Choosing the Right Entity

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Choosing the Right Entity

By
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Learning Objectives

After reading Chapter 1, participants will be able to:

1. Determine the advantages and disadvantages associated with sole proprietorships, and specify the formation requirements.
2. Identify not-for-profit activities particularly as they relate to Schedule C businesses and recall the various requirements permitting such businesses to complete the C-EZ form or request an automatic filing extension.
3. Recognize the taxes imposed on self-employed persons noting compliance with payment requirements, determine how sole proprietorship assets are characterized on disposition and, identify income splitting and estate planning devices available for such business owners and their impact on entity choice.
Sole Proprietorship

Introduction

Sole proprietorships are the simplest business form since they are not separate tax or legal entities but rather, extensions of the individual taxpayer that owns them. A taxpayer is a sole proprietor if they are self-employed and are the sole owner of an unincorporated business. The business has no existence apart from the owner. Its liabilities are the owner’s personal liabilities.

There is no special return to file for the sole proprietorship. The owner reports all transactions of the business on their own individual income tax return (i.e., Schedule C, Form 1040).

Advantages

The advantages of a sole proprietorship are:

(1) All business tax advantages flow to the owner,
(2) Organizational costs should be low;
(3) Legal, accounting, and administrative fees can be lower;
(4) State and federal income taxes may be lower;
(5) Administration is less complicated, and
(6) Easily converted to another entity.
Advantages of a Sole Proprietorship

- All business tax advantages flow to owner
- Organizational Costs Are Low
- Legal & Accounting Fees Can Be Lower
- State & Federal Taxes May be Lower
- Administration is Less Complicated
- Easily converted to another entity
Disadvantages

The disadvantages of a sole proprietorship are:

(1) Personal liability,
(2) Inability to income split,
(3) Limited fringe benefits, and
(4) Self-employment tax.

Formation

Sole proprietorships are the easiest business to form and operate. If a person does business under any name other than their own true name, most states require the filing of a fictitious business name statement (which is also known as a “Doing Business As” statement or just DBA statement). The forms are available at the county recorder’s office as well as through some newspapers. The statement must be published in a newspaper of general circulation in the county in which the business is located.

Note: The fictitious business name statement is generally not required if a person intends to do business under their own name (i.e. Joe Smith and Associates).

Start-Up Expenses

Under §195, start-up expenses (after an initial $5,000 deduction) of a sole proprietor may, at the taxpayer’s election, be amortized over a period of not less than fifteen years. Such expenses include those paid or incurred in connection with investigating the creation or acquisition of an active trade or business, which would be allowable as a deduction in the year paid or incurred if they were paid or incurred in connection with the expansion of an existing trade or business. If the election is not made, such expenses will not be deductible since they are not incurred in carrying on trade or business under §162(a).
Withdrawals

There is no tax effect if a sole proprietor takes money out of their business, or transfers money to or from their business. However, it is a good idea to set up a drawing account. This will help identify amounts that are not for business expenses but that are for personal use.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

1. The least complicated business entity is a sole proprietorship. This entity type is merely an extension of:
   a. joint-venture operators.
   b. the individual owner.
   c. unincorporated associations.
   d. syndications.

2. Despite their simplicity, sole proprietorships have several attractive advantages. Why would someone want to choose a sole proprietorship over other entities?
   a. low organizational costs.
   b. limited liability.
c. the income-splitting opportunities.
d. state and federal income taxes are higher.

3. The author lists four disadvantages of sole proprietorships. What is one of these disadvantages?
   a. Legal fees are high.
   b. The accrual method of accounting must be used.
   c. The fringe benefits are limited.
   d. They are subject to double taxation.

4. A sole proprietorship may incur start-up expenses during its formation. Section 195 provides that a sole proprietor may elect to have such start-up expenses be:
   a. amortized over a five-year period.
   b. currently deducted.
   c. amortized over a 15-year period.
   d. entitled to a tax credit.

5. Expenses that a sole proprietor pays in relation to examining the establishment or purchase of an active trade or business are considered start-up expenses. How are such expenses treated?
   a. They may be deducted if paid in association with an existing business.
   b. They are capitalized in the existing trade or business.
   c. They are treated as intangibles under §197.
   d. They are disallowed as passive losses under §469.
Schedule C

For a sole proprietorship, the business itself does not pay any income taxes. The sole proprietor includes the profits or losses of the business on their income tax return. A sole proprietor reports their income and expenses from their business or profession on Schedule C or Schedule C-EZ (Form 1040). Schedule C is filed with the Form 1040. If a taxpayer operates more than one business as a sole proprietor, they must prepare a separate Schedule C for each business and attach each of them to their tax return. If a separate Schedule C for each business is not prepared there may be a penalty for not properly reporting income and deductions. No special deductions are allowed for the sole proprietor. The ordinary and necessary test of §162 applies with respect to a sole proprietor’s business deductions. Generally, a sole proprietor can offset his other income with losses from his business operation. However, the IRS may restrict such deductions if it determines that the activity is not one engaged in for profit. In such a situation, the §183 “hobby-loss” rules come into play.

Not-For-Profit Activities

If a business activity is not carried on to make a profit, the deductions are limited, and no net loss is allowed to offset other income. Activities done as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors.

Note: The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.
In determining whether an activity is carried on for profit, all the facts in regard to the activity are taken into account. No one factor alone is decisive. Among the factors to be considered are whether:

(1) The activity is conducted in a businesslike manner,
(2) The time and effort put into the activity indicates an intention to make it profitable,
(3) The taxpayer depends on income from the activity for their livelihood,
(4) Losses from the activity are due to circumstances beyond the taxpayer’s control (or are normal in the start-up phase of that type of business),
(5) The taxpayer changes their methods of operation to improve the profitability of the activity,
(6) The taxpayer has the knowledge needed to carry on the activity as a successful business,
(7) The taxpayer was successful in making a profit in similar activities in the past,
(8) The activity makes a profit in some years, and how much profit it makes, and
(9) The taxpayer can expect to make a future profit from the appreciation of the assets used in the activity.

**Deduction & Loss Limit**

If the activity is *not* carried on for profit, deductions can *only* be taken in the following order, to the extent stated in the *three* categories, and only if itemized on Schedule A (Form 1040).

**Category 1**

Deductions that can be taken for personal as well as for business activities are allowed in *full*. All nonbusiness deductions, such as those for mortgage interest, taxes, and casualty losses belong in this category.

**Category 2**

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

**Category 3**

Business deductions that *decrease* the basis of property are allowed last, but only to the extent the gross income from the activity is *more* than deductions taken for it under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss not deductible in category (1) belong in this category.
Note: Amounts in categories (2) and (3) claimed as miscellaneous deductions on Schedule A (Form 1040) are subject to the 2% of adjusted gross income limit.

Profit Presumption - 3/5

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

Note: There is a profit when the gross income from an activity is more than the deductions for it. In addition, if a taxpayer dies before the end of the 5-year (or 7-year) period, the period ends on the date of the taxpayer's death.

If a business or investment activity passes this 3- (or 2-) years-of-profit test, it is presumed carried on for profit and all business deductions from the activity can be taken, even for the years that have a loss.

If a taxpayer is starting a business and does not have 3 years (or 2 years) showing a profit, they may want to take advantage of this presumption at a later time, after they have the 5 (or 7) years of experience allowed by the test.

Taxpayers can choose to do this by filing Form 5213. Filing this form postpones any determination the activity is not carried on for profit until 5 (or 7) years have passed since the activity started. Form 5213 must generally be filed within 3 years of the due date of the taxpayer’s return for the year in which the activity was started.

The benefit gained by making this choice is that the IRS will not immediately question whether the activity is engaged in for profit. Accordingly, it will not restrict deductions. Rather, the taxpayer will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years the activity is carried on. If the taxpayer shows 3 (or 2) years of profit at the end of this period, deductions are not limited under these rules. However, if the taxpayer does not have 3 years (or 2 years) of profit, the limit can be applied retroactively to any year in the 5-year (or 7-year) period with a loss.
Election To Postpone Determination
as To Whether the Presumption Applies That an
Activity Is Engaged in for Profit

To be filed by individuals, estates, trusts, partnerships, and S corporations.

Name(s) as shown on tax return

Address (number and street, apt. no., rural route) or P.O. box number if mail is not delivered to street address)

City, town or post office, state, and ZIP code

The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of:

- The 6th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses; or
- The 4th tax year for any other activity,

after the tax year in which the taxpayer first engaged in the activity.

1 Type of taxpayer engaged in the activity (check the box that applies):

☐ Individual  ☐ Partnership  ☐ S corporation  ☐ Estate or trust

2a Description of activity for which you elect to postpone a determination

2b First tax year you engaged in activity described in 2a

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules, and to the best of my knowledge and belief, it is true, correct, and complete.

__________________________________________________________________________

[Signature of taxpayer or fiduciary] (Date)

__________________________________________________________________________

[Signature of taxpayer’s spouse, if joint return was filed] (Date)

__________________________________________________________________________

[Signature of general partner authorized to sign partnership return] (Date)

__________________________________________________________________________

[Signature and title of officer, if an S corporation] (Date)

For Paperwork Reduction Act Notice, see instructions on back.

Cat. No. 42361U

Form 5213 (Rev. 8-97)
Note: Filing Form 5213 automatically extends the statute of limitations on any year in the 5-year (or 7-year) period to 2 years after the due date of the return for the last year of the period. The statute is extended only for deductions of the activity and any related deductions that might be affected.

Schedule C-EZ

A taxpayer can use Schedule C-EZ, Net Profit From Business, in place of the Schedule C, if the taxpayer operated the business as a sole proprietor and the business met each of the following requirements:

1. Business had expenses of $5,000 or less;
2. Business used the cash method of accounting;
3. Business did not have a net loss;
4. Taxpayer had only one business as a sole proprietor;
5. Taxpayer had no employees for the year;
6. Taxpayer is not required to file Form 4562, Depreciation and Amortization on the business or practice;
7. Taxpayer does not deduct expenses for business use of the taxpayer’s home, and
8. Taxpayer does not have prior year unallowed passive activity losses from this business.

Individual Rates

If the business form selected is a sole proprietorship, individual income tax rates will apply.

2016 Tax Rates

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Taxable Income Rate</th>
<th>Taxable Income Rate</th>
</tr>
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<tr>
<td>Single</td>
<td>$1 to $9,275</td>
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<td></td>
<td>$9,275 to $37,650</td>
<td>15%</td>
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<td>$37,650 to $91,150</td>
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<td>$91,150 to $190,150</td>
<td>28%</td>
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<td></td>
<td>$190,150 to $413,350</td>
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<td>Rate</td>
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<tr>
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<tr>
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<tr>
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<td>Over $466,950</td>
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<tr>
<td>Married, Separate</td>
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<td>$1 to $9,275</td>
<td>10%</td>
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<td>$9,275 to $37,650</td>
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<tr>
<td>Over $233,475</td>
<td>39.6%</td>
<td></td>
</tr>
</tbody>
</table>

**Due Date - Form 1040**

Form 1040 is due by April 15. If a fiscal year is used, the return is due by the 15th day of the 4th month after the close of the fiscal year.

**Extension to File - Form 4868**

If a taxpayer cannot file their return on time, the Form 4868 may be used to request an automatic 4-month extension.

The Form 4868 may **not** be used if:

1. The taxpayer wants the IRS to figure their tax, or
2. The taxpayer is under a court order to file their return by the regular due date.

The Form 4868 must be filed by the date the Form 1040 would be due. When the Form 4868 is filed, the taxpayer must estimate **and** pay any tax they will owe.
Business Entity Impact

While top individual rates (39.6% in 2016) have increased relative to top corporate rates (35%), on income of less than $75,000, individual rates can also be higher. This rate difference has an impact on a taxpayer’s choice of business entity. Thus, taxpayers using a sole proprietorship, limited liability company, partnership or S corporation as a business entity may reconsider using a C corporation, particularly, if profits will be reinvested in the business. Obviously, the issue of double taxation occurs when dividends are paid by a C corporation or when the entity is liquidated, or its appreciated assets are otherwise sold off, and may offset the differential between corporate and individual tax rates. Nevertheless, there are many competing factors that have to be considered before a taxpayer can clearly choose one type of entity over another (e.g., availability of fringe benefits, ability to borrow from one’s pension plan, etc.).

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.
6. Schedule C or Schedule C-EZ (Form 1040) must be used to report a sole proprietor’s business income and expenses. What must a sole proprietor prepare if he or she runs multiple sole proprietorships?
   a. a partnership return.
   b. a Schedule C for every business.
   c. a limited liability company return.
   d. an affiliated group return.

7. For-profit and not-for-profit businesses are treated differently. If the IRS deems a business activity is a not-for-profit, how are deductions treated?
   a. They are fully allowed.
   b. Losses may not be netted within the business.
   c. They are suspended under §469.
   d. They are limited and other income may not be offset by any net loss.

8. The IRS considers all of the facts when deciding whether an activity is carried on for profit. However, which of the following factors is ignored?
   a. whether the taxpayer operates the activity in a businesslike manner.
   b. whether the taxpayer has formerly made a profit in similar activities.
   c. whether the taxpayer materially participates in the business activity.
   d. whether the taxpayer understands what is needed to successfully operate the activity.

9. In general, the IRS deduces that an activity is a for-profit if a profit was made during a certain time period. What is the minimum number of years that an activity must have produced a profit?
   a. three of the last five tax years.
   b. two of the last seven tax years.
   c. two of the last five tax years.
   d. three consecutive years.

10. Instead of using the Schedule C, a sole proprietor who meets at least eight requirements can use Schedule C-EZ, Net Profit From Business. Which item below is one of these requirements that must be met?
    a. The accrual method of accounting was used.
    b. The business had a net loss.
    c. The taxpayer must file Form 4562.
    d. The sole proprietor has only one business.

11. A sole proprietor may file Form 4868. What does the sole proprietor request using this form?
    a. innocent spouse status.
    b. an automatic extension.
c. an offer in compromise.
d. an installment agreement.

Self-Employment Tax

If a taxpayer is a sole proprietor, they will have to pay self-employment tax (§1401). The self-employment tax is the non-employee portion of the Social Security tax-raising system. In 2016, self-employment tax takes 15.3% of income (12.4% for social security [OASDI] and 2.9% for Medicare [HI]) from self-employment. Deductible items like home mortgage interest, real estate taxes, state income tax, Keogh plan or IRA deductions, etc. don’t reduce self-employment tax. However, since 1990, business deductions, plus an amount equal to the self-employment tax on half of self-employment income, are allowable in reducing the self-employment income.

In 2016, the social security tax is imposed on the first $118,500 of self-employment income and the Medicare tax is imposed on all self-employment income.

Incorporation

*Before 1990,* taxpayers could usually save money on this tax by incorporating. As a corporation, any salary paid (up to $48,000 in 1989) was subject to both individual and corporate FICA tax of 7.51% (for a total tax rate of 15.02%) versus a 13.02% rate for self-employment tax. However, the *employer* half of the FICA tax was all *deductible* for corporate income tax purposes. This difference disappeared in 1990.

In addition, one-half of the self-employment tax has become deductible, both for income *and* self-employment tax purposes, thus putting self-employed persons on the
same footing as incorporated ones for Social Security (FICA and self-employment) tax purposes.

“S” Solution

One controversial approach to reduce self-employment tax is to set up an S corporation and pay wages less than the amount that would normally be subject to self-employment taxes. This increases the S corporation’s net income, which would pass through to the taxpayer as a shareholder. Such income could then be distributed as a dividend with only income tax applicable to it (unlike wages or self-employment income, which are subject to both income tax and self-employment tax).

Note: If the wages paid from the S corporation are unreasonably low, the IRS may impute part of the corporate income as additional wages defeating this tactic.

Estimated Tax

Self employed persons are also subject to estimated tax payments, which must reflect self-employment taxes as well as federal income taxes. These estimated payments must be made quarterly. Generally, taxpayers must make estimated tax payments if they expect to owe at least $1,000 in tax for the taxable year, after subtracting their withholding and credits, and they expect their withholding and credits to be less than the smaller of:

1) 90% of the tax for the current taxable year, or
2) 100% of the tax for the prior taxable year.

If a taxpayer’s adjusted gross income for the prior year exceeds $150,000 ($75,000 for married filing separately) the safe harbor percentage is higher than 100%. For 2001, the percentage was 112%; for 2002 and thereafter the percentage is 110%. Effective February 17, 2009, the American Recovery & Reinvestment Act provides that the required annual estimated tax payments of a qualified individual for taxable years beginning in 2009 is not greater than 90% of the tax liability shown on the tax return for the preceding taxable year.
Individual Estimated Tax Relief

Was Taxpayer’s AGI Greater Than $150,000 For the Prior Tax Year?

- **YES**
  - Either 110%* of Last Year’s Liability
  - Or 90% of Current Year’s Liability

- **NO**
  - Either 100% of Last Year’s Liability

*Varies from 100% to 112% from 1998 to 2002*
Qualified individual. A qualified individual means any individual if the adjusted gross income shown on the tax return for the preceding taxable year is less than $500,000 ($250,000 if married filing separately) and the individual certifies that at least 50% of the gross income shown on the return for the preceding taxable year was income from a small trade or business.

Small trade or business: For purposes of this provision, a small trade or business means any trade or business that employed no more than 500 persons, on average, during the calendar year ending in or with the preceding taxable year.

If an individual anticipates that income tax withheld during the year will be less than 90% of estimated tax liability, then he or she is required to make estimated tax payments equal to 25% of the shortfall by each of the following dates:

(i) April 15,
(ii) June 15,
(iii) September 15 of the current year, and
(iv) January 15 of the following year (§6654(d)(1)(B)(i)).

If a taxpayer did not receive their income evenly throughout the year, they may be able to figure their estimated tax using the annualized income installment method. Under this method, the required installment for one or more payment periods may be less than one-fourth of the required annual payment.

Underpayment of Tax - Form 2210

If a sole proprietor did not pay enough income tax and self-employment tax by withholding or by making estimated tax payments, a penalty may have to be paid on the amount not paid. IRS will figure the penalty and send a bill. Or the taxpayer can use Form 2210 to see if they have to pay a penalty and to figure the penalty amount.

Sale of a Business

Each asset in a sole proprietorship is treated separately for tax purposes, rather than as part of one overall ownership interest. A sole proprietor selling an entire business as a going concern figures gain or loss separately on each asset. Thus, a sole proprietor who sells their business is really individually selling all the individual assets of the business.

Classification of Assets

To determine whether the gain or loss on the sale of an asset is capital gain or loss or ordinary gain or loss, the assets sold must be classified as:

(1) Capital assets (e.g., goodwill)
(2) Real property and depreciable property used in business and held for more than one year (e.g., buildings, machinery furniture and fixtures used in a business), and

(3) Other property—for example, stock-in-trade, inventory, or property used in a business and held one year or less.

Gain or loss for each asset sold must be separately figured and then treated according to its classification. Generally, the gains and losses on assets in categories (1) and (2) are capital while gains or losses on assets in category (3) are ordinary.

Other Business Dispositions

A sole proprietor can change the present form of their business without selling assets. This can be done by joining one or more persons who want to consolidate their individual businesses into a partnership or other form of organization and by transferring assets to the new form of business. The form of business may also be changed by incorporating a sole proprietorship or a partnership. In addition, the property of a sole proprietorship or partnership may be transferred to a previously existing corporation.

Income Splitting

There is little potential for income splitting with a sole proprietorship unless a child or other family member is employed by the sole proprietorship or assets are leased to business by such parties. Employment of a family member permits the sole proprietor to retain profits in the family and still receive a deduction under §162(a) for paying a salary.

Estate Planning

Normally, a sole proprietorship’s assets pass under the terms of the sole proprietor’s will or applicable intestate statute. Thus, the proprietorship’s assets will receive a step up in basis under §1014 to their date of death value.
Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

12. Sole proprietors must pay specialized taxes. Which of the following is a sole proprietor required to pay?
   a. the alternative minimum tax.
   b. the excess accumulated earnings tax.
   c. a self-employment tax.
   d. the personal holding company tax.

13. Self-employed taxpayers must pay estimated tax payments. These payments must reflect both self-employment taxes and:
   a. federal income taxes.
   b. federal excise taxes.
   c. business franchise taxes.
   d. worker's compensation insurance contributions.

14. Davis & Associates, a sole proprietorship, sells all of its assets including real property, machinery, furniture, and inventory for a gain. On which asset does Davis & Associates realize an ordinary gain?
   a. real property.
   b. machinery.
   c. furniture.
   d. inventory.
Learning Objectives

After reading Chapter 2, participants will be able to:

1. Determine what constitutes a partnership under §761(a) including the status of joint ventures, cotenancy, publicly traded partnerships, and the special benefits of family partnerships noting several advantages and disadvantages of each and recognize how partners share tax items.

2. Identify the taxation of partners and partnerships and its affect on the preparation of individual returns and K-1s and, specify the exclusion requirements noting tax rate and §1031 exchange impact.

3. Recognize separately stated items noting the relationship of deductions to outside basis, partnership versus partner deductions, allocation of deductions, and related filing requirements to improve accurate tax reporting.

4. Determine the closing of a partnership year, the events that terminate a partnership and the events that do not close the year to insure proper tax allocation.

5. Identify types of transactions between a partner and the partnership that can influence the treatment of the transaction, and specify the character of property contributions under §721.

6. Determine inside and outside basis, including complications caused by the contribution of services, specify their interplay with the at risk & passive rules, their impact on the disposition of partnership interests, and their effect on partnership distributions, and identify how such distributions and liquidations effect gain or loss for partnership and partners.
Provisions for the taxation of partnerships are in §701 through §761. Under these sections, the partnership files an information return (Form 1065). Its income and deductions flow through to, and are reflected on, the tax returns of the partners (Form 1040). The Code prescribes the consequences of many different sorts of transactions involving partnerships and partners but allows substantial flexibility so that the parties can often achieve the tax results they desire.

**Definition of Partnership**

A partnership is the relationship between two or more persons who together carry on a trade or business with each person contributing money, property, labor or skill, and each expecting to share in the profits and losses of the business.

*Note:* "Person" when used to describe a partner means an individual, a corporation, a trust, an estate, or another partnership.

**Section 761(a)**

For income tax purposes, the term “partnership” includes a “syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on,” and that is not a “trust, or estate or a corporation” (§§761(a); 7701(a)(2)).

*Note:* The partnership agreement may be modified for a particular tax year after the close of that tax year but not later than the date (not including any extension of time) for filing the partnership return for that year.
Co-tenancies
A joint undertaking merely to share expenses is not a partnership. *Mere* co-ownership of property that is maintained and leased or rented is *not* a partnership. However, if the co-owners provide services to the tenants, a partnership exists (Reg. §1.761-1(a)(1)).

Partnership Agreement
The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications can be *oral* or *written*.

Modifications
Partners can modify the partnership agreement for a particular tax year *after* the close of the year but *not* later than the date for filing the partnership return for that year. This filing date does not include any extensions of time.

Partner’s Share of Tax Items
A partner’s share of income, gains, losses, deductions, or credits is usually determined by the partnership agreement. However, the partnership agreement or any modification will be disregarded if the allocations to a partner under the agreement do not have *substantial economic effect*. An allocation has substantial economic effect if:

1. There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners’ shares of partnership income or loss *independently* of tax consequences; and
2. The partner to whom an allocation is made actually receives the economic benefit or bears the economic *burden* corresponding to that allocation (§704(b)).

If the allocation does not have substantial economic effect, then the partner’s distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner’s interest in the partnership.

Limited Partners
A limited partner is one whose personal liability for partnership debts is limited to the amount of money or other property the partner contributed or is required to contribute to the partnership. For purposes §469, limited partners are not generally considered to materially participate in trade or business activities conducted through partnerships.
Family Partnerships - §704(e)

If a sole proprietor can form a partnership with relatives, part of the income of the business will be taxed in their lower brackets, rather than his higher brackets. Thus, family partnerships have long been a popular income-splitting device under §704(e). However, if the partnership is not recognized for tax purposes, the tax liability remains with the sole proprietor.

Family partnerships require special treatment because of abuses that may arise from the close association of partners. Distributive shares of partnership income may be channeled to low tax bracket partners (e.g., children) who perform little, if any, real service for the partnership. When the partner is a child under age 18 of a parent-partner, a substantial portion of the child’s distributive income share may be taxed at the parents’ tax rate.

A family member will be recognized as a partner in either of the following cases:

1. Capital is a material income-producing factor and the family member’s capital interest\(^1\) is acquired in a bona fide transaction (even if by gift or purchase from another family member) in which ownership, dominion, and control are received; or
2. Capital is not a material income-producing factor but the family member contributes substantial or vital services (§704(e)).

Family, under §704(e), includes only:

1. Husband and wife,
2. Ancestors,
3. Lineal descendants, and
4. Any trusts for the primary benefit of such persons.

**Note:** Brothers and sisters are not included in this list.

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\(^1\) A capital interest in a partnership is an interest in its assets that is distributable to the owner of the capital interest upon the withdrawal of that partner from the partnership or upon the liquidation of the partnership. The mere right to share in the earnings and profits is not a capital interest in the partnership.
Family Limited Partnership

- Management Control
  - General Partner Manages

- Estate Reduction
  - Estate Freeze Rules

- Income Splitting

- Buy-Sell Agreement

- Creditor Protection
  - Dual Status - General & Limited
  - Corporation As General Partner
  - Multiple Partnerships
  - Partnership Interest is Personal Property
  - Charging Order - ULPA §703
    - Reasonable Reserves
    - Tax Without Cash
Publicly Traded Partnerships - §7704

Under §7704, a publicly traded partnership is treated as a corporation. A publicly traded partnership is any partnership in which the interests are traded on an established securities market or the “substantial equivalent.” The IRS provides certain safe harbors that avoid “substantial equivalence” for private placements, transfers not involving trading, de minimis trading, matching services, and redemptions, and repurchases.

Advantages

The advantages of a partnership include:

1. Income is taxed to the partners rather than to the partnership;
2. Distributed income is not subject to double taxation;
3. Losses and credits generally pass through to partners;
4. The liability of limited partners is normally limited as in a corporation;
5. There can be more than one class of partnership interests;
6. Partners can obtain basis for partnership liabilities;
7. Special allocations are permitted; and
8. A partnership can be used to transfer value and income within a family group by making family members partners.

Disadvantages

The disadvantages of a partnership include:

1. The liability of general partners is not limited;
2. Partners are taxed currently on earnings even if the earnings are not distributed;
3. Partners cannot exclude certain tax favored fringe benefits from their taxable income;
4. Partners may be required to file numerous state individual income tax returns for a multistate partnership business; and
5. In the absence of a business purpose, a partnership must use either a calendar year or the same year as the partners who own a majority of the interests in the partnership.
Partnership Advantages

• Partners are taxed not entity
• Income is only taxed once
• Partners can deduct losses
• Special allocations are permitted
• No double taxation on distributions
• Limited liability for limited partners
• Can be used for income splitting
• Partners get basis for entity debt
• Tax- free liquidating distributions
• No unreasonable compensation issue
• Section 754 inside basis election
Exclusion from Partnership Treatment - §761

Some partnerships may be excluded completely or partially from being treated as partnerships for federal income tax purposes if all the partners agree. If a partnership is used for investment purposes (and not for the active conduct of a business), or for the joint production, extraction, or use of property (but not selling services or the property produced or extracted), the partnership might be able to elect not to be taxed as a partnership (see Reg. §1.761-2(a) for additional requirements). Instead, each partner merely accounts separately for his own share of the income and expenses from the venture (§761(a)).

Complete Exclusion Election

To choose complete exclusion, the partnership must file a partnership return, Form 1065, for the first year it wishes to be excluded. The return must be filed by the due date (including extensions) for filing the return. File this return with the Internal Revenue Service Center for the area where the organization has its principal office or place of business. This is the same place the partnership would file its annual return if the choice were not being made. The return needs to contain only the name, or other identification, and the address of the organization. The return or statement attached to the return must contain the following information:

(1) The names, addresses, and identification numbers of all members of the organization;

(2) A statement that the organization is an investing or operating agreement partnership as defined in Reg. §1.761-2(a);

(3) A statement that all the members have chosen the exclusion from partnership treatment; and

(4) A statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom its provisions may be obtained).
Partial Exclusion Election

To choose *partial* exclusion from partnership treatment, an organization must submit a request to the IRS no later than 90 days after the beginning of the first tax year for which partial exclusion is chosen. The request must specify the provisions from which exclusion is sought. It *must* state that the organization qualifies as an investing or operating agreement partnership under Reg. §1.761-2(a) and that the members choose to be excluded to the extent indicated. The partial exclusion is effective only upon *approval* by the Commissioner, subject to any conditions the Commissioner may impose.

**Note:** The partners of excluded partnerships are not exempt from partnership provisions that impose limits on a partner’s distributive share of a partnership loss, or the requirement of a business purpose for the adoption of a tax year for the partnership which is different from that of its required tax year.

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**Review Questions**

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

15. Sections 701 through 761 cover the taxation of partnerships. Basically, under these sections, how are such entities taxed?
   a. as separate legal entities.
b. as S corporations.
c. as conduits.
d. as limited liability companies.

16. For tax purposes, when two or more individuals perform business activities through an unincorporated business, a partnership is formed. Thus, what could be a partnership?
   a. a trust.
   b. an estate.
   c. a corporation.
   d. a joint venture.

17. Family limited partnerships receive special tax treatment under §704(e). If certain conditions are met, family members will be recognized as partners permitting valuable income splitting. However, which of the following family members are excluded from this special treatment?
   a. husband and wife.
   b. ancestors.
   c. brothers and sisters.
   d. lineal descendents.

18. There are numerous advantages of partnerships. Why would someone choose a partnership over other entities?
   a. There is only one tax on distributed income.
   b. All partners have limited liability.
   c. Partners may exclude fringe benefits.
   d. Partners must only file one income tax return.

19. Certain qualified partnerships may elect to be excluded from being treated as partnerships for federal income tax purposes. To opt for total exclusion, the partnership is required to file a partnership return or statement including detailed information. Which item below is one of those required items of information?
   a. All of the partnership’s tax and legal advisors’ names, addresses, and identification numbers.
   b. A statement that the partnership is not recognized as an investing or operating agreement partnership.
   c. A statement that a profit has been made by the partnership for three out of the last five years.
   d. A statement that all of the partners have opted for the exclusion.
Partners Taxed as Individuals

While a partnership must figure its total income and file Form 1065 that provides information on partnership income or losses for the year, the partnership itself is not subject to income tax. A partnership does not even make estimated tax payments. However, the partners may have to make payments of estimated tax.

Note: A partner’s distributive share of income from a partnership is usually included in figuring net earnings from self-employment. If an individual partner has net earnings from self-employment of $400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040).

The partners are liable for income tax on their distributive share of partnership income in their individual capacities. Guaranteed salary or interest payments are included in income in addition to distributive share income. Thus, the partnership is considered an “aggregate” of the partners, not a separate entity (§701).

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2 The rules that limit the deductions relating to activities not engaged in for profit apply to partners.
**U.S. Partnership Return of Income**

For calendar year 1999, or tax year beginning , 1999, and ending , 1999, and ending

See separate instructions.

### Form 1065

<table>
<thead>
<tr>
<th>A Principal business activity</th>
<th>Use the IRS label. Otherwise, please print or type.</th>
<th>D Employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name of partnership</td>
<td>Number, street, and room or suite no. If a P.O. box, see page 12 of the instructions.</td>
<td>E Date business started</td>
</tr>
<tr>
<td>C Business code number</td>
<td>City or town, state, and ZIP code</td>
<td>F Total assets (see page 12 of the instructions)</td>
</tr>
</tbody>
</table>

G Check applicable boxes: (1) □ Initial return (2) □ Final return (3) □ Change in address (4) □ Amended return
H Check accounting method: (1) □ Cash (2) □ Accrual (3) □ Other (specify) ▶
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶

**Caution:** Include only trade or business income and expenses on lines 1a through 22. See the instructions for more information.

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a</td>
<td>Gross receipts or sales</td>
<td></td>
</tr>
<tr>
<td>1b</td>
<td>Less returns and allowances</td>
<td></td>
</tr>
<tr>
<td>1c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Cost of goods sold (Schedule A, line 8)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Gross profit. Subtract line 2 from line 1c</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Ordinary income (loss) from other partnerships, estates, and trusts</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Net farm profit (loss) (attach Schedule F (Form 1040))</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Net gain (loss) from Form 4797, Part II, line 18,</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Other income (loss) (attach schedule)</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Total income (loss). Combine lines 3 through 7</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Salaries and wages (other than to partners) (less employment credits)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Guaranteed payments to partners</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Repairs and maintenance</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Bad debts</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Rent</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Taxes and licenses</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Interest</td>
<td></td>
</tr>
<tr>
<td>16a</td>
<td>Depreciation (if required, attach Form 4562)</td>
<td></td>
</tr>
<tr>
<td>16b</td>
<td>Less depreciation reported on Schedule A and elsewhere on return</td>
<td></td>
</tr>
<tr>
<td>16c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Depletion (Do not deduct oil and gas depletion.)</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Retirement plans, etc.</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Employee benefit programs</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Other deductions (attach schedule)</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Total deductions. Add the amounts shown in the far right column for lines 9 through 20</td>
<td></td>
</tr>
</tbody>
</table>

**22** Ordinary income (loss) from trade or business activities. Subtract line 21 from line 8

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**Please Sign Here**

Signature of general partner or limited liability company member

Date

**Paid Preparer’s Use Only**

Preparer’s signature

Date

Check if self-employed □

Preparer’s SSN or PTIN

**For Paperwork Reduction Act Notice, see separate instructions.**

Cat. No. 11390Z

Form 1065 (1999)
Exception - Separate Entity for Some Purposes

For some purposes, the partnership is viewed as a separate entity:

1. Elections - The method of depreciation for partnership property, general accounting method, depletion, and installment sales must be chosen at the partnership level, not by individual partners.

2. Administrative Matters - For audits and judicial review, a partnership is considered a separate entity. A “tax matters partner” represents the partnership in dealing with the IRS. However, partnerships with ten or fewer partners (all individuals) can choose to be treated for administrative purposes as an aggregate, not an entity (§§6221 through 6231).

3. Examination Procedures - Under current examination procedures, the tax treatment of partnership items of income, gain, loss, deduction, credit, etc., is determined at the partnership level in unified partnership proceeding rather than at the individual partner’s level. After the proper treatment of a partnership item is determined at this level, the IRS can automatically make related adjustments to the tax returns of the partners based on the partners’ shares of any adjusted items.

Note: These examination procedures do not apply to partnerships made up of 10 or fewer partners who are individuals (but only if no partner is a nonresident alien) or estates if each partner’s share of every partnership item is the same as that partner’s share of every other item. However, these small partnerships may make election to have these procedures apply.

Individual Returns & K-1s

Partners must include in their individual returns their distributive share of partnership income, whether or not distributed (§702; Reg. §1.702-1). A partner is taxable on his distributive share of partnership income regardless of whether he received it or was aware of its existence. Partnership income is taxed when earned; time of distribution is immaterial.

The partnership must prepare a Schedule K-1 (Form 1065) for each partner showing that partner’s share of each partnership item. Each partner must be given a copy of his own Schedule K-1. The partnership must also file Schedule K if over 10 Schedules K-1 are attached to the partnership return.

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3 However, the partners, not the partnership, make choices on treatment of foreign and U.S. possessions taxes, certain mining exploration expenses, and income from discharge of indebtedness. The partners may also individually choose to amortize qualifying costs they incur or pay to investigate acquiring their partnership interests.
Partnership Expenses Paid By a Partner

In general, a partner cannot deduct partnership expenses paid out of his or her personal funds unless required to do so by the partnership agreement. These expenses are usually considered incurred in and deductible by the partnership business. However, if a partner is required by the partnership agreement to pay, out of his or her personal funds, an employee who performs part of the partner’s duties, the partner can deduct that payment as a business expense.

Separately Treated Items

Each partner counts separately his distributive share of certain items of the partnership, so that these items are not lumped together with all other partnership transactions.

All partners, in determining their income tax, separately state their share of a partnership’s:

(1) Gains and losses from sales or exchanges of capital assets,
(2) Gains and losses from sales or exchanges of certain property used in a trade or business (§1231), and from involuntary conversions,
(3) Charitable contributions,
(4) Dividends for which corporate partners can claim a deduction,
(5) Certain taxes paid or accrued to foreign countries and to possessions of the United States,
(6) Depletion allowances on partnership oil and gas properties,
(7) Intangible drilling and development costs, and
(8) Other items of income, gains, losses, deductions, or credits required by the regulations, such as:
   (a) Recoveries of bad debts, prior taxes, and delinquency amounts,
   (b) Gains and losses from wagering,
   (c) Soil and water conservation expenditures,
   (d) Nonbusiness expenses, medical and dental expenses, dependent care expenses, and alimony expenses,
   (e) Interest and taxes paid to cooperative housing corporations,
(f) Any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement that differs from the partnership’s usual allocation of taxable income or loss,

(g) Meal and entertainment expenses paid or incurred by the partnership for a partner, and

Note: The 50% disallowance for meals and entertainment is on the K-1 to show the basis reduction to the partner. No further limitation is applicable on their personal returns.

(h) Any amount that if separately considered by any partner would result in an income tax liability for that partner different from that which would result if the partner did not take the item into account separately.

Note: For example, a credit for the elderly may be available to one or more partners. The partnership must show separately on its return any pensions, annuities, interest, rent, or other income it receives, so that a qualifying partner will get full credit.

Note: For figuring the alternative minimum tax on tax preference income, a partner must count separately any distributive share of items of income and deductions that enter into the computation of tax preference items.

The foregoing must be separately stated since they have a different effect on each partner depending upon his particular tax position. Remaining items of partnership income or deduction are grouped together into a single item and allocated to the partners (§702(a)(8)).

Example

Lazlo and Raoul are equal partners in LR partnership, a self-service coin operated massage parlor. During the tax year, LR sells a nuclear powered combination barbecue and tanning rack at a loss of $10,000. Except for this item, LR has a profit of $30,000. In the same year, Lazlo had a $50,000 gain from condemnation of an apartment house he owned. The $10,000 loss item from the LR partnership is reported separately from the $30,000 profit. The loss is a §1231 loss and $5,000 will be an ordinary loss to Raoul. However, the other $5,000 will be a capital loss to Lazlo because his §1231 gains ($50,000 from the apartment condemnation) exceed his $1231 losses ($5,000 distributive share from the partnership). The $30,000 profit will be $15,000 ordinary income to Lazlo and $15,000 ordinary income to Raoul.

Character of Items & Limitations

Items of partnership income or deduction have the same character in the partner’s hands as they would have if the partner had realized them directly rather than
through the partnership. (§702(b); Reg. §1.702-1(b)). Thus a partner’s distributive share of the partnership’s charitable contributions to organizations qualifying as 50% limit donees under the §170(b)(1)(A) contribution limit rules retains the same character in the partner’s hands.

If a partner treats an item differently on his or her individual return, the IRS can automatically assess and collect any deficiency and penalties that result from adjusting the item to make its treatment consistent with the treatment on the partnership return. However, this does not apply if a partner files Form 8082, Notice of Inconsistent Treatment or Amended Return, with his or her return identifying the different treatment.

In determining the amount of any deduction or exclusion allowable that is subject to a limitation, a partner must usually combine the amounts of any separate deductions or exclusions on his or her individual income tax return with the distributive share of partnership deductions and exclusions before applying the limitation (Reg. §1.702-1(a)(8)(iii)).

**Deduction of Losses**

If the partnership loses money for the year (i.e., its deductions exceed its income), such losses are deductible by the partners. They take the losses into account on the last day of the partnership’s taxable year.

**Outside Basis Limitation - §704(d)**

A partner’s distributive share of the partnership loss (and depletion on partnership oil and gas properties) is allowed only to the extent of the partner’s adjusted basis, before reduction by the current year’s losses, of the partnership’s tax year in which the loss occurred. Any share of loss in excess of the partner’s adjusted basis is not allowed for that year. In short, the amount deductible is limited to the partner’s basis for his partnership interest - often called “outside basis” (§704(d)).
Thus, if a partner has no outside basis (because he has not paid for his interest and nothing happens to raise basis above zero), he cannot deduct his portion of partnership losses (*Falconer v. Commissioner*, 40 T.C. 1011 (1963)).

**Loss Ultimately Deductible**

Any loss that is disallowed will be allowed as a deduction for the following partnership tax year after the year of the loss, and for later tax years, to the extent that the adjusted basis of the partner’s partnership interest at the end of the tax year is *more than zero*. Thus, if a partnership loss is not deductible because it exceeds a partner’s outside basis, he is allowed ultimately to deduct the loss in a later year if his basis then rises above zero.

**Effect of Losses on Outside Basis - §705**

Outside basis is increased by a partner’s distributive share of income plus their share of tax-exempt income. It is decreased by their share of losses for each of the partnership tax years (§705).

**Example**

Dan and Daphne run a combined truck stop and ballerina school as equal partners. The partnership and individual returns are filed on a calendar year basis. The partnership lost $20,000 last year due to a tutu shortage. Dan’s distributive share of the loss was $10,000. Since the adjusted basis of his partnership interest, before considering his share of last year’s loss, was $7,000, Dan could only claim $7,000 of the loss on last year’s individual return. The adjusted basis of his interest at the end of the last year was then reduced to zero.

The partnership showed a $24,000 profit this year. Dan’s $12,000 share of the profit increased the adjusted basis of his interest by $12,000 (not counting the $3,000 excess loss he could not deduct last year). His return for this year will show individual partnership income of $9,000 (his $12,000 distributive share of this year’s profits less the $3,000 loss not allowable last year). The adjusted basis of Dan’s partnership interest at the end of this year is $9,000.
Partnership Tax Return

The partnership files a return, for information purposes, setting forth all items of income and deduction. However, it is not entitled to claim certain deductions to which only individuals are entitled - such as the standard deduction or the personal exemption (§703(a)).

Organization & Syndication Fees - §709

Neither the partnership nor any partner is allowed a deduction for amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership (i.e., syndication expenses). However, the partnership can (after an initial $5,000 deduction) choose to amortize certain organization fees over a period of not less than 180 months. The 180-month period starts with the month the partnership begins business. If the partnership is liquidated before the end of the 180-month period, the remaining balance in this account may be deductible as a loss, but only if the 180-month amortization election has been made.

These rules apply to expenses which:

1. Are incident to the creation of the partnership;
2. Are chargeable to a capital account; and
3. Would be amortized over the life of the partnership if they were incurred for a partnership having a fixed life.

Capitalized Syndication Fees

The special amortization provision does not apply to expenses connected with the issuing and marketing of interest in the partnership, such as commissions, professional fees, and printing costs.

Business Start-up Costs - §195

If a partnership begins or acquires a business, it may (after an initial $5,000 deduction) elect to amortize over a period of at least 180 months certain start-up expenses. To make this election, attach a statement to the partnership return for the tax year in which the amortization period begins. The amortization period starts with the month the partnership begins the business or the month it acquires the business.

The return and statement must be filed by the due date of the partnership return (including extensions). The statement must include a description of the expenses,

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4 If the partnership uses the accrual method of accounting, its deductions for expenses may depend on economic performance. The economic performance rule is discussed in Publication 538, Accounting Periods and Methods.
the amount of the expenses, the date the expenses were paid or incurred, the month in which the partnership began or acquired the business, and the number of months in the amortization period.

Once the partnership chooses a period of time for amortizing start-up expenses, and files the election, it may not change to a different time period.

Definition

Start-up expenses are amounts paid or incurred in connection with creating an active trade or business or for investigating the creation or acquisition of an active trade or business. For a partner, start-up expenses are the amounts paid or incurred to investigate the acquisition of a partnership interest that is an active trade or business and not an investment. A partnership interest is an active trade or business if the partner actively participates in the management of the partnership’s trade or business.

Start-up expenses must be of a type that would be allowable as a deduction in the tax year in which they were paid or incurred, if they were paid or incurred to expand an existing trade or business in the same field.

Filing Requirements

Every partnership must file a return showing its income, deductions, and other information required (§6031). This is an information return and must be signed by one partner (§6063). The return must be filed for every tax year of the partnership even though it has no net income for the year. However, the first return is not required to be filed before the partnership has income or deductions (Reg. §1.6031-1(a)).

Note: If a partnership does not carry on business within the United States nor receive income from sources within the United States, it is not required to file a partnership return unless it has U.S. persons as partners who, in determining their tax liability in whole or in part, take into account, either directly or indirectly, partnership items from it.

Due Date of Return

Form 1065 must be filed on or before April 15 following the close of the partnership’s tax year if its accounting period is the calendar year. A fiscal year partnership must file its return by the 15th day of the 4th month following the close of its fiscal year.

If a partnership needs more time to file its return, it should file Form 7004, Application for Automatic Extension of Time To File Return for U.S. Partnership or for Certain Trusts, by the regular due date of its Form 1065. The automatic extension cannot exceed 3 months.
Failure to File

A penalty is assessed against the partnership if it is required to file a partnership return and fails to file the return on time, including extensions, or fails to file a return that shows all the information required. The penalty is $195 per month (or part of a month) that the partnership return is late or incomplete, up to a maximum of 12 months (§6698(b)). This amount is multiplied by the total number of partners in the partnership during any part of the tax year for which the return is due.

The penalty will not be imposed when the partnership can show that failure to file a complete or timely return is due to reasonable cause. Certain small partnerships (with 10 or fewer partners) will meet this reasonable cause test if:

(1) Each partner is a natural person (other than a nonresident alien) or an estate;
(2) Each partner’s share of each partnership item is the same as that partner’s share of every other item; and
(3) All partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.

This penalty is assessed against the partnership. However, each partner is individually liable for the penalty to the extent that the partner is liable for partnership debts generally.

Failure to Furnish Copies to Partners

The partnership is required to furnish copies of Schedules K-1 (Form 1065) to the partners. A penalty of $50 for each statement not furnished will be assessed against the partnership unless the failure to furnish copies was due to reasonable cause and not willful neglect (§6695(a)).

Special Allocations - §704(b)

All items of income and deduction are divided between the partners subject to the provisions of the partnership agreement (§704(a) & (b)(1)). Such agreed-upon allocations can even be disproportionate to a partner’s interest (§704(b)). However, if the allocation has no substantial economic effect, it will be disregarded and the item will be allocated in accordance with the partner’s interest in the partnership (§704(b); Reg. §1.704-1(b)(1)(i)).
Economic Effect

The “substantial economic effect” test applies to any allocation of specific items of income, gain, loss, deduction, and credit as well as to “bottom line” allocation of taxable income or loss. For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. In other words, there must be an economic benefit or burden to a partner that matches the tax allocation.

“Substantial Effect”

The economic effect must be “substantial” to be honored for tax purposes. This means that the economic effect is weighed against the tax savings produced by the allocation. If the economic effect seems insignificant or transitory and the tax savings are large, the special allocation would be ignored (Reg. §1.704-1(b)(2)(iii)). Basic requirements for substantial economic effect are:

1. A written provision in the partnership agreement reflecting the terms of §704(b),
2. The use of capital accounts to keep track of the special allocations among partners,
3. The restoration of any negative capital accounts prior to termination of the partnership, and
4. Liquidating distributions must be made pursuant to the ratio of the capital accounts.

This means that partnership capital accounts must reflect the tax allocations and that, upon liquidation of the partnership, the distributions to partners must be determined by those capital accounts. If a partner has a deficit balance in his capital account, the partner must be obligated to restore the amount of that balance to the partnership by the end of the taxable year (Reg. §1.704-1(b)(2)(ii)).

Example

Lazlo and Raoul are equal partners in a partnership that owns an apartment house full of flight attendants down at the beach, however Lazlo is Republican and in a much higher tax bracket. The partnership agreement specially allocates all depreciation to Lazlo. The current depreciation deductions reduce Lazlo’s taxable income but they also reduce his partnership capital account, which determines the actual amount he receives when the partnership is dissolved. A partner must pay back a negative balance in their capital account at the time of dissolution. This allocation has substantial economic effect.

If the agreement provided that when the building was sold, Lazlo would be entitled to receive half of the assets of the partnership
regardless of the balance in his capital account. The allocation of depreciation would have no economic effect and would be ignored for tax purposes (Orrisch v. Commissioner, 55 T.C. 395 (1970)).

Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

20. Members of a partnership are taxed as individuals. What is a tax compliance or filing requirement of partnerships?
   a. They must make payments of estimated tax.
   b. They must figure total income and file Form 1065.
   c. They must register with the IRS.
   d. They must pay federal income tax.

21. Partners are taxed on income earned. When must they include their distributive share of partnership income in their individual returns?
   a. even if it is not earned yet.
   b. whether or not the income is distributed.
   c. only if they are aware of the income.
   d. only if they received the income.

22. Each partner counts separately his or her distributive share of certain items of the partnership. Which of the following items is grouped together with all other transactions of a partnership?
   a. gains and losses from capital asset sales or exchanges.
b. contributions to charities.
c. gains or losses from a partnership inventory sale.
d. intangible costs of drilling and development.

23. When a partnership’s deductions surpass its income, the partners may deduct such losses. To what extent is a member’s distributive share of such a loss is permitted?
   a. only to the extent of the partner’s adjusted basis.
   b. only to the extent of the partner’s inside basis.
   c. only to the extent of the partner’s capital account.
   d. only to the extent of the partner’s share of entity debt.

24. Amazingly, some partnerships are exempt from filing a tax return. However, which of the following partnerships is required to file a partnership return?
   a. a partnership that performs business only in Canada.
   b. a partnership that receives income only from clients in Europe.
   c. a partnership that has zero net income.
   d. a partnership who has no income or deductions for a second consecutive year.

25. Allocations of partnership items of income and deduction can be disproportionately allocated among partners. Under what circumstance may the allocations be disproportionate?
   a. only if they have a substantial economic consequence.
   b. if the economic result is insubstantial.
   c. only to the extent of a partner’s outside basis.
   d. only if any negative basis is restored.
Year Taxable - §706(a)

The various items of income and deduction from the partnership are allocated to the partners on the last day of the partnership’s taxable year (§706(a)).

Example: If the partnership’s taxable year ends on January 31, 2017, the partnership’s items of income and deduction from the year that began on February 1, 2016 and ended on January 31, 2017, would appear in the tax returns of the partners for 2017, not 2016. Thus, they have deferred tax on 2016 income until 2017.

Limitation on Choice of Taxable Year

A partner’s ability to take advantage of deferral is limited. Partnerships are generally required to use the required tax year (normally the calendar year) unless a business purpose exists for adoption of another year (§706(b)(1)) or an election under §444 is available.

If a partnership establishes an acceptable business purpose for having a tax year that is different from its required tax year, the different tax year can be used. The deferral of income to the partners is not considered a business purpose.

Partnerships can elect under §444 to use a tax year that is different from the required tax year. Certain restrictions apply to this election. In addition, the electing partnership may be required to make a payment for the deferral.
Closing of Partnership Year

When a partnership terminates, the taxable year closes as to all partners and all income or loss to the date of termination must be reflected on the returns of the partners for the year in which the termination occurs. Furthermore, upon a “termination,” the assets of the partnership are deemed distributed to the partners; if they continue the partnership, this would be treated as a contribution of the assets to a new partnership (Reg. §1.708-1(b)(1)(iv)).

Example

The taxable year of Fender, Bender, & Whiplash, a law partnership ends on January 31. However, the partnership is terminated on December 1, 2016. The partners must reflect on their 2016 returns both the results for the twelve months ending January 31, 2016 and also the results for the ten months between February 1, and December 1, 2016. The result is to telescope twenty-two months of profits into a single taxable year, because both the tax year of the partnership and the year of its termination are within the individual partner’s tax year.

Events That Terminate Partnership - §708(b)

Discontinuance of Business

If no part of the business or the financial operation of the partnership continues to be carried on by any of its partners, the partnership is terminated (§708(b)(1)(A)). However, if one partner of a two-partner firm dies or retires, the partnership remains in existence until all payments due to that partner or the estate have been made (Regs. §1.736-1(a)(6) & §1.708-1(b)(1)(i)).

Winding Up

If the partnership sells its assets, but is still in the process of winding up, it is not terminated, although it may be considered dissolved for state law purposes.

Sale of 50% or More Interest

The sale or exchange of a partnership interest may result in a termination of the entire partnership. If during a twelve-month period, there is a sale or exchange of fifty percent or more of the partnership interests in capital and profits, the partnership terminates as to all partners (§708(b)(1)(B); McCauslen v. Commissioner, 45 T.C. 588 (1966) - sale by one 50 percent partner of his interest to other partner). As a result, the partnership’s tax year ends and income bunching may take
place, because all partners are required to report their share of profits up to the
date of termination.
If the reconstituted partnership wants to use the same fiscal year as did the pre-
vious entity, it must apply for IRS permission, and approval is not guaranteed.
Thus, great care should be exercised in effecting the disposition of a partner’s in-
terest if it represents a 50% or greater interest in capital and profits or if the sum
of the transfers within any 12-month period is expected to do so.

Gift or Bequest Exception

A gift of the partnership interest does not trigger this result, nor does the
death of a partner and a bequest of the interest to survivors (Reg. §1.708-
1(b)(1)(ii); Maxcy v. Commissioner, 59 T.C. 716 (1973)).

Events That Do Not Close the Year - §706(c)

Generally, the taxable year of a partnership does not close by reason of the
death of a partner, the entry of a new partner, the liquidation of a partner’s in-
terest, or the sale or exchange of a partner’s interest (§706(c)(1); however see
§708, concerning the sale or exchange of 50% or more of the interests).

Sale of Individual Partner’s Interest

When a partner sells or exchanges his entire interest in a partnership or his
partnership interest is liquidated, the partnership year closes only as to him
as of the sale date. He will reflect in his tax return for the year in which the
sale occurs his share of all partnership items accruing up to that time
(§706(c)(2)(A)). If the partnership uses an IRS-approved business purpose fis-
cal year and the partner uses a calendar year, income bunching may take
place, because the selling partner’s distributive share of partnership income
for the closed tax year is reported in that partner’s tax year that includes the
sale date.

Death of Partner

Formerly, the death of a partner did not close the year for the partner or the
partnership. Thus, a deceased partner’s distributive share of income for the
year of death was not reported on that partner’s final tax return. Instead the
entire amount was reported on the tax return of the partner’s estate. It was
“income in respect of a decedent,” meaning that it was fully taxable (if a
profit) or deductible (if a loss). (§706(c)(2)(A)(ii); Hesse v. Commissioner, 74
T.C. 1307 (1980) - partnership loss reportable by estate, not on decedent’s
final return)

However, the TRA ’97 now provides that the taxable year of a partnership
closes only with respect to a partner whose entire interest in the partnership
terminates, whether by death, liquidation or otherwise. The provision is effective for partnership taxable years beginning after December 31, 1997.

**Admission of New Partners - §706(d)**

When there is a change in partnership interests during the year (as by admission of a new partner), the various items of income and deduction must be *allocated* between the partners for the periods *before* and *after* the change takes place (§706(c)(2)(B)). Such allocations must be done based on *time*. Retroactive allocations to new partners are *forbidden* (§706(d)(1); Richardson v. Commissioner, 693 F.2d 1189 (5th Cir. 1982)).

**Allocation Techniques**

There are *two* permissible methods for allocating these items:

(i) The partnership can “close the books” just before the change in interests; or

*Note*: Items occurring before the closure would be reflected according to the old allocation; items occurring after the closure would be reflected according to the new allocation.

(ii) The item can simply be allocated on a daily basis.

**Example**

*Engulf & Devour* is a calendar year stock brokerage partnership in which *E* and *D* each have a fifty percent interest. On December 1, *C* is admitted, given a one-third share, and the firm is renamed *Engulf, Devour & Consume*. On July 1, the firm had an ordinary loss of $36,000. *Engulf, Devour & Consume* is not permitted to allocate this loss entirely to *C*. Instead, the partnership has two choices:

*It can “close the books” on December 1. Then, the loss would be entirely allocated to *E* and *D*, because it occurred before the “books closed.”*

*Alternatively, the loss can be allocated on a daily basis. Then, *C* would be entitled to deduct $1,000 of the loss. This figure is one-third of one-twelfth of the loss (one-twelfth because he was a partner only for one-twelfth of the year, one-third because he is a one-third partner).*

**Daily Allocation Required for Cash Items**

For certain “cash basis items” (of cash basis partnerships), the Code *requires* allocation on a daily basis. The “closing the books” method is *not* allowed. These items include interest, taxes, payments for service, pay-
ments for the use of property, or other items to be added by regulation (§706(d)(2)).

Example

Using the previous example, assume that Engulf, Devour & Consume is a cash basis real estate partnership that paid interest of $18,000 on December 15 on a loan that was outstanding the entire year. If it could use the “closing the books” method, C would be entitled to one-third of the interest deduction since payment occurred after C became a partner. Under §706(d)(2), however, this is a cash basis item and must be allocated on a daily basis. Therefore, C could deduct only about $250 (one-third of one-twenty-fourth of the item).

Transactions between Partner and Partnership

Treating Partner as Stranger - §707(a)

If a partner engages in a transaction with the partnership other than in his capacity as a partner, the transaction shall be considered as occurring between the partnership and a stranger (§707(a)).

Example

If a partner loans money to the partnership, the interest on the loan will be taxed as interest income to him and an interest deduction to the partnership. The interest deduction would decrease the partnership’s income and thus decrease the partner’s pro rata
share of that income (Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977)).

Such transactions include:

(1) Non Partner Transactions - the performance of services for, or the transfer of property to, a partnership if there is a related direct or indirect allocation and distribution to a partner, and the entire transaction is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner; and

(2) Sales & Exchange - the direct or indirect transfer of money or other property to a partnership if there is a related direct or indirect transfer of money or other property by the partnership to the contributing partner or another partner, and the transfers together are properly characterized as a sale or exchange of property.

Example

Where a partner was paid for advising the partnership, a service that he also rendered to many other clients, the partner was not acting in the capacity of a partner, and payments for the advice were treated as if made to outsiders. (Rev. Rul. 81-301, 1981-2 C.B. 144)

However, a partner who manages the partnership is acting in his capacity as a partner. Therefore, payments for such services are treated as distributive shares of partnership income or as guaranteed payments under §707(c). (Pratt v. Commissioner, supra)

Payments by Accrual Basis Partnership to Cash Basis Partner

When a partnership incurs any deductible expense, other than a guaranteed payment, from any person owning, directly or indirectly, a capital or profits interest in the partnership, it may not deduct the expense until the expense is paid and included in the person’s gross income. This rule does not apply to certain qualified expenses of partnerships owning low-income housing.

Guaranteed Payments - §707(c)

A partner can agree to work for a salary that is determined without reference to the partnership’s income (§707(c)). Such a salary (called a “guaranteed payment”) would be income to the recipient and often deductible (see below) to the partnership.

Receipt of a guaranteed payment does not change the recipient partner’s outside basis. Also, guaranteed payments are not subject to tax withholding as payments to partnership employees are.
A partnership treats guaranteed payments to a partner for services, or for the use of capital, as if they were made to a person who is not a partner. This is only to the extent the payments are figured without regard to the partnership’s income. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner’s distributive share of ordinary income. Guaranteed payments are not subject to tax withholding as are payments to partnership employees (Reg. §1.707-1(c), R.R. 56-326).

Generally, the payments are deductible by the partnership as a business expense. They are included in Schedules K and K-1 of the partnership return, and are reported by the individual partner on Form 1040 as ordinary income, in addition to his distributive share of the other ordinary income from the partnership.

**Example**

_Under the partnership agreement, Dan is entitled to a fixed annual salary of $10,000 without regard to the income of the partnership. Dan’s distributive share of the partnership income is 10%. The partnership has $60,000 of ordinary income after deducting the guaranteed payment. Dan must include ordinary income of $16,000 in his income tax return for his tax year in which the partnership tax year ends ($10,000 guaranteed payment plus $6,000 ($60,000 x 10%))._

**Section 709**

Guaranteed payments made to a partner or partners for organizing the partnership or syndicating interests in the partnership are capital expenditures and are not deductible by the partnership. Section 709 requires capitalization of such amounts paid to organize a partnership (these can be amortized and deducted over a period of sixty months) or to promote the sale of partnership interests (these cannot be amortized). However, the payments must be included in the partner’s tax return.

**Guaranteed Minimum**

If a partner is to receive a stipulated minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner’s share of the partnership income before considering the minimum payment.
Example

Under the partnership agreement, Dan is to receive 40% of the partnership income, but in no event less than $8,000. The partnership has net income of $15,000. Dan’s share, without regard to the minimum guarantee, is $6,000 (40% of $15,000). Thus, the amount of the guaranteed payment that may be deducted by the partnership is $2,000 ($8,000 less $6,000). Dan’s income from the partnership is $8,000, and the remaining $7,000 will be reported by the other partners in proportion to their shares under the partnership agreement. If the partnership net income had been $30,000, there would have been no guaranteed payment since his share, without regard to the guarantee, would have been greater than the guarantee.

Year Taxed - §706(a)

A partner must include the guaranteed payments in income in the partner’s tax year in which the partnership’s tax year ends. Thus, a guaranteed payment is taxed to the recipient as of the close of the partnership’s taxable year regardless of when it is received by the partner (§706(a)). However, a cash basis partner must include the guaranteed payment in income in the year the partnership accrued the expense, even if it was not paid in that year (Reg. §1.707-1(c)).

Example

Dan is a calendar year partner. The partnership’s fiscal year ends January 3. Dan received guaranteed payments from February 1, 2016, until December 31, 2016. Dan must include the guaranteed payments in income for 2017 and report them on his 2017 income tax return.

Payments Resulting in Loss

Assume that a partnership agreement provided for guaranteed payments to a partner. The payments during the year resulted in a partnership loss in which the partner shared. That partner must report the full amount of the guaranteed payments and must separately count the appropriate distributive share of the partnership loss.

Accident & Health Insurance Premiums

Premiums for health insurance paid by a partnership on behalf of a partner for services rendered as a partner are treated as guaranteed payments. As such, they are deductible as business expenses by the partnership and are includible in the partner’s gross income (R.R. 91-26). Partners may be able to deduct 100% of
the amount paid for medical insurance as an adjustment to income, if they meet certain requirements.

**Certain Losses Disallowed - §707(b)**

Ordinarily when a partner sells property to the partnership (or the partnership sells property to a partner), it will be treated like a sale between strangers - i.e., gain or loss would ordinarily be recognized (§707(a)). However, a loss on such sale is not deductible if the partner owns, directly or indirectly, *more than fifty percent* of the interest in capital or profits of the partnership (§707(b)(1)(A)).

**Two Partnerships**

If the sale or exchange is between *two* partnerships in which the *same* persons own, directly or indirectly, more than a 50% interest of the capital or profits in each, *no* loss deduction is allowed. However, if one of the purchasers later sells the property, any gain realized will be taxable *only* to the extent that it is more than the loss that was not allowed (§707(b)(1)(B)).

**Constructive Ownership**

For disallowance of losses (and certain sales at a gain discussed below), various rules of constructive ownership are provided so that if close relatives of the seller or buyer are partners, the loss would still be disallowed (§§707(b)(3) & 267(c)).

Determination of the 50% ownership in partnership capital or profits is made by applying the following rules:

1. An interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries;
2. An individual is considered as owning the interest owned, directly or indirectly, by or for the individual’s family; *and*
3. An interest constructively owned by a person under rule (1) is treated, for applying rules (1) or (2), as actually owned by that person.

**Note:** However, an interest constructively owned by an individual under rule (2) is not again treated as owned by that person for applying rule (2) to make another the constructive owner of the interest.

Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is *not* an actual partner, but only for establishing that another partner may be considered the constructive owner of the partnership interest.

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6 The family of an individual includes only brothers and sisters (including half-brothers and half-sisters), spouse, ancestors, and lineal descendants.
Sales at Gain

When assets are sold by partner to a partnership (or a partnership to a partner) at a gain and the partner owns, directly or indirectly, more than fifty percent of the capital of profits of the partnership, the gain is ordinary income rather than capital gain. This rule applies only if the asset is not a capital asset in the hands of the transferor. Property that is not a capital asset includes, but is not limited to, trade accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business. Similarly, a capital gain on a sale between two partnerships with fifty percent common ownership is treated as ordinary income (§707(b)(2)).

Contributions of Property - §721

No gain or loss is recognized to the partnership or the partners upon a contribution of property to the partnership in exchange for a partnership interest (§721). This nonrecognition provision is based on the idea that the formation of a partnership is not an appropriate time to tax the partner on gain or loss on the assets contributed to the partnership. This rule applies to a partnership in the process of formation and to one that is already operating.

Note: Section 721 does not deal directly with the effect of receiving cash (or other) “boot” when making transfers to a partnership. This is handled under the provisions dealing with distributions (§733, §731, §752). Under §733, a cash distribution decreases a partner’s outside basis. However, the distribution is not taxable unless it is in excess of the partner’s outside basis immediately before the transfer. Under §752, the transfer of encumbered property is treated as a cash distribution to the extent of the debt assumed or taken subject to by the partnership.
Contribution vs. Sale or Exchange

The partner could sell the asset to the partnership instead of contributing it. Then, he would recognize gain or loss on the transfer. Note that loss deductions are disallowed if the partner directly or indirectly owns more than fifty percent of the partnership and gain is sometimes ordinary.

Disguised Sale - §707(a)

The Code provides that a sale that is disguised as a contribution (followed by an allocation or distribution to the partner which in substance is payment for the property) must be treated as a sale, not a contribution (§707(a)(2)(B)). The IRS recently issued final regulations identifying transactions structured as partnership contributions and distributions that are in fact sales or exchanges (Reg. §1.707-0 and §1.707-2 through §1.707-9). These regulations presume that contributions and distributions made within a two-year period are sales.

Disguised Taxable Exchanges - §704 & §737

A transaction may be treated as an exchange of property between partners on which gain or loss is recognized if a partner contributes property to a partnership and within a short period:

1. Before or after the contribution, other property is distributed to the contributing partner and the contributed property is kept by the partnership; or
2. After the contribution, the contributed property is distributed to another partner.

Property Distribution to Contributing Partner - §737

When property (other than the contributed property) is distributed to a partner who contributed built-in gain property, gain is recognized to the extent of the lesser of:

1. The excess (if any) of:
   a. The fair market value of any property (other than money) received, over
   b. The adjusted basis of the partner’s interest in the partnership immediately before the distribution reduced (but not below zero) by any money received in the distribution, or
2. The net precontribution gain of the partner.

Note: Net precontribution gain means the net gain (if any) that the partner would have recognized if all the partnership property that had been contributed by the partner within 7 years of the distribution had been distributed by the partnership to another partner (§737(b)).
This rule applies to distributions made after June 24, 1992. The Service has issued proposed regulations providing rules for determining when §737 applies and the amount of gain or loss that must be recognized by the contributing partner under §737 (Prop Reg. §1.737-1).

Example

Dan and Ralph form a partnership, with Dan contributing property X and Ralph contributing property Y to the partnership. Y is distributed to Dan within five years of the contributions, at a time when there were no intervening distributions or dispositions of partnership property. Dan recognizes any built-in gain on X to the extent the value of Y exceeds the basis of his partnership interest.

The character of the gain is determined by reference to the proportionate character of the net precontribution gain (§737(a)). This gain is in addition to any gain the partner must recognize if the amount of money distributed is more than his or her basis in the partnership under §731.

Where a partner makes multiple contributions, built-in losses are netted against built-in gains.

Note: To the extent that contributed property is distributed back to the partner that contributed it, that partner doesn’t have to recognize gain or loss (§704(c)(1)(B)).

Anti-Abuse Rules

The regulations under §737 include anti-abuse rules that provide that the provisions of §737 must be applied in a manner consistent with the purpose of §737 (Reg. §1.737-4). Under these regulations, if a principal purpose of a transaction was inconsistent with §737, the IRS can recast the transaction to be consistent with the purpose of §737. The proposed regulations would apply to distributions made after January 8, 1995.

Contributed Property Distribution to Another Partner - §704(c)

When property with a basis different than its fair market value is contributed to a partnership, and within seven years, is distributed to a partner other than the contributing partner, the distribution is treated like a sale by the contributing partner (§704(c)(1)(B)). This provision covers both direct and indirect distributions made after June 24, 1992.

Note: The Service has issued proposed regulations to determine when §704(c)(1)(B) applies and the amount of gain or loss that must be recognized (Prop. Reg. §1.704-4).
Pre- Contribution Gain or Loss Allocation Triggers

- Contribution of property followed by its sale at anytime - §704(c)
  - Three reasonable methods:
    - Traditional
    - Traditional with curative allocations
    - Remedial allocation

- Contribution of property followed by distribution of another property to the contributor - §737

- Contribution of property followed by distribution of that property to another partner - §704(c)(1)(B)
Thus, where a partner contributes property with a basis different from its fair market value to a partnership and within seven years of the contribution, the partnership distributes the property to another partner, the following occurs:

1. The distributed property is treated as sold by the partnership for its fair market value and the contributing partner recognizes gain or loss equal to that which would have been allocated to him under §704(c); and
2. The adjusted basis of the contributing partner’s interest in the partnership, and the adjusted basis of the distributed property, is adjusted to reflect the gain or loss recognized (§704(c)(1)(B)).

However, if like-kind property is distributed to a partner after property contributed by that partner is distributed to another partner, within the time limit, and then the contributing partner does not recognize gain or loss to the extent of the like-kind property’s value (§704(c)(2)).

**Example**

Dan contributes property to a partnership at a time when its basis is $20,000 and its value is $100,000. Two years later, when the property is worth $150,000, the partnership distributes it to Ralph. Dan is treated as recognizing gain in the amount of $80,000.

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**Inside Basis of Contributed Assets - §723**

The partnership’s basis of property contributed to it by a partner is the same as the adjusted basis of such property to the contributing partner (§723). If the contributed property is nonbusiness property, the partnership’s basis is the lesser of the partner’s adjusted basis or the fair market value on the date contributed. The partnership’s basis for its assets is often called “inside basis.”

**Note:** Another option would be for the partner to sell the property to the partnership, rather than contribute it, in which case the partner would be treated under §707(a) as an unrelated party. The partnership’s inside basis would then be equal to its purchase price.

Thus, when the partnership sells the property, the previously unrecognized gain or loss would be recognized and divided among the partners (according to the allocation explained below).

**Allocation of Precontribution Gain or Loss - §704(c)**

The fair market value of property at the time a partner contributes it may be different from its adjusted basis in his or her hands. Absent rules to prevent it, the contribution (and later sale or distribution) of property with a basis different than its fair
market value could result in the abusive shifting of income, gain and loss. The purpose of §704(c) is to prevent the shifting of tax consequences among partners on precontribution gain or loss.

For property contributed to a partnership after March 31, 1984, the partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for all or any part of this difference between value and basis (§704(c)). Thus, only later appreciation or depreciation is allocated among the partners according to their agreement.

Note: The Service has issued regulations providing guidance on how to make such allocations (Reg. §1.704-3). The regulations state that any reasonable method is acceptable and suggest three sample methods.

Example

Dan contributes a liquor store down at the beach to the Free Spirit partnership when its basis is $40,000 but its value is $120,000. While Free Spirit holds the store, it further appreciates to $150,000 and it is sold to Raoul for $150,000. Free Spirit’s inside basis for the store is $40,000. However, its gain of $110,000 is not divided equally among all partners. The $80,000 unrecognized gain at the time of contribution must be allocated to Dan; the balance of the gain ($30,000) is divided among all partners (including Dan) in accordance with the profit sharing ratio of their partnership agreement.

Liabilities

Similar principles govern the assumption of liabilities by the partnership from cash basis partners (who have incurred but not yet deducted the item). When the partnership pays the debt, the entire deduction would be allocated to the contributing partner (§704(c)).

Earlier Optional Application of §704(c)

This same allocation applies to depreciation, depletion, gain, or loss on property contributed to the partnership before April 1, 1984, if the partnership agreement so provides. However, the amount allocated to a partner in this manner may not be more than the total of the amount allowable to the partnership for tax purposes. The allocation may apply to all property contributed, or only to specific items.
Pin The Tail On The Donkey
§704(C)
Character of Subsequent Gain

If contributed property was an unrealized receivable or was an inventory item to the contributing partners, any gain or loss upon disposition of such asset by the partnership is ordinary rather than capital.

Note: Under §751(c), unrealized receivables are rights to payment, not previously includable in income, for past or future sales of goods or services. Inventory items are any assets that would not be capital assets or property described in §1231.

Taint On Contribution- §724

The taint on inventory items lasts only five years after they are contributed to the partnership, but the taint on unrealized receivables lasts indefinitely (§724).

Example

El Camino Del Rey Vista Estates was property held for sale to spendthrift yuppies by partner Dan in the ordinary course of his business (See §§1221(1) & 1231(b)(1)(B)). However, once contributed to XYZ partnership, it became a capital asset (or an §1231 asset). Three years later, XYZ sells El Camino Del Rey Vista Estates at a gain. The gain is ordinary income. Note also that any portion of the gain that relates back to the time before the property was contributed to XYZ must be allocated to Dan (§704(c)).

Character of Subsequent Loss - §724(c)

If contributed property is a capital asset in the hands of the contributing partner, any loss recognized on the disposition of the property for the next five years will be a capital loss to the extent of the “built-in loss” on the asset at the time it was contributed (§724(c)).

Example

In 2016, Dan contributed a squirrel ranch that was a capital asset in his hands to the Fantasy Fur partnership. While only worth $40,000, its basis to Dan was $100,000. The asset was not a capital asset in the hands of Fantasy Fur because it is a dealer in such ranches and held the property for sale in the ordinary course of business under (§1221(1)). Fantasy Fur sells the land for $25,000 in 2018. The partnership has a $75,000 loss of which $60,000 is capital loss and only $15,000 is ordinary loss. Moreover, the $60,000 capital loss must be allocated to Dan (§704(c)).
Contribution of Services

A partner may acquire an interest in partnership capital as compensation in whole or in part for services performed or to be performed. When a partner promises to render services, and in exchange receives an interest in the capital of the partnership, he is immediately taxable on the value of that interest since the interest is considered property paid to the partner in exchange for rendering services (§83; Reg. §1.721-1(b)). The fair market value of any part of an interest in partnership capital transferred to a partner in payment for services rendered to the partnership constitutes a guaranteed payment. However, if a partner merely receives an interest in future profits, the partner may not be taxed until profits are received.

Note: A “capital interest” in a partnership entitles its owner to a pro rata share of the partnership’s assets if the partnership is dissolved. A “profits interest” entitles one only to a share of the profits but not to any part of the assets that other partners have contributed or earned.

In R.P. 93-27, the IRS held that the receipt of a profit interest for services is not a taxable event if the person receives that interest either as a partner or in anticipation of becoming one. The ruling does not apply, however, when:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. The partner disposes of the profits interest within two years of its receipt; or

The fair market value of such an interest generally must be included in the partner’s gross income in the first tax year in which the partner’s interest becomes transferable or not subject to a substantial risk of forfeiture.
The profits interest is a limited partnership interest in a *publicly traded partnership* under §7704.

**Example**

Dan, senior associate of law partnership Trials & Tribulation, is made a ten percent partner on December 31. This entitles him to ten percent of the future profits or losses of Trials & Tribulation. However, if partnership were dissolved later, Dan would receive nothing because he is not entitled to any part of the assets owned by the partnership. Dan has only a profits interest, not a capital interest.

**Basis of Partner’s Interest - Outside Basis**

It is often necessary to determine the basis for a partner’s interest in the partnership (his “outside basis”). In general, when a partner contributes property to a partnership, his outside basis is equal to the adjusted basis of the contributed asset (§722). The determination of the adjusted basis of a partner’s partnership interest is ordinarily made at the end of a partnership’s tax year. However, if there has been a sale or exchange of all or a part of the partner’s interest or a liquidation of his or her entire interest in a partnership, the adjusted basis of the interest must be determined on the date of the sale, exchange, or liquidation. A partner’s adjusted basis for an interest in a partnership can never be less than zero.

The adjusted basis of a partner’s interest is determined without regard to any amount shown in the partnership books as a capital, equity, or similar account.

**Example**

Dan contributes to a partnership property that has an adjusted basis of $400 and a fair market value of $1,000. His partner contributes $1,000 cash. While under the partnership agreement each has a capital account in the partnership of $1,000, which will be reflected in the partnership books, the adjusted basis of Dan’s interest is only $400 and his partner’s basis is $1,000.

**Original Basis - §722**

The original basis of an interest acquired by contributing property and money is the money a partner contributed plus the adjusted basis of the property he or she contributed. If the acquisition of an interest in a partnership results in taxable income to the partner, the income will generally be included in the basis of his or her interest.
Adjustments to Basis

The original basis of an interest will be *increased* by:

1. Further contributions to the partnership,
2. The partner’s distributive share of both taxable and nontaxable partnership income,
3. The excess of the deductions for depletion over the basis of the depletable property, and
4. His or her share of an investment credit recapture adjustment to any partnership property basis that was reduced when the credit was taken.

A partner’s basis will be *decreased* (but never below zero) by:

1. The amount of money and the adjusted basis of property distributed to the partner by the partnership,
2. His or her distributive share of the partnership losses (including capital losses),
3. Nondeductible partnership expenses that are not capital expenditures,
4. The amount of any deduction for depletion with respect to oil and gas wells, and
5. The partner’s share of any partnership property basis reduction that is required if the property qualifies for the investment credit.

If a partner receives distributions of money or other property in a year in which there is a partnership loss, he or she must take the distribution into account *before* computing the amount of the partnership loss that can be deducted.

Effect of Liabilities - §752

Changes in partnership liabilities affect a partner's outside basis as if cash were contributed or distributed by the partnership. Thus an increase in partnership liabilities increases a partner’s outside basis - as if he had contributed cash to the partnership (§752(a)).

A decrease in partnership liabilities decreases outside basis - as if the partnership had distributed cash to him (§752(b)). Similarly, if a partnership takes over a partner’s liability, this decreases his outside basis (§752(b)).

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[8] The term liabilities includes the partnership’s obligations for the payment of outstanding trade accounts, notes, and accrued expenses whether or not they are recorded on the partnership books under its method of accounting.
Example

Beauregard contributes Terra to Stars & Bars, an equal partnership made up of Beauregard and Scarlet. The basis of Terra in Beauregard’s hands is $120,000; its value is $200,000. Terra is subject to a $30,000 liability owed to dirty rotten Yankee carpet baggers. Beauregard’s outside basis is increased $105,000; $120,000 (basis of Terra), decreased by $30,000 (partnership took over his liability), increased by $15,000 (Beauregard’s share of increase in liabilities). Scarlet’s outside basis is also increased $15,000 (her share of increase in liabilities). If Stars & Bars pays off the liability, Beauregard and Scarlet would each decrease their outside basis $15,000.

Deemed Distribution & Contribution

A decrease in a partner’s share of liabilities, or an assumption by a partnership of a partner’s personal ability, is treated as a distribution of money. If the “distribution” exceeds a partner’s outside basis, gain is recognized. (§731(a)(1)). If property is contributed subject to indebtedness or if a partner’s liabilities are assumed by the partnership, the basis of that partner’s interest is reduced by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners’ assumption of the liability is treated as though they contributed money to the partnership.

Example

John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of $8,000 and a $4,000 mortgage. The partnership assumed payment of the mortgage. The adjusted basis of John’s interest is the adjusted basis of contributed property ($8,000), less the part of mortgage assumed by other partners and treated as a distribution ($3,200, i.e., 80% of $4,000) or $4,800.

Example

If, in the above example, the property John contributed had a $12,000 mortgage, the adjusted basis of his partnership interest would be zero. The difference between the amount of the mortgage assumed by the other partners, $9,600 (80% x $12,000), and his basis of $8,000 would be treated as his gain from the sale or exchange of a capital asset. However, this gain would not increase the basis of his partnership interest.
Special Rule for Liabilities of Cash Basis Partnership

Accrued but unpaid liabilities of cash basis partnerships are not treated as liabilities for §752 (H.R. Rept. 98-861, p. 856).

Example

Attorney Dan (who uses the cash method of accounting) contributes his solo law practice to Robbing & Rooking partnership. The basis for the contributed assets is $3,000. Dan owes $7,000 in debts for pencils and white out, which he has not paid. His outside basis is $3,000 and he does not have gain on the contribution.

Partner’s Share of Partnership Liabilities

A partner’s share of partnership liabilities will be determined in accordance with the partner’s ratio for sharing losses under the partnership agreement. However, when none of the partners has any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners will be considered as sharing this liability in the same ratio as they share the profits.

Limited partnerships

In a limited partnership, the limited partners are not liable for partnership debts in excess of their contribution, but the general partner has unlimited liability. Therefore, an increase in partnership liabilities increases the outside basis only of the general partner, not the limited partner.

Exception

If none of the partners has any personal liability on the debt (as in a “nonrecourse” mortgage), both general and limited partners increase their outside bases by the amount of such loan (Reg. §1.752-1(e); R.R. 77-309). However, the “at-risk” rules of §465 may deny the partners the benefit of the basis increase from the nonrecourse loan.

Guarantees

If a loan to the partnership is nonrecourse, but the general partner guarantees it, the loan is allocated entirely to the general partner, not to the limited partners (Deficit Reduction Act of 1984, §79 - requiring Commissioner to amend the regulations under §752; R.R. 83-151).
Example

Lazlo and Raoul are equal partners in Deferred Maintenance a limited partnership that owns a combined low income housing project and polo field. The partnership borrows $500,000 for which the partnership is liable. Lazlo (the general partner) increases his basis $500,000; Raoul does not increase his basis. If Deferred Maintenance were not liable to repay the $500,000, each partner would increase his basis $250,000.

Limits on Deduction of Partnership Losses

At-Risk Rules - §465

A partner can deduct partnership losses only to the extent of his outside basis (§704(d)). However, a partner also is not permitted to deduct partnership losses beyond the amount they have placed “at risk” in the partnership. Special at-risk rules apply to most activities, including activities of a partnership, which are engaged in as a trade or business or for the production of income. These rules limit the amount of loss a partner may deduct to the amounts for which that partner is considered at risk in the activity. Thus, a partner may not deduct losses of the partnership by reason of increases in their basis occurring because of partnership liabilities for which they are not personally liable (§465).

Example

Downtrend & Upshot is a 50-50 partnership (general or limited) which makes stock market investments in South American junk bonds. The partnership borrows $100,000 to buy bonds but has no liability to repay it (since all debts related to South American bonds are insured by U.S. taxpayers). Neither partner can use their share of the $100,000 debt for deducting partnership losses. However,
they can add the debt to their outside basis for any purpose other than deducting losses, e.g., to avoid tax on a cash distribution.

Definition of Amounts at Risk

A partner is considered at risk for:

(1) The amount of money and the adjusted basis of any property he or she contributed to the activity,

(2) The income retained by the partnership, and

(3) Certain amounts borrowed by the partnership for use in the activity.

However, a partner is generally not considered at risk for amounts borrowed unless that partner is personally liable for repayment, or the amounts borrowed are secured by the partner’s property other than property used in the activity. A partner is not considered at risk for amounts protected against loss through guarantees, stop-loss agreements, or other similar arrangements. Nor is the partner at risk for amounts borrowed if the lender has an interest in the activity (other than as a creditor) or if the lender is related to a person (other than the partner) having such an interest.

Passive Losses - §469

Section 469 limits the amount taxpayers can deduct for passive activity losses and credits. The passive activity limits do not apply to the partnership. Instead, they apply to each partner’s share of loss or credit from passive activities. Because the treatment of each partner’s share of partnership income, loss, or credit depends on the nature of the activity that generated it, the partnership must report income, loss, or credits separately for each activity.

Generally, passive activities include activities that involve the conduct of a trade or business if the partner does not materially participate in the activity. It also includes rental activities, regardless of the partner’s participation. The level of each partner’s participation in an activity must be determined by the partner.

Sales & Exchanges of Partnership Interests

A partnership interest is treated as a capital asset (§741). When it is sold or exchanged, gain or loss is recognized to the transferor partner. Such gain or loss is measured by the difference between the amount realized and the selling partner’s adjusted basis in the partnership. It is capital gain or loss, except as provided in §751 - dealing with unrealized receivables and substantially appreciated inventory (§741).
Exchanges & Transfers

On occasion, partnership property or one’s partnership interest might be involved in an exchange rather than a sale, such as when a partnership incorporates or when partners in more than one entity swap interests therein. The tax consequences of an exchange usually are the same as those of a sale. The distinction between sales and exchanges is important, because certain exchanges qualify as nontaxable events.

Like-Kind Exchanges - §1031

An exchange of partnership interests does not qualify for nonrecognition under §1031 and, therefore, is equivalent to a sale. Section 1031(a)(2)(D) indicates that the like-kind exchange rules do not apply to the exchange of partnership interests.

Transfers to Controlled Corporations - §351

Section 351(a) provides that gain or loss is not recognized on the transfer by one or more persons of property to a corporation solely in exchange for stock in that corporation if, immediately after the exchange, such person or persons are in control (80% test) of the corporation to which the property was transferred.

Partner’s Interest Basis

The transfer of a partnership interest to a corporation will be treated as a nontaxable exchange if the conditions of §351 are met. However, the transferor partner generally recognizes gain to the extent that any debt assumed by the corporation or debt to which the partner’s interest is subject exceeds the interest basis (§357(c)).

Note: When a cash basis partnership incorporates and normal operating debts (e.g., salaries and wages due employees, unpaid utilities, and rents due for the use of property) exist that exceed the basis of transferred property, the general rules of §351 trigger gain recognition. However, if such debt is either §736(a) income payments to a partner or an item that otherwise would be deductible, no gain is recognized.

All items of partnership income or loss, deduction, or credit due to the transferred interest are apportioned between the transferor partner and the corporation. Moreover, if the partnership interest transferred represented 50% or more of the total interest in capital and profits, the partnership is terminated. When gain is recognized in the transfer of a partnership interest to a controlled corporation, determining its character requires an allocation similar to the sale of a partnership interest.
Incorporation Methods

When partners decide to incorporate their business, at least three alternative methods might be used to accomplish the desired change in form:

1. The partnership transfers all its assets to the corporation in exchange for stock and the assumption of partnership liabilities. The stock then is distributed to the partners in proportion to their partnership interests.

2. The partnership makes a pro rata distribution of all its assets and liabilities to its partners in complete liquidation. The partners then transfer their undivided interests in the assets and liabilities to the corporation in exchange for stock under §351.

3. Each partner’s interest is transferred to the corporation in exchange for stock under §351. As a result, the partnership terminates, and the corporation owns all partnership assets.

If existing partnership debt was not created in a tax avoidance scheme and it does not exceed the basis of transferred assets, none of the three incorporation methods generate a recognized gain or loss. However, they do cause different tax results (R.R.. 84-111). Thus, selecting the appropriate incorporation method is crucial.

If the corporation plans to issue §1244 stock, the original shareholders, not the partnership, must be partners. Otherwise, any ordinary loss benefits of the stock issue will be forfeited when the partners become shareholders.

If an S election is to be made by the corporation after the partnership’s assets are received, such an election will be invalid if the partnership is the shareholder (Reg. §1.1371-1(e)). If the corporation is already in existence and operates under an S election, the election will terminate if the partnership is a shareholder.
INCORPORATION OF A PARTNERSHIP

#1

OLD PARTNERSHIP

$4 MIL ASSETS
$3 MIL BASIS
$1 MIL DEBT

ASSETS

STOCK

TWO PARTNERS

STOCK BASIS
$.5 MIL EACH

NEW CORPORATION

$4 MIL ASSETS
$3 MIL BASIS
$1 MIL DEBT

STOCK

#2

OLD PARTNERSHIP

$4 MIL ASSETS
$3 MIL BASIS
$1 MIL DEBT

ASSETS

TWO PARTNERS

STOCK BASIS
$.5 MIL EACH

NEW CORPORATION

$4 MIL ASSETS
$2 MIL BASIS
$1 MIL DEBT

STOCK

#3

TWO PARTNERS

STOCK BASIS
$.5 MIL EACH

NEW CORPORATION

$4 MIL ASSETS
$2 MIL BASIS
$1 MIL DEBT

PARTNERSHIP INTERESTS

STOCK
Thus, when a partnership is to be incorporated with §1244 stock or an S election is desirable, the partnership should undertake methods (3) or (1) and make a pro rata distribution of all its assets and liabilities to its partners in a complete liquidation. The partners then should transfer these items to the corporation in a §351 exchange.

**Hot Assets - §751**

A major exception to capital gain or loss treatment on the sale or exchange of a partnership interest arises when the partnership has hot assets that cause ordinary income to be recognized. When a partnership interest is sold, the consideration that is allocable to the partnership’s unrealized receivables and inventory becomes ordinary income to the selling partner (§751(a)). Thus, for this purpose, the partnership is treated like an aggregate rather than an entity; the consequences to the selling partner are the same as if he had sold the underlying assets instead of the partnership interest.

**Unrealized Receivables**

The term “unrealized receivables” generally includes receivables from the sales of ordinary income property and rights to payment for services. Sometimes the method of accounting, the nature of the property, or the property’s holding period affects whether an item is an unrealized receivable. For instance, under the cash method of accounting, trade receivables from inventory sales and from services rendered (including related notes receivable) are included in the term, while under the accrual method they are not. The gain element in installment receivables from the sale of capital assets or §1231 assets is excluded, but that which relates to ordinary income is included in unrealized receivables (§751(c)).

**Example**

Restitutionary rights to payment for unbilled legal services are unrealized receivables. *(Logan v. Commissioner, 51 T.C. 482 (1968))*

**Depreciation Recapture**

Suppose the partnership owns assets on which depreciation would be recaptured as ordinary income if the partnership had sold the assets (§1245 &
§1250). This recapturable depreciation is considered to be an “unrealized receivable” (§751(c)). Thus, on a sale of a partnership interest, the amount received which is allocable to the recapturable depreciation becomes ordinary income.

Inventory

The term “inventory” includes virtually all partnership property except money, capital assets, and §1231 property (Reg. §1.751-1(d)). Specifically, the term includes inventory and other similar noncapital and non-§1231 assets.

“Inventory Items”

This term refers to any assets that, if sold by the partnership, would not be capital assets or property described in §1231. Thus, parcels of real property subdivided primarily for sale to customers in the ordinary course of business are inventory items (§1221(1), §1231(b)(1)(B); Estate of Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968)). Accounts and notes receivable of an accrual basis partnership are also included in the definition of inventory under §751(d), since they are neither capital assets nor §1231 assets.

This definition is broad enough to include all items considered to be unrealized receivables (Reg. §1.751-1(d)(2)(ii)). The disadvantage of including unrealized receivables in inventory can be seen when a determination is made on whether the inventory is substantially appreciated. Because unrealized receivables usually are included at a zero basis in the tests to determine if the inventory is substantially appreciated, they greatly enhance the possibility of this event occurring.

Basis of §751 Property

Under §751, use original asset costs, without regard to special partnership basis adjustments, and inventory bid prices for quantities representing typical purchases. Thus, in making the necessary computations under §751, the basis of an unrealized receivable and of inventory is the same as its inside basis. Of course, the inside basis for an unrealized receivable for rendering services would generally be zero (Reg. §1.751-1(a)(2); §732). The amount allocated to §751 items in the contract of sale of the partnership will generally be regarded by the IRS as correct (Reg. §1.751-1(a)(2)).

Example

The We R Retail Partnership is on the cash basis and has unrealized accounts receivable of $150,000. Dan’s interest therein is $75,000. His outside basis is $200,000 and he sells it for $230,000. However, he first must allocate $75,000 of the sale price to the unrealized re-
ceivables, the basis of which is zero. Thus, Dan has $75,000 of ordinary income. The remaining $155,000 of the sale price is allocated to the balance of the partnership interest. Dan has a $45,000 capital loss on the balance of his partnership interest ($200,000 less $155,000). (See Reg. §1.751-1(g) - additional examples)

**Tax Reporting**

When a partnership owns hot assets, partners who sell or exchange a partnership interest must promptly notify the partnership of such transfers. After the notification is received, the partnership must file an information return with the IRS for the calendar year in which such transfers took place. The return will contain the names and addresses of the transferors and transferees and such other information prescribed by statutory Regulations. In addition, each person whose name is shown on the calendar year return is to be furnished the name and address of the partnership making the return and the information shown on the return as to such person. To avoid incurring any reporting penalties, Regulations under §6050K and §6678 should be consulted when hot assets are present and a partnership interest changes hands.

**Effect**

Thus, the ordinary income from the sale of assets held for sale to customers (see §1221(1)) cannot generally be avoided by the sale of a partnership interest. However, if the assets have not appreciated in excess of 120% of basis, the ordinary income can be transformed into capital gain through a sale of the partnership interest. Furthermore, even though the partnership had property that would produce a short-term capital gain, a sale of a partnership interest held over one year could still produce long-term capital gain.

**Capital Gains - Regulations**

The Service has issued proposed regulations on the taxation of capital gains from sales or exchanges of interests in partnerships, S corporations, and trusts. The proposed regs interpret the look-through provisions of §1(h) and explain the rules on dividing the holding period of a partnership interest. The regs reflect changes made to §1(h) by the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998 (REG-106527-98 (August 6, 1999)).

Under the proposed regs, when a sale or exchange of an interest in a partnership, S corporation, or trust involves collectibles gain or §1250 gain, the amount of each type of gain would be determined as if the entity had sold all of its collectibles or §1250 property in a fully taxable transaction immediately before the transfer. The proposed regs provide special rules that would apply when a partner, shareholder,
or beneficiary recognizes less than all of the gain on the sale or exchange of the interest.

In applying §1(h)(7)(B), the proposed regs provide that gain from the sale of a partnership interest that results in §1250 gain would not be treated as §1231 gain even if §1231 could apply to the disposition of the underlying property.

The proposed regs also provide rules on the allocation of a divided holding period for a partnership interest. Generally, a holding period would be divided if a partner acquired portions of an interest at different times or if an interest acquired in a single transaction had different holding periods under §1223. The holding period for a portion of a partnership interest would be determined based on a fraction equal to the fair market value of the portion to which the holding period relates over the fair market value of the entire interest.

Finally, the proposed regs would permit a selling partner of a publicly traded partnership to use the actual holding period of the interest sold if:

(1) The interest is divided into identifiable units with ascertainable holding periods, and

(2) The selling partner can identify the portion transferred. (Reprinted with permission. Copyright 1999. Tax Analysts.)

Liabilities of Partnership

In computing both the amount realized on the sale of a partner’s interest and the adjusted basis of the sold interest, the selling partner counts partnership liabilities (§752(b), (d)). Likewise, the purchasing partner includes any assumed indebtedness as a part of the consideration paid for the partnership interest.

Example

Daphne sells her partnership interest for $200,000 cash. Her share of partnership liabilities was $80,000. Her amount realized is $280,000.

The general rules do not change even if the loan is nonrecourse and is secured by property worth less than the loan. The selling partner is still considered to realize the full amount of the loan (§7701(g); Commissioner v. Tufts, 461 U.S. 300 (1983)).

Basis of Partnership Assets after Transfer of Interest

General Rule - §743(a)

Ordinarily the inside basis of a partnership asset is not changed merely because a partnership interest has been sold or because of current or liquidating distributions (§743(a)). This rule can produce inequitable results.
Example

In a partnership owning a building with a basis of $30,000 and a fair market value of $90,000, Dan buys a one-third interest in the partnership for $30,000 (an amount equal to one-third of the value of the building). The price paid for the interest was based on fair market value, however, the building’s depreciation is still determined on the partnership’s basis of $30,000, and the new partner’s share is only $10,000.

Special Basis Adjustment - §754 & §743(b)

However, the Code provides that inside basis can be adjusted upon a transfer of a partnership interest. If the partnership makes an election under §754, inside basis will be adjusted as to the partner who acquired the interest so that it is the same as what that partner paid for the interest (§743(b)).

Partnership Distributions - §731

Ordinarily, the distribution of cash or property by the partnership to the partners is not a taxable event. No gain or loss is recognized by a partnership on the distribution of money or other property to a partner (§731(b)).

Note: If a partner is legally obligated to repay any deficit in his capital account, the deficit is treated as a loan, not a distribution. If the partner’s obligation to repay is forgiven or cancelled, the partner is considered to have received a distribution of money or property at the time of cancellation (Reg. §1.731-1(c)(2)).

Similarly, no gain or loss generally is recognized by a partner receiving such distributions, except that:

1. A partner recognizes gain to the extent any money distributed exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution (his “outside basis”) (§731(a)(1)). Thus, when the money distributed to a partner is less than the adjusted basis of the partner’s interest, no gain is recognized to the partner, even if property worth more than the excess of the adjusted basis over the money distributed is also distributed (Reg. §1.731-1(a)).

Note: Any gain recognized is treated as gain from the sale or exchange of a partnership interest (§731(a)). The character of such gain is determined under rules previously discussed governing the sale of a partnership interest. A reduction in a partner’s liabilities (due either to the partnership’s assumption of them

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9 However, a distribution of unrealized receivables or substantially appreciated inventory may be taxable to the partnership.
or a reduction in the partner’s share of partnership liabilities) is treated as a money distribution (§752(b)).

2. Loss is recognized to the extent the adjusted basis of the partner’s interest exceeds the sum of any money, and the basis to the distributee of any unrealized receivables and inventories received if the distribution is in liquidation of the partner’s interest in the partnership and no other property is distributed. This is treated as a loss from the sale or exchange of the partner’s interest (§731(a)).

Election to Report Proportionately: Except for disproportionate distributions (discussed below), gain is not realized under the general distribution rule until the basis is first recovered, and loss is not realized until the final payment has been received. However, where the total retirement or death payments relating to the partner’s property interest are a fixed sum, a retiring partner or a deceased partner’s successor may elect to report a proportionate part of the gain or loss each year. This election must be made in the first tax year for which a payment is received. A statement must be attached to that return indicating the election and showing the computation of the gain included in gross income (Reg. §1.736-1(b)(6)).

Exceptions to General Rule

There are several exceptions to the general rule on nonrecognition of a partner’s gains or losses:

1. Any distribution within 7 years of the contribution to a partner contributing property with a basis different than its fair market value (see earlier discussion);
2. Distributions of property contributed by one partner to another partner within 7 years of the contribution (see earlier discussion);
3. Liquidation payments made to a retiring partner or to a deceased partner’s successor in interest (see later discussion) as a share of income or as a guaranteed payment; and
4. A disproportionate distribution treated as a sale or exchange of property (see later discussion).

Basis Adjustments

Partner’s Interest - §733

Nonliquidating distributions from a partnership reduce the basis of the distributee partner’s interest (but not below zero) by:

(1) The sum of money distributed, and
(2) The basis to such partner of distributed property other than money.

Thus, the outside basis is reduced (but not below zero) by the amount of any money distributed to the partner and by the basis to such partner of distributed property other than money (§733).
**Property Received - §732**

The basis of *property* (other than money) distributed to a partner in a *nonliquidating* distribution is the asset’s adjusted basis to the *partnership* immediately before the distribution. Thus, when a partnership distributes property other than money, the partner has the *same* basis in such property as the partnership had (§732(a)). Note, the outside basis would be *reduced* by that *same* amount.

**Basis Limitation - §732(a)**

The basis of property received may *not* exceed the adjusted basis of the partner’s interest *reduced* by any money received in the same transaction (§732(a)). The result may be that some of the basis of the distributed property could disappear.\(^{10}\)

**Example**

*The adjusted basis of Mike’s partnership interest is $10,000. He receives a nonliquidating distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 minus $4,000, the cash he receives).*

There is a *different* rule for distributions in *complete* liquidation. The basis of property received in *complete* liquidation of a partner’s interest is equal to the adjusted basis of the partner’s interest in the partnership, reduced by any money distributed to the partner in the same transaction.

**Allocation of Basis When Limited - §732(c)**

*When* the basis of distributed assets is *limited* by the partner’s interest, an allocation of basis *must* be made. Under §732(c), basis is allocated to:

1. Any unrealized receivables and inventory items in an amount equal to the partnership’s adjusted basis for each such asset; *and*

2. Any balance of the total basis to be allocated is assigned to any other distributed assets in proportion to their adjusted basis to the partnership.

Thus, when unrealized receivables or inventory is *not* involved, the remaining basis of the partner’s interest is allocated to the assets in the ratio of their adjusted basis to the partnership.

\(^{10}\) A §754 election might solve this problem
Example

The adjusted basis of Ted’s partnership interest is $30,000. In complete liquidation of his interest, Ted receives $10,000 in cash, inventory items having a basis to the partnership of $12,000, and two parcels of land having adjusted basis to the partnership of $12,000 and $4,000.

The basis of Ted’s partnership interest is reduced to $20,000 by the $10,000 cash. This $20,000 basis is then divided among the properties he received. The inventory items in his hands now have a basis of $12,000. To divide the balance of $8,000, Ted adds the bases of the land ($12,000 and $4,000), then takes 12,000/16,000 of $8,000 and 4,000/16,000 of $8,000. The bases of the two parcels of land in his hands are $6,000 and $2,000 respectively.

Partnership’s Basis Greater Than Partner’s Basis

If the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to a partner is greater than the adjusted basis of the partner’s interest (reduced by the money distributed to him or her in the same transaction), the amount of the basis to be divided among these items is in proportion to the partnership’s adjusted basis of the items.

Example

Jenny’s basis for her partnership interest is $18,000. In a distribution in liquidation of her entire interest, she receives $12,000 cash, inventory items having an adjusted basis to the partnership of $12,000, and unrealized receivables having a basis to the partnership of $8,000. The basis of her partnership interest is reduced to $6,000 by the $12,000 cash she receives. This $6,000 basis is divided proportionately between the inventory items and the unrealized receivables. Jenny’s basis for the inventory items is $3,600 ($12,000/20,000 of $6,000). Her basis for the unrealized receivables is $2,400 ($8,000/20,000 of $6,000).

Partner’s Basis Greater Than Partnership’s Basis

If the basis of a partner’s partnership interest to be divided is more than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.
Special Adjustment to Basis

If a partner receives a distribution of property other than cash, the partner may choose a special basis adjustment if:

1. The distribution is made within 2 years after acquiring any part of his or her partnership interest by a sale or exchange or on the death of a partner, and
2. The partnership has not chosen the optional adjustment to basis.

If a partner chooses this special basis adjustment, the partner’s basis for the property distributed is determined by assigning to the distributed property the same adjusted basis it would have had if the partnership had chosen the optional adjustment to basis. However, this assigned adjusted basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership previously had chosen the optional adjustment.

Holding Period - §735

The holding period for property distributed in kind to a partner includes the period that the partnership held the property (§735(b)). If it was contributed to the partnership by the partner, the recipient partner’s holding period also includes the period that the property was held by the contributing partner before the contribution (Reg. §1.735-1(b)).

Partnership Property - §754 & §734

If an election under §754 is in effect, the basis of partnership property is increased upon a distribution to a partner under §734 by the following:

1. Any gain recognized by a distributee partner; and
2. The excess of the adjusted basis of any distributed property to the partnership over the adjusted basis of that property in the hands of the distributee.

Conversely, the following decreases the basis of partnership property:

1. Any loss recognized by a distributee partner; and
2. For a liquidating distribution, the excess of the distributee’s adjusted basis of any distributed property over the basis of such property to the partnership.

Distributions of Receivables or Inventory

Proportionate Distributions

If a partner receives his or her proportionate share of partnership assets in kind, the distribution will not be treated as a sale or exchange. Even, if the partner receives, in kind, his or her share of the partnership’s unrealized receivables or
substantially appreciated inventory items, the distribution of these items will not be treated as a sale or exchange.

Thus, when a partner’s proportionate share of the hot assets is received in a distribution, §751 does not apply, and the general nonrecognition rule controls the tax consequences of the distribution.

Although a proportionate distribution of hot assets may not immediately result in income recognition, any later disposition of unrealized receivables by the distributee partner triggers full ordinary gain or loss recognition. Similarly, a subsequent sale or exchange of inventory items triggers ordinary gain or loss recognition if the partner sells or exchanges such items within five years of the distribution date (Reg. §1.735-1(a)(2)). When the distributed inventory is held over five years, the character of any gain or loss is determined by the character of the property in the hands of the distributee. This rule applies to all inventory items regardless of whether they were substantially appreciated.

Example

Dan receives a proportionate share of inventory items (basis equal to $160,000) in a nonliquidating distribution from the partnership. Fourteen months later, Dan sells the property for $200,000. Even though a capital asset in Dan’s hands, the $40,000 recognized gain is taxed as ordinary income. If the five-year holding period had been met, the $40,000 gain would have been a long-term capital gain.

Disproportionate Distribution - §751(b)

A distribution is “disproportionate” when a partner receives more than his proportionate share of partnership property in the first of the following categories and less than his proportionate share of property in the second category, or vice versa:

(1) Unrealized receivables (including recapturable deductions, certain transfers of franchises, trademarks or trade names) and substantially appreciated inventory items; and

(2) Other property (including money).
In a disproportionate distribution, a partner, in effect, sells or exchanges part or their entire share in property of one category for property of the other category. Such a distribution normally results in recognition of gain or loss to the partner and the partnership. The general rules on partnership distributions apply to the balance of the distribution not treated as a sale or exchange (Reg. §1.751-1(b)).

**Partnership Liquidations**

Distributions in liquidation of partnership interests get flexible treatment and have a multiple character:\(^\text{11}\):

1. Similar to all partnership distributions they are treated as a tax-free return of capital. Unlike corporate shareholders, partners may be able to withdraw their investment without tax consequences.\(^\text{12}\).
2. Depending upon how the transaction is structured, a liquidating distribution may have the same effect as the sale of a partnership interest requiring the parties to recognize gain or loss.

**Types of Liquidating Distributions**

Liquidating distributions can take several forms. A partner’s interest can be liquidated by a series of cash payments or a lump-sum distribution in kind. For example:

1. The cash payments may be based on the partnership’s annual income or may be a guaranteed payment.
2. Distributions in kind may be a lump sum or one of a series in liquidation of a partnership interest.

\(^\text{11}\) However, entirely different rules apply if the interest is sold to another partner.

\(^\text{12}\) Under the general rule, unrealized appreciation or depreciation in the market value of distributed partnership property is not recognized. Thus, the basis of such property is determined by reference to the property’s basis in the hands of the partnership and the basis of the distributee partner’s interest before the distribution.
Statutory rules differ as to liquidating distributions of money and distributions of other property.

Liquidating Distributions of Money

The character and treatment of liquidating distributions of money are governed by §736. Money payments are allocated between amounts paid for the partner’s interest in partnership property under §736(b) and other payments under §736(a). (Reg. §1.736-1(a)(2)) This allocation generally is made under the partnership agreement.

Section 736(a) Payments

Cash payments made to a retiring or deceased partner shall, except as provided below, be considered as a distributive share or as a guaranteed payment:

1. As a distributive share (i.e., income distribution), if they are determined by reference to the partnership income, thus reducing the amount of partnership income available to the continuing partners.
2. As guaranteed payments, if they are not determined by reference to the partnership income, thus producing a deduction from gross income to arrive at the partnership’s taxable income.

The amount received is ordinary income to the recipient whether it is a distributive share or a guaranteed payment. If it is a distributive share, it also increases the recipient’s outside basis by the amount of the distributive share; outside basis is then reduced by the amount of cash actually distributed. If it is treated as a guaranteed payment, it does not affect outside basis at all (§736(a)).

Section 736(b) Payments

When the cash payment is made in exchange for the interest of the retiring or deceased partner in partnership property, it is treated as a current distribution (nonliquidating) by the partnership and not as a distributive share or a guaranteed payment.

Liquidating cash payments under §736(b) are considered a return of capital to the extent of the partner’s basis in the partnership, and capital gain is recognized to the extent of any excess. However, if substantially appreciated inventory is present, ordinary income is created in the year received (Reg. §1.736-1(a)(5)).

Thus, when cash distributed exceeds the recipient’s outside basis, it creates capital gain and if it is less than basis, it generates capital loss. There is no deduction to the other partners (§736(b)).
Distributions of Property in Liquidation

In some situations, partnerships find it impractical or undesirable to liquidate a retiring partner’s interest solely by cash distributions. Instead, some or all the withdrawing partner’s interest is liquidated through other property distributions. If the partnership does not have §751 property or if the distributions do not change the proportionate ownership of such property, the tax treatment of liquidating property distributions is essentially the same as current (nonliquidating) distributions. Thus, when a partnership distributes property in liquidation, there is usually no gain or loss recognized to the partner. The property received takes a basis equal to the partner’s outside basis less any money also distributed (§732(b) & §731(a)(2)).

Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

26. Upon a termination of a partnership, the taxable year closes as to all partners, and the partners must show on the partners’ returns all income or losses to the date of termination. Also, what are the partnership’s assets considered upon such termination?
   a. to be sold.
   b. to be distributed.
   c. to be a contribution to a new partnership.
   d. to be capitalized.
27. An event that terminates a partnership for all partners is the discontinuance of the business. What other event can terminate the partnership?
   a. the death of a partner.
   b. the entry of a new partner.
   c. a sale or exchange of 50% or more of the partnership interests.
   d. the liquidation of a partner's interest.

28. A partner may agree to perform services for a partnership. What term is used for the partner’s salary that is determined without reference to the partnership's income?
   a. a guaranteed payment.
   b. a syndication cost.
   c. a startup expenditure.
   d. a disproportionate allocation.

29. A sale or exchange can occur between two related partnerships with common ownership. In these instances, what results?
   a. Neither entity can dispose of the property for two years.
   b. Any loss can be disallowed.
   c. It is deemed a capital contribution.
   d. It is always treated like a sale between strangers.

30. According to the IRS in R.P. 93-27, when a person renders services in exchange for a profit interest, such event is nontaxable. When does R.P. 93-27 apply?
   a. even if the profits interest relates to an expected income flow.
   b. even if the interest is sold within 2 years.
   c. even if the person receiving that interest is or expects to become a partner.
   d. even if the interest is publicly traded.

31. Generally, when a partnership distributes cash or property to partners, the event is nontaxable. Thus, which of the following events is nontaxable?
   a. A retiring partner receives a liquidation payment.
   b. The year after a partner makes a contribution to another partner, a distribution of property is made.
   c. A disproportionate distribution is treated as an exchange of property.
   d. The adjusted basis of the partner’s interest is more than the partner’s distribution.
Learning Objectives

After reading Chapter 3, participants will be able to:

1. Identify the characteristics of limited liability companies (LLCs) that distinguish them from other entities, particularly C corporations, and specify benefits of an LLC and their effect on choosing a form of entity.

2. Cite reasons for choosing an LLC over S corporations, limited partnerships, and general partnerships and, in contrast, determine the drawbacks of LLCs to assist clients in entity selection.

3. Identify several ways to use the LLC form effectively and thereby fit client objectives and expand business-planning opportunities.

4. Recognize the varying tax consequences of forming or converting to an LLC including possible tax differences using the California Limited Liability Company Act.
CHAPTER 3

Limited Liability Companies

Introduction

A LLC is a non-corporate business that provides its members with a variety of potential tax and legal benefits including limited liability, a single tax, and the option to participate actively in the entity’s management.

Note: Members or designated managers are not personally liable for company debts in a limited liability company.

The Internal Revenue Code does not specifically recognize an LLC as a distinct entity. Thus, an LLC could be treated for tax purposes as:

1. A partnership,
2. An association taxable as a corporation, or
3. A trust.

Although exhibiting the corporate characteristic of limited liability, the entity is usually treated as a partnership for federal tax purposes because it could be organized without continuity of life, centralized management, or free transferability of interests.
Advantages of an LLC

• Similar advantages to limited partnership
• Special allocations available
• Good asset protection
• Separate legal entity
• No restriction on number of members
• Tax consequences flow thru
• Members can employ managers
• Valuation discounts
• Tax free liquidations
• Pass through of entity debt
LLC Benefits

When a limited liability company is characterized as a partnership for tax purposes it can provide several benefits:

(1) Pass-through of tax attributes under the partnership tax rules;
(2) Limited liability to all members;
(3) Control over the business by the members without the risk that management participation will cost members their limited liability; and
(4) Freedom from S corporation eligibility requirements.

Advantages of LLCs over C Corporation

Double Tax

C Corporations pay an entity level federal and state income tax. The distributed income of a C corporation may be taxed twice as the shareholder is also taxed on dividends received from the C corporation. Perhaps the biggest benefit of the LLC over the C corporation is that the LLC is subject to one level of tax which is paid by the members of a LLC that is characterized as a partnership.

Note: C corporations may be subject to an accumulated earnings tax or a personal holding company tax. These taxes are not imposed on an LLC.

Basis Adjustment

A C corporation cannot adjust the tax basis of its assets in connection with a transfer of its shares. If the LLC makes a §754 election then the LLC can adjust the tax basis of its assets in connection with transfers of membership interests. If the LLC is holding assets with a fair market value in excess of basis, the availability of such an adjustment may be valuable and may help the transferring member to obtain a higher price for his interest.

In addition, the basis of the member’s interest in an LLC and the S corporation are increased by the corporation’s profits (or reduced by losses). The basis of the C corporation shareholder in his stock investment is not affected by the profits of the corporation that means upon sale the C corporation shareholder will pay tax on the value of earnings retained in the C corporation.

Special Allocations

A C corporation may not specially allocate income or loss to its shareholders. An LLC, because it is treated as a partnership for income tax purposes, may specially allocate income or loss within the provisions of §704(b).
Contributions

Corporations cannot receive tax-free contributions of property unless, immediately after the contribution, the contributor (alone or with others making contributions in related transactions) holds at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. LLCs generally can receive tax-free contributions of property from any member.

Liquidation

A C corporation is subject to a double tax on liquidation. An LLC generally can be liquidated without triggering any adverse tax consequences to the members.

Unreasonable Compensation

C corporations often run the risk of having shareholder salaries characterized as “unreasonable compensation” and disallowed. The unfortunate consequence of this result is that the payment is taxed as a dividend. The LLC does not run such a risk as it is generally irrelevant to the Service whether the member takes the payment as salary or distributive share of the LLC income under §701.

Non-Tax Benefits

Other non-tax advantages include the following:

1. LLCs may provide members with unique economic, voting, and other rights without creating a second class of stock;
2. Rights of shareholders can be modified by amending the LLCs operating agreement which is not publicly filed;
3. LLC managers can be elected according to the procedure set forth in the operating agreement; and

   Note: C corporations must generally allow their shareholder to use cumulative voting in the election of directors. Cumulative voting is designed to allow minority shareholder interests to obtain board representation.

4. LLC members are not susceptible to a piercing the corporate veil attack solely as a consequence of the members failure to satisfy certain administrative formalities such as annual meetings and election of Board of Directors.

Advantages of LLCs over S Corporations

S corporations operate under many restrictions that are not applicable to LLCs. These restrictions include the following:

1. S corporations are limited to 100 shareholders;
Note: There are no restrictions on who may be a member of an LLC or on the number of members.

(2) S corporations are limited to a single class of stock;
    Note: LLCs can have multiple classes of memberships outstanding and an infinite variety of interests.

(3) S corporations cannot have a shareholder which is a corporation, partnership, LLC, or unincorporated entity other than a qualified estate or trust;
    Note: LLCs can have any form of entity as a member. This flexibility will provide a significant advantage to C corporations that can only get the benefit of losses reported by subsidiaries through filing a consolidated return.

(4) S corporation cannot have a shareholder who is a nonresident alien individual;
    Note: LLCs can have nonresident alien members

(5) S corporation shareholders cannot include indebtedness of the S corporation in basis;
    Note: The tax basis of an LLC membership interest includes the member’s share of the entity’s indebtedness that may shelter from current gain recognition any operating distributions of cash.

(6) S corporation cannot make a §754 election to increase the tax basis of its assets in connection with a transfer of its shares; and
    Note: On the death of a shareholder or sale of stock an LLC can elect to adjust the basis of its assets.

(7) Some states do not fully recognize S corporations. For example, S corporations that are doing business in California must pay a 1.5% net income tax.
    Note: LLCs are not subject to this tax, but must pay an entity level fee based on gross receipts. If the business operates at a loss, the S corporation form is generally preferable. If the entity operates at a profit, then the LLC will generally result in the lesser tax liability.

Advantages of LLCs over Limited Partnerships

Limited partnerships must have at least one general partner that is subject to unlimited liability. LLCs are not required to have a general partner. In addition, limited partners who participate in the management of the limited partnership can be classified as general partners and lose the benefit of limited liability. All members of an LLC can fully participate in management without jeopardizing their protection from such liability.
Outside Basis & Debt Share Advantage

When a LLC is deemed to be a partnership then it is subject to partnership taxation provisions. Partnership taxation provides that an increase in a partner’s share of the partnership’s liabilities is treated as a contribution of cash by the partner to the partnership resulting in a higher tax basis for the partner. This higher tax basis permits the partner to deduct greater pass-through losses and receive distributions tax-free.

A partner’s share of a partnership liability depends on whether the liability is a recourse liability or a nonrecourse liability (§752). A recourse liability is where the partner bears the economic risk of loss. A partner’s share of a recourse liability is that portion of the liability for which the partner bears the economic risk of loss.

A nonrecourse liability is where no partner (or related person) bears the economic risk of loss. Generally, a partner’s share of nonrecourse liability is based on the partner’s share of partnership profits. In a limited partnership, the general partners normally bear the entire risk of loss for recourse liabilities, and the limited partners’ basis for those liabilities is therefore zero.

In a limited liability company, no member is personally liable for the LLC’s liabilities, except to the extent of their investment in the LLC (R.R. 88-76). Thus, no member of an LLC bears the risk of loss for the LLC’s liabilities whether recourse or nonrecourse.

Note: Generally, an LLC is formed by filing Articles of Organization. This filing notifies creditors of limited liability. LLC members are jointly and severally liable for any liabilities accrued before the filing (or in the absence of the filing).

Since even recourse debt can be treated as nonrecourse, LLC members share in the LLC’s liabilities based on their share of profits (i.e., the same rule used to determine a partner’s basis in partnership nonrecourse liabilities). As a result, LLC members can have larger tax bases than if they had formed the business as a limited partnership.

Note: A taxpayer’s ability to use losses from the LLC may also be limited under the at-risk rules or the passive activity loss rules.

This conclusion opens several related tax issues involving debt.

Substantial Economic Effect Rules - §704(b)

Section 704(b) requires that disproportionate special allocations to partners have substantial economic effect. The §704(b) rules track the outside basis principles of §752 and in the allocation of interest turn upon whether a loan is recourse or nonrecourse. Since LLCs have the potential to make all loans nonre-

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1 What makes this treatment odd is that the lender may regard the debt as recourse debt; the lender may have the power to take other assets of the LLC in the event of default, just like a corporation.
course, guidance is needed to calculate nonrecourse deductions that are intended to be specially allocated.

**Discharge of Indebtedness Income**

If a property transfer accompanies debt relief, a *taxable disposition* has occurred. For *nonrecourse* debt, the *entire* debt is included in the amount realized regardless of the property’s fair market value. Thus, the debt relief does *not* generate income eligible for §108 exclusion. With the unsettled treatment of LLC debt, the question arises as to how that debt will be characterized for purposes of the debt relief rules.

**Advantages of LLCs over General Partnerships**

LLC members are not personally liable for the debts and obligations of the entity. LLCs can restrict management powers to a subset of the members or to non-member managers. General partners are fully liable for the debts of the partnership. Management of a general partnership is vested in the general partners who act in a fiduciary capacity vis a vis the partnership.

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32. A limited liability company (LLC) provides its members with numerous potential tax and legal benefits. Which of the following items is one of these potential benefits?
   a. option to use tax year other than calendar year.
   b. direction over the business without risk of losing limited liability.
   c. unlimited availability of nontaxable fringe benefits.
   d. tax-exempt status.

33. The author presents six tax advantages that limited liability companies (LLCs) have over C corporations. According to the author, what is possibly the greatest of these advantages?
   a. single level of tax.
   b. cheaper to operate.
   c. easier to form.
   d. easier to convert to an S corporation.

34. Basis adjustment is one of the tax advantages that limited liability companies (LLCs) have over C corporations. The tax basis of assets in a multimember LLC can be adjusted in relation to what?
   a. transfers of equity ownership similar to a corporation.
   b. tax-free capitalization.
   c. transfers of interests.
   d. a sale of assets.

35. The author lists four non-tax benefits that limited liability companies (LLCs) have over C corporations. Which of the following items is one of these?
   a. low risk of involuntary termination.
   b. less paperwork on formation.
   c. active management are not subject to self-employment tax.
   d. avoidance of "piercing the corporate veil" arguments.

36. The author lists seven advantages that limited liability companies (LLCs) have over S corporations. However, what is one advantage that S corporations have over LLCs?
   a. S corporations can have a partnership as an equity owner.
   b. S corporation equity owners can include corporate debt in basis.
   c. S corporations can have multiple classes of stock.
   d. S corporations have been in existence longer and have a more developed case law and regulatory database.

37. Limited liability companies (LLCs) have advantages over limited partnerships. For example, when limited partners take part in managing a limited partnership, how can the partners be classified?
   a. as corporations.
b. as tax management partners.
c. as general partners.
d. as silent partners.

38. In a limited liability company (LLC), members have limited liability. Thus, all entity debt is essentially:
   a. recourse.
   b. nonrecourse.
   c. assumable.
   d. subordinated.

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Disadvantages

The great disadvantage of an LLC is that they are relatively new. When an LLC is established in one state but does business in another state that has no LLC statute, liability protection can be lost. State tax treatment in the other jurisdiction may also be unclear. Moreover, many basic federal tax issues are unsettled.

There are still uncertainties with respect to the operation and taxability of the LLC. At the federal level there are only a handful of private letter rulings and revenue rulings that discuss issues related to classification. Proposed regs have recently been issued regarding self-employment taxes, but many federal issues remain unresolved.

Note for Californians: In 1999, the FTB reviewed the revenue impact caused by LLCs and adjusted the computation of the fee accordingly. Each year after 1999, the FTB will conduct the same analysis and adjust the fees accordingly.

Other disadvantages include:
(1) Some state LLC statutes (e.g., California) severely restrict the types of businesses that may elect to form as LLCs;
Disadvantages of an LLC

- Uncertainty of self-employment taxes
- Restricted to certain businesses & professions
  - See California “death” list
- Additional taxes & filing fees
  - See California “gross” receipts tax and $800 filing fee
- Must use the calendar year
- Cancellation of indebtedness may stick to member
- Recourse and nonrecourse debt issues
- LLCs have no at-risk amounts because of the limited liability afforded each member
(2) Managers who are *actively* involved in the management of the LLC will be *subject* to self-employment tax;  

**Note:** Inactive LLC members can be treated as managers and their distributive share of the LLC’s income will be subject to self-employment tax if the LLC does not designate managers to operate the business.

(3) The nontaxable fringe benefits available to LLC members are the same as those available to partners in a partnership;  

**Note:** LLCs are not afforded any of the exclusions for cafeteria plan benefits under §125. In addition, LLCs cannot issue equity interests or options to acquire equity interests that qualify for tax-preferred treatment under the rules applicable to corporate incentive stock option and employee stock purchase plans.

(4) The risk of inadvertent termination is higher in the LLC as certain procedural requirements must be met in order to continue the LLC in the event of bankruptcy, death, resignation, or withdrawal of a member;  

(5) LLCs must generally have the *same* tax year as the members of the LLC and, as a result, most LLCs will be restricted to a *calendar year.*

(6) Nonresident members of the LLC will be taxed on their California source income, while nonresident shareholders in a C corporation are not taxed by California on dividend distributions; and  

(7) California LLCs are required to pay the $800 minimum franchise tax plus a fee that is based on gross receipts.  

**Note:** If the LLC operates at a loss then the payment to California will be greater than the payment required from an S corporation which pays a 1.5% income tax or the $800 minimum tax imposed on limited partnerships. Although the fee is deductible, it is not creditable against other states’ income taxes for foreign LLCs doing business in California.

### Uses

Many business enterprises will use the LLC form effectively. This section describes some of the scenarios where the LLC will probably be most popular.

**Professional Firms**

Professional firms *may* benefit from conducting business as a LLC, particularly, by limiting malpractice liability for other professionals with whom one practices. However, LLCs do *not* protect a professional from liability for their *own* acts.

**Note:** California has severe restrictions on professions that can use the LLC format.
A LLC can also shield the members from liabilities of the business (including loans for working capital or furniture, fixtures and equipment, and lease obligations), although, as a practical matter, the creditor will probably require personal guarantees. LLCs can provide the members of professional firm with:

1. The limited liability permitted by law;
2. Control over the firm without risking limited liability;
   
   Note: While most states provide that voting rights will be in proportion to members’ contributions to capital, members are permitted to create different classes of interests.

3. Freedom from the S corporation eligibility requirements; and
   
   Note: An S corporation is subject to the one-class-of-stock rules, and may not be used to provide preferences on distribution of profits. S corporations are limited to 100 shareholders and are subject to ownership limits.

4. Pass-through taxation.
   
   Note: A regular corporation means entity level taxation. Professional C corporations are also ineligible to use graduated rates and are taxed at a flat 34% on income.

Venture Capitalists

Generally, venture capitalists want control over management, and sometimes even in the decision making process. They also want to retain limited liability and would prefer only one level of taxation. The limited partnership form will not allow involvement in management to any great extent, and the corporate form results in a double level of taxation. The LLC allows the venture capitalist to combine the desired elements of management control with the flow through benefits of the partnership. Now the venture capitalist can control events that will trigger sale of assets or other rights without inheriting the duties of a corporate director.

Leveraged Buyouts - LBO

The typical leveraged buyout financing transaction attempts to substitute high interest payments on debt for dividends to avoid the double taxation scheme inherent in the corporate tax system. The debt instruments used in a leveraged buyout often look like equity and run the risk upon audit of being reclassified as equity. Partnerships are not subject to the same scrutiny, as it makes no difference to the IRS whether the payments are characterized as interest or an allocation of profits. Therefore, the high yield instruments do not pose the same risk of reclassification in the LLC entity as they do in the corporate form.

Additionally, the LLC member manager can be given a significant voice in management or increased voting rights if the firm fails to pay the interest on the debt for the same reason. If the LLC runs into financial difficulty, the lenders already have a
significant voice in the control of management and will be less likely to force the LLC into bankruptcy and risk further reshuffling of the ownership interests. The one drawback for the highly leveraged LBO vehicle is the restriction on the transfer of the membership interest in the LLC.

**Joint Venture**

The LLC also provides preferential tax treatment where two or more corporations plan to form a joint venture. If the corporations formed a corporate subsidiary then distributions would be eligible for the dividends received deduction, which provides tax relief for 70% or 80% of the dividend payment dependent upon the ownership interest in the subsidiary. The LLC on the other hand, offers limited liability with only one level of taxation (equivalent to the benefit otherwise afforded by a 100% dividends received deduction). The co-venturers would save tax on 30% of the payments. The restrictions on free transferability are generally not a problem here.

**Corporations Filing Consolidated Returns**

Corporations currently filing consolidated returns may find the LLC alternative attractive. The corporation could retain the benefits of combining the LLC losses with its profits (as is currently available through the consolidated return) coupled with the benefit of limited liability. The benefits of the consolidated return would be preserved without the complexity often associated with filing a consolidated return. Additionally, the consolidated return benefits are only available to the corporation that owns 80% of the subsidiary. The LLC provides the benefits of consolidation to all investors.

**Foreign Investment**

The LLC provides an attractive alternative for foreign investment in the U.S., whether the investment is in real estate or some other business activity. The LLC provides the coveted feature of limited liability without which the foreign investor must rely on distance, unenforceability of foreign judgments, confidentiality, insurance or a combination of some or all of these characteristics to avoid personal liability. In addition, LLCs are well understood in many foreign countries (where they are likely to be taxed as corporations). Accordingly, the LLC format may be attractive to entities doing business abroad or anticipating significant foreign ownership.

*Note:* Foreign individuals and entities may be members of a California LLC.

**Real Estate Ventures**

Real estate ventures typically are structured as general or limited partnerships in order to provide investors with the tax benefits of debt financed depreciation deductions on a flow through basis. Often these investors do not need the nontaxable
fringe benefits available to employees of C corporations. LLCs provide the benefits of flow through deductions without the unlimited liability risks associated with the general partnership.

Charitable Investment

Charities sometimes participate in fund raising ventures through limited partnerships. The transaction often finds the charity participating in limited partnership ventures either as the sole general partner or as one of several general partners. The charity needs to be involved in management to insure that the partnership does not deviate from its charitable purpose. The problem faced by the charity is the conflict inherent in the partnership law versus the requirements of §501(c)(3). Under the partnership law, the general partner manages and assumes the overall risk of the venture. The general partner also undertakes a fiduciary obligation to the limited partners to use his or her best efforts to further the interests of the partnership. Under §501(c)(3) the charity must be organized and operated exclusively for the public, charitable purpose and not for the private benefit of the limited partners.

The LLC form provides an attractive alternative, as the liability is limited and the charity would not be required to undertake personal liability as a general partner. The LLC still allows the charity to maintain control over LLC activities to ensure that these functions are consistent with the charity’s tax-exempt purpose.

Estate Planning

A common practice in estate planning is to consolidate family wealth in a partnership or S Corporation and then spread that wealth among family members by transferring ownership interest in the entity. This is much easier to accomplish with an LLC than with a partnership or S Corporation.

Because there are normally no limitations as to the number or types of LLC owners, complex trusts may be members of an LLC. Restrictions with respect to access to, and allocation and distribution of, income and principal can be placed in the trust agreement without considering the S corporation rules. Trusts of all kinds can be LLC members, while only very specific types of trusts may hold S corporation stock.

LLCs can use a flexible “master” trust with multiple beneficiaries as opposed to qualifying S corporation trusts that are limited to a single beneficiary. This significantly simplifies the structure and reduces administrative costs. Additionally, modifications of existing estate plans to ensure compliance with the restrictions governing S shareholders on death of a shareholder are avoided completely as there is no restriction on the number or type of members which are permitted.

LLC members can also take advantage of the §754 election to step up both inside and outside basis when stock is acquired at death or in a taxable transfer. Upon death, the S corporation shareholder receives only a step up in the basis of the stock itself (“outside basis”) not the basis of the S corporation’s assets (“inside basis”). If
the LLC has a §754 election in place, the heirs’ share of the assets held by the LLC will be assigned a tax basis equal to fair market value. This permits the heirs to obtain benefits from the basis step up without disposing of the LLC membership interest.

LLC membership interests can be made transferable via gift or otherwise through provisions contained in the LLC’s operating agreement. Gifting membership interests can be significantly more convenient than gifting partial interests in assets, particularly real property. In addition, the organization documents can contain enough restrictions on access to the underlying assets that the donee has no more true control over his interests than he would under a trust.

One of the traditional benefits of using a holding company structure to accomplish intra-family wealth transfers is the ability to discount the value of a transferred asset for estate and gift tax purposes if it is a minority interest or is encumbered by meaningful restrictions on subsequent transfer.

An LLC is an ideal vehicle for distribution of family wealth, in that family disputes over assets held by the LLC can be resolved more easily by requiring in the organizational document that disputes be arbitrated and that the member who brings an unsuccessful action pays the legal fees of the LLC in defending the action.

**Problem Uses**

The LLC form will often *not* be appropriate for the following business ventures:

1. **Existing businesses conducted in the corporate form,**
   
   **Note:** Generally, it will be too expensive to convert an existing corporation to an LLC.

2. **Operating companies whose stock is publicly traded; and**
   
   **Note:** Generally, these companies will not be able to qualify for partnership tax treatment as they will exhibit the characteristic of free transferability of interests.

3. **Companies that intend to use traditional equity incentive plans (such as qualified stock option plans and stock purchase plans).**
   
   **Note:** LLCs cannot issue equity interests or options to acquire equity interests that qualify for tax preferred treatment under the rules applicable to corporate incentive stock option and employee stock purchase plans.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

39. Limited liability companies (LLCs) are very popular and have a number of advantages. However, what is a major drawback of LLCs?
   a. They cannot restrict management powers.
   b. Limited liability can be lost.
   c. They are taxed as C Corporations.
   d. Members cannot be a form of entity.

40. Performing business as a limited liability company (LLC) could prove to be beneficial for a professional firm. However, LLCs fail protect professionals from:
   a. liability for loans for working capital.
   b. liabilities of the business.
   c. liability for their individual actions.
   d. liability for lease obligations.
41. Many foreign countries understand limited liability companies (LLCs) and may tax them as corporations. Thus, these entities may appeal to those:
   a. performing business overseas.
   b. wanting to hide assets from their creditors.
   c. wishing to avoid liability on existing loan obligations.
   d. transferring large sums of money outside the United States.

42. Charities may partake in fund-raising ventures through limited liability companies (LLCs). What do LLCs provide for these charities?
   a. avoidance of limited liability on a long-term lease obligations.
   b. creation of fiduciary obligations.
   c. necessary control.
   d. limitation of liability on working capital loans.

43. Limited liability companies (LLCs) can have multiple uses. However, which of the following is a problem use?
   a. existing corporations.
   b. real estate ventures.
   c. foreign investment.
   d. joint ventures.
Federal Tax Consequences

The tax classification of the limited liability company is not explicitly addressed by the Internal Revenue Code. Instead, the classification of the LLC as a partnership or an association taxable as a corporation was generally governed by the regulations issued under §7701(a)(3). Pursuant to Regulation §301.7701-2(a)(3), if an unincorporated organization (like an LLC) possesses more corporate characteristics than unincorporated characteristics, it constitutes an association taxable as a corporation. In interpreting §301.7701-2, the Tax Court, in Larson v. Commissioner, 66 TC 159 (1976) acq. 1979-1 CB 1, concluded that equal weight must be given to four corporate characteristics and that for an unincorporated association to be treated as a partnership for tax purposes, it must lack at least two of the following four corporate characteristics:

(1) Centralization of management,
(2) Continuity of life,
(3) Free transferability of interests, and
(4) Limited liability.

The IRS issued R.P. 95-10 that specified the conditions under which it would consider a ruling request that related to classification of a LLC as a partnership for federal tax purposes. In addition the IRS released Notice 95-14 that stated that the Service was considering simplifying the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis.

Check-the-Box Regulations

The IRS has released final regulations for entity classification, commonly known as the check-the-box regulations (Notice 97-1; TD 8697, CCH 97 FED §47,005). The final rules allow entities that are not required to be classified as corporations (e.g., entities that have complied with the formal state law requirements to be organized as “corporations”) to elect to be taxed as partnerships or corporations. This simplified regime, which applies to domestic as well as foreign business entities, replaces the existing fact-intensive classification regulations that are based on the historical differences between partnerships and corporations under local law (i.e., the “Kintner regs.” under §301.7701).

Among those entities classified as corporations under the final regulations are entities denominated as corporations under applicable law, associations, joint-stock companies, insurance companies, organizations conducting certain banking activi-
ties, organizations wholly owned by a state, and organizations taxable under provisions of the Code other than §7701(a)(3).

The regulations also contain a list of foreign entities that are treated as per se corporations. However, any entity that is not required by the regulations to be treated as a corporation is an eligible entity and may choose its classification. And, an eligible entity with two or more members can be classified as either a partnership or a corporation. A single member entity can be classified as a corporation or can be disregarded as an entity separate from its owner.

The final regulations have default classifications for eligible entities that will provide most entities with the classification they would otherwise choose. Therefore, in many cases, an actual election will not need to be filed.

For domestic eligible entities, the regulations adopt a passthrough default, and the default for foreign eligible entities is based on whether members of the entity have limited liability.

A foreign entity is classified as a partnership if it has two or more members and at least one of them does not have limited liability. A single-member entity whose owner does not have limited liability will be disregarded as an entity separate from that owner.

An existing entity’s “default classification” status is the classification claimed by the entity immediately prior to the effective date of the regulations. An eligible entity’s election of its classification may be made on Form 8832, Entity Classification Election.

The final regulations are effective as of Jan. 1, 1997. However, under a special transition rule for existing entities, the IRS will not challenge the prior classification of an existing eligible entity or an existing entity on the per se list for periods prior to the effective date of the regulations if:

1. The entity had a “reasonable basis” for the claimed classification,
2. The entity and its members recognized the federal tax consequences of any change in the entity’s classification within 60 months before the regulations’ effective date, and
3. Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification was under examination.

The IRS is also notifying taxpayers of the effect of the final regulations on certain revenue rulings and revenue procedures. Effective Jan. 1, 1997, rulings and procedures are now obsolete to the extent that they use the prior classification regulations to differentiate between partnerships and associations. The IRS will publish a list of the obsolete documents in the Internal Revenue Bulletin.
Form 8832
(December 1996)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

Name of entity

Employer identification number (EIN)

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country.

1 Type of election (see instructions):

a □ Initial classification by a newly-formed entity (or change in current classification of an existing entity to take effect on January 1, 1997)

b □ Change in current classification (to take effect later than January 1, 1997)

2 Form of entity (see instructions):

a □ A domestic eligible entity electing to be classified as an association taxable as a corporation.

b □ A domestic eligible entity electing to be classified as a partnership.

c □ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.

d □ A foreign eligible entity electing to be classified as an association taxable as a corporation.

e □ A foreign eligible entity electing to be classified as a partnership.

f □ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

3 Election is to be effective beginning (month, day, year) (see instructions) ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ● ■ 3-20
Self-Employment Tax

A general partner’s distributive share of income from a partnership is included in figuring net earnings from self-employment (§1402). However, while general partners are subject to the self-employment tax on their distributive share of the partnership’s income, limited partners are not (§1402(a)(13)).

Note: If an individual partner has net earnings from self-employment of $400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040).

Proposed Amendments to Limited Partner Regs

In 1997, the IRS issued proposed amendments (REG-209824-96) to the regulations relating to self-employment taxes imposed under §1402. These regulations permitted individuals to determine whether they were limited partners for purposes of §1402(a)(13), eliminating the uncertainty in calculating an individual’s net earnings from self-employment under existing law.

The proposed regulations applied to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity. Thus, the same standards applied when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC.

Generally, an individual was to be treated as a limited partner under the proposed regulations unless the individual:

1. Had personal liability (as defined in §301.7701-3(b)(2)(i) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner;
2. Had authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or
3. Participated in the partnership’s trade or business for more than 500 hours during the taxable year.

If, however, substantially all of the activities of a partnership involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provided services as part of that trade or business was not to be considered a limited partner.

The proposed regulations allowed an individual who is not a limited partner for §1402(a)(13) purposes to nonetheless exclude from net earnings from self-employment a portion of that individual’s distributive share if the individual held more than one class of interest in the partnership. Similarly, the proposed regulations permitted an individual that participated in the trade or business of the partnership to bifurcate his or her distributive share by disregarding guaranteed payments for services. In each case, however, such bifurcation of interests was permitted only to the extent the individual’s distributive share was identical to
the distributive share of partners who qualified as limited partners under the proposed regulation (without regard to the bifurcation rules) and who owned a substantial interest in the partnership. Together, these rules excluded from an individual's net earnings from self-employment amounts that were demonstrably returns on capital invested in the partnership.

**Moratorium**

Under the TRA ‘97, the Service is prohibited from issuing regulations before July 1, 1998, that define whether income from a partnership or LLC is considered earned by a limited partner and, thus, exempt from self-employment tax. While the July 1, 1998 date has come and gone, neither Congress nor the Service chose to act on this matter.

**The Old Quandary – What to Do?**

No one seemed to know when or whether a member of an LLC that is taxed as a partnership was a "general partner" or a "limited partner" for self-employment tax purposes. Yet, clients were often to use common sense when approaching this issue. If they were merely investors who had little to do with the day-to-day workings of the LLC, then no self-employment tax would seem to be applicable. However, in service-type businesses, or where the LLC member was really involved in the business affairs, then hiding behind the guise of being a "limited" member might not make any difference for SECA tax purposes.

**Chief Counsel Advice 201436049**

Signaling the IRS may be ready to approach the issue more aggressively, in May 2014, the Service concluded, in CCA 201436049, that the distributive share of partnership income allocated to members of a large investment management LLC was subject to self-employment tax.

**Note:** Remember, under §1402, self-employment income is generally the gross income derived by an individual from any trade or business carried on by the individual, less deductions allocated to the business and, due to the pass-through nature of partnerships, partners are generally considered to be conducting the business of the partnership. Thus, §1402 provides that a partner's distributive share of partnership income is included in self-employment income. However, §1402(a)(13) provides that the distributive share of partnership income of a limited partner is not self-employment income.

The Service ruled that because of their considerable investment and operational management services, the LLC members were service partners acting as self-employed persons not passive investors. The IRS also cited two cases holding that LLC and LLP members were not limited partners (*Renkmeyer*, 136 T.C. 137 (2011) and *Riether*, 919 F.Supp.2d 1140 (D. N.M. 2012)).
At-Risk Rules

A partner’s deductible share of partnership losses is not only limited by the basis rules of IRC 704(d) but also by the at risk rules and the passive activity rules. The at risk rules limit the deductible losses of the partner to an amount that includes only debt on which partners are considered to be “at risk” (i.e. recourse debt). A member of an LLC will be considered “at risk” to the extent of the amount of money plus the adjusted basis of any property contributed to the LLC, and any income or loss generated by the LLC which flows through to the member. Distributions also reduce the at risk basis. Debt is not included in the at risk basis unless the member is personally liable on the note.

Although a general partner in a partnership is at risk for recourse debt, an LLC member will generally not be at risk on LLC debt. There is some conflict regarding whether the LLC member can include debt if the member personally guarantees the loan. Generally, guarantees do not produce an at-risk amount if the guarantor acquires subrogation rights. In a partnership, the general partner would be liable to the guarantor who had to pay out on a partnership loan that went into default. However, in the LLC there is no member that is required to contribute in the event of default and therefore no subrogation right. If under state law there are no rights to recover from others, then the debt should qualify as at risk debt to the LLC member.

Nonrecourse debt involving real property activities is eligible for special relief from the at risk rules. For this exception to the at risk rules to apply, the lender cannot be related to the taxpayer, the seller (or a person related to the seller), or a recipient of a fee received because of the sale. In general, the loan must be from a commercial lender and reflect an arms length transaction. This type of debt is termed “qualified nonrecourse financing” and the members are treated as being “at risk” for their share of the debt even if no member is personally liable. Where the loan is secured by real estate and does not hold any person personally liable for repayment, the loan qualifies as an exception to the at risk rules. If the LLC incurs debt that is secured by real estate, this debt should qualify under this exception as no person is individually liable.

Debt Discharge Income

When a transfer of property accompanies debt relief, a taxable sale or exchange has occurred. If the debt is nonrecourse debt then the entire debt is included in the amount realized (regardless of the FMV of the property transferred (§7701(g))). Therefore, with nonrecourse debt (unlike recourse debt) none of that debt relief generates debt discharge income eligible for exclusion under §108.

Where the lender has recourse against the assets of the LLC (but not the personal assets of the LLC members), will that debt be treated as nonrecourse for purposes of the debt relief rules? Arguably, it should be recourse debt as such debt is not materially different than corporate recourse debt. However, because subchapter K gov-
erns LLCs, the IRS may try to apply §752 principles and treat the debt as nonrecourse. Again, guidance is needed.

**Passive Loss Rules**

Section 469(a)(1)(A) disallows a deduction for the passive activity loss of individuals, trusts, estates, personal service corporations, and closely held C corporations that do not materially participate in the activity. The test applied to determine material participation is different for individuals and limited partners.

In determining material participation, §469(h)(2) provides that “[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.” A similar per se rule applies to prevent limited partners from claiming the $25,000 allowance for active participants in rental real estate.

Reg. §1.469-5T(e)(3)(I)(B) states that “a partnership interest shall be treated as a limited partnership interest if ... the liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized,...” Although this broad definition in the regulations would arguably include LLCs, neither the regulation nor the statutory mandate for the regulation, was ever intended to encompass LLCs. One can credibly argue that an entity must be a state law partnership before that regulation applies.

In addition, the limited partner per-se-passive rules were enacted because limited partners do not participate much in the business, and because limited partnerships were seen as the preferred vehicle for tax shelter losses (the evil that Congress wished to eradicate in the 1986 Tax Reform Act). Congress wanted to slam the door on limited partner losses. It did so with a per-se-passive rule. If limited liability alone were the motivation, then Congress presumably would have enacted similar per-se-passive rules for S corporation shareholders, regardless of their degree of participation in the business. LLC members, like S shareholders, can freely participate in the affairs of the business; therefore, like S shareholders, they should not be saddled by the limited partner per-se-passive rules under §469. Guidance is needed.

**Method of Accounting**

For tax years beginning after 1986, four types of taxpayers are not permitted to use the cash basis method of accounting. These taxpayers must use the accrual method of accounting. The four types of taxpayers subject to these restrictions include:

1. C Corporations;
2. A partnership that has one or more C corporations as a partner;
3. Tax shelters; and
4. Trusts that are subject to the tax on unrelated trade or business income but only with respect to such income (§448).
The term tax shelter is defined in the regulations to mean:

1. Any enterprise 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. Certain syndicates; and
3. Entities whose principal purpose is the avoidance of federal income tax (Reg. §1.448-1T(b)).

The California Act provides that every interest in an LLC will be a security, unless the person claiming the exception can prove that all of the members are actively engaged in the management of the LLC. It is not clear where the line will be drawn between members actively engaged in the management of the LLC and members that assume a passive role with respect to the business of the entity.

Examples of situations where the analysis becomes unclear include:

1. A member-managed LLC in which fewer than all of the members participate in the management of the business, although each member has the power to do so; and
2. LLCs where only some management powers are delegated to member managers, while other powers are granted to all members.

Under the California Act there seems to be a bias towards classifying an LLC interest as a security. In an amendment to the California Corporate Securities Law that was passed in connection with the California Act, the definition of “security” was expanded to include a reference to LLC interests. If the interest is a security then the offer and sale of the security must be registered under the Securities Act and under the blue sky laws of each state in which an offer or sale is made. Thus it appears under the California statute, member managed LLCs will not be eligible to use the cash method.

This issue has been addressed in several private letter rulings:

1. In PLR 9432018 all of the members were represented to be actively engaged in the business of managers, therefore it was held that the LLC met the active participation requirements.
2. In PLR 9321047, although the agreement provided for members to elect five managers as the management committee with authority to conduct business for the firm, it further provided that all members would be required to vote in order for the firm to take certain actions, including the election of members to the management committee and compensation committee; removal of a member from either committee; admission of a member or provisional member; dismissal of a member; amendment of the agreement; dissolution of the firm; major decisions; and approval of compensation committee recommendations subject to prescribed procedures. Based on the representation that the members would continue to engage in the practice of law and participate in the various described
management activities, it was held that the LLC met the active participation requirements.

3. In PLR 9328005 an executive committee managed the LLC, but vote of all members was required for the LLC to take certain actions such as admit or expel a member; determine compensation of members; make expenditures in excess of a specified amount; borrow funds in excess of a specified amount; open or close a branch office; change the name of the LLC or the location of its principal office; sell or otherwise dispose of all or substantially all of the assets of the LLC; dissolve the LLC; amend the agreement under which the LLC is operated. However, each member of the business did participate in handling client relations; supervising services provided to clients; billing, collecting and negotiating fees; participating in business and practice development activities; staffing projects; including the selection and use of specialists; and supervising, training and evaluating LLC employees. Participation in these management activities was held to constitute active participation.

Syndicates which are considered tax shelters for this purpose include partnerships if over 35% of the losses of such entities during the taxable year are allocated to the limited partners or limited entrepreneurs. A limited entrepreneur is defined as one who does not actively participate in the management of such enterprise. In the LLC, if the members are viewed as limited partners, then the limited partners are allocated all the LLC’s losses that would mean that the LLC qualifies as a tax shelter. Thus, all LLCs with losses would be forced to use the accrual method.

If not classified as a limited partner, then the LLC member would probably be designated as a limited entrepreneur. If the LLC member does not participate in management and if more than 35% of the LLC losses are allocated to the limited entrepreneurs, then accrual basis accounting is required. Therefore, it seems that the only way that a LLC would not be a syndicate would be if it has no losses or at least 65% of any losses were allocated to persons who actively participate in management and are not limited partners or limited entrepreneurs.

Audit Procedures

Under the unified review process applied to partnership tax returns, the partnership is required to designate a tax matters partner (TMP). The TMP is the partner with whom the Service primarily deals. The TMP must be a general partner in the partnership. If no TMP is designated, then the general partner having the largest profits interest in the partnership at the close of the partnership’s tax year is treated as the TMP. If there is more than one such partner (such as would be the case in a 50-50 partnership) the one whose name would appear first in an alphabetical listing is treated as the TMP. If the Service determines that it is impracticable to apply the above rules, it may select a partner who will be treated as the TMP. Since the LLC has no general partners, the strict application of these rules would result in the se-
lection of the TMP by the Service. In point of fact, no member, not even member/managers, qualifies as a TMP under the definition set forth in the regulations. In the interim, and as a safeguard to protect against whatever form final rules regarding LLCs take, the Operating Agreement for the LLC should designate the member/manager who agrees to undertake the responsibilities of the TMP.

Conversion of Partnership to LLC

Generally, a partnership or a limited partnership can convert to an LLC without incurring any income tax if the members of the LLC continue to own their same ownership interest. The partnership could actually use one of several methods to convert tax free to the LLC. These include:

(1) Contribution by all partners of their partnership interests to a newly formed LLC in exchange for corresponding membership interests in the LLC followed by a partnership liquidation;
(2) Creation by the partners of an LLC followed by a merger of the partnership and the LLC in which the LLC is the surviving entity;
(3) Partnership liquidation and distribution of assets to partners who then contribute undivided interest to the LLC; and
(4) Partnership contribution of assets to the LLC followed by liquidation.

Upon conversion, the partnership must avoid termination in order for the transaction to be tax-free. A partnership terminates if 50 percent or more of the interest in its capital and profits are sold or exchanged within a 12-month period. Upon a termination for income tax purposes, the LLC’s books are closed and it is deemed to distribute all of its assets to its members. Each of these persons is then deemed to contribute its share of the former LLC’s assets to a newly created LLC in exchange for a membership interest.

In R.R. 84-52, the Service ruled that a conversion of a general partnership into a limited partnership did not constitute a termination as long as each partner’s total percentage interest in the partnership’s profits, losses, and capital remained the same after the conversion and the business activity of the partnership continued. R.R. 84-52 has been applied in several private letter rulings to the conversion of a partnership into an LLC. In PLR 9029019 the IRS ruled that a general partnership that converted into an LLC did not terminate. In PLR 9010027, the same ruling was issued to a limited partnership that converted into an LLC (see also PLR 9321047).

Conversion of S Corporation to LLC

As a result of the repeal of the General Utilities doctrine by the Tax Reform Act of 1986, corporate liquidations now result in a tax at the entity level as well as a tax to
the shareholder if the distribution is greater than the shareholder’s basis in the stock of the corporation. The corporate liquidation provisions (§336) apply equally to the S corporation and result in double tax whether assets are contributed to the LLC and the LLC interest distributed to the shareholders or the assets are distributed to the shareholders who then contribute them to the new entity. Relief from the double tax burden is afforded the S corporation shareholder to the extent that the gain recognized by the S corporation does increase the basis of the shareholder so that the gain recognized on the distribution to the shareholder is reduced accordingly. However, the LLC election may not be worthwhile for an existing S corporation with substantially appreciated assets that are subject to the built-in gains tax.

Conversion of C Corporation to LLC

A conversion of a corporation to an LLC can take place in one of several ways, however both methods result in the same double tax as described above for the conversion of the S corporation, but there is no step up in the shareholder’s basis as a result of the gain recognition at the corporate level. The methods include:

(1) Contribution by all stockholders of their shares to a newly formed LLC in exchange for corresponding membership interests in the LLC followed by liquidation of the corporation, and

(2) Creation by the stockholders of an LLC followed by a merger of the corporation and the LLC in which the LLC is the surviving entity.

Both of these methods will result in a corporate liquidation and related double tax and loss of tax attributes. In other words, any net operating loss carry forwards or similar tax attributes would be lost at the time of the corporate liquidation. This will oftentimes make it too expensive for a corporate entity to take advantage of the LLC form.

Local Taxes on Conversion

In general, there should not be any sales tax or risk of reassessment of real property values for property tax purposes as a result of a conversion to an LLC. However, these rules are complex and there are numerous exceptions. California’s sales and property taxes are discussed here to illustrate how these taxes would be applied to an entity that converts to an LLC.

Sales & Use Tax

Conversion of a partnership to an LLC will not trigger the sales tax if the ownership of the acquiring corporation is comprised of 80% or more of the owners of the transferor and 80% of the assets are acquired (Calif. Revenue & Taxation §6006.5(b)).
Therefore conversions of partnerships to LLCs should not trigger sales tax because the ownership interests on a conversion will remain largely the same as the predecessor.

The result for conversion of a corporation could be somewhat different because the corporation must formally dissolve/liquidate and then reincorporate. The surrender of a stock interest in a corporation in exchange for tangible personal property distributed in a liquidation or a partial liquidation is not generally taxable. The transaction is not a “sale” and the stock surrendered in consideration is not viewed as consideration (CSTCR 395.2260 & 395.2440).

An exception to the general rule that no sales tax arises on the liquidating distribution of a corporation appears to exist with respect to inventory and other property that has been purchased in an exempt purchase for resale by the corporation. Because the corporation does not sell the property in the ordinary course of business, a transfer of such property to shareholders as a liquidating dividend constitutes a taxable use of the property by the corporation. Therefore, a use tax is imposed on the transfer (CSTCR 395.2300).

Where a shareholder has loaned money to the corporation, liquidation distributions to the creditor-shareholder in satisfaction of corporate debt are taxable (CSTCR 395.1400). Such a transaction is viewed as a sale of assets with the consideration being the discharge of debt.

Example

Susan and Lucy own Curl Up and Dye a beauty shop organized as a C corporation. After several years of losses that are trapped in the C corporation, they decide to liquidate the C corporation and form a LLC. NOL carry-forwards will offset the gain at the corporate level recognized upon liquidation and so the double tax will be substantially reduced. Susan receives most of the tangible property in payment of a large loan that she had made to the corporation. The transfer is deemed to be made in satisfaction of the debt and the sales tax applies, using the book value of the tangible personal property held by the corporation as the sales price. Susan’s debt should be repaid in cash.

Real Property Taxes

The transfer of real property out of the corporate entity or the partnership will subject the property to reassessment unless it qualifies under the exception set forth in Calif. Revenue & Taxation §62. This exception exempts the property from reassessment if the proportional interest remains the same as the proportional interest of stock/capital held in the corporation/partnership. In order for this exception to apply, the shareholder/partner must receive his/her proportional interest in each par-
cel of property owned by the dissolving corporation/partnership. This exception would generally be met if the partners/shareholders of a partnership/corporation converting to an LLC are merely converting their interests and, after the conversion will retain their same economic percentage interest.

The effect of a conversion on existing real property title insurance is unclear. A title insurance company might take the position that its insurance coverage runs only to the corporation or partnership initially named in its policy, and that it does not cover the LLC that emerges from a conversion. To avoid this uncertainty, a partnership or corporation that is converting to the LLC form would be well advised to obtain in advance an endorsement of its existing title insurance policy to insure that the insurance coverage will not lapse because of the conversion.

**Real Property Transfer Taxes**

Most counties in California impose a Documentary Transfer Tax on transfers of real property. Most counties treat transfers to a partnership in exchange for partnership interests as consideration subject to transfer taxes. Clearly if the partnership transferring the property is terminated, the partnership will be liable for the transfer tax. If the partnership is not terminated, then there should be no county or city transfer taxes on California real property as a result of the conversion. Under IRC §708(b)(2)(A) the merger of two or more partnerships will not trigger a termination of the partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership (in this case the LLC). The result here is not entirely clear.

A corporation will be subject to real property transfer taxes and could run the risk of paying two reconveyance fees, once on the liquidation and once on the contribution of the property to the LLC. The corporation should deed the property to the LLC so that only one reconveyance fee will be assessed.

**California Limited Liability Company Act**

Each state that has enacted LLC legislation has adopted their own unique procedures, tax structure, and reporting requirements. This section provides an overview of California’s requirements to illustrate the questions that should be answered before an LLC organizes or qualifies to do business in any state.

Each LLC commences with an initial filing of its Articles of Organization with the Secretary of State. The LLC is not considered fully formed until its members have entered into an operating agreement (which need not be publicly filed).
Formation

The LLC is formed by filing Articles of Organization with the Secretary of State. The Articles of Organization must set forth the name of the LLC which must end with the words “limited liability company” or the abbreviation “LLC.” Since LLCs are a new form of organization, plenty of names are available. If the business was operated in another form and is converting to LLC status, it can continue to use its existing name with the addition of “LLC.” The Articles of Organization must also include the latest date or event upon which the LLC is to dissolve, the purpose of the LLC, information regarding the LLC’s agent for service of process; and a statement regarding the delegation of management to managers (if the LLC opts for a form of centralized management).

The Secretary of State’s Office plans to set up an electronic ordering system for the 12 form packet currently being developed for use by LLCs. The forms are now available and can be obtained from the Limited Liability Company Unit in Sacramento and the branch offices of the Secretary of State. The Sacramento address and phone number is as follows:

Office of the Secretary of State
Limited Liability Company Unit
923 12th Street, Suite 300
P.O. Box 944228
Sacramento, Ca. 94244-2280
(916) 323-4486

Members

California’s statute now permits an LLC have one member. Formally, California’s statute required each LLC to have two or more members. Note that the existence of two members at the moment of formation was crucial to the LLC’s federal income tax classification because in order for the LLC to be treated as a partnership for tax purposes, it must have at least “two” partners. There are virtually no other restrictions on who can be a member.

Permissible Businesses

The LLCs existence begins with the filing of the Articles of Organization with the Secretary of State. A California LLC can organize to conduct any lawful business except banking, insurance, trust company operations, or professional services for which a license, certification or registration is required pursuant to the California Business and Professional Code. The professional services required to be licensed by the state of California are set forth in the following chart.

This rule is probably more comprehensive than intended by the Legislature. Legislation has been introduced that would allow limited liability companies to perform
professional services with an exception for attorneys, certified public accountants, doctors, nurses veterinarians and pharmacists. This same bill also includes provisions that would allow a manager, member officer, or employee of an LLC to hold a license to act as a life, fire, or casualty insurance agent. Currently agents licensed in the insurance business are prohibited from forming an LLC.

**California Licensed Professions**

- Accountants
- Acupuncture
- Advertisers
- Alarm Companies
- Architecture
- Attorneys
- Auctioneers and Auctions
- Automotive Repairs
- Barbering and Cosmetology
- Barbers
- Boxing, Wrestling and Martial Arts
- Cemeteries
- Chiropractors
- Cleaning, Dyeing and Pressing
- Clinical laboratory Tech.
- Clinical Social Workers
- Contractors
- Crematories
- Dental
- Dietitians
- Electronic and Appliance Repair
- Employment Agencies
- Firearm Training
- Funeral Directors
- Gaming Clubs
- Geologists and Geophysicists
- Guide Dogs for the Blind
- Hearing Aid Dispensers
- Home Furnishings
- Horse Racing
- Land Surveyors
Landscape Architects
Locksmiths
Marriage counseling
Medical and Podiatry
Mineral, Oil and Gas Brokerage
Mule Racing
Nurses Registry
Nursing Home Administrators
Optometry
Pharmacies
Photogrammetry
Physical Therapy
Physicians Assistants
Polygraph Examiners
Prescription Lenses
Private Detectives
Private Patrol Operators
Process Servers
Professional Engineers
Professional Photocopiers
Protection Dog Operators
Psychiatric Technicians
Psychologists
Real Estate
Real Estate Appraisers
Registered Dispensing Opticians
Registered Nursing
Repossessor
Research psychoanalyst
Shorthand Reporters
Speech pathologists
Structural pest Control Operators
Tax Preparers
Ticket Sellers
Veterinary Medicine
Vocational nursing
Because of the way the statute is worded, Enrolled Agents could qualify to practice as LLCs in the state. Enrolled agents are licensed by the federal government and are exempt from state licensing requirements. This is probably an unintended "loop-hole."

**Professional Practice**

The important legislative consideration in deciding whether the LLC form is appropriate to a professional practice is how to limit the liability. In states which have allowed professionals to form as LLCs, the statute will typically provide that the members will not be personally liable for the debts and obligations of the LLC to the extent such debts and obligations are attributable to the negligence or wrongful acts of the LLCs other members or employees. The limited liability made available by an LLC will protect a professional from the actions and commissions of co-members but will leave intact the professional’s individual responsibilities. If California were to permit the use of LLCs by professionals, other statutory and regulatory changes would be required before particular professions could use an LLC. State licensing statutes and the regulatory frameworks that accompany them all tend to limit professional practice in groups to the traditional corporate, partnership, and sole practitioner forms and must be modified to accommodate LLCs. Internal professional rules are also affected.

**Limited Liability Partnerships**

The alternative direction taken by other states is to allow professionals to use an entity known as a limited liability partnership. The LLP protects the general partner from liability for negligence of others, but holds the general partner personally liable for most contractual obligations of the partnership as well as for all debts and obligations attributable to the negligence of the general partner and any employee under his/her direct control. Several of the Big 4 Public Accounting Firms have elected to form as LLPs. The reason for selection of this business form, despite the lower degree of insulation from personal liability than LLCs, is the likelihood that the LLP form will be recognized in states that do not allow regulated professionals to operate through LLCs. The idea is that since the liability is not completely limited, states (such as California) might be more likely to accept the LLP form than the LLC form. In addition, because LLPs offer a lower degree of insulation from personal liability than LLCs, there may be an argument that the LLP lacks the corporate characteristic of limited liability under the classification rules discussed herein.

**Formation Fees**

Upon filing, the Secretary of State’s Office will charge the following fees:

**(1)** $80 for filing the articles of organization,
$80 for application for registration as a foreign limited liability company,
$30 for amending the Articles of Organization, amending the application for registration as a foreign LLC, filing a certificate of correction for a LLC, and filing a certificate of continuation for a LLC after a certificate of dissolution has been filed,
$10 for issuing a certificate of reservation of a LLC name,
$80 for filing a certificate of merger with one or more LLCs, and $150 for filing a certificate of merger between the LLC and other business entities,
$5 for filing the annual statement of incorporation for both the California LLC and the foreign LLC, and
There is no fee for filing a certificate of dissolution or a certification of cancellation.

Operating Agreement

The California statute does require that before filing the articles of organization the members shall have entered into an operating agreement. An operating agreement is the LLC analogue to a partnership agreement, and constitutes an agreement among all the LLC’s members regarding the operation of the business of the LLC. In general these agreements address issues that later arise among the members relating to voting, management, financial decision making, changes in membership, and ultimate dissolution of the LLC. The operating agreement is often where the corporate characteristics of free transferability, centralized management, and continuity of life are addressed. California’s statute sets forth default provisions that will apply to matters on which a LLCs operating agreement is silent, so a written agreement is important if the intent is to override these provisions. The operating agreement of an LLC (unlike the articles of incorporation of a corporation) does not have to be filed in order to be effective. Since the operating agreement is not required to be publicly filed, there is no required disclosure of financial relationships among the members. The most significant rules that may be addressed in operating agreements are:

Voting majority rules,
Whether voting will be per capita, according to contribution, or by some other method,
The manner in which an operating agreement may be amended,
Restrictions on the removal of managers,
Limiting or permitting self dealing by members and managers,
Requiring operating agreements to be in writing,
The manner of allocating profits and losses and other tax items among the members,
The manner of allocating distributions among the members,
(9) Providing for specified number or percentage of members to self finance the purchase of the LLC’s assets if the members cannot agree to continue the business of the LLC upon an event of dissolution, and

(10) Restricting the resignation or withdrawal of a member.

**Note:** There is no restriction that must be included in the operating agreement (or the articles of organization) regarding the number of members or the rights and duties of different classes of stock. These onerous S Corporation restrictions (i.e. 100 shareholders and only one class of stock) are not applicable to the LLC.

In most cases, existing partnership agreement forms provide a useful starting point for drafting an operating agreement. There is no requirement in the California statute that the operating agreement be in writing, but logically this should be the case. In order to override any unwanted statutory default provision, a written agreement is required.

There is no requirement in the statute that managers be elected annually, or that regular meetings of members and managers be held. This provision results in less risk of piercing the corporate veil (i.e. requiring shareholders of a corporation to satisfy liabilities and obligations of the corporation out of their personal assets). This is helpful for small corporations where corporate formalities are largely ignored.

**Office in California**

The LLC must continuously maintain in California an office where records are kept concerning:

1. The name, addresses, capital contributions, and shares in profits and losses of members and holders of economic interests;
2. The names and addresses of the managers;
3. The Articles of Organization, Operating Agreements and any related amendments;
4. Federal, state and local tax returns for the six most recent taxable years;
5. Financial statements for the six most recent years; and
6. Other relevant books and records for the past four fiscal years.

**Foreign Limited Liability Companies**

The California statute requires foreign limited liability corporations to register to transact business in the state. The foreign limited liability company is defined broadly and includes, an entity formed under the limited liability company laws of any state other than California, or an entity organized under the laws of any foreign country that is an unincorporated association and is organized under a statute under which an association may be formed that affords each of its members limited liability with respect to liabilities of the entity. In general, the laws of the foreign jurisdiction govern the LLC’s organization and internal affairs, as well as the liability and au-
thority of its managers and members (even if the foreign law is quite different from California’s).

This provision provides planning opportunities. If the LLC statute in California contains a provision that the members wish to avoid (such as naming member managers or the requirement of two members) then the LLC could form under another state’s law where that requirement does not exist. The corporation would then register to do business in California. California’s statute does not impose the requirements of identification of managers on foreign LLCs. In addition, the California LLC statute does not restrict the definition to LLCs organized domestically in one of the states that have adopted LLC legislation.

There is a major exception to this provision for professionals organized as LLCs in other states. A professional LLC organized in another state will be treated as an LLC in California although the members will not have limited liability protection.

California LLCs in Other States

Many states now have legislation that provide for the recognition of LLCs formed in other states, although the states would generally apply their rules to the LLC. In the few states without an LLC statute, it is not clear whether California’s limitation on liability for members, managers, and officers would carry over into the other state, whether the flexible means of internal governance would be respected or how the entity would be taxed.

Reporting Requirements

Secretary of State’s Office

An annual reporting requirement is imposed by California’s Secretary of State. The report is required within 90 days of filing the articles of organization and annually thereafter. The requirement basically obligates the LLC to provide an annual record of the persons managing the LLC, the agent for service of process, the name, and location of principal offices of the business. The obligation can be satisfied by filing a statement with the Secretary of State’s office that there are no changes from prior years. The fee for filing the annual statement is $5.

Member Requirements

If the LLC has more than 35 members then the managers must send financial statements to the members not later than 120 days after the close of the fiscal year. The report must conform to traditional financial statement reporting, and contain a balance sheet, income statement, and statement of changes in financial position. Although this is the language of the statute, more likely than not the intent was to reference a Statement of Changes in Cash Flow. The financial statements should include the report of an independent accountant, if available.
If the LLC does not retain the services of an independent accountant, then the financial statements must be accompanied by a statement of the manager of the LLC that the financial statements were prepared without audit from the books and records. There is no requirement that the financial statements be prepared pursuant to generally accepted accounting principles. Therefore, statements prepared for a lending institution (as may be required by a loan agreement and which may report using the cash method) should suffice.

More problematic is the requirement that the LLC send each member all information necessary to complete federal and state tax returns within 90 days after the end of the tax year. This requirement is misplaced in that the LLC may not be able to report to its members if it has filed for an extension to prepare its own information return. Penalties can be assessed for failure to comply with this requirement; however “justifiable cause” will negate the penalties. It is unclear what is meant by “justifiable cause” and also whether filing for an extension of time to file the LLCs return would meet the requirement. Obviously, no such requirement is imposed on partnerships.

**Franchise Tax Board Requirements**

The tax returns required to be filed by the LLC are due by the fifteenth day of the fourth month following the close of the taxable year. If the LLC is unable to file the return, then the LLC qualifies for an automatic extension until the fifteenth day of the tenth month (or October 15 for calendar year taxpayers).

The return must include the names and addresses of all the members and must include the consent of each nonresident member to file timely returns and pay all taxes owed to the state. This requirement parallels that currently imposed on nonresident shareholders of an S Corporation. If the nonresident consents are not included in the return then the FTB can require the LLC to pay the tax owed by the nonresident member and the tax will be assessed on that member's share of profits at the maximum tax rate. Similar to partnerships and S Corporations, nonresident members will be able to elect to file a nonresident combined return. This procedure offers administrative simplicity, however the tax assessed on the combined return is the maximum imposed under the law.

FTB has designed its own set of forms for annual reporting by LLCs. The Forms (entitled Form 568) include the following package:

- Form 568. Limited Liability Company Return of Income.
- Form FTB 3522. Limited Liability Company Minimum Tax Voucher.
- Form FTB 3537. Payment Voucher for Automatic Extension for Limited Liability Company.
- Form FTB 3832. Limited Liability Company List of Members Consent.
- Form FTB 3885L. Depreciation and Amortization.
- Schedule D (568). Capital Gains or Loss.
• Schedule K-1(568). Capital Gains or Loss; Income, Deduction, Credits, etc.
• Schedule K-1 NR (568). Nonresident Member’s Share of Income, Deduction, Credits, etc.

**Note:** For federal purposes the LLC files on the partnership Form 1065.

**California Taxes & Fees**

**Franchise Tax**

A California LLC is required to pay the $800 minimum franchise tax Similar to limited partnerships, the tax is required to be paid each year until the LLC formally dissolves. The tax is due and payable no later than the fifteenth day of the fourth month of the taxable year. The tax is not prepaid as it is for corporations. No tax is required to be paid if the LLC does not do business in the state and is formed during the last 15 days of the taxable year. The $800 minimum franchise tax is also imposed on foreign LLCs doing business in the state.

The $800 is a tax and is therefore not allowed as a deduction on the California income tax return filed by the LLC or filed by the members. The annual fee (discussed in the paragraphs that follow) is not a tax and is deductible on the California return of the LLC and also on the return of the members. Both payments are deductible as expenses of the trade or business on the federal return filed by the members.

**Entity Level Fee**

In addition to the minimum tax of $800, the LLC is subject to an annual fee based on total income from all sources earned in California. The fee is progressive and escalates with the level of gross receipts.

The fee is required to be paid with the return and is not payable quarterly like estimated taxes. For tax years beginning after 2000, California has a permanent fee schedule based on four ranges of total income. The fee schedule is as follows:

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<tr>
<th>Total Income is At Least:</th>
<th>But Less Than:</th>
<th>LLC Fee:</th>
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Computation of Gross Receipts

Total income for purposes of computing the fee, is defined by referencing the definition of gross income under §61 of the Internal Revenue Code. Although the result is unclear, this provision implies that whether the LLC is organized in California or is a foreign LLC doing business in the state, the entire gross income of the LLC is included in the base for purposes of computing the fee. There is no provision for allocation or apportionment of gross income as is traditionally the case for computation of taxable income of multistate corporations (including Subchapter S corporations). Additionally, the statute does not make any distinction between business and nonbusiness income but rather states that the fee is based on the gross income incurred in the trade or business. Recent legislation clarifies that the fee is based on total income from all sources reportable to California, which implies allocation of nonbusiness income and apportionment of business income (SB 13).

Example

The Never A Dull Moment Newspaper is a California LLC operating only in the state of California. Never A Dull Moment reported the following income for the year:

<table>
<thead>
<tr>
<th>Income Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Income/Sales of Newspapers</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Interest and Dividends</td>
<td>200,000</td>
</tr>
<tr>
<td>Rent payments from California real estate</td>
<td>500,000</td>
</tr>
<tr>
<td>Gain on the sale of Nevada real estate</td>
<td>150,000</td>
</tr>
</tbody>
</table>

Since the statute references IRC §61 all of the above items would be included in the base for computing the LLC fee. Income from the sale of newspapers would be total income (not reduced by expenses related to production of the paper). Interest and dividends would be included although the income might be classified as nonbusiness income. Rent payments would be included and would not be reduced by related rental expenses. Gain on the sale of Nevada real estate would also be included even though the real estate is located out of state. Since IRC §61 references gain on the sale of assets, the net gain is included not the total proceeds collected upon sale.

If Never A Dull Moment were a California LLC operating in several states, then the result is unclear. Under a strict interpretation of the statute, the total income would be included in the base for computing the fee, and therefore the result would be the same as in the preceding paragraph. This would not be the result for an S Corporation organized in California and required to compute its
taxable income for purposes of applying the 1.5% entity level tax. The S Corporation would apportion/allocate its income based on UDITPA principles generally. This would mean that the business income would be apportioned (based on property, payroll and sales in the state) and the nonbusiness income would be allocated. If the apportionment percentage were 25%, then the net business income would be multiplied by 25% to determine the California share. If the interest and dividends were nonbusiness income then the income would be allocated to the commercial domicile, here California. The rent on California real estate would be allocated to California, and the gain on the sale of Nevada real estate would be allocated to Nevada.

Ownership Requirement

Gross income also includes all affiliated LLCs where the taxpayer owns 50% or more of the voting stock through direct or indirect ownership. This is the same test that is applied to determine whether or not the group is a unitary group. Unity of ownership includes either direct or indirect ownership or control of more than 50 percent of the voting stock of a taxpayer. Gross receipts of commonly controlled LLCs are aggregated to determine the entity level fee. This provision is designed to prevent taxpayers from forming multiple LLCs with gross receipts of less than $250,000 and thereby escaping the entity level fee. This would be the only provision regarding aggregation of receipts of multiple entities.

Dissolution

Various events may cause the dissolution of a LLC. Dissolution can occur upon the death, withdrawal, resignation, expulsion, bankruptcy, or dissolution of a member unless the articles or organization or a written operating agreement provide otherwise. If they do not provide otherwise, then the LLC can only be continued by a unanimous vote of all the members. If the LLC is dissolved because of death, withdrawal, resignation, expulsion, bankruptcy, or dissolution of a member the business can be continued by a vote of all the remaining members within 90 days of the occurrence of the event. The articles of organization or operating agreement may require less than unanimous consent for continuation. If the members vote to continue the LLC, then the LLC must file Form LLC-3 (Certificate of Dissolution) and Form LLC-8 (Certificate of Continuation) with the Secretary of States office. If the members intend to dissolve, then upon completion of winding up of the business the LLC must file Form LLC-4/7 (Certificate of Cancellation).

Other events that might cause dissolution include expiration of the period specified in the agreement, consent of a majority of members, or a court order. This might occur where there is a dispute among the members about the advisability of a dissolution and the dispute is significant enough that court intervention is required.
Formal dissolution requires payment of creditors and distribution of assets to the members. In the event of dissolution, the LLC must obtain a Tax Clearance Certificate from the FTB. The expedited process available since 1992 for regular corporations (i.e. a single filing with the Secretary of State’s Office with the Secretary of State’s Office forwarding the dissolution request to the FTB for the Tax Clearance Certificate) is also applied to LLCs. The members will need to file a Certificate of Dissolution and provide for an assumer (i.e. a resident individual, corporation or a LLC doing business in California who agrees to assume all tax obligations.) The date of dissolution is effective with the date of filing with the Secretary of State’s Office. There is no fee assessed for filing a Certificate of Dissolution.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

44. The check-the-box rules are the IRS’s final regulations for classifying entities. These rules allow entities that may be classified as entities other than corporations to elect to be taxed as:
   a. disregarded entities.
   b. partnerships or corporations.
   c. tax-exempt organizations.
   d. S corporations.

45. A partnership may convert to a limited liability company (LLC) tax-free. However, what would cause the transaction to be taxable?
   a. a partnership is liquidated and assets are distributed to partners, and an undivided interest is contributed to an LLC.
b. a partnership and a new LLC merge, and the LLC survives.
c. partners contribute interests to a new LLC for equal membership interests in the LLC, and the partnership is liquidated.
d. termination of 50% or more of the partnership interest in its capital and profits are sold or exchanged within a year.

46. The California Limited Liability Company Act lists California licensed professions that are prohibited from establishing a limited liability company (LLC). However, which of the following professions would be permitted to operate an LLC in California?
   a. a professional engineer.
   b. a registered nurse.
   c. an accountant.
   d. an enrolled agent.

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**Learning Objectives**

After reading Chapter 4, participants will be able to:

1. Determine a “corporation,” for tax purposes, and identify regular corporations from other entities.
2. Identify “personal service corporations” and small business investment companies, their requirements & tax treatment and determine when and how clients can engage or avoid such classification for their benefit.
3. Recognize the transfer of money, property or both by prospective shareholders to a corporation and the requirements of §351.
4. Specify the requirements of §1244 stock and the small business stock exclusion, and determine the differences between start-up expenses and organizational expenses.
5. Identify corporate pitfalls and dangers noting tax recognition of the entity, tax rates, AMT computation, capital gains & losses under §1212 and the dividends received deduction under §243.
6. Specify necessary corporate action for making allowable corporate charitable contributions, benefiting from the repeal of §341, and avoiding tax penalties under §541 and §531.
7. Identify available corporate accounting periods and methods noting the treatment and impact of tax-exempt income, inventory identification &
evaluation, multiple corporations, and corporate liquidations and distributions.
Corporations Defined

Section 7701(a)(3) places a very broad definition upon the term “corporation.” This is defined to include “associations, joint stock companies, and insurance companies.”

Effect of State Laws

The legality of an organization under state laws is not a determining factor. In Morrissey v. Commissioner, 36-1 USTC 9020, 16 AFTR 1274, 56 S. Ct. 289 (USSC 1936), an organization that was a business trust under state law was deemed to be an association for federal income tax purposes, and therefore, was taxable as a corporation. Furthermore, in the U.S. v. Kintner, 54-2 USTC 9626, 47 AFTR 995, 216 F.2d 418 (9th Cir. 1954), a partnership of physicians was deemed to be an association (and likewise, taxable as a corporation), even though applicable state law prohibited the practice of medicine in the corporate form.
Corporate Characteristics

Regulation §301.7701-2(a) provides a checklist of “corporate characteristics.” The number of corporate characteristics present in the organization will determine whether or not it is to be treated as an association for federal income tax purposes. These corporate characteristics are as follows:

1. Associates;
2. An objective to carry on a business or profession and to divide the profits therefrom;
3. Continuity of life;
4. Centralized management;
5. Limited liability to the associates; and
6. Free transferability of interests.

The Regulations provide that in order for an unincorporated organization to be classified as an association for federal income tax purposes, it must possess more corporate characteristics than non-corporate characteristics. Characteristics which are common to both corporate and non-corporate organizations shall be disregarded in making the determination.

Partnership Determinations - 3 Through 6

Consequently, in the determination as to whether or not a partnership will be treated as an association for federal income tax purposes, the first two corporate characteristics listed above would be disregarded. The determination will then be made based upon items 3 through 6. Generally, if a partnership possesses three or more of these characteristics, it will be treated as an association, and taxed like a corporation.

Trust Determinations - 1 & 2

In the case of a trust, the situation would be reversed. Items 3 through 6 would be disregarded and items 1 and 2 would be considered in making the determination.

Professional Associations

Organizations of doctors, lawyers, and other professional people organized under state professional association acts are generally recognized as corporations for federal income tax purposes. A professional service organization must be both organized and operated as a corporation to be classified as one. All of the states and the District of Columbia have professional association acts.
Unincorporated Associations

Although §7701(a)(3) states that the term corporation includes associations, it does not define an association. The Supreme Court, however, has defined an association as “a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise” (Hecht v. Malley, 265 US 144 (1924, S Ct)).

For federal income tax purposes, unincorporated associations that are taxable entities are generally treated as corporations. An association will be taxed as a corporation if it more nearly resembles a corporation than any other organization, that is, it has more corporate characteristics than noncorporate characteristics.

Check-the-Box Regulations

The IRS has released final regulations for entity classification, commonly known as the check-the-box regulations (Notice 97-1; TD 8697, CCH 97 FED §47,005). The final rules allow entities that are not required to be classified as corporations (e.g., entities that have complied with the formal state law requirements to be organized as “corporations”) to elect to be taxed as partnerships or corporations. This simplified regime, which applies to domestic as well as foreign business entities, replaces the existing fact-intensive classification regulations that are based on the historical differences between partnerships and corporations under local law (i.e., the “Kintner regs.” under §301.7701).

Among those entities classified as corporations under the final regulations are entities denominated as corporations under applicable law, associations, joint-stock companies, insurance companies, organizations conducting certain banking activities, organizations wholly owned by a state, and organizations taxable under provisions of the Code other than §7701(a)(3).

The regulations also contain a list of foreign entities that are treated as per se corporations. However, any entity that is not required by the regulations to be treated as a corporation is an eligible entity and may choose its classification. And, an eligible entity with two or more members can be classified as either a partnership or a corporation. A single member entity can be classified as a corporation or can be disregarded as an entity separate from its owner.

The final regulations have default classifications for eligible entities that will provide most entities with the classification they would otherwise choose. Therefore, in many cases, an actual election will not need to be filed.

For domestic eligible entities, the regulations adopt a passthrough default, and the default for foreign eligible entities is based on whether members of the entity have limited liability.
Check-The-Box Rules
Form 8832

Is the entity a trust?
YES → Trust
NO →

Is the entity subject to special rules (e.g., REMICs, REITS)?
YES → Apply special rules
NO →

Is the entity an “eligible entity”?
NO → Corporation
YES →

Is the entity organized under domestic law?
YES →
NO →

Does any member have unlimited liability?
YES →
NO →

Does the entity have only one member?
NO →
YES →

Does the entity have two or more owners?
YES →
NO →

“Tax nothing” unless it elects to be a corporation
Corporation unless it elects to be a partnership

For entities in existence prior to 1/1/97, its previously claimed classification will control
A foreign entity is classified as a partnership if it has two or more members and at least one of them does not have limited liability. A single-member entity whose owner does not have limited liability will be disregarded as an entity separate from that owner.

An existing entity’s “default classification” status is the classification claimed by the entity immediately prior to the effective date of the regulations. An eligible entity’s election of its classification may be made on Form 8832, Entity Classification Election.

The final regulations are effective as of Jan. 1, 1997. However, under a special transition rule for existing entities, the IRS will not challenge the prior classification of an existing eligible entity or an existing entity on the per se list for periods prior to the effective date of the regulations if:

1. The entity had a “reasonable basis” for the claimed classification,
2. The entity and its members recognized the federal tax consequences of any change in the entity’s classification within 60 months before the regulations’ effective date, and
3. Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification was under examination.

The IRS is also notifying taxpayers of the effect of the final regulations on certain revenue rulings and revenue procedures. Effective Jan. 1, 1997, rulings, and procedures are now obsolete to the extent that they use the prior classification regulations to differentiate between partnerships and associations. The IRS will publish a list of the obsolete documents in the Internal Revenue Bulletin.

C Corporations

For purposes of federal income taxes, the corporation is recognized as a separate tax paying entity. This causes, in the case of most corporations, double taxation. Income is taxed first to the corporation that earns it, and secondly to the shareholders when the earnings and profits are distributed as dividends.

Advantages

A “C” corporation can have several tax advantages over S corporations and unincorporated businesses:

1. As a separate taxpayer, it can be used to split income between itself and its owner(s), with potentially lower overall tax rates as a result;

   Note: In certain tax brackets, corporate rates are lower than individual income tax rates.
Advantages of a C Corporation

- Ability to Split Income
- Best Fringe Benefits & Retirement Plans
- Can have unlimited number of the owners
- Can Adopt a Fiscal Tax Year
- Limited Liability
- Multiple classes of equity
- Dividends Received Deduction
- Consolidated Returns
- Section 303 to pay estate tax
(2) A “C” corporation can deduct amounts paid for *fringe benefits* for its employee/owners, such as medical insurance or medical reimbursement plans, disability insurance, or group term life insurance;

**Note:** An S corporation cannot deduct any such expenses paid on behalf of employees who are 2% (or larger) shareholders, and unincorporated businesses cannot deduct such payments on behalf of the owners.

(3) “C” corporations can elect a *fiscal* tax year; and

**Note:** “S” corporations and partnerships must generally be on a calendar year, except for those that were already on a fiscal year and elected on a timely basis to retain such fiscal year or new S corporations or partnerships which may be allowed to elect a year ending in September, October, or November, instead of the calendar year.

(4) “C” corporations are able to deduct up to 80% of the dividends (70% of the dividends received if the corporation receiving the dividend owns less than 20% of the distributing corporation) they receive from investments in other domestic corporations (§243(a)(1)).

**Note:** The deduction is 100% if the shareholder is a small business investment company (§243(a)(2)). The dividends received deduction is not available on dividends received by an S corporation or an unincorporated business.

**Disadvantages**

Disadvantages of a “C” corporation include:

(1) Accrual method of accounting may be required (see the §448(b) personal service corporation and five million or less gross receipts exceptions);

**Note:** “S” corporations and unincorporated businesses can use the cash method of tax accounting, unless they have inventories of goods they sell.

(2) “C” corporations are subject to double taxation where income is paid out as dividends;

**Note:** In actual fact, few closely held corporations go through the formality of paying a dividend.

(3) “C” corporations with certain types of income such as interest, dividends, rents and royalties are potentially subject to the personal holding company tax on such income; and

(4) 75% of the difference between a “C” corporation’s adjusted current earnings and taxable income is an alternative minimum tax preference item.
PSC Corporations - §441, §448, §469

*Personal service corporations* are required to use a *calendar* tax year unless they can establish a business purpose for a different period, or make a §444 election. For this purpose, a personal service corporation generally is a corporation in which the *principal* activity is the performance of personal services that are *substantially* performed by employee-owners (Reg. §1.441-4T(d)). Employee-owners must own *more than 10%* of the fair market value of the corporation’s stock on the last day of the testing period (Reg. §1.441-4T(d)).

**Testing Period**

Generally, the testing period for a tax year is the *prior* tax year. [Reg. §1.441-4T(d)(2)(i)]

**Example**

*Corporation A has been in existence since 1990. It has always used a January 31 fiscal year for its accounting period. To determine if A is a personal service corporation for its tax year beginning February 1, 2016, the testing period is A’s tax year ending January 31, 2016.*

The testing period for a *new* corporation for its first tax year starts with the *first* day of the tax year and ends on the *earlier* of:

1. The last day of its tax year, *or*
2. The last day of the calendar year in which the tax year begins (Reg. §1.441-4T(d)(2)(ii)).

**Example**

*B Corporation’s first tax year begins June 1, 2016. B wants to use a September 30 fiscal year for its accounting period. B’s testing period for its first tax year is June 1, 2016, through September 30, 2016. If B wants to use a March 31 fiscal year, the testing period is June 1, 2016, through December 31, 2016.*

**Personal Services**

Any activity that involves the performance of services in the following fields is considered to be personal services:

1. Health,
2. Law,
(3) Engineering,
(4) Architecture,
(5) Accounting,
(6) Actuarial science,
(7) Performing arts, and
(8) Consulting (Reg. §1.441-4T(e)).

Principal Activity & Substantial Performance

The principal activity of a corporation is considered to be the performance of personal services if, during the testing period, the corporation’s compensation costs for personal service activities is more than 50% of its total compensation costs (Reg. §1.441-4T(f)).

Personal services are substantially performed by employee-owners if during the testing period more than 20% of the corporation’s compensation cost attributable to the performance of personal services is attributable to personal services performed by employee-owners (Reg. §1.441-4T(g)).

Employee-Owner

A person is an employee-owner of a corporation for a testing period if the person:

(1) Is an employee of the corporation on any day of the testing period, and
(2) Owns any outstanding stock of the corporation on any day of the testing period (Reg. 1.441-4T(h)(1)).

Independent Contractor

For purposes of the employee-owner definition, a person who owns any outstanding stock of the corporation and who performs personal services for or on behalf of the corporation is treated as an employee of the corporation. This rule applies even if the legal form of the person’s relationship to the corporation is such that the person would be considered an independent contractor for other purposes (Reg. 1.441-4T(h)(2)).

Passive Loss Limitations - §469(a)(2)

The passive activity rules apply to personal service corporations (§469(a)(2). Under the passive activity rules (§469), a corporation is a personal service corporation if it meets all of the following requirements:

(1) It is a corporation (other than an S corporation);
(2) Its principal activity during the “testing period” is performing personal services (as defined in Reg. §1.441-4T(e) - see above);
Note: The testing period for any tax year is the previous tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:

(a) The last day of its tax year, or

(b) The last day of the calendar year in which its tax year begins.

(3) The services in (2) must be substantially performed by employee-owners; and

Note: This is met if more than 20% of the corporation’s compensation cost for its activities of performing personal services during the testing period is performed by employee-owners (Reg. §1.441-4T(g)).

(4) Its employee-owners own more than 10% of the fair market value of its outstanding stock on the last day of the testing period (Reg. §1.469-1T(g)(2)(i)).

Qualified Personal Service Corporation - §448

A similar tax concept is that of the qualified personal service corporation (QPSC). A corporation is a qualified personal service corporation if:

(1) At least 95% of the value of its stock is held by employees, or their estates or beneficiaries, and

(2) Its employees perform services at least 95% of the time in any of the following fields:

(a) Health,
(b) Law,
(c) Engineering,
(d) Architecture,
(e) Accounting,
(f) Actuarial science,
(g) Performing arts, and
(h) Consulting (§11(b)(2); Reg. §1.448-1(e)(4)).

A QPSC is not permitted the lower graduated tax rates available to other C corporations. All its income is subject to the maximum federal corporate tax rate, currently 35%.

Note: If a QPSC has average annual gross receipts of no more than $5 million for the past three years, it will be allowed to use the cash method of accounting, rather than being required to use accrual method accounting.
Small Business Investment Company - §1243

A small business investment company (SBIC) is one that is licensed and operated under the Small Business Investment Act of 1958. An investor in SBIC stock is allowed an ordinary loss (business loss), rather than a capital loss, on losses from the sale or exchange of such stock (§1243). Investors are allowed capital gain on gains from the sale or exchange of such stock.

Rollover of Gain from Sale of Securities - §1044

Any regular corporation or individual taxpayer may be able to postpone reporting part or all of their capital gain from publicly traded securities sold after August 9, 1993, if they buy certain replacement property within 60 days of the sale and meet certain other requirements (§1044).

Note: The amount of postponed gain is subtracted from the basis of the replacement property. Basis in common stock of a corporate SSBIC is not reduced for purposes of calculating the gain eligible for the 50% exclusion for qualified small business stock under §1202.

Taxpayers qualify to make this choice if they:

(1) Sell publicly traded securities at a gain after August 9, 1993;

Note: Publicly traded securities are securities traded on an established securities market.

(2) Have a capital gain for the sale; and

(3) Buy replacement property during the 60-day period beginning on the date of the sale.

Note: Estates, trusts, S-corporations, and partnerships are not eligible to make this election to rollover gains.

Replacement Property

Replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). A SSBIC is any partnership or corporation licensed by the Small Business Administration under §301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993 (§1044(c)).
Postponed Amount

If an investor makes the choice described in this section, they recognize gain only up to the following amount:

(a) The amount realized on the sale, minus
(b) The cost of any common stock or partnership interest in an SSBIC that was bought during the 60-day period beginning on the date of sale.

If this amount is less than the amount of the gain, the taxpayer can postpone the rest of their gain, subject to the limit described next. If this amount is more than the amount of the gain, the taxpayer must recognize the full amount of the gain.

Annual Limit on Postponed Gain

The amount of gain that can be postponed in each year is limited to the smaller of:

(a) $50,000 ($25,000 if married and file a separate return), or
(b) $500,000 ($250,000 if married and file a separate return), minus the amount of gain postponed for all earlier years.

For corporations, the limits are $250,000 and $1 million.

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47. The term “association” was defined in *Hecht v. Malley*, rather than under any Code provision. How are unincorporated, taxable associations generally treated?
   a. as corporations.
   b. as S corporations.
   c. as charities.
   d. as sole proprietorships.
48. The author lists four disadvantages of C corporations. What is one of these disadvantages?
   a. No dividends received deduction is available.
   b. Earnings are passed through to shareholders.
   c. Possible subjection to a personal holding company tax.
   d. They have limited liability.
49. In general, when the employee-owners of a corporation perform personal services as the main activity, this entity is considered a personal service corporation. What is a general requirement of such entities?
   a. They must use a calendar tax year.
   b. Its compensation costs for such activities is at least 45% of total compensation costs.
   c. They must make a §444 election.
   d. They must use the business year exception.
50. Under §1044, certain taxpayers can postpone their capital gain from publicly traded securities. What must these taxpayers do to take advantage of this deferment?
   a. sell qualified closely held securities.
   b. buy certain replacement property within 60 days.
   c. have a capital loss on the sale.
   d. be an estate, trust, or a regular corporation.
Incorporation - §351

Forming a corporation involves a transfer of money, property, or both by prospective shareholders in exchange for capital stock in the corporation. If money is exchanged for stock, the shareholder or corporation realizes no gain or loss. The stock received by the shareholder has a basis equal to the money transferred to the corporation by the shareholder.

If property is exchanged for stock, it may be either a taxable or nontaxable exchange. However, §351 provides that transferors (i.e., potential shareholders) don’t have to realize any gain or loss in such a transaction.

Basic Requirements

For §351 to apply, the transferors of property to the corporation must, as a group, have control of the corporation immediately after the exchange. No gain or loss is

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1 If the IRS determines that there was a sale and purchase rather than an exchange, no problem to the corporation, but the shareholder may have to recognize a gain on the sale. However, if assets are to be sold, it would generally be better to have the shareholder sell them and then buy the shares with the money than to complete an exchange and have the corporation sell the assets. The shareholder’s gain will be taxed at 15% as opposed to the corporation’s capital gains tax of 35%.
recognized when the transferors receive solely stock. Gain, but not loss, is recognized when the transferors receive other property in addition to stock.

**Note:** If the transferor receives property, including securities of the corporation, or money, in addition to stock in exchange for the property transferred, gain (if any) is taxable to the extent of the money or fair market value of property received (§351(b)(1)).

The gain or loss on a taxable exchange is figured by comparing the adjusted basis of the property transferred with its fair market value at the time of the transfer to the corporation. This may be a capital gain or loss.

**Corporate Nonrecognition**

No gain or loss is recognized by a corporation on the transfer of property and money to the corporation in exchange for corporation stock (including treasury stock). A corporation does not recognize gain or loss on the acquisition or lapse of an option to buy or sell its stock (§1032).

**Property**

Exactly what constitutes “property” for purposes of §351 is vague. No clear definition exists within the Code for the term “property” in this context. However, the Code and regulations defined several items that will not constitute property.

**Stock Solely For Services**

Stock issued for services (past, present or future) is not issued in exchange for property (§351(a)). Transfer of services to a corporation in return for stock results in taxable compensation to transferor (§351(d); *William S. James*, 53 TC 63 (1959) (Acq.)).

Hence, if a new shareholder receives stock from a corporation in exchange for his future services to the corporation, he will realize income to the extent of the value of the stock so received.

**Impact on Recipient**

The person who receives the stock for services has ordinary income on the exchange (§61 and §83).

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2 A solution to this problem might be to have the new shareholder obtain stock from the corporation in exchange for his notes payable over the next several years or, to buy stock from existing shareholders’ in exchange for cash and/or notes.
Impact on Other Shareholders

When some recipients of stock transfer services and others transfer property, the property transferors may not as a group receive the required control. Thus, they would recognize gain or loss on the exchange.

Stock for Debt

If a corporation issues stock in discharge of its own outstanding debt, both the corporation and the shareholder can have income. The corporation will have debt cancellation income if the value of the new stock is less than the amount of the debt (§108(e)(10)(A))³. When §351 doesn’t apply the shareholder recognizes gain or loss on the exchange.

Control

The transferors must be in control of the corporation immediately after the exchange. To be in control, the transferors must, as a group, own:

1. At least 80% of the total combined voting power of all classes of stock entitled to vote, and
2. At least 80% of the total number of shares of all other classes of stock (§368(c)).

When a transferor receives stock for both property and services, he is counted in full as a transferor of property for purposes of the 80% control requirement. However, the value of the stock received for services is ordinary income (Reg.§1.351-1(a)(1)).

Property Basis

The basis of property a corporation receives in exchange for its stock in an 80% control transaction, or as paid-in surplus, or as a contribution to capital is the same basis the transferor had in the property increased by any gain the transferor recognized on the exchange (§362).

If a corporation receives property by issuing stock for it, other than in an 80% control transaction, the basis of the property to the corporation is usually the fair market value of the stock at the time of the exchange. If the stock has no established value, evidence of the fair market value of the transferred property may be used to set the value of the stock if all outstanding stock is issued in exchange for that property (§1012).

³ If the shareholder contributed the debt to capital by forgiving the debt and receiving no stock, the corporation’s income is the difference between the amount of the debt and the shareholder’s basis for the debt (§108(e)(8)).
1. Stock - §351
   • As little as legal

2. Debt - §385

3. Rent - §162

4. Fringe Benefits

5. Wages - §162

S corporations are essentially treated as conduits with their shareholders liable for federal tax. C corporations are subject to tax but are entitled to more fringe benefits.
Stock Basis

The basis of stock received in exchange for the transfer of property to a corporation is the **same** as the basis of property transferred **decreased** by:

1. The fair market value of any other property (except money) received,
2. The amount of any money received, *and*
3. Any loss you recognize on the exchange;

and increased by:

1. Any amount treated as a dividend, *and*
2. Any gain recognized on the exchange.

The basis of property received, other than money or stock, is its fair market value (§358(a)).

Liabilities

Occasionally, a new corporation will assume the liabilities of the previous business or take property subject to a liability. This has no effect on §351. The contributor’s basis in the stock will be **reduced** by the amount of the liability, and the corporation’s basis in the property will be the basis of the contributor immediately prior to the exchange. Gain will be taxed however, to the extent that the liabilities assumed **exceed** the contributor’s adjusted basis (§357(c)).

**EXAMPLE**

*Real property with a basis of $65,000 and present value of $120,000 has a mortgage against it in the amount of $85,000 is transferred to a newly formed corporation in exchange for stock. $20,000 would be taxed as gain to the contributor ($85,000 liability - $65,000 basis = $20,000 gain).*

In 1999, Miscellaneous Trade and Technical Corrections Act changed the tax impact of property taken subject to a liability in connection with corporate organizations and reorganizations. Under this Act, the rule that a liability automatically was treated as assumed where property is taken subject to it was repealed for §351 and various reorganization transfers. Only liabilities specifically treated as assumed under the new rules result in a basis step-up for the transferee corporation. The changes also affect the determination of permissible consideration in a C reorganization, transfers of certain trust funds to regulated investment companies, and property subject to a transferor’s liability in a §1031 swap (H.R. 435, P.L. 106-36, 6/25/99).

A recourse liability (or a portion of it) is treated as assumed if, on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy the
liability (or portion of it), whether or not the transferor has been relieved of the liability.

A nonrecourse liability is treated as assumed by the transferee of any asset subject to the liability, except that the amount of a nonrecourse liability treated as assumed is reduced by the lesser of:

(a) The amount of the liability that the owner of other assets not transferred to the transferee which are also subject to that liability has agreed with the transferee to, and is expected to, satisfy, or

(b) The fair market value of those other assets subject to the liability.

If the owner of untransferred assets also securing a nonrecourse debt does not agree to pay any of it, the amount of the liability treated as assumed by the transferee is not reduced at all. This could trigger gain recognition by the transferor, but the transferee’s basis increase could be limited by the rules described below.

Under the new law, the transferee’s basis cannot be increased under §351 (in a §351 transfer to a controlled corporation) or §362(b) (in a reorganization) above the property’s fair market value by gain recognized by the transferor as a result of the assumption of a liability. For this purpose, fair market value is determined without the §7701(g) rule treating property subject to nonrecourse debt as worth at least as much as the debt.

In addition, if a property transferor recognizes gain as a result of an assumption of a nonrecourse liability that is also secured by assets not transferred to the transferee, and no person is subject to tax on the gain, the transferee’s basis can be increased only by the ratable portion of the liability determined on the basis of the relative fair market values of all assets subject to it.

These changes apply to liabilities related to property transferred in §351 exchanges, the determination of permissible consideration in a C reorganization, the treatment of transfers by corporate parties to a reorganization, transfers by certain trust funds to a regulated investment company (RIC), and property subject to a transferor’s liability in a §1031 exchange.

**Section 1244 Stock**

Perhaps the most frequently overlooked benefit of incorporation is §1244 stock. Shareholders should be advised that if their investment becomes worthless, their loss will generally be treated as a capital loss (§165(g)). Section 1244 allows an original shareholder’s loss to be treated as an *ordinary loss*.

An individual (*not* including a trust or estate) can deduct, as an ordinary loss, a loss on the sale, exchange, or worthlessness of small business stock. This ordinary loss is reported on line 10, Part II of Form 4797. The gain on this stock, however, is a capital
gain if the stock is a capital asset and is reported on Schedule D, Form 1040 (Reg. §1.1244(a)-1; Reg. §1.1244(b)-1).

**Maximum Ordinary Loss**

The deductible ordinary loss on this stock is *limited* to $50,000. On a joint return, the limit is $100,000 even if only one spouse has this type of loss. Thus, if the loss is $110,000 and the taxpayer's spouse has this type of loss, the taxpayer may deduct $100,000 on a joint return. The excess of $10,000 is a capital loss (Reg. §1.1244(b)-1).

*Note:* Do not offset the gains against the losses that are within the ordinary loss limits, even if the transactions are in stock of the same corporation.

**Original Issuance**

The stock must be issued to the individual taking the loss. The ordinary loss deduction is available only to the *original* owner of this stock. To claim a deductible loss on stock issued to a partnership, a taxpayer must have been a partner when the stock was issued and remain so until the time of the loss. Partners add their distributive share of the partnership loss to any individual loss they may have on the stock before applying the deduction limitation (Reg. §1.1244(a)-1(b)).

**Distributed Stock**

If the partnership distributes the stock to the partners, the partners will *not* be able to treat a stock loss as an ordinary loss (Reg. §1.1244(a)-1(b)).

**General Requirements**

The following requirements *must* be met to qualify as §1244 stock:

1. The stock must have been issued for money or other property and not for stock or securities (§1244(c)(1)(B));
2. The stock must be in a domestic corporation (§1244(c)(1));
3. For 5 years prior to the date of the loss, the corporation must have been primarily an active trade or business (§1244(c)(1)(C)); and
4. At the time of the stock issuance, the total amount paid in for stock can’t exceed $1,000,000 (§1244(c)(1)(A)).

---

4 The stock can be common or preferred.

5 Thus it must not have derived more than 50% of its gross receipts from royalties, rents, dividends, interest, annuities, or gain from the exchange of stock or securities.
Section 1244 Requirements

1. Must Be A Domestic Corporation
2. Amount of Cash and/or Property Received For Stock Cannot Exceed $1 Million
3. Stock Must Be Issued Directly to Original Owner, and
4. Stock Cannot Be Issued for Services
Small Business Stock Exclusion - §1202

Since 1998, noncorporate taxpayers may have to pay tax on only one-half of their gain from the sale or exchange of qualified small business stock (§1202). This exclusion applies only to qualified small business stock held for more than 5 years.

Note: One-half of any excluded gain is treated as a preference under the alternative minimum tax.

Eligible Gain Limit

The amount of gain eligible for the exclusion is limited to the greater of:

(1) 10 times the taxpayer’s basis in the stock, or

Note: Basis is determined by valuing contributed property at fair market value on the date of the contribution.

(2) A $10 million gain from the stock.

The $10 million limit is applied on a shareholder-by-shareholder basis.

Qualified Small Business Stock

Qualified small business stock is stock that meets all the following tests:

(1) It must be stock in a C corporation;

(2) It must be originally issued after August 10, 1993;

(3) As of the date the stock is issued, the corporation must be a qualified small business;

Note: A qualified small business is a C corporation with total gross assets of $50,000,000 or less at all times after August 9, 1993, and before it issued the stock. The corporation’s total gross assets immediately after it issues the stock must also be $50,000,000 or less. The corporation’s total gross assets include the assets of any predecessor of the corporation. In addition, all corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.

(4) The taxpayer must acquire the stock at its original issue, directly or through an underwriter, in exchange for money or other property (not including stock), or as compensation for services provided to the corporation (other than services performed as an underwriter of the stock); and

Note: In certain cases, stock may also meet this test if acquired from another person who met this test, or through a conversion or exchange of qualified small business stock.

(5) The corporation must meet the active business test, and be a C corporation during substantially all the time the taxpayer holds the stock.
Active Business Test

A corporation meets the active business test for any period of time if, during that period it:

(1) Is an eligible corporation, and
(2) Uses at least 80% (by value) of its assets in the active conduct of at least one qualified trade or business.

Note: Any specialized small business investment company (SSBIC) is treated as meeting the active business test. An SSBIC is an eligible corporation, defined next, that is licensed to operate under §301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.

Eligible Corporation

An eligible corporation is any U.S. corporation other than:
(a) A Domestic International Sales Corporation (DISC) or a former DISC,
(b) A corporation that has made, or whose subsidiary has made, an election under §936 concerning the Puerto Rico and possession tax credit,
(c) A regulated investment company,
(d) A real estate investment trust,
(e) A Real Estate Mortgage Investment Conduit (REMIC), or
(f) A cooperative.

Qualified Trade or Business

A qualified trade or business is any trade or business other than:
(a) One involving services performed in the fields of:
   (1) Health,
   (2) Law,
   (3) Engineering,
   (4) Architecture,
   (5) Accounting,
   (6) Actuarial science,
   (7) Performing arts,
   (8) Consulting,
   (9) Athletics,
   (10) Financial services, or
   (11) Brokerage services,
(b) One whose principal asset is the reputation or skill of one or more employees,
(c) Any banking, insurance, financing, leasing, investing, or similar business,
(d) Any farming business (including the business of raising or harvesting trees),
(e) Any business involving the production or extraction of products for which percentage depletion can be claimed, or
(f) Any business of operating a hotel, motel, restaurant, or similar business.

Pass-Through Entities

Gain from the disposition of qualified small business stock by a partnership, S corporation, regulated investment company or common trust fund that is taken into account by a partner, shareholder or participant (other than a C corporation) is eligible for the exclusion, provided that:

(1) All eligibility requirements with respect to qualified small business stock are met,
(2) The stock was held by the entity for more than 5 years, and
(3) The partner, shareholder, or participant held its interest in the entity on the date the entity acquired the stock and at all times thereafter and before the disposition of the stock.

In addition, a partner, shareholder, or participant cannot exclude gain received from an entity to the extent that the partner’s, shareholder’s, or participant’s share in the entity’s gain exceeded the partner’s, shareholder’s or participant’s interest in the entity at the time the entity acquired the stock.

Capital Gains & Investment Interest

Any gain that is excluded from gross income is not taken into account in computing long-term capital gain or in applying the capital loss rules of §1211 and §1212. In addition, the taxable portion of the gain is taxed at a maximum rate of 28%. The amount treated as investment income for purposes of the investment interest limitation does not include any gain that is excluded from gross income under the provision.
Start-Up Expenses - §195

A start-up expense is one paid or incurred for creating an active trade or business, or for investigating the possibility of creating or acquiring an active trade or business. However, to be amortizable, it must be deductible if paid or incurred in the operation of an existing trade or business in the same field. Amounts paid or incurred in any activity engaged in for profit and for the production of income, paid before the day the active trade or business begins and in anticipation of the activity becoming an active trade or business, are considered start-up expenses. Start-up expenses should not be confused with organizational expenses (§195(c)).

Formerly, no deduction was allowed for start-up expenses unless the corporation chose to treat those expenses as deferred expenses and to amortize them. When amortized, start-up expenses were historically deducted in equal amounts over a period of not less than 60 months. The amortization period started in the month the active business is started or acquired (§195(a); §195(b)(1)).

The American Jobs Creation Act of 2004 modified the treatment of start-up and organizational expenditures. As a result, a taxpayer is currently allowed to elect to deduct up to $5,000 of start-up and $5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational 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.

Covered Expenses

Start-up expenses are those incurred before the business actually begins operations. They include expenses both for investigating a prospective business and getting the business started. For example, they may include costs for the following items:

1. A survey of potential markets,
2. An analysis of available facilities, labor supply, etc.,
3. Advertisements for the opening of your business,
(4) Salaries and wages for employees who are being trained, and for their instructors,
(5) Travel and other necessary expenses for lining up distributors, suppliers, or customers, and
(6) Salaries and fees for executives, consultants, or for other professional services (H.R. Rept. 96-1278, 10 (PL 96-605), 1980-2 CB 709, 712).

Start-up expenses do not include interest, taxes, or research and experimental expenses that are allowable as deductions (§195(c)(1)).

Amortization

To amortize start-up expenses, complete Part VI of Form 4562, Depreciation and Amortization and attach it to the corporation’s tax return for the tax year in which the amortization period starts. Also attach a statement to the taxpayer’s individual return. It should show the total amount of those expenses and describe what they were for, the date incurred, the month the corporation began business, and the months in the amortization period. The return and statement must be filed by the due date of the return including extensions (Ann. 81-43).

Organizational Expenses - §248

A newly organized corporation may choose to treat its organizational expenses as deferred expenses and to amortize them. To amortize, deduct the expenses in equal monthly amounts over a period of not less than 180 months starting with the first month the corporation is actively engaged in business.

Note: Remember, the American Jobs Creation Act of 2004 modified the treatment of organizational expenditures. As a result, a taxpayer is currently allowed to elect to deduct up to $5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced by the amount by which the cumulative cost of organizational expenditures exceeds $50,000. Organizational expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period.

If the choice is not made, these expenses must be capitalized and may be deducted only in the year the corporation is finally liquidated. These expenses must be incurred before the end of the first tax year the corporation is in business (Reg. §1.248-1(a)(2)).

Definition

Organizational expenses are those incurred directly for the creation of the corporation that would be chargeable to the capital account. If spent for the creation of a corporation having a limited life, the expenses are amortizable over that limited life.
They include expenses of temporary directors and organizational meetings of directors or shareholders, fees paid to a state for incorporation, and accounting expenses and legal services incident to organization, such as drafting the charter, bylaws, minutes of organizational meetings, and terms of the original stock certificates (Reg. §1.248-1(b)(2)).

**Stock Issuance & Syndication Expenses**

Expenses for issuance or sale of stock or securities, such as commissions, professional fees, and printing costs, cannot be deducted or amortized. Nor can expenses for the transfer of assets to the corporation be deducted or amortized (Reg. §1.248-1(c)).

**Amortization**

If a corporation wants to amortize organizational expenses, it must choose to do so when it files its return for the first tax year it is actively engaged in business. The choice must be made not later than the due date (including extensions) of the return for that tax year. The corporation completes Part VI of Form 4562 and attaches it to its return. It must also attach a statement to its return (Reg. §1.248-1(c)). The statement should show the description and amount of the expenses, the date incurred, the month the corporation began business, and the months (not less than 60) over which the expenses are to be deducted. The time over which the corporation chooses to amortize its organizational expenses is binding.

**Start of Business**

A corporation starts business when it starts the activities for which it was organized. Generally, this occurs after its charter is issued. However, a corporation is considered to have begun business if its activities reach the point necessary to establish the nature of its business operations, even though it may not have received its charter. For example, if a corporation acquires the assets necessary to operate its business, it may be considered to have begun business activities (Reg. §1.248-1(a)(3)).
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

51. Under §351, the capitalization of a corporation can be tax-free. For this tax-free treatment to apply, what is required of the transferors of property to the corporation?
   a. They must receive other property plus stock.
   b. They, as a group, must have control of the entity directly following the exchange.
   c. They must control at least 50% of the stock of the corporation after the exchange.
   d. They must receive only stock in exchange for services to be performed for the corporation.

52. When property is transferred to a corporation in exchange for stock, the basis of stock received is equal to the basis of transferred property adjusted by certain factors. What is the basis of property transferred increased by?
   a. the total money received.
   b. any loss recognized.
   c. the fair market value of other property transferred.
   d. the total dividends.

53. Section 1244 allows an original shareholder’s loss on closely held corporation stock to be treated as an ordinary loss. However, §1244 has a number of general requirements. Which of the following items is one of those requirements?
   a. The entity must be an S corporation.
   b. The corporation operated an active trade or business.
c. The amount paid for the stock must be less than $500,000.

d. The stock must have been distributed for stock or securities.

54. To be eligible for the §1202 business stock exclusion, the stock must satisfy five tests. What is one of the tests that must be satisfied?

a. At the issue date, the company’s gross assets must total over $50,000,000.
b. The issue date of the stock must be after December 31, 1986.
c. The issuing company must meet the material participation test.
d. The stock must be C corporation stock.

55. When a corporation incurs expenses for its establishment that would be chargeable to a capital account, the corporation incurs organizational expenses. What may a newly organized corporation do?

a. treat such expenses as start-up expenses.
b. treat such expenses as deferred expenses and amortize them.
c. take such expenses as a tax credit.
d. defer such expenses without making an election.
Tax Recognition of the Corporate Entity

A corporation is generally taxed as a separate entity. However, the Service may question the tax validity of any corporation regardless of the legality of the corporation’s existence under its own state laws. Although the greatest danger is the professional corporation, no entity is truly safe from such scrutiny.

Tax Criteria

In general, when a corporation carries on any business it will be recognized as a separate entity (Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943)). However, when a corporation does virtually nothing except hold title, and serves no business purpose other than to obtain limited liability for the shareholder, the corporation will be ignored (Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945)).

Nominee & Agency Corporations

Often real estate investors use corporations to borrow money and hold title to land to avoid usury limits. A number of cases have held that avoiding usury laws is a business purpose and borrowing money is business activity. However, the Supreme Court’s decision in IRS v. Bollinger, 485 US 340 (1988, S Ct), creates an apparent safe harbor for agency relationships between a corporation and its shareholders, when the corporation holds property as nominee.

Section 482 Reallocation

Where it is necessary to clearly show income or to prevent evasion of taxes, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (§482).

6 Strong v. Commissioner, 66 TC 12 (1976). Aff’d, 553 F.2d 94 (2d Cir. 1977)
Section 482 of the Code permits the Service to reallocate income, expenses, and other items between commonly controlled businesses in order to prevent evasion of taxes or to clearly reflect taxable income. Although it is possible to prove that the Service abused its discretion in making a §482 allocation, it is difficult to do so. In general, the test is that a transaction between related entities’ must be at “arm’s length.” If it is not, the transaction will be restructured so that it is at arm’s length (Eli Lilly & Co. v. U.S., 372 F.2d. 990 (Ct. Cl. 1967).

Section 269A

Section 269A provides that if substantially all of the services of a professional service corporation are performed for one other corporation, partnership or other entity, and the principal purpose of incorporating is the avoidance or evasion of taxes, then the IRS may reallocate income and expenses of the corporation between the corporation and its employee-owners (i.e., employees who own or control more than 10%).

Corporate Income Tax Rates

There are two primary considerations in deciding whether or not to incorporate, limited liability and tax benefits. With few exceptions, tax benefits will emerge as the most important aspect in the decision to incorporate. The tax structure of the corporation as well as the effective use of the various fringe benefit plans available will determine the actual amount of tax savings realized.

Tax Tables

Current Rates

Under the TRA ‘86, the highest marginal tax rate imposed on the income of corporations was 34% (i.e., not considering the 39% marginal rate discussed below). This rate applied to income in excess of $75,000. Rates of 15% and 25% applied to income ranges below $75,000. A corporation with taxable income in excess of $100,000 was required to increase its tax liability by the lesser of 5% of the excess or $11,750. This increase in tax recaptured the benefits of the 15% and 25% rates.

Old TRA ‘86 Rates

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
</table>

This is an area of special concern when taxpayers continue their existing business after incorporating a new one.
Effective for taxable years beginning on or after January 1, 1993\(^8\), OBRA ‘93 provided a new 35% marginal tax rate on corporate taxable income in excess of $10 million. Corporations with taxable income in excess of $15 million now pay an additional tax equal to the lesser of:

1. 3% of the excess, or
2. $200,000.

This increase in tax recaptures the benefits of the 34% rate in a manner analogous to the recapture of the benefits of the 15% and 25% rates.

### Current Rates

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>$50,001 to $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>$75,001 to $100,000</td>
<td>34%</td>
</tr>
<tr>
<td>$100,001 to $335,000</td>
<td>39%</td>
</tr>
<tr>
<td>Over $335,000</td>
<td>34% Flat Rate</td>
</tr>
<tr>
<td>$10,000,001 to $15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>$15,000,001 to $18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>$18,333,334 to Infinity</td>
<td>35%</td>
</tr>
</tbody>
</table>

**Comment:** Because the 35% rate applies only to income in excess of $10 million, the vast majority of corporations will not be subject to the new rate.

**Note:** The maximum corporate rate is now lower than the maximum individual rate. This will obviously impact the decision whether to incorporate or use the S corporation election. However, remember there are many other factors to be weighed before deciding to incorporate or to voluntarily revoke any S elections already made. Especially with the latter course of action, a taxpayer would have to wait five years before having the option to re-elect S status again.

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\(^8\) Fiscal year corporations were required to use a blended rate for any year that included January 1, 1993.
Effective Date: Taxable years beginning after December 31, 1993. Fiscal years including January 1, 1993 must use blended rate.
Tax Return & Filing

After 2015, “C” corporations must file a federal tax return by the 15th day of the 4th (not 3rd) month after their taxable year ends, using Form 1120.

Corporate Estimated Tax

A corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years before January 1, 1994, a corporation generally did not have an underpayment of estimated tax if it made four timely estimated tax payments based on 97% of:

(1) Its current year tax liability, or
(2) Its tax liability computed by annualizing income as of the month or quarter ending immediately prior to its estimated tax payment due dates.

A corporation that was not a “large corporation” generally could avoid the addition to tax if it made four timely estimated tax payments each equal to at least 25% of its tax liability for the preceding taxable year. Additionally, a “large corporation” could have used this rule with respect to its estimated tax payment for the first quarter of its current taxable year.

Note: A “large corporation” is one that had taxable income of $1 million or more for any of the three preceding taxable years.

For tax years beginning after 1993, the OBRA ‘93 increased the 97% requirement applicable for estimated tax payments based on a corporation’s current year tax liability or its liability based on annualized income to 100%.

<table>
<thead>
<tr>
<th>Installment</th>
<th>Percentage of Tax Due</th>
<th>Prior Law</th>
<th>OBRA ‘93</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>24.25</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>48.50</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>72.75</td>
<td>75</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>97.00</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

The OBRA ‘93 did not alter rules permitting the payment of estimated taxes based on a corporation’s tax liability for its preceding taxable year.

Note: The prior year’s tax exception does not apply to a corporation that had no tax liability in the prior year (R.R. 92-54). Thus, a “small corporation,” as well as a “large corporation,” with zero tax in the prior year will fall into the new provision and be required to pay 100% of current year’s tax to avoid an estimated tax penalty.

OBRA ‘93 also added another set of income annualization periods to the two existing sets. Under a new “optional method,” the corporation can compute its annualized income for the first installment based on the first two months’ income, the second installment on the first four months’ income, the third installment on the first seven months’ income and the fourth installment on the first ten months’ income.
Corporate Estimated Taxes

Estimated Payments Based on **Current** Year Taxes Go From 97% to 100%

<table>
<thead>
<tr>
<th>Installment</th>
<th>Old Law</th>
<th>OBRA ‘93</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>24.25%</td>
<td>25%</td>
</tr>
<tr>
<td>2</td>
<td>48.50%</td>
<td>50%</td>
</tr>
<tr>
<td>3</td>
<td>72.75%</td>
<td>75%</td>
</tr>
<tr>
<td>4</td>
<td>97.00%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Estimated Payments Based on 100% of **Prior** Year Taxes (Which Must be Greater Than Zero) Are Still Available to Any Corporation That is Not a **Large** Corporation

Note: A Large Corporation is One That Had Taxable Income of $1 Million or More For Any of Three Preceding Years
The corporation must use one “standard set” of monthly annualization periods unless it elects to use one of the two “optional methods.” Thus, there are now three alternative sets of periods a corporation may use to annualize income. Estimated Tax Annualization Alternate Methods (i.e., months included in annualization calculation by quarter):

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Standard</th>
<th>Opt 1</th>
<th>……Opt 2 - New</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>3 mos</td>
<td>3 mos</td>
<td>……2 mos</td>
</tr>
<tr>
<td>#2</td>
<td>5 mos</td>
<td>3 mos</td>
<td>……4 mos</td>
</tr>
<tr>
<td>#3</td>
<td>8 mos</td>
<td>6 mos</td>
<td>……7 mos</td>
</tr>
<tr>
<td>#4</td>
<td>11 mos</td>
<td>9 mos</td>
<td>……10 mos</td>
</tr>
</tbody>
</table>

Corporations are required to annually elect which of the three alternative periods they will use. The election is made on an annual basis. It must be made on or before the due date of the first estimated tax installment.

**Alternative Minimum Tax**

The corporate alternative minimum tax (AMT) is similar to the AMT that is imposed on individuals. The corporate AMT rate is 20% of Alternative Minimum Taxable Income (AMTI) that is in excess of the exemption amount of $40,000. This exemption amount is reduced by 25% of the amount by which AMTI exceeds $150,000 with the result that when AMTI reaches $310,000, the benefit of the exemption amount is lost.

**Computation**

Alternative minimum taxable income is computed as follows:

- **Regular Taxable Income (before NOL deduction)**
  
  Plus or Minus

- **AMT Adjustments Under §56**
  
  Plus

- **Tax Preferences Under §57**
  
  Equals

- **Alternative Minimum Taxable Income (AMTI) before AMT NOL deduction**
  
  Less

- **AMT NOL deduction (limited to 90%)**
  
  Equals

- **Alternative Minimum Taxable Income (AMTI)**
  
  Less

- **Exemption Amount**
  
  Equals
Alternative Minimum Tax Base  
*Multiplied by 20% (26% and 28% for individuals) Equals*  
AMT before AMT Foreign Tax Credit  
*Less*  
AMT Foreign Tax Credit (possibly limited to 90%)  
*Equals*  
Tentative minimum tax  
*Less*  
Regular Tax Liability before Credits minus Regular Foreign Tax Credit  
*Equals*  
Alternative Minimum Tax (§55(a); §55(b))

Exemption for Small Corporations

A corporation is treated as a small corporation exempt from the AMT for its tax year if that year is the corporation’s first tax year in existence (regardless of its gross receipts for the year), or:

1. It was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997, and
2. Its average annual gross receipts for the 3-tax-year period (or portion thereof during which the corporation was in existence) ending before its current tax year did not exceed $7.5 million ($5 million if the corporation had only 1 prior tax year).

If the corporation qualified as a small corporation exempt from the AMT for its previous tax year, but does not meet the gross receipts test for its current tax year, it loses its AMT exemption status. Special rules apply in figuring AMT for that tax year and all later years based on the “change date.”

Regular Tax Deduction - §55(c)

In the calculation of alternative minimum tax, “regular tax” is deducted from “tentative minimum tax.” The regular tax is the regular tax liability that is used for determining the limitation on various nonrefundable credits reduced by the regular (as opposed to the alternative minimum tax) foreign tax credit and without including:

1. The 5-year and 10-year averaging taxes on lump sum distributions from qualified retirement plan;
2. Any investment credit recapture; or
3. Any recapture of the low-income housing credit.

Tax Preferences & Adjustments

Any item that is treated differently for alternative tax purposes than it is for regular tax purposes is termed a tax preference (§57) or an adjustment (§56; §55(b)(2)(A)). Adjustments involve a substitution of a special AMT treatment of an item from the
regular tax treatment, while a preference involves the addition of the difference between the special AMT treatment and the regular tax treatment. Some adjustments can be negative (i.e., they result in alternative minimum taxable income that is less than taxable income). Tax preferences cannot be negative amounts. Some tax preferences and adjustments only apply to certain types of taxpayers.

Preferences & Adjustments for All Taxpayers
- Depreciation
- Depletion
- Mining Costs
- Pollution Control Facilities
- Incentive Stock Options
- Intangible Drilling Costs
- Long-term Contracts
- Tax Exempt Interest
- Appreciated Charitable Contribution Property
- Financial Institutions’ Bad Debts
- Alternative Tax Net Operating Loss Deduction
- Adjusted Basis of Certain Property

Preferences & Adjustments for Noncorporate Taxpayers & Some Corporations
- Circulation Expenditures
- Farm Losses
- Passive Losses

Preferences & Adjustments for Corporations Only
- Untaxed Book Income
- Earnings & Profits
- Blue Cross/Blue Shield Deduction
- Merchant Marine Capital Construction Fund

Adjustments - §56
As the AMT formula shows, taxable income is increased by positive adjustments and decreased by negative adjustments. Most positive adjustments arise because of timing differences between the AMT and the regular tax related to deferral of income or acceleration of deductions. When these timing differences reverse, negative adjustments are made.
There are other adjustments that are based on permanent differences between the AMT and the regular tax. These adjustments are similar to preferences and are always positive.

**Business Untaxed Reported Profits (Pre-1990)**

An additional positive adjustment is included in determining AMTI for those corporations whose taxable income differs from income used for financial accounting purposes. For 1987 through 1989, one-half of the excess of pretax adjusted net book income over AMTI was a positive adjustment.

*Adjusted net book income* refers to the net income or loss as shown on the taxpayer’s applicable financial statements, subject to several adjustments (§56(f)(2)(A) & Temp. Reg. §1.56-IT(b)(2)(i)). This business untaxed reported profits adjustment is treated as a timing adjustment even if it clearly related to a permanent exclusion. Since the business untaxed reported profits adjustment cannot be negative, AMTI is not reduced where adjusted net book income is less than AMTI.

In determining adjusted net book income, the following order of priority was used:

1. Financial statements filed with the Securities and Exchange Commission,
2. Certified audited financial statements prepared for nontax purposes,
3. Financial statements that must be filed with any Federal or other governmental agency,
4. Financial statements used for credit purposes,
5. Financial statements provided to shareholders,
6. Financial statements used for other substantial nontax purposes, and
7. The corporation’s earnings and profits for the year.

After 1989, the use of pretax book income was replaced by a concept based on adjusted earnings and profits. However, even prior to 1990, corporations had to use current adjusted earnings and profits in determining business untaxed reported profits if it did not have any of the statements listed in 1 through 6 above.

**ACE Adjustment (Post-1989)**

Effective for tax years beginning after 12/31/89, the business untaxed reported profits adjustment is replaced with an adjusted current earnings (ACE) adjustment. The ACE is tax based and can be a negative amount. AMTI is increased by 75% of the excess of ACE over unadjusted AMTI. Or AMTI is reduced by 75% of the excess of unadjusted AMTI over ACE. The negative adjustment is limited to the aggregate of the positive adjustments under ACE for prior years reduced by the previously claimed negative adjustments. Thus, the ordering of the timing differences is crucial because any lost negative adjustment is perpetual. Unad-
justed AMTI is AMTI without the ACE adjustment of the AMT NOL (§56(g)(1) & (2)).

ACE should not be confused with current earnings and profits. Although many items are treated the same, certain items that are deductible in computing earnings and profits (but are not deductible in calculating taxable income) generally are not deductible in computing ACE (e.g., Federal income taxes).

The starting point for computing ACE is AMTI, which is defined as regular taxable income after AMT adjustments (other than the NOL and ACE adjustments) and tax preferences (§56(g)(3)). The resulting figure is then adjusted for the following items in order to determine ACE:

1. **Depreciation:** The depreciation system is calculated using the alternative depreciation system (ADS) in §168(g). Thus, the depreciation is computed using the straight-line method without regard to salvage. The half-year or the mid-quarter convention is used for all property other than eligible real estate.

Effective for property placed in service after December 31, 1993, the depreciation component of the adjustment used in computing ACE is eliminated. AMT depreciation is instead computed using the same method as that used for individuals and corporations for non-ACE purposes (i.e., generally, the 150% declining-balance depreciation method over the applicable mid-points used for AMT purposes. This change would therefore not have any impact to property already eligible for only the straight-line method for regular tax purposes (e.g., residential and nonresidential real property).

2. **Exclusion Items:** These are income items (net of related expenses) that are included in earnings and profits, but will never be included in regular taxable income of AMTI (except on liquidation or disposal of a business). An example would be interest income from tax-exempt bonds. Exclusion expense items do not include fines and penalties, disallowed golden parachute payments, and the disallowed portion of meals and entertainment expenses.

3. **Disallowed Items:** A deduction is not allowed in computing ACE if it is never deductible in computing earnings and profits. Thus, the dividends received and net operating loss deductions are not allowed. However, since the starting point for ACE is AMTI before the NOL, no adjustment is necessary for NOL. An exception does allow the 100% dividends received deduction if the payor corporation and recipient corporation are not members of the same affiliated group and an 80% deduction when a recipient corporation has at least 20% ownership of the payor corporation (§56(g)(4)(C)(i) & (ii)). The exception does not cover dividends received from corporations where the ownership percentage is less than 20%.

4. **Miscellaneous Adjustments:** The following adjustments, which are required for regular earnings and profits purposes, are necessary:
(a) Intangible drilling costs,
(b) Construction period carrying charges,
(c) Circulation expenditures,
(d) Mineral exploration and development cost,
(e) Organization expenditures,
(f) LIFO inventory adjustments,
(g) Installment sales, and
(i) Long-term contracts (§312(n)(1) through (6)).

Other special rules apply to disallowed losses on the exchange of debt pools, acquisition expenses of life insurance companies, depletion, and certain ownership changes.

**Capital Gains & Losses - §1212**

A corporation, other than an S corporation, can deduct capital losses only up to its capital gains. In other words, if a corporation has a net capital loss, the loss cannot be deducted in the current tax year. It is carried to other tax years and deducted from capital gains that occur in those years (§1212(a)(1)). Excess capital losses may be carried back three years and carried forward for five years.

**Net Capital Loss Carryovers**

A net capital loss is first carried back 3 years. It is deducted from any total net capital gain that occurred in that year. If the loss is not completely used up, it is carried forward 1 year (2 years back) and then 1 more year (1 year back). If it is still not used up, it is carried over to future tax years, 1 year at a time, for up to 5 years. When a net capital loss is carried to another tax year, it is treated as a short-term loss. It does not retain its original identity as long term or short-term (§1212(a)(1)).

**Example from Pub. 542 Rev. '06**

A calendar year corporation has a net short-term capital gain of $3,000 and a net long-term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. The corporation treats this $6,000 as a short-term loss when carried back or forward.

The corporation carries the $6,000 short-term loss back 3 years. In year 1, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. It subtracts the $6,000 short-term loss first from the net short-term gain. This results in a net capital gain for year 1 of $7,000. This consists of a net short-
term capital gain of $2,000 ($8,000 - $6,000) and a net long-term capital gain of $5,000.

When carrying a capital loss from 1 year to another, the following rules apply:

1. When figuring this year’s net capital loss, any capital loss carried from another year cannot be used. In other words, capital losses may only be carried to years that would otherwise have a total net capital gain.

2. If capital losses from 2 or more years are carried to the same year, the loss from the earliest year is deducted first. When that loss is completely used up, the loss from the next earliest year is deducted, and so on.

3. A capital loss carried from another year cannot be used to produce or increase a net operating loss in the year it is carried to (§1212; Reg. §1.1212-1(a)(3)).

S Corporation Status

A capital loss may not be carried back from, or to, a year in which the corporation had in effect an election to be treated as an S corporation (§1371(b)(1)).

Asset Types

Obviously, whenever gain or loss is recognized as a result of an asset disposition, the character of the gain or loss will depend upon the nature of the asset so disposed of. There are basically three types of corporate property, these are:

1. *Section 1231 assets* are tangible non-inventory assets that are used in a trade or business and have been held for more than 12 months. The character of the property as being real or personal is immaterial for purposes of § 1231 but, gain can be recaptured when such assets are further subcategorized as §1245 or §1250.

2. *Capital assets* are assets held for investment, whether tangible or intangible. Gains and losses from certain dispositions of capital assets are treated as gains or losses from the disposition of either §1231 assets or ordinary assets.

3. *Ordinary assets* are assets that are held for sale in the ordinary course of the corporation’s trade or business and all other assets that do not qualify as being either capital assets or §1231 assets.

Five-Step Characterization Process

The proper classification of recognized gains and losses into one of the preceding three categories can be accomplished by using the following “five-step” approach:

**STEP 1.** Determine the character of the asset that was disposed of (i.e. was it held for business purposes, investment purposes, etc.).

**STEP 2.** Determine whether the property was real or personal.
**STEP 3.** Determine whether the tax character of the asset was §1231, capital or ordinary.

**STEP 4.** Determine the proper classification of the recognized gain or loss by considering the nature of the disposition, holding period, and the applicability of any recapture rules.

**STEP 5.** Net all gains and losses for the year.

### Netting Capital Gains (Losses)

At the close of each taxable year, the corporation must net all capital gains and losses that were recognized during the year for the purpose of determining the existence of either a net capital gain income (NCGI) or a net capital loss (NCL). The netting procedure is as follows:

- **(a)** First, combine all short-term capital losses and short-term capital gains to determine whether there is a net short-term capital gain or a net short-term capital loss.
- **(b)** Next, combine all long-term capital gains and losses to determine whether there is a net long-term capital gain or a net long-term capital loss.
- **(c)** Finally, combine the net short-term capital gain (loss) with the net long-term capital gain (loss) to determine the amount of the NCGI or NCL.

Capital losses are deductible only to the extent of capital gains (an individual may deduct capital losses to the extent of capital gains plus $3,000). However, nondeductible capital losses can be carried back three years and forward five years (against capital gains only). An individual cannot carry back unused capital losses but he can carry them forward indefinitely (§§1211(a) and 1212(a)).

### Netting Section 1231 Gains (Losses)

As is the case with capital gains and losses, all gains from the dispositions of §1231 assets that are not recaptured, must be netted with all losses from §1231 asset dispositions. The netting of §1231 gains and losses is to determine whether they will be treated as long-term capital gains and losses or as ordinary gains and losses.

### Character of Section 1231 Gains (Losses)

In general, if gains from the disposition of §1231 assets exceed the losses from §1231 assets, the net gain is recognized as a long-term capital gain. However, if the losses exceed the gains, then the net loss is treated as an ordinary loss.

### 5 Year Averaging

It is easy to see why this “best of both worlds” phenomenon caused a great many people to begin bunching their transactions to yield losses only in one
year, and all gains in the next. Congress did not agree that this was a terrific rule. As a result, TRA '84 introduced the five-year averaging rule. In effect, net §1231 gain is treated as ordinary income to the extent that it does not exceed all §1231 losses for the preceding five taxable years. Net §1231 losses that are used in this manner to recapture §1231 gains as ordinary income in one year cannot be used again to recharacterize additional §1231 gains from a subsequent year.

**NOL Carryback & Carryover**

All corporations (except mutual insurance companies, regulated investment companies, and S corporations) are entitled to the net operating loss deduction in computing their tax. The general rules governing NOLs are similar to those for individuals, but the *adjustments* for figuring the losses and loss carryovers differ.

An NOL may be carried back to each of the two *preceding* years, and carried over to each of the 20 *following* years. The loss is *first* carried to the earliest year, and then to the next earliest year, and so forth.

*Note*: Thus, for 2016, an NOL may be used until exhausted in 2014, 2015, and 2016 through 2036. This sequence must be followed. No part of the 2016 loss may be used to offset 2015 income until 2014 income has been absorbed.

A corporation may elect to *give up* the two-year carryback if it makes the election by the due date (with extensions) for filing the return for the year of the loss (§172(b)(1) & §172(b)(3)(C)).

*Note*: A corporation that is in fact dissolved cannot carry back an NOL, even if it is not legally dissolved.

**Temporary Extension of Carryback Period**

The general NOL carryback period was temporarily extended to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002.

In 2008, the American Recovery & Reinvestment Act provided an eligible small business with an election to increase the present-law carryback period for an applicable 2008 & 2009 NOL from two years to any whole number of years elected by the taxpayer that was more than two and less than six. As a result, qualified businesses had the choice to carryback NOLs three, four, or five years.

*Note*: The provision applied *only* to NOLs for any tax year beginning or ending in 2008 or 2009. The regular two year NOL carryback period returned for 2010 and thereafter.

An eligible small business was a taxpayer meeting a $15,000,000 gross receipts test. For this purpose, the gross receipt test of §448(c) was applied by substituting $15,000,000 for $5,000,000 each place it appeared.
Loss Computation

Net operating loss for a current tax year is the amount by which a corporation’s deductions exceed its gross income. Gross income for this purpose may be adjusted to reflect certain dividend deductions (§172(c), §172(d); Reg. §1.172-2). However, no NOL deduction is allowed. The gross income adjustment allows the following special deductions, without limitation:

(1) Deduction for 70% of dividends received from domestic corporations;
(2) Deduction for dividends received on certain public utility preferred stock;
(3) Deduction for dividends received from certain foreign corporations; and
(4) Deduction for dividends paid on certain preferred stock of public utilities.

Deduction Computation

The net operating loss deduction is the total of the NOL carryovers and carrybacks from other years (§172(a)). When NOLs for more than one year are involved, the NOL deduction for any year must be determined from the aggregate carrybacks and carryovers to that year.

Dividends Received Deduction - §243

A corporation is allowed a deduction for a percentage of certain dividends received during its tax year (§243).

Dividends from Domestic Corporations

A corporation may deduct, with certain limitations, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the distributing corporation. Thus, if a corporation owns stock in another domestic corporation subject to federal taxation, it may deduct from its gross income 70% of the dividends that it receives from the other corporation (§243(a)(1)).

Note: Small business investment companies may deduct 100% of the dividends received from a taxable domestic corporation (§243(a)(2)). In addition, if certain conditions are met, members of an affiliated group of corporations may deduct 100% of the dividends received from a member of the same affiliated group (§243(a)(3)).

This deduction reduces the effective federal income tax rate to 10.5% on dividends for a corporation in the 35% bracket, and 4.5% for a corporation in the 15% bracket.

9 For example, capital gains dividends received from regulated investment companies do not qualify for this deduction (§243(d)(2)).
Dividends that are received by the corporation from regulated investment companies such as mutual funds are further limited as to deductibility (§243(c)(2)).

**80% Exception**

A corporation can take a deduction equal to the lesser of 80% of dividends received or its taxable income without the dividend inclusion, when it owns at least 20% but no more than 80% of the paying domestic corporation. Such a corporation is referred to as a 20%-owned corporation.

### Charitable Contributions - §170

A corporation can claim a deduction, with certain limits, for any charitable contributions made in cash or other property. To be deductible, the contribution generally must be made to or for the use of community chests, funds, foundations, corporations, or trusts organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, or other charitable organizations (§501(c)(1); §170(c)(2); §501(c)(3)).

**Note:** A deduction is not allowed if any of the net earnings of an organization that receives the contribution are used for the benefit of any private shareholder or individual.

### Timing of Deduction

A corporation using the *cash* method of accounting may deduct contributions *only* in the year paid (§170(a)(1)).

A corporation using the *accrual* method of accounting can choose to deduct contributions for the tax year they were authorized by the board of directors, but not paid during that year, if payment is made within 2-1/2 months after the close of that year. The choice is made by reporting the contribution on the corporation return for the tax year. A copy of the resolution authorizing the contribution and a declaration stating the resolution was adopted by the board of directors during the tax year must accompany the return. The president or other principal officer must sign the declaration (Reg. §1.170A-11(b); §170(a)(2)).

### Limitation

A corporation cannot deduct contributions that total *more than 10%* of its taxable income (§170(b)(2)). Taxable income for this purpose is figured without taking into account the following:

1. Deduction for contributions;
2. Deductions for dividends received and dividends paid;
(3) Any net operating loss carryback to the tax year; and
(4) Any capital loss carryback to the tax year (Reg. §1.170A-11(b)).

**Carryover of Excess Contribution**

Any charitable contributions made during the year that are more than the 10% limit can, with certain restrictions, be carried over to each of the following 5 years. Any excess not used up within that period is lost.

A carryover of excess contributions is *not* deducted in the carryover year *until* after any contributions made in that year (subject to the 10% limit) have been deducted. A carryover of excess contributions is not allowed to the extent that it increases a net operating loss carryover in a succeeding tax year (§170(d)(2); Reg. §1.170A-11(c)(2)).

**Collapsible Corporations - §341 (Repealed)**

Generally, the complete liquidation of a corporation is treated by the shareholders as a *sale* of their stock, producing capital gains or losses (§331(a)(1)). Similarly, when a shareholder sells his stock to another person, or it is redeemed by the corporation under one of the safe harbors of §302 or §303, a capital gain or loss will be recognized.

Formerly, §341 converted capital gain on the sale or liquidation of a corporation into *ordinary income*. However, this provision was repealed by the 2003 Bush Tax Act (HR 2).

**Definition**

The collapsible corporation rules of §341 denied capital gains treatment to certain sales and distributions where the profit was attributable to *ordinary* assets. A corporation was collapsible if:

1. It was formed or availed of principally:
   - (a) To manufacture, construct or produce property;
   - (b) To purchase property that it holds for less than 3 years and that, in its hands, is:
     - (i) *Inventory* or stock in trade;
     - (ii) Property held for sale to customers in the ordinary course of business,
     - (iii) Depreciable or real property used in a trade or business (except property described in (i) and (ii)), or
     - (iv) Unrealized receivables or fees pertaining to the foregoing properties or services (“§341 assets”); or
(c) To hold stock in a corporation formed or availed of principally for the purposes in (a) or (b); and

(2) With a view to the sale or exchange of its stock (through a liquidation or otherwise) before the corporation has realized the requisite amount of taxable income to be derived from the property (§341(b)(1)).

Presumption

A corporation was presumed collapsible if the fair market value of its “§341 assets” was:

(a) 50% or more of the value of all its assets (excluding cash, government obligations, obligations held as capital assets, and stock in other corporations) and

(b) 120% or more of the adjusted basis of its “§341 assets” (§341(c)).

Covered Transactions

A shareholder’s capital gain from the following transactions was ordinary income if the corporation was “collapsible”:

(1) A sale or exchange of stock in the corporation;

(2) A distribution in complete or partial liquidation of the corporation if the distribution was treated as in part or full payment in exchange for the stock; or

(3) A nonliquidating distribution where the excess of the distribution over the basis in the stock was treated as gain from the sale or exchange of property (§341(a)).

Personal Holding Companies - §541

Sections 541 through 547 (or rather, their predecessors) were enacted in order to eliminate the tax “abuses” of incorporated stock portfolios, artistic talents, etc. Although these Sections are not specifically aimed at personal service corporations, it would appear that the danger of having the personal holding company label applied is most present to professional and other services.

In order to have the personal holding company label applied to it, a corporation must meet the following:

(1) At least 60% of the corporation’s “adjusted ordinary gross income” must be personal holding company income; and

(2) More than 50% of the net value of stock must be owned directly or indirectly, by five or fewer persons.
Penalty Tax

A penalty tax of 20% (in 2016) applies to the corporation’s undistributed personal holding company income in addition to the ordinary corporate income tax. Therefore, a corporation that would be defined as a personal holding company can avoid the penalty tax by simply distributing to its shareholders all of its personal holding company income. Personal holding companies are not subject to the accumulated earnings tax problems that plague other types of corporations.

Professional Corporations

The reason that the status of personal holding company is such a threat to professional corporations is that, among other items of “personal holding company income” such as rent, royalties, dividends, interest, annuities, etc., income from personal service contracts is included.

Income derived by a professional corporation under a personal service contract is construed as personal holding company income if:

(1) The professional who is to perform the services is named in the contract (oral or written) or can be so named by some person other than the corporation; and,

(2) The named professional owns directly, indirectly, or constructively, 25% or more of the value of the corporation’s stock at some time during the taxable year (i.e. any time during the taxable year).
Section 541 imposes an additional 20% penalty tax on corporations where:

- (1) five or fewer individuals own more than 50%, and
- (2) 60% or more of its adjusted ordinary gross income is personal holding company income

PHC income includes rents, interest, royalties, dividends and personal service contracts
Named Professionals

If a client or patient can name the professional who is to perform services for them, then personal holding company income can result. A possible solution to this problem is to make it clear to the client, and state in the corporate bylaws and employment contracts that only the corporation has the right to name the professionals who are to render services.

Avoidance of PHC Status

There are other ways to defeat the personal holding company status. For example, if a named shareholder owns less than 25% of the stock, then there’s no problem. A corporation with five 20% shareholders is safe. Even if a 25% shareholder exists, there is no problem if this individual is not named under a contract to perform personal services. S corporations, obviously, will always avoid this problem since all of their income is currently distributed and, therefore, not subject to the penalty tax.

Accumulated Earnings Tax Trap

A corporation can accumulate its earnings for use in possible expansion or for other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax. If the accumulated earnings tax applies, interest will be charged on the underpayments of the tax from the date the corporate return was originally due, without extensions. This tax applies without regard to the number of shareholders in the corporation (§532(c); §531; §6601(b)(4)).
Excess Accumulated Earnings Under §531

Under §531, a penalty tax (i.e., at an additional 20%) is imposed on corporations that permit earnings & profits to accumulate in excess of the greater of:

(1) the accumulated earnings credit ($250,000/$150,000), or
(2) reasonable business (including operating cycle) needs,
instead of distributing such amounts.
Imposition of Penalty Tax

The accumulated earnings tax is imposed on every corporation formed or availed for the purpose of avoiding income tax on its shareholders, by permitting earnings and profits to accumulate. For a corporation to avoid liability for accumulated earnings tax, if it accumulates earnings and profits beyond its reasonable business needs, it must show that tax avoidance by its shareholders is not one of the purposes of accumulation. The simple existence of a tax avoidance purpose is sufficient for imposing the accumulated earnings tax.

Note: Certain transactions, such as loans to shareholders, investments in assets having no reasonable connection to the corporation’s business, and the corporation’s dividend history, may indicate a prohibited purpose (Reg. §1.533-1(a)(2)).

Although publicly owned corporations are clearly intended to be covered by this Section, the IRS will undoubtedly have trouble finding the prescribed purpose in cases where the corporation’s stock is widely held. Closely held corporations are the primary targets in the imposition of this tax. Personal holding companies (§532(b)(1)) and S corporations (§1363(a)) are exempted from this tax.

Computation

The accumulated earnings tax is 20% (in 2016) of accumulated taxable income (§531). The corporation doesn’t report the tax. Instead, IRS assesses the tax if it believes any is due (Reg. §1.531-1). This tax is in addition to the ordinary corporate income tax.

Note: Tax exempt income cannot directly be subject to the tax however, such income is taken into consideration in determining the reasonableness of accumulated earnings and profits (R.R. 70-497).

Under §535(a), the accumulated taxable income for the year to which the penalty tax applies is:

(a) The corporate taxable income for the year with the deductions and additions listed in §535(b), less

(b) The sum of:

(i) The accumulated earnings credit, and

(ii) The dividends paid deduction.

Accumulated Earnings Credit

In order to permit small corporations to accumulate a minimum amount of earnings and profits, an accumulated earnings credit (§535(c)) is available. Most corporations may accumulate earnings and profits of at least $250,000 without having to prove a business purpose. This amount is known as the minimum accumulated earnings credit. However, personal service corporations whose principal
function is performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting are limited to $150,000.

**Application of Credit to Controlled Groups**

Where a controlled group of corporations exists, only one credit is available for the entire group and, if any one of the corporations is a personal service corporation, the entire group becomes limited to the $150,000 credit. The accumulated earnings tax is imposed on an annual basis. Therefore, only the improper accumulations for the year at issue or for all open years are subject to the tax.

**Reasonable Accumulations**

The defense against the IRS’ attempt to impose the accumulated earnings tax is to assert that the funds are being accumulated for a reasonable business purpose. The determining factor in whether or not a corporation is subjected to the accumulated earnings tax is whether or not profits are accumulated beyond the reasonable needs (or the reasonably anticipated needs) of the corporation. The corporation therefore, must be prepared to show a business reason for the accumulation.

An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonable anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes (Reg. §1.537-1(a)).

Accumulations for future needs of a business are justifiable if the needs are reasonably anticipated (§537). An accumulation cannot be justified where the future needs of the business are uncertain or vague, where plans for the future use of an accumulation are not specific or the plan is postponed indefinitely (Reg. §1.537-1(b)(1)).

**Working Capital**

Working capital is generally considered to be one reasonable business need. The IRS’ view of what constitutes reasonable working capital needs for personal service corporations is explained somewhat by the *Bardahl* case (*Bardahl Mfg. Co. v. U.S.*, 452 F.2d 604 (9th Cir. 1971)). *Bardahl* involved a non-service type corporation with inventory. The court created a formula based on the corporation’s operating cycle. This cycle is composed of an inventory turnover cycle and an accounts receivable turnover cycle. The cycle is then multiplied by the cost of goods sold and operating expenses, less depreciation and income taxes for the
year. The result is the allowable working capital accumulation of the corporation at year end.

Service Corporations
Since service type corporations do not have an inventory, the IRS claims that their operating cycles are composed only of accounts receivable turnover cycles. Based on the Bardahl formula, the average professional corporation would only be allowed a one or two month accumulation of working capital. Fortunately, the courts have been more liberal than the IRS and have not rigidly applied the Bardahl formula.

Minority Stock Redemptions
The accumulation of earnings and profits to fund the redemption of a minority stock interest has been held to serve a reasonable business purpose (Gazette Pub. Co. v. Self, 103 F. Supp. 799 (E.D. Ark. 1952)). Accumulations to redeem as much as 50% even appear to be safe (Mountain State Steel Foundries, Inc., v. Comm., 284 F.2d 737 (4th Cir. 1960); See also Hedburg- Freidheim Contracting Company, 251 F.2d 839 (8th Cir. 1958); and, Cadillac Textiles, Inc., TCM 1975-46 (the accumulation to redeem stock of two deadlock stockholders was not shown to be for a valid business purpose.)).

Majority Stock Redemptions
The accumulation of earnings and profits to redeem a majority stock interest is another question entirely. In the Pelton Steel Casting Co. v. Comm., 251 F.2d 278 (7th Cir. 1958), the court held that the redemption of an 80% stock interest served only a shareholder purpose. This case probably does not, however, constitute a blanket condemnation of majority redemptions.

Stockholder Harmony
The key to establishing a viable business need to accumulate earnings in order to affect a redemption would appear to be the preservation of stockholder harmony without which a closely held corporation is likely to fail. The requirement of some state laws that corporations redeem the stock of deceased shareholders would seem to establish the business purpose for the redemption, and in these cases, a corporate resolution setting forth these requirements and corporate purposes should be adopted.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

56. Under certain circumstances, the IRS may reallocate gross income. Under §482, a reallocation is likely to occur between two or more businesses:
   a. that have a parent-subsidiary relationship.
   b. sharing the same physical facilities.
   c. controlled by the same interests.
   d. that violate the Sherman Antitrust Act.

57. Corporations are required to make estimated tax payments. For tax years subsequent to 1993, what modification did Omnibus Budget Reconciliation Act of 1993 (OBRA ‘93) make to the prior rules for making estimated tax payments?
   a. A third method of computing annualized income is made available.
   b. Large corporations may opt out of making these payments.
   c. The corporation must make four timely payments based on 97% of its current year tax liability or liability based on annualized income.
   d. The corporation must make four timely payments that each equal at least a quarter of the tax liability for the preceding taxable year.
58. Certain corporations are treated as a small corporation exempt from the alternative minimum tax in any given tax year. However, to receive this exemption several requirements must be met. Which of the following is one of these requirements?
   a. The year in question is not the corporation’s first year.
   b. A corporation has been exempt for all prior years.
   c. Gross receipts have not exceeded $2.5 million.
   d. Five or fewer individuals own 50% or more the stock.

59. A corporation can deduct capital losses. What are they deducted against?
   a. capital gains.
   b. the alternative minimum tax.
   c. prior capital gains for five years.
   d. ordinary income.

60. Corporations can claim a deduction, with certain limits, for any charitable contributions made in cash or other property. Which contributions are corporations disallowed from deducting?
   a. those that include property previously used by the corporation.
   b. those that equal over 10% of its taxable income.
   c. those that include property created by the corporation.
   d. those that include property valued greater than $5,000 per item.

61. Under former §341, when profits of certain sales and distributions were attributable to ordinary assets, capital gains treatment was disallowed. Which of the following corporations was deemed collapsible under this provision?
   a. a corporation formed mainly to buy assets and hold them for over 3 years.
   b. a corporation formed mainly to buy stock in a service corporation.
   c. a corporation formed mainly to produce computer software.
   d. a corporation with §341 assets that had a fair market value of less than 100% of their adjusted basis.

62. Corporations should avoid classification as a personal holding company (PHC). However, which of the following corporations could be deemed a PHC?
   a. a corporation that has five shareholders who each own 20% of the stock.
   b. a corporation with a personal service contract naming the expert who is to render services.
   c. a corporation with an expert, owning less than 25% of the stock, who is named by a client.
   d. an S corporation.

63. Corporations must beware of the potential for accumulated earnings tax. Under §531, such a tax will apply where earnings are retained without:
   a. IRS approval.
b. restriction or limit on a corporation's gross receipts.
c. a sufficient business reason.
d. the application of interest.

Tax Exempt Income

Tax-exempt income received by a corporation increases earnings and profits. Therefore, if a corporation receives a payment of tax-free life insurance proceeds, any excess over premiums paid (or cash values) will increase earnings and profits. Likewise, interest on state bonds and other obligations, although not taxable when received by a corporation, increases earnings and profits (Reg. §1.312-6(b)). The proceeds
and interest then lose their tax-free nature when they are distributed to shareholders as dividends (R.R. 71-79).

**Note:** Dividends paid out of the earnings and profits of a corporation are ordinary income to the shareholder (§316; Reg. §1.316-1(a); §61(a)(7); Reg. §1.61-9).

Furthermore, a corporation’s receipt of tax exempt income may trigger an alternative minimum tax problem.

**Accounting Periods & Methods**

Prior to TRA ’86, a corporation, as a new taxpayer, could adopt a calendar year or any fiscal year regardless of the tax year of its unincorporated predecessor (Reg. §1.441-1(b)(3)). This flexibility was not usually accorded to partnerships and S corporations.

Similarly, a corporation could adopt the accounting method of its choice (Reg. §1.446-1(c)). Most corporations chose the cash method because of the ability to defer taxation on earnings until they are actually received. Billing and collection practices can further enhance the ability of the corporation on the cash basis to control its income. A new corporation could adopt the cash basis merely by filing its return on that basis.

**Accounting Periods**

A regular accounting period is either a calendar tax year or a fiscal tax year. If a corporation adopts the calendar year for its annual accounting period, it must maintain books and records and report its income and expenses for the period from January 1 through December 31 of each year.

A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52-53 week year is a fiscal tax year that varies from 52 to 53 weeks (§441(a)).

Generally, partnerships, S corporations, and personal service corporations must use “required tax years.” The required tax year does not have to be used if the partnership, S corporation, or personal service corporation establishes a business purpose for a different period, or makes a §444 election (§441(i); §706(b); §1378).

**Section 444 Election**

Partnerships, S corporations, and personal service corporations may elect to use a tax year that is different from the required tax year under §444. This election does not apply to any partnership, S corporation, or personal service corporation that establishes a business purpose for a different period.
A partnership, S corporation, or personal service corporation may make a §444 election if it:

(a) Is not a member of a tiered structure,
(b) Has not previously had a §444 election in effect, and
(c) Elects a year that meets the deferral period requirement (Reg. §1.444-1T(b); Reg. §1.444-2T).

An election to change a tax year will be allowed only if the deferral period of the elected tax year is not longer than the shorter of:

(a) Three months, or
(b) The deferral period of the tax year being changed (§444(b); Reg. §1.444-1T(b)(2)).

For a partnership, S corporation, or personal service corporation that wants to adopt or change its tax year, by making a §444 election, the deferral period is the number of months between the end of the elected tax year and the close of the required tax year. If the current tax year is the required tax year, the deferral period is zero (Reg. §1.444-1T(b)(4)(ii)(B)).

The §444 election is made by filing Form 8716, Election To Have a Tax Year Other Than a Required Tax Year, with the Internal Revenue Service Center where the tax return is normally filed. Form 8716 must be filed by the earlier of:

(a) The 15th day of the sixth month of the tax year for which the election will be effective, or
(b) The due date (without regard to extensions) of the income tax return resulting from the section 444 election (Reg. §1.444-3T(b); Ann 88-90).

Partnerships and S corporations that make a §444 election must make certain required payments. An electing personal service corporation must make certain distributions.

Business Purpose Tax Year

A business purpose for a tax year is an accounting period that has a substantial business purpose for its existence. Both tax and nontax factors must be considered in determining if there is a substantial business purpose for a requested tax year.

A nontax factor that may be sufficient to establish a business purpose for a tax year is the annual cycle of business activity, called a “natural business year.” The accounting period of a natural business year includes all related income and expenses. A natural business year exists when a business has a peak period and a non-peak period. The natural business year is considered to end at or soon after the end of the peak period. A business whose income is steady from month to month, year-round, would not have a natural business year as such (Reg. §1.7061(b)(4)(iii); R.P. 74-33)
25% Test

The natural business year is determined by the 25% test using the method of accounting used for the tax returns for each year involved. To figure the 25% test:

1. Compute gross receipts from sales and services for the most recent 12-month period that ends with the last month of the requested fiscal year. Divide this amount into the gross receipts of the last 2 months of this same 12-month period.
2. Make the same computation for the two 12-month periods immediately proceeding the 12-month period used in (1).
3. Compare the results; if each of the three results equals or exceeds 25%, the fiscal year is the natural business year.

If the partnership, S corporation, or personal service corporation qualifies for more than one natural business year, the year producing the highest average of the three percentages is the natural business year.

Note: If the partnership, S corporation, or personal service corporation does not have at least 47 months of gross receipts (which may include a predecessor organization’s gross receipts), it cannot use this expeditious procedure to obtain permission to use a fiscal year (R.P. 87-32 sec 4.01(1)).

Length of Accounting Period

Generally, a corporation’s accounting period may not exceed 12 months. However, if the requirements of §441(f) are met, the corporation may elect to adopt a 52-53 week taxable year.

Short Tax Year

A short tax year is a tax year of less than 12 months. There are two situations that can result in a short tax year. The first occurs when the corporation is not in existence for an entire tax year. The second occurs when there is a change in accounting period. Each situation results in a different way of figuring tax for the short tax year (Reg. §1.443-1(a)(2)).

Not in Existence Entire Year

A tax return is required for the short period during which the corporation was in existence. Requirements for filing the return and paying the tax generally are the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year (§443(a)).
Example


Change in Accounting Period

If the corporation changes its accounting period, the tax for the short tax year is figured by placing taxable income for the short period on an annual basis.

Election of Accounting Period

Subject to the limitations discussed below, a corporation may elect either a calendar year or a fiscal year (including a period of 52 or 53 weeks) by filing its first return in a timely manner. Extreme care should be taken in the filing of the initial return. The corporation’s taxable year begins on the date on which the corporation came into existence. Not the date that it commences business. If this mistake is made on the initial return, the corporation will automatically be placed on a calendar year basis. Furthermore, the IRS has ruled that the filing of an extension for an initial return will qualify as an election for the corporation to adopt the accounting period specified on the Form 7004 (R.R. 57-589).

Changing Accounting Periods

Generally, once an accounting period has been elected, no change can be made without the corporation first having obtained the prior consent of the IRS. The IRS will not grant the change unless it can be substantiated as being for a substantial business purpose.

To get this approval, Form 1128 must be filed along with a user fee of $200. This form must be filed by the 15th day of the 2nd month after the close of the short tax year. This short tax year begins on the first day after the end of the present tax year and ends on the day before the first day of the new tax year (R.P. 90-17).

Example

XYZ corporation uses a calendar tax year and, in 2016, wants to change to a fiscal year ending October 31. XYZ must file Form 1128 before December 16, 2016.
Changes without IRS Consent

A corporation (other than an S corporation or a personal service corporation) may change its tax year without first getting the approval of the IRS if the following conditions are met:

(a) It must not have changed its tax year within the 10 calendar years ending with the calendar year in which the short tax year resulting from the change begins,

(b) Its short tax year must not be a tax year in which it has a net operating loss,

(c) Its taxable income for the short tax year must be (when annualized) 80% or more of its taxable income for the tax year before the short tax year, and

(d) It must not try to become an S corporation for the tax year that would immediately follow the short tax year required to effect the change (Reg. 1.442-1(c)).

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. An accounting method is chosen when the first tax return is filed. After that, to change an accounting method, permission from the IRS is required (Reg. §1.446-1(a)(1); Reg. §1.446-1(e)(1)).

Methods Available

Generally, the Code recognizes four types of accounting methods as being generally acceptable. Although the specific requirement of §446 is highly nebulous in its requirement that any method may be used provided that it “clearly reflects income”, there will seldom be any reason to opt for a method that is not described below. The methods that the IRS would most like to see are as follows:

(a) Cash method,

(b) Accrual method

(c) Special methods of accounting for certain items of income and expense, and

(d) Combination (hybrid) method of the cash, accrual, or special methods (Reg. §1.446-1(c)(2)(ii)).

A corporation may use a different accounting method for each trade or business that it engages in (§446(d)).
Paragraph 1: Four types of taxpayers cannot use the cash method of accounting:

1. C corporations;
2. Partnerships that have one or more C corporations as a partner;
3. Tax shelters (as defined in §461(i)); and
4. Trusts that are subject to the UBTI, but only as to that income.

Paragraph 2: However, the cash method can still be used by:

- individuals, S corporations, qualified partnerships & qualified PSC;
- farming & timber businesses; and
- corporation or partnership with gross receipts of $5 million or less.
Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. However, if inventories are necessary in accounting for income, the accrual method must be used for sales and purchases (Reg. §1.446-1(c)(2)). Under the cash method, you only report income when it is received (not when it ‘accrues’) and deductions are not allowed until paid.

Limitation

The cash method of accounting cannot generally be used by C corporations, partnerships that have a C corporation as a partner, tax shelters, and certain tax-exempt trusts (§448 and §461(i))\(^\text{10}\). However, the following may continue to use the cash method:

1. An individual (including a sole proprietorship business),
2. “S” corporations,
3. A qualifying partnership (i.e., a partnership that does not have a C corporation as a partner),
4. A qualified personal service corporation, provided that their stock is owned primarily by employees, and
5. A small business if for every year after 1985 it does not have more than $5 million in average annual gross receipts for any prior three-year period, and provided it does not have inventories for sale to customers (Reg. §1.448-1T(a)).

R.P. 2011-14

The Service has issued (R.P. 2011-14), a revenue procedure describing how qualifying small businesses can obtain automatic consent to change to the cash method of accounting. A qualifying small business under the proposed revenue procedure is one that has average annual gross receipts between $1 million and $10 million that is not prohibited from using the cash method under §448. Form 3115 will serve as the application for consent to change accounting methods.

Accrual Method

The accrual method requires you to report income when it is earned, rather than when it’s received. Expenses can be deducted when all events have occurred that fix the amount of liability for an expense item, even though it

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\(^\text{10}\) Thus, cash basis accounting is generally limited to proprietorships, S corporations and partnership without corporate partners.
may be paid in a subsequent year. Using the accrual method will often be less advantageous than the cash method for tax purposes.

Note: Taxpayers cannot deduct business expenses and interest owed to a related cash basis person until payment is made and the corresponding amount is includible in the gross income of the related person (§267(b)).

**Economic Performance Rule**

Generally, business expenses are not deductible until economic performance occurs. If the expense is for property or services provided, or for use of property, economic performance occurs as the property or services are provided or as the property is used.

If expense is for property or services provided to others, economic performance occurs as the property or services are provided. An exception allows certain recurring expenses to be treated as incurred during a tax year even though economic performance has not occurred (§461(h)(1); §461(h)(2)).

**Example**

*XYZ corporation is a calendar year taxpayer and in December 2015 it buys office supplies. XYZ received the supplies and is billed for them in December, but pays for the supplies in January 2016. XYZ can deduct the expense in 2015 because (1) all events that set the amount of liability and (2) economic performance occurred in that year. The office supplies may qualify as a recurring expense. In that case, XYZ may be able to deduct the expense in 2015 even if economic performance (delivery of the supplies to XYZ) did not occur until 2016.*

**Special Methods**

There are special methods of accounting for certain items of income or expense such as:

(i) Depreciation,
(ii) Amortization and depletion,
(iii) Deduction for bad debts, and
(iv) Installment sales.

**Combination (Hybrid) Method**

Any combination of cash, accrual, and special methods of accounting can be used if the combination clearly shows income and is consistently used. The accrual method must be used for purchases and sales. The cash method may
be used for all other items of income and expenses. The following restrictions do apply:

(i) If the cash method is used for figuring income, the cash method must be used for reporting expenses; and

(ii) If the accrual method is used for reporting expenses, the accrual method must be used for figuring income (Reg. §1.446-1(c)).

Any combination that includes the cash method is treated as the cash method, subject to the limitations applied to this method.

**Changing the Accounting Method**

As with accounting periods, no change in accounting method may be made without the consent of the IRS. Again, in order to have a request for change granted, the corporation will have to demonstrate a substantial business reason for the change (voluntary change). In addition, the IRS may impose a change in method in order to cause the corporation to more clearly reflect income (involuntary change).

**Inventories**

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If a business must account for inventories, it must use the *accrual* method of accounting for purchases and sales (Reg. §1.471-1; Reg. §1.446-1(c)(2)(i)).

The value of inventories at the *beginning* and *end* of each tax year is required to determine taxable income. To determine the value of inventory, both a method for *identifying* the items in inventory and a method for *valuing* these items is needed.
Identification Methods

There are three methods of identifying items in inventory - specific identification, first-in first-out (FIFO), and last-in first-out (LIFO).

Specific Identification Method

The specific identification method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition in addition to other allocable costs, such as labor and transportation. Under the specific identification method goods are matched with their invoices (less appropriate discounts) to find the cost of each item. If there is no specific identification of items with their costs, an assumption must be made to decide which items were sold and which remain in inventory. Normally, this identification is made by either the first-in first-out method, or the last-in first-out method.

FIFO Method

The first-in first-out (FIFO) method assumes that the items purchased or produced first are the first items sold, consumed, or otherwise disposed of (Reg. §1.471-2(d)). The items in inventory at the end of the tax year are valued as the items most recently purchased or produced. If there is intermingling of the same type of goods in the inventory so that they cannot be identified with specific invoices, the FIFO method must be used to value these items, unless the last-in first-out (LIFO) method is elected (see below). Thus, the cost of inventory under the FIFO method is the cost of goods most recently purchased.

LIFO Method

The last-in first-out (LIFO) method assumes that the items of inventory purchased or produced last are sold or removed from inventory first. Thus, items included in the closing inventory are considered to be those from the opening inventory plus those items acquired in the current year in the LIFO order (Reg. §1.472-1a). The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, LIFO will produce a smaller cost of goods sold and a higher closing inventory. Under FIFO the reverse will be true (Reg. §1.472-1(b)).

Note: The ‘86 Act adopted tough uniform capitalization rules that require all manner of indirect expenses to be capitalized and included in the cost of inven-
Valuation Methods

Since valuing the items in inventory is a major factor in figuring taxable income, the way inventory is valued is very important. Several pricing methods, which may be used to figure the correct cost basis of inventory, are recognized for tax purposes. The dollar value that results is the cost basis of the inventory.

The two common ways to value inventory are:

1. The cost method (Reg. §1.471-3), and
2. The lower of cost or market method (Reg. §1.471-4).

The same method must be used to value the entire inventory, and taxpayers may not change to another method without consent from the IRS.

Cost Method

The cost method is the foundation of inventory valuation and may be used under any inventory identification method. Under §471, regulations defining “cost” have been issued by specific industry.

Note: For example, retailers can value each item of merchandise in stock at the end of the year at its retail selling price but adjusted to approximate cost by eliminating the average percent of markup (Reg. §1.471-8(a)). Likewise, miners and manufacturers who use a single process, and derive a product of two or more kinds with a unit cost substantially alike, may allocate a share of total cost to each kind as a basis for pricing inventories (Reg. §1.471-7).

Generally, however, the cost of merchandise purchased during the year is the cost of acquisition in addition to costs allocable to the merchandise. Thus, the cost of the goods purchased ordinarily is the invoice price reduced by trade or other discounts. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods (Reg. §1.471-3(b)).

The costs of goods produced by the taxpayer include the cost of raw materials and supplies entering into or consumed in manufacture, regular and overtime direct labor costs, and the indirect costs (Reg. §1.471-3(c)).

Uniform Capitalization Rules - §263A

Under the uniform capitalization rules, businesses are required to capitalize direct costs and an allocable portion of most indirect costs that benefit or are incurred because of production or resale activities. This means that certain expenses incurred during the year will be included in the basis of property produced or in inventory costs, rather than claimed as a current deduction. These costs will eventually be recovered through depreciation, amortization,
or cost of goods sold when the property is used, sold, or otherwise disposed of.

Businesses are subject to the uniform capitalization rules if they:

(i) Produce real or tangible personal property for use in a trade or business or an activity engaged in for profit,
(ii) Produce real or tangible personal property for sale to customers, or
(iii) Acquire property for resale, but not personal property if the average annual gross receipts are not more than $10,000,000 (Reg. §1.263A-IT(a)(1); Reg. §1.263A-IT(a)(6)(i)).

**Lower of Cost or Market Method**

Except for businesses using the LIFO method, inventories may be valued at the lower of cost or market. Businesses using the LIFO method must value inventory at cost.

Lower of cost or market means that the market value of each item on hand at the inventory date is compared with its cost and the lower value is used as its inventory value (Reg. §1.471-4(a)).

Under ordinary circumstances and for normal goods, *market value* means the usual bid price at the date of the inventory. This price is based on the volume of merchandise usually purchased (Reg. §1.471-4(a)). The courts have uniformly interpreted “bid price” to mean *replacement cost* - that is, the price that a taxpayer would have to pay on the open market to purchase or reproduce the inventory items.

**Multiple Corporations**

If properly handled, multiple corporations can provide important benefits, both tax and non-tax, to the owners. The tax advantages made possible by operating a business through multiple corporations can include:

1. Dividing corporate taxable income among several corporations to substantially reduce income tax liability.
2. Avoiding the tax on unreasonable accumulation of earnings by generating additional accumulated earnings tax credits.
3. Providing additional exemptions in computing the alternative minimum tax.
4. Excluding certain groups of employees from retirement plan and fringe benefit coverage.
5. Facilitating a future sale of part of the business by selling one of the corporations.
6. Adopting different accounting methods and periods which are most suitable for a particular aspect of the business.

**Controlled Group Rules**

To preclude abuse using of multiple corporations, §1561 imposes restrictions on the tax benefits available to controlled groups of corporations:

1. A controlled group of corporations is limited to a total of only one $50,000 taxable income bracket amount and one $25,000 taxable income bracket amount in each taxable income bracket below the top 35% corporate bracket (§1561(a)(1)).
2. Group members are limited to one $250,000 minimum accumulated earnings credit, unless any member is a service corporation, in which case the group gets only one $150,000 minimum credit (§1561(a)(2)).
3. Group members are limited to one $40,000 exemption amount in computing the alternative minimum tax (§1561(a)(3)).
4. Group members are treated as one taxpayer for purposes of the §179 expensing rules (§179(d)(6)).

*Note:* Section 179 has a slightly different definition of controlled group than §1563.

5. All employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer, for retirement plan and fringe benefit purposes (§414(b)).

**Definition**

A “controlled group of corporations” under §1563(a) may be defined as:

1. A parent-subsidiary chain of corporations,
2. A brother-sister group of corporations, or
3. A combination of the two.

**Parent-Subsidiary Groups**

A parent-subsidiary group exists where a parent corporation owns at least 80% of the voting power or 80% of the total value of the stock of one or more subsidiary corporations. Subsidiary corporations in the first chain of subsidiary corporations are also included provided that the 80% stock ownership test is met by another corporation in the chain.
In determining if the 80% ownership test is met, the only constructive ownership test that applies states that a corporation that has an option to acquire stock is deemed to own such stock. The Code also states that certain stock is not to be counted in determining the 80% test, such as non-voting stock that is limited and preferred as to dividends.

Brother-Sister Groups

A brother-sister controlled group exists if:

(a) The same five or fewer individuals, estates or trusts own at least 80% of the voting power or value of the shares of each corporation; and,

(b) These same five or fewer individuals, estates or trusts own more than 50% of the voting power or value of the shares of each corporation, but considering an owner’s stock only to the extent that it is owned identically with regard to each corporation.

Note: Thus, an unequal ownership of stock is counted only to the extent of the lowest percentage interest that is owned in the several corporations.

Consolidated Returns

An affiliated group of corporations may file a consolidated return in place of separate returns by each (§1501 through §1505). However, once a group files a consolidated return, it generally must continue to do so (Reg. §1.1502-75(a)(2)).

Some advantages of consolidated returns are:

(1) Operating losses of one group member offset operating profits of other members;

(2) Intercompany profits and losses aren’t generally taken into income until they are ultimately realized in transactions with outsiders;

(3) A parent increases its basis in the stock of its subsidiary by the subsidiary’s earnings and profits every year, so there’s less gain when the parent sells the stock; and

(4) There is a tax exemption (100% deduction) for intercompany dividends.

Definition

An affiliated group is a parent-subsidiary group of corporations in which:

(1) The common parent must directly own at least 80% of the total voting power and 80% of the total value of the stock in at least one other “includible” corporation; and

(2) Each remaining includible corporation must be 80% owned in voting power and value by one or more of the other includible corporations (§1504(a)).
Corporate Liquidations & Distributions

Under current law, corporate dissolutions may involve double taxation, one tax at the corporate level, and another one at the shareholder level.

A liquidating corporation recognizes taxable gain or loss on distributions of property to shareholders as if the property had been sold to the shareholder for its fair market value (§336(a)). If distributed property is subject to a liability, or if any shareholder assumes a liability of the liquidating corporation, the property’s fair market value is treated as not less than the amount of the liability (§336(b)).

Note: Gain (but not loss) is recognized by a corporation on a non-liquidating distribution of appreciated property to a shareholder under §311. Thus, the property is treated as being sold at the time of the distribution. The corporation will recognize gain on the excess of the fair market value over the adjusted basis of the property (§311(b)(1)).

Liquidating distributions to shareholders are treated as being in exchange for their stock (§331(a)). The amount of money plus the value of property received in the liquidation, less the basis of the stock, is capital gain. If basis exceeds the amount realized, there is a capital loss (Reg. §331-1(b)).

Note: Under §301, a shareholder recognizes ordinary income on a non-liquidating distribution of property by a corporation, if the corporation has either current or accumulated earnings and profits (i.e., it is a dividend under §316). However, the amount taxable as a dividend cannot exceed the earnings and profits of the distributing corporation (Reg. §1.316-1(a)(2)).

The Old General Utilities Doctrine

Under prior law, a corporate distribution of property (whether or not such distribution was incident to a liquidation proceeding) had no tax consequence to the corporation whatsoever. Neither gain nor loss was recognized. This non-recognition rule was generally referred to as the General Utilities Doctrine. This doctrine was codified by the original Internal Revenue Code of 1954 by its enactment of §311 for non-liquidating distributions and §336 for liquidating distributions.
Distributions From C Corporations

1. Dividends are distributions of property (i.e., money, securities, assets) made out of earning & profits (§316)

2. The portion of any distribution that is not a dividend is a return of capital; any excess over basis is gain from the sale of property (§301)

3. On a distribution of appreciated property a corporation recognizes gain as though the property were sold at FMV (§311)
   a. The amount of the distribution is the property’s FMV reduced by any liabilities
   b. The shareholder takes FMV basis in the distributed property (§301)
Subsequently, §337 was added which effectively extended the rules of §336 for distributions during a 12-month period by a corporation in complete liquidation. However, TRA ‘86 effectively repealed the General Utilities Doctrine by amending both §§336 and 337 to the effect that gain or loss is now recognized by the liquidating corporation upon the distribution of property as if the property had been sold at fair market value.

Loss Limitations

Section 336(d) imposes substantial limitations on the deductibility of losses pursuant to a liquidating distribution by way of related party rules (i.e., a shareholder and a corporation are related parties if the shareholder owns directly or indirectly, 50% or more of the value of the corporation’s outstanding stock). The effect is to impose the provisions of §267 on such transactions.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

64. Personal service corporations may make a §444 election. This election allows them to use a tax year other than:
   a. an established business year.
   b. the traditional calendar year by more than four months.
   c. a fiscal year.
   d. the mandatory tax year.
65. Corporations can choose from the cash method, accrual method, special methods for specific items of income and expense, and a hybrid method of accounting. When must a corporation choose its accounting method?
   a. at the time of its first tax return filing.
   b. when the corporation begins to conduct business.
   c. when the corporation files its articles of incorporation.
   d. when the corporation is formed.

66. The author lists six potential tax advantages of using multiple corporations to operate a company. What is one of these cited advantages?
   a. Exclusion of groups of employees from certain retirement plan benefits.
   b. Multiple accumulated earnings credits for affiliated group members.
   c. Independent taxable income bracket amounts.
   d. Multiple alternative minimum tax exemption amounts.

67. Businesses are required to account for inventories to provide evidence of income. Generally, what are businesses with inventories required to do?
   a. choose an identification method or a valuation method.
   b. use the cash accounting method.
   c. use the accrual accounting method.
   d. value inventories only at the end of the tax year.

68. Currently, when a corporation dissolves, it can trigger double taxation. Under §316, what are distributions of money, securities, and assets that are made from earnings and profits?
   a. a return of capital.
   b. dividends.
   c. considered a gain from the sale of property.
   d. deemed ordinary income.
Learning Objectives

After reading Chapter 5, participants will be able to:

1. Determine what constitutes an S corporation and specify the advantages and disadvantages associated with them.
2. Identify variables that impact whether a business can choose S corporation status, ways that an S corporation may be terminated and the related procedures that must be followed.
3. Recognize S corporation tax treatment including special areas involving income and expenses, pass-through items, built-in gain, passive income, tax preference items, LIFO recapture tax, capital gains tax, investment credit recapture, estimated tax payments, and basis of S corporation stock.
4. Identify S corporation owner compensation and distribution options noting reasonable compensation requirements, related party rules, S corporation distribution taxation, tax year choices, fringe benefits, and specifying when the Form 1120S must be filed.
S Corporations

Introduction

A corporation is taxed on its income under corporate tax rules. When it distributes dividends to its shareholders, the shareholders include these already taxed amounts in their income. In effect, regular corporate income is taxed twice, once to the corporation and again to the shareholders.

However, eligible domestic corporations can avoid double taxation by electing to be treated as an S corporation under the rules of Subchapter S. Subchapter S provides an optional method of corporate taxation (§1361 through §1379). It allows small business corporations to elect unusual tax treatment.

Similar to partnerships, all items of income, deduction, credit, gain and loss are passed through on a pro rata basis to the individual S corporation shareholders. In this way, the S corporation passes its items of income, loss, deduction, and credits through to its shareholders to be included on their separate returns.

In short, the S corporation is taxed like a partnership; it pays no taxes, and its income and deductions pass through to the shareholders. In other respects, however, S corporations are taxed like C corporations.

Often, it is advantageous to be taxed as an “S corporation” rather than a “C corporation” (i.e., a corporation taxed under the rules of subchapter C).

\(^1\) However, there are many differences between an S corporation and a partnership.
Advantages

There are many advantages to an S corporation:

1. An S corporation can distribute its profits to shareholders with only a single tax, whereas a C corporation incurs a double tax because dividends are not deductible.

   Note: Distributions of profits to shareholders, whether or not the shareholders are active in the business, are not subject to self-employment tax.

2. The losses of an S corporation are currently deductible by shareholders; shareholders cannot deduct the losses of a C corporation. Thus, S corporations provide an opportunity for the owners of a new business who are anticipating initial losses in the early years to take advantage of both the corporate limited liability and the flow through of losses. If a C corporation were used, losses could only be used as net operating losses by the C corporation.

3. A new corporation may elect S corporation in its initial year in order for its shareholders to utilize initial losses of the corporation, even though the shareholders may ultimately want to have the corporation taxed as a regular C corporation.

4. An S corporation is specifically exempted from the accrual method rules and can continue use of cash method of accounting, if such method is otherwise available because of nature of business.

5. If an S corporation stockholder does not actively participate in management of the corporation any income received will be passive and can be used to offset passive losses.

6. An S corporation provides a corporate shield for liability purposes for those taxpayers who want income and losses taxed to them, but who do not want the potential liability problems of a partnership.

7. A subchapter S corporation may adopt tax deductible and non-deductible fringe benefit plans. However, there are special rules and limits applicable to such plans.

8. An interest expense deduction is allowed for funds borrowed by a shareholder to purchase stock in an S corporation. Such interest constitutes business interest when the shareholder materially participates in the business.

9. Also, many difficult problems of C corporations are not problems for S corporations. For example:

   (i) An S corporation is not subject to the alternative minimum tax; and
   (ii) The personal holding company tax under §541 and the accumulated earnings tax of §531 do not apply to S corporations.
Advantages of a S Corporation

• Single Level of Tax on Earnings
• Limited Liability for All Shareholders
• Losses Can be Deducted by S/Hs
• Can Use Cash Method of Accounting
• No AMT, PHC, PSC or EAE Issues
• No Section 704(c) Problems
• Unreasonable compensation issue is reversed
• Distributions are generally tax-free
• Section 1244 is available
Planning

Specific circumstances where an S corporation may be desirable are:

(i) The business is expected to incur large losses and/or credits that may be better used by the shareholders than the corporation;

Note: Individual shareholders may benefit from a reduction in their taxable income during the first years of the corporation’s existence when it may be operating at a loss.

(ii) The business has little reason to accumulate capital;

(iii) The business will have a large cashflow that it intends to distribute;

(iv) Limited liability requires the use of a corporation; and

(v) When corporate rates are higher than individual rates.

Disadvantages

A subchapter S election has quite a few disadvantages (or potential disadvantages) that receive remarkably little press. It is important for you to consider these factors before electing S corporation status:

1. Since there is no corporate tax rate, nonqualified deferred compensation plans are an impracticality.
2. There is no opportunity to accumulate corporate earnings in a lower corporate tax bracket. It is difficult for an S corporation to reinvest its profits in the business since current profits are taxed to shareholders whether they are distributed or not.
3. Split-dollar and other non-deductible fringe benefits for the shareholders cannot be paid for by lower taxed corporate funds.
4. The 80% dividends received deduction is lost (§243 and §1373(c)-(d)).
5. The state tax laws may not provide for anything like a subchapter S election. Often states that have enacted a corporate income tax have not adopted a similar provision to the federal Subchapter S. Thus, in some states a Subchapter S election will not avoid the corporate double tax.
6. A new or dissident shareholder can cause the termination of the subchapter S election through a disqualified transfer of stock.
7. Neither an S corporation nor a C corporation has the flexibility that partners and partnerships do under §754 to equalize the outside basis of the owner’s interest with the inside basis of the entity’s assets on certain acquisitions of these interests or on property distributions from the entity to the owners.
8. Subchapter S corporations do not enjoy the special allocation of deductions and basis that are afforded partnerships under §704(b) and (c).
9. All income, except long term capital gains, received by the corporation are taxable to the shareholders whether or not they are currently distributed.
10. Use of an S corporation results in a loss of lower tax bracket at the corporate level on the first $75,000 of taxable income.

11. There are restrictions on borrowings by S corporation shareholders from their qualified retirement plans (§4975(d)).

12. If an S corporation shareholder is not a material participant, S corporation losses may only be deducted against passive profits.

13. More record keeping may be required by an S corporation because of the need to maintain accurate records for basis in shareholders stock, to maintain the accumulated adjustments account, and to determine the taxability of distributions.

**Becoming an S Corporation**

A corporation must be formed in accordance with both state and federal law. An S corporation, like other corporations, must generally obtain a corporate franchise or charter from the state in which it intends to incorporate or do business.

The corporate capitalization involves the transfer of money and/or property to the corporation in return for stock in the corporation. Section 351 provides that if one or more persons transfer property or money to a corporation solely in exchange for stock of that corporation, and immediately after the exchange the transferors are in control of the corporation, no gain or loss is recognized to the transferors or the corporation.

Note: Control is defined as owning (1) at least 80% of the total combined voting power of all classes of stock entitled to vote; and (2) at least 80% of the total number of shares of all other classes of stock of the corporation.

A corporation can become an S corporation if:

1. It meets the requirements of S corporation status.
2. All its shareholders consent to S corporation status.
3. It uses a permitted tax year, or elects to use a tax year other than a permitted tax year, explained later.
4. It files Form 2553, *Election by a Small Business Corporation*, to indicate it chooses S corporation status.

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2 The transfer of services to a corporation in exchange for stock results in taxable compensation and can destroy the application of §351.
Small Business Corporation

- Must be a Domestic Corporation
- Can’t be an Ineligible Corporation
- Can’t Have More Than 100 Shareholders
- Can Only Have Individual Shareholders Except for Certain Trusts
- Can’t Have Nonresident Alien as a Shareholder
- Can’t Have More Than One Class of Stock
**S Corporation Status**

Only “small business corporations” may elect to be treated as S corporations. A small business corporation is defined as a domestic corporation (see later discussion) that meets the following eligibility requirements.

**Number of Shareholders**

Formerly, S corporations could not have more than 35 shareholders with none of them being nonresident aliens (§1361(b)(1)(A)). However, the maximum number of S corporation shareholders has been increased to 100. Spouses are treated as a single shareholder (§1361(c)(1)). However, in the event of divorce, if both the former husband and the former wife continue to own shares in the corporation, they will be treated as two shareholders.

**Individuals Only**

It may have only individuals as shareholders. As a result, S corporation shareholders should particularly be advised to enter into a buy-sell agreement that restricts transfers to ineligible persons.

However, there are a number of exceptions to this requirement (§1361(b)(1)(B)).

**Estates**

A decedent’s estate or the estate of an individual in bankruptcy may be a shareholder (§1361(b)(1)(B)).

**Note:** In the case of a testamentary trust or a pour over type trust, where stock is transferred into trust pursuant to the terms of a will, the decedent’s estate will be treated as the owner of the stock until it is actually transferred into the trust, at which time the trust may be treated as the shareholder for a period of 60 days.

**Grantor Trusts**

A trust, all of the income of which is taxed to the grantor or to a third party who has control over the trust (i.e., the “deemed owner”), can be a shareholder for 60 days after the death of the deemed owner. If the income of the trust is includible in the gross estate of the deemed owner, the trust can remain a shareholder for two years after the death of the deemed owner (§1361(c)(2)(A)(i) and (ii)).

Effective for taxable years beginning after December 31, 1996, the 60-day post-death holding period is increased to two years for all grantor trusts (§§1361(c)(2)(A)(i) and (ii)).
Voting Trusts

A voting trust can be a shareholder. A voting trust is a trust created to exercise the stock voting powers transferred to it. The beneficiaries of the voting trust are counted for purposes of complying with the 100-shareholder rule (§1361(c)(2)(A)(vi)). Do not count the trust itself as a shareholder.

Testamentary Trust

A testamentary trust can be a shareholder for a 60-day period starting on the day the stock is transferred (§1361(c)(2)(A)(iii)). A testamentary trust is created by and receives stock pursuant to a will. Effective for taxable years beginning after December 31, 1996, the 60-day post-death holding period is increased to two years for all testamentary trusts.

Qualifying Simple Trusts

A “qualified subchapter S trust” can be a shareholder if the income beneficiary so elects (the election is irrevocable). The beneficiary will then be treated as the shareholder, and the trust will be ignored (§1361(d)). Among other requirements, the trust instrument must provide that all trust income be distributed currently to one individual (who must be a U.S. citizen or resident) and that corpus can be distributed only to that individual (§1361(d)). While only one income beneficiary is allowed, there is no restriction on the number of remainder beneficiaries.

Electing Small Business Trusts

Effective for taxable years beginning after December 31, 1996, an “electing small business trust” can hold stock in an S corporation (1361(c)(2)(A)(v)). To qualify:

(1) All trust beneficiaries must be individuals or eligible estates;

Note: However, a charitable organization may hold a contingent remainder interest.

(2) No trust interest can be acquired by purchase; and

Note: Purchase means any acquisition of property with a cost basis determined under §1012. Thus, an interest in the trust must be acquired by gift, bequest, etc.

(3) The trust must elect to be treated as an electing small business trust (§1361(e)).

Note: The election is made by the trustee and applies to the taxable year of the trust for which made and all subsequent taxable years of the trust unless revoked with the consent of the IRS (§1361(e)(3)).
Each potential current trust beneficiary is counted as a shareholder under the 100-shareholder limitation (§1361(c)(2)(B)(v)).

**Note:** A potential current income beneficiary is any person who is entitled to a distribution from the principal or income of the trust (§1361(e)(2)).

The portion of the trust that consists of S corporation stock is treated as a separate trust. The trust is taxed at the highest individual rate (35% on ordinary income and 15% on net capital gains) on this portion of the trust’s income (§641(a)). No deduction is allowed for amounts distributed to beneficiaries. In addition, this income is not included in the distributable net income of the trust, and thus is not included in the beneficiaries’ income.

**Note:** The net effect of this provision is to create a 35% penalty for this type of trust. In general, taxpayers would be better served by taking advantage of the two-year holding period available to grantor testamentary trusts.

**Aliens**

Non-resident aliens may not be shareholders (§1361(b)(1)).

**C Corporations**

A C corporation is not allowed to be a shareholder in an S corporation.

**Tax-Exempt Entities**

Effective for taxable years beginning after December 31, 1996, tax-exempt organizations described in §401(a) and §501(c)(3) are permitted to be S corporation shareholders (§1361(c)(7)). In counting the number of permitted shareholders, a qualified tax-exempt shareholder counts as one shareholder. However, income and loss of an S corporation will flow-through to qualified tax-exempt shareholders as unrelated business taxable income, regardless of the source or nature of such income. Thus, for example, passive income of an S corporation will flow-through to a tax-exempt shareholder as UBTI. Gain or loss on the sale of S corporation stock will also be treated as UBTI.

**Exception for S Corporation ESOP - §512**

The TRA ‘97 repealed the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder. The repeal of such provision applies only with respect to employer securities held by an employee stock ownership plan (as defined in §4975(e)(7)) maintained by an S corporation.
One Class of Stock

An S corporation may have only one class of stock. One class of stock generally means that the outstanding shares of the corporation must be identical as to the rights of the holders in the profits and in the assets of the corporation.

Note: Authorized but unissued stock and treasury stock are not considered in determining if a corporation has more than one class of stock. Nor is special stock issued to the Federal Housing Administration considered when making this determination.

However, stock may have differences in voting rights and still be considered one class of stock. For example, a corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Recently issued final regulations emphasize that the one class of stock requirement is not to be taken lightly. The new one-class-of-stock regulations apply to corporate tax years beginning after May 27, 1992. Under these regulations, the determination of whether stock has identical rights to distribution and liquidation proceeds is made based on the governing provisions of the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds.

The regulations adopt a number of important positions:

1. A commercial contractual agreement, such as a lease or loan agreement is not a binding agreement relating to distribution and liquidation proceeds, and thus not a governing provision unless a principal purpose of the agreement is to get around this one-class-of-stock provision.

2. State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation’s shareholders. These laws are disregarded in finding whether all outstanding shares have identical rights to distribution and liquidation proceeds if, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the shares have identical rights.

3. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded for the one-class-of-stock rules. Also disregarded are buy-sell agreements, redemption agreements, and agreements restricting the transferability of stock unless:

   (a) A principal purpose of the agreement is to get around the one-class-of-stock rules, and
(b) The agreement establishes a purchase price that, at the time of the agreement, is significantly above or below the fair market value of the stock.

4. Debt obligations of a corporation that are actually contributions of equity capital may be treated as a second class of stock. However, an instrument or obligation that is straight debt is generally not treated as a second class of stock. The term “straight debt” means any written unconditional promise to pay a fixed amount on demand or on a specified date if:

(a) The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors,

(b) The debt cannot be converted directly or indirectly into stock, and

(c) The creditor is an individual (other than a nonresident alien), an estate, or a trust eligible to hold stock in an S corporation.

Note: An obligation that is subordinated (placed in a lower position) to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

An obligation that originally qualifies as straight debt ceases to qualify if:

(a) The obligation is materially modified so that it no longer satisfies the definition of straight debt, or

(b) It is transferred to a third party who is not an eligible shareholder in the S corporation.

5. An instrument, obligation, or other arrangement, regardless of whether it is called a debt, is treated as a second class of stock if:

(a) It constitutes equity or otherwise results in the holder being the owner of stock under federal tax law principles, and

(b) A principal purpose of the transaction is to get around the one-class-of-stock rules or the limitations on eligible shareholders.

6. A call option, warrant, or similar instrument is treated as a second class of stock if, taking into account all facts and circumstances:

(a) It is substantially certain to be exercised, and

(b) It has a strike price substantially below the fair market value of the underlying stock on the date the call option is issued.

7. Stock that is issued in connection with the performance of services, and that is substantially nonvested, is generally not treated as outstanding stock. The holder of that stock is not treated as a shareholder unless he or she makes an election to include in income the fair market value of the stock at the time of the transfer minus the amount paid for the stock. Whether that nonvested stock is treated as a second class of stock depends on the facts and circumstances.
8. An instrument, obligation, or arrangement is not treated as outstanding stock if it:
   (a) Does not convey the right to vote,
   (b) Is an unfunded and unsecured promise to pay money or property in the future,
   (c) Is issued to an employee or independent contractor in connection with the performance of services for the corporation, and
   (d) Is issued pursuant to a plan under which the employee or independent contractor is not taxed currently on income.

Affiliated Groups & Subsidiaries

Prior Law

Prior to December 31, 1996, an S corporation could not be a member of an affiliated group (i.e., it could not own 80% or more of the stock of another corporation). It could only own such stock if the other corporation had not begun business and had no gross income at any time during the taxable year of the S corporation (old §§1361(b)(2)(A), (c)(6)).

However, an S corporation could own less than 80% of another corporation, thereby allowing it to retain investments in multiple businesses. There are no attribution rules under §1504, thus an S corporation could own 79% of another corporation and the S corporation shareholders could own the other 21%. An S corporation could also be a partner in a partnership.

Note: An affiliated group is not the same as a controlled group. An S corporation can be part of a controlled group where its shareholders own the majority interest of other corporations creating an allowable brother-sister control group under §1563(a).

Current Law

Effective for taxable years beginning after December 31, 1996, an S corporation is allowed to own 80% or more of the stock in a C corporation. However, while a C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporation, an S corporation may not join in such an election.

Note: Dividends received by an S corporation from a C corporation in which the S corporation has an 80% or greater ownership is not passive investment income for purposes of §1362 and §1375 to the extent such dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.
Subsidiaries of S Corporations

Sub S - Sub S

Sub S #1

Can Only Own 100%

Sub S #2

Sub S - C Corp

Sub S

Can Own Any Percent

C Corp
An S corporation is also allowed to own a qualified subchapter S subsidiary. A qualified subchapter S subsidiary is a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock were held directly by the shareholders of its parent S corporation) if:

1. 100% of the subsidiary’s stock is held by its S corporation parent, and
2. The parent elects to treat it as a qualified subchapter S subsidiary (§1361(b)(3)(B)).

Under this election, the qualified subchapter S subsidiary is not treated as a separate corporation. Thus, all the assets, liabilities, and items of income, deduction and credit of the subsidiary are treated as belonging to the parent S corporation (§1361(b)(3)(A)).

**Note:** A C corporation is still not allowed to be an S corporation shareholder.

**Domestic Corporation**

An S corporation must be a corporation that is either organized in the United States or organized under federal or state law. The term “corporation” includes a joint-stock company, certain insurance companies, or an association that has the characteristics of a corporation.

Certain domestic corporations are ineligible to elect S corporation status. They are:

(a) A member of an affiliated group of corporations;
(b) A DISC (Domestic International Sales Corporation) or former DISC;
(c) A corporation that takes the Puerto Rico and possessions tax credit for doing business in a United States possession;
(d) A financial institution that is not a qualified bank, including mutual savings banks, cooperative banks, and domestic building and loan associations; and
(e) An insurance company taxed under Subchapter L (§1361(b)(2)).

Effective for taxable years beginning after December 31, 1996, the term “ineligible corporation” means any corporation that is:

(a) A financial institution that uses the reserve method of accounting for bad debts described in §585,

**Note:** A bank (as defined in §581) is allowed to be an eligible shareholder unless it uses a reserve method of accounting for bad debts.

(b) An insurance company subject to tax under subchapter L,
(c) A corporation to which an election under §936 applies, or
(d) A DISC or former DISC (§1361(b)(2)).
**Election Requirement**

An S corporation must correctly elect to be taxed under subchapter S, and the election must not have been terminated.

**Making the Election**

The corporation may make the election at any time during the preceding taxable year or at any time before the 15th day of the 3rd month of the taxable year (for convenience, this is referred to as March 15, since most S corporations must use the calendar year). If made after March 15, the election is treated as made for the following year (§1362(b)).

All persons who are shareholders on the date the election is filed must consent to the election. However, the election will be valid for the year in which it is made only if consent is obtained from all persons who have been shareholders during the tax year up to the date of the election (§1362(b)(2)(B)(ii)).

**Note:** If some shareholders consent after March 15, the election goes into effect the following year (§1362(a)(2), (b)(2)).

**Form 2553**

The election is filed on Form 2553. Shareholders consent by providing the required information on Form 2553, *Election by a Small Business Corporation*, and signing in the appropriate space. The names, social security numbers, stock ownership, and tax year of each shareholder must be listed on the form.

Each shareholder should sign his or her consent on the form. For purposes of the consent, each co-owner is treated as a separate shareholder. This means that both husband and wife must file separate consents to the S election even though they are counted as only one shareholder for the number of shareholders.

The minor or his or her legal representative must make the consent of a minor (or a natural or an adoptive parent of the minor if no legal representative has been appointed). The consent of an estate holding stock in an S corporation must be made by an executor or administrator of the estate.

The consent of a qualified trust holding stock in a newly electing S corporation must be made by each person who is treated as a shareholder to determine whether the corporation meets the S corporation requirements.

A shareholder may also consent by signing a separate consent statement, which should be attached to Form 2553. The separate consent should provide the following information:
S Corporation Election
Form 2553

• All Shareholders Must Consent
• Husband & Wife Must Sign
• Must Be Made By 15th Day of 3rd Month of Taxable Year - Earliest Date:
  • Have Shareholders
  • Acquire Assets, or
  • Business Begins
• No Extension For Filing Election
  • Extension is Available For Consents
(1) The name, address, and identification number of the corporation;
(2) The name, address, and identification number of the shareholder;
(3) The number of shares of stock owned by the shareholder and the date or dates acquired; and
(4) The day and month of the end of each shareholder’s tax year.

Invalid S Elections

For taxable years beginning after December 31, 1982, the IRS may treat a late subchapter election as timely where the IRS determines that there was reasonable cause for the failure to make the election on a timely basis §1362(b)(5)).

Extension

If the corporation’s election would be valid except for the failure of a shareholder to file a consent on time, that shareholder may apply for an extension of time to file the consent. The request for an extension of time to file should be sent to the Internal Revenue Service Center where Form 2553 was filed.

The time for filing a consent may be extended if:

(i) It is shown to IRS’s satisfaction that there was reasonable cause for the failure to file the consent and that the government’s interest will not be jeopardized by treating the election of S corporation status as valid,
(ii) The shareholder who did not file a proper consent files the proper consent within the extended time granted by the IRS, and
(iii) All shareholders file new consents within the extended time. All shareholders include any one shareholder during the period for which the extension is granted.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

69. The author identifies five circumstances where an S corporation would be advantageous. What is one of these circumstances?
   a. Individual rates are lower than corporate rates.
   b. The business has reason to accumulate capital.
   c. The business is expected to incur large gains.
   d. The business will have a small cashflow that it intends to use in the course of business.

70. The author lists 13 potential disadvantages of a subchapter S election. What is one of these drawbacks?
   a. Shareholders are taxed on long-term capital gains the corporation receives.
   b. Qualified deferred compensation plans are not viable.
   c. Lower taxed corporate funds may not be used to pay shareholders’ split-dollar benefits.
   d. The 70% dividends received deduction is postponed.

71. Under §1361, to elect to be treated as an S corporation, a small business corporation must meet numerous eligibility requirements. What is one of these eligibility requirements?
   a. It can have certain trusts as a shareholder.
b. It can have nonresident aliens as shareholders.
c. It must be an ineligible corporation.
d. It must have more than 100 shareholders.

72. One of the requirements of S corporations is that they may have only one class of stock. What position do the one-class-of-stock regulations adopt?

a. A call option, warrant, or similar instrument receives a first class of stock treatment.
b. A possible governing provision is a commercial contractual agreement.
c. Genuine stock redemption or purchase agreements at the time of death are considered for such rules.
d. Stock issued in relation to performing services is by and large not treated as outstanding stock.

S Corporation Termination

A corporation’s status as an S corporation may be terminated by:
(1) Revoking the election,
(2) Ceasing to qualify as an S corporation, or
(3) Violating the passive investment income restrictions on S corporations with pre-S corporation earnings and profits.

Terminations are generally effective on the date of the terminating event. If a corporation’s status as an S corporation has been terminated, it generally must wait 5 tax years before it can again become an S corporation. If it gets the permission of the IRS, the waiting period may be less than 5 years (§1362(g)).
Note: Under the Small Business Act of 1996, any termination of S status before August 20, 1996 is not taken into account. Thus, any small business corporation that terminated its S corporation status within the five-year period before August 20, 1996 may re-elect S status.

If the corporation is terminated because it inadvertently ceased to qualify as an S corporation or because it inadvertently violated the restriction on passive investment income, the IRS may waive the termination (§1362(f)). The termination may be waived if the IRS determines that the termination was inadvertent, the corporation takes steps to correct the event within a reasonable period of time, and the corporation and its shareholders agree to be treated as if the event had not happened.

The corporation may request a determination in the form of a ruling request whether the termination was inadvertent by following the procedures set out in R.P. 90-1. There is a charge for this ruling.

Revoking the Election

The corporation may revoke an S corporation election for any tax year. However, it can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S corporation’s stock consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

Procedure

The revocation must be made by the corporation in the form of a statement. The statement must provide:

1. That the corporation is revoking its election to be treated as an S corporation under §1362(a),
2. The number of shares of stock (including nonvoting stock) outstanding at the time the revocation is made, and
3. The date the revocation is to be effective for revocations that specify a prospective revocation date.

Someone authorized to sign the S corporation return should sign this statement. It should be sent to the service center where the corporation filed its election to be an S corporation.

To this statement of revocation, the corporation should attach a statement of consent, signed by each shareholder who consents to the revocation. It should also provide the number of shares of outstanding stock (including nonvoting stock) each shareholder holds at the time the revocation is made.
Terminating An S Corporation Election

- Elective Termination - Consent of More Than Half of the Shareholders
- Automatic Termination - Failure to Meet Eligibility Requirements
- Passive Income Termination - §1362
- Inadvertent Terminations
  - Must be Inadvertent
  - Corrected Within Reasonable Time
- Consent to IRS Adjustments
- 5-Year Restriction on New S Election
Effective Date

The revocation is effective:

(1) On the first day of the tax year if the revocation is made by the 15th day of the 3rd month of the same tax year;
(2) On the first day of the following tax year if the revocation is made after the 15th day of the 3rd month of a tax year; or
(3) On the date specified if the revocation specifies a date on or after the day the revocation is made (§1362(d)(1)).

A corporation that specifies a prospective date for revocation that is other than the first day of the tax year will create an S termination year.

Ceasing to Qualify

Certain events can cause the corporation to cease qualifying as an S corporation. Some of these include:

(1) Having more than 100 shareholders,
(2) Transferring stock in the S corporation to
   (a) A corporation,
   (b) A partnership,
   (c) An ineligible trust, or
   (d) A nonresident alien,
(3) Creating a second class of stock, and
(4) Acquiring a subsidiary, other than certain nonoperating subsidiaries.

Effective Date

A termination of S corporation status will be effective as of the date the terminating event occurred. A corporation that ceases to be a small business corporation on a date other than the first day of the tax year will create an S termination year.

Passive Income - §1362

The election is also terminated if the S corporation fails the “passive income test.” The passive income test is quite narrowly stated. To fail this test, the corporation must have both:

(1) Earnings and profits from prior years when it was a C corporation, and
(2) Excessive passive income.

Passive income consists of gross receipts from royalties, rents, dividends, interest, annuities, or sales of stock or securities. To flunk the test, the gross receipts of an S corporation must consist of at least 25% passive income for each of three consecu-
tive taxable years (§1362(d)(3)). The election is terminated at the beginning of the 4th year.

Even though a corporation has more than 25% passive income for three years, its election will not be terminated if the corporation elected subchapter S status when it was first formed (it would not have any pre-subchapter S earnings and profits).

**Effective Date**

A termination of S corporation status because of a violation of the passive income restriction will be effective on the first day of the tax year that follows the third consecutive tax year referred to above. See also Inadvertent Termination, discussed later.

**S Termination Year**

Any termination that is effective during the tax year on a date other than the first day of that tax year will create an S termination year. The part of the S termination year ending on the date before the effective date of the termination is an 1120S (S corporation) short tax year. The part of the S termination year beginning on the first day on which the termination is effective is an 1120 (C corporation) short tax year.

After the S termination year is divided into an 1120S short year and an 1120 short year, the separately stated items of income, loss, credit, and deduction, and the amount of the nonseparately stated income or loss must be divided between the periods. There are two methods that can be used to make this division. They are:

1. A pro rata allocation, or

After the separately stated items and the nonseparately stated income or loss are divided, one set of amounts is used for the 1120S short year and the other set of amounts is used for the 1120 short year.

The corporation will have to file two returns to cover the S termination year. One covers the 1120S short year and one covers the 1120 short year. The S termination year will count only as one tax year for figuring carrybacks and carryovers, even though two returns are filed for the year.

**Pro Rata Allocation**

A pro rata allocation must be used unless the shareholders and S corporation specifically indicate they choose to use the other allocation method.

The pro rata allocation is made in the following way:

1. Determine for the entire S termination year the amount of each separately stated item of income, loss, deduction, or credit and the amount of the nonseparately stated income or loss;
2. Divide each amount by the number of days in the S termination year;
(3) Multiply the amounts from step (2) by the number of days in the Form 1120S short year; and

Note: These amounts are used for the Form 1120S filed for the 1120S short year.

(4) Multiply the amounts from step (2) by the number of days in the 1120 short year.

Note: These amounts are used for the Form 1120 filed for the 1120 short year.

The pro rata allocation may not be made if 50% or more of the corporation’s stock is sold or exchanged during the S termination year.

Allocation Based On Normal Accounting Rules

Allocation based on normal accounting rules is the alternate method of allocation. It can be used if the corporation chooses to use it. All persons who are, or were, shareholders at any time during the 1120S short year and on the first day of the 1120 short year must consent to the choice. The corporation makes this choice by filing a statement with the return for the 1120 short year.

Under the alternate method of allocation, the corporation reports all items of income, loss, deduction, or credit based on the corporation’s books and records (including worksheets). Therefore, the items will be split between the 1120S short year and the 1120 short year according to the time they were realized or incurred based on the corporation’s books and records.

The corporation must use the alternate method of allocation if there is a sale or exchange of 50% or more of the stock of the corporation during the S termination year.

Annualization of 1120 Short Year

To figure the tax on the Form 1120 for the 1120 short year, the taxable income for the 1120 short year must be annualized. This annualization is done in the following way:

(1) Multiply the taxable income of the 1120 short year by the number of days in the S termination year;

(2) Divide the amount from step (1) by the number of days in the 1120 short year;

(3) Figure the tax on the amount from step (2);

(4) Multiply the tax from step (3) by the number of days in the 1120 short year; and

(5) Divide the amount from step (4) by the number of days in the S termination year.

To figure the corporate alternative minimum tax for the short year, make the following adjustments:
(1) The alternative minimum taxable income for the short period is placed on an annual basis by multiplying that amount by 12 and dividing the result by the number of months in the short period, and

(2) The tentative minimum tax for the tax year will have the same relation to the tax figured on the annual basis as the number of months in the short period has to 12.

**Taxation of S Corporations**

Generally, an S corporation pays no tax (§1363(a)). However, because the shareholders of an S corporation, rather than the S corporation, are taxed on its income, and some income and expense items are subject to special rules, it is necessary to divide the items of income, loss, expense, and credit of the S corporation into two categories.

One category consists of items that are *separately stated items*, subject to special rules. The other category consists of *combined items*, resulting in a net amount.

Each shareholder reports a pro rata share of each item of income, loss, deduction, or credit that is separately stated and a pro rata share of combined items on his or her income tax return.

When it is reported on the shareholder’s income tax return, the character of any item included in a shareholder’s pro rata share is determined as if the item were realized directly from the source from which the S corporation realized it, or incurred in the same manner in which the corporation incurred it.

**S Corporation Income & Expense**

To figure S corporation income, divide the S corporation’s items of income, loss, expense, and credit into two categories:

(1) Separately stated items, and

(2) Items used to figure nonseparately stated income or loss.

The separately stated items and the nonseparately stated income or loss are collectively known as *passthrough items* because they are passed through to the shareholders on a pro rata basis. However, before they are passed through, some items may be reduced.

The character of each “pass-through” item is preserved. Thus, an item of tax-exempt income received by the corporation is tax-exempt to the shareholders; long-term capital gain earned by the corporation is a long-term capital gain for the shareholders (§1366(b)). If a shareholder owns stock for less than the entire year, the items are prorated on a daily basis (§1377(a)).
Separately Stated Items

The items of income, loss, expense, and credit that must be separately stated are those items that, when separately treated on the shareholder’s income tax return (not as part of a lump-sum amount) could affect the shareholder’s tax liability.

The list of items that must be separately stated includes, but is not limited to:

1. Net income or loss from rental real estate activity
2. Net income or loss from other rental activity
3. Portfolio income or loss
   (a) Interest income
   (b) Dividend income
   (c) Royalty income
   (d) Short-term capital gain or loss
   (e) Long-term capital gain or loss
4. Section 1231 net gain or loss
5. Charitable contributions
6. Health insurance premiums
7. Section 179 expense deduction
8. Expenses related to portfolio income or loss
9. Credits
   (a) Low-income housing credit
   (b) Qualified rehabilitation expenses
   (c) Other credits
   (d) Investment interest expense
   (e) Tax preference and adjustment items needed to figure shareholders’ alternative minimum tax.

Note: The indirect deduction through an S corporation of amounts that are not allowable as a deduction if paid or incurred directly by an individual is not allowed. For example, an individual cannot avoid the 2% floor on miscellaneous itemized deductions or the limits on personal interest by allowing an S corporation in which he or she is a shareholder to pay and deduct these amounts.

Treatment Elections

The S corporation makes all the elections that affect the computation of items it has to report on its return, except as noted below. Each shareholder, rather than the S corporation, makes the following elections:
1) The elections on deduction and recapture of certain mining exploration costs.
2) The election on whether to deduct or claim a foreign tax credit on taxes the S corporation pays or accrues to foreign countries or U.S. possessions.

Nonseparately Stated Items

Nonseparately stated income or loss is the net income or loss (gross income minus allowable deductions) of the corporation stated after excluding all the items that must be separately stated.

Interest Expense on Debt-Financed Distributions

If an S corporation distributed borrowed funds to a shareholder, the corporation should separately state the interest expense on these funds and list as “Interest expense allocated to debt-financed distributions” under other deductions on the shareholder’s Schedule K-1. The shareholder deducts this interest on his or her tax return depending on how the shareholder uses the funds.

If the S corporation borrows money to buy or carry investment property, interest expense from these debts must be identified and separately stated on Schedule K-1 (Form 1120S) for each shareholder. The shareholders are subject to a limit on the deduction of this interest expense. This interest expense does not include any amounts used in determining income or loss from a passive activity, nor does it include any interest expense allocable to a rental real estate activity.

Tax Exempt Income

Tax-exempt income of an S corporation is also passed through directly to the shareholders without losing its character as tax exempt. If tax-exempt income is not distributed, the basis of the shareholders stock will be proportionately increased. Any subsequent distribution of the tax-exempt income will pass through to the shareholders tax-free and will result in a corresponding reduction in basis.

Net Operation Losses

Any net operating loss (NOL) of the S corporation is passed through to the shareholders and is currently deductible by them (§1374(c)(1)). NOLs also pass through on a daily basis, to those who were shareholders at any time during the corporation’s taxable year. This is one of the primary advantages of subchapter S corporation status for new businesses that often incur losses early on. There are some limits, however, on the deductibility of the losses to the shareholders (§1374(c)(2)).
Carryover of C Corporation NOLs

A corporation that becomes an S corporation generally cannot have carryovers or carrybacks from tax years when it was not an S corporation to years when it is an S corporation. See the tax on built-in gains, discussed later, for an exception to this general rule.

However, each year the corporation is an S corporation counts as a year for the purpose of determining the number of years to which an item may be carried back or carried forward.

Example

In its first tax year, a corporation had a net operating loss. In its second year, it elected to become an S corporation. It generally cannot use the net operating loss carryover in this second tax year or in any tax year during which the corporation remains an S corporation. Each year that the corporation is an S corporation counts as a year for purposes of figuring the 20-year carryover period for net operating losses. Therefore, if the corporation does not terminate its S corporation election before the end of the 20-year net operating loss carryover period, the net operating loss incurred in its first tax year, when no S corporation election was in effect, may not be used.

Reduction of Pass-Thru Items

If the corporation is subject to the capital gains tax, the tax on built-in gains, or the tax on excess net passive income, discussed later, the related items are reduced in the following ways:

1. The amount of the corporation’s long-term capital gain is reduced by any capital gains tax the corporation has to pay. If the amount of that tax exceeds the long-term capital gains, the excess is used to reduce the gain on the sale or exchange of §1231 property. For this purpose, “long-term capital gain” does not include any gain from the sale or exchange of any §1231 property.
2. The amount of each recognized built-in gain is reduced by its proportionate share of the tax the corporation has to pay on these gains.
3. The amount of each item of passive investment income is reduced by a portion of the tax on excess net passive income the corporation has to pay. Each item is reduced by an amount that has the same ratio to the tax on excess net passive income as each item of passive investment income has to the total passive investment income for the tax year.
Built-In Gain - §1374

If a taxable corporation converts into an S corporation, the conversion is not a taxable event. However, following such a conversion, an S corporation must hold its assets for a certain recognition period in order to avoid a tax on any built-in gains that existed at the time of the conversion (§1374). The recognition period has been ten-year period beginning with the first day of the first tax year for which the corporation is an S corporation (§1374(d)(7)(A)).

**Note:** If an S corporation has a net recognized built-in gain for any tax year beginning in the recognition period, a tax is imposed on the income of the S corporation for that tax year (§1374(d)(7)).

However, because of several tax acts, this 10-year recognition period has varied, over time, from 7 to 5 years for various tax years. Thus, for 2009 and 2010, it was 7 years. For 2011 through 2014, the "recognition period" was a five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation.

**Note:** The 5-year period refers to 5 calendar years from the first day of the first taxable year for which the corporation was an S corporation.

**Comment:** In the case of built-in gain attributable to an asset received by an S corporation from a C corporation in a carryover basis transaction, no tax was imposed under §1374 if such gain was recognized after the date that was seven years following the date on which such asset was acquired. Shareholders continued to take into account all items of gain and loss under §1366.

For 2015, the five-year recognition period was scheduled to expire and revert to ten years. However, the PATH Act reinstated the five-year recognition period and made it permanent.

The tax generally applies only to a corporation that converted from a regular corporation to an S corporation after 1986. It does not generally apply to any corporation if an election to be an S corporation was in effect for each of its tax years. An S corporation and any predecessor corporation are treated as one corporation for this purpose.

**Example**

_X Corp. was a C corporation for several years until it made an S election. Its only asset at the beginning of its first S corporation year was Blackacre. The value of Blackacre was $100,000 but its basis was only $2,000. Two years later, X Corp. sold Blackacre for $160,000. Because there was a net built-in gain at the time X’s S election went into effect, it is liable for the tax under §1374. It will be subject to corporate income tax on $98,000 of its gain. The remaining $60,000 of its gain is not subject to corporate tax. The entire $158,000 gain is taxed to the shareholders (but it is reduced by_
the amount of tax that X Corp. had to pay on the gain) (§1366(f)(2), 1374).

Net Recognized Built-In Gain

Generally, the term “net recognized built-in gain” for any tax year in the recognition period is the lesser of:

(1) The amount that would be taxable income of an S corporation for the tax year if only recognized built-in gains and recognized built-in losses were taken into account, or

(2) The amount that would be taxable income of the corporation if it were not an S corporation.

Note: Taxable income is the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividend-received deductions.

If the amount in item (1) is more than the amount in item (2), the excess is treated as recognized built-in gain in the following tax year. The carryover provision does not apply to corporations that elected to be S corporations before March 31, 1988.

Recognized Built-In Gains

The term “recognized built-in gain” is any gain recognized when any asset is disposed of during the recognition period, except to the extent the S corporation shows that:

(a) The asset was not held by the S corporation at the beginning of its first tax year as an S corporation, or

(b) The gain is more than the fair market value of the asset at the beginning of the first tax year minus the adjusted basis of the asset at the beginning of that year.

A recognized built-in gain also includes any item of income properly taken into account during the recognition period, but which is from periods before the first tax year the corporation was an S corporation. Therefore, disposing of an asset includes not only sales and exchanges, but also other income recognition events that give up a right to claim or receive income.

Note: The first tax year a corporation is treated as an S corporation is determined by its most recent election to be an S corporation.

For example, the collection of accounts receivable by a cash method S corporation and the completion of a long-term contract performed by a taxpayer
using the completed contract method of accounting are treated as dispositions of an asset.

**Recognized Built-In Loss**

A recognized built-in loss is any loss recognized when any asset is disposed of during the recognition period to the extent the S corporation shows that:

(1) The asset was held by the S corporation at the beginning of its first year as an S corporation, and

(2) The loss is not more than:

(a) The adjusted basis of the asset at the beginning of its first tax year as an S corporation, minus

(b) The fair market value of the asset at the beginning of that year.

**Deduction Items**

Any amount allowable as a deduction during the recognition period, but which came from periods before the first tax year the corporation was an S corporation, is treated as a recognized built-in loss for the tax year it was allowable as a deduction.

**Amount of Tax**

Generally, the amount of tax is figured by applying the highest corporate rate of tax (35%) to the net recognized built-in gain of the S corporation for the tax year. However, the amount of the net recognized built-in gain taken into account for any tax year cannot be more than:

(1) The net unrealized built-in gain, minus

(2) The net recognized built-in gain for previous tax years beginning in the recognition period.

The net unrealized built-in gain is:

(1) The fair market value of the assets of an S corporation at the beginning of its first tax year when an election to be an S corporation is in effect, minus

(2) The total adjusted basis of these assets at that time.

The net unrealized built-in gain must be adjusted for amounts treated as recognized built-in gains or losses.

**Credits**

The only credits allowed against the tax on built-in gains are the gasoline and special fuels tax credit and any carryforward of the general business credit from a pre-S corporation year.
Net Operating Loss Carryovers

Any net operating loss carryover from a pre-S corporation tax year is allowed as a deduction against the net recognized built-in gain of the S corporation for the tax year. To determine the loss that may be carried to later years, the net recognized built-in gain is treated as taxable income. The same rules apply for a capital loss carryover from a pre-S corporation tax year.

Treatment of Certain Property

If the adjusted basis of any asset is fully or partly determined by the adjusted basis of another asset held by the S corporation at the beginning of its first tax year as an S corporation:

1. The asset is treated as held by the S corporation at the beginning of that first tax year, and
2. Recognized built-in gain or loss is determined by the fair market value and adjusted basis of the asset at the beginning of that first tax year.

Transfer of Assets

Generally, if an S corporation acquires an asset, and its basis in the asset is fully or partly determined by a regular corporation’s basis in the asset, then a tax is imposed on any net recognized built-in gain from the asset for any tax year beginning in the recognition period.

However, when figuring the tax, the day the assets were acquired by the S corporation must be taken into account rather than the beginning of the first tax year the corporation was an S corporation.

Passive Income - §1375

Where an S corporation has earnings and profits from its years as a C corporation, and where its passive income exceeds 25% of its gross receipts, it must pay corporate income tax on the “excess net passive income” (§1375).

Note: An S corporation will not be subject to the tax on excess net passive income if it has been an S corporation for each of its tax years.

Gross Receipts

The term “gross receipts” means the total amount an S corporation receives or accrues under the method of accounting it uses to figure its taxable income. Therefore, gross receipts are not reduced by returns and allowances, cost of goods sold, or deductions.

Gross receipts include the total amount received or accrued from the sale or exchange of any kind of property (except capital assets and stock or securities), from services rendered, or from investments. Only the capital gain net income from the sale or exchange of capital assets (other than stock or securities) and
only the gains from the sale or exchange of stock or securities are included in gross receipts.

Gross receipts do not include amounts received from:

1. A loan,
2. Repayment of a loan,
3. Contributions to capital,
4. Issuing stock in the S corporation,
5. Nontaxable sale or exchange, except to the extent that gain is recognized by the S corporation, or
6. The deferred or unrecognized portion of any gain on sales or exchanges made from an installment sale, except for installment sales of publicly traded stocks and securities.

Sales or Exchanges of Stock or Securities

A sale or exchange of stock or securities is included in gross receipts only to the extent of the gain. Losses on sales or exchanges are not a part of gross receipts. Nor are they offset against gains on sales or exchanges when figuring gross receipts. This applies even if the S corporation is a regular dealer in stocks and securities.

However, amounts received in exchange for stock in a corporate liquidation are not included in gross receipts if the S corporation owned more than 50% of each class of the liquidating corporation’s stock on the date of the first distribution with respect to the liquidation. This 50% requirement applies to a class of stock whether or not the class of stock has voting rights. For this requirement, shares of stock of the liquidating corporation held by an S corporation shareholder are not treated as held by the S corporation.

Passive Investment Income

Passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. The amount included in passive investment income for sales or exchanges of stock or securities for an S corporation that is not an “options dealer” or “commodities dealer” is specially figured as explained above.

If the S corporation is an “options dealer” or a “commodities dealer,” any gains or losses from section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options) or from property related to such contracts are not included when the computations are made.
Royalties

Royalties include mineral, oil, and gas royalties, and amounts the S corporation receives for the use of patents, copyrights, secret processes, formulas, goodwill, trademarks, trade brands, franchises, and other like property.

Rents

Rents are amounts the S corporation receives for the use of, or the right to use, its real or personal property. Rents do not include payments for the use or occupancy of property if significant services are also provided to the occupant. Examples of payments not treated as rents include payments for the use or occupancy of rooms or other quarters in hotels, boarding houses, apartment houses that provide hotel services, tourist homes, motor courts, or motels. Generally, significant services are considered provided to the occupant if they are primarily for the occupant’s convenience and are not usually or customarily provided in the rental of rooms or other space for occupancy only.

For example, providing maid service is considered significant service to the occupant. Heat and light, cleaning public entrances, exits, stairways and lobbies, collecting trash, etc., are not considered significant services. Payments for parking cars usually are not rents. Payments for warehousing of goods or the use of personal property are not rents if significant services are provided with the payments.

Interest

Interest is any amount received for the use of money, including tax-exempt interest and unstated interest. Unstated interest includes amounts considered interest on notes or obligations received in installment sales, obligations issued for property, and below-market loans when the contract does not contain a stated rate of interest, or the stated rate is below the appropriate federal rate.

However, interest on obligations acquired in the ordinary course of the S corporation’s trade or business from the performance of services or the sale of inventory or property held primarily for sale to customers is excluded from passive investment income.

Figuring the Tax on Excess Net Passive Income

An S corporation is liable for a tax at a rate of 35% on excess net passive income if its passive investment income is more than 25% of gross receipts, and if at the end of the tax year it has earnings and profits from any tax year in which the corporation was not an S corporation.
Net Passive Income

Net passive income is passive investment income, described above, and reduced by deductions directly connected with the production of passive investment income. This does not include net operating losses and dividends-received deductions allowed to corporations that are not S corporations. Investment-related deductions allowable in figuring net passive income generally include brokerage fees, interest expenses, safe deposit box rentals, and investment advisory fees.

Excess Net Passive Income

Excess net passive income for the tax year is the amount that has the same ratio to net passive income as the amount of passive investment income that exceeds 25% of gross receipts has to total passive investment income. Therefore, to figure excess net passive income, multiply net passive income by a fraction consisting of passive investment income minus 25% of gross receipts over passive investment income.

Example

An S corporation (with subchapter C earnings and profits) has gross receipts of $10,000. Of this amount, $4,000 is passive investment income. After subtracting applicable deductions, net passive investment income is $3,000. Excess passive investment income equals $1,125 ($3,000 x $1,500/$4,000). The corporation must pay corporate income tax on $1,125. If the situation continues for three years, the S election is revoked.

Excess net passive income cannot be more than the S corporation’s taxable income for the year.

Special Provisions

The only credit that can be used by the S corporation to offset this tax is the credit figured on Form 4136, Credit for Federal Tax on Fuels. If any gain is used to figure both the tax on excess net passive income and the tax on capital gains, the amount of gain subject to the capital gains tax is reduced. The amount of passive investment income for purposes of figuring the tax on excess passive income is determined by not taking into account any recognized built-in gain or loss of the corporation. If the S corporation is subject to the tax on excess net passive income, it must reduce the items of passive income passed through to the shareholders.
Waiver of Tax

The IRS may waive the tax on excess net passive income if the S corporation establishes to IRS’s satisfaction that:

(a) It determined in good faith that it had no pre-S corporation earnings and profits at the close of the tax year, and

(b) During a reasonable period of time after it was determined that it did have such earnings and profits at the close of the tax year, the earnings and profits were distributed.

Tax Preference Items

If an S corporation (or any predecessor) was a regular corporation for any of the three immediately preceding tax years, the S corporation is required to adjust tax preference items. In determining its income or loss from operations for tax purposes, these items, which are also items subject to alternative minimum tax and are considered tax preference items, must be adjusted as follows:

1. Section 1250 capital gain treatment. For §1250 property that is disposed of during the tax year, 20% of any excess of the amount that would be ordinary income if the property were §1245 property, over the amount treated as ordinary income under §1250, is treated as ordinary income under §1250 and will be recognized. Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not or has never been §1245 property. Section 1245 property includes any property that is or has been subject to an allowance for depreciation and that is personal property (both tangible and intangible), and certain other property.

2. Percentage depletion. For iron ore and coal (including lignite), the amount allowable as a percentage depletion deduction is reduced by 20% of any excess of the amount of the percentage depletion deduction allowable for the tax year (determined without this adjustment), over the adjusted basis of the depletable property at the close of the tax year (figured without the depletion deduction for the tax year).

3. Pollution control facilities. The amortizable basis of pollution control facilities is reduced by 20% for purposes of determining the amortization deduction for that property.

4. Mineral exploration and development costs. The amount allowable as a deduction for mineral exploration and development costs is reduced by 30%. Special rules apply to the amount not allowed because of this adjustment. This reduction also applies to the intangible drilling costs of an integrated oil company. If an adjustment is made to a tax preference amount under the above rules, then an appropriate adjustment must be made to reduce the tax preference item for purposes of the alternative minimum tax.
LIFO Recapture Tax

If a corporation made an election to be an S corporation after December 17, 1987, and used the LIFO inventory pricing method for its last tax year before its S election became effective, the corporation may be liable for LIFO recapture. The LIFO recapture tax is figured for the pre-S corporation’s last tax year. The LIFO tax is paid in four equal installments. The first installment is due with the corporation’s Form 1120 or Form 1120A for the corporation’s last tax year, and the three remaining deferral installments are paid with the corporation’s Form 1120S for the next 3 tax years.

Capital Gains Tax

An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if:

1. Its net long-term capital gain exceeds its net short-term capital loss by more than $25,000,
2. The excess is more than 50% of the corporation’s taxable income, and
3. The taxable income is more than $25,000.

If the S corporation is also liable for the tax on excess net passive income, it should figure that tax before it figures its capital gains tax.

Before an S corporation can decide whether it is liable for the capital gains tax, it must:

1. Reduce its capital gains to the extent they are subject to the tax on excess net passive income, and
2. Figure its taxable income.

Reducing Corporate Capital Gains

If the S corporation is subject to the tax on excess net passive income, it must reduce its capital gains by the share of excess net passive income that is due to the capital gains. This reduced capital gain is the amount used to decide whether the corporation must pay a capital gains tax and how much is due.

Figuring Corporate Taxable Income

Although an S corporation’s taxable income is generally figured like a partnership’s for filing a return, taxable income for the tax on capital gains, the tax on built-in gains, discussed later, and the limit on excess net passive income are figured, with certain modifications, as though the corporation is filing a corporate tax return.

Taxable income is the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed to
a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividends-received deductions.

**Recapture of Investment Credit**

This tax may apply if the corporation claimed investment credit on a prior year’s corporate income tax return before it became an S corporation. If the S corporation makes an early disposition of the property, the S corporation, and not its shareholders, will be liable for payment of the tax.

**Estimated Corporate Tax Payments**

*If* an S corporation’s tax liability for certain capital gains, net recognized built-in gain, excess net passive income, and recapture of investment credit totals $500 or more, the S corporation *must* pay quarterly estimated tax payments.

**Basis of Stock & Debts**

The amount of losses and deductions a shareholder can take is limited to the adjusted basis of:

(i) The shareholder’s stock, *plus*

(ii) Any loans the shareholder makes to the corporation.

A shareholder must adjust the basis of their stock in an S corporation and the basis of the debts the corporation owes the shareholder.

**Adjustments to Basis**

The shareholder increases the basis of their stock by the amount of corporate income taxed to the shareholder (§1367(a)(1)). The shareholder decreases basis of their stock (but not below zero) by nontaxable distributions and by items of loss and deductions allocated to the shareholder (§1367(a)(2)).

If the items of loss and deduction reduce the basis of stock to zero, the shareholder can continue to deduct these items and reduce the basis of any debts owed by the corporation to the shareholder. If the shareholder does so, and later increases their basis because income items are allocated to them, the basis of the debt will be increased back to its original level (§1367(b)(2)).

**Limitation on Loss Deductions**

If losses and deductions allocated to shareholder reduced to zero the basis of both stock and debt, the shareholder cannot deduct any further losses. However, such disallowed losses can be deducted in a later year if the basis of the stock or debt rises above zero (§1366(d)).
Basis Limit

The amount of losses and deductions a shareholder can take is limited to the adjusted basis of:

1. The shareholder’s stock, *plus*
2. Any loans the shareholder makes to the corporation.

To arrive at the adjusted basis of a shareholder’s stock or loans, the shareholder’s basis must first be determined. If the stock was purchased, the basis is usually its cost. If money was loaned to the S corporation, the basis is usually the amount of the loan. If a shareholder received stock in the S corporation in exchange for property, his or her basis in the stock is generally the same as his or her basis in the property transferred.

Adjustments to Stock Basis

During the time the corporation is an S corporation, each shareholder will increase or decrease the basis of his or her stock, but not below zero.

Increases

Each shareholder’s pro rata share of the following items increases the basis of the stock:
S Corporation Loss & Basis Limitations

Total Basis

Distributions

Loss

Cash

Decreases in Basis

Disallowed Losses Are Carried Forward Indefinitely

Stock Basis

Debt Basis

Increases in Basis
(1) All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to the shareholder,

(2) Any nonseparately stated income of the S corporation, and

(3) The amount of the deductions for depletion that is more than the basis of the property being depleted.

If an amount described in (1) or (2), above, is required to be included in income, a shareholder may increase the basis of the stock only by the amount actually included as gross income on his or her individual income tax return. This amount is increased or decreased by any adjustments in a redetermination of the shareholder’s tax liability.

Decreases

Each shareholder’s pro rata share of the following items decreases the basis of the stock:

(1) Distributions by the S corporation that were not included in the shareholder’s income,

(2) All loss and deduction items of the S corporation that are separately stated and passed through to the shareholder,

(3) Any nonseparately stated loss of the S corporation,

(4) Any expense of the S corporation that is not deductible in figuring its income and not properly chargeable to capital account, and

(5) The shareholder’s deduction for depletion of oil and gas property held by the S corporation to the extent it is not more than the shareholder’s share of the adjusted basis of the property.

Adjustments to Debt Basis

In certain cases, a shareholder may decrease the basis of any loans he or she made to the S corporation, and in later years restore the basis. If for any tax year the amounts specified in items (2), (3), (4), and (5), above, under Decreases, exceed the amount required to reduce the shareholder’s basis in stock to zero, the excess must be used to reduce, but not below zero, the shareholder’s basis in any loans made to the S corporation.

Restoring Basis of Loans

If the shareholder’s basis in any loans made to the S corporation is reduced, as previously explained, any net increase for a later tax year, figured above under Adjustments to basis of shareholder’s stock, should first be used to restore the basis of the loans and next to increase the basis of the stock.
Loan Repayments

If the shareholder’s basis in the loan was reduced (and has not subsequently been completely restored), he or she will have income (other than interest) when the S corporation makes a payment on the loan. Each loan payment (other than interest) must be allocated in part to a return of the shareholder’s basis in the loan and in part to income.

To figure the amount of income to report from the loan payments, the shareholder should:

1. Figure the adjusted basis of the loan before payment.
2. Divide the adjusted basis in the loan by the outstanding loan balance.
3. Multiply the payment by the percentage from step 2. This amount is the part of the payment that will be a return of basis in the loan.
4. Take the difference between the amount of the payment and the amount from step 3. This is the amount that the shareholder must report as ordinary income.

The basis of the loan is reduced even if the shareholder has no tax benefit from the deduction for the basis reduction.

To figure the adjusted basis of the loan for a later payment, for a later restoration of basis, or for a later reduction of basis in the loan because of additional losses, the shareholder should subtract any amounts that are a return of basis from the adjusted basis of the loan.

Guarantees

A shareholder often guarantees payment of corporate loans. When the corporation has losses that exhaust the basis of the shareholder’s stock and direct loans to the corporation, the shareholder may assert that the guaranteed loan gives them additional basis against which corporate losses can be offset. However, the courts hold that the guarantee does not furnish the shareholder with any basis unless and until the shareholder actually makes payment on the guaranty (at which time that payment will be treated as a direct loan to the corporation) (Estate of Leavitt v. Commissioner, 875 F.2d 422 (4th Cir. 1989)).

At-Risk Rules - §465

At-risk rules may limit an S corporation shareholder’s deductible loss from an activity conducted through an S corporation. These limitations apply at the shareholder level. An S corporation shareholder’s amount at risk equals:

(1) The shareholder’s cash contributions and the adjusted basis of other property that the shareholder contributed to the S corporation, plus
(2) Amounts borrowed for use in the activity that the shareholder is personally liable for the repayment of, or has pledged property not used in the activity as security for the borrowed amount.

To determine if the at-risk rules apply to an activity, the S corporation must identify each activity engaged in. Therefore, when the S corporation is involved in more than one activity and one or more of the activities incur a loss for the year, the profit and loss of each activity is figured separately. The S corporation should provide each shareholder with a schedule that reflects that shareholder’s part of gross income and deductions for each activity.

Separate activities must be combined and treated as one activity if:

1. The shareholder actively participates in the management of the trade or business, or
2. 65% or more of the losses from the operations are allocated to persons who actively participate in the management of the trade or business.

In addition, all activities involving tangible personal property leased or held for lease must be treated as one activity.

The at-risk rules do not apply to an activity of holding real property (other than mineral property) if the property was placed in service before 1987, and the shareholder acquired the interest in the S corporation before 1987. However, the at-risk rules do apply to losses from an interest in an S corporation acquired after 1986, regardless of when the property used in the activity of holding real property was placed in service.

Reasonable Compensation

If a family member renders services to an S corporation, there must be reasonable compensation to that individual before allocation of the remaining income to stock held by other family members (§1366(e)). This provision prevents the use of an S corporation to split personal service income.

Related Party Rules

Losses realized on sales or exchanges of property between related parties generally may not be deducted (§267). If the related party who acquired the property on which the loss was disallowed later resells the property at a gain, the gain is recognized only up to the amount that is more than the disallowed loss.

Definition of Related Party

Related parties include the following:

(a) Two corporations that are members of the same controlled group of corporations determined by applying a 50% ownership test,
(b) An individual and a corporation if more than 50% of the value of the outstanding stock is owned by the individual,
(c) A trust fiduciary and a corporation if the trust or grantor of the trust owns more than 50% in value of the outstanding stock of the corporation,
(d) The grantor and a fiduciary of any trust,
(e) A fiduciary of a trust and a beneficiary of the trust,
(f) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
(g) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation, and
(h) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

Stock Attribution Rules
In deciding whether a person owns any of the outstanding stock of a corporation, the following rules apply:

(a) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
(b) An individual is treated as owning the stock owned, directly or indirectly, by or for his or her family,
(c) Any individual owning, other than applying paragraph (a), any stock in a corporation is treated as owning the stock owned, directly or indirectly, by or for his or her partner,
(d) The family of an individual includes only his or her brothers and sisters (half-brothers or half-sisters), spouse, ancestors, and lineal descendants, and
(e) Stock constructively owned by a person under paragraph (a), for applying paragraphs (a), (b), or (c), is treated as actually owned by that person. But stock constructively owned by an individual under paragraphs (b) or (c) is not treated as owned by him or her, for again applying either paragraph (b) or (c), to make another person the constructive owner of that stock.

Business Expenses & Interest
An accrual method S corporation must use the cash method to deduct business expenses and interest owed to cash method related parties. Therefore, an S corporation may not deduct business expenses or interest owed to a cash basis related party until the day payment is made and the amount is includible in the related party’s gross income. This rule will apply even if the S corporation and the
related person cease to be related before the expenses or interest are includible in that person’s gross income.

Related parties include those just above and also include, in the case of any amount paid or incurred by, to, or on behalf of an S corporation:

(a) An S corporation and a shareholder of the S corporation who owns, directly or indirectly, any of the stock of the S corporation,

(b) An S corporation and any person who owns, directly or indirectly, any capital or profits interest of a partnership in which this S corporation owns, directly or indirectly, any capital or profits interest, and

(c) Any person related under the related party rules to a person described in (a) or (b).

The rule in (b) applies to a transaction only if the transaction is related either to the operations of the partnership or to an interest in this partnership.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

73. Four events that cause a corporation to stop qualifying as an S corporation are identified. Which of the following is one of these events?
   a. the acquisition of a subsidiary other than certain nonoperating subsidiaries.
b. the creation of a first class of stock.
c. having less than 100 shareholders.
d. the transference of stock in the S corporation to a resident.

74. Under §1375, corporate income tax must be paid on any amount that exceeds net passive income if the S corporation had earnings and profits when it was a C corporation and in the event that passive income surpasses 25% of gross receipts. What do gross receipts include?
   a. amounts received from deferred gain on sales made from installment sales of publicly traded stocks.
   b. amounts received from issuing stock in the S corporation.
   c. amounts received from nontaxable sales or exchanges.
   d. amounts received from repayment of a loan.

75. Tax preference items must be adjusted by an S corporation that was a regular corporation for any of the three previous tax years. Which tax preference item must the entity reduce by 30%?
   a. the amortizable basis of pollution control facilities.
   b. the amount that may be deducted for mineral exploration and development costs.
   c. the amount allowable as a percentage depletion deduction for iron ore and coal.
   d. the amount allowable as a §1250 capital gain.

76. An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax. What is one of the three conditions that must be met for the capital gains tax to apply?
   a. The S corporation used the LIFO inventory pricing method for its last tax year before its S election became effective.
   b. Its net long-term capital loss exceeds its net short-term capital gain by more than $25,000.
   c. The excess of loss is less than half of the taxable income.
   d. The taxable corporate income exceeds $25,000.

77. The shareholder’s basis must be figured in order to determine the adjusted basis of a shareholder’s stock or loans. Generally, what is a shareholder’s basis in stock if the shareholder traded property for stock?
   a. its cost.
   b. the amount of the loan.
   c. equal to the basis in the transferred property.
   d. zero.
78. S corporation shareholders will increase or decrease the basis of their stock. The basis is decreased by each shareholder’s pro rata share of:
   a. all of the S corporation’s income items.
   b. any of the S corporation’s aggregately-stated income.
   c. S corporation distributions that were excluded from the shareholder’s income.
   d. the amount of the depletion deductions that exceeds the basis of the property being depleted.

Distributions

S corporation distributions may be in the form of cash or property. How S corporation distributions to a shareholder are taxed depends on whether the corporation has earnings and profits.

Earnings & Profits

An S corporation is not considered to have earnings and profits for tax years beginning after 1982 in which it was an S corporation. However, an S corporation can have earnings and profits from:

(1) Liquidations, redemptions, and reorganizations governed by the rules of Subchapter C of the Code,
(2) Tax years in which the corporation was not an S corporation,
(3) Any of the S corporation’s tax years that began before 1983, or
(4) A corporate acquisition that results in a carryover of earnings and profits under §381.

Note: The existence of earnings and profits is also important to an S corporation if it has passive investment income. The presence of earnings and profits can mean that a distribution is a taxable dividend or the corporation is liable for a tax on its excess net passive income.

If an S corporation has earnings and profits, distributions are normally treated as a tax-free return of capital to the shareholders, to the extent they do not exceed the amount of net income accumulated since the corporation became an S corporation. Thus, an S corporation may distribute its accumulated S corporation earnings tax-free to shareholders. However, if distributions exceed the amount
of net income accumulated \textit{since} the corporation became an S corporation, the excess is taxable as an ordinary dividend to the shareholders.

To apply this rule, we need to keep track of the amount of net income accumulated \textit{since} the corporation became an S corporation. This is done through an account referred to as the \textit{accumulated adjustments account}. Distributions in excess of the accumulated adjustments account are taxed as \textit{dividends} to the extent of earnings and profits ($\S$1368(c), (e)).

\textbf{Accumulated Adjustments Account (AAA)}

The accumulated adjustments account (AAA) tracks the accumulated S corporation adjustments to stock basis from which tax-free distributions can be made. It is adjusted each year for income, losses, and expenses in a manner similar to adjustments made to the shareholder’s basis in the stock of the S corporation, except that no adjustment is made for tax-exempt income or related expenses. However, the amounts of any tax-exempt interest or related expenses are adjustments to the adjusted basis of the stock.

On the first day of an S corporation’s first tax year that begins after 1982, the balance of the corporation’s AAA is zero. The balance of the corporation’s AAA at the end of the tax year can be a negative amount. Income in a later year will make the account positive only after the negative balance has been restored.

\textbf{Dividend Election}

An S corporation may elect to have its distributions taxed as \textit{dividends} to the extent of earnings and profits \textit{even though} there is an accumulated adjustments account. All shareholders must consent to this election ($\S$1368(e)(3)). An S corporation might want to make this election in order to remove its earnings and profits, thus avoiding the problem of disqualification under the passive income rule.

The shareholder’s consent to the election is effective only for the tax year in which it is made. If the corporation makes an effective election, each shareholder will report a dividend in the amount of the distribution that is treated as coming out of earnings and profits. After the earnings and profits are completely distributed, any future distributions are generally treated as if the S corporation had no earnings and profits.

\textbf{Note}: If the S corporation does not completely distribute earnings and profits in the first tax year in which it makes the election and wishes to make the same election for the next year, it must repeat the election and again obtain the necessary consents from the shareholders who receive the distributions.
Post-Termination Distributions

After an S election terminates, the corporation can make tax-free money distributions to the extent of any previously undistributed accumulated adjustments account (§1371(e)). This privilege extends only during the “post-termination transition period.”

Transition Period

The post-termination transition period begins on the day after the last day of the corporation’s last tax year as an S corporation. It ends on the later of:

(1) One year after the effective date of the termination, or the due date for the last S corporation return, whichever is later, or
(2) 120 days after a determination that the S corporation’s election had terminated for a previous year.

Note: A determination is defined as a court decision that becomes final, a closing agreement, or an agreement between the corporation and the IRS that the corporation did not qualify.

For taxable years beginning after December 31, 1996, the definition of post-termination period is expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation’s election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period (§1377(b)(1)(B)).

Order of Distribution

If an S corporation has earnings and profits but has not elected to distribute them first, discussed above, any distribution it makes will come from one or more of the following sources in the order indicated.
Distributions From S Corporations

No Accumulated E&P

Total Distribution

Shareholder Basis in S Corporation

Treated As Gain From the Sale of Property

Excluded From Shareholder’s Gross Income

Accumulated CE&P

Total Distribution

Shareholder Basis in S Corporation

AAA Account

CE&P

Treated As Gain From the Sale of Property

Nontaxable Return of Capital

Taxed As A Dividend

Distributions From S
Corporations

No Accumulated E&P

Total Distribution

Shareholder Basis in S Corporation

Treated As Gain From the Sale of Property

Excluded From Shareholder’s Gross Income

Accumulated CE&P

Total Distribution

Shareholder Basis in S Corporation

AAA Account

CE&P

Treated As Gain From the Sale of Property

Nontaxable Return of Capital

Taxed As A Dividend
1. First, a distribution is treated as coming out of the accumulated adjustments account. A distribution out of AAA is applied against and reduces the shareholder’s adjusted stock basis. A distribution out of AAA in excess of the shareholder’s adjusted stock basis is treated as gain from the sale or exchange of property. The AAA is reduced by the amount of the distribution treated as coming from it. If distributions during the tax year exceed the AAA at the close of the tax year (figured before the distributions), the AAA generally is allocated to each distribution made during the year in proportion to the sizes of the distributions.

2. Second, if the S corporation shareholder has previously taxed income (PTI) in the corporation, the PTI is the next source for distribution.

   Note: The PTI account relates to the rules used for Subchapter S corporations before the Subchapter S Revision Act of 1982 became effective. As a result, it rarely exists today. However, if the S corporation has earnings and profits, a distribution from PTI is important to a shareholder because an S corporation shareholder who has PTI may receive a nontaxable distribution from PTI.

A distribution out of PTI is applied against and reduces the shareholder’s basis in the stock. A distribution out of PTI in excess of the shareholder’s basis in the stock is treated as gain from the sale or exchange of property. The shareholder’s PTI account must be reduced by the amount of the distribution made from PTI.

3. Third, a distribution is treated as coming out of the S corporation’s earnings and profits. A distribution is treated as a dividend up to the amount of the corporation’s earnings and profits.

4. Fourth, a distribution is applied against and reduces the shareholder’s basis in the stock.

5. Fifth, the distribution is treated as a sale or exchange of property.

No Earnings & Profits

If an S corporation has no earnings and profits, any distribution a shareholder receives is a return of basis in the shareholder’s stock in the S corporation, and, as such, it reduces the adjusted basis of his or her stock in the S corporation.

At the close of an S corporation’s tax year, the shareholder must adjust his or her basis in the S corporation stock for all increases and decreases. This does not include the decrease to adjusted basis for any distributions during the S corporation’s tax year. The shareholder then uses this adjusted basis to figure the tax treatment of any distributions received during the S corporation’s tax year.
If the distributions are less than or equal to the adjusted basis, they are a return of capital. The adjusted basis of the shareholder’s stock after being reduced for the distributions is next year’s beginning adjusted basis.

If the distributions are more than the adjusted basis of the shareholder’s stock, the excess is a gain from the sale or exchange of property. As such, the gain is generally long- or short-term capital gain. The next year’s beginning basis for shareholder’s stock is zero.

Example

Acme, an S corporation, has no earnings and profits. Acme distributes $80,000 to its only shareholder, Betty. Her adjusted basis in the stock is $50,000. The amount of the distribution that exceeds her adjusted basis in the stock, $30,000 ($80,000 - $50,000), is taxable as a gain from the sale or exchange of property.

Appreciated Property Distributions

If the corporation distributes cash, the shareholder uses the amount received to figure the tax effect and the adjusted basis of his or her stock. If property other than cash is distributed, the amount the shareholder uses as a distribution is the fair market value of the property.

When an S corporation distributes appreciated property, the S corporation will be treated as if it had sold the property to the shareholders at fair market value. Appreciated property is S corporation property that has a fair market value that is more than its adjusted basis to the S corporation.

The amount the shareholder uses as a value to figure the tax treatment of the property distribution is the same fair market value that the S corporation used when it treated the property as if it had been sold to the shareholder for fair market value.

Taxable Year

The term “tax year” is the annual accounting period that is used for keeping records and reporting income and expenses. It is either a calendar year or a fiscal year.

Generally, an S corporation must use the permitted tax year. If, however, it can persuade the IRS that there is a business purpose for use of a different period, the different period may be allowed (§1378).

Permitted year means a taxable year which:

(i) Is a year ending December 31, or
(ii) Is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary. For the purposes of this subsec-
tion, any deferral of income to shareholders shall not be treated as a business purpose (§1378(b)).

In addition, an S corporation may elect under §444 to have a tax year other than the permitted tax year. A number of restrictions apply to a §444 election. A corporation electing S corporation status does not need IRS approval to choose a calendar year as its tax year. An electing S corporation should use Form 2553 to request a tax year other than a calendar year.

**Business Purpose**

A substantial business purpose exists if the corporation’s requested year is a natural business year, or if the requested year satisfies an ownership tax year test. If neither of these tests applies, the corporation can establish a business purpose.

Both tax factors and nontax factors must be considered to determine whether you have a substantial business purpose. A nontax factor for a substantial business purpose is the annual cycle of your business activity.

Significant weight is given to tax factors. A prime consideration in permitting the use of a different tax year is whether it would create a substantial distortion of income. Examples of distortion of income are:

(i) Deferring a substantial portion of income, or shifting a substantial portion of deductions, from one year to another so as to reduce tax liability,

(ii) Causing a similar deferral or shifting for any other person, such as a shareholder, and

(iii) Creating a short period in which there is a substantial net operating loss.

**Change of Tax Year**

An S corporation should file Form 1128, Application to Adopt, Change, or Retain a Tax Year, to apply for permission to change its tax year to a year other than a year ending December 31. This form should be filed by the 15th day of the second calendar month after the close of the short tax year. This short tax year begins on the first day after the end of the corporation’s present tax year and ends on the day before the opening date of its new tax year.

**Form 1120S**

A domestic corporation must file Form 1120S if:

(1) It elected to be taxed as an S corporation,

(2) The IRS accepted the election, and

(3) The election remains in effect.

If an S corporation’s income tax return (Form 1120S) is made on a calendar year basis, the return must be filed by March 15 following the close of the tax year. If an S
corporation is permitted to use a fiscal year as its tax year, its return must be filed by the 15th day of the 3rd month following the close of its fiscal year.

Extension

An S corporation will receive an automatic 6-month extension to file a return by submitting an application for extension on Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return. This form is filed with the Internal Revenue Service Center where the S corporation must file its income tax return. The IRS may terminate this extension at any time by mailing a termination notice to the corporation. Form 7004 must be filed by the due date of the S corporation’s income tax return.

Any automatic extension of time for filing an S corporation’s income tax return will not extend the time for payment of any tax due as shown on the return.

Late Filing

If an S corporation does not file its return by the due date, including extensions, and if it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for not more than one month. An additional 5% is imposed for each additional month or part of a month during which the delinquency continues. The penalty is limited to a total of 25%. The tax due is the tax liability that would be shown on a return minus credits and any tax payments made before the due date. The penalty for late filing is reduced by the late payment penalty.

If the return is not filed within 60 days after the due date, including extensions, the penalty for late filing will be at least $100 or the balance of tax due, whichever is less. This will not apply if reasonable cause is shown.

Reasonable Cause

An S corporation that wishes to avoid a penalty for late filing or payment must be able to show reasonable cause. This should be done by filing with the Director of the Service Center where the return must be filed a statement of the facts establishing reasonable cause for failure to file a return or pay the tax on time. The statement must also contain a declaration that it has been made under the penalties of perjury.

Schedule K-1

An S corporation must furnish a copy of Schedule K-1, Shareholder’s Share of Income, Credits, Deductions, etc., or a substitute Schedule K-1, to each person or entity that was a shareholder during the year. Not furnishing this form or a substitute by the day Form 1120S was filed, or not including all the required information, or including incorrect information, may result in a $50 penalty for each
form not furnished, incomplete, or incorrect. The total penalty, however, cannot be more than $100,000 for the calendar year.

Shareholder’s Treatment Of S Corporation Items

The tax treatment of any S corporation item is determined at the corporate level. Generally, a shareholder is required to treat S corporation items the same way on his or her tax return as they are treated on the S corporation return.

If an item on the shareholder’s return is treated differently from the way it is treated on the S corporation return, the IRS can automatically assess taxes and penalties. It can take action to immediately collect any deficiency and penalties that result from an adjustment to the shareholder’s individual return to make that treatment consistent with the amount or treatment of the item on the S corporation return. However, this adjustment does not apply if the shareholder files Form 8082, with his or her return identifying the different treatment.

The shareholder need not file Form 8082 if a loss, other deduction, or investment credit shown on Schedule K-1 (Form 1120S) is not reported in full on his or her return solely because the shareholder is required to limit the item, such as under the at-risk rules.

These rules do not apply to an S corporation with five or fewer shareholders if each shareholder is a natural person or an estate (but not a passthrough shareholder), unless the corporation chooses to have them apply. There cannot be more than five shareholders at any time during the year. For S corporations, a husband and wife, and their estates, are treated as one shareholder. For stock owned by tenants in common or joint tenants, each individual is considered a shareholder.

Pro Rata Share

Except when terminating S corporation status, each shareholder’s pro rata share of each item to be entered on Schedules K-1 is figured on a per day, per share basis.

A pro rata share is figured as follows:

(1) Divide the item by the number of days in the S corporation’s tax year (to figure the daily amount of the item),

(2) Multiply the daily amount of the item by the percentage of stock owned by the shareholder on that day (to figure the shareholder’s daily part of the daily amount of the items), and

(3) Total the shareholder’s daily parts of the daily amount of the item (to figure the shareholder’s pro rata share of the item for the tax year).
If there is no change in shareholders or in the percentage of stock each shareholder owns during the tax year, each shareholder’s pro rata share of
an item is the amount of the item times the percentage of stock owned by
the shareholder during the year.

Optional 10-year Write-Off of Tax Preferences

Generally, shareholders (who are individuals) may elect to deduct ratably
over 10 years the following qualified expenses incurred during the tax year:

(1) Research and experimentation costs, and

(2) Mining exploration and development costs.

Intangible drilling cost paid or incurred after 1989 may be deducted ratably
over a 60-month period.

In addition, an S corporation shareholder may elect to deduct in equal in-
stallments over a 3-year period the cost of increasing the circulation of a
newspaper, magazine, or periodical.

If one of these elections is made, the costs will not be considered a tax pre-
ference item and will not be used in figuring alternative minimum tax. The
election is made at the shareholder level. Therefore, these expenses are not
deductible by the S corporation. Instead, they are passed through to S corpo-
racion shareholders on Schedule K-1 (Form 1120S).

Note: These elections may be revoked only with the consent of the IRS. Each
shareholder of an S corporation makes a separate election for his or her share of
any qualified expense.

Fringe Benefits

An S corporation is treated as a partnership for purposes of employee fringe bene-
fits. Any more than 2% shareholder is considered a partner (§1372(b)).

Some fringe benefits are much more favorable to taxpayers when the corporate
form is employed. For example, a corporation can pay and deduct medical insurance
premiums for its employees, yet these are not taxed as compensation or dividends
to the employees. This is not possible in a partnership because the premiums are
considered paid by partners directly (and thus can only be deducted within the limits
of §213). However, under the Code, the partnership (not corporation) fringe benefits
rules apply to S corporations.

The following fringe benefits will not be available to a more than 2% shareholder in
an S corporation:

(1) The exclusion from income of amounts paid for an accident and health plan
(§105(b), (c), (d));
(2) The exclusion from income of amounts paid by an employer to an accident and health plan (§106);

(3) The exclusion of the cost of up to $50,000 of group-term life insurance on an employee’s life (§79); and

(4) The exclusion from income of meals or lodging furnished for the convenience of the employer (§119).

Health Insurance Premiums

An S corporation may deduct health and accident insurance premiums paid on behalf of its more than 2% shareholder-employees, their spouses, and dependents. The cost of these premiums is included in the shareholder-employee’s gross income. The cost is not included in the gross income of a shareholder-employee holding 2% or less of the corporation’s outstanding stock or combined voting power. A more than 2% shareholder-employee may deduct an amount equal to 100% of the part of these premiums paid for medical care if:

(1) The amount deducted is not more than the earned income (wages) received as an employee of the S corporation, and

(2) The shareholder-employee is not eligible to participate in any subsidized health plan maintained by any employer of the shareholder-employee or his or her spouse (§162(l)(5)).

Reporting Requirements

An S corporation may deduct as salary and wages on Form 1120S the health and accident insurance premiums paid on behalf of its more than 2% shareholder-employees. If the payments are made under a plan or system for employees and their dependents or for a class of employees and their dependents, the payments generally are excluded from “wages” for social security and Medicare tax purposes.

It must file a Form W-2 for each of its more than 2% shareholder-employees and include these premiums as salary and wages for federal income tax purposes.

Medical Deduction

The deduction for medical insurance premiums is taken on line 26, Form 1040. This amount should not be included with other medical expenses when figuring the medical deduction on Schedule A, Form 1040. However, the balance of the premiums may be included in medical expenses on Schedule A.

Note: The deduction for medical insurance premiums is not to be taken into account in determining an individual’s net earnings from self-employment.

These payments are not to be considered distributions for purposes of the one-class-of-stock requirement, discussed earlier.
<table>
<thead>
<tr>
<th>Entity Tax Comparison</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Who can own the company?</strong></td>
</tr>
<tr>
<td>One individual owner</td>
</tr>
</tbody>
</table>

| **Is there limited liability?** | No. Unlimited personal liability | General partners are personally liable for partnership debts. Limited partners are normally limited to their contribution | Yes. All members have limited liability | Stockholders are generally not liable for debts if corporate formalities are maintained | Stockholders are generally not liable for debts if corporate formalities are maintained |

| **Who pays the Federal income tax?** | Income and deductions are reported by individual on Schedule C (Form 1040). Separate Schedule C’s are needed for each business | Partnership does not pay tax, but files a Form 1065 as an information return. Partners are taxed on their distributive share of income and deduction as shown on their Form K-1. | **Chameleon Rule** By filing Form 8832, an LLC can elect to be taxed as a: (1) tax nothing (e.g., a sole proprietorship if there is only one member), (2) partnership (if there are 2 or more members), or (3) corporation | If formerly a C corporation, there can be tax on built-in gains and passive investment income. Otherwise, an S corporation is not taxed, but only files a Form 1120S as an information return. Shareholders are taxed on income attributable to their stock ownership | Income is taxed twice. Once when earned by C corporation and again when distributed to shareholders as dividend. Corporation files Form 1120. |

| **What is the maximum tax rate in 2016?** | 39.6% | 39.6% | See "Chameleon Rule" above | 39.6% | 39% for the corporation and 39.6% for shareholders |

<p>| <strong>What tax year can be used?</strong> | Same year as the individual owner | Restricted to tax year of majority partners, | See &quot;Chameleon Rule&quot; above | With certain exceptions, must be calendar year or any fiscal year based on | Calendar year or any fiscal year based on |</p>
<table>
<thead>
<tr>
<th><strong>When is the income taxable?</strong></th>
<th>Same year as the individual owner</th>
<th>Partners must report their share of partnership income in the year in which the partnership’s tax year ends</th>
<th>See &quot;Chameleon Rule&quot; above</th>
<th>Shareholders must report their share of corporate income in the year in which the corporation’s tax year ends. However, shareholders and corporation can be subject to estimated taxes</th>
<th>Based on corporation’s taxable year. Corporation is subject to estimated taxes. Shareholders pay tax on dividends in the tax year received</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>How is income allocated to owners?</strong></td>
<td>All to individual owner</td>
<td>According to the partnership agreement, which normally allocates based on profit and loss percentage.</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Pro rata based on share ownership determined on a daily basis, according to the number of shares held on each day of the corporation’s tax year</td>
<td>All to corporation</td>
</tr>
<tr>
<td><strong>What happens when you contribute property to the company?</strong></td>
<td>Nothing - the owner and the company are one and the same</td>
<td>Not a taxable event, unless the property is mortgaged in excess of basis (§721)</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Taxable unless terms of §351 are met</td>
<td>Taxable unless terms of §351 are met</td>
</tr>
<tr>
<td><strong>What is the character of the income when received by the owners?</strong></td>
<td>Income retains its characteristics</td>
<td>Income retains its characteristics</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Income retains its characteristics</td>
<td>All income characteristics are lost on distribution of income to shareholders</td>
</tr>
<tr>
<td><strong>How are net operating losses allocated?</strong></td>
<td>All to individual owner</td>
<td>According to the partnership agreement, which normally allocates based on profit and loss percentage</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Pro rata based on share ownership determined on a daily basis, according to the number of</td>
<td>All to corporation</td>
</tr>
</tbody>
</table>

principal partners or calendar year
dar year unless IRS approves different year for business purposes
dar year unless IRS approves different year for business purposes
filing of first tax return
<table>
<thead>
<tr>
<th><strong>How much loss can owner deduct?</strong></th>
<th>Capital investment plus debt</th>
<th>Partner’s capital investment plus share of partnership debt</th>
<th>See &quot;Chameleon Rule&quot; above</th>
<th>Shareholder’s capital investment plus shareholder loans to corporation</th>
<th>Owner is corporation. Shareholders are not entitled to deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Do the “at-risk” rules apply?</strong></td>
<td>Yes, but individual has an indefinite carryover of excess losses</td>
<td>Yes, but partners have an indefinite carryover of excess losses</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Yes, but shareholders have an indefinite carryover of excess losses</td>
<td>Yes, if closely held, but corporation has an indefinite carryover of excess losses</td>
</tr>
<tr>
<td><strong>Do the passive loss rules apply?</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Yes</td>
<td>Yes, for closely held and personal service corporations</td>
</tr>
<tr>
<td><strong>What happens if earnings are retained?</strong></td>
<td>Taxed to the individual owner</td>
<td>Taxed to the partners, but increases basis in partnership interest</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Taxed to the shareholders, but increases stock basis</td>
<td>Taxed to corporation and subject to accumulated earnings tax penalty</td>
</tr>
<tr>
<td><strong>Are nonliquidating distributions taxable to owners?</strong></td>
<td>No</td>
<td>No, unless money distributed exceeds partner’s basis. Section 751 assets can cause gain to be ordinary</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>No, unless distribution exceeds shareholder’s stock basis or AAA. Accumulated earnings and profits can cause dividend treatment</td>
<td>Yes, to extent of earnings and profits or if distribution exceeds stock basis</td>
</tr>
<tr>
<td><strong>Is the distribution of appreciated property taxable to the company?</strong></td>
<td>No</td>
<td>No</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Yes, but recognized gain is passed through to shareholders</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>What can be done to split income among family members?</strong></td>
<td>Employ children</td>
<td>Employ children; gift or sell partnership interests subject to certain limitations and</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>Employ children; gift or sell stock but watch out for “kiddie backfire” tax. Adjustment can</td>
<td>Employ children; gift or sell stock but watch out for “kiddie backfire” tax</td>
</tr>
<tr>
<td>Question</td>
<td>Response</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How are organizational expenses reported?</td>
<td>Amortized over 180 months</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How is capital gain taxed?</td>
<td>To the individual owner</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How are capital losses reported?</td>
<td>Owner can annually use $3,000 of capital losses against ordinary income. Balance is indefinitely carried over</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How are §1231 gains and losses reported?</td>
<td>Owner is taxed on gains and can deduct losses subject to 5 year lookback rule on losses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How is the alternative minimum tax reported?</td>
<td>Taxed to the individual owner at a 26% to 28% rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is §1244 treatment available?</td>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is there a potential built-in gains tax?</td>
<td>No</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **“kiddie back-fire” tax**
- be required to adequately reflect compensation for services
- Amortized over 180 months
- Amortized over 180 months
- See "Chameleon Rule" above
- Except for certain penalty taxes, it passes through and is taxed to shareholders
- To corporation using regular corporate tax rates
- Amortized over 180 months
- Pro rata by partners
- Pro rata by shareholders
- Corporation is taxed on gains and can deduct losses subject to 5 year lookback rule on losses
- Taxed to the corporation at a 20% rate and subject to the ACE adjustment
- No
- Yes
- No, unless partner contributed property with a basis different than its FMV in which case the
- Yes, if formerly a C corporation. However, built-in gain or loss on contributed property is not allo-
- No, unless later converted to an S corporation. Built-in gain or loss on contributed
<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>See &quot;Chameleon Rule&quot; above</th>
<th>No</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Are special allocations permitted?</strong></td>
<td>No</td>
<td>Yes, if they have substantial economic effect</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Do company liabilities increase the owner’s basis?</strong></td>
<td>Yes</td>
<td>Yes, they increase the partner’s basis in his partnership interest?</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Are fringe benefits widely available?</strong></td>
<td>No</td>
<td>No</td>
<td>See &quot;Chameleon Rule&quot; above</td>
<td>No, especially for 2% or greater shareholders</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Review Questions**

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

79. When an S corporation has earnings and profits and fails to make an election to distribute them first, an order of distribution must be followed. In these instances, what is the first source for the distributions?

   a. accumulated adjustments account (AAA).
   b. previously taxed income (PTI) in the corporation.
c. S corporation’s earnings and profits.

d. shareholder’s basis in the stock.

**80.** Generally, S corporations are required to use the permitted tax year. This means that it can use a taxable year which is:

a. a calendar year.

b. a major partner year.

c. a principal shareholder year.

d. a plan year.
Learning Objectives

After reading Chapter 6, participants will be able to:

1. Recognize basic fringe benefit planning by specifying “income” under §61, and determining the differences between former nonstatutory and current statutory fringe benefits created by recent cases, rulings, and tax law changes.

2. Identify the basic mechanics of typical fringe benefits, determine the fair market value of a fringe benefit under the general valuation rule or the special valuation rules, and cite the general accounting rule and the special two-month pour-over accounting rule.

3. Determine what constitutes a §274 “employee achievement award” and specify the rules for §79 group term life insurance noting how to implement proper coverage.

4. Recognize the mechanics of §105 self-insured medical reimbursement plans, and determine the requirements of §106 medical insurance noting the differences between the two Code sections.

5. Specify the rules for excluding the value of meals and lodging under §119 and determine what constitutes a “cafeteria plan” noting how it operates.

6. Identify the requirements and limits of employee educational assistance programs and dependent care assistance noting how to obtain each type of assistance.

7. Determine “no-additional-cost services” and identify what property or services are excludable from income as qualified employee discounts under §132(c), and specify exceptions to working condition fringes and de minimis fringes.

8. Recognize the requirements for qualified transportation fringe benefits under §132(f), specify valuation methods for employer-provided automobiles, and identify qualifications for the popular physical fitness exclusion and the requirements and benefits of adoption assistance programs.

9. Identify planning services available under §§132, 212 and 67, determine interest-free and below-market loans, recognize the elements of child care benefits and corporate funded educational savings accounts, specify S corporation fringe benefits, and identify ERISA compliance requirements.
CHAPTER 6

Basic Fringe Benefits

Perhaps the term “fringe benefits” is somewhat of a misnomer, since it connotates peripheral importance. With many companies expending over a third of their payroll on such items, they are hardly inconsequential.

Concept

Definition of Income - §61
The Code defines gross income as including “all income from whatever sources derived” and specifies that it include “compensation for services” (§61). The courts have stated that §61 is broad enough to include in taxable income any financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected.

Deductions without Taxable Income
However, certain fringe benefits can provide an unusually tax favored manner of supplementing the compensation of key executives. In such cases, benefits received under them are not taxable to the executive, while the cost of providing them is currently deductible to the employer.
Fringe benefits may include any property or services provided by the employer, such as:

1. An automobile,
2. A flight on an employer-provided aircraft,
3. A free or discounted commercial airline flight,
4. A vacation,
5. A discount on property or services,
6. A membership in a country club or other social club, or
7. A ticket to an entertainment or sporting event.

Benefit Mechanics

Old Dichotomy - Statutory v. Nonstatutory

Formerly there were two basic types of fringe benefits provided to the highly compensated employee. The first group of benefits was that specifically permitted by statute. The second type had developed over the years under a wide variety of plans that had no specific basis in the Code. These nonstatutory benefits usually involved the payment of a particular expense by the employer or the provision of goods and services to the employee. Through a long series of cases, rulings, and administrative customs, each of these plans had developed its own status as to taxability.

Fringe Benefit Provisions

In 1975, the IRS issued proposed regulations for determining when nonstatutory fringe benefits were taxable as compensation. Congress prohibited the issuance of such regulations that would be effective before 1984.
TRA '84 - §132

The Tax Reform Act of 1984 scrapped the moratorium for all fringes, other than faculty housing, by providing statutory rules for excluding certain fringe benefits from an employee’s income. The excluded fringes include:

(1) No-additional-cost services;
(2) Qualified employee discounts;
(3) Working condition fringes; and
(4) De minimis fringes;

**Discrimination**

Under §132, no-additional-cost services, employee discounts, eating facilities, and tuition reductions, must be provided on substantially the same terms to each member of the group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees.

**Note:** Neither working condition fringes or de minimis fringes are subject to antidiscrimination provisions.

**Only Statutory Benefits Remain**

Any fringe benefits that do not qualify for exclusion under §132, or any other provision, are taxable for income and employment tax purposes. Thus, employers must include in employees’ pay, the value of fringe benefits unless:

(i) The benefits are specifically excluded from income by law (i.e., they are a statutory fringe benefit), or
(ii) The employee pays for them.

This is the basis of the general valuation rule.

**General Valuation Rule**

Under the general valuation rule, an employer includes in an employee’s gross income the amount by which the fair market value (FMV) of a fringe benefit exceeds the sum of:

(1) The amount the employee paid for the benefit, plus
(2) The amount specifically excluded by law from gross income.

**Note:** No amount is included in an employee’s gross income if he or she pays FMV for the fringe benefit.

**Fair Market Value**

Fair market value (FMV) is determined based on all facts and circumstances. Specifically, the FMV of a fringe benefit is the amount a person would pay a third party to purchase or lease the fringe benefit.
Note: Neither the amount the employee considers the value of the fringe benefit nor the cost incurred to provide the benefit determines its FMV.

Special Valuation Rules
Special valuation rules can be used to value certain fringe benefits. These special valuation rules are the:

1. Automobile lease valuation rule,
2. Vehicle cents-per-mile valuation rule,
3. Commuting valuation rule, and

For benefits provided after 1992, neither the employer nor the employee may use the special valuation rule to value any benefit, unless one of the following conditions is satisfied:

1. The employer treats the value of the benefit as wages for reporting purposes by the due date of the return (including extensions) for the tax year in which the benefit was provided;
2. The employee includes the value of the benefit in income by the due date of the return for the year the benefit is received;
3. The employee is not a control employee; or
4. The employer demonstrates a good faith effort to treat the benefit correctly for reporting purposes.

Restrictions on Special Valuation Rules
All of the following apply when you use the special valuation rules.

(a) If one of the special rules is used by the employer to value a benefit, the employee must use the same special rule unless:
   - The employer does not treat the value of the benefit as wages for reporting purposes by the due date of the return (including extensions), and
   - One of the conditions just listed in items (2) through (4) above is met.

(b) If the employer and employee properly use a special rule, the employee must include in gross income the value the employer determines under the rule, minus any reimbursement the employee paid and any amount excluded by law from gross income. The special valuation rules can be used to determine the reimbursement the employee owes the employer.

(c) If an employer provides vehicles to more than one employee, the employer does not have to use the same special valuation rule for each employee. If the employer provides a vehicle for use by more than one em-
ployee (for example, an employer-sponsored van pool), the employer can use any special valuation rule. However, the employer must use that rule for all employees who share use of the vehicle.

Withholding & Accounting

When an employer includes the value of a noncash fringe benefit in an employee’s gross income, the employer cannot also deduct the value as compensation. However, the employer can deduct the costs incurred to provide the benefit. The employer may be able to take a depreciation deduction. If the noncash fringe benefit is property leased, the employer may be able to deduct the rent as an ordinary and necessary business expense.

The value of includible fringe benefits provided is generally subject to social security and Medicare tax (FICA), federal unemployment tax (FUTA), and federal income tax withholding. Employers can elect, for employment tax and withholding purposes, to treat taxable noncash fringe benefits provided to employees as if they were paid:

(1) On a pay period,
(2) Quarterly,
(3) Semi-annually,
(4) Annually, or
(5) Any other time period, provided, they are treated as paid no less than once a year.

Employers do not have to use the same time period for all employees. In addition, the election can be changed as long as all benefits provided in a calendar year are treated as paid no later than December 31 of that year. Moreover, the value of a single noncash fringe benefit can be treated as if it were paid on one or more dates in the same calendar year, even if the employee receives the entire benefit at one time.

Example

---

Dan provides his employee with a fringe benefit on March 31 that is valued at $1,000. Dan can treat the $1,000 as though it had been provided equally over 4 quarters and paid on March 31, June 30, September 30, and December 31.

---

General Accounting Rule

The value of any noncash fringe benefit provided to employees in a calendar year must be determined by January 31 of the following year. This is called the general income tax and reporting rule. However, the special accounting period

6-5
rule can be used to determine the value of fringe benefits, rather than using the general income tax and reporting rule.

**Special 2-Month Pour-Over Accounting Rule**

Instead of using the general income tax and reporting rule to report employee benefits on a calendar year basis, a special accounting period rule can be used.

*Note:* The special accounting period rule cannot be used for a fringe benefit that is a transfer of personal property normally held for investment. Nor can it be used for a transfer of real property.

Under the special accounting period rule, the value of benefits provided in the last 2 months of the calendar year, or any shorter period, can be treated as though paid in the next year. To do this, the value of the benefits provided in the last 2 months of a calendar year (or shorter period) is added to the value of benefits provided in the first 10 months (or longer period) of the next year.

*Note:* Not all benefits treated as provided during the last 2 months of a calendar year can be deferred until the next year. Only the value of the benefits actually provided during the last 2 months of the calendar year can be treated this way. Thus, if a fringe benefit was treated as provided equally over the year, only the value of the benefit actually provided during the last 2 months can be deferred.

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

*Note:* If the employer uses the special accounting period rule, the employee must also use it for the same period. However, the employee can use it only when the employer uses it.

**Types of Benefits**

**Employee Achievement Awards - §74(c) & §274(j)**

The general rule of §74 provides that the fair market value of prizes and awards is includible in gross income. Under Reg. §1.74-1(a), such awards and prizes include amounts received from giveaway shows, door prizes, contest awards, and awards from an employer to an employee.
Exclusion

Under §74(c), when an employee achievement award (defined under §274(j)(3)) is deductible by the employer subject to the limits under §274, the fair market value of the award is not taxed to the employee. There are separate exclusion limits for employee achievement awards and qualified plan awards. An employee can exclude from income $400 of an employee achievement award and $1,600 of a qualified plan award.

Definition of Employee Achievement Awards

Section 274(j)(3)(A) provides that an employee achievement award is an item of tangible personal property that an employer gives to an employee and is:

(a) Transferred for length of service or safety,

Service & Safety Award Restrictions

Under §274(j)(4)(B), an item is not treated as having been provided from length of service achievement if the item is received during the recipient’s first 5 years of employment or if the recipient received a service award (other than under the §132(c) exclusion for de minimis fringe benefits) during that year or any of the prior 4 years.

Section 274(j)(3)(C) provides that an item shall not be treated as having been given for safety achievement if:

(i) During the year, the employer previously made safety awards to more than 10% of eligible employees, or

(ii) Such item is awarded to a manager, administrator, clerical employee, or other professional employee.

(b) Awarded as part of a meaningful presentation, and

(c) Awarded under conditions that do not create a significant likelihood of the payment of disguised compensation.

Qualified Plan Award

A qualified plan award is an employee achievement award provided under a qualified award plan.

1 Under §74(c)(1), the award is also excludable from wages from employment tax and Social Security tax purposes.

2 This provision is not available for awards of cash, gift certificates, or equivalent items.

3 Section 274(j) no longer allows employee awards for productivity.

4 All employees are eligible, except managers, administrators, clerical workers, and other professional employees.
A plan is a qualified award plan when:

(a) It is an established written plan or program that does not discriminate in favor of highly compensated employees (defined in §414(q)) as to eligibility or benefits (§274(j)(3)(B)); and

(b) The average cost per recipient of all achievement awards, made under all such qualified award plans during the tax year, does not exceed $400 (§274(j)(3)(B)(ii)).

**Employer Deduction Limits**

There are separate deduction limits for employee achievement awards and qualified plan awards. Under §274(j), there is a $400 limit on the employer’s deduction for all employee achievement safety and service awards (other than qualified plan awards) provided to the same employee during the tax year. If the award is a qualified plan award, the deduction ceiling is raised to $1,600 for safety or service awards made to the same employee. The $400/$1,600 limit is based on the cost (not fair market value) to the employer of the award item.

**Aggregation Limit**

The $400 and $1,600 limits cannot be added together to allow a deduction exceeding $1,600 in aggregate for employee awards made to the same employee during the tax year (§274(j)(2)(B)).

**Special Partnership Rule**

Section 274(j)(4)(A) provides that in the case of an employee achievement award made by a partnership, the deduction §274 limitations apply to the partnership as well as to each partner.

**Employee Impact**

Under §74(c)(2), if any part of the cost of an employee achievement award exceeds the deduction allowed to the employer under §274, the exclusion does not apply and the employee must include in income the greater of:

(i) The portion of the employer’s cost of the award that is not allowable as a deduction to the employer, or

(ii) The difference between the fair market value of the award and the maximum allowable deduction.

The remaining portion of the fair market value of the award is not included in the employee’s gross income.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

81. One of the two original types of fringe benefits was statutory fringe benefits. What characterized statutory fringe benefits?
   a. They were specifically permitted in the Code.
   b. They were generally taxable to the executive.
   c. They involved the payment of a particular expense by the employer.
   d. They involved the provision of goods and services to the employee.

82. Generally, fringe benefits are taxable for income and employment purposes if they fail to qualify for exclusion. When must employers include the value of fringe benefits in employees’ pay?
   a. when the benefits are not statutory.
b. when the benefits are specifically excluded from income by law.
c. when the benefits qualify for exclusion under §132.
d. when the employee pays for the benefits.

83. For benefits provided after 1992, four conditions must be met in order for an employer or an employee to use the special valuation rule. What is one of the conditions?
   a. The value of the benefit is excluded from income at the due date of the return for the year the benefit is received.
b. The employee is a control employee.
c. A good faith effort to treat the benefit correctly for reporting purposes is shown.
d. The value of the benefit is treated as a fringe benefit for reporting purposes.

84. Taxpayers must determine which fringe benefits to withhold and account for. What is the general income tax and reporting rule?
   a. The election can be changed as long as all benefits provided in a calendar year are treated as paid no later than December 31 of that year.
b. By January 31 of the following year, the value of any noncash fringe benefit that employees receive in a calendar year must be determined.
c. The value of benefits provided in the last 2 months of the calendar year, or any shorter period, can be treated as though paid in the next year.
d. The value of includible fringe benefits provided is subject to social security and Medicare tax (FICA).

85. Under §274(j)(3)(A), an employee achievement award is given by an employer to an employee. Moreover, the item of tangible personal property is:
   a. awarded as part of a significant presentation.
b. not given as a recognition for safety.
c. possibly disguised payment for services.
d. received during the recipient’s first 5 years of employment.
Group Term Life Insurance - §79

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Employers can deduct group term life insurance premiums paid or incurred on policies covering the lives of officers and employees if the employer is not the beneficiary under the contract (§264(a)(1)).

Group term life insurance is *term life insurance* provided to a group of employees under a policy carried directly or indirectly by the employer and provides:

1. A general death benefit that is excluded from gross income, *and*
2. An amount of insurance to each employee based on a formula using factors such as age, years of service, compensation, or position that prevents individual selection of insurance coverage.

Travel insurance or accident and health policies that include death benefits, but do not provide general death benefits, are not group term life insurance.

An employee, generally, must include in income the cost of group term life insurance coverage on his or her life that is *more than* the cost of $50,000 of this insurance. The $50,000 relates to insurance protection the employee receives during any part of the tax year (§79(a)). The cost of the group term life insurance that must be included in an employee’s income is not the actual cost of the extra coverage, but an amount figured using a *monthly cost table*.

**Monthly Cost Table**

The monthly cost includible in an employee’s income is determined by figuring the cost of the insurance that exceeds $50,000 during each month. This is done by multiplying the number of thousands of dollars in excess of the $50,000 (figured to the nearest 10th) by the appropriate cost per thousand per month from the following table. The result is then multiplied by the number of months during
the year the employee’s insurance exceeded $50,000 by that number of thousands. From that amount, subtract any amount the employee paid toward the purchase of the insurance. The employee’s age is determined on the last day of the tax year.

The monthly cost of each $1,000 of group term life insurance protection is as follows:

<table>
<thead>
<tr>
<th>Employees Age At Year End</th>
<th>Monthly Inclusion Per $1,000</th>
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<tbody>
<tr>
<td>Under 25</td>
<td>5 cents</td>
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<tr>
<td>25 to 29</td>
<td>6 cents</td>
</tr>
<tr>
<td>30 to 34</td>
<td>8 cents</td>
</tr>
<tr>
<td>35 to 39</td>
<td>9 cents</td>
</tr>
<tr>
<td>40 to 44</td>
<td>10 cents</td>
</tr>
<tr>
<td>45 to 49</td>
<td>15 cents</td>
</tr>
<tr>
<td>50 to 54</td>
<td>23 cents</td>
</tr>
<tr>
<td>55 to 59</td>
<td>43 cents</td>
</tr>
<tr>
<td>60 to 64</td>
<td>66 cents</td>
</tr>
<tr>
<td>65 to 69</td>
<td>$1.27</td>
</tr>
<tr>
<td>70 &amp; over</td>
<td>$2.06</td>
</tr>
</tbody>
</table>

**Example**

*XYZ Company provides group term life insurance to all of its employees. The company plan requires employees to pay 5 cents per thousand dollars of coverage per month toward the premiums. XYZ Company pays the balance. Dave, an employee, has $65,000 of coverage payable in a lump sum upon his death to his wife. Dave is age 52 at the end of the year. The annual premium on Dave’s policy is $325. Of that, Dave paid $39. To figure the amount to include in Dave’s income, subtract $50,000 from his $65,000 of insurance coverage. Multiply the number of thousands of dollars in excess of the $50,000 (15) by the monthly cost in the above table (.23) for Dave’s age bracket. The result is $3.45. Multiply that amount by the number of months during the year the insurance coverage was $15,000 over the $50,000. In this case, it is 12 months times $3.45, or a total of $41.40. From the $41.40 subtract the $39 in premiums paid by Dave. The difference, $2.40, must be included in Dave’s income. XYZ Company’s deduction for life insurance premiums paid on Dave’s policy is $286 ($325-$39).*
**Family Member Cost**

The cost of group term life insurance paid on the life of an employee’s spouse or children is generally *included* in the employee’s income. However, *no* amount is included in income *if* the insurance payable on the death of a spouse or a child does *not exceed* $2,000. The cost of higher amounts of coverage may also be excluded from income *if* it is a *de minimis* fringe benefit. In determining whether the coverage is a *de minimis fringe*, only the excess of the cost of the insurance over the amount paid by the employee is considered.

**Employment Taxes**

Employers must report on Form W-2 the cost *includible* in the employee’s income. The cost of group term life insurance that is income to the employee is *not* subject to income tax withholding and is *exempt* from FUTA tax. However, the cost is subject to social security and Medicare tax withholding. The cost of group term life insurance that is income to employees who quit or retire is also subject to social security and Medicare tax withholding. The former employee is liable for the employee’s share of the tax and the employer must provide (on Form W-2) the amount for the employee to include on line 53, Form 1040.

**Group Requirements**

Generally, life insurance qualifies for treatment as group term life insurance only if it is provided to *at least 10 full-time employees* at some time during the calendar year. However, insurance can *also* qualify as group term if *all* of the following conditions are met:

(1) The employer provides the insurance to all full-time employees or, if evidence of insurability affects eligibility, to all full-time employees who provide evidence of insurability satisfactory to the insurer;

(2) The insurance coverage is figured based on a uniform percentage of pay or based on the insurer’s coverage brackets; *and*

(3) Evidence of insurability is *limited* to a medical questionnaire completed by the employee that does not require a physical exam.

For purposes of these conditions, the employer does *not* have to provide insurance to any of the following:

(1) Employees 65 or older,

(2) Employees working 20 hours or less a week or 5 months or less in any calendar year, *or*

(3) Employees who have not been employed for the waiting period specified in the policy which cannot be more than 6 months.
Insurance is considered to be provided to employees who choose not to receive the insurance unless they are required to contribute to the cost of benefits other than the group term life insurance. For example, if an employee could receive group term life insurance by contributing to the cost, that employee is counted in determining whether the group term life insurance is provided to 10 or more employees, even if that employee chooses not to receive the insurance.

However, if an employee must contribute to the cost of permanent benefits to get group term life insurance, that employee is not counted when determining if the employer provides the group term life insurance to 10 or more employees unless the group term life insurance is actually provided to that employee.

Employee

An employee is:

(1) A person who performs services for an employer and whose legal relationship to the employer is that of an employee,

(2) A full-time life insurance salesperson, or

(3) A person who was formerly an employee.

Note: Certain former employees are exempt from including the cost of this insurance that is more than $50,000 in their income.

Permanent Benefits

Permanent benefits are economic values provided under a life insurance policy that extends beyond one policy year, such as paid-up or cash surrender value. Life insurance that includes permanent benefits is not group term life insurance unless both of the following conditions are met.

(1) The policy or the employer must specify in writing which part of the death benefit provided for each employee is group term life insurance; and

(2) The part of the death benefit specified as group term life insurance for any policy year cannot be less than the difference between the total death benefit provided by the policy and the employee’s deemed death benefit (defined in Reg. §1.79-1(d)(3)) at the end of the policy year.

If the insurance includes permanent benefits, the employer must include in the employees’ income:

(1) The cost of the permanent benefits, minus

(2) The amount paid by the employee for the permanent benefits.

Discriminatory Plan

A discriminatory group term life insurance plan is any plan of an employer that provides group term life insurance that favors key employees as to:

(1) Eligibility to participate, or
(2) The type and amount of life insurance benefits provided under the plan. The participation and benefits tests are to be applied separately to active and former employees.

**Eligibility**

A plan generally does not discriminate if:

(a) The plan benefits at least 70% of all employees,

(b) At least 85% of all participating employees are not key employees,

(c) The plan benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees, or

(d) The eligibility rules for cafeteria plans are satisfied, if the plan is part of a cafeteria plan.

Employers can exclude certain employees from consideration when applying the eligibility-to-participate test. These are employees who:

(a) Have not completed 3 years of service with the employer,

(b) Are part-time or seasonal employees,

(c) Are nonresident aliens who receive no U.S.-source income from the employer, or

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

**Type & Amount of Benefits**

A group term life insurance plan may meet the eligibility-to-participate test and still be a discriminatory plan if it discriminates in terms of the type of life insurance benefits. All benefits available to participating key employees must also be available to all other participating employees. However, group term life insurance benefits will not be considered to discriminate merely because the amount of life insurance, provided to employees, bears a uniform relationship to employees’ pay.

**Key Employee**

A key employee is any employee or former employee who during the year, or any of the 4 preceding years, was:

(1) An officer of the employer having, for any year listed below, annual compensation of more than 50% of the §415(b)(1)(A) limit,
(2) One of 10 employees having annual compensation of more than $30,000 and owning (or considered to own under the related-party rules) the largest interests in the employer,
(3) A 5% owner of the employer, or
(4) A 1% owner of the employer with annual compensation of more than $150,000 (§416(i)(1) & §79(d)(2)).

Key employees also include any former employee who was a key employee upon retirement or separation from service.

Self-Insured Medical Reimbursement Plans - §105

| Fast-Facts |
|------------------|--------------------------------------------------|
| **Employee Tax Impact** | Employer reimbursements are not taxable income |
| **Employer Tax Impact** | Deductible |
| **Nondiscrimination Rules** | Plan may not discriminate in favor of highly compensated employees |
| **Special Documentation** | None, but written plan recommended |
| **Reporting** | Employer may be required to file annual reports on Form 5500 or Form 5500-C. |

A medical reimbursement plan is an arrangement provided by an employer to reimburse employees for medical and dental expenses. The plan may also cover the employee’s spouse and dependents.

Note: A self-insured medical reimbursement plan reimburses employees for medical expenses not reimbursed by an accident or health insurance policy.

Under §105, employer reimbursements for such employee medical expenses are excludable from income. This exclusion will not apply to highly compensated employees if the §105 plan discriminates in their favor.

Allowable Expenses

Section 105(b) states that, in the case of amounts attributable to deductions allowed under §213, gross income does not include amounts paid by an employer to reimburse an employee for expenses incurred by him for medical care.

Requirements

Such amounts received by an employee are generally nontaxable provided that:

(1) They are received as reimbursements for medical expenses actually incurred;

For exclusion purpose, a self-employed individual or a 2% or more S corporation shareholder is not considered an employee (§105(g) and §1372).
(2) The employee received no benefit from the deduction of the medical expenses in prior years; and
(3) The plan is nondiscriminatory.

Benefits

A plan is discriminatory if highly compensated employees have greater benefits than other employees. This means benefit levels cannot be based on a percentage of compensation. Dollar for dollar benefits must be provided. While there is no statutory limit on the amount of benefits payable under such plans, all employees of related companies are combined for purposes of these tests.

Reporting

Employers can generally deduct amounts paid under a self-insured medical reimbursement plan to reimburse employees for medical expenses. Employers do not include these amounts in their employees’ gross income nor do they withhold FICA, FUTA, or income taxes.

If a plan discriminates in favor of highly compensated individuals, all or part of the amounts paid to these individuals must be included in their gross income. Generally, this rule also applies if a highly compensated employee is enrolled in a Health Maintenance Organization (HMO) as an alternative to the self-insured plan.

A highly compensated individual (for these purposes) is:

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

Exposure

Companies should be careful to limit their liability under these plans to a reasonable amount. The most effective method is to place a ceiling on payments to any one employee and to purchase health insurance to cover unusually large medical expenses.
Medical Insurance - §106

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Generally, employers can deduct premiums paid or incurred for health or accident insurance plans. This includes payments made under plans that reimburse premiums paid by employees on personal health insurance policies, including supplemental medical insurance.

These amounts are deducted on the line titled “Employee benefit programs” on the employer’s business return and are generally not includible in the employee’s income.

**Group Health Plan Restrictions - COBRA**

A group health plan is any plan that provides medical care to employees, former employees, or their families. Care may be provided directly or through insurance, reimbursement, or otherwise.

**Coverage Requirement**

If a group health plan does not cover the working aged, active disabled, or those with end stage renal disease, the employer will be subject to an excise tax. The tax is 25% of the expenses incurred for each of the group health plans to which the employer contributes.
Continuation Requirement

A group health plan must provide for continuation of coverage. If a plan fails to provide continuation coverage to qualified beneficiaries the employer will be subject to an excise tax.

Note: An employee's spouse and dependent children, if covered under the plan, are qualified beneficiaries. The covered employee is also a qualified beneficiary if the event is a termination or reduction of hours or a bankruptcy proceeding.

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

The noncompliance period for each failure begins on the day the failure first occurs and ends on the earlier of:

1. The day the failure is corrected, or
2. 6 months after the last day in the period for which the employer could have been required to provide continuation coverage.

To meet the continuation coverage requirement, a group health plan must provide qualified beneficiaries the choice of continuing to be covered by the plan if any of the following events occurs:

1. Covered employee’s death,
2. Covered employee’s termination (other than for gross misconduct) or reduction in hours of employment,
3. Covered employee’s divorce or legal separation from a spouse,
4. Covered employee’s entitlement to Medicare benefits,
5. A dependent child ceases to be a dependent, which ends the child’s eligibility for coverage under the plan guidelines, or
6. Bankruptcy proceeding under Title 11, United States Code, of the employer of a retired covered employee.

If any of these events occurs, the plan must provide an election period of at least 60 days to qualified beneficiaries to choose to continue coverage under the plan. In general, this coverage must be identical to that received by beneficiaries who have not experienced any of these events.

American Recovery & Reinvestment Act

The Act provides that, for a period not exceeding 9 months, an assistance eligible individual is treated as having paid any premium required for COBRA continuation coverage under a group health plan if the individual pays 35 percent of the premium. Thus, if the assistance eligible individual pays 35 percent of the premium, the group health plan must treat the individual as having paid the full premium required for COBRA continuation
coverage, and the individual is entitled to a subsidy for 65 percent of the premium.

**Comment:** In short, laid-off workers would pay 35% of the COBRA premium and the former employer would pay the remaining 65% for nine months.

**Exemptions**

The excise tax generally does *not* apply to:

(a) Any group health plan if all employers maintaining the plan normally employed fewer than 20 employees on a typical business day in the preceding calendar year,
(b) Any governmental plan, or
(c) Any church plan.

The tax does not apply for any period during which the failure was not known to exist and would not have been discovered using reasonable care. The tax also does not apply if the failure is due to reasonable cause, not willful neglect, and is corrected within a 30-day period beginning when the failure is found, or would have been found if reasonable care were used. However, these exceptions do not apply (and the tax does) if the failure is not corrected before the IRS sends a notice of examination for a period during which the failure occurred or continued.

**Continuation Period**

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

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

**Note:** Certain situations may shorten the period of coverage. For example, the coverage period can end earlier if the employer terminates all of its group health plans, if the beneficiary does not pay the premiums on time, or if the beneficiary becomes entitled to Medicare.

**Notice**

Employees and their spouses *must* be given written notice of their continuation coverage election rights when their coverage under a plan begins. Employers generally must notify the plan administrator within 30 days of the death, termination, or reduction in hours, or Medicare entitlement of any covered employee, or of their own Title 11 bankruptcy proceeding.
Employees or their qualified beneficiaries are responsible for notifying the plan administrator if there is a divorce or legal separation, or if a child’s eligibility under the plan ends. This notification generally must be made within 60 days after the date of the event. In addition, within 14 days of their notification, plan administrators generally must inform qualified beneficiaries of their right to choose continuation coverage.

Meals & Lodging - §119

| Fast-Facts |
|-----------------|------------------|
| **Employee Tax Impact** | Tax free if provided for the convenience of the employer. Meals furnished at employer-provided eating facility may be tax free as de minimis benefit if gross income and nondiscrimination requirements are met. |
| **Employer Tax Impact** | Deductible |
| **Nondiscrimination Rules** | None, except for meals at employer-provided eating facilities |
| **Special Documentation** | None, except for employer-provided eating facilities which must meet operating cost and revenue requirements |
| **Reporting** | Employee taxable meals reported on Form W-2 |

The Code specifically excludes from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer (§119(a)). However, meals and lodging furnished to employees must meet the following rules before the employer can exclude their value from the employees’ income:

(1) The meals or lodging must be furnished on the employer’s business premises;

   Note: The employer’s business premise generally means the place of employment. For example, meals and lodging furnished to a domestic worker in an employer’s private home are furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding cattle on land leased or owned by an employer are furnished on the employer’s business premises.

(2) The meals or lodging must be furnished for the employer’s convenience; and
(3) In the case of lodging (but not meals), the employees must be required to accept the lodging as a condition of their employment.\(^6\)

If employees have a choice of either receiving additional pay or meals or lodging, the value of the meals or lodging is treated as income to the employee. However, if employees refuse the meals (and have no choice of additional pay), the value of the meals may not be income.

**Note:** If the value of the meals and lodging is not included in income, it is not subject to social security, Medicare, FUTA, or income tax withholding.

**Convenience of Employer**

Whether or not meals or lodging are furnished for the employer’s convenience must be determined from all the facts and circumstances. Generally, meals or lodging are treated as furnished for the employer’s convenience, if the employer has a *substantial business reason* other than providing the employee additional pay. A statement that the employer did not intend the meals or lodging as pay is not sufficient to prove either item is furnished for the employer’s convenience.

If an employer has a *substantial nonpay business reason* for furnishing meals or lodging, and these items are furnished on the employer’s business premises (and, in the case of lodging, the employees are required to accept the lodging as a condition of their employment), the value is not included in the employee’s income. This is true even though the employer may also intend the meals and lodging to be pay. Thus, the employer excludes the value of meals or lodging from employees’ income even if a law or an employment contract provides that they are furnished as pay.

However, if the employer furnishes meals or lodging to provide additional pay, and does not have a substantial nonpay business reason for furnishing them, the value must be included as additional income to the employee. For example, meals furnished to employees to promote goodwill, to boost morale, or to attract prospective employees are considered additional pay and must be included as income to employees.

**Substantial Nonpay Reasons**

In the following situations, meals furnished *without charge* are regarded as furnished for a substantial nonpay business reason:

**(1)** Meals furnished during working hours so the employee will be available for *emergency calls* during the meal period;

**Note:** However, the employer must be able to show that emergencies have occurred or can reasonably be expected to occur.

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\(^6\) This means they must accept the lodging to allow them to properly perform their duties.
Example

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

(2) Meals furnished during working hours because the nature of the employer’s business restricts the employee to a short meal period (such as 30 or 45 minutes), and the employee cannot be expected to eat elsewhere in such a short time;

Note: Meals can qualify if there are insufficient eating facilities near the place of employment, or if the peak workload occurs during the normal lunch hour. However, if the reason for the short meal period is to allow the employee to leave earlier in the day, the meal will not qualify.

Example

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

(3) Meals furnished to restaurant or other food service employees, for each meal period in which they work, if the meals are furnished during, immediately before, or immediately after work hours;

Example

Dan operates a restaurant business and furnishes his employee, Carol, who is a waitress, two meals per workday without charge during her 7 a.m. to 4 p.m. workday. Dan encourages but does not require Carol to have her breakfast on the business premises before starting work. She must have her lunch on the premises. Since Carol
is a food service employee and works during the normal breakfast and lunch periods, Dan does not treat the value of her breakfast and lunch as income to her.

(4) Meals furnished immediately after working hours that the employer would have furnished during working hours for a substantial nonpay business reason, but because of the work duties were not eaten during working hours; and

(5) Meals furnished to all employees at the employer’s place of business if substantially all employees are furnished meals for a substantial nonpay business reason.

The value of meals furnished on any nonworkday is normally income to the employee. However, if the employee must occupy living quarters on the business premises as a condition of employment, the value of any meal furnish without charge on the business premises is not treated as income.

Example

Dan operates a restaurant business and furnishes his employee, Carol, who is a waitress, meals without charge during her workday. Dan also allows Carol to have meals on the business premises without charge on her days off. Dan must include the value of these meals as income to Carol.

Meals with a Charge

If the employer furnishes meals for which the employees are charged a flat amount, the flat amount charged is not included in employees’ income. This does not depend on the employees’ acceptance of the meals. The employer may have to include the actual value of the meals in the employee’s income if the meals are not furnished on the employer’s business premises or for the employer’s convenience.

Lodging Required by Employer

In addition to meeting the business premises and convenience of employer requirements, in order for the value of lodging to be excluded from an employee’s income, employees must be required to accept the lodging as a condition of their employment. This means that employees need to live on the business premises to be able to properly perform their duties. Examples include employees who must be available at all times and employees who could not perform their required duties without being furnished the lodging.
Thus, if the lodging is furnished as a condition of employment, the value is excluded from an employee’s pay even if the employer is required to provide the lodging as pay under the terms of an employment contract, or a law fixing the terms of employment.

**Example**

*A hospital gives Joan, an employee of the hospital, the choice of living at the hospital free of charge or living elsewhere and receiving a cash allowance in addition to her regular salary. If Joan chooses to live at the hospital, her employer must include the value of the lodging in income to her because her residence at the hospital is not required to properly perform the duties of her employment.*

**Highly Compensated Employees**

Numerous cases and rulings exist in this area defining what is for the convenience of the employer or the employer’s requirement to live on particular premises. However, most of these cases relate to rank and file employees and are not relevant to the highly compensated. Nevertheless, in *Commissioner v. Mabley*, 24 T.C.M. 1974 (1965) the Tax Court held that where executives of a corporation meet on a daily basis for a staff luncheon to conduct company business, the value of the meals will not be included in the employee’s income. However, take a look at the case of *John D. Moss, Jr. v. Comm.*, 80 TC No. 57 (1983), where similar expenses for a law partner will be held to be personal.

**50% Limit on Meals**

The allowable deduction for the expense of providing meals to employees is limited to 50% of the costs unless one of the following exceptions applies:

1. The value of the meals is includible in your employees’ income;

   **Note:** The value of the meals is generally includible in an employees’ income unless:

   1. The meals are furnished to the employees on the employer’s premises and for the employer’s convenience, or
   2. The meals qualify as a de minimis fringe benefit.

2. The employer operates a restaurant or catering service and furnishes the meals to employees at the work site;
3. The employer furnishes the meals to employees as part of the expense of providing recreational or social activities, such as a company picnic;
4. The employer is required to furnish meals to crew members of a commercial vessel under a federal law; or
Note: This includes crewmembers of commercial vessels operating on any U.S. inland waterway if meals would be required under federal law had the vessel been operated at sea. This does not include meals furnished on vessels primarily providing luxury water transportation.

(5) The employer provides the meals on an oil or gas platform or drilling rig located offshore or in Alaska.

Note: This exception also applies to meals provided at a support camp that is near and integral to an oil or gas drilling rig located in Alaska.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

86. Generally, employees who are covered under group term life insurance must include the cost of the coverage over a certain amount. What amount must be included in their income?
   a. an amount figured using a monthly cost table.
   b. any amount the employee paid toward the purchase of the insurance.
   c. the actual cost of the extra coverage.
   d. $2.06 multiplied by the number of thousands of dollars over $50,000.
87. Under §105, if a medical reimbursement plan discriminates in favor of highly compensated individuals, all or part of the amounts paid to these individuals must be included in their gross income. For these purposes, who would be considered a highly compensated individual?
   a. one of the ten highest paid officers.
   b. a shareholder who owns at least 5% in value of the employer’s stock.
   c. an employee whose compensation is in the top 25% of all participant employees.
   d. a person who was formerly employed with the company who earned more than $50,000.

88. Employers can deduct premiums paid or incurred for health or accident insurance plans. Under §106, when will the employer be subject to an excise tax?
   a. if the plan doesn’t provide continuation coverage to qualified beneficiaries.
   b. if all employers maintaining the plan normally employed fewer than 20 employees on a typical business day in the preceding calendar year.
   c. if the employer discontinues coverage for a governmental plan.
   d. if the plan provides no more than 60 days to elect to continue coverage.

89. The value of meals must be included as additional income to employees if the employer fails to show there is a substantial nonpay reason for providing them. In what situation are such meals considered as provided for a substantial nonpay business reason?
   a. meals furnished during a time when the employee might be needed for emergency purposes.
   b. meals furnished on a day that the employee is not working.
   c. meals furnished to employees to draw potential employees.
   d. meals furnished to employees to increase morale.

90. Employees can choose from at least five qualified benefits under a cafeteria plan. What is one of these five qualified benefits?
   a. a vacation days program.
   b. meals and lodging.
   c. scholarships and fellowships.
   d. vanpooling.
Cafeteria Plans - §125

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<td>Special Documentation</td>
<td>Employee’s taxable benefits reported on Form W-2. Annual reports on Form 5500, or Form 5500-C may be required.</td>
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In many instances, employees will differ widely in age and financial position. As a result, some employees will prefer cash to deferred and noncash benefits. Fortunately, §125 has a potential solution in the form of a cafeteria plan.

Cafeteria plans, including flexible spending arrangements, are written plans that allow employees to choose among two or more benefits consisting of cash and qualified benefits.

Generally, a plan that provides for deferred compensation is not a cafeteria plan. However, certain profit sharing or stock bonus plans, and certain life insurance plans maintained by educational institutions can be offered through a cafeteria plan even though they provide for deferred compensation.

Unless actually elected, the fact that cash or certain taxable benefits are available under the plan does not cause an employee to be treated as having received the cash or taxable benefit.

Definition

A cafeteria plan is a written program that permits employee-participants to select among cash and qualified tax-free benefits. Section 125 excludes the employer’s contribution to the plan from being included in the employee’s income to the extent the employee chooses nontaxable benefits (Reg. §1.125-2T and Reg. §1.125-1).

Qualified benefits under a cafeteria plan are not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding. If an employ-
ee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all employment taxes.

Qualified Benefits

A cafeteria plan can offer employees choices that include only cash and qualified benefits that are excludable under a specific Code section. Such qualified benefits include coverage or participation under (Reg. §1.125-2T):

(a) A group-term life insurance plan of up to $50,000\(^7\) (§79);
(b) An accident or health plan (§105 and §106);
(c) A dependent care assistance program (§129);
(d) A qualified cash or deferred arrangement that is part of a profit-sharing or stock bonus plan (§401(k)); and
(e) A vacation days program, provided such vacation days are not redeemable for cash at a later date.

Non-Qualified Benefits

Cafeteria plans cannot offer the following benefits (Reg. §1.125-2T):

(i) Scholarships and fellowships under §117;
(ii) Vanpooling under §124;
(iii) Educational assistance under §127;
(iv) Meals and lodging under §119;
(v) Fringe benefits excludable under §132; and
(vi) Deferred compensation other than a profit sharing or stock bonus plan that includes a §401(k) cash or deferred arrangement (§125(d)(2)).

Controlled Group Rules

The controlled group rules of §414(b), (c) or (m) apply and self-employed individuals are not eligible. A cafeteria plan must not discriminate in favor of highly compensated employees as to benefits and contributions.

Salary Reduction Plans

Cafeteria plans may be funded by the employees pursuant to a salary reduction election whereby such funds become employer contributions for federal income tax purposes. The salary reduction agreement must relate only to compensation, which has not been actually or constructively received by the participant as of the date of the agreement. A cafeteria plan may not offer any benefit that defers the date of receipt of compensation except for the right of the employees to

\(^7\) A cafeteria plan may also offer group-term life insurance coverage that is in excess of $50,000 or is on the lives of the participant’s spouse and/or children.
make elective contributions under a §401(k) cash or deferred profit sharing plan. If the plan is discriminatory for a plan year, a highly compensated participant will be currently taxed on any qualified benefits received during the plan year.

Nondiscrimination

A cafeteria plan cannot discriminate in favor of *highly compensated participants* as to eligibility to participate in the plan or as to contributions or benefits. If the plan does discriminate, highly compensated participants must include in their income the value of the benefits that could have been elected (§125(b)(1)).

Highly Compensated Participants

An individual or participant is highly compensated if he or she is:

1. An officer,
2. A shareholder owning more than 5% of the voting power or value of all classes of the employer’s stock,
3. Highly compensated, or
4. A spouse or dependent of a person described in (1), (2), or (3).

Key Employees

If qualified benefits provided to *key employees* are *more than 25%* of the total of these benefits provided for all employees under the plan, key employees must include in their income the value of the benefits that could have been elected (§125(b)(2)).

A key employee is any employee or former employee who during the year, or any of the 4 preceding years, was:

1. An officer of the employer having, for any year listed below, annual compensation of more than 50% of the §415(b)(1)(A) limit,
2. One of 10 employees having annual compensation of more than $30,000 and owning (or considered to own under the related-party rules) the largest interests in the employer,
3. A 5% owner of the employer, or
4. A 1% owner of the employer with annual compensation of more than $150,000 (§416(i)(1)).

Key employees also include any former employee who was a key employee upon retirement or separation from service.

Timing

The taxable benefits are treated as having been received or accrued in the tax year of the highly compensated participant or key employee in which the plan year ends (§125(b)(2); §125(b)(3)).
Reporting Requirements

If an employer maintains a cafeteria plan, they are required to keep complete records showing the:

1. Number of their employees,
2. Number of employees eligible to participate in the plan,
3. Number of employees participating in the plan,
4. Total cost of the plan for the tax year,
5. Employer’s name, address, and taxpayer identifying number (TIN), and
6. Type of business the employer is engaged in.

In addition, an employer maintaining a cafeteria plan must file a Form 5500 after the plan year.

Employee Educational Assistance Programs - §127

An individual cannot deduct education unless such expenses are incurred to maintain or improve skills of their existing employment (Reg. §1.162-5(a)). Educational expenses paid directly by the employer are normally not taxable to the employee if business related.

The passage of §127 in 1978 liberalized these provisions making all employer provided educational assistance nontaxable to the employee if the plan is nondiscriminatory. An employee can receive up to $5,250 of educational assistance benefits tax-free. The assistance has to be provided under a qualified written plan.

The Tax Relief Act of 2001 extended the exclusion for employer-provided educational assistance to graduate education and made the exclusion (as applied to both undergraduate and graduate education) permanent.

Requirements

To be a qualified plan, a plan must be in writing and for the exclusive benefit of employees. In addition, a plan must:

1. Be set up under a classification that IRS finds does not discriminate in favor of highly compensated employees or their dependents;
   
   **Note:** Employees who are covered by a collective bargaining agreement can be excluded if there is evidence that educational assistance was the subject of good faith bargaining.

2. **Not pay more than** 5% of its benefits during a year for shareholders or owners (or their spouses or dependents);
   
   **Note:** A shareholder or owner is anyone, who on any day of the year owns more than 5% of the stock or of the capital or profits interest in the business.

3. **Not** provide eligible employees a choice between receiving the educational assistance or other remuneration includible in gross income; and
(4) Provide reasonable notification of the availability and terms of the program to eligible employees.

To the extent educational assistance does not meet these requirements, it may qualify as a working condition fringe. However, to qualify as a working condition fringe, the cost of the education must be a job-related deductible expense.

**Educational Assistance**

The term “education” includes any form of instruction or training that improves or develops the capabilities of an individual. Education is not limited to courses that are job-related or part of a degree program (Reg. §1.127-2(c)(4)).

Educational assistance means amounts the employer pays for their employees and includes amounts for tuition, fees, books, equipment, and supplies. Education paid for or provided under a qualified program may be furnished directly by the employer, either alone or in conjunction with other employers, or through a third party such as an educational institution.

However, it does not include costs for:

1. Equipment, tools, or supplies (other than textbooks) if employee may keep these items at the end of the course,
2. Meals,
3. Lodging,
4. Transportation, or
5. Education involving sports, games, or hobbies, unless such education involves the business of the employer or is required as part of a degree program.

**Dependent Care Assistance - §129**

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</table>

Section 129 states that employer provided dependent care assistance for employees when given under a written nondiscriminatory plan is excluded from the em-

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8 Under §129(e)(3) and (4), employee includes a self-employed person. Thus, the §129 exclusion applies to plans established by partnerships and sole proprietorships for the owners of the business and their employees.
ployee’s income, subject to certain conditions and special rules. The dependent care may be directly provided by the employer or given by a third party.

**Amount of Assistance**

Under §129(a)(2) and (b)(1), the aggregate amount excluded from income for dependent care assistance is the smaller of:

(a) $5,000 (or $2,500 in the case of a married individual filing separately), or
(b) The earned income of the employee (or the spouse’s earned income if lower).

For purposes of determining marital status, the rules of §21(e)(3) and (4) apply (§129(a)).

**Requirements**

Under §129(d), a dependent care program must meet the following requirements:

(a) It must be a written plan for the exclusive benefit of employees;
(b) It may not discriminate in favor of highly compensated employees (as defined under §414(q)) or their dependents;
(c) No more than 25% of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for shareholders or owners (or their spouses or dependents) owning more than 5% of the company;
(d) Notice of availability and terms of the plan must be provided to eligible employees;
(e) A written statement must be given to each employee showing the amounts paid under their plan to that employee during the calendar year, and
(f) It must meet the 55% benefits test.

If a plan does not meet these requirements, the plan may still qualify as a dependent care assistance program for employees who are not highly compensated.

**55% Test**

To meet this test, the average benefit under all plans provided to employees who are not highly compensated must be at least 55% of the average benefits under all plans provided to highly compensated employees.

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9 Union employees can be excluded if dependent care benefits were the subject of bargaining between the union and the employer.
10 This statement must be furnished by January 31 of the following year.
Note: For purposes of the 55% benefits test, if the employer provides benefits through a salary reduction arrangement, the plan may exclude employees with compensation of less than $25,000.

To determine both the eligibility test and the 55% benefits test for a plan, the following persons can be excluded from consideration:

(1) Employees who have not attained age 21 and completed 1 year of service, and
(2) Employees not included in a dependent care assistance program who are covered by a collective bargaining agreement, if there is evidence that dependent care benefits were a subject of good faith bargaining.

Reporting

How an employer deducts the expenses for providing dependent care assistance to their employees depends on how they provide the care. If they provide the care in-kind (operate a dependent care facility for their employees), the costs of operating the care facility are deducted in the appropriate categories (depreciation, utilities, salaries, etc.) on the employer’s return. If the employer contracts with a third party to provide the care, or if they reimburse their employees directly for the dependent care expenses they incur, the costs are deducted on the employee benefit programs line of the employer’s return.

Under a qualified dependent care assistance program, an employer can exclude each year up to $5,000 of assistance for each employee. The entire amount paid to an employee or paid on the employee’s behalf is included in Box 10 of the employee’s Form W-2. If the employer furnished the care in-kind, the fair market value of the dependent care provided to that employee is used, less any amount the employee may have paid the employer for care. The fair market value of the care provided is a reasonable estimate of what the employee would pay for care of the type and quality the employer furnished. Any amount above the $5,000 is also included in the employee’s income in Box 1 of the W-2. This excess is subject to federal income tax withholding and FICA and FUTA taxes.

Conflict with Dependent Care

The amount excluded from income bars the employee from the credit available under §21 for payments for dependent care.

No-Additional-Cost Services - §132(b)

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<tr>
<td>Employer Tax Impact</td>
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</tbody>
</table>
The entire value of any no additional cost service provided by an employer for an employee’s use is *excludable* from gross income (§132(b) & Temp. Reg. §1.132-1T). The exclusion applies if:

1. The employer incurs no substantial cost (including forgone revenue) in providing the service (Reg. §1.132-2T);
2. The service is provided by the employer (or another with whom the employer has a reciprocal arrangement) and is of a type provided to its nonemployee customers;
3. The service is provided to current or retired employees (and their spouses or dependent children); and
4. Certain nondiscriminatory requirements are met.

Under this provision, employers may furnish railroad or airline seats or hotel accommodations to employees if customers are not displaced *and* no substantial additional cost is incurred.

**Covered Employees**

Employees covered by this §132 exclusion include:

(a) Current employees, their spouses and dependent children (including a child whose parents have died and who has not reached age 25);
(b) An individual formerly employed and who separated from service because of retirement or disability;
(c) The widow or widower of a former employee; and
(d) Any partner who performs services for a partnership (§132(f) and Reg. §1.132-1T(b)).

**Line of Business Requirement**

The exclusion applies if the service provided to the employee is the same type that is sold to the public in the course of the employer’s *line of business in which the employee works* (Reg. §1.132-4T(a)). Thus, an airline employee can’t exclude the value of a free hotel room even if owned by the same employer because airline and hotel services are considered two different lines of business.

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11 Parents of airline employees are treated as employees in the case of air transportation §132(f)(3)).
Definition

A line of business is determined under the Enterprise Standard Industrial Classification Manual prepared by the Statistical Policy Division of the U.S. Office of Management and Budget (Reg. §1.132-4T).

Reciprocal Agreements

Employees can exclude the value of no-additional-cost services provided by an unrelated employer if all of the following apply:

(1) The service is the same type of service generally provided to customers by both the line of business in which the employee works and the line of business in which the service is provided;

(2) The primary employer and the employer providing the service have a written reciprocal agreement under which a group of employees of each employer, all of whom perform substantial services in the same line of business, may receive no-additional-cost services from the other employer; and

(3) Neither the primary employer nor the other employer incurs any substantial additional cost (including lost revenue) either in providing the service or because of the written agreement.

Nondiscrimination

Highly compensated employees cannot exclude from their gross income a no-additional-cost service unless the benefit is available on the same terms to:

(a) All employees, or

(b) A group of employees defined under a reasonable classification that does not discriminate in favor of highly compensated employees.

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

Highly Compensated Employee

A highly compensated employee is an employee who during the current or preceding year:

(i) Was a 5% owner of the employer,

(ii) Received more than $100,000 (1996 figure) in compensation from the employer,

(iii) Received more than $66,000 (1996 figure) in compensation from the employer and was in the top 20% of all employees when ranked by pay, or

(iv) Was at any time an officer of the employer and received more than $60,000 (1996 figure see change below) in compensation (§414(q)(1)).

For tax years beginning after 12/31/96, an employee is treated as highly compensated if:
(a) The employee is a 5% owner during the year or preceding year, or
(b) For the preceding year, the employee had compensation from the em-
ployer in excess of $80,000 (indexed for inflation), and, if the employer
elects this condition, was in the top 20% of employees by compensation
for the preceding year (§414(q)).

Qualified Employee Discounts - §132(c)

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<tr>
<td>Tax-free if discount is not greater than employer’s gross profit percentage. Portion exceeding the gross profit is taxable.</td>
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<tr>
<td><strong>Employer Tax Impact</strong></td>
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<tr>
<td>Cost of goods or services reduces gross profit.</td>
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<td><strong>Nondiscrimination Rules</strong></td>
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<td>Discounts and services cannot be provided in a discriminatory manner</td>
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<td><strong>Special Documentation</strong></td>
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<td>None</td>
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</tr>
<tr>
<td>Amounts required to be treated as income are reported on Form W-2</td>
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Normally, when an employer sells goods or services to the employee for a price less than the price charged regular customers, the employee realizes income equal to the discount. However, §132(c) and Reg. §1.132-3T(a) allow the employee to exclude the discount\(^{12}\) from income if the property or services are provided:

(1) By the employer and are of the same type ordinarily sold to the public from the same line of business in which the employee works;

(2) To current or retired employees (and their spouses or dependent children);

and

(3) On a nondiscriminatory basis.

Manner of Discount

The exclusion applies whether the qualified employee discount is provided through a reduced price or through a cash rebate from a third party.

Real Estate & Investment Property Exclusion

The exclusion is not available for real property or for personal property of the type commonly held for investment (§132(c)(4)). Thus, a discount on real property (such as a building or land) or on personal property of a kind com-

\(^{12}\) Under Reg §1.132-3T(h)(1), an employee discount is the bargain element in the price at which goods or services are provided to employees for their use as compared to the price nonemployee customers must pay.
monly held for investment (such as stocks or bonds) is not a qualified employee discount.

Amount of Discount

Employee discounts are excluded only up to specific limits. For merchandise, the discount’s excludable amount is limited to the selling price multiplied by the employer’s gross profit percentage \(^\text{13}\) (§132(c)(2)). The gross profit percent is determined based on all property offered to customers (including employee customers) in the ordinary course of the employer’s line of business and experience during the tax year immediately before the tax year in which the discount is available. The gross profit percent is figured by subtracting the total cost of the property from the total sales price of the property and dividing this amount by the total sales price of the property.

The discount exclusion for a service cannot exceed 20% of the selling price, regardless of the actual gross profit percentage (§132(c)(1) and Reg. §1.132-3T(a)).

Nondiscrimination

Highly compensated employees \(^\text{14}\) cannot exclude from their gross income a qualified employee discount unless the benefit is available on the same terms to:

(a) All employees, or
(b) A group of employees defined under a reasonable classification that does not discriminate in favor of highly compensated employees.

Working Condition Fringes - §132(d)

Property or services provided to an employee are excluded to the extent that they would be deductible as ordinary and necessary business expenses if the employee had paid for them (§132(d)). Examples include:

1. Use of a company car or plane for business purposes,
2. Work uniforms,
3. Business periodicals,
4. On the job training,
5. Use of consumer goods provided for product testing (Reg. §1.132-5T(n)), and
6. Use of a driver, bodyguard, or car specially designed for security (Reg. §1.132-5T(m)).

\(^{13}\) Under §132(c)(2)(A) and Reg. §1.32-3T(c), an employer’s gross-profit percentage for any period is its gross profit (gross receipts minus cost of goods sold) divided by the aggregate sales price (gross receipts).

\(^{14}\) See earlier definition under no-additional-cost services.
Covered Employees

Under Reg. §1.132-1T(b)(2), employees covered by this §132 exclusion include:

1. Current employees;
2. A partner who performs services for a partnership;
3. A director of the employer; and
4. An independent contractor who performs services for the employer.

However, an independent contractor who performs services for an employer cannot exclude from income the value of parking or consumer goods that are provided for use in a product testing program. In addition, a director cannot exclude from income the value of consumer goods provided for use in a product testing program.

Additions to Exclusion

In three situations the exclusion is allowed even where the expense is not deductible by the employee:

1. The value of a parking space though normally a personal commuting expense to the employee;
2. The personal use (e.g., commuting) of a demonstrator by an auto salesperson; and
3. Employee business expenses eliminated by the 2% of AGI limitation.

Substantiation

The value of property or services cannot be excluded from the employee income unless the applicable substantiation requirements of either §274(d) or §162 are met (Reg. §1.132-5T(c)).

Exceptions

The following are items that cannot be excluded from an employee’s income as working condition fringe benefits:

1. A service or property offered through a flexible spending account;
   Note: A flexible spending account is an agreement that makes available to employees over a time period a certain amount of unspecified noncash benefits with a predetermined cash value.

2. Any item for which the employee does not have the necessary substantiation to deduct it as a trade, business, or depreciation expense;
3. Expenses the employee can deduct under sections of the Internal Revenue Code other than for trade or business expenses or depreciation;
4. A physical examination program, whether mandatory to some or all employees; and
(5) A cash payment made to an employee unless the employer requires the employee to do all of the following:
(a) Use the money for expenses that are deductible in a specific or prearranged activity as trade, business, or depreciation expenses,
(b) Verify the money is used for such expenses, and
(c) Return any unused money to the employer.

De Minimis (Minimal) Fringes - §132(e)

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<td>Special Documentation</td>
<td>None</td>
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<tr>
<td>Reporting</td>
<td>None</td>
</tr>
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</table>

An exclusion from gross income applies for property or services that are considered of such relatively small value that accounting for them is impractical (§132(e)). According to the House Report benefits that are excluded include:
(1) Coffee & doughnuts,
(2) Occasional theater or sporting event tickets,
(3) Traditional holiday gifts of property having a low value,
(4) Typing of personal letters by a company secretary,
(5) Occasional personal use of the company copying machine,
(6) Monthly transit passes provided at a discount not over $255 (in 2016),
(7) Occasional supper money or taxi fare because of overtime work, and
(8) Occasional company cocktail parties or picnics.

Subsidized Eating Facilities
Eating facilities operated by the employer are also excluded as a de minimis fringe if:
(1) Located on or near the employer’s business premises;
(2) Revenue equals or exceeds direct operating costs; and
(3) Nondiscrimination requirements are met.
Qualified Transportation - §132(f)

An employer can exclude qualified transportation fringe benefits from the gross income of employees, up to certain limits. The following benefits, provided by an employer to an employee, are qualified transportation fringes:

(1) Transportation in a commuter highway vehicle if the transportation is between the employee’s home and work place,

(2) A transit pass, and

(3) Qualified parking.

Cash reimbursements an employer makes to an employee for these expenses under a bona fide reimbursement arrangement are also excludable. Cash reimbursements for transit passes qualify only if a voucher or a similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to employees.

Only employers may provide qualified transportation fringes to employees. The definition of employee includes common-law employees and other statutory employees, such as officers of corporations. Self-employed individuals, including partners, 2% shareholders in S corporations, sole proprietors, and other independent contractors are not employees for purposes of this fringe benefit.

Commuter Highway Vehicle

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

Transit Pass

A transit pass is any pass, token, farecard, voucher, or similar item entitling a person, without additional charge or at a reduced rate, to ride mass transit or in a vehicle that seats at least 6 adults (not including the driver), if it is operated by a person in the business of transporting persons for compensation or hire. Mass transit may be publicly- or privately-operated and includes, for example, bus, rail, or ferry.

Qualified Parking

Qualified parking is parking provided to employees on or near the business premises. It also includes parking provided on or near the location from which employees commute to work using mass transit, commuter highway vehicles, or carpools. It does not include parking on or near the employee’s residence.
Exclusion Limits

Employers may exclude from the gross income of each employee up to:

1. $255 per month (in 2016) for combined commuter highway vehicle transportation and transit passes, and

2. $255 per month (in 2016) for qualified parking (§132(f)(2)).

Note: If the limits are exceeded in any month, only the amount in excess of these limits is includible in gross income. Nothing prohibits the employer from providing these benefits in combination with another.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

91. Educational assistance may qualify as a working condition fringe if it fails to meet four requirements. What is one of the requirements under §127?

a. The plan must pay less than 2% of its benefits annually for shareholders or owners.

b. Eligible employees must be notified within a reasonable time period about the plan’s terms and availability.

c. The plan must provide payment options.

d. The plan must cover lodging, meals, and/or transportation.
92. An employer may provide dependent care assistance for employees tax free. Up to what amount may an employer exclude for each employee annually?
   a. $5,000.
   b. $5,250.
   c. 50% of the total costs.
   d. There is no statutory limit on the amount.

93. Under §132, employers may exclude only the costs of providing hotel accommodations to employees, so long as customers are satisfied with their accommodations. What type of fringe benefit is this?
   a. de minimus fringes.
   b. no-additional-cost services.
   c. qualified employee discounts.
   d. working condition fringes.

94. A qualified employee discount may be provided at a reduced price to the employee. Which of the following may be excluded from income?
   a. a discount on a building.
   b. a discount on land.
   c. a discount on stocks.
   d. a cash rebate from a third party.
95. Under §132(d), certain property or services may be excluded from employees’ income. Under Reg. §1.132-1T(b)(2), who is covered by the working condition fringe exclusion?
   a. a friend of the employer.
   b. a partner in a partnership.
   c. an independent contractor who performs services for the employer.
   d. an individual formerly employed and who separated from service because of retirement or disability.

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**Employer Provided Automobile - §132 & §61**

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<td><strong>Employee Tax Impact</strong></td>
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<td><strong>Nondiscrimination Rules</strong></td>
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If an employer provides an auto (or other highway vehicle) to an employee, the employee’s personal use of the auto is a taxable fringe benefit (§61 and §132). The employer is required to determine the actual value of this fringe benefit that the employee must include in income or reimburse the employer. This value may be determined under either one general or three special valuation methods.
General Valuation Method

Under Reg.§1.61-2T(b)(4), if none of the special methods below are used, the valuation must be determined by reference to the cost to a hypothetical person of leasing from a hypothetical third party the same or comparable vehicle on the same or comparable terms in the geographic area in which the vehicle is available for use.

Special Method #1 - Lease Value

Reg. §1.61-2T(d) states that if an employer provides an employee with an auto, the value of the benefit may be determined using a lease valuation method. If an employer provides an employee with an automobile for an entire calendar year, the automobile’s annual lease value can be used to value the benefit. If an employer provides an employee with an automobile for less than an entire calendar year, the value of the benefit provided is either a prorated annual lease value or the daily lease value. The applicable lease value is included in the employee’s gross income unless excluded by law.

When the automobile lease valuation rule is used:

(1) The employer must adopt it by the first day the automobile is made available to an employee for personal use;

Note: However, if the commuting valuation rule is adopted when the automobile is first made available to an employee for personal use, the employer can change to the automobile lease valuation rule on the first day for which the commuting valuation rule is not used.

(2) The employer must use the rule for all later years in which the automobile is made available to any employee, except that for any year during which use of the automobile qualifies, the employer can use the commuting valuation rule; and

(3) The employer must continue to use the rule if a replacement automobile is provided to the employee and the primary reason for the replacement is to reduce federal taxes.

Annual Lease Value

Under this method an employee reports the annual lease value of the auto from the tables in Reg. §1.61-2T(d)(2)(iii) based on the auto’s fair market value when it is first made available to the employee.

To determine the value of the employer provided auto:

1. Find the fair market value of the car when it was first made available to the employee for personal use;
2. Locate the fair market value on the left hand side of the table;
3. Find the corresponding annual lease value on the right hand side of the table; and
4. Multiply the annual lease value by the ratio of personal miles to total miles.

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For vehicles having a fair market value exceeding $59,999, the annual lease value is equal to: \((0.25 \times \text{automobile fair market value}) + 500\).

The annual lease values figured under this rule are based on a 4-year lease term. The annual lease values figured using the table will generally stay the same for the period that begins with the first date the rule is used for the automobile and ends on December 31 of the 4th full calendar year following that date.

**Note:** Unless the primary purpose of a transfer of an auto from one employee to another is to reduce federal taxes, the annual lease value can be refigured based on the FMV of the automobile on January 1 of the calendar year of transfer.

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

**Note:** If the special accounting period rule is used, the annual lease value for each later 4-year period is calculated at the beginning of the special accounting period that starts immediately before the January 1 date.

### Fair Market Value

To determine the annual lease value of an automobile using the above table, the FMV of an automobile is the amount a person would pay a third party in the area in which the vehicle is purchased or leased to purchase the particular automobile provided. That amount includes sales tax and title fees.

### Safe Harbor Value

Employers can use the safe-harbor value as the FMV. For an automobile the employer owns, the safe harbor value is the employer’s cost, including tax, title, and other purchase expenses, if the auto was purchased at arm’s length.

For a leased automobile, the safe-harbor value is:

1. The manufacturer’s invoice price (including options) plus 4%,
2. The manufacturer’s suggested retail price less 8% (including sales tax, title, and other expenses of purchase), or...
(3) The retail value of the automobile reported by a nationally recognized pricing source.

Items Included in Annual Lease Value Table

The annual lease values in the table include the FMV of maintenance and insurance for the automobile. Neither the employer nor the employee can reduce this value by the FMV of any service included in the amount if the employer does not provide it. For example, the employer cannot reduce the annual lease value by the FMV of a maintenance service contract or insurance not provided by the employer.

Note: However, the employer can take into account such services actually provided for the automobile by valuing the availability of the automobile under the general valuation rule.

The annual lease values do not include the FMV of fuel provided to employees for personal use, regardless of whether the employer provides it, reimburses its cost, or has it charged to the employer. Employer provided fuel can be valued at FMV or at 5.5 cents per mile for all miles driven by the employee.

Note: However, the employer cannot value at 5.5 cents per mile fuel provided for miles driven outside the United States (including its possessions and territories), Canada, and Mexico.

If the employer reimburses an employee for the cost of fuel, or has it charged to the employer, the fuel is valued at the amount of reimbursement, or the amount charged to the employer if it was purchased at arm’s length.

The FMV of any service (other than maintenance and insurance for an automobile) provided is added to the annual lease value of the automobile in determining the FMV of the benefit provided.

Prorated Annual Lease Value

If an automobile is provided to an employee for continuous periods of 30 or more days but less than an entire calendar year, the annual lease value can be prorated. The prorated annual lease value is figured by multiplying the applicable annual lease value by a fraction, using the number of days of availability as the numerator and 365 as the denominator.

Note: When an automobile is provided continuously for at least 30 days, but the period covers 2 calendar years (or 2 special accounting periods), the prorated annual lease value or the daily lease value can be used.

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

**Note:** A prorated annual lease value cannot be used if the reduction of federal tax is the main reason the automobile is unavailable.

**Daily Lease Value**

If an automobile is provided for continuous periods of *one or more but less than 30 days*, the daily lease value is used to figure its value. The daily lease value is figured by multiplying the applicable annual lease value by a fraction, using *four times* the number of days of availability as the numerator and 365 as the denominator.

However, a prorated annual lease value can be applied for a period of continuous availability of less than 30 days by treating the automobile as if it had been available for 30 days.

**Note:** Use a prorated annual lease value if it would result in a lower valuation than applying the daily lease value to the shorter period of availability.

**Special Method #2 - Cents Per Mile**

For autos that are reasonably expected to be *regularly used* in a trade or business throughout the calendar year (or for a shorter period during which it is owned or leased) *or* that satisfies the *mileage rule*, an employer may determine the value of a vehicle provided to an employee by multiplying the standard mileage rate$^{15}$ by the total number of *personal* miles driven by the employee (Reg. §1.61-2T(e)).

The standard mileage rate is applied only to personal miles. Business miles are disregarded. Personal use is any use of the vehicle *other* than use in a trade or business.

**Warning:** The value of the use of an automobile cannot be determined under the vehicle cents-per-mile valuation rule if the FMV of the automobile is more than the maximum recovery deductions allowable for luxury automobiles under §280F for the first five taxable years during which the automobile is in service.

An employer must adopt the cents-per-mile rule by the first day the vehicle is used by an employee for personal use. If the *commuting valuation rule* is adopted when an employee first uses the vehicle for personal purposes, the cents-per-mile rule can be used on the first day the commuting valuation rule is not used.

Once the cents-per-mile rule is adopted for a vehicle, it is used for all later periods in which the vehicle qualifies. However, the commuting valuation rule can be used for any period during which the vehicle qualifies for that rate. If a vehicle

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$^{15}$ This rate is currently 54 cents per mile for 2016.
does not qualify for the cents-per-mile rule during a later period, any other special valuation rule can be adopted for which the vehicle then qualifies.

**Regular Use**

Whether a vehicle is regularly used in an employer’s trade or business is determined based on all the facts and circumstances. A vehicle is considered regularly used in a trade or business if it meets one of the following conditions:

1. At least 50% of the vehicle’s total annual mileage is for that trade or business, or
2. The vehicle is generally used each workday to drive at least 3 employees to and from work in an employer-sponsored commuting pool.

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

**Mileage Rule**

If an employee is provided with a vehicle which the employee is not expected to use regularly in a trade or business but that meets the mileage rule, the cents-per-mile method can still be used to value the benefit provided. A vehicle meets the mileage rule for a calendar year if:

1. It is actually driven at least 10,000 miles in that year, and
2. It is used during the year primarily by employees.

A vehicle is considered used primarily by employees if they use it consistently for commuting. Thus, if only one employee uses a vehicle during the year and that employee drives the vehicle at least 10,000 miles in that calendar year, the vehicle meets the mileage rule even if all miles driven by the employee are personal.

**Note:** If a vehicle is owned or leased only part of the year, the 10,000 mile requirement is reduced proportionately. Use of the vehicle by an individual (other than the employee) whose use would be taxed to the employee is not treated as use by the employee.

**Items Included In Cents-Per-Mile Rate**

The cents-per-mile rate includes the FMV of maintenance and insurance for the vehicle. The rate is not reduced by the FMV of any service included in the rate that the employer has not provided. However, the employer can take into account the services provided for the automobile by valuing the automobile under the general valuation rule.

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

For miles driven outside the United States, Canada, and Mexico, the FMV of fuel provided is not reflected in the cents-per-mile rate. Accordingly, the employer can reduce the cents-per-mile rate, but by no more than 5.5 cents.

**Special Method #3 - Commuting Value**

If the auto is provided under the *written commuting policy statement* exception\(^\text{16}\), the value of the employee’s use of the vehicle for such commuting purposes is computed as $1.50 per one way commute (Reg. §1.61-2T(f)(1)). Employers can use this special rule to figure commuting value if all of the following requirements are met:

1. The employer owns or leases the vehicle and provides it to one or more employees for use in a trade or business;
2. The employer requires the employee to commute to and/or from work in the vehicle for *bona fide noncompensatory business reasons*;
3. The employer establishes a written policy under which the employee is not allowed to use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee’s home);
4. Except for de minimis personal use, the employee does not use the vehicle for personal purpose other than commuting; and
5. The employee required to use it for commuting is not a *control employee*.

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

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

**Control Employee**

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

(i) Who is a Board- or shareholder-appointed, confirmed, or elected officer of the employer whose compensation equals or exceeds $50,000 (adjusted annually under §415(d)),
(ii) Who is a director of the employer,

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\(^{16}\) Under this exception, the employer must have a written policy prohibiting employee use of an auto for personal purposes other than commuting.
(iii) Whose compensation equals or exceeds $100,000 (adjusted annually under §415(d)), or

(iv) Who owns a one-percent or greater equity, capital, or profits interest in the employer (Reg. §1.61-21(f)(5)).

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

A control employee of a government employer is any:

(i) Elected official, or

(ii) Employee whose compensation equals or exceeds that paid to a Federal Government employee holding a position at Executive Level V. (Reg. §1.61-21(f)(6))

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

Note: If the employee required to use the vehicle for commuting is a control employee and the vehicle is not an automobile, the commuting valuation rule can still be used.

Employer-Provided Transportation in Unsafe Areas

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

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

(1) The employee is a qualified employee of the employer,

(2) The employee does not use the transportation for personal purposes other than commuting because of unsafe conditions,

Note: Unsafe conditions exist if, under the facts and circumstances, a reasonable person would consider it unsafe for the employee to walk or use public transportation at the time of day the employee must commute.
(3) The employer provides transportation solely because of unsafe conditions to an employee who would ordinarily walk or use public transportation for commuting, and

(4) The employer established a written policy under which the transportation is not provided for the employee’s personal purposes other than for commuting because of unsafe conditions and the employer’s practice follows the established policy.

Qualified Employee

Under Reg. §1.61-21(k)(6), a qualified employee is one who:

(a) Performs services during the current year,

(b) Is paid on an hourly basis,

(c) Is not claimed under §213(a)(1) of the Fair Labor Standards Act of 1938 (as amended) to be exempt from the minimum wage and maximum hour provisions,

(d) Is within a classification for which the employer actually pays, or has specified in writing it will pay, compensation for overtime equal to or exceeding one and one-half times the regular rate provided in §207 of the 1938 Act, and

(e) Does not receive compensation from the employer in excess of the amount permitted by §414(q)(1)(C).

Physical Fitness Programs - §132(h)(5)

Many argue that stress brought about during work can be relieved through physical activity and therefore view physical fitness programs as a logical extension of the company’s medical program. In addition, such programs in the long run promote good health and thus lower medical costs. Some companies choose to join a medically oriented facility near the company; others incur the construction and related investments cost and elect to develop their own facilities.

In general, the fair market value of any on premises athletic facility provided and operated by an employer for its employees, where substantially all the use of the facility is by employees or their spouses and dependent children, is excluded for income and employment tax purposes (§132(h)(5)). The athletic facility need not be in the same location as the business premises, but must be located on property owned by the employer.

The exclusion does not apply to any athletic facility if access to the facility is made available to the general public through the sale of memberships, the rental of the facility, or a similar arrangement. The exclusion does not apply to any athletic facility

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17 Under Reg §1.132-1T(e)(5), the nondiscrimination rules do not apply to the facilities.
that is for residential use. For example, a resort with athletic facilities would not qualify.

**Adoption Assistance Program - §137**

If taxpayer’s employer has an *adoption assistance program* and pays or incurs *qualified expenses* on employee’s behalf, the employee can exclude from gross income up to $10,000 (indexed for inflation) of these benefits (§137).

**Note:** Qualifying adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child.

The Tax Relief Act of 2001 permanently extended the exclusion from income for employer-provided adoption assistance. In addition, the $10,000 maximum exclusion applies to all eligible children whether or not special needs.

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

1. **(1)** It benefits employees who qualify under rules set up by the employer, which do not favor *highly compensated employees* or their dependents;

   **Note:** To determine whether a plan meets this test, do not consider employees excluded from a plan who are covered by a collective bargaining agreement, if there is evidence that adoption assistance was a subject of good-faith bargaining.

2. **(2)** It does not pay more than 5% of its payments during the year for shareholders or owners (or their spouses or dependents);

   **Note:** A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of the business.

3. **(3)** The employer gives reasonable notice of the plan to eligible employees; and

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

   **Note:** The adoption credit is allowed against the alternative minimum tax permanently.

An adoption assistance program can be part of your cafeteria plan. An adoption assistance program also includes programs that reimburse members of the Armed Forces and Coast Guard for adoption expenses.

**Employment Taxes**

For tax years beginning after 1996, amounts an employer pays or incurs under an adoption assistance program for an employee’s qualifying adoption expenses are *not* subject to income tax withholding. However, these amounts are subject to social security, Medicare, and federal unemployment taxes.
Employers must report all qualifying adoption expenses paid or reimbursed under an adoption assistance program for each employee for the year in box 13 of the employee’s Form W-2. Use Code "T" to identify this amount. Also include this amount in the totals for social security wages in box 3 and Medicare wages in box 5. However, do not include this amount with the employee’s wages in box 1.

**Conflict with Adoption Credit**

A taxpayer may claim both a credit and exclusion for expenses of adopting an eligible child. However, a taxpayer cannot claim both a credit and exclusion for the same expense.

**Eligible Child**

An eligible child must be:

1. Under 18 years old, or
2. Physically or mentally incapable of caring for himself or herself.

**Child with Special Needs**

An eligible child is a child with special needs if he or she is a citizen or resident of the United States (including the District of Columbia and U.S. possessions) and a state determines that the child cannot or should not be returned to his or her parents’ home and probably will not be adopted unless adoption assistance is provided to the adoptive parents.

*Note:* A foreign child cannot be treated as a child with special needs.

Factors used by states to determine if a child has special needs could include:

- **(a)** The child’s ethnic background,
- **(b)** The child’s age,
- **(c)** Whether the child is a member of a minority or sibling group, or
- **(d)** Whether the child has a medical condition or physical, mental, or emotional handicap.

If the state has determined that the child the taxpayer is adopting is a child with special needs, the taxpayer should keep evidence of that fact for their records.

The tax law provides the $10,000 exclusion in the case of a special needs adoption regardless of whether the taxpayer has qualified adoption expenses.
Limits on the Exclusion

The exclusion for qualifying adoption expenses is subject to a dollar limit and an income limit. These limits apply separately. These limits are figured on Form 8839.

Because of the dollar limit and the income limit, all or part of employer’s adoption assistance payments may not qualify for the adoption exclusion. Employees must include in their income any payments that do not qualify for the exclusion.

Dollar Limit

The amount of the exclusion is limited to $10,000 (indexed for inflation) for each effort to adopt an eligible child. If a taxpayer can take both a credit and exclusion, this dollar limit applies separately to each. If the taxpayer and another person adopt a child and both claim the credit or exclusion, this dollar limit applies to their combined credit or exclusion amounts.

The $10,000 amount is the maximum amount of qualifying expenses taken into account over all taxable years. Therefore, it must be reduced by the amount of qualifying expenses taken into account in previous years for the same adoption effort.

Income Limit

The income limit on the adoption credit or exclusion is based on modified adjusted gross income (modified AGI). They both are phased out ratably for taxpayers with modified AGI above $150,000 (adjusted for inflation) and are fully phased out at $190,000 (adjusted for inflation) (§23(d)).

Example

Dan is adopting an eligible child who is not a child with special needs. He takes into account, after applying the dollar limit, $2,000 of qualifying expenses for 2016 and $8,000 for 2017 Dan’s modified AGI for 2016 is $160,000, and his modified AGI for 2017 is $170,000. Under the income limit, Dan’s credit for both years is reduced ratably. His 2016 credit is reduced by 25%, to $1,500. His 2017 credit is reduced by 50%, to $4,000. Dan cannot take any further credit for this adoption effort.

To figure modified AGI for the purpose of the credit and exclusion, add back the following items to adjusted gross income:

- **(a)** The foreign earned income exclusion,
- **(b)** The foreign housing exclusion or deduction, and
- **(c)** The exclusion for income from Guam, American Samoa, Northern Mariana Islands, or Puerto Rico.
Modified AGI for purposes of the exclusion also includes the payments from the employer’s adoption assistance program.

Timing

When a taxpayer can take the exclusion depends on whether the eligible child is a citizen or resident of the United States (including U.S. possessions) at the time the adoption effort begins.

If the eligible child is a U.S. citizen or resident, a taxpayer can take the exclusion even if the adoption never becomes final. Thus, if the taxpayer’s employer pays for qualifying expenses under an adoption assistance program in any year, the exclusion can be taken in the year of payment.

If the eligible child is not a U.S. citizen or resident, the taxpayer cannot take the exclusion unless the adoption becomes final.

Employer-Provided Retirement Advice & Planning - §132

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludable from income and wages. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer’s qualified plan.

“Qualified retirement planning services” are retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer’s plan fits into the individual’s overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

Financial Planning - §212 & §67

One particular benefit that has gained a good deal of popularity with corporate executives in recent years has been the establishment of a financial counseling program for highly compensated employees. Financial planning is the result of extending the coverage of tax planning to include maximizing investment opportunities and adding an analysis of insurance needs.

Popularity

Such programs are conceptually popular for a number of reasons:

(1) Executives, because of their income levels, frequently can benefit from such services;
(2) Executives often tend to be so busy that they ignore their own financial planning; and
(3) Good financial planning results in peace of mind and promotes better performance in the executive.

Taxation
The IRS has ruled that financial counseling fees paid by a company for the benefit of its executives are taxable income. (R.R. 73-13.) However, if fees are incurred for tax or investment advice, they will be deductible by the employee under §212 (subject to the 2% of AGI limitation). As a result, such services can be provided at a relatively low price.

Tax Planning - §212 & §67
As one financial institution advertises, “It’s not what you make that counts—it’s what you keep.” No topic elicits more interest from highly compensated individuals than tax planning and sheltering. In addition to regularly preparing federal and other income tax returns, it is not uncommon for company legal sources to give executives opinions on significant investment decisions. Historically, company tax attorneys have provided such assistance. However, a number of executives feel uncomfortable about others in the company knowing their full financial status. As a result, an outside firm sometimes provides such services.

Taxation
Costs relating to tax matters involved in carrying on a business, including costs of tax advice, are deductible, under §162. However, individuals can also deduct tax related expenses as a “nonbusiness” expense under §212. Thus, the employer can establish programs where key executives receive tax advice, planning, and return preparation. Such amounts will be included in the employee’s taxable income but the employee will receive a corresponding deduction subject to §67. Under §212, individuals can deduct all the ordinary and necessary expenses incurred in connection with the determination, collection, or refund of any tax. This rule applies to income, estate, gift, property, and any other tax imposed by federal, state, municipal, or foreign authorities. It includes the cost of preparing tax returns, determining the extent of liability, contesting tax liability, obtaining tax counsel, protesting assessments, prosecuting refunds, compromising liability, income tax planning advice, estate tax planning advice, and costs of substantiating a deduction (Reg. §1.212-1(e)).

Estate Planning - §212 & §67
In recent years, revolutionary changes have occurred in the estate planning area. Because of such concepts as the unlimited marital deduction and the unified credit,
it is now possible to avoid federal death taxes entirely on the death of the first spouse. In some instances, this can be accomplished by merely using a properly drafted simple will. Much can be done for very little. Similar to the tax planning programs suggested above, the employer can reward key executives with estate planning services which, while includable in taxable income, result in a corresponding individual deduction under §212.

Moving Expenses - §217

<table>
<thead>
<tr>
<th>Fast-Facts</th>
<th>Deducted from income up to maximum amounts. Amounts in excess of maximum deduction included as wages</th>
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<tbody>
<tr>
<td>Employee Tax Impact</td>
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<tr>
<td>Employer Tax Impact</td>
<td></td>
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<tr>
<td>Nondiscrimination Rules</td>
<td>None</td>
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<tr>
<td>Special Documentation</td>
<td>No written plan required</td>
</tr>
<tr>
<td>Reporting</td>
<td>Amount included in wages reported on Form W-2</td>
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</tbody>
</table>

Employers may deduct as wages any payments made as an allowance or reimbursement for the cost of moving an employee to a new job site. The payments are included in the employee’s income. However, these payments are not considered wages for purposes of income tax withholding, FICA, or FUTA if it is reasonable to believe at the time the payments are made that the employee will be allowed a deduction for moving expenses in computing income tax.

However, payments to an employee for nondeductible moving expenses are wages for federal income tax withholding, FICA, and FUTA. Thus, if an employer reimburses an employee for a loss on the sale of a home, the employer must treat the amount as wages and subject it to income tax withholding, FICA, and FUTA. The employer treats the reimbursements to an employee as payment for services and can deduct the amounts.

Statement to Employees

Employers must give their employees a statement describing the payments made to them or on their behalf for moving expenses. The statement must contain sufficient information to enable the employees to properly figure their allowable moving expense deduction. For example, reimbursement for meals should be separately stated since employees can deduct only 50% of the cost of meals.

Form 4782 is used for this purpose. The employer must give this information to their employees by January 31 of the year following the year in which the payments are made. The employer must also show any reimbursement for moving expenses on the employee’s Form W-2.
Interest Free & Below-Market Loans - §7872

An interest free or low interest loan involves the lending of money to an employee who is required to pay no interest or a rate of interest below the market place. The economic benefit lies in the borrower’s ability to use the funds or invest them and retain the return. Below-market interest loans made by the employer offer an attractive benefit to those employees to whom the loans are extended.

Permissible Discrimination

They may be offered on a selective basis without meeting the nondiscrimination rules that apply to many other fringe benefits.

Employee Needs

In addition, these loans can serve needs related to the borrower’s employment, such as the purchase of company stock under a stock purchase plan or stock option arrangement, as well as purely personal needs, such as providing college funds, investments or home mortgage loans.

Imputed Interest

However, the Tax Reform Act of 1984 (§7872) reclassified such loans as “arms-length” transactions with the parties treated as if:

(1) The lender made a loan to the borrower in exchange for a note requiring the payment of interest at the “applicable Federal rate;”

(2) The borrower paid interest in the amount of the “forgone” interest; this treatment requires the lender to treat the forgone interest as income and enables the borrower to take an interest deduction provided, in the case of an individual, the borrower itemizes; and

(3) The lender:

(a) In the case of a gift loan, made a gift subject to gift tax;

(b) In the case of a corporation-shareholder loan, paid a dividend includable in the shareholder’s income; or
SECTION 7872 DOUBLE IMPUTATION

<table>
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<th>INCOME TAX RELATIONSHIP</th>
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<th>GIFT TAX RELATIONSHIP</th>
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<td></td>
<td>PARENTS</td>
<td>CHILD</td>
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</tbody>
</table>

#1 IMPUTED INTEREST (AT AFR)

#2 IMPUTED GIFT (AT AFR)

$10,000 EXCEPTION:  NO IMPUTED INTEREST
NO IMPUTED GIFT

$100,000 EXCEPTION: NO IMPUTED INTEREST
IMPUTED GIFT
(c) In an employer-to-employee loan situation, paid compensation that’s includable in the employee’s income and deductible by the lender.

**Note:** The deemed payment to the employee is compensation income, however, withholding is not required by an employer on such a deemed payment (§7872(f)(9)).

**Types of Loans**

Section 7872 draws a distinction between *demand loans* and *term loans*, although some term loans may be considered demand loans.

**Demand Loans**

In the case of a demand loan, the employee is treated as having paid to the employer imputed interest for any day the loan is outstanding. The employer is treated as having received the imputed amount of interest and as having transferred the same amount to the employee as wages.

**Note:** The TRA ’86 gave IRS authority to issue regs treating loans with indefinite maturities as demand loans (§7872(f)(5)).

**Term Loans**

In the case of a term loan, wage income is recognized in the year the loan is made and the imputed interest expense of the employee is recognized over the life of the loan. As a result, unless the term loan is recharacterized as a demand loan (based on special rules), the term loan does not favor the employee.

**Application of §7872 and Rate Determinations**

The applicable federal rate is determined semiannually for demand loans. The rate for term loans depends on the term of the loan. Section 7872 applies to the following loans made without interest or at below market rates of interest:

1. Loans that involve a gift of the foregone interest;
2. Compensation-related loans between an employer and an employee and between an independent contractor who has performed services for another person;
3. Corporation-shareholder loans between a corporation and any shareholder regardless of whether the shareholder is the lender or borrower;
4. Loans which are arranged for the principal purpose of avoidance of federal taxes; and,
5. Any other type of below market rate loan if the interest arrangement has a significant effect on the federal tax liability of the borrower or the lender.
Summary

Generally, either the borrower will be deemed to have received a gift of the foregone interest, the foregone interest will be deemed to have been compensation (or, possibly, a dividend), or the imputed interest rules will be applied, or any combination of the above. As a rule, interest free loans ceased to be an effective tax planning tool after TRA 84. The IRS would probably deem any use to which they could be put dubious, and they will almost certainly cause more trouble for both the borrower and the lender than they are worth from a viable tax planning point of view.

25% Credit Allowed For Employer Child Care Facilities

Since 2002, taxpayers receive a tax credit equal to 25% of qualified expenses for employee child care and 10% of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per taxable year.

Qualified child care expenses include costs paid or incurred:

(1) To acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer’s qualified child care facility;

(2) For the operation of the taxpayer’s qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or

(3) Under a contract with a qualified child care facility to provide child care services to employees of the taxpayer.

To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws. A facility is not treated as a qualified child care facility with respect to a taxpayer unless:

(1) It has open enrollment to the employees of the taxpayer;

(2) Use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q); and

(3) At least 30% of the children enrolled in the center are dependents of the taxpayer’s employees, if the facility is the principal trade or business of the taxpayer.
New Credit for Employer Provided Child Care Facilities

- Employers are allowed a credit equal to 25% of qualified expenses for employee child care and 10% of qualified expenses for child care resource and referral services up to $150,000
- New provision is effective 2002
Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q)).

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer’s basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the ten-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. Other rules apply.

**Corporate Funded Educational Savings Accounts**

Since 2002, corporations, and other entities (including tax-exempt organizations) are permitted to make contributions to educational savings accounts, regardless of the income of the corporation or entity during the year of the contribution.

The 2001 Tax Act increases the annual limit on contributions to educational savings accounts (formerly known as education IRAs) from $500 to $2,000. Thus, an aggregate contribution that may be made by all contributors to one (or more) educational savings accounts established on behalf of any particular beneficiary is limited to $2,000 for each year.

In addition, the 2001 Tax Act expands the definition of qualified education expenses that may be paid tax-free from educational savings accounts to include “qualified elementary and secondary school expenses,” meaning expenses for:

1. Tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law,

2. Room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and
Education Saving Accounts

- Formerly educational IRAs
- Distributions are tax free if used for qualified education
- Contribution limit raised to $2,000
- Starting in 2002, corporations, tax exempt organizations and other entities can contribute
- Contributions for any tax year are permitted until April 15th of the following year
- Phase out range is increased to $190,000 - $220,000 for MFJ
- Distribution can now pay for elementary & secondary school tuition – public or private
- Covered expenses include tutoring, computer equipment, room & board, uniforms and extended day programs
(3) The purchase of any computer technology or equipment (as defined in §170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in school.

Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is educational in nature.

Fringe Benefit Plans for S Corporations

A major impact of the Sub Chapter S Revision Act of 1982 was to substantially limit, or eliminate altogether, the tax-free advantages of many corporate fringe benefit packages for more than 2% owners. The affected plans are:

(a) The former (but now repealed) $5,000 exclusion under §101(b);
(b) Accident and health insurance plans under §105 and §106;
(c) Group term life insurance under §79; and
(d) Meals or lodging furnished to the employees for the employer’s convenience under §119.

An S corporation is denied deductions for such fringe benefits and shareholder-employees do not receive tax-free treatment for such employer contributions. Furthermore, the transition rules that applied to many S corporations expired on December 31, 1987.

ERISA Compliance

Many fringe benefits (such as group term life insurance or other types of employee "welfare plan" benefits) along with pension or profit sharing retirement plans have to comply with ERISA. There are a number of different types of civil and criminal penalties for failures to comply with ERISA requirements.

ERISA covers both pension and welfare plans. Pension plans are qualified pension and profit sharing plans, including Keogh plans and other benefit programs deferring payments until after employment has terminated.

Welfare’ plans include the typical fringe benefit plans adopted by small firms, such as health insurance, long-term disability, group-term life insurance and accidental death insurance plans.

Welfare Plans

An employer must prepare a Summary Plan Description (SPD) for distribution to all employees covered by a welfare plan within 120 days after the plan is first adopted.
A new employee must be given a copy of the SPD within 90 days after becoming a participant in the plan. Employers must also make available plan documents for inspection by employees. Copies must be furnished upon request.

**Additional Requirements**

When a plan covers 100 or more employees, or if the plan is an uninsured and funded welfare plan, the employer is subject to additional ERISA requirements, including:

1. Filing a copy of the SPD with the Department of Labor;
2. Filing an Annual Return/Report or Registration (Form 5500 series) with the IRS each year;
3. Preparing and distributing a Summary Annual Report to covered employees each year;
4. Preparing a Summary of Material Modifications of the plan (if any) and filing it with the Department of Labor and distributing it to covered employees; and
5. Filing a terminal report if the plan is terminated.

**Review Questions**

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.
96. The safe-harbor value can be used as the fair market value for determining the annual lease value of an automobile. What is the safe harbor value for owned automobiles?
   a. the invoice price plus 4%.
   b. the suggested retail price minus 8%.
   c. tax and title.
   d. the retail value according to a prominent pricing source.

97. The author describes four valuation methods that can be used to determine the value of an employer provided automobile. Under Reg.§1.61-2T(e), for autos with fair market values less than the maximum recovery deductions allowable for the first five years the auto is placed in service, what valuation method should an employer use?
   a. the annual valuation method.
   b. the cents per mile method.
   c. the commuting value method.
   d. the general method.

98. Financial planning is very popular among corporate executives. Under Rev. Rul. 73-13, how are financial counseling fees that a company pays for the benefit of its executives treated?
   a. as deductible as a nonbusiness expense.
   b. as deductible by the employee.
   c. as deductible by the employer.
   d. as taxable income.

99. Under the Sub Chapter S Revision Act of 1982, several tax-free advantages of fringe benefits provided to S corporations were limited or eliminated for more than 2% owners. What is one of the four listed plans that were affected?
   a. accident and health insurance plans.
   b. the child care facility credit.
   c. tax and estate planning services.
   d. educational savings accounts.
Learning Objectives

After reading Chapter 7, participants will be able to:

1. Determine the differences between qualified deferred compensation plans and nonqualified plans and, recognize the major benefit of qualified plans, the basis of the benefits and contributions, the current and deferred advantages and the disadvantages of corporate plans and fiduciary responsibilities and prohibited transactions.
2. Specify the requirements of the basic forms of qualified pension plans.
3. Identify defined contribution and defined benefit plans noting the types of defined contribution plans and specifying their effect on retirement benefits.
4. Determine the differences between self-employed and qualified plans for other business types noting key choice of entity factors.
5. Specify the requirements of IRAs, SEPs and SIMPLEs, and identify tax-free Roth IRA distributions noting where to maximize plan benefits.
Deferred Compensation

Qualified Deferred Compensation

Qualified deferred compensation plans are the most important form of compensation used to provide retirement and separation from service benefits.

Qualified v. Nonqualified Plans

A qualified deferred compensation plan is a plan that meets specified requirements in order to obtain special tax treatment. In general, qualified deferred compensation plans must satisfy the following requirements:

(i) Minimum participation standards under §410,
(ii) Nondiscrimination standards (i.e., the plan cannot discriminate in favor of highly compensated employees) under §401(a)(4),
(iii) Minimum vesting standards under §411,
(iv) Minimum funding standards (particularly, for defined benefit plans) under §412, and
(v) Specified limits on benefits and contributions under §415.
In addition, reporting and disclosure requirements mandated by the Employee Retirement Security Act of 1974 (ERISA) have to be met.

**Major Benefit**

For many employees the retirement plan will be the primary vehicle in their employer provided benefit program. These plans are expressly approved by the Government and are significant wealth building devices. Historically, the employer considered pension plan benefits a “gift” to the employee. Unfortunately, the current thinking of many employees is that such benefits are a “right.”

**Current Deduction**

Qualified deferred compensation allows the employer to have a tax deduction every time the employer puts money aside for the employee’s retirement. “Funding” the retirement plan through the use of a trust or similar arrangement does this.

**Timing of Deductions**

A contribution to a qualified plan is generally deductible in the employer’s taxable year when paid. However, §404(a)(6) provides that an employer is deemed to have made a contribution to the plan as of its year-end, if the contribution is made on a count of such year and is made by the due date of its tax return including extensions. A special rule is provided for CODAs.

**Part of Total Compensation**

Corporate contributions to a qualified plan are currently deductible as an ordinary and necessary business expense. However, keep in mind that benefits will be combined with salary to arrive at total compensation that must be “reasonable.” In the case of shareholder employees, who are common in closely held corporations, this could result in IRS questions when substantial benefits are being provided. It should be pointed out that the reasonableness test must be met even when plan contributions fall within the maximum limits as set forth in the Code.

**Compensation Base**

As a general rule, qualified plan benefits or contributions may not be based on imputed salary or non-qualified deferred compensation arrangements. Therefore, an employee who draws no current salary may not be included in as a participant in a qualified plan. Similarly, shareholder-employees who elect to reduce their current salaries under non-qualified deferred compensation contracts may

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1 Section 404(h)(1)(B) provides the same treatment for SEPs.
suffer the disadvantages of reduced contribution limits for qualified plan purposes.

**Salary Reduction Amounts**

Contributions to a money purchase pension plan, however, may be based on a salary reduction where the reduced amount was used to purchase a tax-deferred annuity for the employee of a tax-exempt employer. The IRS has also ruled that the amount of salary reduction under a §401(k) plan may be counted as compensation for purposes of determining benefits under a defined benefit plan.

For purposes of determining nondiscrimination under §401(a)(4), an employee’s compensation is defined as total compensation included in gross income. An employer also has the option to include in the definition of compensation salary reductions under a §401(k) plan or §125 plan. A qualified plan may not consider any employee’s salary in excess of $265,000 (in 2016) for purposes of determining contributions, benefits, and deductibility of contributions or nondiscrimination requirements. This limit is indexed to the CPI.

**Benefit Planning**

Despite the popularity of qualified retirement plans, benefits are rarely planned with any logic. To have sufficient income to meet one’s retirement needs requires some long term planning.

In companies where the key employees are also shareholders, retirement plan contributions are normally tied to the fluctuations in company profits and the desire to “zero out” or equalize the tax rates between the owners and the company rather than any systematic plan to satisfy pre-determined retirement needs. In larger companies, little is done to develop benefits based on what is needed by the retiree. Here most planning focuses on what is competitive. While this might appear to be a good approach, there is a defect. Employees can always leave for better pay; retirees cannot leave for better benefits.

In either event, needs analysis should concentrate on after tax income and expenses upon retirement adjusted for the new lifestyle of the retiree. An excellent text for an accountant in the area of planning for retirement needs is the “Touche Ross Guide to Personal Financial Management” by W. Thomas Porter.

The material is good and the chart and calculation sheets are superb. Porter indicates that retirement plans are designed to provide only 35 to 40 percent of one’s retirement income even when properly structured and funded. The remaining 60 to 65 percent will hardly come from Social Security. Most people do not realize the importance of investment income to their retirement dreams until they are just a few years away from retiring.
Corporate Plans

Advantages

For a small closely held company that can operate in the corporate form, a qualified corporate pension, or profit-sharing plan generally is the best vehicle for deferring income until retirement. The principal advantages fall into two categories - current and deferred.

Current

The current benefits are:

(1) The employer corporation obtains a current deduction for the amounts paid or accruable to the qualified plan (§404(a));
(2) The employee does not recognize income currently on contributions made by his or her employer even though the benefits may be nonforfeitable and fully vested (§402(a) & §403(a));
(3) Employee benefit trust accumulates tax-free (see §501(a)).

Deferred

Among the deferred tax advantages are:

(1) Lump-sum distributions from a qualified employee benefit plan are eligible for favorable five (or in some cases still ten) year income averaging treatment (§402(e)); and


(2) Certain distributions may be rolled over tax-free into an IRA.

Disadvantages

There are two principal disadvantages of a qualified corporate plan:

Employee Costs

For a closely held corporation, it is often the cost to the shareholder-employee of covering rank and file employees. Generally, the objective of qualified retirement plans of closely held companies is to provide the greatest benefit to the controlling shareholders/executives.
Retirement Plans

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<th>TYPES OF RETIREMENT PLAN</th>
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<td>AGI UNDER $98,000</td>
<td>FULL CONTRIBUTION</td>
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<td>AGI $98,000 - $118,000</td>
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<tr>
<td>AGI OVER $118,000</td>
<td>FULL CONTRIBUTION</td>
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| KEOGH                  | KEOGH                  |
| Defined Contribution   | Defined Benefit        |
| Corporate Defined      | Corporate Defined      |
| Money Purchase Pension | Defined Benefit Pension |
| Profit Sharing Plan    | Annuity Plan           |

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<tr>
<td>Defines Retirement</td>
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</table>
Comparison with IRAs & Keoghs

Qualified corporate plans permit substantially larger contributions than an IRA. Formerly, corporate plans also exceeded Keogh plans as well, but effective 1984, such plans are essentially equal in terms of benefits.

As a result of TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) maximum benefits were reduced, the early retirement age was raised, new rules were enacted for corporate and non-corporate plans, and restrictions were established for “top heavy” plans.

Basic ERISA Provisions

ERISA consists of four main sections (Titles):

**Title I** is primarily concerned with all types of retirement and welfare benefit programs. Health insurance, group insurance, deferred compensation plans, etc. must all be considered from the standpoint of the Department of Labor regulations. Reporting and disclosure requirements are provided for under Title I which requires that detailed plan summaries be provided to all plan participants and beneficiaries. Similarly, any plan amendments must also be reported to the participants and beneficiaries. All participants must also receive copies of the plan’s financial statement from the annual report, as well as an annual statement of accrued and vested benefits.

**Title II** covers only qualified retirement plans and tax-deferred annuities, primarily from a federal tax standpoint.

**Title III** involves jurisdiction, administration, enforcement, and the enrollment of actuaries.

**Title IV** outlines the requirements for plan termination insurance. Because of the complexity and length of these provisions (the DOL it seems, feels obligated to equal or exceed the standards of administrative confusion which have been so competently laid out by the IRS), we will attempt only to cursorily cover some of the provisions commonly affecting qualified plans.

ERISA Reporting Requirements

ERISA imposes a large paperwork burden in connection with any qualified retirement plan. This burden includes preparing reports that must be sent to the IRS, plan participants, plan beneficiaries, the department of Labor, and the Pension Benefit Guaranty Corporation. When a qualified plan is first installed, the IRS approval of the plan is usually sought.

In addition, the Department of Labor must receive a plan description when the plan is first installed (plus additional reports every time the plan is amended). Most plans must file an annual report that includes financial statements (certified by a Certified Public Accountant), schedules, an actuarial statement (certified by an enrolled actuary), and other information. Par-
Participants and beneficiaries are required to receive a summary plan description and a summary annual plan report from the plan. Moreover, participants and beneficiaries are entitled to receive, on request, statements concerning certain benefit information.

**Fiduciary Responsibilities**

The fiduciary responsibilities of plan administration are also detailed by Title I. A federal prudent man investment rule is imposed on fiduciaries and adequate portfolio diversification is normally required. Any person who exercises any discretionary control or authority over the management of a plan, or any authority over the management of the plan’s assets is a fiduciary. Therefore, while plan trustees are clearly fiduciaries, other not-so-obvious persons may also be so classified by ERISA and, therefore, be liable for losses if they violate their fiduciary duties. The law defines a “party-in-interest” as an administrator, officer, fiduciary, employer, trustee, custodian and legal counsel, as well as certain other parties.

**Bonding Requirement**

All fiduciaries, except certain banks, must be bonded. The amount of the bond must not be less than 10% of the amount of funds handled or $1,000, whichever is greater, or generally, not more than $500,000. Plans covering only partners and their spouses, or a sole shareholder, or a sole proprietor and spouse, are not subject to the bonding requirements.

**Prohibited Transactions**

There are also several prohibited transactions which fiduciaries are forbidden to engage in with party-in-interest. However, the Department of Labor may grant a specific exemption to any of these prohibited transactions based upon disclosure and proof of the benefit to the plan. These prohibited transactions are as follows:

1. A sale, exchange, or lease of property between the plan and a party-in-interest;
2. A loan or other extension of credit between the plan and a party-in-interest;
3. The furnishing of goods, services, or facilities between the plan and a party-in-interest;
4. A transfer of plan assets to a party-in-interest or a transfer that is for the use and benefit of a party-in-interest; and
5. An acquisition by the plan of employer securities or real estate that is in violation of ERISA §407(a).
Additional Restrictions

The following actions by plan fiduciaries are also prohibited:

(a) Dealing with the assets of the plan for their own account;

(b) Receiving any consideration for his own account from any party dealing with the plan in connection with a transaction involving plan assets; or

(c) Acting in any capacity in any transaction involving a plan on behalf of a party, or in representation of a party, whose interests are adverse to the interests of the plan, its participants, or beneficiaries.

Fiduciary Exceptions

There are however, some exceptions to these prohibited transactions that do not prevent a fiduciary from doing any of the following:

(a) Receiving benefits from the plan as a participant or beneficiary so long as the benefits so received are consistent with the terms of the plan as applied to all other participants and beneficiaries;

(b) Receiving reasonable compensation for services to the plan unless the fiduciary receives full time pay from the employer or employee organization;

(c) Receiving reimbursements for expenses actually incurred in the course of his duties to the plan; and/or

(d) Serving as an officer, employee, agent, etc., of a party-in-interest.

Loans

Another important exception to the prohibited transaction rules permits qualified plans to make loans to plan participants. Any such loans must be made in accordance with specific provisions in the plan and must provide for a reasonable interest rate and adequate security. Loans must be made available on a nondiscriminatory basis. That is to say, they must be made available to all plan participants on a reasonably equivalent basis.

A loan from a qualified plan to a plan participant or beneficiary is treated as a taxable distribution unless:

(1) The loan must be repaid within 5 years (except for certain home loans), and

(2) The loan does not exceed the lesser of (a) $50,000, or (b) the greater of $10,000 or ½ of the participant’s accrued benefit under the plan.

The $50,000 limit for qualified plan loans is reduced where the participant has an outstanding loan balance during the 1-year period ending on the day before the date of any new loan (§72(p)(2)(A)(ii)). In addition, except as provided in regulations, a plan loan must be amortized in substantially
level payments, made not less frequently than quarterly, over the term of the loan (§72(p)(2)(C)).

Formerly, the above exceptions to the prohibited transaction rules did not apply to plan loans to owner-employees.

Note: For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10% of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5% of the outstanding stock of the corporation, and (4) the owner of an IRA.

However, since 2002, the rules relating to plan loans made to owner employees (other than the owner of an IRA) are eliminated. Thus, the general statutory exception applies to such transactions.

**Employer Securities**

With the exception of profit sharing and pre-ERISA money purchase pension plans, pension plans may not acquire or hold qualifying employer securities or real property in the plan in excess of 10% of the fair market value of all of the plan’s assets.

In addition, ERISA imposes restrictions on the investment of retirement plan assets in employer stock or employer real property (ERISA §407). Under these restrictions, a retirement plan may hold only a “qualifying” employer security. Under the 2006 Pension Protection Act, in order to satisfy the plan qualification requirements of the Code and the vesting requirements of ERISA, certain defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities. Such a plan is required to permit applicable individuals to direct that the portion of the individual’s account held in employer securities be invested in alternative investments. An applicable individual includes:

1. any plan participant; and
2. any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

Thus, participants must now be allowed to immediately diversify any employee contributions or elective contributions invested in employer securities. For employer contributions, participants must be able to diversify out of employer stock after they have been in the plan for three years.

**Excise Penalty Tax**

Where a disqualified person participates in a prohibited transaction, an initial non-deductible excise tax equal to 5% of the amount of the transaction is imposed on such person. An additional tax equal to 100% of the transaction
amount is imposed if the transaction is not corrected within the correction period that is 90 days from the notice of deficiency, plus any extensions.

**PBGC Insurance**

Defined benefit pension plans may be subject to the plan termination insurance requirements of the Pension Benefit Guarantee Corporation (PBGC). The basic purpose is to guarantee payment of vested plan benefits at the time of termination of a plan where the plan’s assets are insufficient to pay such benefits.

**Sixty-Month Requirement**

The PBGC guarantees the plan benefits to the extent that a plan has been in existence for 60 months at the time of plan termination. This 60-month requirement allows for a phase-in of 20% per year for plans that have not been in existence for 5 years. The funds to be accumulated by the PBGC are derived from an annual premium to be paid for each active participant and retiree. Even fully insured plans are required to obtain PBGC coverage.

**Recovery Against Employer**

Where the PBGC is required to pay benefits to participants, it may recover such amounts from the employer up to 30% of the employer’s net worth plus additional sums. Although this contingent employer liability may be covered by special risk insurance, the premiums are substantial.

**Termination Proceedings**

The PBGC can also be thoroughly involved in the operations of defined benefit pension plans. For example, the PBGC may institute proceedings to terminate a plan if it finds that:

1. The plan failed to comply with the minimum funding standards;
2. The plan is unable to pay benefits when they become due;
3. A distribution is made to an owner-employee of $10,000 in a 24 month period, unless the payment is made due to the death of the owner-employee if, after the distribution, there are unfunded vested liabilities; or
4. The possible long-term liability of the plan to the PBGC will increase unreasonably if the plan is not terminated.

**Plans Exempt from PBGC Coverage**

Some plans are specifically excluded from the requirement of PBGC insurance coverage. These plans are as follows:
(a) Individual account plans, such as money purchase pension plans, target benefit plans, profit sharing plans, thrift and savings plans, and stock bonus plans;
(b) Governmental plans;
(c) A church plan which is not volunteered for coverage, does not cover the employees of a non-related trade or business and is not a multi-employer plan in which one or more of the employers are not churches or a convention or association of churches;
(d) Plans established by fraternal societies or other organizations described in §501(c)(8), (9) or (18) which receive no employer contributions and cover only members (not employees);
(e) A plan that has not, after the date of enactment, provided for employer contributions;
(f) Nonqualified deferred compensation plans established for a select group of management or highly compensated employees;
(g) A plan outside the United States established for non-resident aliens;
(h) A plan that is primarily for a limited group of highly compensated employees where the benefits to be paid, or the contributions to be received, are in excess of the limitations of §415;
(i) A qualified plan established exclusively for substantial owners;
(j) A plan of an international organization that is exempt from tax under the provisions of the International Organizations Immunity Act;
(k) A plan maintained only to comply with worker’s compensation, unemployment compensation, or disability insurance laws;
(l) A plan established and maintained by a labor organization described in §501(c)(5) that does not, after the date of enactment, provide for employer contributions;
(m) A plan which is a defined benefit plan to the extent that it is treated as an individual account plan under §3(35)B of the Act; or
(n) A plan established and maintained by one or more professional service employers that has, from the date of enactment, not had more than 25 active participants. Once one of these plans has more than 25 active participants, it will remain covered even if the number of active participants subsequently falls back below 25.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

100. The author identifies two deferred tax advantages of corporate retirement plans. What is one of these advantages?
   a. There is a tax-free accumulation of the employee benefit trust.
   b. The employee may roll over into an IRA certain distributions tax-free.
   c. Amounts paid or accruable to the qualified plan are currently deductible for the employer corporation.
   d. Employer contributions aren’t recognized currently as income.

101. The author lists two major disadvantages of qualified corporate plans. What is one of these disadvantages?
   a. Loans may not be made to plan participants.
   b. Lump-sum distributions are ineligible for favorable five-year income averaging treatment.
   c. The expense to the shareholder-employees of paying for taking care of the majority of the employees.
   d. No plan may hold any more than 10% of the fair market value of the total assets in qualifying employer real property.
102. A fiduciary employs unrestricted control or authority over management of a qualified deferred compensation plan or of such a plan’s assets. What is a fiduciary permitted to do?
   a. be involved, in any manner, in any deal that involves another plan on behalf of a party whose interests are opposing the plan’s interests.
   b. have authority over the plan’s assets for their own account.
   c. obtain any payment for his own account from any party involved in the plan in association with a transaction involving plan assets.
   d. operate as an officer, employee, or agent of a party-in-interest.

103. The Pension Benefit Guarantee Corporation (PBGC) guarantees payment of certain benefits upon a plan’s termination if a plan fails to satisfy such payment. What plan is included in the requirement of PBGC insurance coverage?
   a. a governmental plan.
   b. a plan established by fraternal societies which receive no employer contributions and cover only members (not employees).
   c. a defined nondiscriminatory benefit plan where benefits to be paid are no more than the limitations of §415.
   d. a qualified plan established exclusively for substantial owners.

Basic Requirements of a Qualified Pension Plan

There are three basic forms of qualified plans: pension plans, profit-sharing plans, and stock bonus plans. The qualification requirements for all of these plans are iden-
tical, except that certain fundamental differences in the plans require variations in the application of some rules.

Written Plan

The employer must establish and communicate to its employees a written plan (and, usually, a trust), which is valid under state law (Reg. §1.401(a)(2)).

Communication

A plan must actually be reduced to a formal written document and communicated to employees by the end of the employer’s taxable year, in order to be qualified for such year. Under ERISA, a summary plan description must be furnished to participants within 120 days after the plan is established or, if later, 90 days after an employee becomes a participant (DOL Reg. §2520.104b-2(a)). The summary plan description must be written in such a manner that it will be understood by the average plan participant and must be sufficiently comprehensive in its description of the participant’s rights and obligations under the plan (DOL Reg. §2520.102-2).

Trust

The assets of a qualified plan must be held in a valid trust created or organized in the United States. As an alternative, a custodial account or an annuity contract issued by an insurance company or a custodial account held by a bank (for a plan which uses IRAs) may be used (ERISA §403(b)). Under §401(f), these custodial accounts and annuity contracts will be treated as a qualified trust, and the person holding the assets of the account or contract will be treated as the trustee thereof.

Requirements

A trust is a matter of state law. In order to be a valid trust, three requirements must be met:

(i) The trust must have a corpus (property);
(ii) The trust must have a trustee; and
(iii) The trust must have a beneficiary.

Both the plan and the trust must be written instruments. They may, however, be two separate or one combined instrument.

To obtain a deduction for a year, the trust must be established before year end, although the actual contribution is not required until the due date of filing the employer tax return including extensions (§404(a)(6)). Although this contradicts the requirement that a valid trust have a corpus, the IRS has held that if the trust is valid in all respects under local law except for the existence of corpus, and if the contribution is made within the above prescribed time
limits, it will be deemed to have been in existence on the last day of the year (R.R. 81-114).

Permanency
The plan must be a permanent and continuing program. It must not be a temporary arrangement set up in high tax years as a tax savings scheme to benefit the employer. Although the employer may reserve the right to terminate the plan and discontinue further contributions, the abandonment of a plan for any reason other than business necessity can indicate that the plan was not a bona fide program from its inception (Reg. §1.401-1(b)(2)). Thus, if a plan is discontinued after only a short period of years, the IRS may retroactively disqualify the plan.

Exclusive Benefit of Employees
The plan and trust must be for the exclusive benefit of employees and their beneficiaries. A qualified plan cannot be a subterfuge for the distribution of profits to shareholders. Thus, the plan cannot discriminate in favor of certain highly compensated employees.

Highly Compensated Employees
Under §414(q)(1), a “highly compensated employee” is any employee who:

1. Was a 5% owner (as defined in §416(i)), at any time during the year or the preceding year, or
2. For the preceding year, had compensation from the employer in excess of $80,000 (indexed for inflation), and, if the employer elects this condition, was in the top 20% of employees by compensation for the preceding year (§414(q)).

Reversion of Trust Assets to Employer
There must ordinarily be no reversion of trust assets and contributions to the employer except for actuarial errors or an excess of plan assets upon termination of a defined benefit pension plan.

The trust instrument must make it impossible, before the satisfaction of all liabilities to employees and beneficiaries, for assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or beneficiaries. This provision must be written into the trust instrument (Reg. §1.401-2).

Participation & Coverage
The plan must cover a required percentage of employees or cover a nondiscriminatory classification of employees. The plan may not discriminate in favor of highly compensated employees.
Section 401(a)(3) requires that a plan meet the minimum participation standards of §410. Section 410 divides these participation standards into two general categories:

(i) Age and service requirements (that is, the rights of an employer to exclude certain employees on account of age or years of service), and

(ii) Coverage requirements, which relate to the portion of the employer’s total work force that must participate in the plan.

Age & Service

A qualified plan cannot exclude any employee from participation on account of his age or years of service, except for the exclusion of employees who are:

(i) Under age 21, or

(ii) Have less than one “year of service.”

Note: In the case of a plan that provides for 100 percent vesting after no more than two years of service, it can require a two-year period of service for eligibility to participate.

An employee who has satisfied the minimum age and service requirements of the plan (if any) must actually begin participation (i.e., enter the plan) no later than the earlier of:

(i) The first day of the first plan year beginning after he satisfied the requirements; or

(ii) Six months after he satisfied the requirements (Reg. §1.410(a)-4(b)).

A year of service is a 12-consecutive-month period (referred to as the computation period) during which the employee has at least 1,000 “hours of service.”

Hours of service include:

(i) Hours for which the employee is paid, or entitled to payment, for the performance of duties;

(ii) Hours for which the employee is paid, or entitled to payment, during periods when no duties are performed, such as vacation, illness, disability, maternity or paternity leave; and

Note: The plan does not have to credit the employee with more than 501 hours of service for this category.

(iii) Hours for which back pay is awarded or agreed to by the employer.

Coverage

To insure that lower paid employees have the benefit of a retirement plan, tax law requires qualified plans to provide coverage for them. This is accomplished by two sets of requirements. The first set is three tests:

(i) A percentage test,
(ii) A ratio test, and
(iii) An average benefits test.

The second set requires a specific minimum number of covered participants.

**Percentage Test**

Under this test, the plan must “benefit” at least 70% of all the employees who are not highly compensated employees.

**Note:** This is not the same as the 70% test under pre-TRA ’86 law. This test is broader, since it requires that 70% of “all nonhighly compensated employees,” rather than “all employees” (which includes both highly and nonhighly compensated employees).

**Ratio Test**

To satisfy this test, a plan must benefit a percentage of nonhighly compensated employees that is at least 70% of the percentage of highly compensated employees benefiting under the plan.

**Example**

*An employer has two highly compensated employees and 20 non-highly compensated employees. If the plan covers both of the highly compensated employees (100%), it must cover at least 14 of the nonhighly compensated employees (70% of 100% = 70% required coverage). If the plan covers only one of the highly compensated employees (50%), it must cover at least seven of the nonhighly compensated employees (70% of 50% = 35% required coverage).*

**Average Benefits Test**

A plan will meet the average benefits test if:

(i) The plan meets a nondiscriminatory classification test (using the §414(q) definition of highly compensated employees); and

(ii) The average benefit percentage of nonhighly compensated employees, considered as a group, is at least 70% of the average benefit percentage of the highly compensated employees, considered as a group.

The classification test is met for a plan year if the classification system is reasonable and established under objective business criteria that identify the employees who benefit under the plan. This classification must meet a safe and unsafe harbor range that compares the percentage of nonhighly compensated employees to the percentage of highly compensated employees benefiting under the plan.
Numerical Coverage

The second set of requirements was added to the Code to eliminate discrimination in favor of highly compensated employees through the use of multiple plans. Section 401(a)(26) provides that a trust will not be qualified unless it benefits the lesser of:

(i) 50 employees; or

(ii) 40% of “all employees.”

Thus, each plan must have a minimum number of employees covered, without regard to any designation of another plan.

The additional participation rules of §401(a)(26) only apply to defined benefit plans. A defined benefit plan does not meet the §401(a)(26) rules unless it benefits the lesser of:

(i) 50 employees, or

(ii) The greater of:

(a) 40% of all employees of the employer, or

(b) 2 employees (one employee if there is only one employee).

Related Employers

An employer could attempt to circumvent the coverage requirements of §410(b) by operating its business through multiple entities. Because of this potential abuse, certain related employers are treated as a single employer for purposes of the coverage tests. That is, all employees of each entity in the group are used in computing the percentage or classification tests.

The related employers that fall into this classification are:

(i) Trades or businesses under common control (both parent-subsidiary and brother-sister forms),

(ii) Affiliated service groups, and

(iii) Leased employee arrangements.

Vesting

Vesting refers to the percentage of accrued benefit to which an employee would be entitled if they left employment prior to attaining the normal retirement age under the plan. Vesting represents that portion of the employee’s benefit that is nonforfeitable.

Section 401(a)(7) requires a plan to meet the rules under §411, regarding vesting standards. These vesting standards contain three classes of vesting:

(i) Full and immediate vesting;

(ii) Minimum vesting under §411(a)(2); and

(iii) Compliance with §401(a)(4) nondiscrimination requirements.
Full & Immediate Vesting

Under §411(a), a participant’s normal retirement benefit derived from employer contributions must be nonforfeitable upon the attainment of normal retirement age, regardless of where the employee happens to fall on the plan’s vesting schedule at normal retirement age.

Section 411(a)(1) requires that a participant must be fully vested at all times in the accrued benefit derived from the employee’s own contributions to the plan. This requirement applies regardless of whether the employee contributions are voluntary or mandatory.

Section 411(d)(3) requires that a qualified plan provide that accrued benefits become nonforfeitable for participants who are affected by a complete or partial termination of, or a discontinuance of contributions to, a plan.

Minimum Vesting

For employer contributions, plans have historically had to meet the requirements of two minimum vesting schedules:

1. Five-Year Cliff Vesting. Under this schedule, participants who have completed five years of service with the employer must receive a 100% nonforfeitable claim to employer-derived benefits. Thus, the schedule is as follows:

<table>
<thead>
<tr>
<th>Completed Years of Service</th>
<th>Nonforfeitable Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-4</td>
<td>0%</td>
</tr>
<tr>
<td>5</td>
<td>100%</td>
</tr>
</tbody>
</table>

2. Three-to-Seven Year Graded Vesting. This schedule is graded in a similar fashion to the old five-to-15 year graded schedule, except, of course, that it provides a more rapid rate of vesting. The schedule is:

<table>
<thead>
<tr>
<th>Completed Years of Service</th>
<th>Nonforfeitable Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-2</td>
<td>0%</td>
</tr>
<tr>
<td>3</td>
<td>20%</td>
</tr>
<tr>
<td>4</td>
<td>40%</td>
</tr>
<tr>
<td>5</td>
<td>60%</td>
</tr>
<tr>
<td>6</td>
<td>80%</td>
</tr>
<tr>
<td>7</td>
<td>100%</td>
</tr>
</tbody>
</table>

Note: The general rules for counting years of service for vesting are similar to those for participation. However, three important differences exist. First, all years of service after the attainment of age 18 (rather than age 21) must be counted. Years of service before age 18 may be disregarded. Sec-
ond, contributory plans (those with mandatory employee contributions) may disregard any years of service in which an employee failed to make a contribution. Finally, years of service during which the employer did not maintain the plan or a predecessor plan may be disregarded.

In the case of matching contributions (as defined in §401(m)(4)(A)), plans had to meet the requirements up to minimum vesting schedules:

1. **Three-Year Cliff Vesting.** Under this schedule, participants who have completed three years of service with the employer must receive a 100% nonforfeitable claim to employer-derived benefits.

2. **Two-to-Six Year Graded Vesting.** This schedule is graded in a similar fashion to the old five-to-15 year graded schedule, except, of course, that it provides a more rapid rate of vesting. The schedule is:

<table>
<thead>
<tr>
<th>Completed Years of Service</th>
<th>Nonforfeitable Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>20%</td>
</tr>
<tr>
<td>3</td>
<td>40%</td>
</tr>
<tr>
<td>4</td>
<td>60%</td>
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<tr>
<td>5</td>
<td>80%</td>
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<tr>
<td>6</td>
<td>100%</td>
</tr>
</tbody>
</table>

However, for plan years beginning after December 31, 2006, the expedited vesting schedule that applied to employer matching contributions was extended to all employer contributions to defined contribution plans by Pension Protection Act of 2006 (§411(a)(2)).

As a result, for plan years beginning after 2006, a defined contribution plan (e.g., profit-sharing and §401(k) plans) must vest all employer contributions according to the schedule that, before 2007, applied only to employer matching contributions. For example, if a defined contribution plan used cliff vesting, accrued benefits derived from all employer contributions must now vest with the participant after three years of service. Likewise, if a defined contribution plan used graduated vesting, all employer contributions must now vest with the participant at the rate of 20% per year, beginning with the second year of service.

**Nondiscrimination Compliance**

Even if a plan adopts one of the statutory vesting schedules, it may still discriminate in favor of highly compensated employees in practice. If the IRS determines either that there has been a “pattern of abuse” under the plan or that there is reason to believe that there will be an accrual of benefits or forfeitures tending to discriminate in favor of highly compensated employees, it can require a more accelerated vesting schedule under §411(d)(1).
Contribution & Benefit Limits

Section 401(a)(16) requires a plan to comply with §415 limitations for contributions and benefits. These limitations set the maximum amounts that the employer may provide under the plan. A plan must include provisions to ensure that these limitations are never exceeded for any participant; otherwise, the entire plan will become disqualified for the year.

The limitations imposed on both defined contribution and defined benefit plans are based on the participant’s compensation. However, there is a maximum dollar amount of compensation that may be considered. Initially set at $200,000, it was decreased by OBRA ’93 to $150,000. In 2016, it is $265,000.

Defined Benefit Plans (Annual Benefits Limitation) - §415

A defined benefit plan may not provide “annual benefits” in excess of the lesser of:

(i) A dollar limit of $160,000 (subject to COLAS) ((§415(b)(1)(A)); or
(ii) 100% of the participant’s average annual compensation for the three consecutive years in which their compensation was the highest (§415(b)(1)(B)).

The $160,000 limit is subject to cost of living adjustments. In 2016 plan years, this amount is $210,000.

The annual benefit means a benefit payable annually at the participant’s social security retirement age in the form of a straight-life annuity, with no ancillary benefits, under a plan to which employees do not contribute and under which the employee makes no rollover contributions.

Note: Employee contributions, whether mandatory or voluntary, are considered to be a separate defined contribution plan to which the limitations thereon apply.

Defined Contribution Plans (Annual Addition Limitation) - §415

A defined contribution plan’s “annual additions” to a participant’s account for any limitation year may not exceed the lesser of:

(i) $53,000 in 2016 (or, if greater, one-fourth of the defined benefit dollar limitation) (§415(c)(1)(A)); or
(ii) 100% of the participant’s compensation (§415(c)(1)(B)).

Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee (§415(c)(2)).
Limits on Deductible Contributions - §404

To be deductible, a contribution to a qualified plan must be an ordinary and necessary expense of carrying on a trade, business or other activity engaged in for the production of income. In addition, a contribution may not be deducted unless it is actually paid into the plan.

1. Defined contribution plans: For profit-sharing, stock bonus, simplified employee pension, and money purchase pension plans, deductible contributions are limited to 25% of the compensation otherwise paid or accrued during the taxable year to plan beneficiaries (§404(a)(3)(A)).

2. Defined benefit plans: An employer is permitted to use either one of two methods for determining the minimum deductible annual contribution to a defined benefit pension plan:
   a. The level funding method (§404(a)(1)(A)(ii)), or
   b. The normal cost method (§404(a)(1)(A)(iii)).

   Note: However, if the annual contribution necessary to satisfy the minimum funding standard provided by §412(a) is greater than the amount determined under either of the above two, the limit may be increased to that amount.

As to the maximum deductible annual contribution (subject to a special rule for plans with more than 100 participants), the employer may not deduct an amount that exceeds the full funding limitation determined under the minimum funding rules (§412).

3. Combination plans: Where any employee is the beneficiary under both a defined benefit and a defined contribution plan of the employer, deductible contributions are limited to 25% of the compensation otherwise paid or accrued during the taxable year to plan beneficiaries (§404(a)(9)).

Assignment & Alienation

Section 401(a)(13) requires qualified plans to provide that the participants’ benefits under the plan may not be assigned, alienated or subject to attachment, garnishment, levy, execution, or other equitable process.

However, several exceptions to this rule exist:

1. Any voluntary revocable assignment of an amount that does not exceed 10% of any benefit payment, may be made by a participant or beneficiary, as long as the purpose of the assignment is not to defray the costs of plan administration.

2. A loan by the plan to the participant or beneficiary that is secured by the participant’s accrued benefit will not be considered an assignment or alienation, if the loan is exempt from the prohibited transaction tax of §4975 because it meets the requirements under §4975(d)(1).
3. The following arrangements are deemed not to be an assignment or alienation:

(a) Arrangements for the withholding of federal, state, or local taxes from plan benefits;
(b) Arrangements for the recovery by the plan of overpayments of benefits previously made to a participant;
(c) Arrangements for the transfer of benefit rights from the plan to another plan;
(d) Arrangements for the direct deposit of benefit payments to a bank, savings and loan association or credit union, provided that the arrangement does not constitute an assignment of benefits; and
(e) Arrangements whereby a participant directs the plan to pay any portion of a benefit to a third party if it is revocable at any time by the participant or beneficiary and the third party acknowledges in writing that he has no enforceable right to the benefit payments.

4. The assignment and alienation prohibition does not apply to the creation, assignment, or recognition of a right to any benefit payable pursuant to a “qualified domestic relations order” (QDRO).

Note: A “domestic relations order” means any judgment, decree, or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant and which is made pursuant to a state domestic relation law (including a community property law).

Miscellaneous Requirements

Forfeitures arising from the non-vested accounts of terminated employees under defined benefit plans must be used to reduce employer contributions. Under money purchase or target benefit plans, forfeitures may be reallocated to the accounts of remaining participants or used to reduce employer contributions.

A disability pension and incidental post-retirement and pre-retirement death benefits can be provided. However, benefits for sickness, accident, hospitalization, or medical expenses may not be furnished to active plan participants.

One of the most important Code requirements is the minimum funding standard which must be met by defined benefit, target or assumed benefit and money purchase plans. The major purpose of this requirement is for the employer to make adequate funding. An excise tax is imposed on the employer for failure to meet this standard.

When a plan provides for a normal retirement benefit in the form of an annuity for life, and the employee has been married for the one-year period ending on the annuity starting date, a joint and survivor spousal annuity must be provided.
Basic Types of Corporate Plans

Under ERISA, qualified corporate retirement plans are one of two basic types:

(1) Defined contribution plans, or
(2) Defined benefit plans.

Although defined benefit plans offer several advantages, defined contribution plans are frequently better to start with and are generally more practical for the small corporation.

Defined Benefit

Mechanics

Generally, a defined benefit plan attempts to specify benefit levels for employees. Once benefit levels are established, contributions are determined based upon actuarial calculations.

The employer bears the risk of the investment program used by the employee benefit trust that administers the plan’s assets. If that program causes the plan assets to fall below the amount actuarially necessary to pay the defined benefits then the employer must make additional contributions.

Thus, defined benefit plans are subject to the minimum funding requirements under ERISA, whereas those rules have little meaning for defined contribution plans. In such a plan, income in excess of the forecast levels benefits the employer by reducing future contributions (§412(b)(3)).

Although contributions may vary based on the investment program, such plans are a fixed obligation of the corporation and contributions must be made annually to the plan regardless of the company’s profits.

Defined Benefit Pension

The primary form of the defined benefit plan is the defined benefit pension plan. A defined benefit pension plan must provide for the payment of definitely determinable benefits to the employees over a period of years after retirement. In short, it guarantees a monthly income for a participant at retirement age. Benefits are measured by years of service with the employer, years of participation in the plan, percent of average compensation, or a combination thereof. In addition, most defined benefit pension plans pay Pension Benefit Guaranty Corporation premiums to insure that participant’s guaranteed benefits will always be paid at retirement.
Defined Contribution

Mechanics

In defined contribution plans, an individual account is established for each employee. The total vested amount of each employee’s account at termination or retirement will be the amount available to provide each covered employee with a benefit. The employer defines or fixes the annual cost rather than defining the benefit it wants to have its employees to receive. Contributions to the employee’s account are based on a formula that is usually expressed as a percentage of the employee’s salary.

Discretion

Contributions need not be mandatory as exampled by profit sharing plans that are in this category. Considerable discretion by the board of directors is permitted without jeopardizing the qualification of the plan. (Reg. §1.401-1(b)(1)(ii)). The key is that there is no exact benefit. The procedure is not one of defining benefits and then determining the contributions necessary to fund it. Benefits are the result of the contributions made to the plan and the investment performance (or lack thereof) of the employee benefits trust that administers the plan’s assets. As a result, the participant/employee bears the risk of the investment program and benefits are directly dependent upon it.

Favorable Circumstances

A defined contribution plan can be recommended in the following instances:

1. The principals are relatively young (e.g. - more than 20 years from retirement) and will have many years to accumulate contributions;
2. There are older employees and the principals do not want to make the higher contributions necessary to fund a defined benefit plan for a few years;
3. The principals want the plan costs tied to compensation rather than age, actuarial assumptions or the rise and fall of the stock market; or
4. The business is cyclical and the principals want the flexibility not to make contributions in bad years.

Types of Defined Contribution Plans

There are a variety of defined contribution plans:

Profit Sharing

A profit sharing plan is a defined contribution plan under which the plan may provide, or the employer may determine, annually, how much will be contributed to the plan out of profits or otherwise. As a result profit sharing
plans cannot provide determinable benefits. However, distributions can occur prior to retirement.

Requirements for a Qualified Profit Sharing Plan

A profit sharing plan is a vehicle through which an employer may share some of his profits\(^2\) with his employees. We will discuss profit sharing plans of the deferred type only (i.e., payment is to be made to the participant in a future taxable year). Since each participant is credited with a share of the allocated profits and the gains or losses thereon, ultimate benefits are unknown. In this respect, profit sharing plans are similar to money purchase pension plans and are generally more suitable where the employees (or shareholder-employees) are under age 45.

Written Plan

The Code requirements for a qualified profit sharing plan are essentially the same as for a qualified pension plan. However, unlike certain pension plans that do not require a trust (i.e. those funded exclusively with life insurance and annuity contracts), qualified profit sharing plans usually require a formal written trust agreement and substantial and recurring employer contributions.

Eligibility

The eligibility requirements for profit sharing plans are generally more liberal than those of pension plans. A maximum age provision is not permissible however; this poses no great cost problem since actuarial funding is not required.

In addition, since employer contributions are not required to be made out of current or accumulated profits or earnings, these plans may be established by private, non-profit organizations and presumably, by local governments as well.

Deductible Contribution Limit

Since 2002, the maximum annual deduction is 25% of the aggregate gross compensation of all plan participants. Contribution and some credit carry-overs are also permitted.

Substantial & Recurrent Rule

Keep in mind the “substantial and recurrent” rule. Generally, the IRS will expect a contribution of some sort to be made if there are profits. How-

\(^2\) TRA 86 provides that a contribution to a qualified profit sharing plan does not require that the employer have current or accumulated earnings or profits.
ever, a contribution need not be made in every plan year. If contributions are not made on a fairly consistent basis, the IRS may claim that the plan has been discontinued and require full vesting to the participants.

**Profit v. Pension Plan**

A profit sharing plan may be preferable to a pension plan based upon the following considerations:

1. When the business is young and substantial earnings are being retained;
2. When most employees, including owners and key-employees are young and have limited past service;
3. When business earnings and profits are erratic or generally low;
4. When the incentive element is more important to the plan participants than a guaranteed pension;
5. When the average age of the employees is so high as to make actuarial contributions prohibitive, but the employer still wishes to provide some post-retirement assistance;
6. When the availability of distributions during employment is an important factor;
7. When a major objective of the employer is to encourage employee savings through a matching contribution plan;
8. Profit sharing plans are not subject to minimum funding requirements, plan termination insurance, and actuarial certification and reports. Profit sharing plans offer reduced administrative expenses and governmental regulations.

**Money Purchase Pension**

A money purchase plan is a pension plan but, nevertheless, it is categorized as a defined contribution plan. The employer contributes a fixed amount each year based upon a percentage of each employee’s compensation. The employee’s benefits are the amount of total contributions to the plan plus (or minus) investments gains (or losses).

<table>
<thead>
<tr>
<th>Profit Sharing &amp; Money Purchase Pension Plans</th>
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<tbody>
<tr>
<td><strong>Planholder</strong></td>
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<tr>
<td>Sole proprietorships (i.e., self-employed)</td>
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<td>------------------------------------------</td>
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<tr>
<td><strong>Eligibility Requirements</strong></td>
</tr>
<tr>
<td>The employer must include employees who have:</td>
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<tr>
<td>Reached age 21</td>
</tr>
<tr>
<td>Completed 2 years of service if 100% vesting is elected or completed</td>
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<tr>
<td>1 year of service if a vesting schedule is elected</td>
</tr>
<tr>
<td>The plan must also meet certain coverage and participant requirements.</td>
</tr>
<tr>
<td><strong>Contribution Limits</strong></td>
</tr>
<tr>
<td>Profit Sharing: Maximum deductible amount is 25% of total eligible participant compensation. Employer contributions are discretionary and can be based on, but are not limited to profits.</td>
</tr>
<tr>
<td>Money Purchase: Maximum deductible amount is 25% of total eligible participant compensation. Employer must contribute a predetermined percentage each year. Contributions are mandatory regardless of profits.</td>
</tr>
<tr>
<td>Combination Plans: Combined Money Purchase Pension and Profit Sharing Plans are subject to a single maximum deductible limit of 25% of compensation.</td>
</tr>
<tr>
<td>Annual Additions Maximum: Annual additions to any participant’s account may not exceed 100% of compensation, or $53,000 in 2016, if less. Minimum Employer Contribution may be required if plan primarily benefits key employees.</td>
</tr>
<tr>
<td><strong>Deadlines For Establishment &amp; Contributions</strong></td>
</tr>
<tr>
<td>Establishment: On or before the last day of the employer’s fiscal year, for the year in which the deduction is taken</td>
</tr>
<tr>
<td>Funding: On or before the date the employer’s federal income tax return is due, plus extensions.</td>
</tr>
<tr>
<td>Pension Plans: Must be funded no later than 8½ months after the plan year-end, even if the deadline for deduction purposes is later.</td>
</tr>
<tr>
<td>Filings: Each year there are assets in the plan, a 5500 series tax form should be filed with the IRS no later than the last day of the 7th month following the plan year end (except for certain “one participant” plans with $250,000 or less in assets).</td>
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<tr>
<td><strong>Distributions</strong></td>
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<tr>
<td>Earliest (without 10% tax penalty):</td>
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<tr>
<td>Death</td>
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<tr>
<td>Permanent disability</td>
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<tr>
<td>Attainment of age 59½</td>
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<td>Distribution to pay for deductible medical expenses</td>
</tr>
<tr>
<td>Separation from service and age 55</td>
</tr>
<tr>
<td>Plan termination and age 59%</td>
</tr>
<tr>
<td>Separation from service and periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59¾, if later</td>
</tr>
<tr>
<td>Payments made to an alternate payee because of a divorce settlement as required by a Qualified Domestic Relations Order</td>
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<tr>
<td>Profit Sharing Plans Only (if plan permits): In-service withdrawal and age 59¾. Hardship withdrawal and age 59¾.</td>
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<td>Latest (without 50% excise tax penalty):</td>
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Tax Treatment on Distribution

Taxed as ordinary income. Distributions from an account containing non-deductible voluntary contributions must consist of a non-taxable portion and a taxable portion.

Lump-Sum Distributions: Individuals who were age 50 on 1/1/86 can elect 10-year or 5-year averaging with limited capital gain treatment. Thus, averaging is not realistically available unless the individual was born before 1935.

Cafeteria Compensation Plan

Under a “cafeteria” or “flexible benefit plan” an employee can select from a package of employer provided benefits, some of which may be taxable and others not taxable. Employer contributions under a written plan are normally excluded from the employee’s gross income to the extent that nontaxable benefits are selected (§125(b)).

Thrift Plan

Thrift plans are a mixed breed of retirement plan. Although they vary in form, in general the employee contributes some percentage of their compensation to the plan; the employer then matches their contribution dollar for dollar or in some other way spelled out in the plan. Lower employer costs are a factor in the popularity of these plans.

Section 401(k) Plans

This is an arrangement whereby an employee will not be taxed currently for amounts contributed by an employer to an employee trust, even though the employee could have elected under the plan to receive the contribution in cash. Section 401(k) has several requirements:

(1) It must be a qualified profit-sharing or stock bonus plan;
(2) Each employee can elect to receive cash or to have an employer contribution made to the employee trust;
(3) Benefits are not distributable to an employee earlier than age 59½, termination of service, death, disability, or hardship;
(4) Each employee’s accrued benefit under the plan is fully vested; and
(5) There is no discrimination in favor of highly paid employees.

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<thead>
<tr>
<th>Planholder</th>
<th>Corporations</th>
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<td>The plan must also meet certain coverage and participant requirements. Employees who have completed 1 year of service must be eligible to make salary deferral contributions.</td>
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<td><strong>Maximum Deductible Amount</strong>: Maximum deductible amount is 25% of total eligible participant compensation. This amount includes employer basic, employer match and salary deferral. Employer contributions are discretionary and can be based on, but not limited to, profits.</td>
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<td><strong>Maximum Salary Deferral Amount</strong>: Not to exceed $18,000 (in 2016) and is included in the maximum contribution limit. Subject to a special anti-discrimination test.</td>
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<td><strong>Non-Deductible Voluntary Contributions</strong>: are included in the maximum contribution limit. Subject to a special anti-discrimination test.</td>
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**Review Questions**

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

**104.** The Code presents two sets of requirements so that plans would be nondiscriminatory. What is one of these requirements?

   a. The plan benefits a percentage of nonhighly compensated employees that is at least 50% of the percentage of nonhighly compensated employees benefiting under the plan.

   b. The plan benefits at least 70% of all the employees.

   c. The plan meets the discrimination classification test.

   d. The trust will qualify only when it benefits the lesser of 50 employees or 40% of all employees.

**105.** For matching contributions, plans must meet requirements up to minimum vesting schedules. Under the two-to-six year graded vesting schedule, what is the nonforfeitable claim to employer-derived benefits after three years of completed service?

   a. 40%.

   b. 60%.
c. 80%.
d. 100%.

106. Generally, the mechanics are the same for the defined benefit plans. How do defined benefit plans work?
   a. An individual account is established for each employee.
   b. Contributions to the employee’s account are based on a formula that is usually expressed as a percentage of the employee’s salary.
   c. The employer defines or fixes the annual cost.
   d. The employer must make adequate funding under ERISA.

107. The author identifies four circumstances under which defined contribution plans would be auspicious. What is one of these circumstances?
   a. The principals of a cyclical business want to be able to make contributions in only good years.
   b. The principals are relatively old.
   c. The principals want the plan costs tied to age, actuarial assumptions, or the rise and fall of the stock market.
   d. There are younger employees and the principals want to make the higher contributions necessary.

108. A profit sharing plan is a type of defined contribution plan. What is a characteristic of a profit sharing plan of the deferred type?
   a. Total contributions are limited to $5,500 per working individual.
   b. Employer contributions are flexible and can be based on profits.
   c. Employer contributions are mandatory regardless of profits.
   d. Employer must contribute a predetermined percentage each year.

109. Section 401(k) plans must meet five requirements. What is one such requirement?
   a. Employees may receive benefits at any time.
   b. Plan benefits that have accrued are fully vested.
   c. The plan must be a qualified money purchase pension plan.
   d. Employees must receive cash.
Death Benefits

Death benefits under a qualified plan are permissible only if they are “incidental” (Reg. §1.401-1(b)(1)(i)). Although non-insured death benefits must also be incidental, our discussion will be limited to pre-retirement death benefits that are provided by life insurance.

The specific rules are as follows:

Defined Benefit Plans

Under defined benefit plans, if whole life or (preferably) universal life insurance is purchased, the death benefit is incidental only if one of the following three requirements is met:

1. The amount of life insurance does not exceed 100 times the anticipated monthly retirement benefit;
2. The death benefit is equal to the reserve (cash value) under the policy plus the participant’s share of the auxiliary fund; or
3. Where less than 50% of the total contributions for a participant are used to pay premiums, the total death benefit may consist of the face amount of insurance plus the participant’s account or share in the auxiliary fund.

Money Purchase Pension & Target Benefit Plans

Where whole life is purchased, the total life insurance premiums must be less than 50% of the total contributions made on behalf of a participant. Alternatively, the 100 to 1 rule may be satisfied.

Where pure term or universal life is purchased, the premiums may not exceed 25% of the contributions for a participant. Where whole life and term are purchased, the term premium plus 50% of the whole life premium must meet the 25% test.

Employee Contributions

Sometimes an employer establishes a plan that requires employees to contribute as a condition of participation. Under pension plans, employees may be required to contribute in order to reduce the employer’s cost. Profit sharing thrift plans require employees to contribute in order to receive the benefit of a matching employer contribution.
Non-Deductible

In either case, the employee’s contribution is not deductible. An important note is that if employee contributions are required, the plan is still not permitted to be discriminatory.

Employees may also be permitted to make voluntary contributions to the plan that are, of course, also not deductible.

Specific nondiscrimination rules apply to employers making matching contributions. These nondiscrimination rules are essentially the same as for §401(k) plans.

Life Insurance in the Qualified Plan

Cash value life insurance purchased under the auspices of a qualified plan have the dual advantage of provided cash with which to fund the retirement aspect of the plan, and simultaneously providing an additional death benefit over and above the $50,000 limit of group term in the event that the employee dies prior to retirement (although I have had employees who were dead for years and then retired).

Return

Although the cash accumulation of a life insurance policy is generally a little lower than that of an annuity, it will generally surpass most CDs, and carries no more risk than an annuity. The advantage of having the death benefit provided under the same policy that will provide the retirement benefits may be sufficient inducement for an employer to opt for the slightly lower net yield.

Universal Life

In the event that life insurance policies are used to fund the retirement plan, a universal life product will probably be the most advantageous product to use. In addition, universal life insurance would be the product of choice in the profit sharing plan, since the premiums are entirely flexible (i.e., in a year with low profits, you don’t have to worry a great deal about lapsed policies or forced contributions in excess of profits to keep the policies in force).

Compare

Although the general requirements for using life insurance to fund the qualified plan have been discussed, it is not enough to merely know about the use of “life insurance.” The policies offered by different companies, although similar in function, can have substantial differences in terms of mortality cost, current rates, methods of determining current rates, interest bonuses, and guaranteed rates to name a few. You should carefully consider several plans
of insurance in several different scenarios before making any specific recommendations to your client.

Plan Terminations & Corporate Liquidations

A qualified plan must be intended as permanent. If a plan is terminated within a few years of its inception for other than a valid business reason, the plan may be subject to retroactive disqualification with the resultant loss of all corporate deductions. For this reason, if a plan termination is contemplated, a favorable determination should be applied for and received from the IRS prior to any such termination. This permanency requirement does not impede the employer’s customarily retained right to unilaterally terminate the plan or cease contributions. The termination of a plan requires that all participants be fully vested in their accrued benefits or account balances. ERISA may require specific allocations to be made upon the termination of a defined benefit plan.

10-Year Rule

A consequence of the termination of a profit sharing plan because of the cessation of contributions is the immediate and full vesting of the account balances. After the plan has been in existence for ten years, it may be discontinued without the necessity of the employer showing a valid business reason. The complete liquidation of an employer would ordinarily be sufficient grounds for the termination of the plan and trust, thereby avoiding the tax penalties.

Lump-Sum Distributions

As long as lump-sum payments are made to plan participants on account of their separation from service, or upon attainment of at least age 55½, ten-year income averaging will be available. The IRS has ruled that a separation from service for tax purposes occurs only upon the employee’s death, retirement, resignation, or discharge. However, if the corporation is liquidated and the former owners decide to separately conduct their professional practices, a separation from corporate service will have occurred.

Asset Dispositions

Another potential way of handling the assets of a qualified plan upon the liquidation of the employer is to terminate the plan but maintain the trust. Distributions can then be made to the plan participants according to the terms of the trust.

Under ERISA, a qualified lump-sum distribution may be rolled over tax-free into an individual IRA if the transfer is made within 60 days of the date on which the participant receives such distribution.
Only that portion of the distribution that represents employer contributions may be rolled over. Non-deductible employee contributions are not eligible for the rollover although the earnings on such contributions and any deductible voluntary employee contributions may be rolled over.

A major shortcoming of this rollover provision is that ultimately, the distributions from the IRA will be fully taxable as ordinary income without the potential but limited benefit of ten-year averaging. If the amounts to be rolled over are eligible to be rolled over into another qualified corporate or Keogh retirement plan however, ten-year averaging may be allowed with respect to any ultimate lump-sum distributions.

**IRA Limitations**

Although an IRA may not receive or invest in a life insurance contract of any kind whatsoever, this provision should not create any major problems for a split funded corporate retirement plan where it is desirable to keep the life insurance in force. The reason for this is that partial rollovers are permissible under §402(a)(5) so that employee life insurance policies need not be rolled over.

**Self-Employed Plans - Keogh**

Although qualified plans for unincorporated businesses are now virtually equal with corporate plans, there are still sufficient differences to warrant a brief discussion of them separately from all other plans.

*Note:* The term “Keogh plan” has been used over the years to distinguish a retirement plan established by a self-employed individual or partnership from a corporate retirement plan. However, with fewer and fewer differences, a self-employed plan is increasingly referred to by its characteristic format (e.g., SEP IRA, SIMPLE 401(k), self-employed 401(k) or even defined contribution or defined benefit plan).

While the federal tax consequences will undoubtedly be a consideration in the decision to incorporate, it is unlikely that the availability of a corporate retirement plan will weigh considerably as one of the considerations.

**Contribution Timing**

Cash basis self-employeds are now afforded the advantages of accrual basis taxpayers for purposes of making their contributions to Keogh plans. That is, a contribution may be made any time prior to the due date of the return, rather than by the close of the taxable year. This is undoubtedly of considerable benefit to those taxpayers who have set-up Keogh profit sharing plans. Prior to this change, it was virtually impossible to determine the allowable amount of the contribution by the close of the tax year since a self-employed individual does not generally know how much they will earn during a taxable year until the year is over.
However, the Keogh plan itself, as well as any related trust instruments, must be established prior to the close of the taxable year for which the first contributions are to be made.

**Controlled Business**

Where an owner-employee controls (either as a sole proprietor or as a more than 50% partner), one unincorporated business and participates as an owner-employee in the Keogh plan of another unincorporated business, whether or not he or she controls the second business, he or she must establish a plan for the regular employees of the business that they control with benefits or contributions similar to those which they are receiving. Therefore, if a 10% or less partner participates in a Keogh plan, they do not need to establish a similar plan for the sole proprietorship that they own.

If the individual in question controls more than one business, they must treat the controlled businesses as one for purposes of figuring the maximum contribution that they can make for themselves. An owner-employee’s maximum contribution limits cannot be exceeded even though they participate in more than one plan. That is to say, participation in two plans does not double the allowable deduction.

**General Limitations**

Under the provisions of ERISA, all businesses that are under common control, including incorporated businesses, unincorporated businesses, estates and trusts, must be aggregated for purposes of the limitations on benefits, contributions, participation, and vesting. The regulations to §414(b) and (c) state that the percentage to be applied to determine if there is common control are 80% in the case of parent-subsidiary controlled groups and the 80% and more than 50% tests for brother-sister controlled groups.

As a result of ERISA, corporate and noncorporate employees are generally taxed alike on their distributions. An owner-employee’s cost basis does not include any taxable or non-deductible term cost charges when a Keogh plan has been funded with life insurance.

The beneficiary of a deceased self-employed person or owner-employee will generally be taxed in the same manner as the deceased would have been taxed. When life insurance proceeds are paid as a death benefit, the excess of the proceeds over the policy’s cash value will be tax-free.

**Effect of Incorporation**

A partnership or sole proprietorship may have an existing Keogh plan at the time of incorporation. Since a qualified corporate plan will generally be created, the
following alternatives concerning the disposition of the Keogh account should be considered:

1. The plan may be frozen. All employer and employee contributions simply stop. Life insurance or annuity contracts may be placed on a reduced, paid-up basis but the extended term insurance option for life insurance in as much as immediate taxability may result to the self-employed. The assets in the plan or trust will continue to share in dividends, interest and capital appreciation on a tax-free basis. Distributions to self-employees and regular employees will continue to be governed by the plan’s provisions and the IRC restrictions. This approach is frequently used although the continued maintenance of the plan or trust typically requires the payment of administrative fees and annual reporting to the IRS.

2. The assets in the Keogh trust may be sold and the proceeds used by the trustee to purchase single premium nontransferable deferred annuities. These annuities can then be distributed tax-free to the participants who will be taxed only upon the surrender of the annuities or the commencement of payments. In addition, the trustee may continue to hold the annuities.

3. The assets of the Keogh plan may be transferred by the trustee, to the trustee of a qualified corporate account. The transferred Keogh assets must remain segregated from the corporate assets. This will probably increase the administrative costs somewhat. It is important that any such transfer be made only between the trustees or custodians of the two plans involved. It may also be possible to arrange for the transfer of a nontransferable annuity or retirement income endowment policy that is not held by a trustee or custodian (PLR 8332155).

4. Nontransferable annuity contracts which are part of an unincorporated plan and are not held by a trustee may be surrendered back to the insurer in consideration for which the insurer will issue new policies to the trustee of the qualified corporate plan (R. R. 73-259).

5. When the Keogh trust owns life insurance contracts, a sale of the contracts for their cash values to the trustee of a corporate plan is permissible since there is a fair exchange of values (R. R. 73-503). The life insurance contracts now held by the trustee of the corporate plan are no longer subject to any of the Keogh plan restrictions.

6. A self-employed individual or an owner-employee who receives a qualified lump-sum distribution in cash or property from his Keogh plan may make a tax-free rollover of all or part of the property or cash to an IRA or annuity. The rollover may not be made into an endowment contract, and must be made within the 60-day period.
Mechanics

A sole proprietor or a partnership (but not a partner) can set up a Keogh plan. Such plans can cover self-employed persons (e.g., the sole proprietor or partners) as well as common law employees.

Note: A common law employee, a partner or a shareholder in an S corporation cannot set up such a plan.

Under a Keogh plan, a self employed individual (this term includes a sole proprietor and partners owning 10% or more of an interest in a partnership) is allowed to take a deduction for money he or she sets aside to provide for retirement. Such a plan is also a means of providing retirement security for the employees working for the self-employed individual.

Parity with Corporate Plans

Since 1983, Keogh plans essentially match the benefits and contributions provided by corporate plans under the parity provisions of TEFRA. As a result, self employed individuals who may be disposed to incorporate to secure the greater corporate benefits will need to make a careful cost/benefit analysis before proceeding to incorporate. Since 1984, a bank no longer need be trustee.

Figuring Retirement Plan Deductions For Self-Employed

When figuring the deduction for contributions made to a self-employed retirement plan, compensation is net earnings from self-employment after subtracting:

(i) The deduction allowed for one-half of the self-employment tax, and
(ii) The deduction for contributions on behalf of the self-employed taxpayer to the plan.

This adjustment to net earnings in (ii) above is made indirectly by using a self-employed person’s rate.

Self-Employed Rate

If the plan’s contribution rate is a whole number (e.g., 12% rather than 12.5%), taxpayers can use the following table to find the rate that applies to them.

Self-Employed Rate Table

<table>
<thead>
<tr>
<th>Plan’s Rate</th>
<th>Self-Employed’s Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.009901</td>
</tr>
<tr>
<td>2</td>
<td>.019608</td>
</tr>
<tr>
<td>3</td>
<td>.029126</td>
</tr>
</tbody>
</table>
If the plan’s contribution rate is not a whole number (e.g., 10.5%), the taxpayer must calculate their self-employed rate using the following worksheet:

**Self-Employed Rate Worksheet**

1. Plan contributions rate as a decimal (for example, 10% would be 0.10) $\ldots$
2. Rate in Line 1 plus 1, as a decimal (for example, 0.10 plus 1 would be 1.10) $\ldots$
3. Divide Line 1 by Line 2, this is the taxpayer’s self-employed rate as a decimal $\ldots$

**Determining the Deduction**

Once the self-employed rate is determined, taxpayers figure their deduction for contributions on their behalf by completing the following steps:

**Step 1**
Enter the self-employed rate from the Table or Worksheet above $\ldots$

**Step 2**
Enter the amount of net earnings $\ldots$
from Line 29, Schedule C or Line 36, Schedule F
Step 3
Enter the deduction for self-employment tax from Line 25, Form 1040
Step 4
Subtract Step 3 from Step 2 and enter the amount
Step 5
Multiply Step 4 by Step 1 and enter the amount
Step 6
Multiply $265,000 (in 2016) by the plan contribution rate. Enter the result but not more than $53,000 (in 2016)
Step 7
Enter the smaller of Step 5 or Step 6. This is the deductible contribution.
Enter this amount on Line 27, Form 1040

Individual Plans - IRA’s

The government wants to encourage everyone to save for retirement. Savings for this purpose also contributes to the formation of investment capital needed for economic growth. For many individuals, including those covered by corporate retirement plans, IRAs play an important role.

Deemed IRA

If an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements that apply to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA for all purposes of the code (§408).

Mechanics

Any individual whether or not presently participating in a qualified retirement plan can set up an individual retirement plan (IRA) and take a deduction from gross income equal to the lesser of $5,500 (in 2016) or 100% of compensation. Individuals age 50 and older may make additional catchup IRA contributions. The maximum contribution limit (before application of adjusted gross income phase-out limits) for an individual who has celebrated his or her 50th birthday before the end of the tax year is increased by $500 for 2002 through 2005, and $1,000 for 2006 and later.
Note: One way in which taxation of a lump sum distribution may be postponed is by transferring it within 60 days of receipt of payment into an IRA. This postpones the tax until the funds are withdrawn.

Phase-out

The taxpayer and spouse must be nonactive participants to obtain the full benefits of an IRA. If either is an active participant in another qualified plan, the deduction limitation is phased out proportionately between $98,000 and $118,000 of AGI in 2016. For single and head of household taxpayers the phase out is between $61,000 and $71,000 in 2016 (up from $60,000 and $70,000 of AGI in 2014).

AGI

AGI is determined by taking into account §469 passive losses and §86 taxable Social Security benefits and ignoring any §911 exclusion and IRA deduction.

Special Spousal Participation Rule - §219(g)(1)

Deductible contributions are permitted for spouses of individuals who are in an employer-sponsored retirement plan. However, the deduction is phased out for taxpayers with AGI between $184,000 and $194,000 (in 2016).

<table>
<thead>
<tr>
<th>Individual Retirement Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Planholder</strong></td>
</tr>
<tr>
<td>Individual taxpayer</td>
</tr>
<tr>
<td>Individual taxpayer and non-working spouse</td>
</tr>
<tr>
<td><strong>Eligibility Requirements</strong></td>
</tr>
<tr>
<td>Individuals under 70½ years old who have earned income</td>
</tr>
<tr>
<td><strong>Contribution Limits</strong></td>
</tr>
<tr>
<td><strong>Maximum Contribution Limit:</strong></td>
</tr>
<tr>
<td>In 2016, $5,500 per working individual $11,000 per married couple with a working &amp; a non-working spouse</td>
</tr>
<tr>
<td><strong>Tax-Deductible Contributions - Who Qualifies:</strong></td>
</tr>
<tr>
<td>If neither individual nor spouse is covered by an employer-sponsored retirement plan, 100% is deductible at any income level.</td>
</tr>
<tr>
<td>If individual or spouse is covered by an employer-sponsored plan in 2016:</td>
</tr>
<tr>
<td><strong>Adjusted Gross Income</strong></td>
</tr>
<tr>
<td>Married</td>
</tr>
<tr>
<td>Below $98,000</td>
</tr>
</tbody>
</table>
### Deductibility

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Single Deductibility</th>
<th>Joint Deductibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below $61,000</td>
<td>Yes</td>
<td>Full</td>
</tr>
<tr>
<td>$61,000 - $71,000</td>
<td>Yes</td>
<td>Partial*</td>
</tr>
<tr>
<td>Over $71,000</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

* Subtract $200 of deductibility for each $1,000 of income over the floor amount (round to lowest $10); $200 minimum.

### Deadlines For Establishment & Contributions

- On or before tax filing deadline, not including extensions (usually April 15 or the next business day if April 15 falls on a holiday or weekend).

**Penalties:**
- $50 penalty for failure to file Form 8606 to report nondeductible contributions
- $100 penalty for overstating the designated amount of nondeductible contributions

### Distributions

**Earliest (without 10% tax penalty):**
- Death, Permanent disability, Attainment of age 59½: Periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if later. Transfer of assets from a participant’s IRA to spouse’s or former spouse’s IRA in accordance with a divorce or separation document.

**Latest (without 50% excise tax penalty):**
- April 1 of the calendar year following the year in which the participant reaches age 70½

### Tax Treatment on Distribution

All distributions from any type of IRA are taxed as ordinary income. Remember, however, that if the individual made nondeductible contributions, each distribution consists of a nontaxable portion and a taxable portion.

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**Spousal IRA**

If a taxpayer files a joint return and their compensation is less than that of their spouse, the most that can be contributed for the year to the taxpayer’s IRA is the lesser of:

1. $5,500 in 2016 (or $6,500 in 2016 if taxpayer is 50 or older), or
2. Total compensation includable in the gross income of both taxpayer and their spouse for the year, reduced by:
   - (a) The spouse's IRA contribution for the year to a traditional IRA, and
   - (b) Any contributions for the year to a Roth IRA on behalf of the spouse.

This means that the total combined contributions that can be made for the year to a taxpayer’s IRA and their spouse’s IRA can be up to $11,000 in 2016,
or $12,000 in 2016 if only one spouse is 50 or older, or $13,000 in 2016 if both spouses are 50 or older.

**Eligibility**

Individuals can set up and make contributions to a traditional IRA if:

1. They (or, if they file a joint return, their spouse) received taxable compensation during the year, and
2. They were not age 70½ by the end of the year.

An individual can have a traditional IRA whether or not they are covered by any other retirement plan. However, a taxpayer may not be able to deduct all of their contributions if the taxpayer or their spouse is covered by an employer retirement plan.

**Contributions & Deductions**

Any employer, including a corporation, may establish an IRA plan for the benefit of some or all of its employees. Contributions may be made by the employer on an additional compensation basis or on a salary reduction plan. There is no nondiscrimination requirement with respect to the establishment, availability or funding of an IRA plan. However, employee participation in an IRA plan cannot be used as a basis for determining nondiscrimination in any other employer provided plan. Installation and trustee fees paid by the employer with respect to such plans should be deductible as ordinary and necessary business expenses. A separate accounting is required for each employee’s interest in the trust, but commingling of assets is permissible for investment purposes.

**Employer Contributions**

Amounts contributed by an employer will be tax-deductible as additional compensation and includable in the employee’s income. However, the employee will be entitled to an offsetting deduction for the contributed amounts. Employer contributions will be subject to FICA and FUTA but not to federal income tax withholding if the employer reasonably believes that the employee will be entitled to a deduction for the contributed amounts.

**Retirement Vehicles**

Any individual may establish one or more of the types of IRA funding vehicles as long as the annual contributions limit is not exceeded in the aggregate. The types of funding vehicles available are as follows:

(a) A fixed or variable individual retirement annuity may be purchased. The contract must be nontransferable, nonforfeitable and may not be pledged as security for a loan except to the issuing insurance company. An endowment contract must have level premiums and the cash value at maturity must not
be less than the death benefit. In addition, the death benefit at some time during the contract must exceed the greater of the cash value or the premiums paid. Whole life insurance may not be used and, the annuity contract may provide for a waiver of premium, but no other collateral benefits.

(b) A written trust or custodial account may be used to fund an individual retirement account. The rules concerning the trustee are generally the same as those for a Keogh plan. The only prohibited investment for the account is life insurance. Trust assets must not be commingled with other assets except in a common trust or investment fund.

(c) Retirement bonds were available for purchase prior to April 30, 1982 and may still be retained by some IRA participants. Since these vehicles are no longer available there is little point in discussing them. Although the Code does not specifically prohibit an IRA from investing in certain types of property, an investment in collectibles will be regarded as a currently taxable distribution to the participant.

Note: Since 1987, United States minted gold and silver coins after December 31, 1986, are not considered to be collectibles.

Distribution & Settlement Options

In order to encourage participants to set aside funds for their retirement, tax law imposes a 10% penalty tax on “pre-mature distributions.” That is, distributions that are received by the participant prior to the attainment of age 59½. This penalty tax is imposed in addition to the participant’s ordinary income tax liability. However, this penalty does not occur where the distribution is the result of the death, disability or the timely repayment of excess contributions.

Life Annuity Exemption

Distributions made prior to age 59½ are exempted from the penalty tax if they are made over a period of years based on the participant’s life expectancy. Payments may also be made in the form of a joint and survivor annuity based on the participant’s and the spouse’s life expectancy and must be substantially equal.

The plan must provide for a lump-sum distribution of the participant’s entire interest no later than the required beginning date or for a distribution under one of the following periods:

(a) The participant’s life;
(b) The lives of the participant and a designated beneficiary;
(c) A period of years not in excess of the participant’s life expectancy; or
(d) A period of years not in excess of the life expectancy of the participant and a designated beneficiary.
Minimum Distributions

Funds cannot be kept indefinitely in a traditional IRA. Eventually they must be distributed. However, the requirements for distributing IRA funds differ, depending on whether the taxpayer is the IRA owner or the beneficiary of a decedent’s IRA.

Owners of traditional IRAs must start receiving distributions by April first of the year following the year in which they attained age 70½. April 1st of the year following the year in which a taxpayer reaches age 70½ is referred to as the required beginning date (RBD).

**Note:** The minimum distribution amount for the year the taxpayer attained age 70 ½ must be received no later than April 1st of the next year. Thereafter, the required minimum distribution for any year must be made by December 31st of that later year.

If the minimum required distribution is not made, then an excise tax equal to 50% of the excess of the minimum required distribution over the amount actually distributed will be imposed on the payee.

Required Minimum Distribution

The required minimum distribution for each year is determined by dividing the IRA account balance as of the close of business on December 31st of the preceding year by the applicable distribution period or life expectancy.

2009 Waiver of Required Minimum Distribution Rules (Expired)

For 2009, under the Worker, Retiree, and Employer Recovery Act, no minimum distribution was required for calendar year 2009 from individual retirement plans and employer-provided qualified retirement plans that were defined contribution plans (within the meaning of section 414(i)). Thus any annual minimum distribution for 2009 from these plans required under current law, otherwise determined by dividing the account balance by a distribution period, was not required to be made. The next required minimum distribution calendar year was 2010. This relief applied to life-time distributions to employees and IRA owners and after-death distributions to beneficiaries.

**Comment:** In short, the Act suspended the minimum distribution requirements, both initial and annual required distributions, for defined contribution arrangements, including IRAs, for calendar year 2009. Thus, plan participants and beneficiaries were allowed, but were not required, to take required minimum distributions for 2009. However, it should be noted that the required distributions for 2008, or for years after 2009, were not waived by the new law.
Definitions

IRA Account Balance

The IRA account balance is the amount in the IRA at the end of the year proceeding the year for which the required minimum distribution is being figured. The IRA account balance is adjusted by certain contributions, distributions, outstanding rollovers, and recharacterizations of Roth IRA conversions.

Designated Beneficiary

The term “designated beneficiary” is a term of art, and basically means that the beneficiary must be a human being. Thus, an estate is not a “designated beneficiary” nor is a charity or other legal entity. If there is more than one beneficiary, then all of them must be human beings, or there is no designated beneficiary.

Note: There is an exception to this rule if each beneficiary has his or her or their own certain separate account.

If the beneficiary is a trust, and all of the beneficiaries of the trust are human beings, they will be treated as designated beneficiaries, if certain conditions are met.

Date The Designated Beneficiary Is Determined

Generally, the designated beneficiary is determined on the last day of the calendar year following the calendar year of the IRA owner’s death. Any person who was a beneficiary on the date of the owner’s death, but is not a beneficiary on the last day of the calendar year following the calendar year of the owner’s death (because, for example, he or she disclaimed entitlement or received his or her entire benefit), will not be taken into account in determining the designated beneficiary.

Distributions during Owner’s Lifetime & Year of Death after RBD

Required minimum distributions during the owner’s lifetime (and in the year of death if the owner dies after the required beginning date) are based on a distribution period that generally is determined using Table III from IRS Publication 590 and set forth below. The distribution period (i.e., which table is used) is not affected by the beneficiary’s age unless the sole beneficiary is a spouse who is more than 10 years younger than the owner.

Table III
### Uniform Lifetime

For Use by Unmarried Owners and Owners Whose Spouses Are Not More Than 10 Years Younger

<table>
<thead>
<tr>
<th>Age</th>
<th>Distribution Period</th>
<th>Age</th>
<th>Distribution Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td>27.4</td>
<td>93</td>
<td>9.6</td>
</tr>
<tr>
<td>71</td>
<td>26.5</td>
<td>94</td>
<td>9.1</td>
</tr>
<tr>
<td>72</td>
<td>25.6</td>
<td>95</td>
<td>8.6</td>
</tr>
<tr>
<td>73</td>
<td>24.7</td>
<td>96</td>
<td>8.1</td>
</tr>
<tr>
<td>74</td>
<td>23.8</td>
<td>97</td>
<td>7.6</td>
</tr>
<tr>
<td>75</td>
<td>22.9</td>
<td>98</td>
<td>7.1</td>
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<td>76</td>
<td>22.0</td>
<td>99</td>
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<tr>
<td>77</td>
<td>21.2</td>
<td>100</td>
<td>6.3</td>
</tr>
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<td>78</td>
<td>20.3</td>
<td>101</td>
<td>5.9</td>
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<td>79</td>
<td>19.5</td>
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<td>80</td>
<td>18.7</td>
<td>103</td>
<td>5.2</td>
</tr>
<tr>
<td>81</td>
<td>17.9</td>
<td>104</td>
<td>4.9</td>
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<td>82</td>
<td>17.1</td>
<td>105</td>
<td>4.5</td>
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<td>83</td>
<td>16.3</td>
<td>106</td>
<td>4.2</td>
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<td>84</td>
<td>15.5</td>
<td>107</td>
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<td>86</td>
<td>14.1</td>
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<td>87</td>
<td>13.4</td>
<td>110</td>
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<td>88</td>
<td>12.7</td>
<td>111</td>
<td>2.9</td>
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<td>89</td>
<td>12.0</td>
<td>112</td>
<td>2.6</td>
</tr>
<tr>
<td>90</td>
<td>11.4</td>
<td>113</td>
<td>2.4</td>
</tr>
<tr>
<td>91</td>
<td>10.8</td>
<td>114</td>
<td>2.1</td>
</tr>
<tr>
<td>92</td>
<td>10.2</td>
<td>115 and over</td>
<td>1.9</td>
</tr>
</tbody>
</table>
Sole Beneficiary Spouse Who Is More Than 10 Years Younger

If the sole beneficiary is owner’s spouse and their spouse is more than 10 years younger than the owner, use the life expectancy from Table II (Joint Life and Last Survivor Expectancy) in IRS Publication 590.

The life expectancy to use is the joint life and last survivor expectancy listed where the row or column containing the owner’s age as of their birthday in the current year intersects with the row or column containing their spouse’s age as of his or her birthday in the current year. To figure the required minimum distribution for the current year divide the account balance at the end of the preceding year by the life expectancy.

Distributions after Owner’s Death

Beneficiary Is an Individual

If the designated beneficiary is an individual, such as the owner’s spouse or child, required minimum distributions for years after the year of the owner’s death generally are based on the beneficiary’s single life expectancy.

Note: This rule applies whether or not the death occurred before the owner’s required beginning date.

To figure the required minimum distribution for the current year, divide the account balance at the end of the preceding year by the appropriate life expectancy from Table I (Single Life Expectancy) (For Use by Beneficiaries) in IRS Publication 590. Determine the appropriate life expectancy as follows.

• Spouse as sole designated beneficiary. Use the life expectancy listed in the table next to the spouse’s age (as of the spouse’s birthday in the current year). If the owner died before the year in which he or she reached age 70½, distributions to the spouse do not need to begin until the year in which the owner would have reached age 70½.

• Surviving spouse. If the designated beneficiary is the owner’s surviving spouse, and he or she dies before he or she was required to begin receiving distributions, the surviving spouse will be treated as if he or she were the owner of the IRA.

Note: The Pension Protection Act of 2006 extended the special treatment granted to spousal beneficiaries to nonspouse beneficiaries.

• Other designated beneficiary. Use the life expectancy listed in the table next to the beneficiary’s age as of his or her birthday in
the year following the year of the owner’s death, reduced by one for each year since the year following the owner’s death. A beneficiary who is an individual may be able to elect to take the entire account by the end of the fifth year following the year of the owner’s death. If this election is made, no distribution is required for any year before that fifth year.

Multiple Individual Beneficiaries

If as of the end of the year following the year in which the owner dies there is more than one beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary if both of the following apply:

i. All of the beneficiaries are individuals, and

ii. The account or benefit has not been divided into separate accounts or shares for each beneficiary.

Beneficiary Is Not an Individual

If the owner’s beneficiary is not an individual (e.g., if the beneficiary is the owner’s estate), required minimum distributions for years after the owner’s death depend on whether the death occurred before the owner’s required beginning date.

a. Death on or after required beginning date. To determine the required minimum distribution for the current year divide the account balance at the end of the preceding year by the appropriate life expectancy from Table I (Single Life Expectancy) (For Use by Beneficiaries) in IRS Publication 590. Use the life expectancy listed next to the owner’s age as of his or her birthday in the year of death, reduced by one for each year since the year of death.

b. Death before required beginning date. The entire account must be distributed by the end of the fifth year following the year of the owner’s death. No distribution is required for any year before that fifth year.

Trust as Beneficiary

A trust cannot be a designated beneficiary even if it is a named beneficiary. However, the beneficiaries of a trust will be treated as having been designated as beneficiaries if all of the following are true:

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

3. The beneficiaries of the trust who are beneficiaries with respect to the trust’s interest in the employee’s benefit are identifiable from the trust instrument.

4. The IRA trustee, custodian, or issuer has been provided with either a copy of the trust instrument with the agreement that if the trust instrument is amended, the administrator will be provided with a copy of the amendment within a reasonable time, or all of the following:

   (a) A list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement),

   (b) Certification that, to the best of the employee’s knowledge, the list is correct and complete and that the requirements of (1), (2), and (3) above, are met,

   (c) An agreement that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the IRA trustee, custodian, or issuer corrected certifications to the extent that the amendment changes any information previously certified, and

   (d) An agreement to provide a copy of the trust instrument to the IRA trustee, custodian, or issuer upon demand.

   If the beneficiary of the trust is another trust and the above requirements for both trusts are met, the beneficiaries of the other trust will be treated as having been designated as beneficiaries for purposes of determining the distribution period.

Inherited IRAs

The beneficiaries of a traditional IRA must include in their gross income any distributions they receive. The beneficiaries of a traditional IRA can include an estate, dependents, and anyone the owner chooses to receive the benefits of the IRA after he or she dies.

**Spouse.** If an individual inherits an interest in a traditional IRA from their spouse, they can elect to treat the entire inherited interest as their own IRA.

**Beneficiary other than spouse.** Formerly, when an individual inherited a traditional IRA from someone other than their spouse, they could not treat it as their own IRA. They could not roll over any part of it or roll any amount over into it (§408(d)(3)(C)). In addition, they were not permitted to make any contributions to an inherited traditional IRA (§219(d)(4)).
However, the Pension Protection Act of 2006 extended the special treatment granted to spousal beneficiaries to nonspousal beneficiaries. For distributions after 2006, nonspousal beneficiaries are allowed to roll over (in a trustee to trustee roll over) to an IRA structured for that purpose amounts inherited as a designated beneficiary. Thus, the benefits of a beneficiary other than a surviving spouse maybe transferred directly to an IRA.

The IRA is treated as an inherited IRA of the nonspousal beneficiary. For example, distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries. The provision applies to amounts payable to a beneficiary under a qualified retirement plan, governmental §457 plan, or a tax-sheltered annuity.

Note: Nonspousal beneficiaries can also apply for waivers of the 60 day rollover period. In addition, this provision will benefit same-sex couples.

**Estate Tax Deduction**

A beneficiary may be able to claim a deduction for estate tax resulting from certain distributions from a traditional IRA. The beneficiary can deduct the estate tax paid on any part of a distribution that is income in respect of a decedent. He or she can take the deduction for the tax year the income is reported.

**Review Questions**

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.
110. One condition must be met in order for a death benefit under a qualified plan to be allowable. What is this condition?
   a. It is more than the cash value under the policy.
   b. It is incidental.
   c. The expected retirement benefit doesn’t exceed 100 times the life insurance amount.
   d. The total benefit does not include the face amount of insurance.

111. A consideration of incorporating is how to deal with a self-employed retirement plan. How might a self-employed individual deal with her self-employed plan upon incorporation?
   a. A qualified lump-sum cash distribution from the plan may be taxed on a rollover into an IRA.
   b. Annuity contracts that are nontransferable, part of the plan, and not held by a trustee may be moved to a qualified corporate account.
   c. Account assets may be moved to a Keogh account.
   d. The plan may be frozen.

112. A Keogh plan is a special plan for certain individuals to take a deduction for money they set aside to provide for retirement. Which individuals may use this plan?
   a. sole proprietors.
   b. employees of an S corporation.
   c. employees of a C corporation.
   d. partners owning 10% or less of an interest in partnerships.

113. Individual taxpayers, and individuals taxpayers and their non-working spouses, may be individual retirement arrangement (IRA) participants. What are the eligibility requirements IRAs?
   a. completed 1 year of service if vesting schedule is elected.
   b. completed 2 years of service if 100% vesting is elected.
   c. individuals under 70½ years old who have earned income.
   d. sole proprietor or more than 50% partner.

114. If four conditions are met, trust beneficiaries will be treated as having been designated as beneficiaries of an individual retirement arrangement (IRA). What is one of these four conditions?
   a. Trust beneficiaries cannot be identified by the trust instrument.
   b. A trust instrument lies with the IRA trustee, and it is agreed that, if amended, they will be provided with a copy within a reasonable time.
   c. The trust is revocable.
   d. The trust is a valid trust under federal law.
Post-Retirement Tax Treatment of IRA Distributions

The cost basis of a participant in an IRA account is almost always zero. Therefore, all distributions are fully taxable as ordinary income in the year in which they are received. The distribution of an annuity contract to a participant is not taxable when received. Rather, when the annuity payments begin, they will be fully taxable as ordinary income. Furthermore, the transfer of a participant’s interest in an IRA plan to their former spouse under a decree of divorce or a written instrument incident to such divorce is not a taxable distribution. Thereafter, the IRA will be treated for tax purposes as being owned by the former spouse.

Income In Respect of a Decedent

Distributions to a beneficiary or estate of a deceased individual will generally be taxed in the same manner as if the participant received them. Life insurance death benefits however, will not lose their tax-exempt character. Any amounts that are taxable to the beneficiary should be regarded as income in respect of a decedent. Therefore, the beneficiary will be entitled to a deduction from gross income for any federal estate taxes attributable to the inclusion of the IRA in the decedent’s gross estate.

Estate Tax Consequences

The estate tax consequences are generally nil, since the surviving spouse is usually the beneficiary and is entitled to the unlimited marital deduction. However, there were previously some interesting rules in effect which worked to exclude $100,000 of the IRA amount from the gross estate of the
decedent. These rules were repealed by TEFRA and, therefore, some estate plans may need reworking to prevent the over-funding of the “by-pass trust.”

**Losses on IRA Investments**

If a taxpayer has a loss on their traditional IRA investment, they can recognize the loss on their income tax return, but only when all the amounts in all their traditional IRA accounts have been distributed to them and the total distributions are less than their unrecovered basis, if any. Basis is the total amount of the nondeductible contributions in the traditional IRAs. The loss is claimed as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income. A similar rule applies to Roth IRAs. The rule applies separately to each kind of IRA. Thus, to report a loss in a Roth IRA, all the Roth IRAs (but not traditional IRAs) have to be liquidated, and to report a loss in a traditional IRA, all the traditional IRAs (but not Roth IRAs) have to be liquidated.

**Prohibited Transactions**

If an individual engages in a prohibited transaction with their account, the account will become disqualified retroactively to the first day of the calendar year in which the disqualifying event occurs. Where an employer or a union has established a retirement account, and a participant engages in a prohibited transaction, such individual’s account will be treated as a separate account for disqualification purposes.

The examples of prohibited transactions with a traditional IRA include:

(a) Borrowing money from it,
(b) Selling property to it,
(c) Receiving unreasonable compensation for managing it,
(d) Using it as security for a loan, and
(e) Buying property for personal use (present or future) with IRA funds.

**Effect of Disqualification**

If an IRA is disqualified, the participant is taxed as though they received a complete distribution of the fair market value of the assets in the account. Furthermore, all income accrued in the account subsequent to such disqualification will be currently taxable to the recipient.

**Penalties**

For each prohibited transaction by a sponsoring employer or union, the law imposes a tax of 15% of the amount involved. Such tax is to be paid by any disqualified person who engages in the prohibited transaction, with the exception of a fiduciary acting only in that capacity. If the transaction is not cor-
rected within the correction period, then an additional tax equal to 100% of the amount involved is imposed. However, an account will not be disqualified where an employer commits the prohibited transaction. This excise tax of 15% or 100% is not imposed on an individual who engages in a prohibited transaction with respect to their own account. Prohibited transactions are defined in §4975.

Borrowing on an Annuity Contract

If an owner borrows money against their traditional IRA annuity contract, they must include in their gross income the fair market value of the annuity contract as of the first day of their tax year. They may also have to pay the 10% additional tax on early distributions.

Tax-Free Rollovers

Generally, a rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another retirement plan. The tax-free rollover provisions relate to all types of qualified plans, IRAs, annuities, and TSAs.

Note: A transfer of funds in a traditional IRA from one trustee directly to another, either at the taxpayer’s request or at the trustee’s request, is not a rollover. Since there is no distribution to the taxpayer, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers.

Amounts paid or distributed to an individual out of an IRA or annuity are not currently taxable if:

(1) The amount so received is reinvested into another IRA within the 60 day period allowed by law; or

Note: For distributions made after December 31, 2001, no hardship distribution can be rolled over into an IRA.

(2) The amount received represents the amount in the account or the value of the annuity attributable solely to a rollover contribution from a qualified corporate trust or qualified annuity plan and the amount, together with any earnings, is paid into another qualified corporate account or Keogh plan or trust within the 60 day period.

Note: Generally, a rollover is tax free only if a taxpayer makes the rollover contribution by the 60th day after the day they receive the distribution. Beginning with distributions after December 31, 2001, the IRS may waive the 60-day requirement where it would be against equity or good conscience not to do so.

Amounts not rolled over within the 60-day period do not qualify for tax-free rollover treatment. Taxpayers must treat them as a taxable distribution from either their IRA or employer’s plan. These amounts are taxable in the year distributed,
even if the 60-day period expires in the next year. Taxpayers may also have to pay a 10% tax on early distributions.

**Rollover from One IRA to Another**

Taxpayers can withdraw, tax-free, all or part of the assets from one traditional IRA if they reinvest them within 60 days in the same or another traditional IRA. Since this is a rollover, taxpayers cannot deduct the amount that they reinvest in an IRA.

**Waiting Period between Rollovers**

If a taxpayer makes a tax-free rollover of any part of a distribution from a traditional IRA, they cannot, within a one-year period, make a tax-free rollover of any later distribution from that same IRA. In addition, taxpayers cannot make a tax-free rollover of any amount distributed, within the same one-year period, from the IRA into which they made the tax-free rollover. The one-year period begins on the date the taxpayer received the IRA distribution, not on the date they rolled it over into an IRA.

**Partial Rollovers**

If a taxpayer withdraws assets from a traditional IRA, they can roll over part of the withdrawal tax free and keep the rest of it. The amount kept will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% tax on premature distributions.

**Rollovers from Traditional IRAs into Qualified Plans**

For distributions after December 31, 2001, taxpayers can roll over tax free a distribution from their IRA into a qualified plan. The part of the distribution that they can roll over is the part that would otherwise be taxable. Qualified plans may, but are not required to, accept such rollovers.

**Rollovers of Distributions from Employer Plans**

For distributions after December 31, 2001, taxpayers can roll over both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA. If a taxpayer has both deductible and nondeductible contributions in their IRA, they will have to keep track of their basis so they will be able to determine the taxable amount once distributions from the IRA begin.

**Withholding Requirement**

If an eligible rollover distribution is paid directly to a participant, the payer must withhold 20% of it. This applies even if the participant plans to roll
over the distribution to a traditional IRA. This withholding can be avoided by a direct rollover.

<table>
<thead>
<tr>
<th>Affected item</th>
<th>Result of a payment to you</th>
<th>Result of a direct rollover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Withholding</td>
<td>The payer must withhold 20% of the taxable part.</td>
<td>There is no withholding.</td>
</tr>
<tr>
<td>Additional tax</td>
<td>If you are under age 59½, a 10% additional tax may apply to the taxable part (including an amount equal to the tax withheld) that is not rolled over.</td>
<td>There is no 10% additional tax.</td>
</tr>
<tr>
<td>When to report as income</td>
<td>Any taxable part (including the taxable part of any amount withheld) not rolled over is income to you in the year paid.</td>
<td>Any taxable part is not income to you until later distributed to you from the IRA.</td>
</tr>
</tbody>
</table>

**Waiting Period between Rollovers**

Taxpayers can make more than one rollover of employer plan distributions within a year. The once-a-year limit on IRA-to-IRA rollovers does not apply to these distributions.

**Conduit IRAs**

Taxpayers can use a traditional IRA as a holding account (conduit) for assets they receive in an eligible rollover distribution from one employer's plan that they later roll over into a new employer's plan. The conduit IRA must be made up of only those assets and gains and earnings on those assets. A conduit IRA will no longer qualify if mixed with regular contributions or funds from other.

**Keogh Rollovers**

If a taxpayer is self-employed, they are generally treated as an employee for rollover purposes. Consequently, if a taxpayer receives an eligible rollover distribution from a Keogh plan (a qualified plan with at least one self-employed participant), the taxpayer can roll over all or part of the distribution (including a lump-sum distribution) into a traditional IRA.

**Direct Rollovers From Retirement Plans to Roth IRAs**

Amounts that have been distributed from a tax-qualified retirement plan, a tax-sheltered annuity, or a governmental §457 plan may be rolled over into a traditional IRA, and then rolled over from the traditional IRA into a Roth IRA. However, historically, distributions from such plans could not be
rolled over directly into a Roth IRA. The Pension Protection Act of 2006 now allows distributions from tax-qualified retirement plans, tax-sheltered annuities, and governmental §457 plans to be rolled over directly from such plan into a Roth IRA, subject to the rules that apply to rollovers from a traditional IRA into a Roth IRA.

For example, a rollover from a tax-qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10% early distribution tax does not apply. Similarly, an individual with AGI of $100,000 or more could not roll over amounts from a tax-qualified retirement plan directly into a Roth IRA.

**Rollovers of §457 Plans into Traditional IRAs**

Prior to 2002, taxpayers could not roll over tax free an eligible rollover distribution from a governmental deferred compensation plan (as defined in §457) to a traditional IRA. Beginning with distributions after December 31, 2001, if a taxpayer participates in an eligible deferred compensation plan of a state or local government, they may be able to roll over part of their account tax free into an eligible retirement plan such as a traditional IRA. The most that a taxpayer can roll over is the amount that would be taxed if the rollover were not an eligible rollover distribution. Taxpayers cannot roll over any part of the distribution that would not be taxable. The rollover may be either direct or indirect.

**Rollovers of Traditional IRAs into §457 Plans**

Prior to 2002, taxpayers could not roll over tax free a distribution from a traditional IRA to a governmental deferred compensation plan. Beginning with distributions after December 31, 2001, if a taxpayer participates in an eligible deferred compensation plan of a state or local government, they may be able to roll over a distribution from their traditional IRA into a deferred compensation plan of a state or local government. Qualified plans may, but are not required to, accept such rollovers.

**Rollovers of Traditional IRAs into §403(B) Plans**

Prior to 2002, taxpayers could not roll over tax free a distribution from a traditional IRA into a tax-sheltered annuity. Beginning with distributions after December 31, 2001, a taxpayer may be able to roll over distributions tax free from a traditional IRA into a tax-sheltered annuity. They cannot roll over any amount that would not have been taxable. Although a tax-sheltered annuity is allowed to accept such a rollover, it is not required to do so.
Rollovers from SIMPLE IRAs

For distributions after December 31, 2001, taxpayers may be able to roll over tax free a distribution from their SIMPLE IRA to a qualified plan, a tax-sheltered annuity (§403(b) plan), or deferred compensation plan of a state or local government (§457 plan). Previously, tax-free rollovers were only allowed to other IRAs.

<table>
<thead>
<tr>
<th>Rollover Individual Retirement Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Planholder</strong></td>
</tr>
<tr>
<td>Recipients of partial or lump-sum distributions from an employer sponsored retirement plan within one taxable year. Distributions cannot be a series of periodic payments.</td>
</tr>
<tr>
<td><strong>Eligibility Requirements</strong></td>
</tr>
<tr>
<td>Recipients of total distributions due to:</td>
</tr>
<tr>
<td>- Separation from service*</td>
</tr>
<tr>
<td>- Attainment of age 59½</td>
</tr>
<tr>
<td>- Termination of plan by employer</td>
</tr>
<tr>
<td>- Permanent disability**</td>
</tr>
<tr>
<td>- Death of employee (if spouse is beneficiary)</td>
</tr>
<tr>
<td>- Qualified Domestic Relations Order</td>
</tr>
</tbody>
</table>

*Does not apply to self-employed individuals  
** Does apply to self-employed individuals  

| **Recipients of partial distribution due to:** |
| - Separation from service                     |
| - Death of employee (if spouse is beneficiary) |
| - Permanent disability                        |

| **Contribution Limits**                      |
| Maximum Contribution Limit: Up to 100% of the distribution. Employee voluntary non-deductible contributions cannot be rolled; earnings on these contributions can. The participant can keep a portion of the payout and roll over the rest. |

| **Deadlines For Establishment & Contributions** |
| Rollovers must be completed by the 60th day after receipt of the distribution. Rollovers from an employer-sponsored retirement plan are an irrevocable election. |

| **Distributions** |
| Earliest without 10% tax penalty: |
| - Death |
| - Permanent disability |
| - Attainment of age 59½ |
| - Periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59 ½, if late |
| - Transfer of assets from a participant’s IRA to spouse’s or former spouse’s IRA in accordance with a divorce or separation document. |

| Latest (without 50% excise tax penalty): |
| - April 1 of the calendar year following the year in which the participant reaches age 70½ |
**Roth IRA - §408A**

A Roth IRA is a special tax-free nondeductible individual retirement plan for individuals with AGI of $132,000 (in 2016) or less and married couples with AGI of $194,000 (in 2016) or less. It can be either an account or an annuity.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA. Unlike a traditional IRA, contributions to a Roth IRA are not deductible. However, distributions from a Roth IRA are tax free if made more than 5 years after a Roth IRA has been established and if the distribution is:

1. Made after age 59½, death, or disability, or
2. For first-time homebuyer expenses (up to $10,000).

**Eligibility**

Individuals can contribute to a Roth IRA if they have taxable compensation and their modified AGI is less than:

- **(a)** $194,000 (in 2016) for married filing jointly,
- **(b)** $10,000 (in 2016) for married filing separately and taxpayer lived with their spouse at any time during the year, and
- **(c)** $132,000 (in 2016) for single, head of household, qualifying widow(er) or married filing separately and taxpayer did not live with their spouse at any time during the year.

Contributions can be made to a Roth IRA regardless of an individual’s age. Contributions can be made to a Roth IRA for a year at any time during the year or by the due date of the individual’s return for that year (not including extensions).

**Contribution Limitation**

The contribution limit for Roth IRAs depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

**Roth IRAs Only**

If contributions are made only to Roth IRAs, taxpayer’s contribution limit generally is the lesser of:

1. $5,500 in 2016 or $6,500 in 2016 if you are 50 or older, or
2. Taxpayer’s taxable compensation.
However, if modified AGI is above a certain amount, the contribution limit may be reduced. Worksheets for determining modified adjusted gross income and this reduction are provided in the IRS Publication 590.

**Roth IRAs & Traditional IRAs**

If contributions are made to both Roth IRAs *and* traditional IRAs established for the taxpayer’s benefit, the contribution limit for Roth IRAs generally is the same as the limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.
### ROTH IRA Rules

<table>
<thead>
<tr>
<th>Tax Benefits:</th>
<th>Earnings &amp; qualified distributions are excluded from income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum Contribution:</td>
<td>Non-deductible $5,500 maximum per year for 2016</td>
</tr>
<tr>
<td>AGI phaseout:</td>
<td>MFJ: $184,000 - $194,000</td>
</tr>
<tr>
<td></td>
<td>Other: $117,000 - $132,000</td>
</tr>
<tr>
<td>Who is eligible?</td>
<td>Anyone regardless of age (subject to phaseout)</td>
</tr>
<tr>
<td>What is a qualified</td>
<td>5 years after 1(^{st}) contribution and:</td>
</tr>
<tr>
<td>distribution?</td>
<td>(1) after age 59½,</td>
</tr>
<tr>
<td></td>
<td>(2) after death,</td>
</tr>
<tr>
<td></td>
<td>(3) attributable to disability, or</td>
</tr>
<tr>
<td></td>
<td>(4) 1(^{st}) time home buyer (10K)</td>
</tr>
<tr>
<td>Nonqualified distributions:</td>
<td>Distributions recover basis first</td>
</tr>
<tr>
<td>Qualified rollover:</td>
<td>Regular IRA to Roth IRA or Roth IRA to Roth IRA</td>
</tr>
<tr>
<td>Conversion – Regular IRA to</td>
<td>(1) AGI must not exceed 100K</td>
</tr>
<tr>
<td>Roth IRA:</td>
<td>(2) If married, must file MFJ</td>
</tr>
<tr>
<td></td>
<td>(3) Must treat as a taxable distribution</td>
</tr>
<tr>
<td>98 Conversion Relief:</td>
<td>Income is spread over 4 years</td>
</tr>
<tr>
<td>Effective Date:</td>
<td>Tax years beginning after 1997</td>
</tr>
</tbody>
</table>
This means that the contribution limit is the lesser of:

1. $5,500 in 2016 or $6,500 in 2016 if taxpayer is 50 or older minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
2. Taxpayer’s taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if modified AGI is above a certain amount, the contribution limit may be reduced. Worksheets for determining modified adjusted gross income and this reduction are provided in the IRS Publication 590.

**Effect of Modified AGI on Roth IRA Contribution**

<table>
<thead>
<tr>
<th>IF you have taxable compensation and your filing status is:</th>
<th>AND your modified AGI is:</th>
<th>THEN:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Filing Jointly</td>
<td>Less than $184,000</td>
<td>You can contribute up to $5,500 in 2016 or $6,500 in 2016 if age 50 or older.</td>
</tr>
<tr>
<td></td>
<td>At least $184,000 but less than $194,000</td>
<td>The amount you can contribute is reduced.</td>
</tr>
<tr>
<td></td>
<td>$194,000 or more</td>
<td>You cannot contribute to a Roth IRA.</td>
</tr>
<tr>
<td>Married Filing Separately and you lived with your spouse at any time during the year</td>
<td>Zero (-0-)</td>
<td>You can contribute up to $5,500 in 2016 or $6,500 in 2016 if 50 or older.</td>
</tr>
<tr>
<td></td>
<td>More than zero (-0-) but less than $10,000</td>
<td>The amount you can contribute is reduced.</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>You cannot contribute to a Roth IRA.</td>
</tr>
<tr>
<td>Single, Head of Household, Qualifying Widow(er), or Married Filing Separately and you did not live with your spouse at any time during the year</td>
<td>Less than $117,000</td>
<td>You can contribute up to $5,500 in 2016 or $6,500 in 2016 if age 50 or older.</td>
</tr>
<tr>
<td></td>
<td>At least $117,000 but less than $132,000</td>
<td>The amount you can contribute is reduced.</td>
</tr>
<tr>
<td></td>
<td>$132,000 or more</td>
<td>You cannot contribute to a Roth IRA.</td>
</tr>
</tbody>
</table>

**Conversions**

It is possible to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. Taxpayers may be able to recharacterize contributions made
to one IRA as having been made directly to a different IRA. In addition, taxpayers can roll amounts over from one Roth IRA to another Roth IRA.

A conversion from a traditional IRA into a Roth IRA is allowable if, for the tax year the taxpayer makes a withdrawal from a traditional IRA, both of the following requirements are met:

1. Taxpayer’s modified AGI is not more than $100,000; and
2. Taxpayer is not a married individual filing a separate return.

Amounts can be converted from a traditional IRA to a Roth IRA in any of the following three ways:

1. **Rollover.** Taxpayer can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution. A rollover from a Roth IRA to an employer retirement plan is not allowed.

   **Note:** Taxpayers can withdraw all or part of the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. If properly (and timely) rolled over, the 10% additional tax on early distributions will not apply. Taxpayers must roll over into the Roth IRA the same property they received from the traditional IRA.

2. **Trustee-to-trustee transfer.** Taxpayer can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.

3. **Same trustee transfer.** If the trustee of the traditional IRA also maintains the Roth IRA, taxpayer can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

   **Note:** Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Taxpayers must include in their gross income distributions from a traditional IRA that they would have to include in income if they had not converted them into a Roth IRA.

**Recharacterizations**

Individuals may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution.

To recharacterize a contribution, the contribution must be transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for the tax return for the year during which the contribution was made, taxpayers can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. It will be treated as having
been made to the second IRA on the same date that it was actually made to the first IRA. Taxpayers must report the recharacterization, and must treat the contribution as having been made to the second IRA, instead of the first IRA, on their tax return for the year during which the contribution was made.

**Note:** If a taxpayer files their return timely without making the election, they can still make the choice by filing an amended return within six months of the due date of the return (excluding extensions).

**Reconversions**

Taxpayers cannot convert and reconvert an amount during the same taxable year, or if later, during the 30-day period following a recharacterization. If a taxpayer reconverts during either of these periods, it will be a failed conversion.

**Taxation of Distributions**

Taxpayers do not include in their gross income qualified distributions or distributions that are a return of their regular contributions from their Roth IRA(s). They also do not include distributions from their Roth IRA that they roll over tax free into another Roth IRA.

A qualified distribution is any payment or distribution from a taxpayer’s Roth IRA that meets the following requirements:

1. It is made after the 5 taxable period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for the taxpayer’s benefit, and
2. The payment or distribution is:
   a. Made on or after the date taxpayer reaches age 59½,
   b. Made because taxpayer is disabled,
   c. Made to a beneficiary or to taxpayer’s estate after taxpayer’s death, or
   d. One that meets the requirements for first-time homebuyer expenses (up to a $10,000 lifetime limit).

Taxpayers must pay a 10% additional tax on early distributions on the taxable part of any distributions that are not qualified distributions. Worksheets are provided in IRS Publication 590 to figure the taxable part of a distribution that is not a qualified distribution.

**No Required Minimum Distributions**

Taxpayers are not required to take distributions from their Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a
Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

If a Roth IRA owner dies, the minimum distribution rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his or her required beginning date. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is a qualified distribution.

**Simplified Employee Pension Plans (SEPs)**

A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make deductible contributions for the benefit of participating employees. The contributions are made to individual retirement arrangements (IRAs) set up for participants in the plan. Traditional IRAs set up under a SEP plan are referred to as SEP-IRAs (§408(k)).

Like an individual IRA, an employee may participate in a SEP even though he is also a participant in a qualified plan. A simplified employee pension plan is an IRA that meets all of the following requirements:

(a) For the calendar year, the employer contributes for each employee who has attained age 21 and who has performed any service for the employer during three of the preceding five years;

   **Note:** Any employee who has not earned at least $300 in the current year may be excluded; however, most part-time employees will have to be covered. Contributions and deductions are available even if the employee has attained age 70½ (the normal IRA age limit).

(b) Contributions must not discriminate in favor of highly compensated employees;

   **Note:** Employees who are members of unions where good faith bargaining on retirement benefits has occurred, as well as nonresident aliens with no income from sources within the United States may be excluded.

(c) Employer contributions may be integrated with Social Security based upon the rules for qualified defined contribution plans; and

   **Note:** However, contributions based on a salary reduction arrangement may not be integrated.

(d) Each plan participant must own the IRA account or annuity and employer contributions must not be conditioned upon the retention in such plan of any amount so contributed.

   **Note:** In other words, 100% immediate vesting and no prohibitions against withdrawals from the account;

(e) The employer has complete contribution flexibility since the employer is not required to contribute to the SEP each year regardless of whether or not there
are profits. The amount to be contributed each year may also vary at the election of the employer so long as the contributions remain nondiscriminatory in nature.

(f) Employer contributions must be made pursuant to a written instrument and be based on a definite written allocation formula that specifies:

(i) The requirements for an employee to share in an allocation; and

(ii) The manner in which the amount allocated is to be computed.

The Small Business Job Protection Act of 1996 eliminated salary reduction simplified employee pension plans (SAR-SEPs) in favor of SIMPLE retirement plans. However, SAR-SEPs in effect on 12/31/96 can continue to receive salary reduction contributions and new employees can make salary reduction contributions.

<table>
<thead>
<tr>
<th>Salary Reduction (SAR-SEP) &amp; Simplified Employee Pension Plans (SEP-IRA)</th>
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<tbody>
<tr>
<td><strong>Planholder</strong></td>
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<td>Corporations</td>
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<td>S corporations</td>
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<td>Non-profit organizations (SEP only)</td>
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<td>Partnerships</td>
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<td>Sole proprietorships (i.e., self-employed)</td>
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<td><strong>Eligibility Requirements</strong></td>
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<tr>
<td>The employer must include employees who have:</td>
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<td>Reached age 21</td>
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<tr>
<td>Worked at least 3 or more of the last 5 preceding years</td>
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<tr>
<td>Annual compensation of at least $600 (in 2016)</td>
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<tr>
<td>SEP: All eligible employees must participate in the plan.</td>
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<tr>
<td>SAR/SEP: Employer must have 25 or fewer eligible employees</td>
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<tr>
<td>at all times during the preceding year. 50% of all eligible</td>
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<tr>
<td>employees must participate in the salary reduction provision</td>
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<td>of the plan.</td>
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<tr>
<td><strong>Contribution Limits</strong></td>
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<tr>
<td>SEP Maximum Contribution Limit: Employer contributions are</td>
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<tr>
<td>limited to 25% of each participant’s compensation not to</td>
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<tr>
<td>exceed $53,000 in 2016 (overall limit includes employer</td>
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<td>basic and salary reduction contributions).</td>
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<tr>
<td>SAR/SEP Maximum Contribution Limit: Salary reduction</td>
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<td>contributions are limited to 25% of each participant’s</td>
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<td>compensation not to exceed $18,000 (in 2016). These</td>
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<tr>
<td>contributions, reported in Box 16 on the employee’s W-2</td>
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<td>Form, are subject to an anti-discrimination test.</td>
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<tr>
<td>Minimum SEP &amp; SAR/SEP Contribution: Minimum employer</td>
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<td>contribution of 3% may be required if certain highly</td>
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<td>compensated or key employees participate.</td>
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<td><strong>Deadlines For Establishment &amp; Contributions</strong></td>
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<tr>
<td>On or before the employer’s tax filing deadline plus</td>
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<td>extensions. A SEP may be maintained on a calendar or fiscal</td>
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<td>year basis.</td>
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<tr>
<td><strong>Distributions</strong></td>
</tr>
<tr>
<td>Earliest without 10% tax penalty:</td>
</tr>
</tbody>
</table>
Death
Permanent disability
Attainment of age 59½
Periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if later
Transfer of assets from a participant’s IRA to spouse’s or former spouse’s IRA in accordance with a divorce or separation document.

**Latest (without 50% excise tax penalty):**
April 1 of the calendar year following the year in which the participant reaches age 70½

<table>
<thead>
<tr>
<th>Tax Treatment on Distribution</th>
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</thead>
<tbody>
<tr>
<td>All distributions from any type of IRA are taxed as ordinary income. Remember, however, that if the individual made nondeductible contributions, each distribution consists of a nontaxable portion and a taxable portion.</td>
</tr>
</tbody>
</table>

**Contribution Limits & Taxation**

The SEP rules permit an employer to contribute to each participating employee's SEP-IRA up to 25% of the employee's compensation or $53,000 in 2016, whichever is less. These contributions are funded by the employer.

An employer who signs a SEP agreement does not have to make any contribution to the SEP-IRAs that are set up. But, if the employer does make contributions, the contributions must be based on a written allocation formula and must not discriminate in favor of highly compensated employees.

The employer's contributions to a SEP-IRA are excluded from the employee's income rather than deducted from it. This means that, unless there are excess contributions, employees do not include any contributions in their gross income; nor do they deduct any of them.

Employees can make contributions to their SEP-IRA independent of employer SEP contributions. They can deduct them the same way as contributions to a regular IRA. However, their deduction may be reduced or eliminated because, as a participant in a SEP, they are covered by an employer retirement plan.

**SIMPLE Plans**

A savings incentive match plan for employees (SIMPLE plan) is a tax-favored retirement plan that certain small employers (including self-employed individuals) can set up for the benefit of their employees. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions.

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

(1) Using SIMPLE IRAs (SIMPLE IRA plan), or
(2) As part of a §401(k) plan (SIMPLE 401(k) plan).

SIMPLE IRA Plan

A SIMPLE IRA plan is a retirement plan that uses SIMPLE IRAs for each eligible employee. Under a SIMPLE IRA plan, a SIMPLE IRA must be set up for each eligible employee.

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

Employers can set up a SIMPLE IRA plan if they meet both the following requirements:

(a) They meet the employee limit, and
(b) They do not maintain another qualified plan unless the other plan is for collective bargaining employees.

Employee Limit

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

Other Qualified Plan

The SIMPLE IRA plan generally must be the only retirement plan to which the employer makes contributions, or to which benefits accrue, for service in any year beginning with the year the SIMPLE IRA plan becomes effective. However, if the employer maintains a qualified plan for collective bargaining employees, they are permitted to maintain a SIMPLE IRA plan for other employees.

Set up

Employers can use Form 5304-SIMPLE or Form 5305-SIMPLE to set up a SIMPLE IRA plan. Each form is a model savings incentive match plan for employees (SIMPLE) plan document. Which form the employer uses depends on whether they select a financial institution or their employees select the institution that will receive the contributions.
Use Form 5304-SIMPLE if the employer allows each plan participant to select the financial institution for receiving his or her SIMPLE IRA plan contributions. Use Form 5305-SIMPLE if the employer requires that all contributions under the SIMPLE IRA plan be deposited initially at a designated financial institution.

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

**Contribution Limits**

Contributions are made up of salary reduction contributions and employer contributions. The employer must make either matching contributions or nonelective contributions. No other contributions can be made to the SIMPLE IRA plan. These contributions, which the employer can deduct, must be made timely.

**Salary Reduction Contributions**

The amount the employee chooses to have the employer contribute to a SIMPLE IRA on his or her behalf cannot be more than $12,500 in 2016. These contributions must be expressed as a percentage of the employee's compensation unless the employer permits the employee to express them as a specific dollar amount. The employer cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the $12,500 (in 2016) limit. Participants who are age 50 or over can make a catch-up contribution to a SIMPLE IRA of up to $2,500 in 2016.

**Employer Matching Contributions**

Employers are generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if the employer makes nonelective contributions.

Instead of matching contributions, employers can choose to make *nonelective* contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 (or some lower amount the employer selects) of compensation for the year. If the employer makes this choice, they must make nonelective contributions whether or not the employee chooses to make salary reduction contributions. Only $265,000 in 2016 of the employee's compensation can be taken into account to figure the contribution limit.
Deduction of Contributions

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

Distributions

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

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

SIMPLE §401(k) Plan

Employers can adopt a SIMPLE plan as part of a 401(k) plan if they meet the 100-employee limit. A SIMPLE 401(k) plan is a qualified retirement plan and generally must satisfy the rules discussed applicable to such type plans. However, a SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy rules if the plan meets the following conditions:

(1) Under the plan, an employee can choose to have the employer make salary reduction contributions for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not more than $12,500 in 2016 and participants who are age 50 or over can make a catch-up contribution of up to $2,500 in 2016;
(2) The employer must make either:
   (a) Matching contributions up to 3% of compensation for the year, or
   (b) Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation for the year;
(3) No other contributions can be made to the trust;
(4) No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE §401(k) plan; and
(5) The employee's rights to any contributions are nonforfeitable.

No more than $265,000 in 2016 of the employee's compensation can be taken into account in figuring salary reduction contributions, matching contributions, and nonelective contributions.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

115. If distributions from a Roth IRA are made five years after the plan’s formation, and if one of two conditions is met, the distributions may be tax free. What is one of these two conditions?
   a. if it is for first first-time homebuyer expenses.
   b. if it is made after age 21.
   c. if it is made prior to a disability.
   d. if it is made prior to death.

116. Under a simplified employee pension (SEP) IRA, the employer must contribute for each employee. However, each employee may have:
   a. attained age 18 to qualify.
   b. attained age 70½ to receive distributions.
   c. earned at least $450 in the tax year to qualify.
   d. performed services for the employer during two of the preceding four years.

117. A savings incentive match plan for employees (SIMPLE) 401(k) plan may discriminate if five conditions are met. What is one of the five conditions?
   a. The employee may request that the employer make $20,000 in salary reduction contributions to a trust.
   b. Contributions may be made from any source to a trust.
   c. Any entitlement that the employee has to contributions may be forfeited.
   d. Employer’s matching contributions must be up to 3% of compensation for the year.
Learning Objectives

After reading Chapter 8, participants will be able to:

1. Identify the advantages of nonqualified deferred compensation, specify the purposes of nonqualified plans and factors that a nonqualified retirement benefit can be based on, determine the contractual provisions of such arrangements and necessary provisions, recognize the IRS’s position on nonqualified compensation, and determine “constructive receipt” and “economic benefit.”

2. Specify the differences among unfunded bare contractual promise plans, funded company account plans and segregated asset plans and the tax consequences of each, and identify the basic tax consequences associated with nonqualified plans.
A substantial percentage of highly compensated individuals either enter into or actively consider deferred compensation arrangements with their employer. The basic thrust of such arrangements is to postpone the receipt of currently earned income until a later taxable year.

**Postponement of Income**

Instead of paying additional compensation now, the employer pays it to the executive at some future time. These payments are referred to as “deferred” compensation plans because they represent compensation currently being earned but which will not be paid until a future date.
Note: If the income has already been earned (i.e., the employee has an undisputed right to it) deferral is generally impossible. The term “nonqualified” refers to the fact that the plan does not attempt to meet the stringent coverage and contribution requirements necessary to obtain government approval for retirement plan treatment.

Advantages
The biggest advantage of nonqualified deferred compensation is that the employer is not restricted by the red tape and all of the rules and regulations accompanying qualified plans. Some of those restrictions include the following:

IRS Scrutiny & Approval
Every qualified plan must receive a specific approval from the IRS, in the form of a determination letter, in order to be considered “legal.” Nonqualified plans are not subjected to these procedures.

Nondiscrimination
The employer may provide nonqualified deferred compensation as a fringe benefit based on merit rather than age and seniority. Qualified plans may not “discriminate” in favor of certain highly compensated personnel.

ERISA
The Employee Retirement Income Security Act basically exempts an unfunded arrangement maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (ERISA §201(2)).

Funding
ERISA prescribes specific funding requirements, under which the employer must write a check on behalf of the plan every year. Nonqualified plans may be “funded” from working capital, from funds set aside by the employer, or from a combination of both, depending on the needs of the plan and the employer.

No Immediate Cash Outlay
Deferral allows the employer to offer a benefit that does not require an immediate cash outlay to the employee. It also allows the company to replace benefits lost by the new employee due to relocating from one company to another.

Annual Report
The Internal Revenue Service must receive an annual report for every qualified plan. In addition, many plans must provide summary plan descriptions, annual
summaries, and other materials to participants. A nonqualified deferred compensation plan can avoid these costs.

**Notice Requirement**

However, Department of Labor regulations *require* that an employer providing a nonqualified deferred compensation plan send a brief notice (such as a short letter) to the Department (ERISA §110,§104(a)(3) and DOL Regs. §2520.104-23). The notice must state that a plan has been established and it must describe the overall nature of the plan.

**Purposes & Benefits**

Nonqualified plans have been used for many purposes including the following:

1. Recruitment,
2. Retirement benefits for ineligible older employees,
3. Replacement of lost benefits,
4. Equalization of retirement benefits among all employees,
5. Rewards and incentives, *and*
6. Reduction of employer’s costs.

**Benefit Formula**

A nonqualified retirement benefit can be based on any number of factors, such as:

1. Company stock performance,
2. Return on an investment portfolio,
3. Employee’s final five-years’ average pay,
4. Cost-of-living index, *or*
5. Any other logical method.

**Incentive**

Deferred compensation plans that are tied to company *profits* are usually referred to as “incentive” plans. Under these plans, employees may earn deferred bonuses *only* in years of company profits.

Alternatively, the portfolio of “investments” of the plan may consist of the employer’s stock. Under such plans, company earnings are used to calculate the growth of the phantom portfolio.

**Deferred Bonuses**

Bonuses, based on productivity or profits, are helpful to a company as an incentive for top executives. An added “sweetener” to these bonuses is the oppor-
tunity to allow the executive to defer some or the entire bonus to a future date. The deferral may be for a few years, or may last until the executive retires.

**Contractual Arrangement**

Deferred compensation requires a *contractual agreement* between the employer and employee. In return for the employee’s present services, the employer agrees to pay the employee compensation in the future.

**Necessary Provisions**

At a minimum, the agreement should include the following:

1. Identification of the parties;
2. Acknowledgment of the employer-employee status;
3. A description of the deferral;
4. The nature of any growth of the deferred amounts and a statement holding the employer harmless with respect to the “growth rate” of such indices;
5. Acknowledgment that the employer owns the assets;
6. The timing and manner of payment of deferred amounts;
7. Forfeiture provisions;
8. A statement that the employer is not a “trustee”;
9. A provision denying the right of the employee to assign, transfer, pledge or otherwise encumber the deferred amounts;
10. A statement binding all parties and their legatees, administrators, executors, legal representatives, and successors; and
11. Acknowledgment that the deferred compensation is not included in the definition “compensation” for purposes of any qualified retirement plans sponsored or maintained by the employer.

**Tax Status**

**Service’s Position**

The IRS approaches deferred compensation arrangements with great scrutiny. The focus of the IRS attack is an effort to require immediate taxation of the “benefit” of the deferred compensation on the employee’s tax return during the years of accrual.

Even though this result would allow a deduction for the employer in the same year, the IRS wishes to eliminate the “tax bracket straddle” as well as the tax advantage of the deferral for the employee.

Moreover, if the employer is a corporation in a lower tax bracket (such as 15 percent), the IRS might win in two ways: It allows the employer a tax deduction
at a low tax rate, while imposing additional income tax on the employee at a high tax rate.

**Note:** For the employee, obviously, the result is disastrous. A high tax bill and no cash with which to pay it. Remember, the compensation was deferred, and is still being held by the employer.

**Rationale**

The Service’s position is essentially based on R.R. 71-419, R.R. 69-650, and R.R. 60-31. Under these rulings, a taxpayer will not be in constructive receipt of deferred income if:

(a) The taxpayer elects to defer the income *before* it is earned,

(b) The deferred income remains subject to the claims of the employer’s general creditors,

(c) The deferred income may *not* be assigned or otherwise anticipated by the taxpayer.

These principles were incorporated, under R.P. 71-19, to form the Service’s original ruling policy. To issue a favorable ruling concerning the application of the constructive receipt doctrine to an unfunded deferred compensation plan, the Service requires that:

(a) The election to defer be made before the beginning of the period of service for which the compensation is to be paid, even though the plan contains forfeiture provisions; and

(b) If the plan permits any other elections subsequent to the beginning of service, the plan provide substantial forfeiture provisions that remain in effect throughout the whole period of deferral.

**Congressional Moratorium**

In 1978, the IRS attempted to reverse its long-standing position with the adoption of Proposed Regulation §1.61-16. This Regulation held that an employee who had the option of receiving compensation currently would be taxed currently even though he elected to defer receipt to a later year under a plan meeting all the requirements of R.R. 71-19 under the doctrine of constructive receipt.

Congress responded. In 1978, as part of the Revenue Act of 1978, Congress required the IRS to stop making new rules in the area of deferred compensation (P.L. 95-600, §132(a)).

---

1 Even if set aside in a separate account
2 It seems clear that a deferral of even a final month’s compensation should be permitted if the employee elects the deferral before the beginning of the month.
No Ruling or Regulation Policy

As a result, the IRS has discontinued its efforts to propose new regulations in this area. In addition, R.P. 84-22 provides that the Service will no longer issue rulings or determination letters involving “the tax consequences of a non-qualified unfunded deferred compensation arrangement with respect to a controlling shareholder-employee eligible to participate in the arrangement.”

Constructive Receipt

In general, the employee/executive need only report income in the year in which payments are actually received.

Beyond Actual Receipt

However, actual receipt is not always necessary. Income can be constructively received. Accordingly, care must be taken to avoid constructive receipt of such compensation prior to the time that the employee actually receives the cash or benefit. Under the constructive receipt doctrine, a taxpayer who has the right to receive cash or property, but elects not to, is treated “as if” he actually received it.

Simple Set-Asides Are Not Possible

As a result, a corporation cannot just set aside current salary in an account and pay it to the executive at a later date with the hopes that it will only be taxable when it is taken from the account. The executive would pay tax currently on the compensation if he or she had a vested right to receive the payments.

Revenue Ruling 60-31

It is imperative that any deferred payments be viewed in light of this doctrine in order to avoid taxation to the recipient in the year in which granted. This was defined in R.R. 60-31, which states:

“Under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it.”

Regulations

Regulation §1.451-2(a) further defines the doctrine of constructive receipt:

“Income, although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it
is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.”

Time & Control Concept

From the above, it can be seen that the doctrine of constructive receipt is a time and control concept. It determines when an item of income comes within the control of the taxpayer and thus is subject to income tax.

Control

The key words of Reg. §1.451-2(a) are “made available” to the taxpayer so that he may draw upon it at any time. Constructive receipt is based upon the principle that income that is subject to a taxpayer’s unfettered command and he is free to enjoy at his own option is taxed to him whether he sees fit to enjoy it or not (Corliss v. Bowers, 281 U.S. 376).

Normally, in a deferred compensation arrangement, if the employee does not have the option to take cash currently in lieu of future income, control is absent. In C.E. Gullett, 31 BTA 1067 (1935) the Court stated:

“It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.”

Timing

Deferral must occur before the employee has a right to the income. Where compensation is deferred after all services have been performed and deferral is attempted after the agreed payment date, the income will be subject to current taxation (Joseph Frank, 22 T.C. 945 (1954) and Richard R. Deupree, 1 T.C. 113 (1942)).

The chances of the constructive receipt doctrine being applied can best be minimized if the individual makes a decision to enter into the arrangement before the amount is even earned (Ray Robinson, 44 T.C. 20).

Note: Some conservatively interpret this as before January 1 of the year on which the deferred compensation is agreed upon citing R.R. 69-650 which indicated that a decision by December 31 was required in connection with compensation to be earned during the following year.
After-the-Fact Contract

An agreement entered into after the services have been rendered, but before the compensation becomes payable might be an effective deferral if the arrangement is done in good faith. See Howard Veit, 8 T.C.M. 919 (1949); Ernest K. Gann, 31 T.C. 211; Rev. Proc. 71-19; and R.R. 67-449.

If the Service feels that circumstances do not reflect good faith, they will attempt to apply the constructive receipt doctrine (Willits v. Commissioner 50 T.C. 602 (1968), acq.). Certainly, the more time between the decision and the event, the less likely there is to be a problem with the IRS. R.R. 71-19 sets forth the conditions under which IRS will issue an advance ruling in this matter.

Amendment to Existing Contract

Nevertheless, an amendment to an existing deferred compensation arrangement to further defer a payment date will not constitute constructive receipt of the payment if the amendment is made prior to the time in which the taxpayer has a right to receive the deferred amounts. (Goldsmith v. U.S. 586 F.2d 810 (Ct. Cl. 1978))

Economic Benefit

Another tax principle closely allied with the doctrine of constructive receipt is the theory of economic benefit. This theory of income taxation has been applied by the courts to impose current tax liability on taxpayers who receive an “economic benefit” or a “cash equivalent.” Receipt is not the issue - “something” generally has been received. The issue is whether the “something” has a market value.

Has Something of Value Been Transferred?

The economic benefit concept is that income may be received in-kind as well as in cash. Under §61, gross income means “all income from whatever source derived.” This includes as income a property interest having a fair market value. Under this concept, the IRS attempts to interpret an action by the employer as resulting in something of market value being given to the employee. For example:

Insurance Coverage Has a Calculable Value

While the mere promise by the company to pay income in the future may have no economic value (R.R. 60-31), if the payment is funded through a “split-dollar” insurance contract providing a death benefit, then an economic value can be calculated on a yearly basis by comparing the employee’s cost with the imputed value of the premium.
The employee got the promise of an insurance company to pay him benefits in the future. It is the promise of an insurance company and not the mere promise of the employer that has economic value (see Brodie, 1 T.C. 275 (1942)).

**Segregated Funds Have Immediate Economic Value**

If an employer sets up a trust or escrow account to which the employee has nonforfeitable rights but which is not currently made available to him, then the amount of annual contribution will be construed to be an economic benefit and the employee will be taxed that year on the value of that contribution.

Establishing the trust or escrow places the funds beyond the range of corporate creditors and the risks of the business. The employer’s promise is a secured one and now has economic or financial value that can be measured. Time alone is not deemed to be a “substantial restriction.” Thus, the employee has current taxable income.

**Value v. Control**

Economic benefit is not concerned with the taxpayer’s control over income but rather what has value and thus may constitute income. The basic requirements for the application of the doctrine to deferred compensation arrangements are:

1. The benefit or interest transferred must have an ascertainable fair market value; and
2. The benefit or interest must be nonforfeitable or transferable.

**Revenue Ruling 60-31**

The most comprehensive statement of the IRS’s position on deferred compensation is R.R. 60-31. This ruling sets forth five factual patterns and speaks to the taxability of each.

**Situation 1**

The taxpayer/employee and his employer enter into an arrangement whereby the taxpayer is entitled to receive certain amounts of additional compensation that would be credited to a bookkeeping reserve to be accumulated and paid in annual installments equal to one-fifth of the reserve. The payments will begin only after termination of the taxpayer’s employment, the taxpayer becoming a part-time employee, or the taxpayer becoming partially or totally disabled.

The reserve amounts are only a contractual obligation and there is no intent that the employer would hold the amounts in trust for the employee’s bene-
fit. This additional compensation was held to be taxable only when actually received by the taxpayer.

**Situation 2**

The employer established a plan whereby a percentage of the company’s earnings were designated for division among the participants in a deferred compensation program. The amount was not currently paid to the participants but was set aside on the company’s books as a separate account for each participant.

Each account was also credited with the net earnings realized from investing any portion of the amount in an employee’s account. Distribution was made when the employee reached the age of 60, was no longer employed by the company, or became totally disabled.

Payments were contingent on a noncompetition agreement and the employee making himself available for consultation after retirement. Such amounts were held to be nontaxable until actually received.

**Situation 3**

Taxpayer entered into a publishing agreement with a company for the payment of royalties. An additional agreement was signed the same day providing that the publisher would not pay the taxpayer more than $100 in any one calendar year. Any sum in excess of this amount was to be carried over into succeeding accounting periods.

These amounts were not segregated from the publishing company’s other resources. The agreements were entered into before the royalties were earned and prior to the time the services were actually performed. The ruling holds that the payments were taxable only upon receipt.

**Situation 4**

A football player entered into a contract under which he was to receive a bonus of $150. The contract provided that this sum was to be paid to an escrow agent designated by the football player, and the escrow agent agreed to pay this sum plus interest to the taxpayer in installments over a period of five years. The ruling holds that the taxpayer was taxable in the year the club unconditionally paid the amount over to the escrow agent.

**Situation 5**

The Service held that the profit-sharing arrangement between a boxer and a promoter constituted a joint venture, and the taxpayer’s share of the re-
ceipts was currently taxable in his income under the general theory of partnership taxation³.

**Employer - Employee Relationship**

Situation 5 above points out that the successful structuring of a deferred compensation arrangement is dependent on an employer-employee or at least principal-agent relationship. Where a joint venture or partnership exists, an agreement between the partners that one of the partner’s share of profits will be distributed at a later date does not defer tax on such share until the later date because income is taxable to a partner or venturer when it is received by the partnership or venture.

**General Principles**

Under R.R. 60-31, a deferred compensation benefit is not “received” for federal income tax purposes, until the employer makes actual payment to the employee, as long as the following three rules are met:

1. The decision to defer compensation must be made *before* the employee performs any services covered by the deferral;

2. The deferred compensation account must *not* be “funded” with a trust or escrow; and

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³ The Service’s use of the joint venture theory is questionable because under very similar facts, the Tax Court held that no joint venture existed (*Robinson*, 44 TC 20 (1965)).
**Funding Avoidance**

*This simply means that any assets set aside for the payment of future benefits must be actually held by the employer. The funds may not be turned over to a trust or other third party. This requirement places the employee at risk, with respect to the ability of the employer to make the payments at a future date and generally places the employee in no better a position than that of a general creditor.*

3. The promise must *not* be secured by collateral, promissory note, or other security.

**Employee as General Creditor**

*This is really an extension of the second rule. The IRS rules are designed to ensure that the employee has no right to any assets at the present time. Therefore, the promise to pay future benefits may not be secured by collateral or a negotiable instrument of any kind. As a result, the employee becomes a general creditor of the corporation with respect to corporate liabilities for deferred compensation payments.*

These examples indicate that when, *prior* to performing any services, the taxpayer enters into an arrangement with his employer whereby he receives an *unfunded* promise to pay compensation in the future, deferral should result.
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

**118.** R.R. 71-419, R.R. 69-650, and R.R. 60-31 are the basis of the IRS’s position on deferred compensation plans. Thus, if all other conditions are met, when will the IRS treat a taxpayer as successfully deferring income?
   a. if the employer’s general creditors cannot lay claim to such income.
   b. if the taxpayer does not actually receive the income.
   c. the deferred income may not be assigned to the taxpayer.
   d. the taxpayer elects to defer the income after it is earned.

**119.** Courts may apply the economic benefit doctrine in determining whether a deferred compensation plan is valid. What is the issue involved in the theory of economic benefit?
   a. whether the taxpayer has received something.
   b. whether the employee is at risk.
   c. whether a market value can be applied to the something received.
   d. whether the taxpayer has control over income.

**120.** R.R. 60-31 provides three general principles that must be met in order for a taxpayer to be deemed to receive the payment when the employer actually makes the payment. What is one of these general principles?
   a. The employee must choose to defer compensation prior to carrying out any services covered by the deferral.
   b. A trust must fund the deferred compensation plan.
   c. An escrow must fund the deferred compensation plan.
   d. Collateral, a promissory note, or other security must secure the promise to
Unfunded Bare Contractual Promise Plan - Type I

An unsecured, unfunded, nonnegotiable promise of the employer to pay future benefits has no fair market value for tax purposes and is not currently taxable to the employee. See Bedell v. Comm., 30 Fed 622; Richards Estate v. Comm., 150 F.2d 837; and Bella Hammel, 7 T.C. 992.

However, if the employee has a right to presently receive the amount, the obligation has a cash equivalency, or it is funded and consideration separately set aside for the employee, current taxation will result. Thus, in setting up an unfunded deferred compensation plan and avoiding constructive receipt of income the employer should not set aside funds in an escrow or trust account but merely promise to pay the executive in the future. The executive’s rights to payment are therefore no greater than the rights of a general creditor.
Basic Types of Nonqualified Deferred Compensation

• Type I - Unfunded Bare Contractual Promise Plan
  – Employee bears all risk

• Type II - Funded Company Account Plan
  – Limited Protection:
    • Employer may invest deferred amounts
    • Employer may obtain life insurance to fund payment on death
    • Contract can be guaranteed by third parties

• Type III - Segregated Asset Plan
  – Must meet requirements of §83
    • Subject to a substantial risk of forfeiture
Risk

As a general creditor, the employee is at risk, with respect to the deferred benefits, and depends upon the survival and soundness of the company. If the company goes bankrupt, or if all company assets and income become subject to the claims of creditors, the employee may lose some or all of the deferred benefit. It is the employer’s “bare bones promise to pay” that “funds” the employee’s deferred benefit. To achieve deferral, the employee must be willing to take the risk of being a general creditor of the employer. While every company expects to exist in near perpetuity, there are enough bankruptcies to require serious assessment of this probability.

Funded Company Account Plan - Type II

Although deferred cash compensation arrangements are normally unfunded and evidenced by a mere contractual promise of the employer, such arrangements may also be funded by company assets or bookkeeping accounts. Funded plans certainly raise the specter of constructive receipt and thus taxability to the employee. However, with careful planning, employee taxation can be avoided.

Ownership & Segregation

The tax treatment of the employer and employee will vary based on how the deferred amounts in a funded plan are actually segregated and to whom they belong. If funds are set aside they should belong to the employer not the employee.

Funded Benefits Subject to Forfeiture

Even if the funds are improperly segregated and essentially “belong” to the employee all is not lost. If the funded benefits are subject to a substantial right of forfeiture, employee taxation can still be deferred with appropriate action (See discussion of Type III plans and §83). The tax consequences of a nonqualified deferred compensation plan, except for incentive stock option plans, are initially determined based upon whether or not the plan is funded or unfunded. If the plan is funded with assets outside the company, then the next issue is whether or not the employee’s interest in the plan is forfeitable or nonforfeitable.

Bookkeeping Reserve or Separate Account

Although the employer may not transfer assets to escrow or to a trust (and may not give the employee a collateral interest or negotiable instrument), the employer may, under limited circumstances, designate some of its own assets as a “deferred compensation fund.” Even if the deferred amounts are credited to a
bookkeeping reserve or even placed in a separate account, so long as the funds belong to the employer and are subject to claims by the general creditors of the employer, deferral will still result (R.R. 60-31).

Setting Up Accounts

The assets must remain solely the property of the employer, and designation of those assets as a fund designed for future payment of deferred compensation liabilities may not, in any way, create any rights of the employee. Funds set aside for this purpose should be labeled “special account” or a similar designation on the company books so as to avoid any indication that those funds “must” be used for payment of deferred compensation. Similarly, the corporation should acknowledge, by Board of Directors resolution, that the funds set aside are available for paying deferred compensation liabilities or any other liabilities of the corporation.

Employee Still Bears Economic Risk

Because it is necessary that the deferred amounts remain subject to the general creditors of the employer in order to achieve deferral for tax purposes, the economic viability of the employer must be weighed carefully.

Limited Protection

There are methods available that have been approved by the IRS to afford the employee some limited protection. Examples are:

Investment of Deferred Amounts

Based on R.R. 60-31, it appears clear that the employer may invest deferred amounts and the employee will still qualify for tax deferral. Although invested amounts must remain subject to the claims of general creditors of the employer, an investment arrangement offers the employee some protection in that, if the employer invests wisely, the plan will increase the amount of assets available to the employer to actually pay the deferred amounts. According to the IRS, the employer cannot be specifically required to hold any particular asset as a funding device, and the employer must retain the right to veto any employee investment direction.

Rabbi Trust - PLR 8113107

This letter ruling involved a congregation that sought to establish a trust for the benefit of a rabbi. Amounts placed in the trust were invested and managed by trustees. The net income was paid
to the rabbi at least quarterly. Principal and income of the trust would be distributed upon the rabbi’s death, disability, or termination of his services.

Trust property was subject to the claims of the congregation’s general creditors and the rabbi could not assign, alienate, or pledge the trust property. In addition, the trust property was not subject to any claims that the rabbi’s creditors might have.

The Service held that the rabbi did not actually or constructively receive income, or economic benefit, from the placement of the property into the trust. Such amounts would only be included in income when actually received or made available to the rabbi.

Some practitioners take the position that if the employee directs the investing of assets held by the employer, this could be interpreted by the IRS as an exercise of the “rights” over those funds. Thus, the IRS could assert that the employee essentially “owns” the funds, and should pay tax on them.

If this is a concern or if the “employee” is also a shareholder in the corporation, the ongoing management of such assets might be left in the hands of a mutual fund manager, insurance company, or other third party.

Life Insurance

If the employer purchases life insurance on the executive payable to it and which is owned by it free of restrictions, the employee will have no rights or interest in the policy, therefore, policy values can be attributed to the employee only by disregarding the corporation which the courts have not done (Casale v. Comm., 26 T.C. 1020 (1956); and R.R. 59-184). In fact, under R.R. 68-99, the Service ruled that an employer may, at its option, purchase a life insurance policy to fund a deferred compensation arrangement.

The ruling requires that all rights to any benefits under the insurance contract are solely the property of the employer, and the proceeds of the contract are payable by the insurance company only to the employer. Thus, the employee does not receive a present economic benefit from the policy, and consequently the basic concept of deferral is not defeated by the insurance funding (R.R. 72-25).

Premiums

Premiums paid by the employer on the life insurance policy are not taxable to the employee because he has no rights or interest in the policy. This is so even though the employer uses the proceeds of the policy to discharge its obligation under the deferred compensation agreement (Centre v. Comm., 55 T.C. 16 (1970)).
Note that the premium payments would not be deductible by the employer (I.R.C. §264(a)(i)). Nevertheless, the life insurance proceeds received by the employer upon the employee’s death would be income tax free (I.R.C. §101(a)). The company is simply transferring some of its cash assets into a cash value account that it controls.

However, life insurance premiums paid by an employer on the life of the employee under circumstance where the proceeds are payable to the employee’s beneficiaries will result in current taxable income to the employee (Reg. §1.61-2(d) and Paul L. Frost, 52 T.C. 89 (1969)). Finally, if the policy is transferred to the employee upon termination of employment, he will be taxable on the value of the policy received at that time.

Third Party Guarantees

The guarantee of the employer’s obligation by a third party does not appear to affect the ability to defer the compensation. In Robinson v. Commissioner, 44 T.C. 20 (1965), acq., deferred compensation for a boxer was personally guaranteed by the president of the promotional corporation. The Tax Court held that the taxpayer did not constructively receive funds payable in subsequent years under the deferral agreement.

Surety Bond

It is not uncommon for executives of large corporations to purchase a surety bond protecting their interest in unfunded and unsecured deferred compensation plans. Sometimes these bonds are purchased by the corporation on behalf of the executive. If the bond is purchased by the executive, the question arises as to whether or not the bond “secures” the employer’s promise to pay future benefits in the same way as collateral or a promissory note. If the employee purchases the bond, then the employee (and not the corporation) is securing the payment of the deferred compensation benefits, and no adverse tax consequences should arise.

If the bond is purchased by the employer the question arises as to whether the cost of the bond (i.e., the premiums) constitutes a taxable “benefit” to the employee. If the corporation pays for the bond, however, the corporation is essentially committing its own assets to secure the payment, similar to funding.

To avoid an IRS attack, the corporation should establish that it was purchasing the bond on behalf of the employee, upon the employee’s choice or direction. The cost of the bond, furthermore, should show up on the W-2 of the employee as an imputed premium.
Segregated Asset Plan - Type III

If the deferred amounts are segregated outside of the company into a separate account that belongs to the employee and is not subject to the claims of the employer’s general creditors, the deferred amount is normally held to be currently taxable. However, it is possible to segregate an amount in an account that is not subject to the claims of the employer’s creditors and still avoid employee taxation, provided, the requirements of §83 are met.

Section 83 Approach

There is a limited exception to the requirement that deferred compensation benefits must be “unfunded” (or funded only from the general assets of the corporation). This is called the “Section 83” approach. Under this approach, funds covering the payment of future obligations are transferred to an outside account. However, the benefits themselves are subject to a “substantial risk of forfeiture,” as defined under Reg. §1.83(c)(1). This approach also requires that the funding arrangement qualify as a “transfer” of “property” under §83.

Section 83

Sometimes referred to as the “restricted property” provision, §83 provides the rules for the taxation of stock or other property that is transferred, subject to restrictions, as compensation for services rendered by employees. While drafted with stock and stock options plans as the primary target, §83 also applies to funded deferred compensation plans. It embraces all real and personal property. However, it does not apply to unfunded plans or qualified retirement plans. For this section to apply the property must be transferred for the performance of services.

Tight Rope Format

By actually funding the liability (but making the liability itself contingent on future services), the employer walks the thin line between a “vested” right to an unfunded obligation and a completely “non-vested” right to an actual fund (in a trust or escrow). Extreme caution must be exercised when walking this thin line.

ERISA Question

No trust or escrow should be used and future deferred compensation benefits should be made subject to substantial risk of forfeiture. In addition, the “Section 83” approach has not been tested under ERISA reporting requirements. It is possible that §83” fund-
Transferable or Not Subject To A Risk of Substantial Forfeiture

Plans funded using segregated assets are governed by the rules of §83 that apply to transfers of property for services. Under §83(a), the executive is taxable on a funded plan when the right to such funds is either:

(a) Transferable, or
(b) Not subject to a risk of substantial forfeiture.

Note the dual criteria of transferability and lack of a substantial restriction. Obviously, property is transferable only if the rights of a transferee are not subject to a substantial risk of forfeiture. From a practical viewpoint, therefore, while the statute sets two criteria for the recognition of taxable income, there is only one - the presence or absence of a substantial risk of forfeiture.

Section 83(c)(1) provides that rights are subject to a substantial risk of forfeiture when full enjoyment is dependent on the future performance (or refraining from performance) of substantial services by any individual. Such a risk does not exist if the forfeiture will only occur on death, disability, criminal activity, or violation of a covenant not to compete. (See Reg. §1.83).

Substantial Restrictions

Some examples of substantial restrictions might be:

Redemption or Forfeiture

Transfer of property to an employee subject to a binding commitment to resell the property to the employer at its original value or even forfeit the property entirely if the employee leaves employment for any reason during a test period, would be a substantial restriction. To the extent that rights to benefits are forfeitable, no immediate benefit is derived, even though:

(a) The employer acknowledges the liability of benefit payment by setting up a liability account on the employer’s balance sheet, called “deferred compensation account,” on behalf of the employee; and
(b) The employee has a legal right to the benefits as long as the employee continues to work for the employer until retirement (or until the end of the deferral period).

Condition Related to a Purpose of the Transfer

A requirement that property transferred to an employee be returned if the total earnings of the company do not increase could be a condition related to a purpose of the transfer.
Noncompetition

Factors which may be taken into account in determining whether a covenant-not-to-compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee’s health, and the practice of the employer to enforce such agreements.

Consultation

Property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform “substantial services.”

Time Alone is Not Enough

The IRS takes the position that if deferred amounts are placed in an irrevocable trust or escrow account and are not subject to substantial risk of forfeiture but only to the mere passage of time, the deferred amounts will be currently taxed to the employee (See E.T. Sproull v. Commissioner 16 T.C. 244 (1951) and Jacuzzi v. Commissioner 61 T.C. 262 (1972)).

Realization & Taxation

When the property becomes transferable or not subject to a substantial risk of forfeiture, the employee is then taxed on the excess of the fair market value of the property received over the amount the employee paid for that property. If the recipient of the property sells or otherwise disposes of it before it is released from the substantial risk of forfeiture, income is realized at that time.

30-Day Election Period

The employee may elect to be taxed prior to the time that his or her rights to the property become transferable or are no longer subject to a substantial risk of forfeiture. Such an election must be made within 30 days after the transfer or grant of the funded deferred compensation arrangement.

Deduction Allowed

Section 83 allows a deduction to the employer when the employee realizes income as a result of:

(1) Receiving nonforfeitable property,
(2) The property becomes nonforfeitable because it is relieved of forfeiture restrictions, or
Timing

Under §162 a deduction is allowed in an amount equal to the income reported by the employee. However, the taxable year for the employer’s deduction is the taxable year in which the taxable year of the employee ends.

Withholding

In addition, the employer must deduct and withhold income taxes as required by §3402 otherwise the deduction will be disallowed (Reg. §1.83-6(a)).

Tax Consequences

There was a time, in the early days of the income tax system in this country, when it was possible for an employer to “accrue” a deferred compensation expense and take a deduction for it. At the same time, the employee did not have to report, as income, the deferred compensation until it was actually paid.

Reciprocal Taxation/Deduction Rule

The Revenue Act of 1942, however, killed this favorable situation. That Act installed a provision, now known as §404(a)(5), which provides that accruals under nonqualified deferred compensation plans are deductible on the employer’s tax return only in the year in which the employee actually receives the cash (or other property) from the deferred compensation plan.

TRA ‘86 Clarification

The TRA ‘86 clarified that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the Code section under which the amounts might otherwise be deductible and that deductibility is governed (and where appropriate, allowable) by §404 and not by any other Code section (§§404(a), 404(d) & 404A(a)). This clarification was necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation.

Thus, the tax position of the employer and the employee are reciprocal. The employer will normally only receive a deduction for the contribution to the non-
qualified deferred compensation plan when the employee suffers taxation on the same amount. Benefit payments will be taxable to the employee only as and when received. See James F. Oates, 18 T.C. 570 (1953); Harold Johnson, 14 T.C. 560 (1950); J.D. Amend, 13 T.C. 178 (1949); and Frederick J. Wolfe, 8 T.C. 689 (1948). No deduction is allowed to the employer at the time the promise of future benefits is made to the employee.

**No Difference for Cash or Accrual**

Section 404(a)(5) permits the employer a deduction only when payments (or benefits) are received by the employee, regardless of whether the employer is on a cash or accrual basis of accounting (see also Sol Jacobs, Jr., 45 T.C. No. 10 (1965)). The language of §404(a)(5) is as follows:

“If the plan is not qualified, the deduction may be taken only in the taxable year in which an amount attributable to the contribution is includable in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participated only if separate accounts are maintained for each employee.”

**Separate Accounts for Two or More Participants**

Section 404(a)(5) provides that in a funded plan if more than one employee participates in the nonqualified plan, separate accounts must be kept for each in order to obtain the deduction. Remember also, in a funded plan the determining factor for the employer’s deduction is the time when the employee’s interest becomes nonforfeitable, since this constitutes receipt of the benefits equal to actual payment.

**Employer Deduction Traps**

It would seem the delay of the tax deduction would be penalty enough, and the IRS would have no grounds to challenge the deduction when the employer finally takes it. However, there are several grounds on which the IRS could attack the deduction:

1. The payments are not paid pursuant to a “plan;”
2. The total compensation is unreasonable;
3. The corporation is not contractually bound;
4. The payments are “allocable” to tax-exempt income; and
5. The payments are part of a “golden parachute” arrangement.
Income Tax on Employer Held Assets

If a company sets aside assets to brace itself against future liabilities, the earnings on those assets are usually taxable to the company. The company might minimize the tax burden of carrying those assets by:

1. Buying stock qualifying for the dividends-received deduction;
2. Investing in municipal bonds or other tax-exempt securities; and
3. Purchasing life insurance policies.

Deferred Annuities

Employers frequently purchased deferred annuities in order to fund the employer’s obligation to provide their employees with nonqualified deferred compensation. Income credited to a deferred annuity contract was not currently includible in the gross income of the owner of the contract. Under the TRA ’86, if an annuity contract is held by a person who is not a natural person, then the annuity contract is not treated as an annuity contract and the “income on the contract” (for any taxable year of the policyholder) is treated as ordinary income received or accrued by the owner during that taxable year (§72(u)(1)). Thus, the annuity’s inside buildup can no longer be used to accumulate tax-free investment earnings to pay out later as (deductible) deferred compensation.

Inclusion in Income Under §409A

Since 2005, new §409A provides comprehensive rules regarding the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans. As a result, if at any time a nonqualified deferred compensation plan fails to meet any one of three requirements, the compensation plus related earnings must be included in taxable income, with the tax increased by a 20% penalty and increased by interest (i.e., at the IRS underpayment rate plus 1%) on the underpayments that would have occurred had the deferred compensation been includible in income for the year in which first deferred.

The three requirements that must continuously be met to avoid early taxation plus a penalty and interest are:

1. The distribution rule;
2. The election rule; and
3. The acceleration of benefits rule (i.e., under which the plan may not permit the acceleration of the time or schedule of any payment, except as provided in regulations).

Essentially, all amounts deferred under a non-qualified deferred compensation plan in tax years beginning after 2004, now become taxable when they are no longer subject to a substantial risk of forfeiture, unless certain requirements are
satisfied. This effectively means that the distinction between funded and unfunded plans will no longer apply. This change in the law also appears to make the Rabbi trust a less attractive funding mechanism for non-qualified deferred compensation plans (§409A). Under §409(a)(1)(A)(i), which was added by the 2004 Jobs Act all amounts deferred under a nonqualified deferred compensation (NQDC) plan for all tax years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless the plan:

(1) meets the distribution acceleration of benefit, and election requirements under §409A, and

(2) is operated in accordance with these requirements.

If a NQDC plan is not in compliance with or does not operate in compliance with these rules at any time during a tax year (i.e., starting with the 2005 tax year and thereafter), all amounts deferred under the plan for that tax year and all preceding tax years, by any participant with respect to whom the failure relates, are included in gross income for that year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. The amount included in income also is subject to:

(1) interest (at the underpayment rate plus one percentage point) on the tax underpayments that would have occurred had the compensation been included in income for the tax year when first deferred, or if later, when not subject to a substantial risk of forfeiture; and

(2) additional income tax equal to 20% of the compensation required to be included in gross income.

State Tax Issues

The tax situation must be thoroughly reviewed on a state as well as federal basis to ensure it results in the expected tax and economic position. Some states may even apply an exit tax on any deferred compensation earned in that state but not taxed at time of relocation.

Accounting

An employer accounts for nonqualified deferred compensation plans on its own books and records, rather than on the books and records of a separate trust as is the case for qualified plans.

Two Sets of Rules

There are two separate sets of accounting “rules” that relate to nonqualified deferred compensation plans. The first set of rules is the “generally accepted accounting principles” that govern the preparation and reporting of financial statements for use by creditors, shareholders, and (in the case of publicly-held
corporations) the general public. These are the “financial accounting rules.” The other set of rules are those that govern the preparation of income tax returns. Those are the “IRS rules.”

Financial Accounting Rules

The primary pronouncement covering the accounting rules for deferred compensation arrangements is APB-12. This pronouncement covers both defined benefit arrangements and defined contribution arrangements. If a group of employees are participants in a nonqualified defined benefit plan, however, a separate set of rules apply.

Under APB-12, each deferred compensation arrangement is examined on an employee-by-employee basis. The amounts attributable to current services performed by each employee are accrued. The accrual covers the deferred compensation benefits that will eventually be paid to the employee (or the employee’s beneficiary).

A separate pronouncement, APB-8, as modified by FASB-36, comes into play if the following two factors are present:

1. The defined benefit arrangement covers a “group”; and
2. The plan, taken as a whole, is tantamount to a pension plan.

IRS Rules

The IRS does not permit a deduction on the employer’s tax return for the accrual of the deferred compensation liability during the pre-retirement years. The entries accruing that liability, therefore, are not reflected in the calculation of taxable income.

The accrued deferred compensation liability, on the balance sheet of the employer, on the other hand, is carried to the corporate employer’s income tax return at Schedule L. Similarly, an entry showing the “nondeduction” should be included in the Schedule M-1 on the corporation return.

At the time the retirement benefit is paid to the employee, a deduction for the payment will be taken on the employer’s income tax return even though no expense, other than the accrual of interest, is reflected on the employer’s financial statements. This will, in turn, require another entry on the Schedule M-1, indicating the deduction (for Federal income tax purposes) of an item that was not deducted for financial reporting purposes.

Estate Planning Considerations

Death During Deferral

Even though deferred compensation is primarily an income tax savings technique for the executive while he is alive, it can have important estate tax consequences
as well as tax significance to the executive’s estate and beneficiaries after his or her death. The reason for this is that the executive may die before receiving any of the deferred compensation payments or after receiving only a portion of the payments.

This is another risk to the employee and is usually addressed by a contract provision that allows for a portion of the benefit to be paid to the employee’s survivors if the employee dies prior to retirement, and a continuation of the retirement benefits to the employee’s survivors for a maximum number of years if the employee dies during the early years of retirement.

For example, death before retirement could result in a payment to the survivors of the employee for 10 years, while death during the first 10 years of retirement could result in the continuation of the retirement payments through the tenth year after the date of employee’s retirement. The latter feature is often designated as a “salary continuation” feature, and is sometimes included as part of the deferred compensation agreement so as to allow “salary continuation” upon death even during the pre-retirement years.

Income Tax Consequences

For income tax purposes, deferred compensation paid after death is income in respect of a decedent and is taxable as ordinary income to the recipient whether the recipient is the estate, spouse, trust, or other beneficiary. However, the recipient is entitled to an income tax deduction for the estate tax, if any, attributable to inclusion of the deferred compensation right in the executive’s estate. The allowance of this income tax deduction for the attributable estate tax has the effect of reducing the recipient’s income tax on the deferred compensation payments.

Estate Tax Consequences

For estate tax purposes, the value of the beneficiary’s right to receive the deferred compensation is included in the gross estate of the executive at his or her death. Any estate tax attributable to the inclusion of the deferred compensation is deductible by the recipient for income tax purposes.

Gift Tax Consequences

Under most circumstances, installing a nonqualified deferred compensation benefit does not generate a gift tax, even if an employee designates someone as surviving beneficiary. That’s because the survivor’s rights are contingent on the employee’s death.

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4 This income tax reduction may come at the price of estate tax rates up to 49%.
However, if the employee makes an irrevocable assignment of a nonforfeitable benefit, a taxable gift could occur. If that happens, the gift would probably not qualify for the $14,000 (in 2016) annual gift tax exclusion because the gift would be considered the gift of a future interest.

The primary task of the estate planner is to determine who should be the recipient of unpaid deferred compensation and take steps to see that the deferred compensation will be paid under the contract to the selected recipient or recipients when the executive dies.

Withholding, Social Security & IRA’s

Since the employer must withhold income taxes on “all remuneration for services performed by an employee,” deferred compensation benefit payments are subject to withholding (§3401(a)).

Other Payroll Taxes

Effective for years after 1983 for Social Security taxes (FICA), and for years after 1984 for Federal Unemployment Taxes (FUTA), nonqualified deferred compensation benefits are considered taxable as wages. As a result, the payments are subject to withholding (§3121(v)(2) & §3306(r)(2)).

Social Security Benefits

If a retired employee does not perform any services for the employer, benefits received pursuant to a nonqualified deferred compensation retirement plan will not affect the employee’s eligibility for Social Security benefits (Social Security Ruling 66-9). However, if the retiree performs services for the employer, amounting to more than 45 hours during a month, the retiree’s Social Security benefits could be reduced. There is, however, a one-year “grace period” which will serve to reduce the effect. In addition, any earnings received by the retiree after age 70 will not offset Social Security benefits.

IRA’s

Despite the fact that deferred compensation benefits are considered “compensation” for purposes of Social Security taxes and benefits, they are not, according to the IRS, considered “compensation” for purposes of IRA contributions (Letter Ruling 8251113).
Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regards to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and reference, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

121. The author describes three major types of deferred compensation plans. What obligation is taxable to the employee at a future time?
   a. one that an employee does not secure, fund, or negotiate to pay future benefits.
   b. one that is funded and consideration is separately put aside for the employee.
   c. one that has a cash equivalency.
   d. one that the employee has a right to presently receive.

122. The IRS has approved some methods to provide employees with limited protection. Under R.R. 68-99, what may an employer do, at her option, to fund a deferred compensation arrangement?
   a. guarantee the employer’s obligation by a third party.
   b. invest deferred amounts.
   c. buy a life insurance policy.
   d. receive premium payments.

123. A limited loophole exists to the unfunded requirement. Under what approach can the employee transfer funds covering the payment of future obligations to an outside account, but the benefits themselves remain subject to a “substantial risk of forfeiture”?
   a. the bare contractual promise approach.
   b. the deferred compensation fund approach.
   c. the ownership and segregation approach.
   d. the Section 83 approach.
124. Under new §409A, once a new nonqualified deferred compensation plan fails to comply or operate in compliance with three rules, the taxpayer faces certain tax consequences. Which of the following may apply depending on location?
   a. an exit tax.
   b. additional income tax.
   c. interest on tax underpayments.
   d. inclusion of deferred amounts in income.

125. Employees should consider how their deferred compensation plan will affect their estate planning. What is a tax consequence of death prior to receiving the deferred income?
   a. The income is taxed as ordinary income.
   b. The recipient’s income tax increases.
   c. A taxable gift cannot occur.
   d. The recipient may not deduct any estate tax.

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**Answers & Explanations**

1. The least complicated business entity is a sole proprietorship. This entity type is merely an extension of:
   a. Incorrect. A joint venture is a form of partnership where two or more persons or entities combined to accomplish a specific business purpose. A sole proprietorship is separate and distinct from a partnership. Thus, a sole proprietorship is not an extension of a joint venture.
   b. Correct. Sole proprietorships are the simplest business form since they are not separate tax or legal entities but rather, extensions of the individual taxpayer that owns them. The business has no existence apart from the owner. Its liabilities are the owner’s personal liabilities.
   c. Incorrect. A sole proprietorship is not an association of two or more persons or entities. There can be only one owner of a sole proprietorship. And a sole proprietorship is not an extension of such an association.
   d. Incorrect. Syndications are marketing programs and sometimes entities that promote and sell equity interest in a business. Thus, sole proprietorships is not an extension of a syndication. [Chp. 1]
2. Despite their simplicity, sole proprietorships have several attractive advantages. Why would someone want to choose a sole proprietorship over other entities?
   a. Correct. A reason that someone would choose a sole proprietorship over other entities is that there are low organizational costs compared to other entities.
   b. Incorrect. A drawback of sole proprietorships is that the individuals are held personally liable.
   c. Incorrect. One of the drawbacks of sole proprietorships is that there are few opportunities for a sole proprietor to split income.
   d. Incorrect. One of the benefits of sole proprietorships is that often the state and federal income taxes are lower. [Chp. 1]

3. The author lists four disadvantages of sole proprietorships. What is one of these disadvantages?
   a. Incorrect. Legal fees for sole proprietorships are often very low compared to other entities. A sole proprietorship is relatively easy to form.
   b. Incorrect. A sole proprietorship can generally use the cash method of accounting unless inventory is material in the production of income.
   c. Correct. A disadvantage of a sole proprietorship is that the fringe benefits that are available to them are limited. Other entities offer greater opportunities in this area.
   d. Incorrect. Sole proprietorships are subject to a single tax, not a double tax, on income. [Chp. 1]

4. A sole proprietorship may incur start-up expenses during its formation. Section 195 provides that a sole proprietor may elect to have such start-up expenses be:
   a. Incorrect. Formerly, startup expenses could be amortized over a period of not less than five years. However, recent legislation has extended this period.
   b. Incorrect. Except for an initial $5,000, startup expenses must be amortized, not deducted.
   c. Correct. Under §195, start-up expenses (after an initial $5,000 deduction) of a sole proprietor may, at the taxpayer’s election, be amortized over a period of not less than fifteen years.
   d. Incorrect. There's no tax credit for startup expenditures. [Chp. 1]

5. Expenses that a sole proprietor pays in relation to examining the establishment or purchase of an active trade or business are considered start-up expenses. How are such expenses treated?
   a. Correct. Startup expenses include those paid or incurred in connection with investigating the creation or acquisition of an active trade or business, which would be allowable as a deduction in the year paid or incurred if they were paid or incurred in connection with the expansion of an existing trade or business.
b. Incorrect. Startup expenditures would have to be deductible for an existing trade or business not subject to capitalization.

c. Incorrect. Intangibles if required on the acquisition of the business must also be amortized over a period of 15 years under §197. However, these are not startup expenditures.

d. Incorrect. Startup expenditures are not passive losses under §469. [Chp. 1]

6. Schedule C or Schedule C-EZ (Form 1040) must be used to report a sole proprietor’s business income and expenses. What must a sole proprietor prepare if he or she runs multiple sole proprietorships?

a. Incorrect. An individual who operates two sole proprietorships does not become a partnership. Thus, no partnership return is filed.

b. Correct. If a taxpayer operates more than one business as a sole proprietor, they must prepare a separate Schedule C for each business and attach each of them to their tax return. If a separate Schedule C for each business is not prepared there may be a penalty for not properly reporting income and deductions.

c. Incorrect. There is no such thing as a federal limited liability company tax return. Depending upon the election made and the number of members, a limited liability company can be a sole proprietorship, partnership, or corporation.

d. Incorrect. Affiliated groups are typically made up of corporations which have a parent subsidiary relationship under §1504. In addition, there is no such type of return. [Chp. 1]

7. For-profit and not-for-profit businesses are treated differently. If the IRS deems a business activity is a not-for-profit, how are deductions treated?

a. Incorrect. If the activity is not carried on for profit, deductions can only be taken in a strict order pursuant to three categories, to the extent stated in those categories, and only if itemized on Schedule A (Form 1040).

b. Incorrect. Losses and income can still be netted within the business. However, net losses cannot be used against other income.

c. Incorrect. The disallowed losses under the not-for-profit business rules are not suspended under §469. This section deals with the suspension of passive losses.

d. Correct. When a business activity is not carried on to make a profit, the deductions are limited and no net loss is allowed to offset other income. Activities done as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors. [Chp. 1]

8. The IRS considers all of the facts when deciding whether an activity is carried on for profit. However, which of the following factors is ignored?

a. Incorrect. Operating in a businesslike manner is very important in the determination of whether or not it is a not-for-profit activity. If the taxpayer fails to
keep minimum books and records or conduct themselves in a businesslike manner, the IRS is frequently successful in labeling the activity as not-for-profit.

b. Incorrect. Courts and the IRS have been very lenient in granting business status to activities conducted by taxpayers who have been successful in running business operations in other industries or areas.

c. Correct. Material participation is a standard used under the passive loss rules pursuant to §469. It is not a concept applied in the not-for-profit provisions under §183.

d. Incorrect. Knowledge sufficient to run a business or compete in a certain industry is critical to maintaining prospects of a successful for-profit business. [Chp. 1]

9. In general, the IRS deduces that an activity is a for-profit if a profit was made during a certain time period. What is the minimum number of years that an activity must have produced a profit?

a. Correct. An activity is presumed carried on for profit if it produced a profit in at least three of the last five tax years including the current year.

b. Incorrect. This is not the general rule but an exception for specified industry. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least two of the last seven tax years including the current year.

c. Incorrect. Two out of the last five years is not the standard under §183 for determining not-for-profit businesses. However, this is the standard for determining the availability of the home sale exclusion rule under §121.

d. Incorrect. Under §183, there's no requirement that the three years of the last five be consecutive years. [Chp. 1]

10. Instead of using the Schedule C, a sole proprietor who meets at least eight requirements can use Schedule C-EZ, Net Profit From Business. Which item below is one of these requirements that must be met?

a. Incorrect. To use the Schedule C-EZ the business must use the cash method of accounting.

b. Incorrect. The Schedule C-EZ requires that the business did not have a net loss.

c. Incorrect. If a taxpayer files the Form 4562, they cannot use the Schedule C-EZ.

d. Correct. To use the Schedule C-EZ, the taxpayer must have only one business as a sole proprietor. [Chp. 1]

11. A sole proprietor may file Form 4868. What does the sole proprietor request using this form?

a. Incorrect. The Form 4868 is not used to request innocent spouse relief. Besides, innocent spouse tax relief would only be requested after a tax return had been filed.
b. Correct. If a taxpayer cannot file their return on time, the Form 4868 may be used to request an automatic 4-month extension. However, the Form 4886 may not be used if the taxpayer wants the IRS to figure their tax or the taxpayer is under a Court order to file their return.

c. Incorrect. The Form 4868 is not used to request an offer in compromise. Offers in compromise occur after a tax return has been filed or an amount is assessed against the taxpayer.

d. Incorrect. The Form 4868 is not used to request an installment agreement. Typically, such agreements are used to permit taxpayers to make payments of their taxes over a period of time. [Chp. 1]

12. Sole proprietors must pay specialized taxes. Which of the following is a sole proprietor required to pay?

a. Incorrect. While the alternative minimum tax affects millions of taxpayers, just because one operates as a sole proprietor does not necessitate being subject to it.

b. Incorrect. The excess accumulated earnings tax, under §531, only applies to corporations that accumulate earnings in excess of certain set of thresholds without having satisfactory business reasons were doing so.

c. Correct. If a taxpayer is a sole proprietor, he will have to pay self-employment tax (§1401). The self-employment tax is the non-employee portion of the Social Security tax-securing system.

d. Incorrect. Sole proprietorships are not subject to a personal holding company tax under §541. [Chp. 1]

13. Self-employed taxpayers must pay estimated tax payments. These payments must reflect both self-employment taxes and:

a. Correct. Estimated tax payments must reflect self-employment taxes as well as federal income taxes.

b. Incorrect. Federal excise taxes are not collected through the estimated tax system. Excise taxes are essentially a charge on the sale of certain luxury items.

c. Incorrect. No business franchise taxes are collected through the estimated tax payment system.

d. Incorrect. Worker's compensation insurance contributions are not collected through the estimated tax payment system. [Chp. 1]

14. Davis & Associates, a sole proprietorship, sells all of its assets including real property, machinery, furniture, and inventory for a gain. On which asset does Davis & Associates realize an ordinary gain?

a. Incorrect. Davis & Associates would realize a capital gain on the real property that they sell.

b. Incorrect. Davis & Associates would realize a capital gain on the machinery that they sell.
c. Incorrect. Davis & Associates would realize a capital gain on the furniture they sell.

d. Correct. Davis & Associates would realize an ordinary gain on the inventory they sell. Other property on which they would realize a gain includes stock-in-trade or property used in a business and held one year or less. [Chp. 1]

15. Sections 701 through 761 cover the taxation of partnerships. Basically, under these sections, how are such entities taxed?

a. Incorrect. From a tax perspective, partnerships are not separate tax paying entities. A partnership itself only files an information return. The partners themselves pay the actual tax.

b. Incorrect. S corporations are taxed like, but not as, partnerships. There are many differences between S corporation and partnership taxation.

c. Correct. Under these sections, the partnership files an information return (Form 1065). Its income and deductions flow through to, and are reflected on, the tax returns of the partners (Form 1040).

d. Incorrect. Depending on the number of members and elections made, limited liability companies can be taxed as sole proprietorships, partnerships, or corporations. [Chp. 2]

16. For tax purposes, when two or more individuals perform business activities through an unincorporated business, a partnership is formed. Thus, what could be a partnership?

a. Incorrect. Trust taxation is provided for in Subchapter J of the Internal Revenue Code. Trusts are different tax entities than partnerships.

b. Incorrect. Estates are separate legal entities subject to their own unique taxation. They are not taxed like partnerships.

c. Incorrect. For income tax purposes, a partnership does not include a corporation.

d. Correct. A joint venture can be a partnership. Under the Code, the term "partnership" includes a joint venture by means of which any business is carried on. [Chp. 2]

17. Family limited partnerships receive special tax treatment under §704(e). If certain conditions are met, family members will be recognized as partners permitting valuable income splitting. However, which of the following family members are excluded from this special treatment?

a. Incorrect. Family members, under §704(e), include husband and wife.

b. Incorrect. Ancestors are included under §704(e) as family members receiving special treatment in a family limited partnership.

c. Correct. Brothers and sisters are not included in the list of family members receiving this special treatment.
d. Incorrect. The family limited partnership provisions of §704(e) include lineal descendents as qualifying family members. [Chp. 2]

18. There are numerous advantages of partnerships. Why would someone choose a partnership over other entities?
   a. Correct. An advantage that partnerships have is that there is only one tax on distributed income.
   b. Incorrect. Limited partners have limited liability, but general partners are personally liable.
   c. Incorrect. Some fringe benefits may not be excluded from partners’ taxable income.
   d. Incorrect. Several state individual income tax returns may have to be filed if the partnership is in more than one state. [Chp. 2]

19. Certain qualified partnerships may elect to be excluded from being treated as partnerships for federal income tax purposes. To choose complete exclusion, the partnership must file a partnership return and statement including detailed information. Which item below is one of those required items of information?
   a. Incorrect. The statement attached to the partnership return must provide the names, addresses, and identification numbers of all members of the organization.
   b. Incorrect. The exclusion from partnership treatment is generally available only to investing or operating partnerships. As a result, the attachment must include a statement that the organization is such a partnership.
   c. Incorrect. No such statement is required on the attachment. The "three out of the last five year" concept has relationship to the not-for-profit rules under §183.
   d. Correct. The complete exclusion from partnership treatment can only be granted if all partners agree. As a result, the attachment to the return must include a statement that all members have chosen the exclusion from partnership treatment. [Chp. 2]

20. Members of a partnership are taxed as individuals. What is a tax compliance or filing requirement of partnerships?
   a. Incorrect. A partnership is not subject to income tax and does not make estimated tax payments. However, the partners may have to make payments of estimated tax.
   b. Correct. A partnership must figure its total income and file Form 1065 that provides information on partnership income or losses for the year.
   c. Incorrect. Unless labeled as a tax-sheltered, partnerships are not required to register with the IRS.
21. Partners are taxed on income earned. When must they include their distributive share of partnership income in their individual returns?
   a. Incorrect. A partner is taxable on his distributive share of partnership income when the income is earned.
   b. Correct. Partners must include in their individual returns their distributive share of partnership income, whether or not distributed (§702; Reg. §1.702-1). Time of distribution is immaterial.
   c. Incorrect. A partner is taxable on his distributive share of partnership income regardless of whether he or she was aware of its existence.
   d. Incorrect. A partner is taxable on his distributive share of partnership income regardless of whether he or she received it. [Chp. 2]

22. Each partner counts separately his or her distributive share of certain items of the partnership. Which of the following items is grouped together with all other transactions of a partnership?
   a. Incorrect. All partners, in determining their income tax, separately state their share of a partnership’s gains and losses from sales or exchanges of capital assets.
   b. Incorrect. All partners, in determining their income tax, separately state their share of a partnership’s charitable contributions.
   c. Correct. Gains or losses from the sale of partnership inventory is not separately stated to partners.
   d. Incorrect. All partners, in determining their income tax, separately state their share of a partnership’s intangible drilling and development costs. [Chp. 2]

23. When a partnership’s deductions surpass its income, the partners may deduct such losses. To what extent is a member’s distributive share of such a loss permitted?
   a. Correct. A partner’s distributive share of the partnership loss (and depletion on partnership oil and gas properties) is allowed only to the extent of the partner’s adjusted basis, before reduction by the current year’s losses, of the partnership’s tax year in which the loss occurred.
   b. Incorrect. The amount deductible is limited to the partner’s basis for his or her partnership interest - often called “outside basis” (§704(d)).
   c. Incorrect. A partner’s capital account relates to disproportionate special allocations under §704(b) and not to a partner’s outside basis.
   d. Incorrect. While a partner’s share of entity debt can increase their adjusted basis in their partnership interest, this is not a complete calculation of outside basis. Outside basis sets the limit under §704(d). [Chp. 2]
24. Amazingly, some partnerships are exempt from filing a tax return. However, which of the following partnerships is required to file a partnership return?
   a. Incorrect. A partnership that performs business only outside the U.S. is not required to file a partnership return.
   b. Incorrect. A partnership that receives income from only outside the U.S. is not required to file a partnership return.
   c. Correct. A partnership whose net income is zero must file the partnership return every year.
   d. Incorrect. A partnership that has never had income or deductions is not required to file the partnership return. [Chp. 2]

25. Allocations of partnership items of income and deduction can be disproportionately allocated among partners. Under what circumstance may the allocations be disproportionate?
   a. Correct. Disproportionate special allocations must have substantial economic effect. If the allocation has no substantial economic effect, it will be disregarded and the item will be allocated in accordance with the partner’s interest in the partnership.
   b. Incorrect. The economic effect must be “substantial” to be honored for tax purposes. This means that the economic effect is weighed against the tax savings produced by the allocation. If the economic effect seems insignificant or transitory and the tax savings are large, the special allocation would be ignored.
   c. Incorrect. Outside basis is a limitation on a partner’s ability to use losses. It is not a limitation on the allocation of those losses among partners.
   d. Incorrect. A partner’s basis cannot be negative. Only their capital accounts can be negative. [Chp. 2]

26. Upon a termination of a partnership, the taxable year closes as to all partners, and the partners must show on the partners’ returns all income or losses to the date of termination. Also, what are the partnership’s assets considered upon such termination?
   a. Incorrect. The assets of a partnership are not deemed sold on the termination of the partnership and the closing of the partnership year.
   b. Correct. Upon a “termination,” the assets of the partnership are deemed distributed to the partners.
   c. Incorrect. A termination of the partnership would only be deemed a contribution of the assets to a new partnership if the partners continue to operate as a partnership.
   d. Incorrect. No capitalization of the partnership assets occurs on the termination of the partnership. [Chp. 2]

27. An event that terminates a partnership for all partners is the discontinuance of the business. What other event can terminate the partnership?
28. A partner may agree to perform services for a partnership. What term is used for the partner’s salary that is determined without reference to the partnership’s income?

a. Correct. A partner can agree to work for a salary that is determined without reference to the partnership’s income (§707(c)). Such a salary is called a “guaranteed payment” and would be income to the recipient and often deductible to the partnership.

b. Incorrect. A syndication cost is a cost incurred to market the partnership and its underlying interests.

c. Incorrect. A start expenditure is a cost incurred before the partnership has an existing trade or business. Such costs can be amortized over a period of 15 years under §195.

d. Incorrect. A disproportionate allocation is not a payment for work performed by a partner but an allocation of income items that are not proportionate to the partner’s interest in the partnership. [Chp. 2]

29. A sale or exchange can occur between two related partnerships with common ownership. In these instances, what results?

a. Incorrect. A two-year restriction on dispositions does not exist under this rule. However, if one of the purchasers later sells the property, any gain realized will be taxable only to the extent that it is more than the loss that was not allowed.

b. Correct. If the sale or exchange is between two partnerships in which the same persons own, directly or indirectly, more than a 50% interest of the capital or profits in each, no loss deduction is allowed.

c. Incorrect. Sales or exchanges between related partnerships are not treated as capital contributions.
d. Incorrect. When certain thresholds of ownership are met, the sale or exchange is not treated like a sale between strangers. Gain can be converted to ordinary and losses can be disallowed. [Chp. 2]

30. According to the IRS in R.P. 93-27, when a partner renders services in exchange for a profit interest, such event is nontaxable. When does R.P. 93-27 apply?
   a. Incorrect. The ruling does not apply if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
   b. Incorrect. The ruling does not apply if the partner disposes of the profits interest within two years of its receipt.
   c. Correct. In R.P. 93-27, the IRS held that the receipt of a profit interest for services is not a taxable event if the person receives that interest either as a partner or in anticipation of becoming one.
   d. Incorrect. The ruling does not apply if profits interest is a limited partnership interest in a publicly traded partnership under §7704. [Chp. 2]

31. Generally, when a partnership distributes cash or property to partners, the event is nontaxable. Which of the following events is nontaxable?
   a. Incorrect. A retiring partner must recognize gains or losses from a liquidation payment.
   b. Incorrect. If in the year after a partner makes a contribution to another partner, a distribution of property is made, the partner must recognize any gain or loss that results.
   c. Incorrect. A partner must recognize the gain or loss on a disproportionate distribution that is treated as an exchange of property.
   d. Correct. A partner does not recognize gain on a distribution when adjusted basis of the partner’s interest is more than the partner’s distribution. This is the case even if property worth more than the surplus of the adjusted basis over the money distributed is also distributed. [Chp. 2]

32. A limited liability company (LLC) provides its members with numerous potential tax and legal benefits. Which of the following items is one of these potential benefits?
   a. Incorrect. Most LLCs are required to use the calendar year. Further, the same tax year of the LLC members must be used by the LLC.
   b. Correct. The members of the LLC do not run the risk of losing their limited liability even though they manage the business. This is one the major benefits of LLCs.
   c. Incorrect. LLCs share the limited availability of nontaxable fringe benefits. They may not take advantage of the exclusions for cafeteria plan benefits, nor can they issue equity interest or options for the purpose of obtaining equity interests
that are eligible for tax-preferred treatment afforded to corporate incentive
stock options and employee stock purchase plans.

d. Incorrect. An LLC is not inherently a tax-exempt organization or entity. Sepa-
rate qualification would be necessary to attain this status. [Chp. 3]

33. Perhaps the biggest benefit of a LLC over a C corporation is that a LLC is:
a. Correct. The biggest benefit that an LLC has over the C corporation is that the
LLC is subject to only one level of tax which is paid by the members of a LLC that
is characterized as a partnership.
b. Incorrect. There is no inherent operational superiority of a LLC over a regular
corporation.
c. Incorrect. LLCs are not necessarily easier to form than C corporations. Many
states have detailed filing requirements for LLCs that equal or rival the paper-
work necessary for a regular corporation.
d. Incorrect. Actually, a C corporation is easier to convert to an S corporation.
LLCs are first required to elect to be taxed as a corporation before they can file
the Form 2553 and elect S corporation status. [Chp. 3]

34. Basis adjustment is one of the tax advantages that limited liability companies
(LLCs) have over C corporations. The tax basis of assets in a multimember LLC
can be adjusted in relation to what?
a. Incorrect. A C corporation cannot adjust the tax basis of its assets in conne-
tion with a transfer of its shares.
b. Incorrect. Tax-free capitalizations typically result in carryover basis without
any adjustment.
c. Correct. When an LLC is taxed as a partnership, it is entitled to make a §754
basis election in connection with transfers of membership interests.
d. Incorrect. A sale of assets does not result in any adjustment to basis. [Chp. 3]

35. The author lists four non-tax benefits that limited liability companies (LLCs)
have over C corporations. Which of the following items is one of these?
a. Incorrect. LLCs face a higher risk of involuntary termination since specific pro-
cedural requirements must be met.
b. Incorrect. The formation of a LLC does not necessarily have less paperwork re-
quired than the formation of a C corporation. Many states have detailed for-
mation and filing requirements for LLCs.
c. Incorrect. Active management of LLCs are subject to self-employment tax. Fur-
ther, those LLC members who are inactive may be treated as managers if the
company fails to assign operating managers. Thus, these members’ distributive
share of income would also be subject to self-employment tax.
d. Correct. LLC members are not susceptible to a piercing the corporate veil at-
tack solely as a consequence of the members failure to satisfy certain adminis-
trative formalities such as annual meetings and election of Board of Directors. [Chp. 3]

36. The author lists seven advantages that limited liability companies (LLCs) have over S corporations. However, what is one advantage that S corporations have over LLCs?

a. Incorrect. S corporations cannot have a shareholder that is a corporation, partnership, LLC, or unincorporated entity other than a qualified estate or trust. On the other hand, LLCs can have any form of entity as a member.

b. Incorrect. S corporation shareholders cannot include indebtedness of the S corporation in basis. The tax basis of an LLC membership interest includes the member’s share of the entity’s indebtedness that may shelter from current gain recognition any operating distributions of cash.

c. Incorrect. S corporations are limited to a single class of stock whereas LLCs can have multiple classes of memberships outstanding and an infinite variety of interests.

d. Correct. S corporations have been a creature of tax law since the 1950s and, as a result, there is far more case law and tax resource data available. [Chp. 3]

37. Limited liability companies (LLCs) have advantages over limited partnerships. For example, when limited partners take part in managing a limited partnership, how can the partners be classified?

a. Incorrect. Participation in management would not reclassify a partner as a corporation. Incorporating is not that simple.

b. Incorrect. A tax management partner (TMP) is someone designated to deal with the IRS in audit. Participation in management would not reclassify a partner as a tax management partner although this partner could act as a TMP.

c. Correct. Limited partners who participate in the management of the limited partnership can be classified as general partners and lose the benefit of limited liability. All members of an LLC can fully participate in management without jeopardizing their protection from such liability.

d. Incorrect. The term "silent partner" is not a tax concept but one used by the general population to describe an undisclosed business partner. And, participating in management would not reclassify a partner as an undisclosed business partner. Active management would make a silent partner a disclosed business partner. [Chp. 3]

38. In a limited liability company (LLC), members have limited liability. Thus, all entity debt is essentially:

a. Incorrect. A recourse liability is where the partner bears the economic risk of loss. Since no member of an LLC is personally liable for the LLC’s liabilities, they do not have recourse liability.
b. Correct. In a limited liability company, no member is personally liable for the LLC’s liabilities, except to the extent of their investment in the LLC (R.R. 88-76). Thus, no member of an LLC bears the risk of loss for the LLC’s liabilities whether recourse or nonrecourse. Thus, even recourse debt can be treated as nonrecourse.

c. Incorrect. An assumable loan refers to the ability of another to take over the debt. There is nothing inherent in the LLC format that makes all entity debts assumable.

d. Incorrect. A subordinated loan refers to the junior position of a loan with another loan taking priority over it. There is nothing inherent in the LLC format that makes all entity debts subordinated. [Chp. 3]

39. Limited liability companies (LLCs) are very popular and have a number of advantages. However, what is a major drawback of LLCs?

a. Incorrect. Whereas, in a general partnership, management is vested in the general partners, LLCs can restrict management powers to a few members or to nonmember managers.

b. Correct. A major drawback of LLCs is that limited liability can be lost when an LLC does business in a state that has no LLC statute. Because this form of entity is so new, the laws are not always clear.

c. Incorrect. LLCs are taxed as partnerships. Therefore, they do not have the double taxation that is characteristic of C corporations.

d. Incorrect. Unlike shareholders of S corporations who may not be an entity other than a qualified estate or trust, members of LLCs can be any form of entity. [Chp. 3]

40. Performing business as a limited liability company (LLC) could prove to be beneficial for a professional firm. However, LLCs fail protect professionals from:

a. Incorrect. A LLC can protect its members from personal liability on working capital loans since entity loans of a LLC are nonrecourse.

b. Incorrect. A LLC can shield the members from liabilities of the business.

c. Correct. LLCs do not protect a professional from liability for their own acts.

d. Incorrect. It is possible for a LLC to protect its members from personal liability on the LLC’s lease obligations. [Chp. 3]

41. Many foreign countries understand limited liability companies (LLCs) and may tax them as corporations. Thus, these entities may appeal to those:

a. Correct. LLCs are well understood in many foreign countries (where they are likely to be taxed as corporations). Accordingly, the LLC format may be attractive to entities doing business abroad or anticipating significant foreign ownership.

b. Incorrect. Although LLCs are used in asset protection planning, they do not offer any unique ability to hide assets from creditors.
c. Incorrect. A LLC does not protect a member from pre-existing legal obligations.

d. Incorrect. There is no exception for LLCs from reporting the transfer of large sums of money outside the United States. [Chp. 3]

42. Charities may partake in fund-raising ventures through limited liability companies (LLCs). What do LLCs provide for these charities?

a. Incorrect. Charitable fund-raising ventures are typically of short duration and should not involve long-term lease obligations. Such obligations could jeopardize charitable status and constitute unrelated business taxable income.

b. Incorrect. There is a greater risk of creating fiduciary obligations by using a limited partnership where general partners can have such an obligation to the limited partners.

c. Correct. The LLC form provides an attractive alternative to a limited partnership, since the liability is limited and the charity would not be required to undertake personal liability as a general partner. The LLC allows the charity to maintain control over LLC activities to ensure that these functions are consistent with the charity’s tax-exempt purpose.

d. Incorrect. Charitable fundraising activity should not involve loans for working capital. Charities as exempt organizations are prohibited from engaging in business activities and can be subject to unrelated business taxable income taxation if they do. [Chp. 3]

43. Limited liability companies (LLCs) can have multiple uses. However, which of the following is a problem use?

a. Correct. Generally, it will be too expensive to convert an existing corporation to an LLC.

b. Incorrect. Real estate ventures typically are structured as general or limited partnerships in order to provide investors with the tax benefits of debt financed depreciation deductions on a flow through basis. Often these investors do not need the nontaxable fringe benefits available to employees of C corporations. LLCs provide the benefits of flow through deductions without the unlimited liability risks associated with the general partnership.

c. Incorrect. The LLC provides an attractive alternative for foreign investment in the U.S., whether the investment is in real estate or some other business activity. The LLC provides the coveted feature of limited liability without which the foreign investor must rely on distance, unenforceability of foreign judgments, confidentiality, insurance or a combination of some or all of these characteristics to avoid personal liability.

d. Incorrect. The co-venturers would save tax on 30% of the dividend payments under an LLC. [Chp. 3]
44. The check-the-box rules are the IRS’s final regulations for classifying entities. These rules allow entities that may be classified as entities other than corporations to elect to be taxed as:

a. Incorrect. Only if an election is not made, is the organization taxed as a disregarded entity.

b. Correct. The check-the-box regulations allow entities that must not be classified as corporations (e.g., entities that have complied with the formal state law requirements to be organized as “corporations”) to elect to be taxed as partnerships or corporations.

c. Incorrect. Typically, qualification is a tax-exempt organization is established under §503(c). The check-the-box rules have nothing to do with tax-exempt status.

d. Incorrect. S corporation status is not an option to be elected under the check-the-box regulations. However, once a qualified entity elects corporate status, you can subsequently filed the Form 2553 and become an S corporation. [Chp. 3]

45. A partnership may convert to a limited liability company (LLC) tax-free. However, what would cause the transaction to be taxable?

a. Incorrect. One of the methods of converting a partnership to an LLC tax-free is to have a partnership liquidation. The assets must then be distributed to the partners, and an undivided interest must be contributed to an LLC.

b. Incorrect. When there is a merger between a partnership and a new LLC, where the LLC survives, the transaction is tax-free.

c. Incorrect. One of the ways to convert a partnership to an LLC tax-free is to have the partners contribute their interests to a new LLC. In exchange for their contribution, the partners receive membership interests in the new LLC. Subsequently, the partnership should be liquidated.

d. Correct. To make certain that a conversion from a partnership to an LLC is tax-free, the partnership must avoid termination. And, termination occurs if 50% or more of the interest in its capital and profits are sold or exchanged within a 12-month period. [Chp. 3]

46. The California Limited Liability Company Act lists California licensed professions that are prohibited from establishing a limited liability company (LLC). However, which of the following professions would be permitted to operate an LLC in California?

a. Incorrect. Professional engineers are listed as a California licensed profession. The state of California must license these services. Therefore, under the California Limited Liability Company Act, professional engineers may not establish a California LLC.

b. Incorrect. Generally, nurses and other medical service professions are prohibited from establishing LLCs because these professionals require licensing, certifi-
cation, or registration. Even under the proposed legislation, these professionals would be prohibited from forming LLCs.

c. Incorrect. These individuals must be licensed, certified, or registered pursuant to the California Business and Professional Code. Thus, accountants are prohibited from conducting business as California LLCs.

d. Correct. Enrolled agents, who are licensed by the federal government, but are exempt from state licensing requirements, may qualify to operate a business as an LLC. This is because of the way that the Act is worded: those professional services for which license, certification, or registration is required pursuant to only the California Business and Professional Code are prohibited from organizing to conduct lawful business as LLCs. [Chp. 3]

47. The term “association” was defined in *Hecht v. Malley*, rather than under any Code provision. How are unincorporated, taxable associations generally treated?

a. Correct. An association will be taxed as a corporation if it more nearly resembles a corporation than any other organization. For federal income tax purposes, unincorporated associations that are taxable entities are generally treated as corporations.

b. Incorrect. S corporations are creatures of a specific election made using the Form 2553.

c. Incorrect. Charities are not taxable entities. To be an exempt charitable organization, the entities require special qualification under §503(c).

d. Incorrect. Sole proprietorships involve a single owner not a group of members. [Chp. 4]

48. The author lists four disadvantages of C corporations. What is one of these disadvantages?

a. Incorrect. An advantage of C corporations is that the dividends received deduction is available.

b. Incorrect. For purposes of federal income taxes, the corporation is recognized as a separate tax paying entity not a conduit or pass-through. This causes, in the case of most corporations, double taxation.

c. Correct. A disadvantage of C corporations is that a personal holding company tax applies to corporations in which more than 60% of their income is from rents, royalties, or dividends.

d. Incorrect. Limited liability is an advantage of C corporations and a stand-alone reason for forming them. [Chp. 4]

49. In general, when the employee-owners of a corporation perform personal services as the main activity, this entity is considered a personal service corporation. What is a general requirement of such entities?
a. Correct. Personal service corporations are required to use a calendar tax year unless they can establish a business purpose for a different period, or make a §444 election.

b. Incorrect. A corporation qualifies as a personal service corporation if, during the testing period, its compensation costs for personal service activities is over 50% of its total compensation costs. Thus, a corporation whose compensation costs for such activities is less than 50% of the total compensation costs is not a personal service corporation.

c. Incorrect. Personal service corporations are not required to make a §444 election.

d. Incorrect. Personal service corporations are not required to use the business year exception. [Chp. 4]

50. Under §1044, certain taxpayers can postpone their capital gain from publicly traded securities. What must these taxpayers do to take advantage of this deferment?

a. Incorrect. In order to use §1044, the taxpayer must sell publicly traded securities, not qualified closely held securities, at a gain after August 9, 1993.

b. Correct. Any regular corporation or individual taxpayer may be able to postpone reporting part or all of their capital gain from publicly traded securities sold after August 9, 1993, if they buy certain replacement property within 60 days of the sale and meet certain other requirements (§1044).

c. Incorrect. Section 1044 requires that the taxpayer have a capital gain, not a capital loss, on the sale.

d. Incorrect. The §1044 election to rollover gains is eligible to regular corporations. However, it is not available to estates, trusts, S corporations, or partnerships. [Chp. 4]

51. Under §351, the capitalization of a corporation can be tax-free. For this tax-free treatment to apply, what is required of the transferors of property to the corporation?

a. Incorrect. The transferors may receive other property in addition to stock, but it is not required.

b. Correct. For §351 to apply, the transferors of property to the corporation must, as a group, have control of the corporation immediately after the exchange.

c. Incorrect. To be in control of the corporation, the transferors must essentially own 80% of the stock of the corporation after the exchange.

d. Incorrect. Only stock may be received in the exchange, but it is not required. Stock received for services is taxable to the recipient. [Chp. 4]
52. When property is transferred to a corporation in exchange for stock, the basis of stock received is equal to the basis of transferred property adjusted by certain factors. What is the basis of property transferred increased by?
   a. Incorrect. The basis of property transferred is decreased by the total money received.
   b. Incorrect. The basis of property transferred is decreased by any loss recognized on the exchange.
   c. Incorrect. The basis of property transferred is decreased by the FMV of other property transferred (i.e., received).
   d. Correct. The basis of property transferred is increased by both the total dividends and any recognition of gain. [Chp. 4]

53. Section 1244 allows an original shareholder’s loss on closely held corporation stock to be treated as an ordinary loss. However, §1244 has a number of general requirements. Which of the following items is one of those requirements?
   a. Incorrect. There’s no requirement that the entity be an S corporation to take advantage of §1244. However, it must be a domestic corporation.
   b. Correct. Section 1244 requires that for five years prior to the date of the loss, a corporation must have been primarily an active trade or business.
   c. Incorrect. Under §1244, at the time of the stock issuance, the total amount paid in for stock cannot exceed $1 million.
   d. Incorrect. Section 1244 requires that the qualifying stock must have been distributed for money or other property, not for stock or securities. [Chp. 4]

54. To be eligible for the §1202 business stock exclusion, the stock must satisfy five tests. What is one of the tests that must be satisfied?
   a. Incorrect. A minimum requirement for qualifying as small business stock is that, at the issue date, the company must be a qualified small business. If the issuing company’s gross assets total over $50,000,000, it would not be deemed a qualified small business. A qualified small business has no more than $50,000,000 at all times, before and after stock is issued.
   b. Incorrect. If the issue date of the stock is before August 10, 1993, then the stock would not be deemed qualified small business stock. To qualify for the exclusion, the stock must have been issued subsequent to August 10, 1993.
   c. Incorrect. Material participation is used to determine whether activities are passive or nonpassive for the purpose of §469. To be deemed qualified small business stock, the issuing company must satisfy the active business test, not the material participation test. To satisfy this test, the business must be an “eligible corporation” and no less than 80% its assets must be used in the active conduct of one or more qualified trade or businesses.
   d. Correct. Under §1202, qualified small business stock must be stock in a C corporation. Further distinction is made under another requirement which indicates
that the corporation may not be a current or former Domestic International Sales Corporation, a corporation that has made a §836 election, a regulated investment company, a real estate investment trust, a Real Estate Mortgage Investment Conduit, or a cooperative. [Chp. 4]

55. When a corporation incurs expenses for its establishment that would be chargeable to a capital account, the corporation incurs organizational expenses. What may a newly organized corporation do?
   a. Incorrect. Organizational expenses are distinguished from start-up expenses.
   b. Correct. A newly organized corporation may choose to treat its organizational expenses as deferred expenses and to amortize them. Section 248 permits such treatment subject to the limitations contained in new §195.
   c. Incorrect. A tax credit is not allowed for organizational expenses of a newly organized corporation.
   d. Incorrect. If an election is not made to treat expenses otherwise, they must be capitalized. They may still be deducted, but they must be deducted in the year of liquidation. [Chp. 4]

56. Under certain circumstances, the IRS may reallocate gross income. Under §482, a reallocation is likely to occur between two or more businesses:
   a. Incorrect. The application of a §482 reallocation is not based upon the parent-subsidiary relationship. In fact, corporations in that relationship can typically file a consolidated return.
   b. Incorrect. The joint use or sharing of the same physical facilities is not a basis for the application of a §482 relocation.
   c. Correct. Where it is necessary to clearly show income or to prevent evasion of taxes, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (§482).
   d. Incorrect. Violation of the Sherman Antitrust Act does not trigger the application of a §482 reallocation. [Chp. 4]

57. Corporations are required to make estimated tax payments. For tax years subsequent to 1993, what modification did Omnibus Budget Reconciliation Act of 1993 (OBRA ’93) make to the prior rules for making estimated tax payments?
   a. Correct. Under OBRA ’93, a third method of computing annualized income is made available. This method provides a new set of income annualization periods. Thus, under this method, a corporation may figure annualized income for the first of the four installments based on the first two months of income; the second installment is based on the first four months of income; the third installment is based on the first seven months of income; and the last installment is based on the first ten months of income.
b. Incorrect. OBRA ’93 does not allow large corporations to opt out of making these payments. Previously, corporations that were not deemed large corporations could avoid addition to tax. Large corporations may still not make estimated payments to avoid addition to tax.

c. Incorrect. Under prior law, a corporation could avoid the addition to tax by making four timely estimated tax payments based on 97% of either its current year tax liability or its liability based on annualized income. OBRA ’93 increases the 97% requirement to 100%.

d. Incorrect. Under both prior law and OBRA ’93, corporations that are not large corporations may avoid the addition to tax by making four timely payments that each equal at least a quarter of the tax liability for the preceding taxable year. OBRA ’93 made no modification to this rule. [Chp. 4]

58. Certain corporations are treated as a small corporation exempt from the alternative minimum tax in any given tax year. However, to receive this exemption several requirements must be met. Which of the following is one of these requirements?

a. Incorrect. A corporation is treated as a small corporation exempt from the AMT for its tax year if that year is the corporation’s first tax year in existence (regardless of its gross receipts for the year).

b. Correct. To receive the exemption a corporation must have been treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997.

c. Incorrect. The exemption requires that a corporation’s average annual gross receipts for the 3-tax-year period (or portion thereof during which the corporation was in existence) ending before its current tax year did not exceed $7.5 million ($5 million if the corporation had only 1 prior tax year).

d. Incorrect. It is not a requirement of the exemption that five or fewer individuals own 50% or more of the stock. [Chp. 4]

59. A corporation can deduct capital losses. What are they deducted against?

a. Correct. A corporation, other than an S corporation, can deduct capital losses only up to its capital gains.

b. Incorrect. Capital losses of a corporation cannot be used against the alternative minimum tax.

c. Incorrect. Excess capital losses can be carried back three years and carried forward for five years.

d. Incorrect. Corporations cannot deduct capital losses against ordinary income. Capital losses can only be used against capital gains. [Chp. 4]

60. Corporations can claim a deduction, with certain limits, for any charitable contributions made in cash or other property. Which contributions are corporations disallowed from deducting?
a. Incorrect. There's no charitable restriction on the property that states that the corporation may not have previously used it.

b. Correct. A corporation cannot deduct contributions that total more than 10% of its taxable income (§170(b)(2)). Any charitable contributions made during the year that are more than the 10% limit can, with certain restrictions, be carried over to each of the following five years.

c. Incorrect. Subject to special valuation rules, property that has been created by the corporation can be the subject of a charitable contribution.

d. Incorrect. There's no per item value restriction on corporate charitable contributions. [Chp. 4]

61. Under former §341, when profits of certain sales and distributions were attributable to ordinary assets, capital gains treatment was disallowed. Which of the following corporations was deemed collapsible under this provision?

a. Incorrect. A corporation formed mainly to buy assets and then hold them for over three years would not have been considered collapsible under §341.

b. Incorrect. A corporation formed mainly to buy stock in a service corporation generally would not be considered a collapsible corporation. However, if the corporation had a “view” to the sale or exchange of such stock prior to realizing the necessary amount of taxable income to be realized from the property, the corporation could have been deemed collapsible.

c. Correct. A corporation formed mainly to produce computer software would have been considered collapsible under §341. Generally, if a corporation was formed or availed of mainly to manufacture, construct, or produce property, it was collapsible.

d. Incorrect. In instances where a corporation had §341 assets with a FMV of less than 100% of their adjusted basis, the entity was not presumed collapsible. The presumption of being collapsible was made if the corporation’s §341 assets had a FMV of over half the value of the corporation’s aggregate assets, and over 120% of the adjusted basis of these assets. [Chp. 4]

62. Corporations should avoid classification as a personal holding company (PHC). However, which of the following corporations could be deemed a PHC?

a. Incorrect. A corporation that has five shareholders may be classified as a PHC. However, if each shareholder owns equal shares of 20% throughout the entire taxable year, the corporation avoids this status.

b. Correct. A corporation that has a personal service contract naming the expert who is to render services can be treated as a PHC. Thus, personal holding company income can result. To avoid this treatment, the corporation could explain the problem to the client and indicate in the corporate bylaws and employment contracts that no one but the corporation may name the expert who is to perform services.
c. Incorrect. In an instance where a client names an expert of a corporation and the expert owns less than 25% of the stock, the corporation does not acquire PHC status. If the expert were to own at least 25% of the value of the stock at some time during the taxable year, then it is possible that the corporation could be deemed a PHC.

d. Incorrect. An S corporation always avoids PHC status. All of an S corporation’s income is currently distributed. [Chp. 4]

63. Corporations must beware of the potential for accumulated earnings tax. Under §531, such a tax will apply where earnings are retained without:

a. Incorrect. There is no IRS approval procedure. Thus, this is no cause for the tax.

b. Incorrect. The restriction or limit is on a corporation retaining and accumulating its earnings, not on the corporation’s gross receipts.

c. Correct. A corporation can accumulate its earnings for bona fide business reasons.

d. Incorrect. If the accumulated earnings tax applies, interest will be charged on the underpayments of the tax from the date the corporate return was originally due, without extensions. [Chp. 4]

64. Personal service corporations may make a §444 election. This election allows them to use a tax year other than:

a. Incorrect. This election does not apply to any personal service corporation that establishes a business purpose for a different period.

b. Incorrect. Even when made, it only permits at most a three month variation from the required taxable year.

c. Incorrect. Other than pursuant to a §444 election or special business purpose year, a personal service corporation may not use a fiscal year.

d. Correct. Personal service corporations may elect to use a tax year that is different from the required tax year under §444. [Chp. 4]

65. Corporations can choose from the cash method, accrual method, special methods for specific items of income and expense, and a hybrid method of accounting. When must a corporation choose its accounting method?

a. Correct. An accounting method is a set of rules used to determine when and how income and expenses are reported. An accounting method is chosen when the first tax return is filed.

b. Incorrect. An accounting method does not have to be selected when a corporation first begins to conduct business.

c. Incorrect. An accounting method does not have to be selected upon the filing of a corporation's articles of incorporation.

d. Incorrect. An accounting method does not have to be selected upon incorporation. The first tax return is used to make that selection. [Chp. 4]
66. The author lists six potential tax advantages of using multiple corporations to operate a company. What is one of these cited advantages?
   a. Correct. Using multiple corporations to operate a business can allow the owner(s) to exclude certain groups of employees from retirement plan and fringe benefit coverage. For example, one corporation that employs higher-end executives could offer these employees premier fringe benefits while another corporation employing manufacturers and laborers could offer limited retirement and fringe benefits.
   b. Incorrect. While a benefit of having multiple corporations is the avoidance of the tax on unreasonable accumulation of earnings by creating additional accumulated earnings tax credits, there is a limitation on the credits that are allowed. More specifically, group members are limited to one $250,000 minimum accumulated earnings credit. If any member is a service corporation, the group is limited to only one $150,000 minimum credit.
   c. Incorrect. An advantage of having multiple corporations for the purpose of operating a business is the ability it offers to split corporate taxable income among several corporations to significantly reduce income tax liability. However, it is limited to an aggregate of only one $50,000 taxable income bracket amount and one $25,000 taxable income bracket amount in each taxable income bracket below the top 35% corporate bracket for affiliated group members.
   d. Incorrect. Operating a business using multiple corporations allows its owners to provide additional exemptions in computing the alternative minimum tax. Yet, this is also limited: affiliated group members are limited to one $40,000 exemption amount for purposes of calculating AMT. [Chp. 4]

67. Businesses are required to account for inventories to provide evidence of income. Generally, what are businesses with inventories required to do?
   a. Incorrect. Businesses with inventories are required to use both an identification method and a valuation method to determine the value of the inventory.
   b. Incorrect. Section 446 is an exception to the $5 million cash method safe harbor rule contained in §448.
   c. Correct. If a business must account for inventories, it must use the accrual method of accounting for purchases and sales (Reg. §1.471-1; Reg. §1.446-1(c)(2)(i)).
   d. Incorrect. Businesses with inventories are required to value inventories at both the beginning and at the end of each tax year to figure taxable income. Without a reference, a valuation only at the end of the tax year would be meaningless. [Chp. 4]

68. Currently, when a corporation dissolves, it can trigger double taxation. Under §316, what are distributions of money, securities, and assets that are made from earnings and profits?
a. Incorrect. Under §301, any portion of a distribution that is not a dividend is a return of capital.
b. Correct. Under §316, distributions of property, such as money, securities or assets, which are made from earnings and profits are dividends.
c. Incorrect. Under §301, any amount over the basis is a gain from the sale of property.
d. Incorrect. Under §301, shareholders recognize ordinary income on non-liquidating distributions of property. [Chp. 4]

69. The author identifies five circumstances where an S corporation would be advantageous. What is one of these circumstances?

a. Correct. When corporate rates are higher than individual rates, an S corporation may be desirable.
b. Incorrect. When the business has little reason to accumulate capital, an S corporation may be desirable.
c. Incorrect. When the business is expected to incur large losses and/or credits that may be better used by the shareholders than the corporation, an S corporation may be desirable.
d. Incorrect. When the business will have a large cashflow that it intends to distribute, an S corporation may be desirable. [Chp. 5]

70. The author lists 13 potential disadvantages of a subchapter S election. What is one of these drawbacks?

a. Incorrect. A potential disadvantage of a subchapter S election is that, all income, except long term capital gains, received by the corporation are taxable to the shareholders whether or not they are currently distributed.
b. Incorrect. A potential disadvantage of a subchapter S election is that, since there is no corporate tax rate, nonqualified deferred compensation plans are an impracticality.
c. Correct. A potential disadvantage of a subchapter S election is that, split-dollar and other non-deductible fringe benefits for the shareholders cannot be paid for by lower taxed corporate funds.
d. Incorrect. A potential disadvantage of a subchapter S election is that, the 80% dividends received deduction is lost. [Chp. 5]

71. Under §1361, to elect to be treated as an S corporation, a small business corporation must meet numerous eligibility requirements. What is one of these eligibility requirements?

a. Correct. A trust, all of the income of which is taxed to the grantor or to a third party who has control over the trust (i.e., the “deemed owner”), can be a shareholder for 60 days after the death of the deemed owner. A voting trust can be a shareholder. A testamentary trust can be a shareholder for a 60-day period starting on the day the stock is transferred (§1361(c)(2)(A)(iii)). A “qualified subchap-
ter S trust” can be a shareholder if the income beneficiary so elects (the election is irrevocable). Effective for taxable years beginning after December 31, 1996, an “electing small business trust” can hold stock in an S corporation (§1361(c)(2)(A)(v)).

b. Incorrect. Nonresident aliens may not be shareholders (§1361(b)(1)).

c. Incorrect. A small business corporation cannot be an ineligible corporation. Effective for taxable years beginning after December 31, 1996, the term “ineligible corporation” means any corporation that is: A financial institution that uses the reserve method of accounting for bad debts described in §585, an insurance company subject to tax under subchapter L, a corporation to which an election under §936 applies, or a DISC or former DISC (§1361(b)(2)).

d. Incorrect. The maximum number of S corporation shareholders has now increased to 100. Spouses are treated as a single shareholder (§1361(c)(1)). [Chp. 5]

72. One of the requirements of S corporations is that they may have only one class of stock. What position do the one-class-of-stock regulations adopt?

a. Incorrect. A call option, warrant, or similar instrument is treated as a second class of stock if, taking into account all facts and circumstances: It is substantially certain to be exercised, and it has a strike price substantially below the fair market value of the underlying stock on the date the call option is issued.

b. Incorrect. A commercial contractual agreement, such as a lease or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds, and thus not a governing provision unless a principal purpose of the agreement is to get around this one-class-of-stock provision.

c. Incorrect. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded for the one-class-of-stock rules.

d. Correct. The one-class-of-stock regulations adopt what position that stock that is issued in connection with the performance of services, and that is substantially nonvested, is generally not treated as outstanding stock. The holder of that stock is not treated as a shareholder unless he or she makes an election to include in income the fair market value of the stock at the time of the transfer minus the amount paid for the stock. [Chp. 5]

73. Four events that cause a corporation to stop qualifying as an S corporation are identified. Which of the following is one of these events?

a. Correct. Acquiring a subsidiary, other than certain nonoperating subsidiaries, can cause the corporation to cease qualifying as an S corporation.

b. Incorrect. Creating a second class of stock can cause the corporation to cease qualifying as an S corporation.
c. Incorrect. Having more than 100 shareholders can cause the corporation to cease qualifying as an S corporation.

d. Incorrect. Transferring stock in the S corporation to a corporation, a partnership, an ineligible trust, or a nonresident alien can cause the corporation to cease qualifying as an S corporation. [Chp. 5]

74. Under §1375, corporate income tax must be paid on any amount that exceeds net passive income if the S corporation had earnings and profits when it was a C corporation and in the event that passive income surpasses 25% of gross receipts. What do gross receipts include?

a. Correct. Gross receipts include the total amount received or accrued from the sale or exchange of most kinds of property, from services rendered, or from investments. They include amounts received deferred or unrecognized portion of any gain on sales or exchanges made from installment sales of publicly traded stocks and securities.

b. Incorrect. Gross receipts do not include amounts received from issuing stock in the S corporation.

c. Incorrect. Gross receipts do not include amounts received from nontaxable sale or exchange, except to the extent that gain is recognized by the S corporation.

d. Incorrect. Gross receipts do not include amounts received from repayment of a loan. [Chp. 5]

75. Tax preference items must be adjusted by an S corporation that was a regular corporation for any of the three previous tax years. Which tax preference item must the entity reduce by 30%?

a. Incorrect. The amortizable basis of pollution control facilities is reduced by 20% for purposes of determining the amortization deduction for that property.

b. Correct. The amount allowable as a deduction for mineral exploration and development costs is reduced by 30%. Special rules apply to the amount not allowed because of this adjustment. This reduction also applies to the intangible drilling costs of an integrated oil company.

c. Incorrect. For iron ore and coal (including lignite), the amount allowable as a percentage depletion deduction is reduced by 20% of any excess of the amount of the percentage depletion deduction allowable for the tax year (determined without this adjustment), over the adjusted basis of the depletable property at the close of the tax year (figured without the depletion deduction for the tax year).

d. Incorrect. For §1250 property that is disposed of during the tax year, 20% of any excess of the amount that would be ordinary income if the property were §1245 property, over the amount treated as ordinary income under §1250, is treated as ordinary income under §1250 and will be recognized. [Chp. 5]
76. An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax. What is one of the three conditions that must be met for the capital gains tax to apply?

a. Incorrect. If a corporation made an election to be an S corporation after December 17, 1987, and used the LIFO inventory pricing method for its last tax year before its S election became effective, the corporation may be liable for LIFO re-capture.

b. Incorrect. An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if, among other things, its net long-term capital gain exceeds its net short-term capital loss by more than $25,000.

c. Incorrect. An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if, among other things, the excess is more than 50% of the corporation’s taxable income.

d. Correct. An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if, among other things, the taxable income is more than $25,000. [Chp. 5]

77. The shareholder’s basis must be figured in order to determine the adjusted basis of a shareholder’s stock or loans. Generally, what is a shareholder’s basis in stock if the shareholder traded property for stock?

a. Incorrect. If the stock was purchased, the basis is usually its cost.

b. Incorrect. If money was loaned to the S corporation, the basis is usually the amount of the loan.

c. Correct. To arrive at the adjusted basis of a shareholder’s stock or loans, the shareholder’s basis must first be determined. If a shareholder received stock in the S corporation in exchange for property, his or her basis in the stock is generally the same as his or her basis in the property transferred.

d. Incorrect. During the time the corporation is an S corporation, each shareholder will increase or decrease the basis of his or her stock, but not below zero. [Chp. 5]

78. S corporation shareholders will increase or decrease the basis of their stock. The basis is decreased by each shareholder’s pro rata share of:

a. Incorrect. The basis of the stock is increased by each shareholder’s pro rata share of all income items of the S corporation.

b. Incorrect. The basis of the stock is increased by each shareholder’s pro rata share of any nonseparately stated income of the S corporation.

c. Correct. The basis of the stock is decreased by each shareholder’s pro rata share of distributions by the S corporation that were not included in the shareholder’s income.
d. Incorrect. The basis of the stock is \textit{increased} by each shareholder’s pro rata share of the amount of the deductions for depletion that is more than the basis of the property being depleted. [Chp. 5]

79. When an S corporation has earnings and profits and fails to make an election to distribute them first, an order of distribution must be followed. In these instances, what is the first source for the distributions?

a. Correct. If an S corporation has earnings and profits but has \textit{not} elected to distribute them first, any distribution it makes will first come out of the accumulated adjustments account. A distribution out of AAA is applied against and reduces the shareholder’s adjusted stock basis.

b. Incorrect. If the S corporation shareholder has previously taxed income (PTI) in the corporation, the PTI is the second source for distribution. A distribution out of PTI is applied against and reduces the shareholder’s basis in the stock. A distribution out of PTI in excess of the shareholder’s basis in the stock is treated as gain from the sale or exchange of property. The shareholder’s PTI account must be reduced by the amount of the distribution made from PTI.

c. Incorrect. Third, a distribution is treated as coming out of the S corporation’s earnings and profits. A distribution is treated as a dividend up to the amount of the corporation’s earnings and profits.

d. Incorrect. Fourth, a distribution is applied against and reduces the shareholder’s basis in the stock. [Chp. 5]

80. Generally, S corporations are required to use the permitted tax year. This means that it can use a taxable year which is:

a. Correct. For an S corporation, permitted year means a taxable year which is a year ending December 31\textsuperscript{st} or any other accounting period for which the corporation establishes a business purpose.

b. Incorrect. S corporations do not have partners.

c. Incorrect. There is no principal shareholder year. However, partnerships can have a choice of either a major partner or principal partner year.

d. Incorrect. Plan year is a concept used for retirement plans not S corporations. [Chp. 5]

81. One of the two original types of fringe benefits was statutory fringe benefits. What characterized statutory fringe benefits?

a. Correct. Statutory fringe benefits were specifically permitted by \textit{statute}.

b. Incorrect. A characteristic of fringe benefits, including statutory benefits, is that they are generally \textit{not} taxable to the executive, and the employer may currently deduct the cost of providing the fringe benefits.

c. Incorrect. \textit{Nonstatutory} benefits usually involved the payment of a particular expense by the employer.
d. Incorrect. *Nonstatutory* benefits usually involved the provision of goods and services to the employee. [Chp. 6]

82. Generally, fringe benefits are taxable for income and employment purposes if they fail to qualify for exclusion. When must employers include the value of fringe benefits in employees’ pay?

a. Correct. Employers must include the value of fringe benefits in employees’ pay if the benefits are nonstatutory. While there is no longer a nonstatutory category of fringe benefits, if the benefits aren’t covered under a statute, the value of the fringe benefits must be included in pay.

b. Incorrect. Employers must include in employees’ pay the value of fringe benefits unless the benefits are specifically excluded from income by law.

c. Incorrect. Any fringe benefits that do not qualify for exclusion under §132, or any other provision, are taxable for income and employment tax purposes.

d. Incorrect. Employers must include in employees’ pay the value of fringe benefits unless the employee pays for the benefits. [Chp. 6]

83. For benefits provided after 1992, four conditions must be met in order for an employer or an employee to use the special valuation rule. What is one of the conditions?

a. Incorrect. For benefits provided after 1992, neither the employer nor the employee may use the special valuation rule to value any benefit, unless the employee includes the value of the benefit in income by the due date of the return for the year the benefit is received.

b. Incorrect. For benefits provided after 1992, neither the employer nor the employee may use the special valuation rule to value any benefit, unless the employee is not a control employee.

c. Correct. For benefits provided after 1992, neither the employer nor the employee may use the special valuation rule to value any benefit, unless the employer demonstrates a good faith effort to treat the benefit correctly for reporting purposes.

d. Incorrect. For benefits provided after 1992, neither the employer nor the employee may use the special valuation rule to value any benefit, unless the employer treats the value of the benefit as wages for reporting purposes by the due date of the return (including extensions) for the tax year in which the benefit was provided. [Chp. 6]

84. Taxpayers must determine which fringe benefits to withhold and account for. What is the general income tax and reporting rule?

a. Incorrect. Employers can elect, for employment tax and withholding purposes, to treat taxable noncash fringe benefits provided to employees as if they were paid: on a pay period, quarterly, semi-annually, annually, or any other time period, provided they are treated as paid no less than once a year. The election can
be changed as long as all benefits provided in a calendar year are treated as paid no later than December 31 of that year.

b. Correct. The value of any noncash fringe benefit provided to employees in a calendar year must be determined by January 31 of the following year. This is called the general income tax and reporting rule.

c. Incorrect. Under the special accounting period rule, the value of benefits provided in the last 2 months of the calendar year, or any shorter period, can be treated as though paid in the next year.

d. Incorrect. The value of includible fringe benefits provided is generally subject to social security and Medicare tax (FICA), federal unemployment tax (FUTA), and federal income tax withholding. [Chp. 6]

85. Under §274(j)(3)(A), an employee achievement award is given by an employer to an employee. Moreover, the item of tangible personal property is:

a. Correct. Section 274(j)(3)(A) provides that an employee achievement award must be awarded as part of a significant presentation. Often such awards are given at giveaway shows, as door prizes, contest awards, and awards from an employer to an employee.

b. Incorrect. Section 274(j)(3)(A) provides that an employee achievement award is an item of tangible personal property that an employer gives to an employee and is transferred for length of safety. Thus, the tangible personal property may be given as a recognition of safety.

c. Incorrect. Section 274(j)(3)(A) provides that an employee achievement award is an item of tangible personal property that is awarded under conditions that do not create a significant likelihood of the payment of disguised compensation.

d. Incorrect. Section 274(j)(3)(A) provides that an employee achievement award is an item of tangible personal property that is transferred for length of service. Under §274(j)(4)(B), an item is not treated as having been provided from length of service achievement if the item is received during the recipient’s first 5 years of employment. [Chp. 6]

86. Generally, employees who are covered under group term life insurance must include the cost of the coverage over a certain amount. What amount must be included in their income?

a. Correct. The cost of the group term life insurance that must be included in an employee’s income is an amount figured using a monthly cost table. This amount is figured by calculating the monthly cost of the insurance that is more than $50,000.

b. Incorrect. In determining the monthly cost includible in an employee’s income, any amount the employee paid toward the purchase of the insurance is subtracted from the product of: 1) the number of thousands of dollars in excess of the $50,000, 2) the appropriate cost per thousand per month from the table,
and 3) the number of months during the year the employee’s insurance exceeded $50,000 by that number of thousands.

c. Incorrect. The cost of the group term life insurance that must be included in an employee's income is not the actual cost of the extra coverage. Instead, a special calculation is required.

d. Incorrect. For group term life insurance, the only time the number of thousands of dollars over $50,000 is multiplied by $2.06 is when the participant is 70 years or over at the end of the tax year. [Chp. 6]

87. Under §105, if a medical reimbursement plan discriminates in favor of highly compensated individuals, all or part of the amounts paid to these individuals must be included in their gross income. For these purposes, who would be considered a highly compensated individual?

a. Incorrect. A highly compensated individual (for these purposes) is one of the five highest paid officers.

b. Incorrect. A highly compensated individual (for these purposes) is a shareholder who owns more than 10% in value of the employer’s stock.

c. Correct. A highly compensated individual (for these purposes) includes employees whose compensation is in the top 25% of all participant-employees. Nonparticipants who can be excluded from participation in the plan are not included in the determination.

d. Incorrect. For group term life insurance reporting purposes, the definition of “employee” includes persons who were formerly employed with the company, regardless of their pay. [Chp. 6]

88. Employers can deduct premiums paid or incurred for health or accident insurance plans. Under §106, when will the employer be subject to an excise tax?

a. Correct. A group health plan must provide for continuation of coverage. If a plan fails to provide continuation coverage to qualified beneficiaries the employer will be subject to an excise tax.

b. Incorrect. The excise tax generally does not apply to any group health plan if all employers maintaining the plan normally employed fewer than 20 employees on a typical business day in the preceding calendar year. This is one of the three exemptions listed by the author.

c. Incorrect. If the employer discontinues coverage for a governmental plan, no excise tax will apply. This is listed as one of three exemptions to the tax.

d. Incorrect. A plan is required to provide at least 60 days to elect to continue coverage. No more time is required. Thus, if the company follows all other requirements, the employer will not be subject to an excise tax. [Chp. 6]

89. The value of meals must be included as additional income to employees if the employer fails to show there is a substantial nonpay reason for providing
them. In what situation are such meals considered as provided for a substantial nonpay business reason?

a. Correct. Meals furnished during working hours so the employee will be available for emergency calls during the meal period are regarded as furnished for a substantial nonpay business reason. The employer must be able to demonstrate that the emergency could occur or could have occurred.

b. Incorrect. The value of meals furnished on any non-workday is normally income to the employee.

c. Incorrect. Meals furnished to employees to attract prospective employees are considered additional pay and must be included as income to employees.

d. Incorrect. Meals furnished to employees to promote goodwill or to boost morale are considered additional pay and must be included as income to employees. [Chp. 6]

90. Employees can choose from at least five qualified benefits under a cafeteria plan. What is one of these five qualified benefits?

a. Correct. A cafeteria plan can offer employees choices that include only cash and qualified benefits that are excludable under a specific Code section. Such qualified benefits include coverage or participation under a vacation days program, provided such vacation days are not redeemable for cash at a later date.

b. Incorrect. Cafeteria plans cannot offer meals and lodging under §119.

c. Incorrect. Cafeteria plans cannot offer scholarships and fellowships under §117.

d. Incorrect. Cafeteria plans cannot offer vanpooling under §124. [Chp. 6]

91. Educational assistance may qualify as a working condition fringe if it fails to meet four requirements. What is one of the requirements under §127?

a. Incorrect. Under §127, a qualified plan must pay less than 5%, not 2%, of its benefits annually for shareholders or owners.

b. Correct. Under §127, a qualified plan’s terms and availability must be communicated to eligible employees within a reasonable time period. This permits all eligible employees to take advantage of the fringe and helps to limit possible discrimination.

c. Incorrect. Under §127, there is no requirement stating that the qualified plan needs to provide payment options. Yet, the eligible employees may not have a choice between receiving payment or receiving educational assistance.

d. Incorrect. Under §127, there is no requirement stating what is to be covered under the plan. However, the definition of educational assistance includes only tuition, fees, books, equipment, and supplies. It does not include costs for lodging, meals, and/or transportation. [Chp. 6]

92. An employer may provide dependent care assistance for employees tax free. Up to what amount may an employer exclude for each employee annually?
a. Correct. The amount that an employer may exclude for each employee annually is $5,000 or less. Specifically, the aggregate amount that employers may exclude from income, for these purposes, is the lesser of: $5,000 or the employee’s or spouse’s earned income, whichever is lower. If the individual is married filing separately, it is the lesser of: $2,500 or the employee’s or spouse’s earned income.

b. Incorrect. Under §127, $5,250 can be excluded from an employee’s wages each year for educational assistance. This amount is over the limit that employer’s may exclude for each employee for dependent care assistance.

c. Incorrect. Generally, the limit on the allowable deduction for meals is 50% of the costs. Fifty percent of dependent care costs could total much greater than the deductible limit.

d. Incorrect. For self-insured medical reimbursement plans, there is no statutory limit on the amount that companies may exclude for each employee annually. It is advisable to place a ceiling on reimbursements. Dependent care assistance is often a huge expense, and any amount that the employer pays beyond the limit is included in the employee’s income on Form W-2. [Chp. 6]

93. Under §132, employers may exclude only the costs of providing hotel accommodations to employees, so long as customers are satisfied with their accommodations. What type of fringe benefit is this?

a. Incorrect. An exclusion from gross income applies for property or services that are considered of such relatively small value that accounting for them is impractical.

b. Correct. The entire value of any no additional cost service provided by an employer for an employee’s use is excludable from gross income. Under §132(b), employers may furnish railroad or airline seats, or hotel accommodations to employees if customers are not displaced and the employer doesn’t incur any supplementary expenses due to the provision.

c. Incorrect. Section 132(c) and Reg. §1.132-3T(a) allow the employee to exclude the discount from income if the property or services are provided. Typically, this discount is offered on services or merchandise provided by the employer.

d. Incorrect. Property or services provided to an employee are excluded to the extent that they would be deductible as ordinary and necessary business expenses if the employee had paid for them. [Chp. 6]

94. A qualified employee discount may be provided at a reduced price to the employee. Which of the following may be excluded from income?

a. Incorrect. A discount on a building is not a qualified employee discount. Thus, the exclusion is not available for this discount.

b. Incorrect. A discount on land is not a qualified employee discount. Thus, the exclusion is not available for this discount.
c. Incorrect. A discount on stocks or bonds is not a qualified employee discount. Thus, the exclusion is not available for this discount.

d. Correct. A cash rebate from a third party is a qualified employee discount. Thus, this rebate would also qualify for the exclusion from income. [Chp. 6]

95. Under §132(d), certain property or services may be excluded from employees’ income. Under Reg. §1.132-1T(b)(2), who is covered by the working condition fringe exclusion?

a. Incorrect. Under Reg. §1.132-1T(b)(2), employees covered by this §132 exclusion include a director of the employer; yet, the director may not exclude the value of consumer goods provided for use in a product-testing program. Goods or services provided to friends would not qualify as an ordinary and necessary business expense since they are not business related.

b. Incorrect. Under Reg. §1.132-1T(b)(2), employees covered by this §132 exclusion include a partner who performs services for a partnership, not a partner in a partnership. The partner must perform services in order to receive fringes that are deductible as ordinary and necessary business expenses.

c. Correct. Under Reg. §1.132-1T(b)(2), employees covered by this §132 exclusion include an independent contractor who performs services for the employer. However, this independent contractor may not exclude any value of parking or the value of consumer goods provided for use in a product-testing program.

d. Incorrect. Under Reg. §1.132-1T(b)(2), employees covered by this §132 exclusion include current employees, but not retired employees. This is because of the ordinary and necessary business expense requirement. [Chp. 6]

96. The safe-harbor value can be used as the fair market value for determining the annual lease value of an automobile. What is the safe harbor value for owned automobiles?

a. Incorrect. The safe-harbor value for a leased automobile can be the invoice price plus 4%.

b. Incorrect. The safe-harbor value for a leased automobile can be the manufacturer’s suggested retail price minus 8%, including sales tax, title, and other purchase expenses.

c. Correct. The safe-harbor value for an owned automobile is the tax and title and any other expenses of purchase.

d. Incorrect. The safe-harbor value for a leased automobile can be the retail value according to a prominent pricing source. [Chp. 6]

97. The author describes four valuation methods that can be used to determine the value of an employer provided automobile. Under Reg.§1.61-2T(e), for autos with fair market values less than the maximum recovery deductions allowable for the first five years the auto is placed in service, what valuation method should an employer use?
a. Incorrect. Reg. §1.61-2T(d) states that if an employer provides an employee with an auto, the value of the benefit may be determined using a lease valuation method. Under this method an employee reports the annual lease value of the auto from the tables in Reg. §1.61-2T(d)(2)(iii) based on the auto’s fair market value when it is first made available to the employee.

b. Correct. For autos with fair market values less than the maximum recovery deductions allowable for the first five years the auto is placed in service, an employer may determine the value of a vehicle provided to an employee by multiplying the standard mileage rate by the total number of personal miles driven by the employee. The value cannot be determined using this method if the auto’s FMV is more than the maximum recovery deductions allowable in this time period.

c. Incorrect. If the auto is provided under the written commuting policy statement exception, the value of the employee’s use of the vehicle for such commuting purposes is computed as $1.50 per one way commute.

d. Incorrect. Under Reg.§1.61-2T(b)(4), if none of the special methods are used, the valuation must be determined by reference to the cost to a hypothetical person of leasing from a hypothetical third party the same or comparable vehicle on the same or comparable terms in the geographic area in which the vehicle is available for use. [Chp. 6]

98. Financial planning is very popular among corporate executives. Under Rev. Rul. 73-13, how are financial counseling fees that a company pays for the benefit of its executives treated?

a. Incorrect. Counseling fees are not deductible as a nonbusiness expense. However, individuals can deduct tax-related expenses as a “nonbusiness” expense under §212.

b. Incorrect. If fees are incurred for tax or investment advice, they will be deductible by the employee under §212 (subject to the 2% of AGI limitation).

c. Incorrect. If fees are incurred for tax or investment advice, they will not be deductible by the employer under §212. Thus, employers are able to provide these services at a somewhat low cost.

d. Correct. The IRS has ruled that financial counseling fees paid by a company for the benefit of its executives are taxable income. [Chp. 6]

99. Under the Sub Chapter S Revision Act of 1982, several tax-free advantages of fringe benefits provided to S corporations were limited or eliminated for more than 2% owners. What is one of the four listed plans that were affected?

a. Correct. The four plans that the author lists as being affected by this Act include: the former, but now repealed, $5,000 exclusion under §101(b), accident and health insurance plans under §105 and §106, group term life insurance under §79, and meals or lodging under §119.
b. Incorrect. The child care facility credit is new. Since 2002, taxpayers are able to take advantage of a 25% tax credit for qualified expenses for employee child care. It must have an open enrollment to the employees of the taxpayer. This is a new benefit, so it couldn’t have been affected by the Act.

c. Incorrect. Employers can offer tax and estate planning services to key executives. This is a popular benefit among executives and it has not been limited or eliminated yet.

d. Incorrect. Since 2002, contributions may be made to educational savings accounts, regardless of the income of the corporation or entity during the year of contribution. This is a new benefit, so it couldn’t have been affected by the Act.

100. The author identifies two deferred tax advantages of corporate retirement plans. What is one of these advantages?

a. Incorrect. A current benefit of a corporate plan is that employee benefit trust accumulates tax-free.

b. Correct. One of the two listed deferred tax advantages of corporate plans is that certain distributions may be rolled over tax-free into an IRA.

c. Incorrect. A current benefit of a corporate plan is that the employer corporation obtains a current deduction for the amounts paid or accruable to the qualified plan.

d. Incorrect. A current benefit of a corporate plan is that the employee does not recognize income currently on contributions made by his or her employer even though the benefits may be nonforfeitable and fully vested. [Chp. 6]

101. The author lists two major disadvantages of qualified corporate plans. What is one of these disadvantages?

a. Incorrect. One of the exceptions to the prohibited transaction rules allows for loans to be made to plan participants. Thus, this is not a disadvantage.

b. Incorrect. A deferred tax advantage of a qualified corporate plan is that lump-sum distributions from a qualified employee benefit plan are eligible for favorable five (or in some cases still ten) year income averaging treatment.

c. Correct. For a closely held corporation, it is often the cost to the shareholder-employee of covering rank and file employees. Generally, the objective of qualified retirement plans of closely held companies is to provide the greatest benefit to the controlling shareholders/executives.

d. Incorrect. Most pension plans may not acquire or hold 10% of the fair market value of the total assets in qualifying employer real property or securities. However, profit sharing and pre-ERISA money purchase pension plans may. Thus this is not one of the disadvantages of a qualified corporate plan. [Chp. 7]
102. A fiduciary employs unrestricted control or authority over management of a qualified deferred compensation plan or of such a plan’s assets. What is a fiduciary permitted to do?

a. Incorrect. One of the three listed prohibited actions that plan fiduciaries may not engage in is acting in any capacity in any transaction involving a plan on behalf of a party, or in representation of a party, whose interests are adverse to the interests of the plan, its participants, or beneficiaries.

b. Incorrect. One of the three listed prohibited actions that plan fiduciaries may not engage in is dealing with the assets of the plan for their own account.

c. Incorrect. One of the three listed prohibited actions that plan fiduciaries may not engage in is receiving any consideration for his own account from any party dealing with the plan in connection with a transaction involving plan assets.

d. Correct. There are four listed exceptions to the prohibited transactions. One of these exceptions allows fiduciaries to operate as an officer, employee, agent, etc., of a party-in-interest. [Chp. 7]

103. The Pension Benefit Guarantee Corporation (PBGC) guarantees payment of certain benefits upon a plan’s termination if a plan fails to satisfy such payment. What plan is included in the requirement of PBGC insurance coverage?

a. Incorrect. Governmental plans are specifically excluded from PBGC insurance coverage.

b. Incorrect. Plans established by fraternal societies or other organizations which receive no employer contributions and cover only members (not employees) are specifically excluded from PBGC insurance coverage.

c. Correct. Plans that are primarily for a limited group of highly compensated employees where the benefits to be paid, or the contributions to be received, are in excess of the limitations of §415 are specifically excluded from PBGC insurance coverage.

d. Incorrect. Qualified plans established exclusively for substantial owners are specifically excluded from PBGC insurance coverage. [Chp. 7]

104. The Code presents two sets of requirements so that plans would be nondiscriminatory. What is one of these requirements?

a. Incorrect. To insure that lower paid employees have the benefit of a retirement plan, tax law requires that the plan satisfy the ratio test. To satisfy this test, a plan must benefit a percentage of nonhighly compensated employees that is at least 70% of the percentage of highly compensated employees benefiting under the plan.

b. Incorrect. To insure that lower paid employees have the benefit of a retirement plan, tax law requires that the plan satisfy the percentage test. Under this test, the plan must “benefit” at least 70% of all the employees who are not highly compensated employees.
c. Incorrect. To insure that lower paid employees have the benefit of a retirement plan, tax law requires that the plan satisfy the average benefits test. A plan will meet the average benefits test if: the plan meets a nondiscriminatory classification test; and the average benefit percentage of nonhighly compensated employees, considered as a group, is at least 70% of the average benefit percentage of the highly compensated employees, considered as a group.

d. Correct. To insure that lower paid employees have the benefit of a retirement plan, tax law requires that a trust will not be qualified unless it benefits the lesser of 50 employees; or 40% of all employees. Thus, each plan must have a minimum number of employees covered, without regard to any designation of another plan. [Chp. 7]

105. For matching contributions, plans must meet requirements up to minimum vesting schedules. Under the two-to-six year graded vesting schedule, what is the nonforfeitable claim to employer-derived benefits after three years of completed service?

a. Correct. For matching contributions, under the two-to-six year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 3 years of completed service is 40%.

b. Incorrect. For matching contributions, under the two-to-six year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 4 years of completed service is 60%.

c. Incorrect. For matching contributions, under the two-to-six year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 5 years of completed service is 80%.

d. Incorrect. For matching contributions, under the two-to-six year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 6 years of completed service is 100%. [Chp. 7]

106. Generally, the mechanics are the same for the defined benefit plans. How do defined benefit plans work?

a. Incorrect. In defined contribution plans, an individual account is established for each employee.

b. Incorrect. Generally, a defined benefit plan attempts to specify benefit levels for employees. Once benefit levels are established, contributions are determined based upon actuarial calculations.

c. Incorrect. In defined benefit plans, the employer defines the benefit it wants to have its employees to receive rather than defining or fixing the annual cost.

d. Correct. Defined benefit plans are subject to the minimum funding requirements under ERISA, whereas those rules have little meaning for defined contribution plans. [Chp. 7]
107. The author identifies four circumstances under which defined contribution plans would be auspicious. What is one of these circumstances?

a. Correct. A defined contribution plan can be recommended if the business is cyclical and the principals want the flexibility not to make contributions in bad years. This is because the employer can choose to make contributions voluntary, and contributions are determined by a formula, usually expressed as a percentage of the employee's salary.

b. Incorrect. A defined contribution plan can be recommended if the principals are relatively young (e.g. - more than 20 years from retirement) and will have many years to accumulate contributions.

c. Incorrect. A defined contribution plan can be recommended if the principals want the plan costs tied to compensation rather than age, actuarial assumptions or the rise and fall of the stock market.

d. Incorrect. A defined contribution plan can be recommended if there are older employees and the principals do not want to make the higher contributions necessary to fund a defined benefit plan for a few years. [Chp. 7]

108. A profit sharing plan is a type of defined contribution plan. What is a characteristic of a profit sharing plan of the deferred type?

a. Incorrect. The contribution limits of individual retirement accounts (IRAs) are $5,500 per working individual and $11,000 per married couple with a working and non-working spouse in 2016.

b. Correct. The maximum deductible amount of profit sharing plans is 25% of total eligible participant compensation. Employer contributions are discretionary and can be based on, but are not limited to profits.

c. Incorrect. Employer contributions to money purchase pension plans are mandatory regardless of profits.

d. Incorrect. Employers must contribute a predetermined percentage each year to money purchase pension plans. [Chp. 7]

109. Section 401(k) plans must meet five requirements. What is one such requirement?

a. Incorrect. A requirement of a section 401(k) plan is that benefits are not distributable to an employee earlier than age 59½, termination of service, death, disability, or hardship.

b. Correct. A requirement of a section 401(k) plan is that each employee’s accrued benefit under the plan is fully vested.

c. Incorrect. A requirement of a section 401(k) plan is that it must be a qualified profit-sharing or stock bonus plan.

d. Incorrect. A requirement of a section 401(k) plan is that each employee can elect to receive cash or to have an employer contribution made to the employee trust. [Chp. 7]
110. One condition must be met in order for a death benefit under a qualified plan to be allowable. What is this condition?
   a. Incorrect. A death benefit would be allowable under a defined benefit plan if the benefit were equivalent to the cash value under the insurance policy plus the participant’s share of the auxiliary fund.
   b. Correct. It may be allowable under a qualified plan only if the death benefit is incidental. To be deemed incidental, it must meet one of three requirements.
   c. Incorrect. A death benefit would be allowable under a defined benefit plan if the expected retirement benefit were to exceed 100 times the life insurance amount.
   d. Incorrect. A death benefit would be allowable under a defined benefit plan if the total benefit were comprised of the face amount of insurance and the participant’s account or share in the auxiliary fund. [Chp. 7]

111. A consideration of incorporating is how to deal with a self-employed retirement plan. How might a self-employed individual deal with her self-employed plan upon incorporation?
   a. Incorrect. A self-employed individual or an owner-employee who receives a qualified lump-sum distribution in cash or property from her self-employed plan may make a tax-free rollover of all or part of the property or cash to an IRA or annuity. However, it is required that the rollover is made within the 60-day grace period. Also, the rollover may not be made into an endowment contract.
   b. Incorrect. Nontransferable annuity contracts which are part of an unincorporated plan and are not held by a trustee may be surrendered back to the insurer in consideration for which the insurer will issue new policies to the trustee of the qualified corporate plan.
   c. Incorrect. The assets of the Keogh plan may be transferred by the trustee, to the trustee of a qualified corporate account.
   d. Correct. The plan may be frozen. All contributions end. Life insurance or annuity contracts may be placed on a reduced, paid-up basis, but the extended term insurance option for life insurance in as much as immediate taxability may result to the self-employed. On a tax-free basis, dividends, interest, and capital appreciation will continue to be shared, and distributions continue to be administered by plan provisions and IRC restrictions. This is a popular approach, but it is costly. [Chp. 7]

112. A Keogh plan is a special plan for certain individuals to take a deduction for money they set aside to provide for retirement. Which individuals may use this plan?
   a. Correct. Under a Keogh plan, a self-employed individual is allowed to take a deduction for money he or she sets aside to provide for retirement. Self-employed individuals include sole proprietors.
b. Incorrect. Partners, but not owner/employees, of an S corporation are considered self-employed. Thus, these employees may not use a Keogh plan.

c. Incorrect. Employees of a C corporation are not considered self-employed. Thus, these employees may not use a Keogh plan.

d. Incorrect. Self-employed individuals include partners owning 10% or more of an interest in a partnership. Thus, these parties could not use a Keogh plan. [Chp. 7]

113. Individual taxpayers, and individuals taxpayers and their non-working spouses, may be individual retirement arrangement (IRA) participants. What are the eligibility requirements IRAs?

a. Incorrect. The eligibility requirements of profit sharing pension plans, money purchase pension plans, and 401(k) plans are: reached age 21 and completed 2 years of service if 100% vesting is elected or completed 1 year of service if a vesting schedule is elected.

b. Incorrect. The eligibility requirements of profit sharing pension plans, money purchase pension plans, and 401(k) plans are: reached age 21 and completed 2 years of service if 100% vesting is elected or completed 1 year of service if a vesting schedule is elected.

c. Correct. The eligibility requirements of IRAs are that the individuals are under 70½ years old who have earned income. Such individuals can establish and make contributions to a traditional IRA. Regardless of whether or not such individuals are covered under any other retirement plan, they may have a traditional IRA. Yet, if covered under an employer retirement plan, the contributions made to the IRA may not be deductible.

d. Incorrect. The eligibility requirements of a Keogh plan are that the individual is either a sole proprietor or more than 50% partner. [Chp. 7]

114. If four conditions are met, trust beneficiaries will be treated as having been designated as beneficiaries of an individual retirement arrangement (IRA). What is one of these four conditions?

a. Incorrect. The beneficiaries of a trust will be treated as having been designated as beneficiaries if, among other things, the beneficiaries of the trust who are beneficiaries with respect to the trust’s interest in the employee’s benefit are identifiable from the trust instrument.

b. Correct. The beneficiaries of a trust will be treated as having been designated as beneficiaries if, among other things, the IRA trustee, custodian, or issuer has been provided with a copy of the trust instrument with the agreement that if the trust instrument is amended, the administrator will be provided with a copy of the amendment within a reasonable time.

c. Incorrect. The beneficiaries of a trust will be treated as having been designated as beneficiaries if, among other things, the trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.
d. Incorrect. The beneficiaries of a trust will be treated as having been designated as beneficiaries if, among other things, the trust is a valid trust under state law, or would be but for the fact that there is no corpus. [Chp. 7]

115. If distributions from a Roth IRA are made five years after the plan’s formation, and if one of two conditions is met, the distributions may be tax free. What is one of these two conditions?
   
a. Correct. Distributions from a Roth IRA are tax free if made more than five years after a Roth IRA has been established and the distribution is made for first-time homebuyer expenses (up to $10,000).
   
b. Incorrect. Distributions from a Roth IRA are tax free if made more than five years after a Roth IRA has been established and the distribution is made after age 59½, not age 21.
   
c. Incorrect. Distributions from a Roth IRA are tax free if made more than five years after a Roth IRA has been established and the distribution is made after disability.
   
d. Incorrect. Distributions from a Roth IRA are tax free if made more than five years after a Roth IRA has been established and the distribution is made after death. [Chp. 7]

116. Under a simplified employee pension (SEP) IRA, the employer must contribute for each employee. However, each employee may have:
   
a. Incorrect. For the calendar year, the employer contributes for each employee who has attained age 21, not 18.
   
b. Correct. Contributions and deductions are available even if the employee has attained age 70½ (the normal IRA age limit).
   
c. Incorrect. Employee participants must have earned at least $500 in the tax year to qualify.
   
d. Incorrect. For the calendar year, the employer contributes for each employee who has performed any service for the employer during three of the preceding five years. [Chp. 7]

117. A savings incentive match plan for employees (SIMPLE) 401(k) plan may discriminate if five conditions are met. What is one of the five conditions?
   
a. Incorrect. While the employee may request that the employer make salary reduction contributions to a trust, the amount may not exceed a specified amount for each taxable year. For 2016, this amount is not to exceed $12,500.
   
b. Incorrect. One of the conditions that must be met is that no other contributions can be made to the trust. However, participants over age 50 may make a catch-up contribution.
   
c. Incorrect. One of the conditions that must be met is that the employee's rights to any contributions are nonforfeitable.
d. Correct. One of the conditions that must be met is that the employer must make either matching contributions up to 3% of compensation for the year, or nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation for the year. [Chp. 7]

118. R.R. 71-419, R.R. 69-650, and R.R. 60-31 are the basis of the IRS’s position on deferred compensation plans. Thus, if all other conditions are met, when will the IRS treat a taxpayer as successfully deferring income?

a. Incorrect. Under these rulings, a taxpayer will not be in constructive receipt of deferred income if, among other things, the deferred income remains subject to the claims of the employer’s general creditors. Thus, if creditors cannot lay claim to such income, the taxpayer constructively receives the income.

b. Incorrect. If a taxpayer does not actually receive the income, it is still possible that he has constructively received the income. Therefore, if the taxpayer has a right to receive the income, he could be treated as though he actually received it.

c. Correct. Under these rulings, a taxpayer will not be in constructive receipt of deferred income if, among other things, the deferred income may not be assigned by the taxpayer. In other words, if the company assigns income to the taxpayer and the taxpayer knows how much he has, the taxpayer is in constructive receipt of the income. He does not have to be in actual receipt of the income.

d. Incorrect. Under these rulings, a taxpayer will not be in constructive receipt of deferred income if, among other things, the taxpayer elects to defer the income before it is earned. If he elects to defer it after it’s earned, he will be in constructive receipt of deferred income. [Chp. 8]

119. Courts may apply the economic benefit doctrine in determining whether a deferred compensation plan is valid. What is the issue involved in the theory of economic benefit?

a. Incorrect. Receipt is not the issue involved in the theory of economic benefit - “something” generally has been received.

b. Incorrect. As a general creditor, the employee is at risk with respect to the deferred benefits, and depends upon the survival and soundness of the company.

c. Correct. The issue involved in the theory of economic benefit is whether the “something” has a market value.

d. Incorrect. Economic benefit is not concerned with the taxpayer’s control over income but rather what has value and thus may constitute income. [Chp. 8]

120. R.R. 60-31 provides three general principles that must be met in order for a taxpayer to be deemed to receive the payment when the employer actually makes the payment. What is one of these general principles?
a. Correct. The decision to defer compensation must be made before the employee performs any services covered by the deferral. A new employee can do this via an employment contract. A current employee must establish the plan prior to the calendar year that such services are rendered.

b. Incorrect. The deferred compensation account must not be “funded” with a trust. The employer may not turn over the account to a trust. The risk must lie with the employer, not the employee.

c. Incorrect. The deferred compensation account must not be “funded” with escrow. The employer must hold any deferred compensation.

d. Incorrect. The promise must not be secured by collateral, promissory note, or other security. The employee is in effect a general creditor of the company. [Chp. 8]

121. The author describes three major types of deferred compensation plans. What obligation is taxable to the employee at a future time?

a. Correct. An unsecured, unfunded, nonnegotiable promise of the employer to pay future benefits has no fair market value for tax purposes. Thus, it is not currently taxable to the employee.

b. Incorrect. If it is funded and consideration is set aside separately for the employee, current taxation will result. The employee would constructively receive the amounts.

c. Incorrect. If the obligation has a cash equivalency, current taxation will result. No amount that an employee has deferred may have a cash equivalency or else it will be treated as constructively received.

d. Incorrect. If the employee has a right to presently receive the amount of the obligation, current taxation will result. The amount may not be reserved in any way in order for it to be successfully deferred. [Chp. 8]

122. The IRS has approved some methods to provide employees with limited protection. Under R.R. 68-99, what may an employer do, at her option, to fund a deferred compensation arrangement?

a. Incorrect. The guarantee of the employer’s obligation by a third party does not appear to affect the ability to defer the compensation. R.R. 68-99 does not address this issue.

b. Incorrect. Based on R.R. 60-31, it appears clear that the employer may invest deferred amounts and the employee will still qualify for tax deferral.

c. Correct. Under R.R. 68-99, the Service has ruled that an employer may, at her option, purchase a life insurance policy to fund a deferred compensation arrangement.

d. Incorrect. Premiums paid by the employer on the life insurance policy are not taxable to the employee because he has no rights or interest in the policy. This is
so even though the employer uses the proceeds of the policy to discharge its obligation under the deferred compensation agreement. [Chp. 8]

123. A limited loophole exists to the unfunded requirement. Under what approach can the employee transfer funds covering the payment of future obligations to an outside account, but the benefits themselves remain subject to a “substantial risk of forfeiture”? 

a. Incorrect. An unfunded bare contractual promise plan is one of the three examples of nonqualified deferred compensation plans that the author describes in detail.

b. Incorrect. A deferred compensation fund is an account to which a company designates some of its assets under limited circumstances.

c. Incorrect. The tax treatment of the employer and employee will vary based on how the deferred amounts in a funded plan are actually segregated and to whom they belong. If funds are set aside they should belong to the employer.

d. Correct. Under the Section 83 approach, funds covering the payment of future obligations are transferred to an outside account. However, the benefits themselves are subject to a “substantial risk of forfeiture,” as defined under Reg. §1.83(c)(1). This approach also requires that the funding arrangement qualify as a “transfer” of “property” under §83. [Chp. 8]

124. Under new §409A, once a new nonqualified deferred compensation plan fails to comply or operate in compliance with three rules, the taxpayer faces certain tax consequences. Which of the following may apply depending on location?

a. Correct. Depending on the state of the taxpayer, he may be assessed an exit tax. Such a tax is applied on compensation that has been deferred in that state but has not been taxed on the occurrence of a relocation.

b. Incorrect. One tax consequence that a taxpayer would certainly face is an additional tax on income. This is because such income is taxable when no substantial risk of forfeiture exists.

c. Incorrect. Once the compensation plan fails to comply, the taxpayer can expect to pay interest on any tax underpayment that would have occurred.

d. Incorrect. When the plan no longer complies with or operates in compliance with the three rules, the income is included in gross income. This can be expected. [Chp. 8]

125. Employees should consider how their deferred compensation plan will affect their estate planning. What is a tax consequence of death prior to receiving the deferred income?

a. Correct. For income tax purposes, the income in respect of the decedent is taxable as ordinary income to the recipient. The income would be treated as or-
dinary income upon receipt, regardless of whether or not the plan participant is still living.

b. Incorrect. The recipient’s income tax decreases because the recipient may take an income tax deduction for the estate tax.

c. Incorrect. Generally, a gift does not occur in these cases. However, one can occur if an irrevocable assignment of a benefit that is nonforfeitable is made.

d. Incorrect. The recipient may deduct any estate tax that results from including deferred income in the executive’s gross estate. [Chp. 8]
Glossary

**Accrual method:** A method of accounting in which income and expense items are determined based upon the right to receive or the duty to pay.

**Adjusted basis:** The original basis of property increased by improvements and reduced by depreciation.

**Adjusted gross income (AGI):** Total income reduced by allowable adjustments, such as for an IRA, student loan interest, alimony and Keogh deductions. The AGI is important in determining whether various tax benefits are phased out.

**Alternative minimum tax:** A tax triggered when certain tax benefits reduce regular income tax below a certain threshold.

**Bad debts:** Legally binding debts owed a taxpayer that are partially or totally worthless and uncollectible.

**Business purpose:** A requirement that an expense claimed as a deduction from taxable business income must serve a genuine business purpose.

**Capital gains:** Gain from the disposition or exchange of a capital asset.

**Capital loss:** Loss from the disposition or exchange of a capital asset.

**Dividend:** A share of a company's profits that it pays to investors.

**Estimated tax:** Advance payments of tax liability based either on wage withholding or periodic installment payments.

**Gross income:** Money, goods, services, and property a person receives that must be reported on a tax return. Includes unemployment compensation and certain scholarships. It does not include welfare benefits and nontaxable Social Security benefits.

**Guaranteed payment:** A payment that is made to partners without regard to the partnership's income or loss.

**Net operating loss:** A business loss that exceeds current income and may be carried back against income of prior years or carryforward as a deduction against future income.

**Personal service corporation:** A type of closely held C corporation whose principal activity is the performance of personal services in health, law, engineering, architecture, accounting, actuarial sciences, performing arts, and consulting.

**Self-employment tax:** Similar to Social Security and Medicare taxes but for self-employed individuals.

**Tax year:** An annual accounting period for reporting income and keeping records.

**Unrealized receivables:** The right to payment for goods delivered or services rendered.
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