, an independent contractor is an individual who controls what will be done and how it will be done and the contract dictates the desired result of the work. Behavioral control, financial control, and type of relationship are the three major factors under the common law standards [(Independent Contractor (Self-employed) or Employee; IRS Training Materials [Course 3320-102] titled "Independent Contractor or Employee?"). It is not necessary that the entity actually direct or control the manner in which the services are performed; it is sufficient if the entity has the right to do so (§54.4980H-1(a)(15)).

> **Comment.** The relief under §530 applies solely for purposes of the employment tax provisions of the Code and therefore does not protect employers from potential liabilities under §4980H (Preamble XII).

> **Tax practitioner planning**. Reclassifying employees as independent contractors will not circumvent the ACA requirements. In fact, it is expected that IRS examiners who find misclassified workers will add ACA penalties to payroll tax deficiencies.

Owners not included. A sole proprietor, a partner in a partnership, or a 2% S corporation shareholder is not an employee for §4980H purposes.

Determination and Potential Application of Employer Penalty for Categories of Employees		
Employee category	**How is this category of employee used to determine "large employer"?**	**Once an employer is determined to be a "large employer," could the employer be subject to a penalty if this type of employee received a premium credit?**
Full-time	Counted as one employee, based on a 30-hour or more work week	Yes
Part-time	Prorated (calculated by taking the hours worked by part-time employees in a month divided by 120)	No
Seasonal	Counted, but if this creates ALE status for 120 days or less, then exclude	Not likely under current "safe-harbor" options
Temporary Agency Employees	Generally, counted as an employee of the temporary agency (except for those workers who are independent contractors)	Yes, for those employed by a temporary agency and who are determined to be full-time, on average, for up to 12 months
Franchise Employees	For franchise owners, if they own more than one entity, all employees across the entities must be counted	Yes, for those counted as working for the franchise and who are full-time, on average, for up to 12 months

WHO NEEDS TO BE OFFERED HEALTH COVERAGE?

Only Full-Time Employees Need Be Offered Coverage

Only employees employed on average at least 30 "hours of service" per week (alternatively, 130 hours in a calendar month) need to be offered adequate and affordable health coverage. For this purpose, when determining whether an employee has sufficient hours of service to be a full-time employee, one of two measurement methods must be used: the "monthly measurement method" and the "look-back measurement method."

WHAT IS THE PENALTY FOR NON-COMPLIANCE BY A LARGE EMPLOYER?

ALEs Must Offer Health Coverage to Full-Time Employees or Pay a "Shared Responsibility" Payment (§54.4980H-4; §54.4980H-5; Preamble VIII.A, & IX.A, & XV.D.5; Q&A #18 -#39)

One of Two Penalties May Apply

1. Employer Doesn't *Offer* Health Coverage (§4980H(a))

In 2019, $2,500 per employee non-deductible annual penalty for employers who don't offer health coverage; first 30 employees exempt. If an ALE does not offer at least 95% (increased from 70% in 2015), [or, if greater, five] of its full-time employees (and their dependents) the opportunity to enroll in minimum essential

coverage under an eligible employer-sponsored plan for any calendar month, and the ALE receives a §1411 Certificate from the IRS that at least one full-time employee has received a premium assistance credit, the ALE will owe an assessable excise tax equal to the product of the annual 2019 §4980H(a) penalty of $2,500 per employee payable monthly ($208.33 is the monthly §4980H(a) applicable payment amount) and the number of full-time employees of the ALE in excess of 30 employees [§4980H(a); §54.4980H-4(a); Preamble, (XV)(D)(7)(b)).

For this purpose, full-time employees are reduced by the number of those employees:

1. who are new full-time employees during their first three months of employment,
2. who are new variable hour or new seasonal employees during the months of that employee's initial measurement period and the associated administrative period (see previous discussion of both periods), or
3. who were offered the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that satisfied minimum value and met one or more affordability safe harbors (see §54.4980H-5(e); §54.4980H-5(a)].

2. Employer *Offers Unaffordable or Inadequate Coverage* (§4980H(b))

A $3,750 (2019) per employee non-deductible annual penalty payable monthly if employee receives premium assistance credits from the Marketplace. Even if ALEs offer coverage to full-time employees (thereby avoiding liability under §4980H(a)), ALEs may still be subject to a penalty if the offered coverage fails to provide minimum value or fails to be affordable to an employee, and the employee decline the offered coverage and obtains a premium assistance credit from the Marketplace/Exchange (as evidenced by receipt of a §1411 Certificate). The penalty is equal to the product of the number of full-time employees who received a premium assistance credit for that month multiplied by the §4980H(b) monthly payment of $312.50 ($3,750 ÷ 12 months) in 2019 [Preamble VIII.A; §54.4980H-5(a); Notice 2015-87, Q&A-13; Q&A #54].

"Adequate and affordable" health coverage must be offered. Employer-offered health insurance coverage must be both affordable and adequate to the employee. A plan is considered to provide adequate coverage (also called minimum value) if the plan's actuarial value is at least 60% of the share of the total allowed costs that the plan is expected to cover (such as a "bronze plan"). Coverage is considered affordable if the employee's required contribution to the plan does not exceed 9.86% (2019) of the employee's household income for the taxable year. Because an employer generally will not know an employee's household income, three separate optional safe harbors are available to determine affordability: (1) the Form W-2 wages safe harbor; (2) the rate of pay safe harbor; and (3) the federal poverty line safe harbor.

IRS can't double-dip penalties. The penalty for any calendar month is capped at the number of the employer's full-time employees for the month (less up to 30 employees), multiplied by $208.33 (1/12 of $2,500) or $312.50 (1/12 of $3,750). For a calendar month, an employer may be liable for a penalty under §4980H(a) or under §4980H(b), but may not be liable for an assessable payment under both §4980H(a) and §4980H(b). The cap ensures that the payment for an employer that offers coverage can never exceed the payment that employer would owe if it did not offer coverage (§54.4980H-5(a) & (d)).

PENALTY NOTICES

Employer Notification When Employees Receive Premium Assistance Credits - Understanding your Letter 226-J

Penalty applies if ALE did not provide affordable and adequate insurance coverage to any employee receiving premium assistance credit. The IRS has begun enforcement of the ACA employer mandate. Applicable Large Employers (ALEs) must provide affordable, minimum essential health insurance coverage to their full time employees or be subject to a §4980H penalty. The letter generally applies to the tax year 2016. Tax year 2015 notices went out last year.

> **Tax practitioner planning.** The IRS identified 32,240 ALEs with potential 2015 penalties of $4.37 billion. Because of "limited resources" the IRS has contacted only 6,000 of the potential 32,000 problem businesses. (TIGTA ACA Report 2018-43-022)

Letter 226-J is the initial letter issued to Applicable Large Employers (ALEs) to notify them that they may be liable for an Employer Shared Responsibility Payment (ESRP). The determination of whether an ALE may be liable for an ESRP and the amount of the proposed ESRP in Letter 226-J are based on information from Forms 1094-C and 1095-C filed by the ALE and the individual income tax returns filed by the ALE's employees.

What the employer needs to do:

- Complete the response form (Form 14764) indicating the employer's agreement or disagreement with the letter within 30 days. The IRS will acknowledge receipt of the Form 14764 with Letter 227 (a series of five responses).

  Tax Practitioner planning. If the employer does not respond within 30 days, the IRS will assess the penalties. Send all responses by registered mail.

- If the employer disagrees with the proposed ESRP liability, provide a full explanation of the disagreement and/or indicate changes needed on Form 14765 (Premium Tax Credit Listing). Return all documents as instructed in the letter, again **within 30 days**.
- If the employer agrees with the proposed ESRP liability, follow the instructions to sign the response form and return with full payment in the envelope provided.

Common Reasons That the Recent 2016 Penalty Notice Might Be Incorrect

1. Employer may not be an ALE for the 2016 benefit year. This could be because the employer had fewer than 50 FTE employees or the employees in 2016 that caused the employer's workforce to exceed 50 FTEs were seasonal workers working less than four months during the preceding calendar year (§54.4980H-2(b)(2)).

2. The employer is an ALE when it counts its full-time and FTE employees, but it does not have more than 50 full-time employees in 2016. Because the penalty for not providing health insurance does not apply to the first 50 full-time employees, no penalty results for 2016 (§54.4980H-4(a)).
3. The employer used the "look-back rule" and the employee was a part-time worker in the prior year (§54.4980H-3(d)(1)(i)).
4. The worker was a seasonal worker working less than six months during the year and was properly excluded from the ALE's health insurance coverage (§54.4980H-1(a)(38)).
5. The employee opted out or did not timely enroll in the employer's adequate and affordable health insurance plan (§1.5000A-3(e)(3)(i)(A) & (B)).

OTHER PROVISIONS

Forty Percent Excise Tax Imposed on Insurance Companies Offering High-Cost "Cadillac" Health Coverage (New §4980I) - Effective in 2022 (Continuing Resolution, HR 195, Jan. 22, 2018)

Cadillac tax deferred for two years. The Cadillac tax on excessive employer-sponsored health insurance premiums has been deferred for tax years beginning after Dec. 31, 2021, instead of after Dec. 31, 2019, by the PATH Act.

Single coverage of $10,200/ family coverage of $27,500. A 40% excise tax will be imposed on insurers if the aggregate value of employer-sponsored health insurance coverage for an employee (including, for purposes of the provision, any former employee, surviving spouse and any other primary insured individual), that exceeds the threshold amount of $10,200 for individual coverage and $27,500 for family coverage (to be inflation adjusted), multiplied by the health cost adjustment percentage and increased by the age and gender adjusted excess premium amount.

> **Tax practitioner idea.** There is bipartisan support for repealing this Cadillac tax or at least before the penalty applies or increasing the premium amount.

Medical Device Tax Postponed Until 2020 (Continuing Resolution, HR 195, Jan. 22, 2018)

The 2.3% Medical Device Tax has been suspended for 2018 and 2019.

WHAT HEALTH COVERAGE DOES THE EMPLOYER HAVE TO OFFER?

Minimum Essential Coverage (MEC) [§54.4980H-1(a)(27); Q&A #17 & #18]

MEC is defined as an employer sponsored group health or insurance plan offered to its employees that is a governmental plan, any other plan or coverage offered in the small or large group market, or a grandfathered plan offered in the group market. MEC does not include health insurance coverage of certain excepted benefits if the benefits are provided under a separate policy, certificate, or contract of insurance. Future regulations are expected to provide that an employer-sponsored plan will not fail to be MEC solely because

it is a plan to reimburse employees for medical care for which reimbursement is not provided under a policy of accident and health insurance (a self-insured plan) [see generally §5000A(f)].

Adequate

Adequate coverage (a.k.a. minimum value). A plan is considered to provide adequate coverage if the plan's actuarial value is at least 60% of the share of the total allowed costs that the plan is expected to cover. If the coverage offered by an ALE fails to provide minimum value, an employee may be eligible to receive a premium assistance credit from the Marketplace.

Affordability

"Affordable" health coverage means employee's cost can't exceed 9.86% (2019) of household income. If an employee's share of the premium for employer-provided coverage would cost the employee more than 9.86 in 2019 of that employee's annual household income, coverage is not considered affordable and the employee may qualify for a premium assistance credit from the Marketplace.

Household income and MAGI. Household income means the modified adjusted gross income of the employee and any members of the employee's family (that includes spouse and dependents) who are required to file a federal income tax return. MAGI for this purpose is AGI increased by:

- foreign income excluded from gross income under §911,
- tax-exempt interest a taxpayer receives or accrues during the taxable year, and
- Social Security benefits not included in gross income for the taxable year.

Affordability safe harbors for §4980H(b) purposes. In most cases, employers will not know their employees' household incomes. Employers may choose instead to use an optional affordability safe harbor based on information that is readily available to employers:

1. ***Rate of pay safe harbor*** - cost of coverage doesn't exceed 9.86% of employees lowest rate of pay for the year 201 9;
2. ***Form W-2 safe harbor*** - cost of the coverage to the employee does not exceed 9.86% of the employee's Box 1 wages as reported on Form W-2 for the year 2019; or
3. ***Federal poverty level (FPL) safe harbor*** - cost of coverage does not exceed 9.86% of the 2019 federal poverty level (§54.4980-5(e)(2)).

HOW TO COMPLY WITH THE EMPLOYER MANDATE REPORTING REQUIREMENTS

2019 Filing Requirement Deadlines (ACA Information Center for ALEs; Information Reporting by ALEs).

This chart provides a reminder about the upcoming filing requirements and the 2019 deadlines. This chart applies only for reporting in 2020 for coverage in 2019.

Action	Reporting Due Dates in 2019 for:		
	ALE - Including Those That are Self-Insured	Self-Insured Employers That Are **NOT** ALEs	Furnished to Individuals
File 1095-B; 1094-B	Not Applicable	Paper: Feb. 28 E-file: Mar. 31	Jan. 31
File 1095-C; 1094-C	Paper: Feb. 28 E-file: Mar. 31	Not Applicable	Jan. 31

Information reporting penalties increased to $50/$110/$270/$550 + $50/$110/$270/$550 per each failure to file Form 1095. An ALE member that fails to comply with the information reporting requirements may be subject to the general reporting penalty provisions under §6721 (failure to file correct information returns) and §6722 (failure to furnish correct payee statement). The waiver of penalty and special rules under §6724 and the applicable regulations, including abatement of information return penalties for reasonable cause, may apply to certain failures under §6721 or §6722.

§6721 & §6722 Penalty for Small and Large Businesses			
Time of Filing	Penalty Rate	Tax Year 2018	**Tax Year 2019**
Not more than 30 days late	**Per return**	**$50**	**$50**
	Maximum - Gross Receipts ≤ $5 Million Maximum - Gross Receipts >$5 Million	$191,000 $545,500	$194,500 $556,500
31 days late - Aug. 1	**Per return**	**$100**	**$110**
	Maximum - Gross Receipts ≤ $5 Million Maximum - Gross Receipts >$5 Million	$545,500 $1,637,500	$556,500 $1,669,500
After Aug. 1	**Per return**	**$270**	**$270**
	Maximum - Gross Receipts ≤ $5 Million Maximum - Gross Receipts >$5 Million	$1,091,500 $3,275,500	$1,113,000 $3,339,000
Intentional Disregard*	**Per return (or 5%/10% of aggregate amount)**	**$540**	**$550**
	Maximum	No limit	No Limit

Resources:

- ACA Information Center for Tax Professionals
- ACA Information Center for ALEs
- Information Reporting by ALEs
- Health Care Tax Tip Archive
- T.D. 9745; T.D. 9663; T.D. 9661
- Treasury Fact Sheet on Information Reporting

- REG-132455-11; REG-136630-12
- Section 6055; §6056
- Questions and Answers on Employer Health Care Arrangements.
- Questions and Answers on Employer Shared Responsibility Provisions (§4980H).
- Questions and Answers on Reporting of Offers of Health Insurance Coverage by Employers (§6056), including guidance on who is an ALE member.
- Questions and Answers on Information Reporting by Health Coverage Providers (§6055), for additional reporting requirements applicable to sponsors of self-insured health plans.
- Questions and Answers on Reporting Value of Employer-provided Coverage on Form W-2.
- Questions and Answers about Information Reporting by Employers on Form 1094-C and Form 1095-C, for more information about Forms 1094-C and 1095.

Comment. A more complete discussion of the information that must be reported to the IRS (including simplified methods of reporting) can be found in the final §6055 and §6056 regulations, (T.D. 9660 and T.D. 9661), in the instructions to Form 1094-C and Form 1095-C and the Questions and Answers on Form 1094-C and Form 1095-C.

Publications:

- Publication 5208, Affordable Care Act: Are You an Applicable Large Employer?
- Publication 5200, Affordable Care Act: What Employers Need to Know

SMALL BUSINESS HEALTH CARE TAX CREDIT §45R

Five Facts about the Small Business Health Care Tax Credit (SHOP Marketplace How-to Guides, Fact heets, Tools, and Other Resources)

1. The maximum credit is 50% of premiums paid for small business employers and 35% of premiums paid for small tax-exempt employers.
2. To be eligible for the credit, the employer must pay premiums on behalf of employees enrolled in a qualified health plan offered through a Small Business Health Options Program Marketplace, or qualify for an exception to this requirement.
3. The credit is available to eligible employers for two consecutive taxable years.
4. The employer can carry the credit back or forward to other tax years if the employer does not owe tax during the year.
5. The employer may get both a credit and a deduction for employee premium payments. Since the amount of the health insurance premium payments will be more than the total credit, if the employer is eligible, the employer can still claim a business expense deduction for the premiums in excess of the credit.

Small Employer Health Credit Requirements (§45R; T.D. 9672; NPRM REG-113792-13)

Who is a qualifying employer? Small employers that provide health care coverage to their employees and that meet certain requirements (qualified employers) generally are eligible for a federal income tax credit for health insurance premiums they pay for certain employees. To qualify, employers must:

1. Have fewer than 25 full-time equivalent employees (FTEs) for the tax year;
2. Have average annual wages of its employees below $54,200 per FTE in 2019, per Rev. Proc. 2018-57;
3. Pay the premiums under a "qualifying arrangement"; and
4. Purchase the qualifying health insurance (QHP) through a Small Business Health Options Program (SHOP) Marketplace prior to 2018 (§1.45R-2(a)).

Fifty Percent Credit. The Small Employer Health Care Credit is 50% (35% for tax-exempt organizations) of qualified premiums. The credit is limited to 50% of ***the lesser of***:

1. The total amount of nonelective health insurance premiums the employer contributes for its employees through the Marketplace's SHOP (prior to 2018); or
2. The total amount of nonelective contributions which would have been made for each employee in #1 above at a premium determined by HHS for the small group market in the employer's state or the area within the state (§45R(a), (b) and (g)).

Tax-exempt employer maximum credit is 35%. Qualifying tax-exempt organizations are eligible for a credit of up to 35% of qualified health premiums. The credit amount, however, is limited to the total amount of income and Medicare tax the employer is required to withhold from employees' wages for the year and the employer's share of Medicare tax on employees' wages (§1.45R-3(e)(1)).

Use Form 8941 to calculate the Health Care Tax Credit (Form 8941 Instructions (2016); Form 8941, Credit for Small Employer Health Insurance Premiums). Both small businesses and tax-exempt organizations use Form 8941 to calculate the health insurance premium credit.

The Future of the SHOP: CMS Intends to Allow Small Businesses More Flexibility when Enrolling in Healthcare Coverage

The Small Business Health Options Program (SHOP) Marketplaces were created to make it easier for small employers to provide health coverage to employees. However, insurance company and agent/broker participation, as well as overall enrollment in the federally-facilitated SHOP Marketplaces has been lower than anticipated and, at its current pace, is unlikely to reach expectations. Nationwide (including both federally-facilitated and State-based SHOP Marketplaces), as of Jan. 2017, approximately 27,000 employers have active coverage through SHOP Marketplaces, covering nearly 230,000 individuals. These numbers fall significantly short of the Congressional Budget Office (CBO) estimate that 4 million people nationwide would enroll in coverage through the SHOP Marketplaces by 2017.[4]

[4] http://www.gao.gov/assets/670/666873.pdf

CMS intends to propose rulemaking that would change how small employers and employees in SHOPs using HealthCare.gov enroll in SHOP plans taking effect on or after Jan. 1, 2018. Under the approach CMS intends to propose, instead of enrolling online at HealthCare.gov, employers would enroll directly with an insurance company offering SHOP plans, or with the assistance of an agent or broker registered with the federally-facilitated SHOP. Under the intended approach, employers would still obtain a determination of eligibility by going to HealthCare.gov.

Under the approach CMS intends to propose, it is anticipated that states operating State-based SHOP Marketplaces would be able to provide for online enrollment, or could opt to direct small employers to insurance companies and SHOP-registered agents and brokers to directly enroll in SHOP plans. CMS anticipates that the changes it intends to propose for 2019 will reduce burden on insurance companies, consumers, and American taxpayers, and make SHOP plans more readily available to those small businesses that need affordable health insurance options.

Prior to 2018, QHP must be purchased through SHOP Marketplace (Overview of the SHOP Marketplace; §45R(b)(1)). Only premiums paid on behalf of employees enrolled in a qualified health plan (QHP) offered through a SHOP Marketplace qualify for the credit. The only way to apply for or renew SHOP small business coverage is online. The SHOP Marketplace is open to employers with 50 or fewer full-time equivalent employees (FTEs). This includes non-profit organizations. In all states, employers can offer one health plan to their employees.

Employers may use their current agent or broker to help enroll, find a new agent or broker in the area familiar with SHOP plans, or handle the enrollment themselves. When applying, the employer can search for agents and brokers registered to sell SHOP plans by ZIP code.

No open enrollment period restrictions. The employer can enroll in SHOP any month, any time of year. There's no restricted enrollment period when the employer can start offering a SHOP plan.

Full-Time Equivalent (FTE) Defined

The number of an employer's FTEs is determined by dividing:

1. The total hours for which the employer pays wages to employees during the year (but not more than 2,080 hours for any employee) by
2. 2,080 (§45R(d)(2)(A)).

Employers given three options to calculate annual hours worked (§1.45R-2(d); Notice 2010-44). These methods are chosen on an employee by employee basis and include:

1. Determine actual hours of service from records of hours worked (i.e., time cards).
2. Use a days-worked equivalency whereby the employee is credited with 8 hours of service for each day the employee earned at least one hour of pay.
3 Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week the employee earned at least one hour of pay.

An employer with 25 or more employees can still qualify for the credit if some of its employees are part-time. Because the limitation on the number of employees is based on FTEs, an employer with 25 or more employees could qualify for the credit if some of its employees work part-time.

Some employees of the business are not counted in FTEs (§1.45R-1(a)(5)(iii)). The following individuals are not considered employees for these purposes:

1. ***Seasonal workers,*** unless the seasonal worker works for the employer more than 120 days during the tax year. However, while seasonal workers are excluded from the calculation of FTEs and average annual wages, any health insurance premiums paid on their behalf are included when determining the amount of the credit (Notice 2010-44). Employers may apply a reasonable good faith interpretation of the term seasonal worker (T.D. 9672, Preamble, II).
2. ***A self-employed sole proprietor***.
3. ***A partner in a partnership***.
4. ***A 2% shareholder of an eligible small business which is an S corporation***.
5. ***Any 5% owner of an eligible small business***.
6. ***A family member*** of any of the business owners or partners, or a member of such a business owner's or partner's household described in # 2 through #5 above. For this purpose, a family member is defined as a child (or descendant of a child), a sibling or step-sibling; a parent (or ancestor of a parent), a step-parent, a niece or nephew, an aunt or uncle, or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. "Family member" also includes any other member of the household who qualifies as a dependent under §152(d)(2)(H) (§45R(e)(1)).

Determining average annual wages (§1.45R-2(f)). The amount of average annual wages is determined by first dividing (1) the total wages paid by the employer to employees during the employer's tax year by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000 (if not otherwise a multiple of $1,000). For this purpose, wages means §3121(a) wages as defined for FICA purposes (without regard to the social security wage base limitation). Bonuses are also included to the extent treated as wages for FICA purposes.

Calculating the reduced credit if the number of FTEs exceeds 10 or average annual wages exceed $27,100 in 2019 (Rev. Proc. 2018-57). The health care insurance premium credit is available only to the small employer and phases out as the employer's FTE ***or*** average salary climbs above a ceiling. In other words, two phase-outs apply:

1. First, if the number of FTEs exceeds 10, the amount of the credit is reduced (but not below zero). The reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.
2. Second, if average annual wages exceed $27,100, the credit is also reduced. This amount is adjusted for inflation. The reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed $27,100 and ***the denominator of which is $27,100*** (§45R(d)(3)(B); §1.45R-3(c)(1) & (2)).

BUSINESS CLIENT LETTER

Tax Reform and What it Means for Your Business in 2019

Dear Client:

President Trump promised, when he was on the campaign trail, that he would push for tax reform legislation. On Dec, 22, 2017, he signed The Tax Cuts and Jobs Act into law, the first major tax reform in 31 years. The new tax reform law makes many changes to the tax code. Your business will be impacted. Tax benefits include a reduction in the corporate tax rate, increase in the bonus depreciation allowance, an increase in the §179 expensing amount and the repeal of the corporate alternative minimum tax. Owners of S corporations, partnerships, LLCs, sole proprietorships and farms are allowed a deduction of 20% of qualified business income, subject to a number of limitations. A few highlights follow:

Corporate taxes. Beginning in 2018, the new tax reform law reduces the C corporate tax rate to 21%, from a top rate of 35%. Corporate alternative minimum tax was repealed.

Bonus depreciation. The new tax reform law temporarily increases the 50% bonus depreciation allowance to 100% for qualifying property placed in service after Sep. 27, 2017, and before Jan. 1, 2023. A phaseout of the deduction begins Jan. 1, 2023. The new law also removes the requirement that the original use of qualified property must begin with the taxpayer. For the first time, bonus depreciation will be allowed on the purchase of used property.

Section 179 expensing. The new tax reform law increases the §179 expensing amount to $1.02 million and the investment limitation to $2.55 million. Additional real property, such as a roof on a non residential property, can qualify for a §179 expensing deduction.

Pass-through businesses. The new tax reform law allows noncorporate taxpayers to deduct up to 20% of domestic qualified business income from an S corporation, partnership, LLC, sole proprietorship or farm. In some situations, net rental income can qualify for some or all of the 20% deduction. Limitations apply based on wages paid or if the qualified business income is from a specified service business (like law, accounting, medical, etc.) Neither limitation applies if the taxpayer's taxable income on his or her Form 1040 is less than $160,750 for a single person ($321,400 for a married filing joint couple.)

Listed property. The new tax reform law increases the depreciation for passenger automobiles placed in service after Dec. 31, 2017. For 2018, the maximum amount of allowable depreciation was $10,000 for the year in which the vehicle is placed in service; $16,000 for the second year; $9,600 for the third year; and $5,760 for the fourth and later years. 2019 depreciation numbers come out in the fall. The new law removes computers and peripheral equipment from the definition of listed property. Therefore, laptop computers, for example, are not subject to the strict substantiation requirements that apply to other listed property.

Tax deferred exchanges. The tax deferred exchange rules in §1031 will only apply to real property. Personal property, such as autos, machines, tractors, equipment, etc. may no longer qualify under the tax deferred exchange rules.

Deductions and credits. The entertainment deduction has been repealed. The cost of tickets to concerts, football games or the ballet are no longer deductible. The §199 domestic production activities deduction is eliminated. The new tax reform law retains the research and development credit, but will require five-year amortization of research and development expenditures. The new tax reform law creates a temporary credit for employers paying employees who are on family and medical leave.

Interest deductions. For businesses with gross receipts in excess of $26 million, the new tax reform law caps the deduction for net interest expenses at 30% of adjusted taxable income.

Stock options. The new tax reform law allows qualified employees of private companies to defer tax on the exercise of options for up to five years. CEOs, CFOs, highly compensated employees and 1% owners are not eligible for the deferral.

Net operating losses. The new tax reform law limits the net operating loss deduction to 80% percent of taxable income for losses arising in tax years beginning after Dec. 31, 2017. The carryback for NOLs is eliminated, except for qualifying farm losses. NOL loss carryforwards will be indefinite, subject to the percentage limitation.

These are just a few of the changes included in the new tax reform law. Your 2019 business taxes will be affected. That's guaranteed by the scope of the changes.

We can answer your questions:

- Are my withholding and estimated tax payments correct for 2019?
- Will I qualify for the new 20% business income deduction?
- How can I maximize the new 20% business income deductions?
- Is this the year to buy additional equipment or a new vehicle for my business?

Please call our office and we can look at your particular business and its tax planning needs.

Sincerely,

2019 FEDERAL TAX UPDATE
PREPARING BUSINESS RETURNS

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