2014 SCHEDULE C/F & GENERAL BUSINESS FEDERAL TAX UPDATE

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2014 SCHEDULE C/F AND GENERAL BUSINESS FEDERAL TAX UPDATE

CHAPTER HIGHLIGHTS

- Final regulations include significant changes to ACA employer mandate
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- Bonus depreciation is gone and §179 expensing severely limited—changes coming?
- Up to $10,000 of building improvements may be expensed
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- Affordable Care Act (ACA) and §105 plans (HRAs) collide—are HRAs gone?
- Cafeteria Plan rule change makes medical §125 plans more employee-friendly

GENERAL BUSINESS ITEMS

Form 1099-K Still Required to Report Credit Card Receipts But No Separate Reporting Required on Tax Forms—Now or In the Foreseeable Future (IRS Payment Card Reporting FAQs)

Many businesses will annually receive Form 1099-Ks ,which report credit card sales. Payment settlement entities (such as Visa, MasterCard, and Paypal) are required to report payments to merchants for goods and services in settlement of payment card and third-party network payment transactions (§6050W; LTR 201219013). The IRS created Form 1099-K, Merchant Card and Third Party Payments specifically for this purpose.

Small business exemption. A de minimis exception from filing Form 1099-K exists if the aggregate value of transactions by a merchant does not exceed $20,000 and if the aggregate number of transactions does not exceed 200 in the calendar year.

Form 1099-K Audits Begin - IRS Issues Guidance (IRS Notices; IRS Letters 5035, 5036, 5039, 5043; Form 14420)

The IRS has conceded that taxpayers are not required to reconcile income reported on Form 1099-K (merchant card reporting) with income reported on their tax returns (Sch. C instructions). This does not, however, alleviate the responsibility of credit card processors to file annually IRS. Upon receipt of Form 1099-K, the IRS reviews the reported credit card income and compares it to total income reported on the taxpayer's return (see www.bizstats.com). If the IRS determines that the proportion of credit card receipts relative to total gross receipts is unusually high, it sends the taxpayer a Notification of Possible Income Underreporting. There are four different notifications, ranging from "review the information for accuracy. If you don't find any inaccuracies, no further action is required" to "provide a written explanation telling us why the portion of your gross receipts from card payments ... may be higher than expected." In some cases, taxpayers are required to file Form 14420, Verification of Reported Income. In late 2012, the IRS sent 25,000 such letters to taxpayers challenging the total reported gross receipts based on analysis of the 1099-K and the taxpayer's tax return. Clients should be warned that 1) the IRS has a new tool to check for unreported income and 2) their books may need to be changed to account more carefully for merchant card deposits.

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

"In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed (§183(a))."

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

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

If no profit motive, hobby rules restrict deductions (§183(b)). When taxpayers are engaged in an activity with an ***actual and honest objective of making a profit***, expenses incurred in a §162 trade or business or a §212 activity for the production of income are deductible even if such expenses exceed income from the activity. But, if no profit motive exists, the §183(b) hobby rules allow deductions only to the extent of gross income unless the deductions would have been allowed anyway (for example, mortgage interest and property taxes deductible on Schedule A). Gross income under §183 includes the total of all gains from the sale, exchange, or other disposition of property and all other gross receipts derived from such activity (§1.183-1(e)).

Deductions for hobby activities are claimed as itemized deductions on Schedule A (Form 1040). Hobby loss deductions must be taken in the following order and only to the extent stated in each of three categories:

1. First, deductions that a taxpayer may claim for personal as well as business activities (e.g., home mortgage interest and property taxes) may be taken in full.
2. Next, direct deductions that don't result in an adjustment to basis (e.g., advertising, supplies, etc.) are taken to the extent gross income for the activity exceeds deductions from the first category.
3. Last, deductions that reduce basis of business property (e.g., depreciation and amortization) to the extent gross income for the activity is more than the deductions taken in the first two categories.

> **Preparer note.** Activities conducted in S corporations and partnerships are subject to the §183 loss limitations but not activities conducted in C corporations.

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

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

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

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

Hobby Loss Rules Didn't Apply to Professional Musician, Despite Lack of Actual Profit (*Thomas Allen Gullion, pro se v. Comm.*, TCS 2013-65)

Tom Gullion is an American Saxophonist from Indiana. Gullion studied with David Baker at the world-renowned Indiana University Jacobs School of Music as well as Northwestern University. While still at university, he joined the J. J. Johnson quintet and later went on to live in Spain, where he performed extensively with Clunia Jazz. Gullion recorded two successful CDs: *Cat's Cradle* and *Greens and Blues*. In 2002, Gullion moved to Wisconsin and started working as a computer programmer. He continued to play the saxophone, organizing the Driftless Jazz Festival in Southwestern Wisconsin.

Musician had substantial outside income. For 2008, Gullion and his wife reported $43,642 in wages, as well as $70,223 of income on a Schedule C from a specialized design services firm. According to information returns for 2008, $42,951 of these wages were attributable to Gullion. For 2009, Gullion and his wife reported $133,245 in wages, of which $131,897 was attributable to Gullion. Gullion also reported activities related to the Driftless Jazz Festival on a second Schedule C. The following table reflects his gross receipts and net losses from his musical activities.

Year	Gross Receipts	Net (Loss)
2004	$1,483	($12,163)
2005	530	(11,842)
2006	983	(17,872)
2007	1,615	(20,315)
2008	2,625	(32,541)
2009	2,931	(26,003)
2010	3,154	(9,467)

Total	**13,321**	**(130,203)**
2011	unknown	647 profit!

Preparer note. It is unknown how Gullion created the 2011 profit. Did expenses decrease?

Musician 6 - IRS 0! Court used only 6 of 9 factors to determine musical activities was a trade or business. The court was satisfied that Gullion's musical activities were conducted with continuity and regularity during 2008 and 2009, the years in issue. Nevertheless, the court pointed out a taxpayer must conduct the activity with the requisite profit motive or intent for the activity to be considered a trade or business. The court focused only on the §1.183-2(b) factors it thought were important and applicable in this case.

Expertise of the taxpayer. Gullion had played the saxophone since the age of 8 and had played professionally since the age of 16. He has studied under and performed with well-known musicians. The court concluded he was knowledgeable of the music industry.

Taxpayer's time and effort. The IRS claimed that Gullion worked full time as a software programmer and did not have time for a music career. The court disagreed. Gullion was dedicated to his music career. He organized a jazz festival in Wisconsin and recorded four CDs. Gullion's testimony was credible concerning the time he spent on his music career. Courts have often recognized that a taxpayer may engage in more than one trade or business at any one time (see *Gestrich v. Comm.*, 74 T.C. 525, 529 (1980), aff'd without published opinion, 681 F.2d 805 (3d Cir. 1982)). The court also stated, "It is also well-settled that the term 'trade or business' includes the arts" (see *Churchman v. Comm.*, 68 T.C. 696; *Ralph Louis Vitale, Jr. v. Comm.*, T.C. Memo. 1999-131, aff'd without published opinion, 217 F.3d 843 (4th Cir. 2000); 00-1166).

Similar activities. Gullion earned a living from his music before moving to Wisconsin. He also testified that he intended to be profitable again and that he was profitable in 2011. Gullion pointed out that the music industry has undergone changes over the years and that it is now difficult to make a profit. He contended that he made changes so he can become profitable. For instance he planned to embark on a tour in Spain in summer 2013. In addition, Gullion wanted to change the course of his career, placing more emphasis on his own music and focusing on composing. He wanted to leave behind a legacy of work.

History of income or losses. The court stated that "a history of losses is less persuasive in the art field than it might be in other fields," as economic success in the arts frequently takes longer to achieve than success in other fields (*Churchman v. Comm.* 68 T.C. at 701-702). The court agreed that Gullion had a series of losses from 2004 to 2010 and a small profit in 2011. The IRS contended that Gullion's small profit in 2011 could not offset years of sustained losses that total over $100,000. However, Gullion was able to explain these losses to the court's satisfaction.

Financial status of taxpayer. The court stated: "(t)he fact that (Gullion) does not have substantial income or capital from sources other than the activity may indicate that the activity is engaged in for profit. (Gullion) did not have substantial income or sources of capital. (Gullion) earned income for his work in the computer software industry; however, the income was not considerable, and (Gullion) contends that he wants to work full-time on his music."

Planning opportunity. The court's comment that Gullion did not have substantial income or sources of capital is the key to this factor. His musical career didn't look like a "tax shelter" to the court.

Elements of personal pleasure or recreation. The court held that Gullion "derives pleasure from his music, but his goal is to make a profit."

Also see:

- *William G. and Jamie K. Pederson v. Comm.,* TCM 2013-54, where ClassicStar's horse breeding scam claims another victim.
- *William R. Dodds v. Comm.,* TCM 2013-76, no horse breeding losses for Minnesota CPA.
- *Gregory K. And Aletha A. Craig, pro se. v. Comm.,* TCS 2013-58 where the taxpayers did not prove horse activity was engaged in for profit since in a seven year period they showed only $950 of gross income and losses totaling $118,861.
- *Sal A. Westrich v. Comm.,* TCS 2013-35, semi-retired professor's writing activity ruled a hobby as it never generated any income and most of the expenses were related to travel to France.
- *Bruce Phillips v. Comm.* TCM 2013-215, where bowling activity with -0- income and $28,000 of expenses was ruled not for profit and where the tax return preparer refused to sign the 2008 return because "he was afraid of an audit."

GROSS INCOME - §61

Where to Deduct Legal Fees

Type of Award	Federal Return
Physical injuries	Award not taxable, so fees not deductible.
Trade or business legal expenses	Business return, e.g., Schedule C.
Other than physical injuries pre-10/23/2004	Miscellaneous itemized deduction subject to 2% AGI limit.
Unlawful discrimination, claims against Federal gov't, Medicare secondary payor post-10/22/2004	AGI deduction to extent of award.(AJCA-2004 reversing Supreme Court in *Banaitis & Banks*)
All other lawsuits	Miscellaneous itemized deduction subject to 2% AGI limit.
Opt-out class action lawsuits	Report net income after attorney fees (LTR 200551008; LTR 200518017)

Payments to Settle Lawsuit Deductible as Ordinary and Necessary Business Expenses (LTR 201412002)

The liabilities incurred to settle a securities lawsuit, including legal fees and other expenses attributable to the lawsuit, are deductible as ordinary and necessary business expenses.

Award Was Business Income - Litigation Expenses Were Ordinary and Necessary Business Expenses (*Richard D. Bagley v. Comm.*, (DC Calif.) No. CV 10-00483-RT (FMOx), August 5, 2013)

Lawsuit filed under False Claims Act created taxable income for Whistleblower—IRS and taxpayer disagree on where to report income and related expenses. Richard Bagley, MBA, was the Chief Financial Manager for TRW's space and technology group. Starting about 1989 and continuing through 1991, Bagley became aware of false claims made by TRW to the government, which he brought numerous times to the attention of his superiors. Bagley was laid off in August 1993 as a result of a "reorganization" at TRW. In October 1994, Bagley retained legal counsel to file lawsuits under the False Claims Act (FCA). From 1994 to 2003, Bagley exclusively worked on his FCA prosecution activity and was not otherwise employed. In June 2003, Northrop Grumman Corp., the successor to TRW, agreed to pay the United States $111.2 million to settle the FCA allegations in the two FCA suits filed by Bagley, and Bagley was awarded $27,244,000 under the FCA whistleblower provisions. Northrop Grumman issued Bagley a Form 1099-MISC reporting the award in Box 3, Other Income. Northrop also paid $9,407,295 to Bagley's attorneys, Phillips & Cohen, LLP, as payment of the statutory attorneys' fee. Northrop issued Bagley a Form 1099-MISC reporting the $9,407,295 Statutory Fee in Box 14, gross proceeds paid to an attorney. Of the $36,651,295 of income, Bagley paid a total of $18,477,815 to his attorneys. Bagley filed an amended 2003 Federal tax return and reported the $36,651,295 gross income as attributable to his "trade or business" of being a private attorney general and reported the $18,477,815 paid to his attorneys as ordinary and necessary business expenses deductible pursuant to §162. The IRS argued that Bagley's award was "Other Income" under §212 and the related attorney fees of $18,477,815 was an itemized deduction reportable on Schedule A.

Preparer note. The IRS's position initially cost Bagley an additional $3,874,407 of Federal tax.

Whistleblower prosecuted FCA suits in a business-like manner. Bagley was able to document that he personally spent 5,963 hours investigating and prosecuting the FCA claims. He maintained detailed contemporaneous time logs reflecting the time he spent on the litigation. He actively participated in the FCA prosecution by attending meetings with his attorneys and government representatives, reviewing documents, creating written summaries of information, drafting and editing pleadings and filings, creating damage calculations, and providing guidance to his attorneys about regulations and pricing. While Bagley was not an attorney on the FCA lawsuits, he conducted himself in much the same manner as a lawyer would when litigating a lawsuit. In fact, Bagley identified himself as a "Private Attorney General" on his 2003 IRS Form 1040.

Planning point. Keeping track of time contemporaneously for 10 straight years was critical.

Expertise of Whistleblower as "Private Counsel." If Bagley's business was that of a private attorney general prosecuting a FCA claim relating to fraudulent schemes at TRW, there was likely no one else with more relevant expertise to conduct such a business. He worked for TRW from 1967 through 1993 and he was an expert concerning TRW's systems, procedures, personnel, and culture. Bagley was also exceedingly knowledgeable about the FAR, the accounting rules that relate to the cost pools, and the pricing provisions of government contracts and claims settlement procedures. Equally important expertise to guide his investigation and preparation of the FCA lawsuits was his first-hand knowledge of the fraudulent schemes and the identity of relevant witnesses and the location of documentary evidence.

Planning point. Keeping track of what work was being performed along with time spent was also critical.

Whistleblower's income from the FCA prosecution activity was a single pay-out of $36,651,295 in 2003. Bagley's income from the FCA prosecution activity was a single pay-out of $36,651,295 in 2003. The IRS argued that a one-time pursuit of a FCA award with a single-payout, which had no income stream through 2002, was not indicative of a business. This argument has been previously rejected by the courts with regard to other activities (see *Ellsworth v. Comm'r*, 21 T.C.M. 145, 150-51 (1962), (finding a trade or business existed even though it would take the taxpayer 15 years to generate a profit); and *Snyder v. U.S.* [82-1 USTC ¶9285], 674 F.2d 1359, 1363 (10th Cir. 1982), (a taxpayer could be in a trade or business of producing a book even though he had not yet finished the product or generated a profit).

Taxpayer was involved in FCA prosecution with regularity during previous 10 years. The court concluded: "(Bagley) pursued the FCA lawsuit 'full-time, in good faith, and with regularity,' by performing a multitude of tasks: attending meetings, reviewing documents that had been produced, creating and revising documents (memoranda, summaries, and court filings), doing damage calculations, and generally assisting his attorneys and the government in understanding the nature of the fraudulent claims and where they could find the documents and witnesses necessary to litigate effectively the case. This was not a hobby or an activity Bagley engaged in for pleasure or amusement." Accordingly, the court concluded that Bagley was engaged in the trade or business, within the meaning of §162(a), of prosecuting a FCA lawsuit against TRW, incurred and paid necessary and ordinary business expenses in the amount of $18,477,815 related to that trade or business, and was entitled to a refund of Federal income taxes paid in the amount of $3,874,407 plus interest with regard to his 2003 tax year.

Preparer note. IRS's last-ditch argument was that a one-time whistleblower claim can't be a "regular" business, as it was only being done once. The IRS shouldn't have litigated this case! Bagley spent 10 years fighting the Federal government to go after TRW and another 10 years fighting the IRS!

DEDUCTION - §162 TRADE OR BUSINESS EXPENSES

Lawyer's Record Storage Expenses Deductible Even Though Business Closed (*Robin S. Trupp v. Comm.*, TCM 2012-108)

Attorney Robin Trupp was self-employed from 1981 through 2003, during which time he accumulated voluminous client files. In 2004, Trupp closed his solo practice and went to work as a non-equity partner of Arnstein and Lehr, LLP. When Trupp closed his solo practice, he moved all of his client files into a storage facility that he personally paid for. In 2005, Trupp provided documentation reflecting payments of $3,838 made to the storage facility. The IRS denied the deduction for the storage facility payments, arguing that Trupp failed to request reimbursement for the expenses under Arnstein & Lehr's accountable plan reimbursement policy. Trupp countered that Arnstein & Lehr would not have reimbursed the storage expenses. As evidence, Ray Warner, chairman of Arnstein & Lehr's executive committee, testified at Trupp's trial that Arnstein & Lehr tried "as a matter of policy, to have lawyers maintain their own pre-joinder files." The Court allowed Trupp the storage deduction.

DEDUCTION - MATERIALS & SUPPLIES

***New!* Capitalization of Tangible Assets—Final Regulations (T.D. 9636, §§1.162-3, 1.162-4, 1.162-11)**

The IRS issued final regulations (and withdrew 2006 and 2008 proposed regulations and amended and finalized 2012 temporary regulations) that explain and clarify how to treat the acquisition, production, and improvement of all tangible property. The IRS also introduced substantial changes to the present materials and supplies regulations.

The final regulations generally are effective on January 1, 2014 (T.D. 9636, Preamble IX). The final regulations generally apply to amounts paid or incurred in taxable years beginning on or after January 1, 2014. A taxpayer may choose to apply the final regulations to taxable years beginning on or after January 1, 2012. Taxpayers may also choose to apply the 2011 temporary regulations to taxable years beginning on or after January 1, 2012 and before January 1, 2014.

Deducting Costs of Materials and Supplies (§1.162-3)

Deduct materials and supplies when *consumed* if deducting at purchase time would distort income. Similar to the previous material and supplies regulations, amounts paid to acquire or produce materials and supplies are deductible in the taxable year in which the materials and supplies are used or consumed (not when paid) in the taxpayer's operations (§1.162-3(a)(1)). The only exception to this rule is if the amount of the year-end adjustment would not distort taxable income.

Deduct materials and supplies when *paid* but only if amount is "incidental," i.e., it doesn't cause a distortion of taxable income. Acting as a relief provision, amounts paid to acquire (or produce) incidental materials and supplies that are carried on hand and for which no record of consumption is kept or physical inventories at the beginning and end of the year are not taken, are generally deductible in the taxable year in which these amounts are paid, ***but only if taxable income is clearly reflected*** (§1.162-3(a)(2)).

> **Preparer note.** Therefore, year-end materials and supplies are *not* deductible if "non-incidental" in amount, resulting in a year-end adjustment for all cash-basis taxpayers.

Definition of "materials and supplies." Specifically, the regulations define a "material and supply" as tangible property used or consumed in the taxpayer's operations that is not inventory and that:

1. Is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of that property; ***or***
2. Is fuel, lubricants, water, and similar items expected to be consumed in 12 months or less, ***or***
3. Has an economic useful life of 12 months or less, ***or***
4. Is property costing $200 or less (or other amount as identified by the IRS) , ***or***
5. Is identified as a material and supply in future guidance (§1.162-3(c)(1)).

Property with 12-month or less economic useful life treated as material and supply *unless* treated differently on applicable financial statements. Any property that has an economic useful life of 12 months or less (beginning when the property is used or consumed) is treated as a material and supply (§1.162-3(c)(1)(iii)). The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period[1] over which the property may reasonably be expected to be useful to the taxpayer in its trade or business (§1.162-3(c)(4)).

Taxpayer's "applicable financial statements" may override the material and supply rules. If a taxpayer has an "applicable financial statement" (AFS)[2], the economic useful life for this purpose is the useful life initially used for purposes of determining depreciation on its AFS. An exception is provided if a taxpayer does not assign a useful life to certain property on its AFS (for example, if the item is currently expensed on the taxpayer's AFS because it is considered de minimis) (§1.162-3(c)(4)(ii)).

Items costing $200 or less may be expensed. A $200 de minimis rule has been added to the definition of materials and supplies without regard to how the taxpayer treats the purchase on their financial statements (§1.162-3(c)(4)(iv)).

> ***Example - depreciable personal property treated as deductible materials if $200 or less: de minimis safe harbor.*** In 2014, VendorBill purchases 50 scanners for $150 each for a total cost of $7,500. VendorBill's employees begin using 35 of the scanners, and VendorBill stores the remaining 15 scanners for use in a later taxable year. As the scanners are materials and supplies, VendorBill can deduct the 35 scanners in 2014, but the remaining 15 scanners are deductible in the year each scanner is first used in VendorBill's business. But, if VendorBill's scanners qualify for the de minimis safe harbor, and VendorBill properly elects to apply the de minimis safe harbor to amounts paid in 2014, VendorBill may deduct the amounts paid for all 50 scanners in 2014, the taxable year the amounts were paid (§1.162-3(h), Exp. 7 & 8).
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> ***Example - property that costs $200 or less; bulk purchase.*** Harold is a consultant who, in 2014, pays $500 to purchase a box of 10 printer toner cartridges. During 2014, Harold's employees place 8 of the toner cartridges in printers and store the remaining 2 cartridges for use in a later taxable year. The toner cartridges are materials and supplies because even though purchased in one box costing more than $200, the allocable cost of each unit of property equals $50. Harold may deduct the $400 paid for 8 of the cartridges in 2014 and the remaining 2 cartridges in a future tax year, unless Harold properly elects to apply the de minimis safe harbor to amounts paid in 2014 (§1.163-3(h), Exp. 9).

Items costing more than $200 may be immediately expensed under the repair vs improvement "de minimis" rules. The regulations do not allow businesses to create a material and supply de minimis amount above $200. But, businesses have the option to apply the de minimis rule to any material or supply costing more than $200 by ***electing*** to use the repair versus improvement "de minimis" rules. This election is made by deducting the amounts paid on a timely filed tax return (including extensions).

> **Preparer note.** The requirement to have an applicable financial statement was removed in the final regulations, making this election available to far more small businesses (§1.263(a)-1(f)(ii)).

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[1] See §1.167(a)-1(b) for the factors considered in determining this period.

[2] Including financial statements: filed with the SEC (the 10-K or Annual Statement to Shareholders), certified audited by an independent CPA, or provided to any Federal or state agency (other than the IRS) (§1.162-3(c)(4)(iii)).

Election to capitalize rotable and temporary parts available. Rotable spare parts are materials and supplies acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation (for example, commercial airplane engines) [§1.162-3(c)(2)]. Temporary spare parts are materials and supplies used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation. Rotable and temporary spare parts are used or consumed in the taxpayer's operations in the taxable year in which the taxpayer disposes of the parts, unless an election is made to capitalize (and depreciate), the de minimis rule is used, or the optional method of accounting is used for rotable and temporary spare parts (§1.162-3(a)(3)).

> **Example.** BTC operates a fleet of vehicles used in its service business. Whenever BTC acquires a new type of vehicle, it also acquires a substantial number of rotable spare parts to replace quickly similar parts in its vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. In 2014 BTC acquires several vehicles and a number of rotable spare parts. In 2015, BTC repairs several vehicles by using these rotable spare parts. In 2016, BTC removes these rotable spare parts from its vehicles, repairs the parts, and reinstalls them on other similar vehicles. In 2018, BTC can no longer use the rotable parts it acquired in 2014 and disposes of them as scrap. The amounts that BTC paid for the rotable spare parts in 2014 are deductible in 2018, the taxable year in which BTC disposes of the parts (§1.162-3(h), Exp. 2).

Rotable part optional method (§1.162-3(e)). Taxpayers may use an optional method to account for rotable and temporary spare parts. If the optional method is used, taxpayers must use it for all of its pools of rotable and temporary spare parts used in the same trade or business and for which it uses this method for its books and records. The optional method is a method of accounting under §446(a). Under the optional method, taxpayers must deduct the amount paid to acquire or produce the part in the taxable year that the part is first installed on a unit of property for use in the taxpayer's operations. Subsequently, when the part is removed from a unit of property to which it was installed, taxpayers:

1. Must include in gross income the fair market value of the part.
2. Must include in the basis of the part the fair market value of the part included in income and the amount paid to remove the part from the unit of property.
3. May not currently deduct and must include in the basis of the part any amounts paid to maintain, repair, or improve the part in the taxable year these amounts are paid.
4. Must deduct the amounts paid to reinstall the part and those amounts included in the basis of the part in the taxable year that the part is reinstalled on a unit of property.
5. Must deduct the amounts included in the basis of the part in the taxable year in which the part is disposed of by the taxpayer.

> **Example.** CJ5 operates a fleet of vehicles in its business. Whenever CJ5 acquires a new type of vehicle, it also acquires a substantial number of rotable spare parts to replace similar parts in its vehicles as they break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. In 2014, CJ5 acquires a number of rotable spare parts. In 2015, CJ5 repairs several vehicles and uses the 2014 rotable parts to replace worn or damaged parts. In 2016, CJ5 pays amounts to remove the 2014 rotable parts from its vehicles. In 2017, CJ5 pays to maintain, repair, or improve the 2014 rotable parts. In 2018, the 2014 rotable parts are installed on other vehicles. In 2021, CJ5 removes the 2014 rotable parts from these vehicles and stores the parts for later use. In 2022, CJ5 disposes of the 2014 rotable parts.

Under the optional method, CJ5 deducts the amounts paid to acquire and install the 2014 rotable parts in 2015, when the rotable parts are first installed. In 2016, when CJ5 removes the 2014 rotable parts from its vehicles, it includes in its gross income the fair market value of each part. CJ5 adds fair market value included in its income plus any amounts paid to remove the part from the vehicle as the parts' basis in 2016. In 2017, CJ5 adds to the basis of each 2014 rotable part amounts paid to maintain, repair, or improve the part. In 2018, the year that it reinstalls the 2014 rotable parts (as repaired or improved) in other vehicles, CJ5 deducts the reinstallation costs and the basis of each installed part. In 2021, when the rotable parts are removed from its vehicles, CJ5 includes in income the fair market value of each 2014 rotable part removed. In 2022, the year that it disposes of the 2014 rotable parts, CJ5 deducts the remaining basis of each rotable part (§1.162-3(h), Exp. 3).

Preparer note. There is no capitalization election available for materials and supplies other than rotable or temporary parts.

DEDUCTION - §162: REPAIR VS. IMPROVEMENTS

Deductible Repair or a Depreciable Improvement?

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

What Kind of Property Is Depreciable?

Generally, depreciable property:

1. ***Is a capital expenditure in depreciable property;***
2. Is used in a trade or business or held for the production of income; and
3. Has a definite useful life of more than one year (§167 & §168).

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

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

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

***New!* Capitalization of Tangible Assets (T.D. 9636; §1.165-2; §§1.167(a)-4, 7, 8; §1.168(i)-7; §§1.263(a)-1, 2, 3 & 6; §1.263A-1; §1.1016-3)**

Introduction. The IRS issued final regulations which explain and clarify how to treat the acquisition, production, and improvement of all tangible property (e.g., when to capitalize amounts paid to sell, acquire, produce, or improve tangible property).

This includes general rules for capital expenditures, amounts paid for the acquisition or production of tangible property, and amounts paid for the improvement of tangible property (§1.263(a)-1,-2, &-3). The regulations also provide significant changes related to the definition of units of property and restorations and allow for industry-specific repair allowance methods to be released by the IRS in the future.

The final regulations generally are effective on January 1, 2014 (§1.263(a)-1(h)). The new regulations generally apply to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2014. However, taxpayers may choose to apply the final regulations to taxable years beginning on or after January 1, 2012.

General rule for repairs and maintenance. A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized (§1.162-4).

General rule for capital expenditures. No deduction is allowed for:

1. Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate or
2. Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made (§1.263(a)-1(a)).

Recovery of capitalized amounts. Amounts that are capitalized are recovered through depreciation, cost of goods sold, or by an adjustment to basis (§1.263(a)-2(h)).

Amount Paid to Buy and Sell Tangible Property (§1.263(a)-1; §1.263(a)-2)

Items that must be capitalized. With the exception of the de minimis rule and the material and supply relief provision, taxpayers must capitalize amounts paid to acquire, produce, or improve real or personal property, including leasehold improvement property, land, and land improvements; to acquire or create intangibles; or to acquire a trade or business (or a change in the capital structure of a business entity). Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs, and costs for work performed prior to the date that the property is placed in service by the taxpayer. A taxpayer also must capitalize amounts paid to acquire real or personal property for resale, such as commissions and other transaction costs (§1.263(a)-1(c), (d) & (e); §1.263(a)-2(d)(1)).

> ***Example -work performed prior to placing real property into service must be capitalized.*** In 2014, Patricia purchases an office building. Prior to placing the building into service, she incurs costs to repair cement steps, refinish wood floors, patch holes in walls, and paint the interiors and exteriors of the building. In 2013, Patricia places the office building into service. The amounts paid must be

capitalized as costs of acquiring the building because they were for work performed prior to Patricia's placing the building in service (§1.263(a)-2(d)(2), Exp. 10).

Amounts Paid to Sell Property Must Be Capitalized (§1.263(a)-1(e)(1)).

Transaction costs reduce amount realized. Except in the case of dealers in property, commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized and treated as a reduction in the amount realized. Dealers in property include taxpayers that maintain and sell inventories and taxpayers that produce property for sale in the ordinary course of business (for example, the home construction business).

Defense or perfection of title to property must be added to basis (§1.263(a)-2(e)(1)). Amounts paid to defend or perfect title to real or personal property, including contesting condemnations and challenging building lines, must be capitalized.

Transaction costs must be added to basis (§1.263(a)-2(f)). A taxpayer must capitalize amounts paid to facilitate the acquisition or production of real or personal property, including both costs incurred during the investigation and costs that are inherently facilitative such as:

1. Transporting the property (for example, shipping fees and moving costs);
2. Securing an appraisal or determining the value or price of property;
3. Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
4. Application fees, bidding costs, or similar expenses;
5. Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);
6. Examining and evaluating the title of property;
7. Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
8. Conveying property between the parties, including sales and transfer taxes, and title registration costs;
9. Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;
10. Architectural, geological, engineering, environmental or inspection services pertaining to particular properties; and
11. Services provided by a qualified intermediary or other facilitator of an exchange under §1031.

Expenses used to determine whether to buy and which property to buy need not be capitalized. Unless the expenses are "inherently facilitative," an amount paid in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire (§1.263(a)-2(f)(2)(iii)(A)).

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

$5,000 per invoice for businesses with AFS. The final regulations create a de minimis safe harbor determined at the invoice or item level and based on the policies that the taxpayer utilizes for its financial accounting books and records. Businesses with applicable financial statements may rely on the new de minimis safe harbor only if the amount paid for property does not exceed $5,000 per invoice, or per item, as substantiated by the invoice.

$500 per invoice for businesses without AFS. Businesses without applicable financial statements may rely on the de minimis safe harbor only if the amount paid for property does not exceed $500 per invoice, or per item, as substantiated by the invoice. If the cost exceeds $500 per invoice (or item), then no portion of the cost of the property will fall within the de minimis safe harbor.

$5,000 per Invoice De Minimis with an Applicable Financial Statement (§1.263(a)-1(f)(1)(i)):

1. **Written policy:** establishes, at the beginning of the tax year, written accounting procedures expensing, for non-tax purposes, de minimis items:
   a. Costing less than a certain dollar amount or
   b. With an economic life of 12 months or less,

2. **Tax/book consistency:** recognizes the de minimis costs as expenses on its AFS, and

3. **De minimis amount:** the amount paid for the property does not exceed $5,000 per invoice (or per item, as substantiated by the invoice) or other amount as determined by the IRS.

Consolidated entities. If the taxpayer's financial results are reported on the AFS for a group of entities, the group's AFS may be treated as the AFS of the taxpayer. Also, the written accounting procedures provided for the group and utilized for the group's AFS may be treated as the written accounting procedures of the taxpayer.

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

$500 per invoice de minimis without an applicable financial statement (§1.263(a)-1(f)(1)(ii)):

1. **Written policy:** establishes, at the beginning of the tax year, written accounting procedures expensing, for non-tax purposes, de minimis items:
   a. Costing less than a certain dollar amount or
   b. With an economic life of 12 months or less,

2. **Tax/book consistency:** recognizes the de minimis costs as expenses on its books and records, and

3. **De minimis amount:** the amount paid for the property does not exceed $500 per invoice (or per item, as substantiated by the invoice) or other amount as determined by the IRS.

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

Requirements to use the de minimis safe harbor: election must be timely made (beginning of year), in proper format, and timely attached to yearly tax return; annual election is irrevocable (§1.263(a)-1(f)(5)). A taxpayer may annually elect to immediately expense amounts paid for the acquisition or production of a unit of property or of any material or supply. The election is made by including a statement on the taxpayer's timely filed original Federal tax return (including extensions) and is irrevocable. The statement must be titled "Section 1.263(a)-1(f) de minimis safe harbor election." If elected, the de minimis safe harbor must be applied to all amounts paid in the taxable year for tangible property that meet the requirements of the de minimis safe harbor, including amounts paid for materials and supplies that meet the requirements. The election may not be made by filing an application for change in accounting method.

To deduct material or supplies costing more than $200 each, the taxpayer must *elect* to use the repair vs improvement "de minimis" safe harbor. Because taxpayers are limited to a $200 de minimis amount when deducting materials and supplies, taxpayers who wish to apply the de minimis rule to any material or supply costing more than $200 may ***elect*** to use the repair vs improvement de minimis safe harbor rules. (§1.2623(a)-1(f)(3)(ii)).

> **Preparer note.** The supplementary information to the final regulations makes it clear that the de minimis rules are a safe harbor. It also notes that the de minimis safe harbor is not intended to prevent a taxpayer from reaching an agreement with an IRS examiner and that it is not intended that examining agents must now revise their materiality thresholds in accordance with the de minimis safe harbor limitations. Thus, if an examiner and a taxpayer agree that an amount in excess of the de minimis safe harbor limitations is not material, that agreement should be respected, regardless of the de minimis safe harbor. However, taxpayers seeking deductions in excess of the safe harbor amounts have the burden of proving that such treatment clearly reflects income (T.D. 9636, Supplementary Information, IV, C).

Anti-abuse rule (§1.263(a)-1(f)(6)). If a taxpayer acts to manipulate transactions with the intent to achieve a tax benefit or to avoid the application of the safe harbor limitations, the IRS will make appropriate adjustments. For example, a taxpayer is deemed to act to manipulate transactions with an intent to avoid the purposes and requirements of the safe harbor if the taxpayer applies the de minimis safe harbor to amounts substantiated with invoices created to componentize property that is generally acquired or produced by the taxpayer as a single unit of tangible property, and this property, if treated as a single unit, would exceed any of the limitations.

> ***Example - Taxpayer with AFS.*** Cole Inc.'s financial results are reported on audited financial statements that are used to secure credit. Cole has a written accounting policy at the beginning of 2014, which it follows, to expense amounts paid for property costing $5,000 or less. In 2014, Cole pays $6,250,000 to purchase 1,250 computers at $5,000 each. Cole receives an invoice from its supplier indicating the total amount due ($6,250,000) and the price per item ($5,000). The amounts paid for the computers meet the requirements for the de minimis safe harbor. If Cole elects to apply the de minimis safe harbor for 2014, it may not capitalize the amounts paid for the 1,250 computers or any other amounts meeting the criteria for the de minimis safe harbor and may deduct these

amounts in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business (§1.263(a)-1(f)(7), Exp. 3).

Example - Taxpayer without AFS. Accent Inc. purchases 10 printers in 2014 at $250 each, for a total cost of $2,500. Accent does not have an AFS but has accounting procedures in place at the beginning of 2014 to expense amounts paid for property costing less than $500 and expenses the amount paid for the printers on its books and records. If Accent elects to apply the de minimis safe harbor for 2014, it may not capitalize the amounts paid for the 10 printers or any other amounts meeting the criteria for the de minimis safe harbor and may deduct these amounts in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business (§1.263(a)-1(f)(7), Exp. 1).

Example - Taxpayer without AFS. Beech Inc. purchases 10 computers in 2014 at $600 each, for a total cost of $6,000. Beech does not have an AFS but has accounting procedures in place at the beginning of 2014 to expense amounts paid for property costing less than $1,000 and it treats the amounts paid for the computers as an expense on its books and records. The amounts paid for the printers do not meet the requirements for the de minimis safe harbor because they exceed $500 per invoice (or per item, as substantiated by the invoice). Beech may not apply the de minimis safe harbor election (§1.263(a)-1(f)(7), Exp. 2).

Preparer note. This does not necessarily mean that Beech cannot expense the computers, but it does mean that if the computers are expensed, Beech will have the burden to prove that such expensing is reasonable to the IRS and/or the courts.

Example - 12-month economic useful life. Girard operates a restaurant where, in 2014, he purchases 10 hand-held point-of-service devices at $300 each ($3,000 total) and 3 tablet computers at $500 ($1,500 total). Each point-of-service device and each tablet computer has an economic useful life of 12 months or less. Girard does not have an AFS, but he has accounting procedures in place at the beginning of 2014 to expense amounts paid for property costing $300 or less and to expense amounts paid for property with an economic useful life of 12 months or less. Thus, Girard expenses the amounts paid for the hand-held devices on its books and records because each device costs $300, and he also expenses the amounts paid for the tablet computers on its books and records because the computers have an economic useful life of 12 months of less. The amounts paid for the hand-held devices and the tablet computers meet the requirements for the de minimis safe harbor (§1.263(a)-1(f)(7), Exp. 7).

Example - continued - limitation. Assume the facts as in the example directly above, except Girard purchases the 3 tablet computers at $600 each for a total cost of $1,800. The amounts paid for the tablet computers do not meet the de minimis rule safe harbor because the cost of each computer exceeds $500. Therefore, the amounts paid for the tablet computers may not be deducted under the safe harbor (§1.263(a)-1(f)(7), Exp. 8).

Recordkeeping requirements. These regulations do not impose any specific record-keeping requirements for the use of the de minimis safe harbor. However, under §6001, taxpayers are required to keep books and records sufficient to establish their eligibility to use the de minimis safe harbor. Specifically, taxpayers must maintain books and records reasonably sufficient to determine:

1. The total amounts paid and deducted as materials and supplies;
2. The total amounts paid and not capitalized;
3. The computation of the de minimis amount;
4. That income has not been distorted by the aggregate of the deductions if the aggregate amount exceeds the de minimis amount; and
5. That the regulations requirements have been met (§6001).

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

Improvements now called "betterments." In attempting to determine whether an amount must be capitalized as an improvement (and therefore not a deductible repair), taxpayers generally must capitalize amounts paid that:

1. Result in a betterment (a.k.a. an improvement) to a unit of property (UOP);
2. Restore (a unit of) property; or
3. Adapt (a unit of) property to a new or different use (§1.263(a)-3(d)(1)-(3)).

Determining the "Unit of Property" (§1.263(a)-3(e))

The judicial "unit of property" test. When a repair is made to a discrete component part of a larger item of property, the business must determine whether to apply the "repair regulations" to the component part or to the larger item of property. Otherwise stated, the business must identify which "unit of property" is being "repaired" and whether the repair materially adds to the value or appreciably prolongs the life of that unit of property. Even though the courts have addressed the unit of property issue under §263(a), their holdings are based on the particular facts of each case and do not contain rules that are generally applicable. Looking to two similar cases, *Ingram Industries, Inc. v. Comm.*, (TCM 2000-323) and *Smith v. Comm.*, (2002-2 USTC ¶50,583), in *FedEx v. Comm.*, (6th Cir.) (2005-1 USTC ¶50,186, affirming 2003-2 USTC ¶50,697), the court felt four factors should be considered in identifying the appropriate unit of property when applying the repair regulations:

1. Whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes,
2. Whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property,
3. Whether the larger unit of property and the smaller unit of property can function without each other, and
4. Whether the component part can be and is maintained while affixed to the larger unit of property (*FedEx v. Comm.*, 2003-2 USTC ¶50,697, affirmed by 2005-1 USTC ¶50,186 (6th Cir.)).

The Court of Appeals concluded in *FedEx Corp. v. United States*, (412 F.3d 617 (6th Cir. 2005)) that the aircraft, and not the aircraft engine, was the appropriate unit of property (also see: *Smith v. Commissioner*, 300 F.3d 1023 (9th Cir. 2002) concluding that an aluminum reduction cell, rather than the entire cell line, was the appropriate unit of property; *Ingram Industries, Inc. v. Commissioner*, TCM 2000-323, concluding that a towboat, and not the towboat engine, was the appropriate unit of property; but also see: *LaSalle Trucking Co. v. Commissioner*, TCM 1963- 274, concluding that truck engines, tanks, and cabs were each separate units of property).

The IRS's definition of "unit of property" (§1.263(a)-3(e)(1)). In trying to provide guidance on amounts paid to repair, improve, and rehabilitate tangible property, the regulations first create rules to determine the appropriate "unit of property." For example, to determine whether an amount paid materially increases the value of property it is necessary to know what property is at issue. The smaller the unit of property, the more likely it is that amounts paid in connection with that unit of property will materially increase the value of or restore the property. Taxpayers and the IRS frequently disagree on the unit of property to which the capitalization rules should be applied, and the current temporary §263(a) regulations attempt to provide guidance on determining the appropriate unit of property.

"Unit of property" definition: all components that function interdependently are one "unit of property." Generally, all the components that are functionally interdependent comprise a single unit of property (that is, the placing in service of the component is dependent upon the placing in service of the composite property) (§1.263(a)-3(e)(1)). Special rules exist for buildings, plant property, network assets, leased property (both buildings and other than buildings), and improvements to property. Additional rules apply if a taxpayer has assigned different MACRS classes or depreciation methods to components of property or subsequently changes the class or depreciation method of a component or other item of property. Property that is aggregated and subject to a general asset account election or accounted for in a multiple asset account (that is, pooled) may not be treated as a single unit of property.

Definition of a "building" (§1.263(a)-3(e)(2)). Generally each "unit of property" for a building is comprised of each building and its structural components[3]. However, a taxpayer is required to apply the improvement standards separately to the primary components of the building, that is, the building structure or any of the specifically defined building systems. Thus, a cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems. The building structure is defined as the building (as defined in §1.48-1(e)(1)) and its structural components (as defined in §1.48-1(e)(2)) other than the components specifically enumerated as building systems. The building systems are defined to include: 1) the heating, ventilation, and air conditioning systems (HVAC); 2) the plumbing systems; 3) the electrical systems; 4) all escalators; 5) all elevators; 6) the fire protection and alarm systems; 7) the security systems; 8) the gas distribution systems; and 9) any other systems identified in published guidance.

Accordingly, if an amount paid results in a restoration of a building structure such as the replacement of an entire roof, then the expenditure constitutes an improvement to the building unit of property. Similarly, if an amount paid results in a betterment to a building system such as an improvement to the HVAC system, then the expenditure also constitutes an improvement to the building unit of property (see, for example, *Smith v. Comm.*, 300 F.3d 1023 (9th Cir. 2002) (holding that costs to replace a substantial portion of floor were capital expenditures); *Tsakopoulous v. Comm.*, TCM 2002-8 (holding that costs to replace the roof on a portion of the suites of a shopping center were capital expenditures); *Hill v. Comm.*, TCM. 1983-112 (holding that costs to replace the water heater and furnace in rental property were capital expenditures); *Stewart*

[3]For condominium owners, the unit of property is the individual unit owned by the taxpayer and the structural components that are part of the condominium unit. Similarly, for a taxpayer that has an ownership interest in a cooperative housing corporation, the unit of property is the portion of the building in which the taxpayer has possessory rights and the structural components that are part of the portion of the building subject to the taxpayer's possessory rights. For both condominiums and cooperatives, an amount is paid for an improvement to these units of property if the amount results in an improvement to the building structure that is part of the condominium or cooperative unit or to the portion of any building system that is part of the condominium or cooperative unit.

Supply Co. v. Comm., TCM 1963-62 (holding that costs to replace the front wall of a building and make electrical connections to that wall were capital expenditures); *First Nat'l Bank v. Comm.,* 30 B.T.A. 632 (1934) (holding that costs of replacing the electrical system in a bank building were capital expenditures); *Georgia Car and Locomotive Co.*, 2 B.T.A. 986 (1925) (holding that costs of a new roof on a building were capital expenditures). The approach for buildings is conceptually similar to the plant property rule, which segregates plant property into units of property that perform discrete and major functions within the plant.

Example - Work performed on building's HVAC system must be capitalized. Janet must treat her office building *and* its structural components as a single unit of property. Janet pays for work performed on the roof-mounted HVAC units. The HVAC system is comprised of ten roof-mounted units that service different parts of the building. Even though the roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, the amount Janet paid for work on the roof-mounted units results in an betterment to the building HVAC system. If the payment results in an improvement to the building structure *or* any designated building system, they must be capitalized and depreciated (not deducted as a repair) (§1.263(a)-3(e)(6), Exp. 1).

Example -Work performed on one elevator is an improvement to the entire building system and must be capitalized. Larry's retail business building contains two elevator banks, each containing three elevators. All of the elevators, including all their components, comprise a building system. Therefore, if an amount paid for work on the elevators results in an improvement (for example, a betterment) to the entire elevator system, Larry must treat these amounts as an improvement to the building (§1.263(a)-3(e)(6), Exp. 2).

Example - Cost segregation study that allocates purchase between building and parking lot creates two "units of property" that must be separately capitalized. In 2010, NorthEast Department Store purchased and placed in service a building and a parking lot, depreciating both as 39-year nonresidential real property. In 2014, NorthEast completed a cost segregation study under which it properly determined that the parking lot qualifies as 15-year MACRS property and changed its method of accounting to use a 15-year depreciation for the parking lot. Starting in 2014, NorthEast must treat the parking lot as a unit of property separate from the building (§1.263(a)-3(e)(6), Exp. 18).

Rules for Leased Property (§1.263(a)-3(f))

Lessee improvements. A lessee must capitalize the amount it pays to improve a unit of leased property, except to the extent that §110 applies to a construction allowance received by the lessee for the purpose of such improvement or where the improvement constitutes a substitute for rent. Because a lessee improvement involves the acquisition or production of a new and distinct interest in property and this property interest is often different from the underlying leased property, amounts paid for a lessee improvement are treated as the acquisition or production of a new unit of property (that is, a unit of property separate from the leased unit of property), rather than an improvement to the underlying property. This treatment is consistent with the depreciation requirements under §168(i)(8)(A), which do not allow a taxpayer to depreciate leasehold improvements over the term of the underlying lease, but rather require that a taxpayer depreciate the leasehold improvement over the applicable recovery period under MACRS for the type of property acquired or produced.

Lessor improvements. The rules for lessor improvements are corollaries to the rules provided for lessee improvements. In general, a lessor must capitalize amounts paid for leasehold improvements where the lessor is the owner of the leasehold improvement, where §110 applies, or where the lessee's improvement is a substitute for rent. However, in contrast with a lessee, the lessor is the owner of the underlying property. As such, a lessor improvement is treated in the same manner as any other owner improvement to a unit of property. Therefore, a lessor improvement is treated as an improvement to the underlying property under §1.263(a)-3 and is not treated as the acquisition or production of a new unit of property. Finally, amounts capitalized by the lessor may not be capitalized by the lessee.

> ***Example - Payment to fix structural components affecting leased buildings must be capitalized by lessee.*** If Janet leases a building and pays for work on the HVAC system that results in an improvement to the heating and air conditioning system in the leased building, Janet must treat this amount as an improvement to the entire leased building (§1.263(a)-3(f)(4), Exp. 2).

> ***Example -A construction allowance provided to a tenant to make additions to the landlord's building must be capitalized by the landlord.*** In 2014, Teddy Clothing leases a building from its owner, LandMark Realty. Pursuant to the lease, LandMark provides a construction allowance to Teddy Clothing, to be used to construct an extension to the retail sales facility for additional warehouse space. LandMark Realty must treat the leased building and its structural components as a single unit of property and the amount paid must be treated as an improvement to the building. Teddy Clothing is not permitted to capitalize the amounts paid for the lessor-owned improvement (§1.263(a)-3(f)(4), Exp. 3).

> ***Example - A construction allowance granted to the lessee to construct shelving and other personal property with ownership retained by the lessee must be capitalized as personal property by the lessee.*** Pursuant to a lease, LandMark Realty provides a construction allowance to Teddy Clothing, which it uses to acquire and construct partitions for fitting rooms, counters, and shelving. Amounts paid for acquisition or construction of any personal property used in the leased property do not constitute a substitute for rent. Teddy Clothing's expenditures for the partitions, counters, and shelving are not improvements to the leased property but rather constitute amounts paid to acquire or produce separate units of personal property (§1.263(a)-3(f)(4), Exp. 4).

New! **Building Repair Safe Harbor for Small Taxpayer (§1.263(a)-3(h))**

Total of repair maintenance and improvements may not exceed lesser of $10,000 or 2% of unadjusted basis of building. A qualifying taxpayer (see below) may elect to deduct immediately , rather than capitalize and depreciate (over the next 27.5 years for residential rental property or 39 years for commercial property), improvements made to property the taxpayer owns or leases. To qualify, the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building property may not exceed the lesser of:

1. 2% of the unadjusted basis of the eligible building property or
2. $10,000.

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

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

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

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

> ***Example - Small taxpayer safe harbor applicable.*** Arnold is a qualifying taxpayer who owns an office building in which he provides accounting services. In 2014, Arnold's building has an unadjusted basis of $750,000, and he pays $5,500 for repairs, maintenance, improvements, and similar activities to the office building. Because Arnold's building has an unadjusted basis of $1,000,000 or less it constitutes eligible building property. The $5,500 paid by Arnold during 2014 for repairs, maintenance, etc. on his building does not exceed the lesser of $15,000 (2% of $750,000, the building's unadjusted basis) or $10,000. Arnold may elect to immediately deduct amounts paid for repair, maintenance, etc. on the office building in 2014 (§1.263(a)-3(h)(10), Exp. 1).
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> ***Example - Safe harbor applied building-by-building.*** A qualifying taxpayer with annual gross receipts under $10 million, Betty owns two multi-family rental properties, one in Elkhart and one in Goshen. In 2014, each property has an unadjusted basis of $300,000 (less than the $1,000,000 threshold). Betty pays $5,000 and $7,000 for improvements in 2014 on the Elkhart and the Goshen buildings, respectively. The $5,000 paid by Betty for improvements on the Elkhart property does not exceed the lesser of $6,000 (2% of the building's $300,000 unadjusted basis) or $10,000. Betty may elect not to apply the capitalization rules and currently deduct the improvement amounts on her 2014 tax return. However, the $7,000 Betty spent to improve her Goshen property exceeds $6,000, the lesser of the two limitations, and, therefore, she is not eligible to make the election for the Goshen property. Instead, the Goshen property improvements, but not repairs, must be capitalized and depreciated (§1.263(a)-3(h)(10), Exp. 3).
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> **Example - Safe harbor applied to leased building property.** Clancy, who makes under $10 million of gross receipts, leases retail space in a strip mall. The $4,000-per-month lease is a triple-net lease, and the lease term, with renewals, is 20 years. The unadjusted basis of Clancy leased retail space is $960,000 ($4,000 monthly rent x 12 months × 20 years). Being under $1 million, the space is an eligible building under the safe harbor qualifications. In 2014, Clancy pays $7,000 for repairs,

maintenance, improvements, and similar activities performed on the space, which does not exceed the lesser of $19,200 (2% times $960000) or $10,000. Therefore, Clancy may deduct the $7,000 without applying the repair vs improvement rules ***if*** he properly and timely makes the safe harbor election (§1.263(a)-3(h)(10), Exp. 4).

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

Routine Repair and Maintenance Safe Harbor (§1.263(a)-3(i))

Routine maintenance is a deductible repair and not deemed to improve property. Routine maintenance for buildings, building systems, and for property other than buildings is the recurring activities that taxpayers expect to perform to keep the property in its ordinarily efficient operating condition. Routine maintenance activities include, but are not limited to, the inspection, cleaning, and testing of the building, building systems, or other property and the replacement of damaged or worn parts with comparable and commercially available replacement parts. Routine maintenance may be performed any time during the ***useful life*** of the building, building systems, or other property. The final regulations introduce routine maintenance safe harbors for both buildings and property other than buildings.

Buildings and building systems: safe harbor if repairs expected more than once in 10 years (§1.263(a)-3(i)(1)(i)). The routine maintenance safe harbor for buildings and building systems only applies if the taxpayer reasonably expects to perform the maintenance or repair activities more than once during the 10-year period beginning at the time the building or its systems are placed in service by the taxpayer. It is not required that the taxpayer actually perform the maintenance two or more times during the 10-year period, only that the taxpayer reasonably expects to do so. A taxpayer's expectations will not be deemed unreasonable if it can be substantiated that the expectations were reasonable at the time the property was placed in service. To evaluate the reasonableness of taxpayer expectations, the IRS will consider the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property.

Property other than buildings: safe harbor if repairs expected more than once during class life (§1.263(a)-3(i)(1)(ii)). An amount paid for routine maintenance performed on depreciable property other than buildings or building systems are deemed not to improve that property if, at the time the property is placed in service, the taxpayer reasonably expects to perform the maintenance activities more than once during the ADR class life (not economic life) of the unit of property. Again, a taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the class life, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property.

Routine maintenance does not include the amounts paid (§1.263(a)-3(i)(3)):

- For the replacement of a component of property that the taxpayer has properly deducted a loss for that component (other than a casualty loss under §1.165-7);
- For the replacement of a component of property that the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- For the repair of damage to property that the taxpayer has taken a basis adjustment as a result of a casualty loss under §165 or relating to a casualty event described in §165;
- To return property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
- For repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts.

Example - Escalator handrails replaced every 4 years are routine maintenance on a building. Gatsby Inc. acquired a large retail mall that contained an escalator system with 40 escalators. In 2014, when Gatsby placed the mall into service, it reasonably expected that the escalator handrails would need to replaced approximately every four years. After a routine inspection of the escalator system in 2017, Gatsby paid to replace the handrails. Because the replacement of the handrails involved recurring activities that Gatsby expected to perform to keep the escalator system in an ordinarily efficient operating condition, and Gatsby reasonably expected to perform these activities more than once during the 10-year period beginning at the time building system was placed in service, the amounts paid for the handrail replacements are deemed not to improve the building unit of property and are not required to be capitalized (§1.263(a)-3(i)(6), Exp. 13).

Example - HVAC maintenance in year 4 and year 11 but it was reasonable to expect maintenance every four years . HTC, Inc. acquired a new office building to house its operations. In 2014, when HTC placed its building into service, it reasonably expected that every four years, it would need to pay an outside contractor to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the system operating efficiently. The scheduled maintenance at these intervals was recommended by the manufacturer of the HVAC system and was routinely performed on similar systems in similar buildings. In 2017, HTC paid a contractor to perform the scheduled maintenance. HTC did not, however, perform the scheduled maintenance again until 2025.HTC's reasonable expectation that it would perform the maintenance every 4 years is not deemed unreasonable merely because it did not actually perform the maintenance a second time during the 10-year period. As long as HTC can substantiate that its expectation was reasonable at the time the property was placed in service using the other factors considered in §1.263(a)-3(i)(1)(i), then the amounts HTC paid for the maintenance of the HVAC system in 2017 and in 2025 are within the routine maintenance safe harbor under §1.263(a)-3(i)(1)(i).

Example - Routine maintenance on airplane's rotable jet engines need not be capitalized. Jet Black (Jet) is a commercial airline transporting passengers and freight. Jet both owns various types of aircraft and is required to establish and adhere to a continuous maintenance program for each aircraft within its fleet. The maintenance program requires an engine shop visit (ESV), which Jet expects to perform on its aircraft engines approximately every 4 years in order to keep its aircraft in its ordinarily efficient operating condition. In 2014, Jet purchased a new aircraft, which included four new engines attached to the airframe. In 2018, Jet performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor that performs the ESV and makes repairs if needed. After the ESVs, the engines are returned to Jet to be reinstalled on another aircraft or stored for later installation. The unit of property for Jet's aircraft is the entire aircraft, including the aircraft engines, and the class life of Jet's aircraft is 12 years. Because Jet expects to perform the ESVs more than once during the 12- year class life of the aircraft, the ESVs are routine maintenance and meet the safe harbor. The ESV costs are not required to be capitalized (§1.263(a)-3(i)(6), Exp. 1).

Example - Routine maintenance is deductible even after the ADR class life of the property is over. Assume the same facts as in the above example, except that Jet incurs costs to perform an ESV on one of its aircraft engines in 2028, well after the end of the aircraft's class life. Because this ESV involves the same routine maintenance activities that were performed on aircraft engines during the aircraft's class life, this ESV also is within the routine maintenance safe harbor. The cost of this ESV is not required to be capitalized (§1.263(a)-3(i)(6), Exp. 2).

Example - Routine maintenance resulting from prior owner's use must be capitalized. In January 2014, Kevlar, Inc. purchased a used machine with a class life of 10 years. Kevlar expects to perform scheduled maintenance on the machine every three years. At the time Kevlar purchased the machine, the machine was approaching the end of a three-year scheduled maintenance period. In February 2014, Kevlar performed the manufacturer-recommended scheduled maintenance. Because the costs were incurred primarily as a result of the prior owner's use of the property, not Kevlar's use, the amounts paid for the scheduled maintenance must be capitalized. Three years later, in 2017, Kevlar again pays for scheduled maintenance. The 2017 expenditures, qualifying as routine maintenance, are not required to be capitalized (§1.263(a)-3(i)(6), Exp. 4 & 5).

Preparer note. An exception to capitalizing this scheduled maintenance resulting from the prior owner's use exists if, considering the facts and circumstances, the expenditures did not create an improvement—that is, it did not 1) ameliorate a material condition or defect in the machine or 2) materially increase machine capacity or productivity (§1.263(a)-3(j)(3), Exp. 3).

Capitalizing Improvements: a.k.a. Betterments (§1.263(a)-3(j))

When an expenditure must be depreciated. A taxpayer must capitalize (and therefore depreciate and not expense) amounts paid that result in the "betterment" (improvement) of property, but only if it:

1. Ameliorates a ***material*** condition or defect that existed prior to acquisition (or arose during the production of the property), whether or not the taxpayer was aware of the condition or defect at the time of acquisition (or production); or
2. Is for a ***material*** addition, including a physical enlargement, expansion, extension, or addition of a major component to the property or a material increase in capacity (including additional cubic or square space) of the property; or
3. Is reasonably expected to ***materially*** increase the productivity, efficiency, strength, quality, or output of the property (§1.263(a)-3(j)(1)).

Improvement (betterment) rules in general. To make things difficult, the regulations don't define *material* other than to instruct that "the applicability of each quantitative and qualitative factor for a material addition or material increase in capacity to property depends on the nature of the property." For example, if an addition or an increase in a particular factor cannot be measured in the context of a specific type of property, this factor is not relevant in the determination of whether an amount has been paid for a betterment to the unit of property (§1.263(a)-3(j)(2)). What does that mean? It means it is a facts and circumstances test to be applied immediately before and after each expenditure.

> **Preparer note.** When considering whether or not an expenditure is a betterment, treatment for tax purposes is not required to be the same as treatment in the taxpayer's financial statements.

IRS nixes requests for bright lines. The IRS noted in its preamble to the regulations that many commenters requested that the final regulations provide quantitative bright lines for determining the materiality of additions to units of property or an increase in capacity, productivity, efficiency, strength, quality, or output. The IRS responded that "Quantitative bright lines, although objective, would produce inconsistent results given the broad array of factual settings where the betterment rules apply. Instead, the final regulations continue to rely on qualitative factors to provide fair and equitable treatment for all taxpayers in determining whether a particular cost constitutes a betterment" (T.D. 9636 Supplemental Info, VI. G. 3.).

Appropriate comparison concept. In cases in which an expenditure is necessitated by normal wear and tear or damage to the unit of property that occurred during the taxpayer's use of the unit of property, the determination of whether an expenditure is for the improvement of property is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure. For example, if an expenditure is made to correct the effects of normal wear and tear, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (§1.263(a)-3(j)(2)(iv)).

> **Preparer note.** Comparing the properties condition immediately before the circumstances requiring the expenditure to the condition immediately after the expenditure is the appropriate judicial and administrative comparison. In spite of these extensive repair regulations, it still results in the most disagreement between the taxpayer and the IRS auditor.

Damage to property. If the expenditure is made to correct damage to a unit of property that occurred during the taxpayer's use of the unit of property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to damage (§1.263(a)-3(j)(2)(iv)(B)).

The Regulations contain numerous situational examples illustrating when, and when not, to capitalize an improvement (§1.263(a)-3(j)(3):

- Remediation costs to replace underground gasoline storage tanks unknown at time of purchase is a land improvement that must be capitalized (§1.263(a)-3(j)(3), Exp. 1).
- Cleanup of asbestos in existing building need not be capitalized (§1.263(a)-3(j)(3), Exp. 2).
- Expenditures made to fix a defect existing prior to purchase of a Zamboni, but the defect wasn't material under the facts and circumstances and can be deducted (§1.263(a)-3(j)(3), Exp. 4).
- Repairing pre-existing conditions two years after acquisition must be capitalized as an improvement if aware of condition prior to acquisition (§1.263(a)-3(j)(3), Exp. 5).
- Building refreshment and limited improvements by nationwide chain of retail stores not an improvement (only kept buildings in efficient operating condition) (§1.263(a)-3(j)(3), Exp. 6, 7).
- Amounts paid by retailer to upgrade wiring and to remove and replace recess lighting throughout

stores materially increased the productivity, efficiency, and quality of the stores' electrical systems. Amounts paid to remove and rebuild walls, replace ceilings, rebuild facades, replace doors, and to replace flooring materially increased the productivity, efficiency, and quality of store buildings' structures (§1.263(a)-3(j)(3), Exp. 8).

- Relocating and reinstalling cash registers at another site is not an improvement (§1.263(a)-3(j)(3), Exp. 9).
- Relocating and reinstalling manufacturing equipment at another site resulting in increased capacity is an improvement that must be capitalized (§1.2623(a)-3(j)(3), Exp. 10).
- City requirement to earthquake-proof front of hotel by adding expansion bolts creates an improvement that must be capitalized; the new requirement that the hotel meet new safety standards to continue operating is not relevant (§1.263(a)-3(j)(4), Exp. 11).
- Maintenance expenses must be capitalized when incurred simultaneously with a material capacity increase. Harbor had a channel that was originally 20 feet deep, but erosion reduced depth to 18 feet. Bringing it back to 20 feet deep need not be capitalized. But, dredging channel to 25 feet is a material upgrade and 100% of the dredging costs must be capitalized; no proration is allowed. (§1.263(a)-3(j)(3), Exp. 15, 16, 17).
- Removing drop-ceiling and repainting original ceiling is not an improvement (§1.263(a)-3(j)(3), Exp. 18).
- Adding new insulation that reduces annual power costs by 50% is an improvement (§1.263(a)-3(j)(3), Exp. 21).
- Adding a second electrical panel with additional circuits and adding wiring and outlets throughout the building is an improvement (§1.263(a)-3(j)(3), Exp. 23).
- Replacing roof membrane is a repair, not an improvement (§1.263(a)-3(j)(3), Exp. 13).

Preparer note. The 2012 temporary regulations had additional examples making it clear that replacing the roofing on a building, as long as no substantial upgrade in the roofing materials was made, was deductible as a repair. Interestingly, these examples were eliminated from the final regulations, where the only reference to roofing is a rubber membrane.

Capitalization of Restorations (§1.263(a)-3(k))

When expenses to restore real or personal property must be capitalized. A taxpayer must capitalize amounts paid to restore a unit of real or personal property when:

1. **Replacing component of property adjusted for loss of component**: Is for the replacement of a component of a unit of property, and the taxpayer has properly deducted a loss for that component (other than a casualty loss under §1.165-7);
2. **Replacing component of property adjusted by sale**: Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
3. **Repairing property adjusted for casualty loss**: Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under §165, or relating to a casualty event described in §165;
4. **Restoring deteriorated property:** Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
5. **Rebuilding to like-new condition:** Results in the rebuilding of the unit of property to a like-new

condition after the end of its class life. Property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications.

6. **Replacing major component or substantial structural part of property:** Results in the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property (§1.263(a)-3(k)(1)).

Restorations of buildings. An amount is paid to improve a building if it is paid to restore the building or a building system. For example, an amount is paid to improve a building if it is paid for the replacement of a part or combination of parts that comprise a major component or substantial structural part of the building structure or any one of its building systems (§1.263(a)-3(k)(2)).

Replacement of a major component or a substantial structural part. To determine whether the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative and qualitative significance of the part or combination of parts in relation to the unit of property (§1.263(a)-3(k)(6)).

Major component. A major component is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. An incidental component of the unit of property, even though such component performs a discrete and critical function in the operation of the unit of property, generally will not, by itself, constitute a major component.

Substantial structural part. A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the unit of property.

Major components and substantial structural parts of buildings. In the case of a building, an amount is for the replacement of a major component or a substantial structural part of the building unit of property if the replacement includes a part or combination of parts that comprise a major component, a significant portion of a major component, or a large portion of the physical structure of any building, condominium, cooperative, leased building, or leased portion of a building.

Restoration examples:

- Replacement of major component or substantial structural part of roof must be capitalized (§1.263(a)-3(k)(7), Exp. 14).
- Replacing one of three furnaces in the HVAC system is not an improvement, and the cost can be expensed (§1.263(a)-3(k)(7), Exp. 16).
- Replacing the only chiller in an HVAC system is an improvement and must be capitalized (§1.263(a)-3(k)(7), Exp. 17).
- Replacing three of the ten roof-mounted HVAC units is an expense (§1.263(a)-3(k)(7), Exp. 18).
- Replacing the entire sprinkler or electrical system is an improvement, but replacing 30% of the wiring is a repair (§1.263(a)-3(k)(7), Exp. 19, 20 & 21)
- Replacing all the toilets and sinks in retail building is an improvement and must be capitalized but replacing 8 of 20 sinks is a repair (§1.263(a)-3(k)(7), Exp. 22 & 23).
- Updating a hotel 2 floors at a time, or all floors over three years, is an improvement (§1.263(a)-3(k)(7), Exp. 24).

- Replacing 100 of 300 exterior windows is a repair unless the 300 windows comprise a significant portion of the building's exterior. But, replacing 200 of the 300 exterior windows is an improvement that must be capitalized (§1.263(a)-3(k)(7), Exp. 25, 26 & 27).
- Replacing wood flooring in the hotel lobby is not an improvement but replacing the floors in all the public areas is an improvement that must be capitalized (§1.263(a)-3(k)(7), Exp. 28 & 29).

HVAC units not qualified leasehold improvement (CCA 201310028). The IRS Chief Counsel concluded that the installation of a heating, ventilation, and air conditioning (HVAC) unit on the roof of a building or on a concrete pad adjacent to the building is not an improvement to the interior portion of a building and, therefore, does not constitute a qualified leasehold improvement property (QLIP) for purposes of using a 15- year life. HVAC systems installed on commercial building must be depreciated over 39 years.

Restoration of damage from casualty - limitation. The amount that must be capitalized from an amount paid to restore a unit of property after its basis has been adjusted due to a casualty loss is limited to the excess (if any) of:

1. The adjusted basis of the single, identifiable property for determining the loss allowable on account of the casualty over
2. The amount paid for restoration of damage to the unit of property that also constitutes an improvement (§1.263(a)-3(k)(4)).

Amounts in excess of limitation. Any amounts paid in excess of the limitation must be treated with applicable IRS provisions such as the repair versus improvement regulations and acquisition of property rules (§1.263(a)-3(k)(4)(B)(ii)).

> ***Example - Restoration after casualty loss with no insurance.*** Barry owns an office building that is used in his trade or business. The office building's adjusted basis is $500,000 when it is damaged by a tornado. Under §165, Barry deducts a casualty loss of $50,000 and reduces his basis in the office building to $450,000. Barry pays a contractor $50,000 to repair the damaged building. Barry must treat the $50,000 he paid to the contractor to restore the building as an improvement because he properly adjusted his basis by that amount as a result of a casualty loss deduction and the amount did not exceed the limit (his basis or the amount he paid for the damage restoration). The restoration is an improvement to the building, and Barry must capitalize the amount paid ((§1.263(a)-3(k)(7), Exp. 3).
>
> **Preparer note.** The IRS isn't going to let Barry double-dip the Code and call the $50,000 a repair even though it is only 10% of the basis of the building (and probably less than 10% of the building's fair market value).
>
> ***Example - Restoration after casualty event with insurance proceeds.*** Using the same facts as in the previous example, assume that Barry receives insurance proceeds of $50,000. Barry cannot deduct a casualty loss because he was fully compensated by the insurance but he properly reduces his basis in the building by the amount of the insurance proceeds. Next Barry pays a contractor $50,000, which must be capitalized as a restoration (improvement) of the building, because he has made a basis adjustment and the contractor payment does not exceed the limit (§1.263(a)-3(k)(7) Exp. 4).
>
> ***Example - Restoration after casualty event with repair costs exceed limitation.*** Claire owns a

building that is used in her trade or business. A tornado damages the building when its adjusted basis was $500,000. The cost to restore the property to its pre-tornado condition was $750,000. Claire deducts a casualty loss of $500,000 (her total adjusted basis) and reduces her basis in the building to $0. Claire hires a contractor to repair the building, which entails replacing the building's entire roof at a cost of $350,000 and pumping water from the building, cleaning debris, and replacing areas of damaged flooring at a cost of $400,000. Claire is required to capitalize as an improvement the $350,000 paid to replace the roof structure because the roof structure is a substantial structural part of the building (major component). Claire must treat as a restoration $150,000 ($500,000 adjusted basis less $350,000 amount paid for restoration of damage to the building) of the remaining $400,000 she paid the contractor for costs related to repairing and cleaning the building. Thus, in addition to the $350,000 to replace the roof structure, she must also capitalize the $150,000 as an improvement to the building. Claire is not required to capitalize the remaining $250,000 of repair and cleaning costs (§1.263(a)-3(k)(7) Exp. 5).

The new IRS regulations contain numerous situational examples illustrating when and when not to capitalize a restoration. Unless otherwise stated, assume that the taxpayer has not properly deducted a loss for or taken into account the adjusted basis on a sale or exchange of any unit of property, asset, or component of a unit of property that is replaced.

Adapting Property to a New or Different Use (§1.263(a)- 3(l))

Taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer. These rules apply not only to buildings, but to condominiums and cooperative and leased real property (§1.263(a)-3(l)(1) & (2)).

Examples:

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

Election Available to Capitalize Repair and Maintenance Costs (§1.263(a)-3(n))

A taxpayer may annually elect to treat amounts paid for repairs and maintenance as amounts paid to improve tangible property subject to the allowance for depreciation if the taxpayer incurs these amounts in carrying on the taxpayer's trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records regularly used in computing income. A taxpayer who makes this election in a taxable year must apply it to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. The election is made by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) and is irrevocable. The election is not available for repairs or maintenance of rotable or temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts.

> **Example.** Quinn is a towboat operator that owns a fleet of towboats that it uses in its trade or business. Each towboat, including its engines, is a unit of property with a class life of 18 years, and the towboat engines are not rotable spare parts. In 2014, Quinn acquired and placed in service a new towboat. In 2017, Quinn pays to perform scheduled maintenance on the towboat's engines. The scheduled maintenance on Quinn's towboat is within the routine maintenance safe harbor, so the related expenses may be currently deducted. However, on its books and records, Quinn treats amounts paid for scheduled maintenance on its towboat engines as capital expenditures and, for administrative convenience, decides to account for these costs in the same way for Federal income tax purposes. Quinn makes the appropriate election, capitalizes the routine maintenance expenses, and begins depreciating the amounts.

Impact on Accounting Methods (§1.263(a)-3(q))

Accounting method changes. Any change required to comply with the repair regulations is a change in method of accounting, which requires IRS consent. The IRS has issued a series of revenue procedures detailing the required changes and the procedures required to change the accounting methods.

Importance of Making Accounting Changes under IRS's Repair Regulations (Rev. Proc. 2014-16; Rev. Proc. 2014-17)

Automatic consent rules. Rev. Proc. 2014-16 modifies the procedures and requirements of Rev. Proc. 2012-19 and Rev. Proc. 2011-14 regarding certain accounting method changes for amounts paid to acquire, produce, or improve tangible property. The revenue procedure also explains how a taxpayer may obtain automatic consent from the IRS to change to the methods of accounting provided in the new repair regulations for materials and supplies, repairs and maintenance, capital expenditures, improvement of tangible property, self-constructed assets, and for certain costs related to real property acquired through foreclosures or similar transactions.

IRS wants accounting method change requests - lots of them. The revenue procedure makes it clear the IRS expects taxpayers making any change to comply with the new regulations, no matter how small, to request consent from the IRS to make the accounting method change, even if there is no §481(a) adjustment. Only if the business's current method of accounting exactly matches the requirements in the regulations does the business not need (and, in fact, cannot file for) an accounting method change.

What changes qualify for automatic consent? The revenue procedure details an extensive list of changes requiring the filing of Form 3115, some of which are:

Accounting Method Changes under the Final Tangible Property Regulations Requiring IRS Consent		
Description of change	**DCN**[4]	**Citation**
Change to deduct amount paid for repairs or maintenance or change to capitalize amounts for improvements to tangible property. Includes changes in method of identifying the unit of property or, if a building, the building structure and systems.	184	§§1.162-4, 1.263(a)-3
Change to deduct incidental or non-incidental materials and supplies when used	185, 186	§1.263(a)-3(m)
Change to deduct incidental materials and supplies when paid	187	§1.162-3(a)(2), (c)(1)
Change to deducting non-incidental rotable and temporary parts when disposed of	188	§1.163-3(a)(3), (c)(2)
Change to optional method for rotable and temporary parts	189	§1.163-3(e)
Change to capitalize acquisition or production costs and, if depreciable, to depreciate such property	192	§1.263(a)-2
Change to deduct costs of investigating acquisition of real property	193	§1.263(a)-2(f)(2)(iii)

Form 3115 filed with Ogden IRS Center in lieu of national office copy. Taxpayers changing their method of accounting under this Rev. Proc. must file a signed copy of the completed Form 3115 with the IRS in Ogden, UT (Ogden copy), instead of filing the national office copy. It must be filed no earlier than the first day of the year of change and no later than the date the taxpayer files the original Form 3115 with its Federal income tax return for the year of change (the extended due date at the latest).

IRS Issues Transition Guidance for Dispositions Under Proposed Repair Regulations (Rev. Proc. 2014-17)

The IRS has provided automatic consent to make changes under the repair regulations on dispositions of tangible property. This follows the release of the automatic consent procedures to change accounting methods to comply with the final repair regulations (see T.D. 9564, I.R.B. 2012-14, 614). The proposed repair regulations (NPRM REG-110732-13, I.R.B. 2013-43, 404) on dispositions will be finalized later in the year.

Form 3115 must be filed by September 15, 2014 to use repair regulations in year 2013. Taxpayers wishing to use (apply) the final or temporary regulations to 2013 must file a change of accounting method by September 15, 2014.

> **Preparer note.** According to the IRS, this may involve "a lot of work" so don't wait until September.

Form 3115 must be filed by September 15, 2015 to use repair regulations in year 2014. Taxpayers

[4]Represents "designated automatic accounting method change number".

applying the regulations for 2014 must file a change of accounting methods by September 15, 2015. These dates take into account the extended due dates for returns filed by a calendar-year taxpayer.

There are three types of changes that taxpayers can or must make under the final regulations.

1. Group one changes are required and are retroactive, with mandatory adjustments under §481(a), including the optional method for rotable spare parts, capitalizing certain acquisition or production costs, unit of property changes and deducting repairs, including the routine maintenance safe harbor.
2. Group two includes mandatory changes with modified or prospective §481 adjustments beginning in 2014. For a taxpayer who changes in 2014, the adjustment is prospective. For taxpayer changes in a later year, such as 2015, the adjustment must include prior years back to 2014.
3. Group three changes are elective. Therefore, there are no adjustments and no change of accounting method.

Accounting Method Changes Under MACRS Disposition and General Asset Account Regs (Rev. Proc. 2014-17)

The automatic accounting method change procedures relating to MACRS accounting method changes that were issued in conjunction with the new IRS repair regulations have been issued. This guidance allows a late *partial* disposition election or a revocation of a general asset account election to be treated as a change in method of accounting for a limited period of time. This late partial disposition election allows a taxpayer to claim a loss on structural components retired prior tax years through a §481(a) adjustment, either because of Rev. Proc. 2011-14 or Rev. Proc. 2012-20 by the changes made in new Rev. Proc. 2014-16 or Rev. Proc. 2014-17. For example, a taxpayer who retired a roof in 2010 will now be allowed to make a late partial disposition election by filing this accounting method change.

> **Example.** Nick, a calendar year taxpayer, acquired and placed in service a building and its structural components in 1990. Nick depreciated the building and its structural components under §168. In 2000, he replaced the entire roof of the building but did not recognize a loss on the retirement of the original roof and continues to depreciate the original roof. Nick also capitalized the cost of the replacement roof and has been depreciating this roof under §168 since 2000. A change by him to treat the building as an asset and each structural component of the building as a separate asset for disposition purposes and also to change from depreciating the original roof to recognizing a loss upon its retirement is a covered change (see Section 6.29(3)(a) and (b) of Rev. Proc. 2014-17 APPENDIX).

A taxpayer will also be allowed to revoke a retroactive general asset account (GAA) election previously made under Rev. Proc 2011-14 for assets placed in service in tax years that began before January 1, 2012. This is important because the proposed GAA regulations did not allow a taxpayer to make a partial disposition election for structural components of a building (or components of any other asset) in a GAA. Additional new accounting method changes allow a taxpayer to change to a method of depreciating leasehold improvements.

Each of the following changes in depreciation or amortization is a change in method of accounting:

1. A change in the depreciation method or amortization method, period of recovery, or convention of a depreciable or amortizable asset;

2. A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling); or
3. For depreciable or amortizable assets that are mass asset (see §1.446-1(e)(2)(ii)(d)(2)).

None of the following changes in depreciation or amortization is a change in method of accounting:

1. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under the economic recovery rules (e.g., §167, former §168, or an additional first year depreciation deduction. However, if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code or regulations (for example, §167(f)(1), §168(c), §168(g)(2), §168(g)(3), or §197), such a change is a change in method of accounting;
2. The making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election, except as otherwise expressly provided; and
3. Any change in the placed-in-service date of a depreciable or amortizable asset, except as otherwise expressly provided by the Code or regulations. (see §1.446-1(e)(2)(ii)(d)(3)).

Transition rule for certain elections on 2012 or 2013 returns. Taxpayers who wish to make the election to apply the safe harbor for small taxpayers (§1.263(a)-3(h)) or the election to capitalize repair and maintenance costs (§1.263(a)-3(n)) for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before the date of publication in the Federal Register (applicable taxable year) have been granted additional time. The taxpayer must make the election by filing an amended Federal tax return (including the required statements) on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

Optional application of Temporary Regulations TD 9564. Taxpayers may choose to apply §1.263(a)-3T as contained in TD 9564 to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

DEPRECIATION/MACRS §167, §168 & §179

§179 Expensing Options (§315, American Taxpayer Relief Act of 2012)

§179 Chart	2008-2009	2010-2013	2014
Maximum §179 Deduction	$250,000	$500,000	**$25,000**
Maximum Annual Qualifying Property Before Phase-out	$800,000	$2,000,000	**$200,000**

Increased §179 Limits Expired. A taxpayer may elect to deduct the cost of certain qualified business property placed in service for the year rather than depreciate those costs over time. The 2003 tax cuts temporarily increased the maximum dollar amount that may be deducted from $25,000 to $100,000. These amounts have been further increased and extended several times on a temporary basis, including most recently as part of the American Taxpayer Relief Act of 2012 which extended $500,000 and $2,000,000 thresholds for the taxable years beginning in 2012 and 2013.

§179 cannot create or increase a loss. The expensing election is limited to the amount of taxable income from all of the taxpayer's active trades or businesses. Taxable income is computed without the §179 deduction, without any net operating loss carrybacks or carryforwards, and without deducting one-half of self-employment (§1.179-2(c)(1)). The net income, and losses, from all actively conducted businesses of the taxpayer (i.e., all Schedules C's, F's and K-1's) are aggregated for purposes of this income limitation (§1.179-2(c)(1)). The "net income definition" includes a partner's share of income from a partnership (or shareholder's share of income from an S corporation) as long as the partner/shareholder is active (§1.179-2(c)(2); -2(c)(6)(ii)). Also aggregated are §1231 gains (or losses) from the sale of business assets and interest income from working capital (§1.179-2(c)(1)). §179 deductions that are disallowed because of the income limitation may be carried forward indefinitely, subject to the annual limitations for total §179 expense and for maximum assets purchases (§1.179-3(a)). The taxpayer may choose the properties for which the cost will be carried forward, as well as the portion of each property's cost to be carried forward.

> **Preparer note.** A taxpayer can include wages and salaries of the taxpayer (and spouse), even if the earned wages are not from the business deducting the §179 property (§1.179-2(c)(6)(iv)).

> **Preparer note.** Vehicles for which a §179 deduction has been claimed must maintain business use greater than 50% or be subject to §179 recapture. Such recapture is reported on Form 4797 in the year that business use drops to 50% or below, and the recaptured amount is reported as other income on the schedule where the depreciation was originally taken (i.e., Sch. C). An amended return is not required (see *Michael Birdsill v. Comr.*, TCS 2008-55).

Magnetic Signs Don't Make Hummer Deductible (*Rafael Castillo v. Comm.*, TCM 2013-72)

Rafael Castillo was a real estate sales agent in Modesto, CA who purchased a Hummer in 2006 for $34,799. Rafael testified that he used the Hummer to advertise his real estate business by attaching removable magnetic signs to the side of the Hummer. Claiming the Hummer was used 100% for business in 2006, Rafael deducted §179 expense of $56,000 ($21,201 more than his basis!).

> **Preparer note.** Interestingly, the IRS did not argue that the 2006 §179 expense of $56,000 should be disallowed, instead argued that business use of the Hummer dropped below 50% in 2007 and the 2006 §179 expense should be recaptured.

A little help from his friends not enough for the Tax Court. At trial, Rafael presented business associates as witnesses to corroborate his business use of the Hummer and produced a log that he testified was prepared contemporaneously. The court found that the log was suspect because it was belatedly produced and the mileage shown on the log conflicted with Rafael's estimates at trial of the mileage that the Hummer was used for business.

> **Preparer note.** Contrary to popular belief, the court also noted that attaching a removable sign to the Hummer did not convert personal use to business use and ruled in favor of the IRS.

§179 Deduction for Some Real Estate Expired at the end of 2013 (§179(f); American Taxpayer Relief Act of 2012)

ATRA extended the definition of §179 qualifying property which includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. This provision is now effective for tax years beginning in 2010, 2011, 2012, and 2013. The maximum amount of §179 expense that could be elected for real property assets was annually limited to $250,000, not $500,000.

> **Preparer note.** Any §179 expense deduction that is later recaptured on sale of real property is taxed as ordinary income (§1245(a)(2)).

15-Year Depreciable Life for Certain Real Estate Improvements Expired at the End of 2013

The American Taxpayer Relief Act of 2012 extended through 2013 the special 15-year cost recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

> **Planning point.** Qualified leasehold improvement property qualifies for bonus depreciation.

Qualified restaurant property is any §1250 property that is a building (if the building is placed in service after December 31, 2008 and before January 1, 2014) or an improvement to a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method and a half-year convention.

Qualified retail improvement property is any improvement to an interior portion of a building, which is nonresidential real property if such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Real Property §179 Carryovers Addressed (Notice 2013-59)

Confusion caused by real estate related §179. Taxpayers who immediately deduct qualified real property improvements under §179(f) are not allowed to carry over any excess expense to years when §179(f) is not available (i.e. 2014). Instead, real estate related §179 carryover still remaining and not deductible is treated as an asset placed in service on the first day of the tax year. Given the number of expirations and extensions of this law since its 2010 enactment, it is no surprise that taxpayers may have made errors in their intended or unintended treatment of real property eligible under §179(f). In response, the IRS has clarified that if a taxpayer elects or elected to apply §179(f) to qualified real property placed in service in taxable years beginning in 2010, 2011, 2012, or 2013, the taxpayer is permitted to increase the portion of the cost of such property expensed by filing an amended tax return for that taxable year. Any such increase in the amount expensed under §179 is not a revocation of the election for that prior taxable year.

What about the carryovers? The IRS has also given taxpayers great flexibility in the treatment of any §179(f) carryovers. Taxpayers that did not have sufficient income to use all of their 2010 or 2011 §179(f) and then treated the excess as property placed in service on the first day of the taxpayer's last taxable year beginning in 2011 may either continue that treatment or amend its tax return for the last taxable year beginning in 2011 to carry over the 2010 disallowed §179 deduction or the 2011 disallowed §179 deduction to any taxable year beginning in 2012 or 2013, assuming the statute of limitations is still open.

Carryovers of real-estate-related and non-real-estate-related §179 property must be prorated. If a taxpayer elects to claim §179 expense for qualified real property and also for other types of §179 property in the same year, and some or all of the cost of the §179 expense is carried to future years, the aggregate amount of the carryover of disallowed deduction for that taxable year must be allocated pro rata between the qualified real property and the other types of §179 property.

> **Example.** During 2012, Sehra Inc. purchased and placed in service §179 qualified equipment that cost $100,000 and §179 qualified real property that cost $200,000. For 2012, Sehra elected to expense the entire cost of the equipment and the entire cost of the qualified real property. Because of the taxable income limitation, the maximum §179 deduction Sehra can claim for 2012 is $180,000, and it has a §179 carryover to 2013 of $120,000, which is allocated pro rata between the qualified real property and equipment placed in service during 2012. Thus, $80,000 of the carryover amount is allocated to the qualified real property, and $40,000 of the carryover amount is allocated to the equipment.

§168(k) Bonus Depreciation (American Taxpayer Relief Act of 2012)

Congress allowed businesses, beginning January 1, 2008 through December 31, 2009, to take an additional "bonus" depreciation deduction allowance equal to 50% of the cost of new business depreciable personal property placed in service in those years. Under the Small Business Jobs Act of 2010, this bonus depreciation deduction allowance was extended through December 31, 2010. The 2010 Tax Relief Act further extended and temporarily increased the bonus depreciation percentage for investments in qualified new business property. For qualified property placed in service after September 8, 2010 and through December 31, 2011, the bill provided for 100% bonus depreciation. For property placed in service January 1, 2012 through December 31, 2013, ATRA provides bonus depreciation of 50%. The law also allows corporate taxpayers to elect to accelerate some AMT credits in lieu of bonus depreciation through 2013.

Bonus Depreciation Chart				
Effective date	Jan. 1, 2008 to Sept. 8, 2010	Sept. 9, 2010 to Dec. 31, 2011	2012 - 2013	**2014**
Deduction percentage	50%	100%	50%	**0%**

> **Planning opportunity.** While §179 expensing is limited to $25,000 for purchases of SUVs weighing more than 6,000 pounds (GVW), there is no similar limit to bonus depreciation. So the purchase of a new SUV will qualify the taxpayer for a 50% write off (times the business percentage) for 2013.

Qualifying property. In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements:

- The property must be: 1) property to which MACRS applies with an applicable recovery period of

20 years or less, 2) water utility property (as defined in §168(e)(5)), 3) computer software other than computer software covered by §197, or 4) qualified leasehold improvement property (as defined in §168(k)(3)).

- The original use of the property must commence with the taxpayer after Dec. 31, 2007.
- The taxpayer must purchase the property within the applicable time period.
- The property must be placed in service after Dec. 31, 2007, and before Jan. 1, 2014. An extension of the placed in service date to Jan. 1, 2015 is provided for certain property with a recovery period of 10 years or longer and certain transportation property.

Bonus Depreciation Allowed for Luxury Autos Used for Business.

The limitation on the amount of depreciation deductions allowed for luxury automobiles (§280F) is increased in the first year by $8,000 for automobiles that qualify (and do not elect out of the increased first-year deduction). The $8,000 increase is not indexed for inflation.

Chart Comparing §179 Expensing and Bonus Depreciation		
	§179	**§168(k)**
New or used property	Both new or used	New, original use only
Placed in service	For tax years beginning in ...	Calendar year 2008 - 2013
Limited to taxable income	Yes	No
Eligible property	Generally, only personal property, but in 2010 - 2013 some real property improvements qualified	MACRS life of 20 years or less
Recapture for personal use	Yes, if business use drops to 50% or less	No, unless listed property
Types of activities	Active trade or business only	All activities (rentals)
Election can be modified	Once, on amended return	No, binding w/o IRS permission
Deduction amount limited	$25,000 in 2014 ($500,000 in 2013)	No
Like-kind exchange basis	New boot only	100% of basis
Purchase amount limited	Yes, phaseout starts @ $200,000 in 2014 ($2,000,000 in 2013)	No, unlimited purchases

AUTOMOBILE EXPENSES

The 2014 Standard Mileage Rate for Business Driving is 56¢ (Notice 2013-80)

The IRS provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred of operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate.

	2013	**2014**	2015
Business	56.5¢	**56¢**	
Medical and moving	24¢	**23.5¢**	
Charity	14¢	**14¢**	

2014 deemed depreciation per business mile is 22¢. To compute the basis of a vehicle when the standard mileage has been used (generally when the vehicle is sold), the depreciation component of the standard mileage rate is 22¢ per mile (Notice 2013-80).

Year	Amount
2014	22¢
2012 & 2013	23¢
2011	22¢
2010	23¢
2008 & 2009	21¢
2007	19¢
2005 & 2006	17¢
2003 & 2004	16¢
2001 & 2002	15¢

Depreciation Deduction Limitations for Autos in 2014 (Rev. Proc. 2014-21)

Dollar limits are placed on the amount of annual depreciation claimed on "luxury" business autos in the year the auto is first placed in service (§280F). The §179 expensing election is also subject to the depreciation limits for luxury autos (§280F(d)(1)). The maximum amount of depreciation that may be claimed on 100% business use luxury autos and trucks are (percentages are applied to original depreciable basis less bonus depreciation):

Rev. Proc. 2014-21	**Auto - 2014**	**Trucks and Vans - 2014**
1st year	$3,160	$3,460
2nd year	$5,100	$5,500
3rd year	$3,050	$3,350
Each succeeding year	$1,875	$1,975

- The first-year depreciation on a new 2014 $60,000 luxury auto is $3,160.
- The first-year depreciation on a new 2014 $60,000 SUV (GVW of >6,000 lb) is $32,000.
- The first-year §179 on a $60,000 “non-personal-use” truck is $32,000.

> **Preparer note.** The additional first-year bonus depreciation of up to $8,000 for passenger autos and §179 expensing beyond $25,000 both expired at the end of 2013. Congress has not addressed extending either of these provision to the 2014 tax year at the time this was written.

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

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

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

> **Preparer note**. The GVW is listed on a metal plate on the inside of the driver's door. GVW can also be found at www.intellichoice.com.

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

Maximum FMV of Automobile to Value Personal Use Using Cents-Per-Mile (Notice 2014-11)

Bottom-line: Can't use cents-per-mile method when calculating value of company car used personally. If an employer provides an employee with a vehicle that is available to the employee for personal use, the value of the personal use must generally be included in the employee's income and wages (§61; §1.61-21). But, the value of the personal use may not be determined under the vehicle cents-per-mile valuation rule for a calendar year if the fair market value of the passenger automobile on the first date the passenger automobile is made available to the employee exceeds a specified dollar limit.

2014: $16,000 for a passenger automobile and $17,300 for a truck or van. The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2014, for which the vehicle cents-per-mile valuation rule provided under §1.61-21(e) may be applicable, is $16,000 for a passenger automobile and $17,300 for a truck or van ($16,000 and $17,000 in 2013).

2014: Fleet-average valuation rule is $21,200 for a passenger automobile and $22,300 for a truck or van. The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2014 for which the fleet-average valuation rule provided under §1.61-21(d) may be applicable is $21,300 for a passenger automobile and $22,600 for a truck or van ($21,200 and $22,300 in 2013).

Leased Vehicle Inclusion Amount - In General (Rev. Proc. 2014-21)

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

The lease term began in:	And the vehicle's FMV on the 1st day of the lease exceeded:
2014 Autos	$18,500
2014 Trucks and vans	$19,000

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

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

1. Multiply the inclusion amount (found in Rev. Proc. 2014-21; Sec. 4.02) by a fraction equal to the number of days the car is leased during the year divided by 365.
2. Multiply the product in 1. by the car's percentage of business and investment use during the year.

Commuting Is Non-deductible

As a general rule, daily transportation expenses (whether by car, air, bus, taxi, etc.) paid or incurred by a taxpayer in going between the taxpayer's residence and one or more regular places of business or employment (commonly called commuting) are *nondeductible* personal expenses (§262) unless they are otherwise deductible, e.g., taxes or interest (§1.162-2(e) & §1.262-1(b)(5)).

What happens if taxpayer chooses to work while commuting to office? Commuting costs are still personal expenses. The IRS states "you cannot deduct commuting expenses, even if you work during the commuting trip. Additionally, the use of the car to display material that advertises the taxpayer's business does ***not*** change the use of the car from personal use to business use" (Pub. 463, part 4).

But Some "Home-Client-Home" Commuting Expenses May Be Deductible

The taxpayer *is* permitted to deduct the costs of commuting in several situations, detailed below.

IS "COMMUTING" DEDUCTIBLE?		
FROM	TO	TAX RESULT
Regular (or Second) Work Location[5]	Another Regular (or Second) Work Location	Deductible (Rev. Rul. 55-109)
	Residence	Not Deductible (§1.262-1(b)(5))
Residence	Regular Work Location[6]	Not Deductible (§1.262-1(b)(5))
	Second Work[7]	Not Deductible (§1.262-1(b)(5))
	Temporary[8] Work Location ***INSIDE*** City	If taxpayer has a regular work location - Deductible (Rev. Rul. 99-7)
		If taxpayer doesn't have a Regular work location - A non-deductible commute (Rev. Rul. 99-7)
	Temporary Work Location ***OUTSIDE*** City	Deductible, No regular work location requirement (Rev. Rul. 99-7)
Residence is "Principal Place of Business" e.g., Office-in-home	Regular or Second Work Location; All Temporary Work Locations Inside or Outside of City	Deductible (Rev. Rul. 94-47)

[5] A regular place of business is any location where the taxpayer works or performs services on a regular basis, whether or not the taxpayer is at that location every week or on a set schedule. For example, daily transportation expenses incurred by a doctor in going between the doctor's residence and one or more offices, clinics, or hospitals at which the doctor performs services on a regular basis are nondeductible commuting expenses (Rev. Rul. 90-23).

[6] You cannot deduct commuting expenses, even if you work during the commuting trip (Pub. 463, #4).

[7] If second work is expected to last less than 1 year, try the temporary work exception

[8] Employment at a work location is temporary if it realistically is expected to last for 1 year or less when work commences and stays temporary until the date the taxpayer realizes it will extend past 1 year (Rev. Rul. 99-7).

IS "COMMUTING" DEDUCTIBLE?		
FROM	TO	TAX RESULT
Residence is "Regular Place of Business" e.g., non-deductible office in home	Regular Work or Second Work, and all Temporary Work Locations	Not Deductible (Rev. Rul. 94-47); *Walker* (101 TC 537 (1993)) disagrees if home office is a "regular place of business," even though it is not a "principal place of business."

Synopsis of Deductible Commuting

As mentioned in the chart, three exceptions to the general rule that commuting expenses are nondeductible have evolved over the years.

1. **Home office exception[9].** The first judicially created exception is that expenses incurred traveling between a taxpayer's residence and a place of business are deductible if the residence is the taxpayer's principal place of business.
2. **Temporary distant worksite exception[10].** The second judicially created exception is that travel expenses between a taxpayer's residence and temporary work locations outside of the metropolitan area where the taxpayer lives and normally works are deductible.
3. **Temporary with regular work location exception[11]**. The third IRS-created exception is that travel expenses between a taxpayer's residence and temporary work locations, regardless of the distance, are deductible if the taxpayer also has one or more regular work locations away from the taxpayer's residence. For example, going to a two-day tax conference in town is now deductible.

Commuting to Multiple Regular Work Locations Not Deductible (*Refugio Bogarin, pro se v. Comm. TCS 2013-67*)

Meat cutter had 11 regular work locations, and none of the multiple locations were temporary. Refugio was employed as a journeyman meat cutter at Safeway grocery stores operated by Vons Companies, Inc. During 2009 and 2010, Safeway assigned him to work at 11 Safeway stores in Southern California. His store assignments generally depended on Safeway's staffing needs at any given time. Refugio used his personal vehicle for work-related transportation. He normally worked an eight-hour shift in a single store and returned home at the end of each shift. Refugio considered the Safeway store in Rancho Mirage, California, 15 miles from his residence, to be his "home store"—the Safeway store where he was first hired. But, Refugio only worked at his "home store" nine days during 2009. Refugio was assigned to the Safeway store in Yucca Valley 21 days during 2009 and 3 days during 2010; and although he submitted expense reimbursement requests to the Yucca Valley store manager, Safeway did not provide any transportation reimbursements for these trips. Refugio believed he was entitled to a deduction for vehicle expenses to the extent that any daily round trip from his residence to an assigned Safeway store exceeded 30 miles—the distance to and from his

[9] *Curphey v. Comm.* 73 TC 766 (1980); *Stohmaier v. Comm.,* 113 TC 106 (1999)

[10] *Schurer v. Comm.,* 3 TC 544 (1944); *Dahood v. U.S.* 747 F2d 46 (1st Cir. 1984); Rev. Rul. 99-7;

[11] Rev. Rul. 99-7

"home store". The court determined that the fact that Refugio was often assigned to different Safeway stores daily or weekly did not alter the conclusion that his transportation expenses were nondeductible commuting expenses.

Also see:

- *Kristopher and Jessika Saunders, pro se v. Comm.* TCM 2012-200, Commuting not deductible to temporary work locations because no stop at regular place of business first.
- *Glenn Patrick Bogue v. Comm.*, TCM 2011-164, in an extraordinary examination of the commuting deduction, the court would not allow Bogue to deduct commuting no matter what he said.

AFFORDABLE CARE ACT (ACA)

THE EMPLOYER MANDATE - AN OVERVIEW

Basics of the Employer Shared Responsibility Provisions - The Employer Mandate (Final Regs; T.D. 9655; §54.4980H-1 through -6; Q&As on Employer Shared Responsibility Provisions; Treasury Fact Sheet)

> **Preparer note**. Final regulations on the Employer Shared Responsibility provisions under §4980H have been issued. The IRS has also developed a topical index to help locate information on the Affordable Care Act, efficiently gathered by new topic-mapping technology, in addition to its constantly updated News Releases, Multimedia, and Legal Guidance page.

ACA Contains Both Carrots and Sticks

The Affordable Care Act (ACA), to support the individual mandate's requirement for all to have health coverage, provided two incentives for employers to expand health coverage for their employees. ACA, starting March 2010, *encouraged* qualified businesses with fewer than 25 employees to provide health coverage by essentially paying up to 50% (increasing from 35% in 2011- 2013) of the health insurance premiums. ACA *imposes* a shared responsibility payment (penalty or tax) on a large employer that fails to offer affordable health coverage providing a minimum value of essential coverage (a 60%-benefit bronze plan) to 95% (70% in 2015) of its full-time employees.

Employer Benefits and Burdens in ACA			
1-10 employees (FTEs)	**11-24 employees (FTEs)**	**25 to 99 employees (FTEs)**	**100 or more employees (FTEs)**
Business credit is available to subsidize 50% (35% in 2010-2013) of the cost of the health insurance premium paid by the employer if employee wages average less than $25,000. Employer must pay 50% or more of insurance to qualify for credit. Started in 2010.	A phased-out business credit is available to subsidize a portion of the cost of the health insurance premium paid by the employer if employee wages average less than $50,000. This credit is available for only two consecutive years starting in 2014.	Employer is not required to offer health insurance to employees, although employees are required to carry minimum essential health coverage. The 99 employees reduces to 49 employees starting in 2016.	Employer must offer affordable basic insurance or be subject to a "shared responsibility" penalty starting in **2015.** 100 employees reduces to 50 employees starting in 2016. If employee's required contribution for the employer-provided insurance is so expensive for a low-wage employee that employee cannot participate, employee may receive credit from the exchange starting in **2014.**

Employer Mandate Postponed Until January 1, 2015

Effective date of employer shared responsibility provisions deferred until January 1, 2015. The Employer Shared Responsibility penalty provisions generally are not effective until January 1, 2015, meaning that no penalty payments will be assessed for 2014 (per Notice 2013-45).

- **Employers with 100 or more employees (about 2% of employers) in 2015:** The employer mandate will generally apply to larger firms with 100 or more full-time employees starting in 2015.
- **Employers with 50 to 99 employees (about 2% of employers) in 2016:** The employer mandate will generally apply to employers with 50 or more full-time employees starting in 2016.

WHO IS A LARGE EMPLOYER?

Entities with 50 or More Full-Time Equivalent Employees (T.D. 9655; Treasury Fact Sheet, Final Regs)

Overview. Large employers must offer a health coverage plan to its full-time employees; therefore, the definitions of "large employer" and "full-time employee" are essential to comply with the Affordable Care Act. A full-time employee is an individual employed on average at least 30 hours of service per week. An employer that meets the 50 full-time employee threshold is referred to as "an applicable large employer". If the employer does not offer ***affordable*** health coverage that provides a ***minimum value*** to their full-time employees (and their dependents), the employer may be liable for an "Employer Shared Responsibility" (employer mandate) penalty payment under §4980H if at least one of its full-time employees receives a premium assistance credit for purchasing individual coverage from the state's Health Insurance Marketplace (a.k.a. the Exchange) [Q&A #1].

> **Practitioner note.** All large employers are subject to the employer mandate penalty provisions, including for-profit, non-profit, and Federal, state, local, and Indian tribal government employers (Q&A #7).

The large employer calculation. An employer's status as a large employer for a calendar year is determined by taking the sum of the total number of full-time employees (including any seasonal workers) for each calendar month in the ***preceding calendar year*** and the total number of FTEs (including any seasonal workers) for each calendar month in the preceding calendar year, and dividing by 12. The result, if not a whole number, is then rounded to the next lowest whole number. If the result of this calculation is less than 50, the employer is not a large employer for the current calendar year. If the result of this calculation is 50 or more, the employer is a large employer for the current calendar year, unless the seasonal worker exception applies (§4980H(c)(2)(a); §54.4980H-2(b)(1); Preamble, V.A.; Preamble, V.F; Q&A # 12).

Penalty relief available in 2015 for employers with fewer than 100 full-time employees (including full-time equivalents). Employers with fewer than 100 full-time employees (including full-time equivalents) in 2014 that meet the conditions described below are not subject to the Employer Shared Responsibility penalty under §4980H(a) or (b) for any calendar month during 2015. For employers with non-calendar-year health plans, this applies to any calendar month during the 2015 plan year, including months during the 2015 plan year that fall in 2016. In order to be eligible for the relief, an employer must certify that it meets the following conditions:

1. ***Limited Workforce Size.*** The employer must employ on average fewer than 100 full-time employees (including full-time equivalents) on business days during 2014.
2. ***Maintenance of Workforce and Aggregate Hours of Service***. During the period beginning on Feb. 9, 2014 and ending on Dec. 31, 2014, the employer may not reduce the size of its workforce or the overall hours of service of its employees in order to qualify for this transition relief. However, an employer that reduces workforce size or overall hours of service for bona fide business reasons is still eligible for the relief.
3. ***Maintenance of Previously Offered Health Coverage***. During the period beginning on Feb. 9, 2014 and ending on Dec. 31, 2015 (or, for employers with non-calendar-year plans, ending on the last day of the 2015 plan year) the employer does not eliminate or materially reduce the health coverage, if any, it offered as of Feb. 9, 2014. An employer will not be treated as eliminating or materially reducing health coverage if:
    - A It continues to offer each employee who is eligible for coverage an employer contribution toward the cost of employee-only coverage that either:
        - i. is at least 95% of the dollar amount of the contribution toward such coverage that the employer was offering on Feb. 9, 2014 or
        - ii. is at least the same percentage of the cost of coverage that the employer was offering to contribute toward coverage on Feb. 9, 2014;
    - B In the event of a change in benefits under the employee-only coverage offered, that coverage provides minimum value after the change; and
    - C It does not alter the terms of its group health plans to narrow or reduce the class or classes of employees (or the employees' dependents) to whom coverage under those plans was offered on Feb. 9, 2014. Therefore, it is not available for an employer that modifies the plan year of its plan after February 9, 2014, to begin on a later calendar date (for example, changing the start date of the plan year from January 1 to December 1 (Preamble XV.D.6; Q&A #34).

New Employers—the Reasonable Expectation Standard

Employers not in existence in preceding calendar year. An employer not in existence during an entire preceding calendar year will still be treated as a "large employer" for the current calendar year if the employer is reasonably expected to employ an average of at least 50 full-time employees (taking into account FTEs) during the current calendar year and it actually employs an average of at least 50 full-time employees (taking into account FTEs) during the calendar year. An employer is treated as not having been in existence throughout the prior calendar year only if the employer was not in existence on any business day in the prior calendar year. This "reasonable expectation" standard will help new employers having difficulty establishing a group health plan in the first months of operation (§4980H(c)(2)(C)(ii);§54.4980H-2(b)(3); Preamble V.B; Q&A #5).

> **Example—New employer.** Abacus Corp. incorporated on January 1, 2016, having three employees on that date. However, prior to incorporation, Abacus's owners purchased a factory that they intended to open within two months of incorporation and they expected to employ approximately 100 employees. By March 15, 2016, Abacus has more than 75 full-time employees. Because Abacus can reasonably be expected to employ (and actually employs), on average, at least 50 full-time employees during 2016, Abacus Corp. is a "large employer" for the entire year 2016 [§54.4980H-2(d), Exp. 5].

An employer is treated as not having been in existence throughout the prior calendar year only if the employer was not in existence on any business day in the prior calendar year (Preamble V.B).

> **Example.** Employer Lam, Inc. comes into existence on May 1, 2016. During 2016, Lam's status as a large employer is determined based on the average number of employees that it is reasonably expected Lam will employ on business days in 2016. To determine the employer's status as an applicable large employer for 2017, Lam's status as an applicable large employer is determined based on the number of employees that it employed on business days from May 1 through December 31, 2016 (rather than relying on the employer's reasonable expectations) [Preamble V.B].

After reaching 50 employees, large employers must offer coverage by April 1 of the following year. If the large employer offers coverage on or before April 1 of the first year after the employer becomes a large employer, and no employee was offered coverage at any point in the prior calendar year, the employer will not be subject to any employer mandate penalty for January through March of that first year if the coverage offered provides minimum value (MV). However, if the large employer does not offer coverage to the employees on or before April 1 of the first calendar after becoming a large employer (or doesn't offer adequate and/or affordable coverage), the large employer may be subject to the employer mandate penalty for those initial calendar months in addition to any subsequent calendar months. This relief provision applies only during the first year for which an employer is a large employer (even if the employer falls below the 50 full-time employee threshold for a subsequent year and then expands and becomes a large employer again) [§54.4980H-2(b)(5); Preamble V.F & VII.D].

Predecessor and Successor Employers

An employer includes any predecessor employer when determining applicable employer status. As rules for identifying successor employers have been developed in the employment tax context for determining when wages paid by a predecessor may be attributed to a successor employer (see §31.3121(a)(1)-1(b)), until further guidance is issued, taxpayers may rely upon a reasonable, good-faith interpretation of the statutory provision on predecessor (and successor) employers for purposes of the large employer determination

(§4980H(c)(2)(C)(iii); Preamble V.E).

Related Entities May Be One Employer

Controlled group or affiliated service group must be aggregated into single activity as the §414 business aggregation rules apply. An applicable large employer may consist of multiple related entities (such as corporations) due to the application of the aggregation rules. Each such entity is referred to as an *applicable large employer member*. When determining whether an employer is a large employer, all entities treated as a single employer under §414 (such as a franchise owner with several restaurants) are also treated as a single employer for purposes of counting the number of full-time and full-time equivalent employees. Thus, all employees of a controlled group under §414(b) or (c) or an affiliated service group under §414(m) and (o) (including employees of partnerships, proprietorships, etc., which are under common control of one owner or group of owners) are taken into account in determining whether the members of the controlled group or affiliated service group together constitute a large employer. However, the IRS did not make a determination about whether the controlled group rule applies to government entities or churches, or a convention or association of churches. The IRS has said that until further guidance is issued, government entities, churches, and a convention or association of churches may rely on a reasonable, good-faith interpretation of the controlled group rule (Preamble V.A; Preamble V.D).

> **Example.** Power owns 100% of all classes of stock of Crowbar, Inc. and Tool, Inc. Power has no employees at any time in 2015, but Crowbar has 40 full-time employees, and Tool has 60 full-time employees in every calendar month in 2015. Because Power, Crowbar, and Tool are a controlled group of corporations under §414(b) and have a combined total of 100 full-time employees, Power, Crowbar, and Tool are treated as an "applicable large employer" (§54.4980H-2(d), Exp 1).

WHO IS A FULL-TIME EMPLOYEE?

Employer Determination of "Full-Time" Based on Employee's "Hours of Service"

Number of employees determines if the employer mandate applies to an employer. An employer's number of full-time employees matters both for purposes of whether the employer mandate ***provisions apply*** to an employer ***and*** whether the employer mandate ***penalty payment is owed*** by an employer (and the amount of that payment) [Preamble VI].

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

> **Planning idea.** These rules are generally based on the definition of the term "hour of service" in the same manner that hours of service are credited under a qualified retirement plan (see 29 CFR 2530.200b-2(a)) [Preamble VI.A].

Full-time employees who are eligible for health coverage through another source, such as Medicare, Medicaid, or a spouse's employer, must be included. For purposes of determining whether an employer is an applicable large employer, ***all*** employees are counted (subject to a limited exception for certain seasonal workers), regardless of whether the employees are eligible for health coverage from another source, such as

Medicare, Medicaid, or a spouse's employer or are exempt from the individual mandate, such as members of a Health Care Sharing Ministry or members of a Federally recognized Indian tribe (Q&A #7-#11)

Including non-resident aliens employees. Holders of H-2A[12] and H-2B[13] visas, such as for agricultural workers, are included in the definition of employee for purposes of the §4980H penalty (although a large employer may be eligible for seasonal employee relief). Hours of transportation employees do not include hours to the extent the compensation for such hours of service constitutes income from sources without the United States as determined under §863 (Preamble XIV.B & C).

Services performed outside of the United States. Hours generally do not include hours worked outside the United States, regardless of an employee's residency or citizenship status. However, all hours for which an individual receives U.S.-source income are hours for purposes of §4980H (REG-138006-12, Explanation of Provisions Preamble, (II)(B)(2); Q&A #13 & 14).

Work performed in certain capacities are not included as an hour of service. Hours of service performed by volunteers (e.g., volunteer firefighter), student interns (under Federal or state-sponsored work study programs), members of religious orders who have taken a vow of poverty, or those who perform similar services are not counted as an hour of service (Q&A #16; Preamble VI.B).

Calculating Employee's Work Hours

Full-time employee works at least 30 hours per week or 130 hours per month. In counting the number of employees for purposes of determining whether an employer is a large employer, a full-time employee is counted as one employee, and all other employees are counted on a pro-rated basis. A full-time employee is an employee who is employed on average at least 30 "hours of service" per week. As an alternative, 130 hours in a calendar month will be treated as the monthly equivalent of 30 hours per week ((52 × 30) ÷ 12 = 130). This monthly standard takes into account that the average month consists of more than four weeks [Preamble VII; Q&A #4].

Converting part-time employees to full-time equivalents (FTEs). All employees (including seasonal workers) who were not full-time employees for any month in the preceding calendar year are included in calculating the employer's FTEs for that month by:

1. Calculating the aggregate number of hours (but not more than 120 hours for any employee) for all employees who were not employed on average at least 30 hours per week for that month and
2. Dividing the total hours in step (1) by 120. This is the number of FTEs for the calendar month (§54.4980H-1(a)(22); §54.4980H-2(c); Preamble V.G).

Preparer note. After performing this calculation, if the number of FT employees results in a fraction, always round down to the next lowest whole number.

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[12] An H-2A visa allows a foreign national entry into the U.S. for temporary or seasonal agricultural work.

[13] The H-2B visa nonimmigrant program permits employers to hire foreign workers to come temporarily to the United States and perform temporary nonagricultural services or labor on a one-time, seasonal, peak-load, or intermittent basis.

Example—Monthly FT + Monthly FTEs = Large Employer. Tiger Inc. has, in addition to 47 full-time employees, 5 part-time employees for the month. The total number of hours worked for the month by the part-time workers is 480. Tiger Inc. is a large employer because it must add four full-time equivalent employees (480 aggregate hours /120) for that month.

	Actual # of Employees	Hours worked	Divided by	FTE
Full-time	47			47
Part-time	<u>5</u>	480	120	<u>4</u>
Total	52			**51**

Example—Weekly FT + Monthly FTEs = Large Employer. During each calendar month of 2015, Dan's Minimart has 20 full-time employees working an average of 35 hours per week, 40 employees working an average of 80 hours per month, and no seasonal workers. Each of the 20 employees, who average 35 hours per week, count as one full-time employee for each month. To determine the number of FTEs for each month, the total hours of the employees who are not full-time employees (but not more than 120 hours per employee) are aggregated and divided by 120. The result is that the MiniMart has 26.7 FTEs for each month. Because the Minimart has 46 full-time employees (the sum of 20 full-time employees and 26.7 FTEs rounded down) during each month in 2015, and because the seasonal worker exception is not applicable, Dan's Minimart is not a "large employer" for 2016 (§54.4980H-2(d), Exp. 2).

	Actual # of Employees	Hours worked	Divided by	FTE
Full-time	20			20
Part-time	<u>40</u>	80 hrs/mo = 3,200	120	<u>26.7</u>
Total	60			**46**

Hours include both hours worked and benefit hours. For both applying the look-back measurement method and the monthly measurement method, hours are used in determining whether an employee is a full-time employee and in calculating an employer's FTEs, including employees who are not compensated on an hourly basis. An employee's hours include:

1. ***Each hour worked.*** Each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer;
2. ***PLUS: Benefit hours.*** Each hour for which an employee is paid, or entitled to payment, by the employer on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty, or leave of absence. All periods of paid leave must be taken into account (§54.4980H-3(b)(2); Preamble, VI.A); Q&A #16).

Converting employees not paid on an hourly basis requires the employer to calculate the employee's number of hours under any of the following ***three methods***:

1. Counting ***actual hours*** (as in the case of employees paid on an hourly basis) from records of hours worked and hours for which payment is made or due for vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence;
2. Using a ***days-worked equivalency*** method whereby the employee is credited with eight hours for each day for which the employee would be required to be credited with at least one hour under these service crediting rules; or
3. Using a ***weeks-worked equivalency*** of 40 hours per week for each week for which the employee would be required to be credited with at least one hour under these service crediting rules (§54.4980H-3(b)(3)(i)(A)-(C)); Preamble, V.A.).

Different methods may be used for different classes of employees. Employer must annually choose one of these three methods for counting hours for all non-hourly employees. Employers need not use the same method for all non-hourly employees. Rather, an employer may apply different methods for different classifications of non-hourly employees, so long as the classifications are reasonable and consistently applied and different methods for the same employees in different years (§54.4980H-3(b)(3)(ii); Preamble VII.G).

Anti-abuse provision. The use of the days-worked or weeks-worked equivalency method are prohibited if the result would substantially understate an employee's hours in a manner that would cause that employee not to be treated as a full-time employee or if the result is to understate the hours of service of a substantial number of employees (even if no particular employee's hours of service are understated substantially and even if the understatement would not cause the employee to not be treated as a full-time employee) [§54.4980H-3(b)(3)(iii); Preamble, VI.A].

> **Example.** An employer may not use a days-worked equivalency for an employee who generally works three 10-hour days per week, because the equivalency would substantially understate the employee's hours as 24 hours per week, which would result in the employee not being treated as a full-time employee. The number of hours calculated using the days-worked or weeks-worked equivalency method must generally reflect the hours actually worked and the hours for which payment is made or due (§54.4980H-3(b)(3)(iii)).

Employees compensated on a commission, adjunct faculty, transportation employees, and analogous positions subject to special rules. Employers of these types of employees must use any reasonable method for crediting hours. But, a method of crediting hours would not be reasonable if it took into account only some of an employee's hours with the effect of recharacterizing, as non-full-time, an employee in a position that traditionally involves more than 30 hours per week (Preamble VI.C).

When seasonal employees may be excluded from the large employee determination. An employer is not treated as employing more than 50 full-time employees, and therefore is not a large employer for the current calendar year, if:

- The employer's workforce exceeds 50 full-time employees and FTEs for either 120 days or fewer (whether or not consecutive) or four calendar months (whether or not consecutive) during the preceding calendar year, and

- The employees that cause the employer's workforce to exceed 50 full-time employees are ***seasonal workers*** (§4980H(c)(2)(B)(i); §54.4980H-2(b)(2); Preamble V.C.; Q&A #4).

Definition of seasonal worker. A seasonal worker is a worker who performs labor or services on a seasonal basis (as defined by the Secretary of Labor), including retail workers employed exclusively during the holiday season and workers whose employment is ordinarily the kind exclusively performed at certain seasons or periods of the year and that, from its nature, may not be continuous or carried on throughout the year. Specific holidays are not indicated in the regulations nor is the length of any holiday season. Employers may apply a reasonable, good faith interpretation of the term "seasonal worker" (§54.4980H-1(a)(39); Preamble V.C; Q&A #4).

> **Planning idea.** A seasonal *employee* is defined as one customarily hired for six months or less, whereas a seasonal worker is defined by employers applying a reasonable, good-faith interpretation as one who performs labor or services on a seasonal basis (§54.4980H-1(a)(38).

Seasonal worker exception for new businesses. In the case of an employer that was not in existence on any business day during the preceding calendar year, the seasonal worker exception applies so that the employer will not be treated as a large employer if it reasonably expects its workforce to exceed 50 full-time employees (including FTEs) for 120 days or fewer during the current calendar year, and expects the employees in excess of 50 employed during such 120-day period to be seasonal workers (§54.4980H-2(b)(2); Preamble V.C).

> **Planning idea.** An employee would not necessarily be precluded from being treated as a seasonal worker merely because the employee works on a seasonal basis for five consecutive months. The inclusion of seasonal workers is required when determining large employer status and then excludes them only if the previous conditions are satisfied (§4980H(c)(2)). The 120-day period is relevant only for applying the seasonal worker exception for determining status as a large employer and is not relevant for determining whether an employee is a seasonal employee for purposes of the full-time employee look-back measurement method (meaning that an employee who provides services for more than 120 days per year may nonetheless qualify as a seasonal employee).

> **Example. Seasonal worker exception.** Nano Labs Corporation has 40 full-time employees for the entire calendar year, none of whom are seasonal workers, and no part-time FTEs during 2015. Nano also has 80 seasonal full-time workers working from September through December 2015. Before applying the seasonal worker exception, Nano has 40 full-time employees during eight months of 2015, and 120 full-time employees during four months of 2015, resulting in an average of 66.6 employees for the year (rounded down to 66 full-time employees). However, because Nano's workforce equaled or exceeded 50 full-time employees (counting seasonal workers) for no more than four months (treated as the equivalent of 120 days) in 2015, the seasonal workers are disregarded, and the number of full-time employees would be less than 50 for every month in 2015, including September through December. Therefore, because of the seasonal worker exception, Nano is not a large employer for 2016 (§54.4980H-2(d), Exp. 3).

	Actual # of Employees	Months worked	Divided by	FTE
Full-time	40	12 months		40
Part-time	0			-0-
Seasonal	80	4 months		N/A
Total	120*			**40**

*66 average full-time employees for year (rounded down)

Example. Some seasonal workers employed more than 4 months. Assume the same facts in the previous example except that Nano Labs Corp has 20 FTEs in August, some of whom are seasonal workers. The seasonal worker exception does not apply if the number of an employer's full-time employees (including seasonal workers) and FTEs equals or exceeds 50 employees for more than 120 days during the calendar year. Because Nano has at least 50 full-time employees for a period greater than four calendar months (treated as the equivalent of 120 days) during 2015, the seasonal worker exception does not apply. Nano averaged 68 full-time employees in 2015 [(40 × 7) + (60 × 1) + (120 × 4)] ÷ 12 = 68.33, rounded down to 68]. Nano ***is*** a large employer for calendar year 2016 (§54.4980H-2(d), Exp. 4).

	Actual # of Employees	Months worked	Divided by	FTE
Full-time	40	12 months		40
Part-time	0			N/A
Seasonal	20	5 months		8
Seasonal	60	4 months		20
Total	120*			**68***

*68 average full-time employees for year (rounded down)

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

§3508 real estate agents and direct sellers. Workers identified in §3508 (qualified real estate agents and direct sellers) do not constitute employees for purposes of §4980H. Therefore, they do not constitute full-time employees for any purpose, and their hours of service are not taken into account in determining the number of an employer's FTEs [Preamble XII.B].

Owners not included. Sole proprietors, partners in partnerships, and 2% S corporation shareholders are not employees for §4980H purposes.

Table: Determination and Potential Application of Employer Penalty for Categories of Employees

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

Source: CRS analysis of P.L. 111-148 and P.L. 111-152.
#The controlled group rule applies under §414 (b), (c), (m), or (o) of the IRC and includes employees of partnerships, proprietorships, etc., which are under common control by one owner or group of owners.

USING "HOURS OF SERVICE" TO DETERMINE WHICH EMPLOYEES NEED TO BE OFFERED COVERAGE?

When Determining Whether an Employee Has Sufficient Hours of Service to Be a Full-time Employee, Only Two Measurement Methods May Be Used: (1) the "Monthly Measurement Method" and (2) the "Look-back Measurement Method"

Under the ***"monthly measurement method,"*** an employer determines each employee's status as a full-time employee by counting the employee's hours of service for each month. Alternatively, an employer may use the ***"look-back measurement method,"*** under which the status of an employee as a full-time employee during a future period (referred to as the stability period) is based upon the hours of service of the employee in a prior period (referred to as the measurement period). No other methods are available [§54.4980H-3(a); Preamble VII.A; Q&A #15).

Planning point. Being a post-event calculation, the ***"monthly measurement method"*** does not allow any advance planning to avoid the employer mandate penalty payment. Pre-planning is only available under the ***"look-back measurement method."***

Preparer note. These methods prescribe minimum standards for the identification of full-time employee status. Employers always may make additional employees eligible for coverage or otherwise offer coverage more expansively than required.

Monthly Measurement Method

Each employee's monthly "hours of service" determine the employee's full-time status. Under the monthly measurement method, a large employer determines each employee's status as a full-time employee by counting the employee's hours of service for each calendar month (§54.4980H-3(c)(1)).

New or newly eligible full-time employees must be offered health coverage by end of third month. Under the monthly measurement method, if an employee is reasonably expected at her or his start date to be a full-time employee or an existing employee becomes newly eligible (and is not a seasonal employee) and the employer's group health plan coverage is offered to the employee at or before the conclusion of the employee's initial three full calendar months of employment, a large employer will not be subject to the §4980H(a) employer mandate penalty. If the coverage provides minimum value that is affordable, the employer also will not be subject to the §4980H(b) penalty. This rule cannot apply more than once per period of employment of an employee (§54.4980H-3(c)(2); Preamble VII.C.2).

Planning point. If the employer did not offer coverage to the full-time employee by the end of the employee's initial three full calendar months of employment, the employer may be subject to a §4980H employer mandate penalty for those months as well as for any subsequent months for which coverage was not offered (§54.4980H-3(c)(2); Preamble VII.C.2).

Full-time status for new employee is determined at the end of each month. Full-time employee status for a "new" employee, who is reasonably expected at the employee's start date to be a full-time employee (and who is not a seasonal employee), is based, under the monthly measurement method, on that employee's hours of service during each calendar month (§54.4980H-3(c)(1); Preamble, VII.B).

Example. Monthly measurement method - when employee becomes eligible for an offer of coverage. Amazoo has 200 full-time employees (including FTEs), uses the monthly measurement method to identify full-time employees, and offers coverage only to employees who are full-time employees (and their dependents). Amazoo hires Mandy on Jan. 1, 2016. For each calendar month in 2016, Mandy averages 20 hours of service per week and, therefore, is not eligible for an offer of coverage under Amazoo's group health plan (not being a full-time employee). On Jan. 1, 2017, Mandy is promoted and, after completing a 90-day waiting period at the end of Mar. 2017, becomes eligible for an offer of coverage. Effective Apr. 1, 2017, Amazoo offers Mandy coverage that provides minimum value.

Because Amazoo offers minimum value coverage to Mandy no later than the first day following the period of three full calendar months beginning with the first full calendar month in which she is otherwise eligible for an offer of coverage under its group health plan, Amazoo is not subject to an employer mandate penalty for Jan. through Mar. 2017 by reason of its failure to offer coverage to Mandy. After Mar. 2017, an offer of minimum value coverage will only result in an employer mandate penalty if Amazoo's offer to Mandy is not affordable and Amazoo received a Section 1411 Certification. Of course, Amazoo is not subject to an employer mandate penalty for failure to offer coverage to Mandy in 2016 because she was not a full-time employee during any month (§54.4980H-3(c)(5), Exp. 1).

Planning idea. Employers **must** know at the end of *each* month when *each* part-time employee's hours exceed 30 hours a week (or 130 hours a month).

Initial "full-time" status based on reasonable facts and circumstances. An employer's determination of whether a newly hired employee is full-time or part-time status is reasonable is based on the facts and circumstances. Factors to consider include, but are not limited to, whether the employee is replacing an employee who was or was not a full-time employee, the extent to which employees in the same or comparable positions are or are not full-time employees, and whether the job was advertised or otherwise communicated to the new hire or otherwise documented (for example, through a contract or job description), as requiring hours of service that would average 30 (or more) hours of service per week or less than 30 hours of service per week (§54.4980H-1(a)(49)(ii)(C); Preamble VII.C.2).

Short-term or high-turnover positions. There are no special provisions when hiring short-term employees who are expected to average at least 30 hours of service per week but are hired into positions expected to continue for less than 12 months (but not including seasonal employees). Nor are there special provisions addressing high-turnover positions (Preamble VII.F.1 & .2).

Hours of service may be based on successive one-week periods. To provide additional flexibility, an employer is also allowed to determine an employee's full-time employee status for a calendar month under the monthly measurement method based on the hours of service over successive one-week periods. Under this optional method, referred to as ***the weekly rule***, full-time employee status for certain calendar months is based on hours of service over four-week periods and for certain other calendar months on hours of service over five-week periods. In general, the period measured for the month must contain either the week that includes the first day of the month or the week that includes the last day of the month, but not both. For this purpose, week means any period of seven consecutive calendar days applied consistently by the large employer for each calendar month of the year. For calendar months calculated using four week periods, an employee with at least 120 hours of service is a full-time employee, and for calendar months calculated using five week periods, an employee with at least 150 hours of service is a full-time employee. However, a large employer is only treated as having offered coverage for a calendar month if it offers coverage to a full-time employee for the entire calendar month, regardless of whether the employer uses the weekly rule (§54.4980H-3(c)(3); §54.4980H-1(a)(50); Preamble VII.B).

Example. Use of weekly rule. CostKey, Inc. uses the monthly measurement method in combination with the weekly rule to determine whether an employee is a full-time employee for a particular calendar month. CostKey uses Sunday through Saturday as a week and includes the week that includes the first day of a calendar month and excludes the week that includes the last day of a calendar month (except in any case in which the last day of the calendar month occurs on a Saturday). CostKey measures hours of service for the five weeks from Sunday, December 27, 2015 through Saturday, January 30, 2016 to determine an employee's full-time employee status for January 2016, for the four weeks from Sunday, January 31, 2016 through Saturday, February 27, 2016 to determine an employee's status for February 2016, and the four weeks from Sunday, February 28, 2016 through Saturday, March 26, 2016 to determine an employee's status for March 2016. For January 2016, CostKey treats an employee as a full-time employee if the employee has at least 150 hours of service (30 hours per week × 5 weeks). For February 2016 and March 2016, CostKey also treats an employee as a full-time employee if the employee has at least 120 hours of service (30 hours per week × 4 weeks). CostKey has correctly applied the weekly rule as part of the monthly measurement method for determining each employee's status as a full-time employee for the months January, February, and March 2016. (§54.4980H-3(c)(5), Exp. 3)

Employees Rehired after Termination of Employment or Resuming Service after Other Absence

After returning to work, a continuing employee must be offered coverage by the first of the following month. ***Under the monthly measurement method***, a continuing employee treated as a full-time employee is treated as offered coverage upon resumption of services if the employee is offered coverage as of the first day that employee is credited with an hour of service, or, if later, as soon as administratively practicable. For this purpose, offering coverage by no later than the first day of the calendar month following resumption of services is deemed to be as soon as administratively practicable. (§54.4980H-3(c)(4)(iv)).

An employee may only be treated as a new employee after a 13-week period of absence. Under the ***monthly measurement method***, if an employee who resumes employment did not have one work hour for a least 13 consecutive weeks prior to being rehired (26 weeks for an employee of an educational organization), the employer may treat the prior employee as a previously terminated and a newly rehired employee for any subsequent hour instead of a continuing employee [§54.4980H-3(c)(4)(i) & (ii); Preamble VII.B.; Preamble VII.E.1].

Averaging method for special unpaid leave and employment break periods. Under the monthly measurement method, the special unpaid leave and employment break period rules do not apply. That is because determinations under the monthly measurement method are based on hours of service during that particular calendar month and are not based on averaging over a prior measurement period (§54.4980H-3(c)(4)(iii); Preamble, VII.B).

Preparer note. This rule does not determine whether the employee is treated as a continuing full-time employee (for example, an employee on leave) or a terminated employee for some or all of the period during which no hours of service are credited (§54.4980H-3(c)(4)(i) & (ii)).

Example. 9 week unpaid leave under monthly measurement method. Assuming the same facts as in previous Amazoo example, except that Mandy has zero hours of service during a nine week period of unpaid leave (that constitutes special unpaid leave) beginning on June 25, 2017 and ending on August 26, 2017. As a result of the nine week period during which Mandy has zero hours of service, she averages less than 30 hours of service per week for July and August 2017. But, Mandy averages more than 30 hours of service per week for each month between and including September through December 2017. Amazoo does not use the rule of parity (and is not an educational organization).

Because Mandy's unpaid leave was less than 13 consecutive weeks, Amazoo may not treat her as having terminated employment and having been rehired as a new employee. Therefore, Amazoo may not again apply the monthly measurement method rule. In addition, although the nine consecutive weeks of zero hours of service constitute special unpaid leave, the averaging method for periods of special unpaid leave does not apply under the monthly measurement method. Therefore, Amazoo may treat Mandy as a non-full-time employee only for July and August 2017. Coverage must be offered by the first day of the first full month Mandy returns to work (§54.4980H-3(c)(5), Exp. 2).

The 4-week+ parity rule. As an alternative to the 13 week rule, an employer may choose a shorter "rule of parity" period (measured in weeks). Under the rule of parity, employers may treat an employee who has terminated and been rehired as a new employee if the no-work period is at least four weeks long and the no-work period exceeds the employee's previous length employment immediately before the no-work period (with the length of that previous period determined under these rules governing employee rehires or other resumptions) [§54.4980H-3(c)(4)(i), (ii) & (v); Preamble VII.B.; Preamble VII.E.1].

Example of "rule of parity." Under the optional rule of parity, if an employee works three weeks for an large employer, terminates employment, and is rehired by that employer ten weeks after terminating employment, that rehired employee is treated as a new employee because the ten-week period with no credited hours is longer than the immediately preceding three-week period of employment.

International transfers. An employer may treat an employee as having terminated (or rehired) employment if the employee transfers to (or from) a position that is anticipated to continue indefinitely or for at least 12 months and if substantially all of the compensation will (or did) constitute income from sources without the United States (within the meaning of §861-§863) [§54.4980H-3(c)(4)(vi)].

Preceding Year "Look-back Measurement" Method - Introduction

Optional look-back measurement method assures employer if employee "full-time" or "not full-time" before offering health coverage! ***The optional look-back measurement method is meant to be relief from the general "end-of-month" method when determining full-time employees***. As an alternative to the ***monthly measurement method,*** under which an employer determines each employee's status as a full-time employee by counting the employee's hours of service for each month, the ***look-back measurement method*** allows the employer to determine the status of an employee as a full-time employee during a future period (referred to as the stability period) based upon the hours of service of the employee in a prior period (referred to as the standard/or initial measurement period) [§54.4980H-3(d)(1)(i); Preamble VII.C.1.; Q&A #15].

Determining current full-time employee status at the end of the month may cause practical difficulties. Determining full-time employee status solely on a monthly basis causes practical difficulties for employers, employees, and the state Marketplace/Exchange. These difficulties include uncertainty and inability to predictably identify which employees are full-time employees and thus need to be offered insurance to avoid the employer mandate penalty. The problem is the employer won't know whether an employee is a full-time employee for a given month until after the month is over!

Planning idea. While the "month-by-month" and the "optional look-back" measurement methods prescribe different *minimum* standards to identify full-time employees, employers always can treat ***all*** employees as eligible for coverage at an earlier date.

IRS look-back rules provide "relief" for existing, new, variable-hour, and seasonal employees. As discussed on the next pages, the regulations create different, and often difficult, "look-back" requirements for:

- Full-time "ongoing" employees,
- Full-time "new" employees,
- Seasonal employees,
- Full-time "new variable hour" employees,
- Variable-hour employees changing to non-variable employees in the year, and
- Employees rehired after employment terminated or after a temporary leave (§54.4980H-3(d)).

Three definitions to initially understand the look-back measurement period method.

Standard (for ongoing employees) and initial (for new employees) measurement period is a time period of at least 3, but not more than 12, consecutive months that a large employer selects and uses in determining whether an ongoing (standard period) employee or a new (initial period) employee has been a full-time employee (§54.4980H-1(a)(25) & (46)).

Adjusting the start/end dates of weekly/semi-monthly payrolls allowed for "administrative convenience." For "administrative convenience," employers are permitted to adjust the starting and ending dates of their three-to-twelve-month measurement periods to begin and end with the beginning and ending of regular payroll periods if each of the payroll periods is one week, two weeks, or semi-monthly in duration (§54.4980H-3(d)(1)(ii)).

Administrative "open enrollment" period - up to 90 days is allowed to notify and enroll employees. Because employers may need time between the end of the standard measurement period and the beginning of the associated stability period to determine which ongoing employees are eligible for coverage and to notify and enroll employees, large employers are allowed the option of having an "administrative period" between the end of the standard measurement period and the start of a stability period. The administrative period may last up to 90 days. However, any administrative period between the standard measurement period and the stability period may neither reduce nor lengthen the standard measurement period or the stability period ((§54.4980H-1(a)(1); §54.4980H-3(d)(1)(vi)).

Stability period is a time period selected by the large employer that follows, and is associated with, a standard measurement period or an initial measurement period and is used by the large employer as part of the process of determining whether an employee is a full-time employee under the look-back measurement method. The stability period must be at least six consecutive calendar months but no shorter nor longer in duration than the standard measurement period.(§54.4980H-3(d)(iii) & (iv);§54.4980H-1(a)(45)).

> **Example.** If SouthEast Airlines chooses a standard measurement period of 12 months, it could choose to make it the calendar year, a non-calendar plan year, or a different 12-month period such as one that ends shortly before the start of the plan's annual open enrollment period. If SouthEast determines that Danielle, a pilot, was employed on average at least 30 hours per week during the

standard measurement period, then SouthEast must treat Danielle as a full-time employee during a subsequent stability period, regardless of number of hours Danielle works during the stability period, so long as she remains an employee (§54.4980H-3(d)(1)(i)).

Shorter measurement periods permitted for stability period starting during 2015. For purposes of stability periods beginning in 2015, employers may adopt a transition measurement period that is shorter than 12 consecutive months (but that is no less than 6 consecutive months) and that begins no later than July 1, 2014 and ends no earlier than 90 days before the first day of the plan year, beginning on or after January 1, 2015 (90 days being the maximum permissible administrative period) [Preamble XV.D.2].

Example. An employer with a calendar year plan may use a measurement period from April 15, 2014 through October 14, 2014 (six months), followed by an administrative period ending on December 31, 2014 (Preamble XV.D.2).

Example. An employer with a plan year beginning April 1 that also elected to implement a 90-day administrative period may use a measurement period from July 1, 2014 through December 31, 2014 (six months), followed by an administrative period ending on March 31, 2015. However, an employer with a plan year beginning on July 1 must use a measurement period that is longer than 6 months to comply with the requirement that the measurement period begin no later than July 1, 2014, and end no earlier than 90 days before the stability period. For example, the employer may have a 10-month measurement period from June 15, 2014 through April 14, 2015, followed by an administrative period from April 15, 2015 through June 30, 2015 (Preamble XV.D.2).

Preceding Year "Look-back Measurement" Method - As It Applies to *Existing* Employees

"Ongoing" (existing) employees look-back rules. "Ongoing employees" generally have been employed for at least one complete previous "standard measurement period." Under the look-back measurement method for ongoing employees, a large employer determines each ongoing employee's current full-time, or not full-time, status by looking back at a "standard measurement period," regardless of the employee's number of hours of service during the (present) stability period. The large employer determines the months in which the standard measurement period starts and ends. This look-back measurement method is chosen on an employee-by-employee basis by the employer provided that the determination is made on a uniform and consistent basis for all employees in the same category (§54.4980H-1(a)(31); §54.4980H-3(d)(1)(i); .Preamble VII.C.1 & VII.C.11; Q&A #15).

Employees currently working an average of at least 30 hours per week (or 130 hours a month) must be treated as full-time in subsequent (future) period. If the employer determines that an employee was employed on average at least 30 hours per week (or 130 hours a month) during the "standard measurement period," then the employer must treat the employee as a full-time employee during the future "stability period" regardless of the employee's number of hours during the stability period, so long as he or she remains an employee. If an employee was not employed an average at least 30 hours per week during the standard measurement period, the employer may treat the employee as a part-time employee during the stability period that follows (§54.4980H-3(d)(1)(i),(iii) & (iv)).

Change in position of employment or other employment status during year doesn't impact full-time or non-full-time status until following year. If an ongoing employee's position of employment or other employment status changes before the end of a stability period, the change will not affect the employees status as a full-time employee (or not a full-time employee) for the remaining portion of the stability period (§54.4980H-3(d)(1)(vii)).

> **Example.** If an ongoing employee is not treated as a full-time employee during a stability period because the employee's hours during the prior measurement period were insufficient for full-time-employee treatment, and the employee changes position of employment to a position that involves an increased level of hours, the treatment of the employee as a non-full time employee during the remainder of the stability period is unaffected (§54.4980H-3(d)(1)(vii)).

No change until end of standard measurement period. The large employer may change its standard measurement period and stability period for subsequent years, but not once the standard measurement period has begun.

> **Example. Using look-back method for ongoing employees.** Wilton Meat Packing chooses to use a 12-month stability period that begins January 1 and a 12-month standard measurement period that begins October 15. Wilton's group health plan covers only full-time employees (following the "hours of service" rules) using the look-back measurement method. Wilton chooses to use an administrative period between the end of the standard measurement period (October 14) and the beginning of the stability period (January 1) to determine which employees were employed on average 30 hours per week during the standard measurement period, notify them of their eligibility for the plan for the calendar year beginning on January 1 and of the coverage available under the plan, answer questions and collect materials from employees, and enroll those employees who elect coverage in the plan. Previously determined full-time employees already enrolled in coverage continue to be offered coverage through the administrative period (§54.4980H-3(d)(1)(viii), Exp).

> **Facts.** Alfie and Barbara have been continuously employed by Wilton for several years. Alfie was employed on average 30 hours per week during the standard measurement period that began October 15, 2015 and ended October 14, 2016. Barbara had previously been employed on average 30 hours per week for all prior standard measurement periods, but not during the standard measurement period October 15, 2015 through October 14, 2016.

> **Example. Ongoing employee working full-time since 2015.** Because Alfie was employed for the entire standard measurement period of October 15, 2015 and ends October 14, 2016, he is an ongoing employee during the stability period January 1, 2017 through December 31, 2017. And because Alfie was employed on average 30 hours per week during that standard measurement period, he must be offered coverage for the entire 2017 stability period (including the administration period of October 15, 2017 through December 31, 2017). Now to 2018, in which part of the 2017 stability period becomes part of Alfie's 2017 standard measurement period (from January 1, 2017 to October 14, 2107). Because, in 2018, Alfie was employed on average 30 hours per week during the standard measurement period (October 15, 2016 to October 14, 2017), he must be offered health coverage for the entire 2018 stability period, including the administration period from October 15, 2018 through December 31, 2018 (§54.4980H-3(d(1)(viii), Exp).

2015		2016		2017		2018	
Period 10/15 12/31		10/15 12/31		10/15 12/31		10/15 12/31	
Standard	**Employed Full-Time**		Employed Full-Time				
Admin.	75dy		75dy		75dy		75dy
Stability				**Ongoing—Offer HI**		Ongoing—Offer HI	

Example. Ongoing employee converts from part-time to full-time. Because Barbara was employed for the entire standard measurement period that began October 15, 2015 and ended October 14, 2016, she is also an ongoing employee with respect to the stability period in 2017. But because Barbara did not work full-time during this standard measurement period, she is not required to be offered coverage for the stability period in 2017 even though she worked full-time (30+ hours per week in 2017). However, in 2018, because Barbara was employed on average 30 hours per week during its prior standard measurement period, (October 15, 2016 through October 14, 2017) she must be offered coverage through the end of the 2018 stability period (§54.4980H-3(d(1)(viii), Exp).

2015		2016		2017		2018	
Period 10/15 12/31		10/15 12/31		10/15 12/31		10/15 12/31	
Standard	**Not Full-Time**		Employed Full-Time				
Admin.	75dy		75dy		75dy		75dy
Stability				**Ongoing —No HI Offered**		Ongoing—HI Offered	

Example (conclusion): look-back measurement standards complied with for ongoing employees. Wilton complies with the look-back measurement standards for ongoing employees because:

- The standard measurement and stability periods are no longer than 12 months,
- The stability period for ongoing employees who work full-time during the standard measurement period is not shorter than the standard measurement period,
- The stability period for ongoing employees who do not work full-time during the standard measurement period is no longer than the standard measurement period, and
- The administrative period is no longer than 90 days (§54.4980H-3(d(1)(viii), Exp).

Preceding Year "Look-back Measurement" Method - As Applied to *New* Employees

Reasonable expectation that new employees will be full-time. For a new employee who is reasonably expected, at the employee's start date, to be a full-time employee (and is not a seasonal employee), a large employer determines such employee's status as a full-time employee based on the employee's hours of service for each calendar month. If the employee's hours of service for the calendar month equal or exceed an average of 30 hours of service per week, the employee is a full-time employee for that calendar month. Once a new employee who is reasonably expected at the employee's start date to be a full-time employee (and is not a seasonal employee) becomes an ongoing employee, the existing ongoing rules apply for determining full-time employee status (§54.4980H-3(d)(2)(i)).

Application of §4980H to initial full three calendar months of employment. A large employer will not be subject to a $2,000 §4980H(a) employer mandate penalty for any calendar month of the three-month period beginning with the first day of the first full calendar month of employment if, for the calendar month, the employee is otherwise eligible for an offer of coverage under a group health plan of the employer, provided that the employee is offered coverage by the employer no later than the first day of the fourth full calendar month of employment if the employee is still employed on that day. In addition, if the offer of adequate coverage provides minimum value, the employer also will not be subject to the $3,000 §4980H(b) employer mandate penalty for the first three full calendar months of employment. An employee is otherwise eligible to be offered coverage under a group health plan for a calendar month if the employee meets all conditions to be offered coverage under the plan for that calendar month, other than the completion of a waiting period (§54.4980H-3(d)(2)(iii)).

Preceding Year "Look-back Measurement" Method - New *Variable Hour, Seasonal, and Part-Time* Employee Look-back Rules

New variable-hour and new seasonal employees are determined to be full-time by using a more complicated look-back measurement method. If a large employer uses the look-back measurement method for its ongoing employees, the employer may also use this optional method for new variable hour employees, new seasonal employees and new part-time employees. Therefore, a large employer is permitted to determine whether a new variable hour/seasonal/part-time employee must be treated as a full-time employee using an ***initial measurement period*** of between three and 12 consecutive months (as selected by the employer) that begins on any date between the employee's start date and the first day of the first calendar month following the employee's start date (or, if later, as of the first day of the first payroll period beginning on or after the employee's start date). Effectively, this allows employers to group new hires into 12 groups throughout the year for purposes of determining the initial measurement period. The large employer measures the new employee's hours during the initial measurement period and determines whether the employee was employed on average at least 30 hours per week during this period. If a new variable hour employee, new seasonal employee, or new part-time employee has on average at least 30 hours of service per week during the initial measurement period, the large employer member must treat the employee as a full-time employee during the stability period that begins after the initial measurement period (and any associated administrative period). Otherwise such employees may be treated as part-time. The administrative and stability period, the offer of coverage rules, and the change in employment status during the initial measurement period rules for such employees must generally follow the same rules as for ongoing employees (§54.4980H-3(d)(3)(i) - (vii); §54.4980H-1(a)(49); Preamble VII.C.2, VII.C.6, VII.C.9).

> **Preparer note.** The term variable-hour employee is used as a category of employees under the look-back measurement method and is not relevant to the monthly measurement method (§54.4980H-1(a)(49)(iii)).

Once a new variable-hour employee, new seasonal employee, or new part-time employee has been employed for an entire standard measurement period, the applicable large employer member must test the employee for full-time employee status, beginning with that standard measurement period, at the same time and under the same conditions as apply to other ongoing employees (§54.4980H-3(d)(4)).

Months may be non-calendar or based on payroll periods. The initial measurement period need not be based on calendar months but instead may be based on months, defined as either a calendar month or as the period that begins on any date following the first day of the calendar month and that ends on the immediately preceding date in the immediately following calendar month (for example, from March 15 to April 14). In contrast, a stability period must be based on calendar months. An employer is also allowed to base measurement periods on one week, two week, or semi-monthly payroll periods (§54.4980H-3(d)(1)(ii); Preamble VII.C.12).

Limited non-assessment period for certain employees. The employer mandate penalty does not apply with respect to an employee who is in the initial measurement period (or the associated administrative period), for a period of time after an employee experiences a change to full-time employee status during the initial measurement period, or with respect to a new employee who is reasonably expected to be a full-time employee and to whom coverage is offered on the first of the month following the employee's initial three full calendar months of employment (Preamble VII.D).

Who is a variable hour worker? A new employee is a variable hour employee if, based on the facts and circumstances ***at the start date, it cannot be determined that the employee is reasonably expected to be employed on average at least 30 hours per week or*** if the 30 hours per week is reasonably expected to be of limited duration during the initial measurement period because ***the work hours are variable or otherwise uncertain***. Effective Jan. 1, 2015, and except in the case of seasonal employees, the employer will be required to assume for this purpose that although the employee's hours might be expected to vary, the employee will continue to be employed by the employer for the entire initial measurement period; accordingly, the employer will not be permitted to take into account the likelihood that the employee's employment will terminate before the end of the initial measurement period. In some cases, variable hour employees may not work the necessary 30 hours on average over a specified time period (up to 12 months) to be considered full-time. However, a new employee who is expected to be employed initially at least 30 hours per week may be a variable hour employee, if, based on the facts and circumstances at the start date, the period of employment at more than 30 hours per week is reasonably expected to be of limited duration (§54.4980H-1(a)(49); Preamble VII.C.6.; CRS Report R41159, Potential Employer Penalties Under ACA, July 22, 2013).

Variable-hour employee factors. Factors to consider in determining whether it can be determined that the employee is reasonably expected to be (or reasonably expected not to be) employed on average at least 30 hours of service per week during the initial measurement period include, but are not limited to, whether the employee is replacing an employee who was a full-time employee or a variable-hour employee, the extent to which the hours of service of employees in the same or comparable positions have actually varied above and below an average of 30 hours of service per week during recent measurement periods, and whether the job was advertised, or otherwise communicated to the new employee or otherwise documented (for example, through a contract or job description) as requiring hours of service that would average at least 30 hours of service per week, less than 30 hours of service per week, or may vary above and below an average of 30 hours of service per week. These factors are only relevant for a particular new employee if the employer has no reason to anticipate that the facts and circumstances related to that new employee will be different. In all cases, no single factor is determinative. For purposes of determining whether an employee is a variable-hour employee, the applicable large employer member may not take into account the likelihood that the employee may terminate employment with the applicable large employer (including any member of the applicable large employer) before the end of the initial measurement period (§54.4980H-1(a)(49)(ii)(A); Preamble VII.C.6).

Example of variable hour employee. Cinda is hired on an hourly basis by BigMart, Inc. to fill in for employees who are absent and to provide additional staffing at peak times. BigMart expects that Cinda will average 30 or more hours per week for her first few months of employment, while assigned to a specific project, but also reasonably expects that the assignments will be of unpredictable duration, that there will be periods of unpredictable duration between assignments, that the hours per week required by subsequent assignments will vary, and that Cinda will not necessarily be available for all assignments.

Result. BigMart cannot determine whether Cinda is reasonably expected to average at least 30 hours per week for the initial measurement period. Accordingly, BigMart may treat Cinda as a variable- hour employee during the initial measurement period (§54.4980H-3(d)(5), Exp. 15).

Who is a seasonal worker/employee? For purposes of determining how many employees are considered full-time for purposes of applying the §4980H $2,000 or $3,000 per full-time employee penalty, some seasonal workers may be excluded. In this case, an excludible seasonal employee means an employee in a position for which the customary annual employment is six months or less (not the 120 days previously discussed). The reference to customary means that by the nature of the position an employee in this position typically works for a period of six months or less, and that period should begin each calendar year in approximately the same part of the year, such as summer or winter. In certain unusual instances, the employee can still be considered a seasonal employee even if the seasonal employment is extended in a particular year beyond its customary duration (regardless of whether the customary duration is six months or is less than six months) [§54.4980H-1(a)(38); Preamble, VII.C.8].

Example. If ski instructors at a resort have a customary period of annual employment of six months, but are asked in a particular year to work an additional month because of an unusually long or heavy snow season, they would still be considered seasonal employees.

An employee in a seasonal position might be promoted or transferred to a permanent position. For example, a ski instructor might be moved to the position of grounds manager, who is anticipated to work year round. In general, if a seasonal employee experiences a change in employment status before the end of the initial measurement period in such a way that, if the employee had begun employment in the new position or status, the employee would not have been a seasonal employee (and would have reasonably been expected to be employed on average at least 30 hours of service per week), the employer has until the first day of the fourth month following the change in employment status, or, if earlier, the first day of the first month following the end of the initial measurement period (plus any applicable administrative period), if the employee averaged 30 hours of service per week or more during the initial measurement period, to treat the employee as a full-time employee (Preamble, VII.C.8).

Transition from new variable hour or seasonal employee to ongoing employee. Once a new variable-hour employee or new seasonal employee has been employed for an entire standard measurement period, the large employer must test the employee for full-time employee status, beginning with that standard measurement period, at the same time and under the same conditions as apply to other ongoing employees (§54.4980H-

3(d)(4)(i)).

> **Example.** An applicable large employer member with a calendar year standard measurement period that also uses a one-year initial measurement period beginning on the employee's start date would test a new variable-hour employee whose start date is February 12 for full-time status first based on the initial measurement period (February 12 through February 11 of the following year) and again based on the calendar year standard measurement period (if the employee continues in employment for that entire standard measurement period) beginning on January 1 of the year after the start date.

Who is a new part-time employees? A new part-time employee is reasonably expected at the employee's start date not to be a full-time employee (and who is not a variable hour employee or a seasonal employee). The same rules that apply to new variable hour employees and new seasonal employees apply to new part-time employees (Preamble VI.C.11).

When employment status changes for new variable, seasonal and part-time employees. When variable hour employees change to non-variable hour employees or part-time employees change to full-time employees, employers must change status by the end of the third month. If the position of employment or other employment status of a new variable-hour employee or new seasonal employee materially changes before the end of the initial measurement period in such a way that, if the employee had begun employment in the new position or status, the employee would have reasonably been expected to be employed on average at least 30 hours per week, the employer is not required to treat the employee as a full-time employee for purposes of determining and calculating any employer mandate penalty until the first day of the fourth full calendar month following the change in employment status or, if earlier and the employee averages more than 30 hours per week during the initial measurement period, the first day of the first month following the end of the initial measurement period (including any optional administrative period associated with the initial measurement period) [Preamble VII.C.10].

When employment status changes to part-time status, employer may switch to the monthly measurement method after three months. A special rule applies when an employee experiences a change in employment status from full-time employee status to part-time employee status. The employer is allowed to apply the monthly measurement method to such an employee within three months of the change if the employee actually averages less than 30 hours of service per week for each of the three months following the change in employment status and if the employer has offered the employee continuous coverage that provides minimum value (MV) from at least the fourth month of the employee's employment. Otherwise, under the look-back measurement method, full-time employee status in a stability period is based on hours of service in the prior applicable measurement period, regardless of whether the employee experiences a change in employment status either during the measurement period or during the stability period. Under the look-back measurement method, each employee's hours of service are measured (not just variable hour employees and seasonal employees) during the measurement period. In general, under the look-back measurement method, if the change in employment status results in a change in hours of service, that change is captured in a subsequent stability period (Preamble VII.C.10 & VII.G).

Variable hour or seasonal employees may have periods of time between stability periods. In certain circumstances, there may be a period of time between the stability period associated with the initial measurement period and the stability period associated with the first full standard measurement period during which a variable hour employee or seasonal employee has been employed. This generally may occur in cases in which a new employee begins providing services a short period after the beginning of the standard measurement period that would apply to the employee if the employee were an ongoing employee (§54.4980H-3(d)(3)(i)).

> **Example.** Suppose Apco, Inc. uses 12-month measurement and stability periods for both its new variable-hour employees and its ongoing employees, with the standard measurement period for ongoing employees running from October 15 of one year to the following October 14, the administrative period for ongoing employees running from October 15 through December 31 and with the calendar year as the stability period for ongoing employees. If, Tandy, a new variable-hour employee, is hired on October 25, 2015, and Apco chooses to begin the initial measurement period for new variable hour employees on the first day of the first calendar month beginning after the start date, the initial measurement period for Tandy will run from November 1, 2015, through October 31, 2016. If Tandy averages at least 30 hours of service per week during the initial measurement period, Apco must treat Tandy as a full-time employee for a period of at least 12 months beginning no later than December 1, 2016 (the first day of the 14th calendar month after hire). If that period begins on December 1, 2016, the period for which Tandy must be treated as a full-time employee will end no earlier than November 30, 2017. The first standard measurement period applicable to Tandy is the period from October 15, 2016, through October 14, 2017. If Tandy averages 30 hours of service per week during this standard measurement period, Apco must treat Tandy as a full-time employee for the stability period that is co-extensive with the 2018 calendar year. However, this would leave a period of time between the end of the stability period associated with Tandy's initial measurement period (November 30, 2017) and the beginning of the stability period associated with the first standard measurement period applicable to Tandy (January 1, 2018).

Consistency between initial and standard measurement period required. In circumstances in which there is a period of time between the stability period associated with the initial measurement period and the stability period associated with the first full standard measurement period during which a new employee is employed, the treatment as a full-time employee or not-full-time employee that applies during the stability period associated with the initial measurement period continues to apply until the beginning of the stability period associated with the first full standard measurement period during which the employee is employed. If the employee is being treated as a full-time employee during the initial stability period, that treatment must be extended until the first day of the stability period associated with the first full standard measurement period during which the employee is employed, and if the employee is being treated as not a full-time employee during the initial stability period, that treatment may be extended until the first day of the stability period associated with the first full standard measurement period during which the employee is employed.

> **Example (cont'd).** Thus, in the previous example, Tandy is a full-time employee for the month of December 2017.

Further, for a variable-hour employee or seasonal employee who does not average at least 30 hours of service per week during the initial measurement period, the maximum length for a stability period associated with the initial measurement period is the end of the first full standard measurement period (plus any associated administrative period) during which the new employee was employed (rather than at the end of the standard measurement period (plus any associated administrative period) in which the initial measurement period ends), which was the rule contained in the proposed regulations (Preamble VII.C.13).

Special Anti-Abuse Rules

An anti-abuse rule addresses practices that have the effect of circumventing or manipulating the application of the employee rules.

Using Temporary Staffing Agencies or Leasing Companies.

Implementation of the employer mandate may be particularly challenging for temporary staffing agencies because of the distinctive nature of their employees' work schedules. It is anticipated that many new employees of temporary staffing agencies will be variable-hour employees because, based on the facts and circumstances, their periods of employment at 30 or more hours per week are reasonably expected to be of limited duration with the potential for significant gaps between assignments, and there is often considerable uncertainty as to the likelihood and duration of assignments and as to whether an individual will accept any given assignment and will continue in it (§54.4980H-1(a)(49)(ii)(A); Preamble VII.C.7).

Additional factors relevant to the determination of whether a new employee of a temporary staffing firm intended to be placed on temporary assignments at client organizations is a variable-hour employee generally relate to the typical experience of an employee in the position with the temporary staffing firm that hires the new employee (assuming the temporary staffing firm employer has no reason to anticipate that the new employee's experience will differ) and include:

1. Whether employees in the same position with the temporary staffing firm retain, as part of their continuing employment, the right to reject temporary placements that the employer temporary staffing firm offers the employee;
2. Whether employees in the same position with the temporary staffing firm typically have periods during which no offer of temporary placement is made;
3. Whether employees in the same position with the temporary staffing firm typically are offered temporary placements for differing periods of time; and
4. Whether employees in the same position with the temporary staffing firm typically are offered temporary placements that do not extend beyond 13 weeks.

Anti-abuse rules when using temporary staffing agencies. Employers will not be able to use temporary staffing agencies (or other staffing agencies) purporting to be the common law employer to evade application of §4980H.

> **Example that will not work.** The employer, Clem, plans to employ a bricklayer for only part of a week, such as 20 hours, and then to hire the same bricklayer through a temporary staffing agency for the remaining hours of the week, thereby resulting in neither Clem nor the temporary staffing agency appearing to employ the bricklayer as a full-time employee.
>
> **Example that will not work**. Sandy, a professional tax preparer, works 20 hours per week for Acme, a temporary staffing agency, who supplies her to Donald's Tax Office. Sandy also works for Blandee, another temporary staffing agency, who also supplies her to Donald's Tax Office for the remainder of the week, resulting in neither the temporary staffing agencies nor Donald's Tax Office appearing to employ Sandy as a full-time employee.

Employee's Full-Time Status Must Be Protected when Switching between the two Measurement Methods.

When an employee experiences a change in employment status from a position for which the look-back measurement method is used to a position for which the monthly measurement method is used (or vice versa), the employee's status as a full-time employee during the transition period is expected to be protected. For example, an employee transferring from a position for which the employer is using the look-back measurement method to a position for which the employer is using the monthly measurement method and who at the date of transfer is in a stability period during which the employee is treated as a full-time employee, the employee must continue to be treated as a full-time employee during the remainder of the stability period. If the employee is in a stability period for which the employee is not treated as a full-time employee, the employer may continue to treat the employee as not a full-time employee during the remainder of the stability period. With respect to the stability period that immediately follows the stability period during which the employee transferred, the employee must be treated as a full-time employee for any calendar month during which the employee would be a full-time employee under either the previously applicable look-back measurement method (and thus not lose the hours of service accumulated during the measurement period during which the transfer occurs) or the applicable monthly measurement method. After that immediately following stability period, the employer may determine the employee's status solely through application of the monthly measurement method (Preamble VII.G).

For an employee transferring from a category of employment to which the monthly measurement method applies to a position to which the look-back measurement method applies, the employer is generally required to recreate the stability periods that would apply based upon the employee's hours of service before the transfer. However, for the stability period immediately subsequent to the transfer, the employee must be treated as a full-time employee for any calendar month that the employee would be a full-time employee under either the previously applicable monthly measurement method or the applicable look-back measurement method. The regulations provide several examples to illustrate the application of these rules. (Preamble VII.G)

A large employer is allowed to begin to apply the monthly measurement method in lieu of the otherwise applicable stability period beginning on the first day of the fourth full calendar month following the change in employment status. This rule applies only with respect to an employee to whom the large employer offered minimum value coverage from at least the first day of the month following the employee's initial three full calendar months of employment through the month in which the change in employment status occurs and applies only if during each of the three full calendar months following the change in employment status the employee has on average less than 30 hours of service per week. An employer may apply the monthly measurement method to an employee even if the employer does not apply the monthly measurement method to employees in the same category (for example, an employer could apply the monthly measurement method to an hourly employee, even if the employer uses the look-back measurement method to determine full-time employee status of all other hourly employees). The employer may continue to apply the monthly measurement method through the end of the first full measurement period (and any associated administrative period) that would have applied had the employee remained under the look-back measurement method. (Preamble VII.G)

> **Preparer note.** These rules, with respect to a transfer from a position to which one look-back measurement method applies to a position to which another look-back measurement method

applies, are complex because the methods may differ not only in the length of the applicable measurement and stability periods, but also the starting dates of the measurement periods (for example, the use of a calendar year for one measurement period but a non-calendar-year period for another measurement period) [Preamble VII.G].

Chart -- Time Frame for Determining Full-Time Status

	Measurement Period	Admin Period	Stability Period
Definition	Measure (on average) whether employees are full time or not	Identify and enroll full-time employees	Period in which penalty may be due relative to employees found to be full-time during measurement period
On-going employees	3 to 12 months (a)	Up to 90 days (may neither reduce nor lengthen the measurement or stability period—can overlap prior stability period)	At least 6 months but cannot be shorter in duration than measurement period
New employees hired as full-time	Not applicable	Up to 90 days to enroll	Not applicable
New variable hour and seasonal employees	3 to 12 months (b)	Up to 90 days (measurement period and administrative period cannot exceed 13 months) [c]	3 to 12 months but cannot be longer than measurement period

(a). For ongoing employees, this is referred to as the "standard" measurement period.
(b). For new employees, this is referred to as the "initial" measurement period.
(c). Technically, the initial measurement and administrative period cannot last beyond the final day of the first calendar month beginning on or after the one year anniversary of the employee (about 13 months).

10 Variable Hour Look-back Examples

Assumption for Examples 1 through 8 below:

- All full-time employees (and their dependents) are offered minimum essential coverage under an eligible employer-sponsored plan,
- Coverage is affordable (or treated as affordable under a safe harbor), and
- Coverage provides minimum value.

Employer has selected:

- 12-month standard measurement period starting Oct. 15 for ongoing employees, and a 12-month stability period associated with that standard measurement period starting Jan. 1.

- Thus, during the administrative period from Oct. 15 through Dec. 31 of each calendar year, the employer continues to offer coverage to employees who qualified for coverage for that entire calendar year based upon working on average at least 30 hours per week during the prior standard measurement period.

Example #1 for new variable-hour employees (12-Month Initial Measurement Period Followed by 1+ Partial Month Administrative Period). For new variable-hour employees, Boxworks Enterprises uses a 12-month initial measurement period that begins on the start date and applies an administrative period from the end of the initial measurement period through the end of the first calendar month beginning on or after the end of the initial measurement period. Boxworks hires Yanni on May 10, 2015. Yanni's initial measurement period runs from May 10, 2015 through May 9, 2016. Yanni has an average of 30 hours per week during this initial measurement period. Boxworks offers coverage to Yanni for a stability period that runs from July 1, 2016 through June 30, 2017. For each calendar month during the period beginning with June 2015 and ending with June 2016, Yanni is otherwise eligible for an offer of coverage with respect to the coverage that is offered to him on July 1, 2016.

Yanni:

- Has an average of 30 hours per week during his initial measurement period.

Boxworks:

- Uses an initial measurement period that does not exceed 12 months;
- An administrative period totaling not more than 90 days; and
- A combined initial measurement period and administrative period that does not last beyond the final day of the first calendar month beginning on or after the one-year anniversary of Yanni's start date.

No penalty. Accordingly, from Yanni's start date of May 10, 2015 through June 30, 2017, Boxworks is not subject to any payment under §4980H with respect to Yanni, because Boxworks complies with the standards for the initial measurement period and stability periods for a new variable hour employee. Incidentally, Boxworks must test Yanni again based on the period from October 15, 2015 through October 14, 2016 (Boxwork's first standard measurement period that begins after Yanni's start date) [§54.4980H-3(d)(5), Exp. 1].

New Variable Hour Employee—Initial Period

2015		2016				2017	
Period (**Start Date:** 5/10			5/9	6/30 7/1		6/30	
Initial 12 month+	New: Full Time			52			
Admin.			52				
Stability					Must Initially Offer HI		

New Variable Hour Employee—Using Standard Measurement Method after Initial Period

	2014	2015	2016	2017
Period	10/15 12/31	10/15 12/31	10/15 12/31	10/15 12/31
Standard	N/A—Use Initial	If Employed Full-Time		
Admin.		75dy	75dy	75dy
Stability		N/A	N/A	Must Offer HI

Comment. It would seem that Boxwork's subsequent stability period requiring him to make an offer of health coverage would occur six months into Boxworks initial offer if Yanni stays employed full- time during the first standard measurement period beginning after his start date, that being October 15, 2015 to October 14, 2016. Could that be true? If it is, and Boxworks doesn't offer health coverage to Yanni starting January 1, 2017, it would seem Boxworks penalty would start in the month of January 2017, and not be deferred until July 2017 as this IRS example states (see above conclusion).

Example #2 for new variable worker (11-Month Initial Measurement Period Followed by 2+ Partial Month Administrative Period). Using the same facts in Example #1, except that Boxworks uses an 11-month initial measurement period that begins on the start date and applies an administrative period from the end of the initial measurement period until the end of the second calendar month beginning after the end of the initial measurement period. Boxworks hires Yanni on May 10, 2015. Yanni's initial measurement period runs from May 10, 2015 through April 9, 2016. Yanni has an average of 30 hours per week during this initial measurement period. Boxworks offers coverage to Yanni for a stability period that runs from July 1, 2016 through June 30, 2017.

No Penalty. Same as Example 1 (§54.4980H-3(d)(5), Exp. 2).

New Variable Hour Employee—Initial Period

	2015	2016	2017
Period (**Start Date:** 5 /10		4/9 5/30 7/1	6/30
Initial 11 month+	New—Full-Time		
Admin.		82d	
Stability		Must Initially Offer HI	

Example # 3 for new variable worker (11-Month Initial Measurement Period Preceded by Partial Month Administrative Period and Followed by 2-Month Administrative Period). Using the same facts as Example 1, except that Boxworks uses an 11-month initial measurement period that begins on the first day of the first calendar month beginning after the start date and applies an administrative period that runs from the end of the initial measurement period through the end of the second calendar month beginning on or after the end of the initial measurement period, Boxworks hires Yanni on May 10, 2015. Yanni's initial measurement period runs from June 1, 2015, through

April 30, 2016. Yanni has an average of 30 hours per week during this initial measurement period. Boxworks offers coverage to Yanni for a stability period that runs from July 1, 2016 through June 30, 2017.

No Penalty. Same as Example 1(§54.4980H-3(d)(5), Exp. 3)

New Variable Hour Employee—Initial Period

2015			2016		2017	
Period (**Start Date:** 5/10 6/1			4/30 7/1		6/30	
Initial 11 month+		New: Full Time				
Admin.	21		2mo			
Stability				Must Initially Offer HI		

Example #4 for new variable workers (12-Month Initial Measurement Period Preceded by Partial Month Administrative Period and Followed by 2-Month Administrative Period). For new variable hour employees, Boxworks uses a 12-month initial measurement period that begins on the first day of the first month following the start date and applies an administrative period that runs from the end of the initial measurement period through the end of the second calendar month beginning on or after the end of the initial measurement period. Boxworks hires Yanni on May 10, 2015. Yanni's initial measurement period runs from June 1, 2015, through May 31, 2016. Yanni has an average of 30 hours per week during this initial measurement period. Boxworks offers coverage to Yanni for a stability period that runs from August 1, 2016 through July 31, 2017.

Penalty. Boxworks does not satisfy the standards for the look-back measurement method (see §54.4980H-3(d)(3)(vi)(B)) because the combination of the initial partial month delay, the 12-month initial measurement period, and the two-month administrative period means that the coverage offered to Yanni does not become effective until ***after*** the first day of the second calendar month following the first anniversary of Yanni's start date. Accordingly, Boxworks is subject to a potential payment under §4980H for each full calendar month during the initial measurement period and associated administrative period (§54.4980H-3(c)(5), Exp. 4).

New Variable Hour Employee—Initial Period

2015		2016			2017		
Period (**Start Date:** 5/10 6/1		5/31	8/1		7/30		
Initial 12 month+		New: Full-Time					
Admin.	21		2mo				
Stability				Must Initially Offer HI			

Example #5 for new variable workers: continuous full-time employee. In addition to the same facts as Example 1, Boxworks tests Yanni again based on his hours from October 15, 2015 through October 14, 2016 (Boxworks first standard measurement period that begins after Yanni's start date), determines that Yanni has an average of 30 hours a week during that period, and offers him coverage for July 1, 2017 through December 31, 2017. (Yanni already has an offer of coverage for the period of January 1, 2017 through June 30, 2017 because that period is covered by the initial stability period following the initial measurement period, during which he was determined to be a full-time employee.)

No penalty. Boxworks is not subject to any payment under §4980H for 2017 with respect to Yanni (§54.4980H-3(d)(5), Exp. 5).

New Variable Hour Employee—Using Standard Measurement Method after Initial Period

	2014	2015	2016	2017
Period	10/15 12/31	10/15 12/31	10/15 12/31	7/1 10/15 12/31
Standard	N/A—Use Initial		Employed Full-Time	
Admin.				
Stability		N/A	N/A	Offered HI / Must Offer HI

Example #6 for new variable workers that initially were full-time employees but became non-full-time employees. In addition to the same facts as in Example 1, Boxworks tests Yanni again based on Yanni's hours from October 15, 2015 through October 14, 2016 (Boxwork's first standard measurement period that begins after Yanni's start date), and determines that Yanni has an average of 28 hours a week during that period. Boxworks continues to offer coverage to Yanni through June 30, 2017 (the end of the stability period based on the initial measurement period during which Yanni was determined to be a full-time employee), but does not offer coverage to him for the period of July 1, 2017 through December 31, 2017.

No penalty. Boxworks is not subject to any payment under §4980H for 2017 with respect to Yanni, provided that it offers coverage to him from July 1, 2016 through June 30, 2017 (the entire stability period associated with the initial measurement period) [§54.4980H-3(d)(5), Exp. 6].

New Variable Hour Employee—Initial Period

	2015	2016	2017
Period (**Start Date:** 5/10		5/9 5/31 7/1	6/30
Initial 12 month+	New: Full-Time		
Admin.		21d	
Stability		Must Initially Offer HI	

New Variable Hour Employee—Using Standard Measurement Method after Initial Period

	2014	2015	2016	2017
Period	10/15 12/31	10/15 12/31	10/15 12/31	10/15 12/31
Standard	N/A—Use Initial	Not Employed Full-Time		
Admin.		75dy	75dy	75dy
Stability		N/A	N/A	No Offer of HI required

Example #7 for new variable worker that was initially a non-full-time employee. Using the same facts as found in example 1, except that Yanni has an average of 28 hours per week during the period from May 10, 2015 through May 9, 2016, and Boxworks does not offer coverage to him in 2016.

No penalty. From Yanni's start date through the end of 2016, Boxworks is not subject to any payment under §4980H, because it complies with the standards for the measurement and stability periods for a new variable hour employee with respect to Yanni, and because of those standards, Yanni is not a full-time employee for any month during 2016 (§54.4980H-3(d)(5), Exp. 7).

New Variable Hour Employee—Initial Period

	2015	2016	2017
Period	(**Start Date:** 5/10	5/9 5/31 7/1	6/30
Initial 12 month+	New: Not Full-Time		
Admin.		21d	
Stability		No Offer of HI required	

Example #8 for the new variable-hour worker who initially was a non-full-time employee but became a full-time employee. Assuming the same facts as in the previous example (Example 7), Boxworks tests Yanni again based on his hours from October 15, 2015 through October 14, 2016 (Boxwork's first standard measurement period that begins after Yanni's start date), determines that Yanni has an average of 30 hours per week during this standard measurement period, and offers coverage to Yanni for 2017.

No penalty. Boxworks is not subject to any payment under §4980H for 2017 with respect to Yanni (§54.4980H-3(d)(5), Exp. 8).

New Variable Hour Employee—Using Standard Measurement Method after Initial Period

	2014	2015	2016	2017
Period	10/15 12/31	10/15 12/31	10/15 12/31	10/15 12/31
Standard	N/A—Use Initial	If Employed Full-Time		
Admin.		75dy	75dy	75dy
Stability		N/A	N/A	Must Offer HI

Example #9 for new variable hour employees initially full-time. For new variable hour employees, CostWhat, Inc. uses a six-month initial measurement period that begins on the start date and applies an administrative period that runs from the end of the initial measurement period through the end of the first full calendar month beginning after the end of the initial measurement period. CostWhat hires Zoe on May 10, 2015. Zoe's initial measurement period runs from May 10, 2015 through November 9, 2015, during which she has an average of 30 hours per week. CostWhat offers coverage to Zoe for a stability period that runs from January 1, 2016 through June 30, 2016.

Requirements met: CostWhat uses:

- An initial measurement period that does not exceed 12 months;
- An administrative period totaling not more than 90 days; and
- A combined initial measurement period and administrative period that does not last longer than the final day of the first calendar month beginning on or after the one-year anniversary of Zoe's start date.

Result. From Zoe's start date through June 30, 2016, CostWhat is not subject to any payment under §4980H, because CostWhat complies with the standards for the measurement and stability periods for a new variable hour employee with respect to Zoe. But, CostWhat must test Zoe again based on her hours from November 15, 2015 through May 14, 2016 (CostWhat's first standard measurement period that begins after Zoe's start date) [§54.4980H-3(d)(5), Exp. 9].

New Variable Hour Employee —Initial Period

	2015		2016	2017
Period (**Start Date:** 5/10	11/9	12/31	6/30 12/31	6/30
Initial 6 month+	Full-Time			
Admin.		52d		
Stability			Must Offer HI	

New Variable Hour Employee—Using Standard Measurement Method after Initial Period

2014		2015		2016		2017	
Period 11/15 12/31 5/15 11/15 12/31 5/14 6/30 11/15 12/31 11/15 12/31							
Standard		6	Employed Full-Time				
Admin.			46				
Stability		N/A		52	Must Offer HI		

Example #10 for initially full-time employee who becomes non-full-time employee. Continuing with the same facts as in the previous Example 9, CostWhat, Inc. tests Zoe again based on her hours from November 15, 2015 through April 30, 2016 (CostWhat's first standard measurement period that begins after Zoe's start date), during which Zoe has an average of 28 hours per week. CostWhat continues to offer coverage to Zoe through June 30, 2016 (the end of the initial stability period based on the initial measurement period during which Zoe has an average of 30 hours per week) but does not offer coverage to her from July 1, 2016 through December 31, 2016.

Result. CostWhat is not subject to any §4980H penalty for 2016 ([§54.4980H-3(d)(5), Exp. 10]()).

New Variable Hour Employee—Initial Period

2015			2016		2017	
Period (**Start Date:** 5/10 11/9 12/31 6/30 12/31 6/30						
Initial 6 month+	Full-Time					
Admin.		52d				
Stability			Must Offer HI			

New Variable Hour Employee—Using Standard Measurement Method after Initial Period

2014		2015		2016		2017	
Period 11/15 12/31 5/15 11/15 12/31 5/14 6/30 11/15 12/31 11/15 12/31							
Standard		6	Not Full-Time				
Admin.			52		46		
Stability		N/A			No HI Offer		

WHAT IS THE PENALTY FOR NONCOMPLIANCE BY A LARGE EMPLOYER?

Starting January 1, 2015, Large Employers must Offer Health Coverage to Full-time Employees or Pay a "Shared Responsibility" Payment (§54.4980H-4; §54.4980H-5; Preamble VIII.A, & IX.A, & XV.D.5; Q&A #18 -#39; CRS Report - Potential Employer Penalties Under the ACA, R41159)

One of Two Penalties May Apply

One penalty for not offering coverage to full-time employees and another penalty for offering full-time employees unaffordable or inadequate coverage. ***Starting January 1, 2015***[14] (postponed from Jan. 1, 2014), a ***large employer*** (50+ employees (100+ in 2015)) will be liable for one of two monthly ***"shared responsibility" payment*** penalties (Preamble XV.D.7.a; Q&A # 18):

1. A $2,000 (§4980H(a)) penalty if the employer ***does not offer health coverage*** or offers coverage to less than ***95% (70% in 2015)***, ***or if greater, five,*** of its ***full-time employees (and their dependents starting in 2016)***, **and** at least ***one*** full-time employee ***receives a premium assistance credit*** for coverage obtained at the Marketplace/Exchange (which will be certified to the employer); **or**
2. A $3,000 (§4980H(b)) penalty for an employer who ***offers health coverage*** to at least 95% (70% in 2015) of its full-time employees (and their dependents starting in 2016), but the offered coverage was either ***unaffordable*** to the employee or ***did not provide minimum value (MV) of essential coverage and at least one full-time employee receives a premium assistance credit*** to help pay for coverage at the Marketplace/Exchange (which will be certified to the employer).

IRS can't double-dip penalties. The amount of the payment for any calendar month is capped at the number of the large employer's full-time employees for the month (minus up to 80 employees in 2015 and minus 30 employees after 2015), multiplied by $166.67 (1/12 of $2,000). For a calendar month, a large employer may be liable for an assessable payment under §4980H(a) or under §4980H(b), but may not be liable for an assessable payment under both §4980H(a) and §4980H(b). ***The cap ensures that the payment for an employer that offers coverage can never exceed the payment that employer would owe if it did not offer coverage*** (§54.4980H-5(a) & (d)).

Basic Penalty Rules for Noncompliant Large Employer

- $2,000 for each full-time employee if no coverage offered, and employee receives premium assistance credit from the Marketplace
- $3,000 for each full-time employee if inadequate or unaffordable coverage offered, and employee receives premium assistance credit from the Marketplace
- 30 employee de minimis rule applies (80 employees in 2015)

Employer Doesn't *Offer* Health Coverage

A $2,000-per-employee non-deductible annual penalty over 80 employees (reduced to 30 employees on January 1, 2016), payable monthly, if employer doesn't offer health coverage. Starting January 1, 2015, if a large employer does not offer to at least 70% (increased to 95% in 2016) to all but 30% (5% in 2016), [or, if greater, five] of its full-time employees (and their dependents after 2015) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan for any calendar month, and the large employer receives a §1411 Certificate from the IRS that at least one full-time employee has received a premium assistance credit, the large employer will owe for that calendar month (or any calendar month in 2015 that falls within an employer's non-calendar 2015 plan year), an assessable excise tax equal to $2,000

[14] And for employers with non-calendar-year plans, any calendar months during the 2015 plan year that fall in 2016.

per full-time employee multiplied times the number of full-time employees of the large employer in excess of 80 employees (reducing to 30 employees starting in 2016) [§4980H(a); §54.4980H-4(a); Preamble, (XV)(D)(7)(b); Q&A #14 & #38).

The 80-employee transition relief applies to all calendar months of 2015 plus any calendar months of 2016 that fall within the employer's 2015 plan year and is available for an employer only if it did not modify the plan year of its plan after February 9, 2014 to begin on a later calendar date (for example, changing the start date of the plan year from January 1 to December 1) [Preamble, (XV)(D)(7)(c)].

> **Example. Large employer with >80 FT employees in 2015.** In 2015, Wind Power Inc. *fails to offer* minimum essential coverage to its 150 full-time employees, one of whom receives a tax credit for enrolling in a state-Marketplace-offered plan. Wind Power, Inc. will be assessed a §4980H(a) annual penalty of $140,000, payable monthly ($2,000 per employee x 70, the number of employees over 80).

> **Example. Large employer with <30 FT employees in 2016**. In 2016, Larry's Minimart fails to offer minimum essential coverage to its full-time employees, 15 of whom receive a tax credit for enrolling in a state Marketplace-offered plan. During each calendar month, the Minimart has 20 full-time employees working an average of 35 hours per week, 40 employees working an average of 90 hours per month, and no seasonal workers. Because the Minimart has 50 FTE employees during each month in 2016 and because the seasonal worker exception is not applicable, Larry's Minimart is a "large employer" for 2016. But, Larry's Minimart is not assessed a §4980H(a) penalty, as he has fewer than 30 full-time employees (§54.4980H-2(d), Exp. 2).

Allocated 80/30 among related entities. The large employer's 80/30 relief is allocated ratably among all members of the large employer on the basis of the number of full-time employees employed by each large employer during the calendar year. If a large employer's total allocation is a fractional number that is less than one, it will be rounded up to one. This rounding rule may result in the aggregate reduction for the entire group of large employers exceeding 80/30 (§54.4980H-4(e)).

Employer *Offers Health Coverage but* Employee Gets Premium Assistance Credit from Marketplace

A $3,000 per employee non-deductible annual penalty payable monthly if employee receives premium assistance credits from the Marketplace. Starting January 1, 2015, large employers who offer a group health plan that is not minimum essential health coverage or is not affordable to at least 70% (95% starting January 1, 2016) of its full-time employees (and their dependents starting in 2016) for any calendar month, will be subject to a penalty of $250 ($3,000 annually) for every full-time employee who receives a premium assistance credit from a state Marketplace/Exchange (§4980H(b); §54.4980H-5(a)).

2015 $3,000 penalty capped by §4980H(a) penalty minus 80 full-time employees. But, the amount of the payment for any calendar month is capped at the number of the large employer's full-time employees for the month (minus up to 80 employees, reduced to 30 employees starting January 1, 2016) multiplied by $166.67 (1/12 of $2,000). ***The cap ensures that the payment for an employer that offers coverage can never exceed the payment that the employer would owe if it did not offer coverage*** (§4980H(c)(2)(D)(ii); §54.4980H-5(a)). (Q&A #39).

Full-time seasonal employees also excluded from the penalty calculation. When determining how many employees are considered full-time for purposes of applying the penalty, the 120-day period is not used to determine whether someone is a seasonal employee. A seasonal employee is one hired into a position for which the customary annual employment is six months or less (§54.4980H-1(a)(38)).

"Affordable and adequate" health coverage must be offered. For employers who do provide health insurance coverage, to avoid paying the second potential employer mandate penalty, the offered health insurance coverage must be both affordable and adequate to the employee. Employers who offer health insurance coverage that is inadequate or unaffordable will not be treated as meeting the employer mandate requirements if at least one full-time employee declines their coverage and obtains health coverage at the Marketplace/Exchange and receives a premium credit (as evidenced by receiving a §1411 Certificate). Individuals who are offered employer-sponsored coverage can only obtain premium assistance credits for Exchange coverage if, in addition to other criteria, their employer's coverage fails to meet either the affordable or adequate criteria. Coverage is considered affordable if the employee's required contribution to the plan does not exceed 9.5% of the employee's household income for the taxable year.

How is an employer going to know that an employee received a premium assistance credit at the Marketplace and therefore owes an employer shared responsibility payment? The IRS will send the employer a §1411 Certificate informing them of their potential liability and providing them an opportunity to respond before any liability is assessed or notice and demand for payment is made. The contact for a given calendar year will occur after the employees' individual tax returns are due for that year claiming premium assistance credits and after the due date for employers that meet the 100/50 full-time employee (plus full-time equivalents) threshold to file the information returns identifying their full-time employees and describing the coverage that was offered (if any). If it is determined that an employer is liable for an employer mandate penalty payment after the employer has responded to the initial IRS contact, the IRS will send a notice and demand for payment. That notice will instruct the employer on how to make the payment. Employers will not be required to include the Employer Shared Responsibility payment on any tax return that they file (Preamble X; Q&A #27 & 28).

Allocating penalty among related large employers. The monthly §4980H(b) liability applies solely to the employee's large employer. If the employee was an employee of more than one large employer during the month, the §4980H(b) penalty is allocated among the different employers in accordance with the number of hours the employee worked for each employer for that month(§54.4980H-5(d)).

Dependent Coverage

Dependent coverage: employers have additional time to expand their 2015 health plans to add dependent coverage - 2014 relief extended to plan years that begin in 2015. Transition relief has been provided for plan years that begin in 2014 (2014 plan years) to plan years that begin in 2015 (2015 plan years). Under this transition relief, an employer that takes steps during its 2014 plan year toward offering dependent coverage will not be subject to a penalty payment solely on account of a failure to offer coverage to dependents for that plan year. This extended transition relief applies to employers for the 2015 plan year for plans under which (1) dependent coverage is not offered, (2) dependent coverage that does not constitute minimum essential coverage is offered, or (3) dependent coverage is offered for some, but not all, dependents. This transition relief is not available to the extent the employer had offered dependent coverage during either the plan year that begins in 2013 (2013 plan year), or the 2014 plan year and subsequently dropped that offer of coverage. The transition relief, as extended, applies only for dependents who were without an offer of coverage from the employer in both the 2013 and 2014 plan years and if the employer takes steps during the 2014 or 2015 plan year (or both) to extend coverage under the plan to dependents not offered coverage during the 2013 or 2014 plan year (or both) [Preamble XV.D.5; Q&A #33].

Definition of dependent. The term dependent means a child (as defined in §152(f)(1), but ***excluding*** a stepson, stepdaughter, or an eligible foster child [and excluding any individual who is excluded from the definition of dependent under §152 by operation of §152(b)(3)]) of an employee who has not attained age 26. A child attains age 26 on the 26th anniversary of the date the child was born. A child is a dependent for purposes of §4980H for the entire calendar month during which he or she attains age 26. Absent knowledge to the contrary, a large employer may rely on an employee's representation about that employee's children and the ages of those children (Preamble XI.A, B, & C).

> **Preparer note.** The term dependent does not include the spouse of an employee (Preamble XI.A). In addition, a child who is not a U.S. citizen or national from the definition of dependent is excluded, unless that child is a resident of a country contiguous to the United States or is within the exception for adopted children (Preamble XI.D).

Other Provisions

Employee must be given opportunity to elect (or decline to elect) enrollment in health coverage at least once during plan year. Employers will not be treated as having made an offer of coverage to full-time employees for a plan year if employees do not have an effective opportunity to elect to enroll (or decline to enroll) in coverage no less than once during the plan year (§54.4980H-4(b)).

Evidence proving offer of coverage has been made annually is required. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including:

- Adequacy of notice of the availability of the offer of coverage,
- The period of time during which acceptance of the offer of coverage may be made, and
- Any other conditions on the offer (§54.4980H-4(b)).

Offers made by Professional Employer Organization (PEO). If certain conditions are met, an offer of coverage to an employee performing services for an employer that is a client of a professional employer organization (PEO) or other staffing firm (in the typical case in which the professional employer organization or staffing firm is not the common law employer of the individual) made by the staffing firm on behalf of the client employer under a plan established or maintained by the staffing firm, is treated as an offer of coverage made by the client employer. For this purpose, an offer of coverage is treated as made on behalf of a client employer only if the fee the client employer would pay to the staffing firm for an employee enrolled in health coverage under the plan is higher than the fee the client employer would pay to the staffing firm for the same employee if the employee did not enroll in health coverage under the plan (Preamble IX.B).

No penalty if employee doesn't timely enroll during employer's open enrollment period. An employee or related individual is treated as eligible for coverage under an eligible employer-sponsored plan for a month during a plan year[15] if the employee or related individual ***could have enrolled*** in the plan for any day in that month ***during an open or special enrollment period***, regardless of whether the employee or related individual is eligible for any other type of minimum essential coverage. COBRA continuation coverage must also be timely enrolled (§1.5000A-3(e)(3)(i)(A) & (B)).

No penalty if employee doesn't timely pay their portion of the health insurance premium. An employer will not be treated as failing to offer an employee (and his or her dependents) minimum essential coverage if the employee's coverage is terminated solely due to the employee failing to timely pay the employee portion of the premium.

HHS issues guidance when employer told they cannot satisfy a health insurance issuer's minimum participation requirements. Concern has been expressed about potential employer mandate penalties in the case of a large employer that cannot obtain or maintain coverage for its employees because the employer cannot satisfy a health insurance issuer's minimum participation requirements. ***In the large group market, a minimum participation requirement cannot be used to deny guaranteed issue.*** For small employers such as relatively small applicable large employers, final regulations issued by HHS provide that an issuer must guarantee issued coverage to a small employer during an annual, month-long open enrollment period regardless of whether the small employer satisfies any minimum participation requirement (see 45 CFR 147.104(b)(1)). HHS regulations generally define a small employer as one that has at least one, but not more than 100 employees. For plan years beginning before January 1, 2016, states may set the upper limit at 50 employees (Preamble IX.A).

Other Examples

$3,000 penalty capped. In 2015, Sigma Star, Inc. offers health coverage and has 100 full-time employees, 50 of whom receive a premium assistance credit for the year from the Marketplace. For each employee receiving a premium assistance credit, the employer owes a §4980H(b) $3,000 penalty, for a total penalty of $150,000. The maximum penalty for this employer is capped at the §4980H(a) amount of the penalty that it would have been assessed for a failure to provide coverage, or $40,000 ($2,000 multiplied by 20 (100-80)). Since the §4980H(b) calculated penalty of $150,000 is more than the maximum amount, Sigma Star, Inc. pays the $40,000 calculated penalty. This penalty is assessed on a monthly basis.

Penalty capped at -0-. In 2016, Bahama Bay Company, Inc. offers health coverage and has 30 full-time employees, 20 of whom receive a tax credit for the year for enrolling in a state-Exchange-offered plan. For each employee receiving a tax credit, the employer owes a §4980(b) $3,000 penalty, for a total penalty of $60,000. But, the maximum §4980H(a) penalty for this employer is capped at the amount of the penalty that it would have been assessed for a failure to provide coverage, or zero ($2,000 multiplied by -0- (30-30)). Since the §4980H(b) calculated penalty of $60,000 is more than the maximum §4980H(a) amount, Bahama Bay pays no penalty.

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[15] The eligible employer-sponsored plan's regular 12-month coverage period (or the remainder of a 12-month coverage period for a new employee or an individual who enrolls during a special enrollment period) [§1.5000A-3(e)(2)(iii)).

WHAT HEALTH COVERAGE DOES THE EMPLOYER HAVE TO OFFER TO COMPLY WITH ACA?

Minimum Essential Coverage (MEC)

MEC includes coverage under an eligible employer-sponsored plan, even a grandfathered plan, which is a group health plan or group health insurance coverage offered by an employer to an employee that is a governmental plan, any other plan or coverage offered in the small or large group market, or a grandfathered plan offered in the group market. But, MEC does not include health insurance coverage that consists of coverage of certain excepted benefits if the benefits are provided under a separate policy, certificate, or contract of insurance. Future regulations are expected to provide that an employer-sponsored plan will not fail to be MEC solely because it is a plan to reimburse employees for medical care for which reimbursement is not provided under a policy of accident and health insurance (a self-insured plan) [see generally §5000A(f);§54.4980H-1(a)(27); Q&A #17 & #18].

Adequate coverage, a.k.a. minimum value. A plan fails to provide minimum value if the plan's share of the total allowed costs of benefits provided under the plan is less than 60% of those costs. A plan is considered to provide adequate coverage (also called minimum value) if the plan's actuarial value (i.e., share of the total allowed costs that the plan is expected to cover) is at least 60%. If the coverage offered by a large employer fails to provide minimum value, an employee may be eligible to receive a premium assistance credit from a state Exchange.

Minimum value calculator determines actuarially if employer's coverage offers minimum value (The Center for Consumer Information & Insurance Oversight (CCIIO)). A minimum value calculator will be made available by the IRS, which works in a similar fashion to the CCIIO Actuarial Value Calculator that HHS is making available. The percentage of the total allowed cost of benefits will be determined using one of the main methodologies described in HHS's proposed regulations and Notice 2012-31. Employers can input certain information about the plan such as deductibles and co-pays into the calculator and get a determination as to whether the plan provides minimum value (using CCIIO's Minimum Value Calculator) by covering at least 60% of the total allowed cost of benefits that are expected to be incurred under the plan (Q&A #12 on Employer shared Responsibility Provisions under the ACA; Preamble, III(B)).

> **Planning idea.** The actuarial value calculation for determining minimum value includes the employer contributions to health savings accounts (HSAs) and health reimbursement accounts (HRAs) that are part of a high deductible health plan (HDHP).

Affordability

Affordable health coverage—employee's cost can't exceed 9.5% of household income. If an employee's share of the premiums for employer-provided coverage would cost the employee more than 9.5% of that employee's annual household income, the employee may be eligible for a premium assistance credit from the state Exchange, which can trigger a penalty being imposed on the employer.

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

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

If an employer offers multiple healthcare coverage options, the affordability test applies to the lowest-cost option available to the employee that also meets the "minimum value" requirement [§54.4980-5(e)(1); Preamble, III(C)].

Affordability safe harbors, for §4980H(b) purposes, allow employer an alternative to the employee's household income test. Because employers generally will not know their employees' household incomes, employers may choose instead to use one of the following three affordability safe harbors based on information that is readily available to employers:

1. Form W-2 safe harbor - cost of the coverage to the employee does not exceed 9.5% of the employee's Box 1 wages as reported on Form W-2;
2. Rate of pay safe harbor - cost of coverage doesn't exceed 9.5% of employees lowest rate of pay for the year; or
3. Federal poverty level (FPL) safe harbor - cost of coverage does not exceed 9.5% of the Federal poverty level.

> **Preparer note.** The information needed to calculate these safe harbors is readily available to the employer, allowing it to know immediately whether or not any penalty will be due for any employee. Of the three, the rate of pay and FPL safe harbors are known prior to the start of a year, giving employers the most certainty. The W-2 safe harbor likely results in the employer paying the lowest amount towards coverage, but it is not 100% known until the end of the year when the W-2s are prepared.

These safe harbors are all optional. An employer may, but is not required to, choose to use one or more of these safe harbors for all of its employees or for any reasonable category of employees, provided it does so on a uniform and consistent basis for all employees in a category (Preamble VIII.A). If an employer meets the requirements of the selected safe harbor, the offer of coverage is deemed affordable for purposes of §4980H(b) regardless of whether it is affordable to the employee under §36B. The affordability safe harbors apply solely for implementing the (up to $3,000) §4980H(b) rules (§54.4980H-5(e)(2); Preamble VIII.A; Q&A #19).

W-2 affordability safe harbor test. Under the Form W-2 wages safe harbor, the employer calculates the affordability of the coverage based solely on the wages paid to the employee by that employer (and any other member of the same applicable large employer that also pays wages to that employee), as reported in Box 1 of the Form(s) W-2 ("Wage and Tax Statement").

> **Preparer note.** Form W-2, Box 1 wages are used for this safe harbor. That means that an employee's participation in a §401(k) or §125 cafeteria plan will reduce the wages used to calculated the safe harbor (Preamble VIII.B).

Form W-2 safe harbor—Full-year offer of coverage. An employer will not be subject to a penalty under §4980H(b) if an employee's required contribution for the calendar year for the employer's lowest cost self-only coverage does not exceed 9.5% of that employee's Form W-2 - Box 1 wages for the calendar year. Application of this safe harbor is determined after the end of the calendar year and on an employee-by-employee basis, taking into account the Form W-2 wages and the required employee contribution for that year. To qualify for this safe harbor, the employee's required contribution must remain a consistent amount or percentage of all Form W-2 wages during the calendar year (or for plans with fiscal year plan years, within the portion of each plan year during the calendar year), so that a large employer is not permitted to make discretionary adjustments to the required employee contribution for a pay period. A periodic contribution that is based on a consistent percentage of all Form W-2 wages may be subject to a dollar limit specified by the employer (Preamble VIII.B; §54.4980H-5(e)(2)(ii)(A)).

Example. Low wage employee. Garden Inc. has 100 full-time employees and is subject to the requirements of ACA. Garden pays Mary, one of its employees, $1,500 a month. The cost for Mary's self-only company health coverage is $400 a month. Under the affordability safe harbor, Garden requires Mary to pay $142.50 (9.5% of $1,500) toward the cost of coverage and it pays the balance of the monthly premium, $257.50.

Example. Middle wage employee. Garden Inc. has 100 full-time employees and is subject to the requirements of ACA. Garden pays John, one of its employees, $5,000 a month. The cost John's self-only company health coverage is $400 a month. Under the affordability safe harbor, Garden requires John to pay $475 (9.5% of $5,000) toward the cost of coverage. Garden is not required to pay any of the monthly premium.

Example. Full year. Edwina is employed by the Dept. of Revenue from January 1, 2015 through December 31, 2015. The employee contribution for self-only coverage is $100 per calendar month ($1,200 for the calendar year). For 2015, Edwina's W-2 wages are $24,000. Because the 2015 employee contribution is less than 9.5% of Edwina's W-2 wages for 2015 ($1,200 is 5% of $24,000), the coverage offered is affordable for 2015 [§54.4980H-5(e)(2)(v), Exp. 1].

W-2 Wages	$24,000.00
9.5% of household income	9.5%
W-2 safe harbor amount	$ 2,280.00
Individual's required contribution ($100 per month)	$ 1,200.00
Required contribution must be less than W-2 safe harbor amount	Affordable

Form W-2 safe harbor —Adjustment for partial-year offer of coverage. For an employee offered coverage for a partial calendar year, the Form W-2 safe harbor is applied by adjusting the Form W-2 wages to reflect the period for which coverage was offered, then determining whether the employee's required contribution for the employer's lowest cost self-only coverage that provides minimum value, totaled for the periods during which coverage was offered, does not exceed 9.5% of the adjusted amount of Form W-2 wages. To adjust Form W-2 wages for this purpose, the Form W-2 wages are multiplied by a fraction equal to the number of calendar months for which coverage was offered over the number of calendar months in the employee's period of employment with the employer during the calendar year. For this purpose, if coverage is offered during at least one day during the calendar month, or the employee is employed for at least one day during the calendar month, the entire calendar month is counted in determining the applicable fraction (§54.4980H-5(e)(2)(ii)(B)).

Example. Partial year. Bonita is employed by WalMight from January 1, 2015 through September 30, 2015. The employee contribution for self-only coverage is $100 per calendar month, or $900 for Bonita's period of employment. For 2015, Bonita's W-2 wages from WalMight are $18,000. For purposes of applying the affordability safe harbor, the W-2 wages are multiplied by 9/9 (9 calendar months of coverage offered over 9 months of employment during the calendar year). Affordability is determined by comparing the adjusted W-2 wages ($18,000) to the employee contribution for the period for which coverage was offered ($900). Because the result is less than 9.5% of Bonita's W-2 wages for 2015 ($900 is 5% of $18,000), the coverage offered is affordable for 2015 [§54.4980H-5(e)(2)(v), Exp. 2].

W-2 Wages for partial year (9 months)	$18,000
÷ Individual's required contribution ($100 per month X 9 months*)	÷$ 900
Percentage of W-2 applied to individual's required contribution	= 5.0%
Safe harbor required contribution percent	9.5%
Individual's required contribution must be less than 9.5%	Affordable

*Wages and coverage period the same (both 9 months)

Rate of pay affordability safe harbor test.

Rate of pay safe harbor. A large employer satisfies the rate of pay safe harbor if the employee's required contribution for the month for the lowest cost self-only coverage that provides minimum value does not exceed 9.5% of an amount equal to 130 hours multiplied by the lower of the employee's hourly rate of pay as of the first day of the coverage period (generally the first day of the plan year) or the employee's lowest hourly rate of pay during the calendar month. The rate of pay safe harbor provides employers with a design-based method for satisfying affordability without having to analyze each employee's wages and hours. Under this safe harbor, for an hourly employee, the employer uses an assumed rate of 130 hours per calendar month regardless of whether the employee actually works more or less than 130 hours during a calendar month. The affordability calculation under the rate of pay safe harbor is not altered by a leave of absence or reduction in hours worked. In addition, an employer is permitted to apply the rate of pay safe harbor to an hourly employee even if the employee's rate of pay is reduced during the year (Preamble VIII.C).

Example. Under the rate of pay safe harbor, if an hourly employee treated as a full-time employee earns $10 per hour in a calendar month (and earned at least $10 per hour as of the first day of the coverage period) but has one or more calendar months in which the employee has a significant amount of unpaid leave or otherwise reduced hours, the employer may still require an employee contribution of up to 9.5% of $10 multiplied by 130 hours ($123.50).

Preparer note. The rate of pay safe harbor cannot be used, as a practical matter, for tipped employees or for employees who are compensated solely on the basis of commissions (Preamble VIII.C).

For salaried employees, monthly salary is used instead of 130 multiplied by the hourly rate of pay and, solely for purposes of this "rate of pay safe harbor," a large employer may use any reasonable method for converting payroll periods to monthly salary. A large employer may use this safe harbor only to the extent it does not reduce the monthly wages of salaried employees during the calendar year (including due to a reduction in work hours). For this purpose, if coverage is offered during at least one day during the calendar month, the entire calendar month is counted both for purposes of determining the assumed income for the calendar month and for determining the employee's share of the premium for the calendar month (§54.4980H-5(e)(2)(iii); Preamble VIII.C).

Example. Rate of pay safe harbor—convert hourly rate to monthly assuming 130 hours for month. David is employed by Widget, Inc. from January 1, 2016 through December 31, 2016. The employee contribution for self-only coverage is $85 per calendar month. David is paid at a rate of $7.25 per hour (the minimum wage in Widget's jurisdiction), for all of 2016. For purposes of applying the affordability safe harbor, Widget may assume that David earned $942.50 per calendar month (130 hours multiplied by $7.25 per hour). Affordability is determined by comparing the assumed income per month ($942.50) to the employee contribution per month ($85). Because $85 is less than 9.5% of David's assumed income ($85 is 9.01% of $942.50), the coverage offered is affordable for 2016 [§54.4980H-5(e)(2)(v), Exp. 4].

Wages for month: ($7.25 per hour X 130 hours)	$ 942.50
Individual's required contribution per month	÷$ 85.00
Percentage of rate-of-pay applied to individual's required contribution	= 9.01%
Safe harbor required contribution percent	9.5%
Individual's required contribution must be less than 9.5%	Affordable

Example. Rate of pay safe harbor - use the lowest hourly rate paid during the year. Eileen is employed by Dacor from May 15, 2015 through December 31, 2015. Dacor offers Eileen and her dependents coverage from August 1, 2015 through December 31, 2015. The employee contribution for self-only coverage is $100 per calendar month. From May 15, 2015 through October 31, 2015, Eileen is paid at a rate of $10 per hour. From November 1, 2015 through December 31, 2015, she is paid at a rate of $12 per hour. For purposes of applying the affordability safe harbor Dacor may assume that Eileen earned $1,300 per calendar month (130 hours multiplied by the lowest hourly rate of pay for the calendar year, or $10). Affordability is determined by comparing the assumed income ($1,300 per month) to the employee contribution ($100 per month). Because $100 is less than 9.5% of Eileen's assumed monthly income ($100 is 7.69% of $1,300), the coverage offered is affordable for 2015 [§54.4980H-5(e)(2)(v), Exp. 5].

Wages for first 6 months: ($10 per hour X 130 hours)	$1,300.00
Wages for last 2 months: ($12 per hour X 130 hours)	$1,560.00
Employee wages at beginning of wage period	$1,300.00
Individual's required contribution per month	÷$ 100.00
Percentage of rate-of-pay applied to individual's required contribution	=
7.69% Safe harbor required contribution percent	9.5%
Individual's required contribution must be less than 9.5%	Affordable

Federal poverty line (FPL) affordability safe harbor test.

Federal poverty line safe harbor. A large employer satisfies the Federal poverty line safe harbor with respect to an employee for a calendar month if the employee's required contribution for the calendar month for the large employer's lowest cost self-only coverage that provides minimum value does not exceed 9.5% of a monthly amount determined as the Federal poverty line for a single individual for the applicable calendar year, divided by 12. For this purpose, if coverage is offered during at least one day during the calendar month, the entire calendar month is counted both for purposes of determining the monthly amount for the calendar month and for determining the employee's share of the premium for the calendar month. For this purpose, the applicable Federal poverty line is the Federal poverty line for the state in which the employee is employed (§54.4980H-5(e)(2)(iv); Preamble VIII.D).

> **Preparer note.** Employers are permitted to use the guidelines in effect six months prior to the beginning of the plan year, so as to provide employers with adequate time to establish premium amounts in advance of the plan's open enrollment period (Preamble VIIIl.D).

> **Example. Federal poverty line safe harbor.** Frank is employed by Wildbrush, Inc. from January 1, 2015 through December 31, 2015. Wildbrush uses the look-back measurement method with Frank being treated as a full-time employee for the all of 2015. Frank is regularly credited with 35 hours per week but is credited with only 20 hours during March and only 15 hours during August. The (assumed) Federal poverty line for 2015 for an individual is $11,170. For Frank, Wildbrush determines the monthly employee contribution for employee single-only coverage for each calendar month of 2015 as an amount equal to 9.5% multiplied by $11,170, which is $1,061.15, and that amount is then divided by 12, and the result is $88.43. Regardless of Frank's actual wages for any calendar month, including the months of March and August, when he has lower wages because of significantly lower hours , the coverage under the plan is treated as affordable with respect to Frank (§54.4980H-5(e)(2)(v), Exp. 6).

Federal Poverty Line	$11,170.00
9.5% of household income	9.5%
Federal Poverty Line safe harbor amount	$ 1,061.15
	÷ 12
Monthly Federal Poverty Line safe harbor amount	$ 88.43
Individual's monthly required contribution no matter the wages earned	$ 88.43
Required contribution must be less than FPL safe harbor amount	Affordable

IDEAS TO REDUCE PENALTIES

Example: Calculating and reducing the cost of complying. PearStem Software has 100 full-time employees. 60 are salaried engineering and management workers and 40 are hourly clerical and production workers. The company does not provide a health plan for its employees but knows it must comply with ACA requirements in 2014. Management asks the company's insurance agent to estimate the 2014 cost of providing single-only health insurance to its full-time employees. The agent estimates that the premium for a bronze plan will be $4,000 for each employee for a total of $400,000. What can PearStem do to reduce its share of that expense?

Employees	#	Self-Only	Employee Cost	Employer Cost	Employer Total Cost
High-paid employees	60	$4,000	$4,000	- 0 -	-0-
Low-paid employees	40	$4,000	$1,800	$2,200	$88,000
	100	$400,000	$302,000		**$88,000**

1. The business can reduce some of its clerical and production workers to part-time. Management determines that 10 of its clerical and production employees are skilled, long-term workers and that it will have to provide coverage for them. But it decides that it can run its clerical and production function with part-time workers who work no more than 25 hours a week. The company does not have to provide coverage for part-time workers, saving $66,000.

Employees	#	Self-Only	Employee Cost	Employer Cost	Employer Total Cost
High-paid employees	60	$4,000	$4,000	- 0 -	-0-
Part-time low paid	30	$4,000	$4,000	- 0 -	- 0 -
Low-paid employees	10	$4,000	$1,800	$2,200	$22,000
	100	$400,000	$378,000		**$22,000**

2. The business can use the W-2 safe harbor to calculate the employee's share of the premium. Engineering and management staff all earn wages of more than $45,000 each. Therefore, the salaried employees are able, under the affordability test, to pay the entire $4,000 premium for self-only health coverage (9.5% of $45,000 = $4,275). For the ten clerical and production staff that management will retain as full-time employees, each averages wages of about $20,000. Thus, each hourly employee will be able to pay a portion of their own premium. Of the $4,000 self-only premium, the employee will pay $1,900 and the company $2,100. While the company could not imagine paying $400,000 for health insurance coverage, it can plan for the $21,000.

Employees	#	Self-Only	Employee Cost	Employer Cost	Employer Total Cost
High-paid employees	60	$4,000	$4,000	- 0 -	-0-
Part-time low paid	30	$4,000	$4,000	- 0 -	- 0 -
Low-paid employees	10	$4,000	$1,900	$2,100	$21,000
	100	$400,000	$379,000		**$21,000**

EMPLOYER MANDATE REPORTING REQUIREMENTS

One Year Delay in Reporting Requirements (H.R. 2667; Notice 2013-45; Treasury Notes Blog dated July 3, 2013; §6055; §6056; Notice 2012-32, Notice 2012-33; Dept of Labor List of ACA Regulations and Guidance)

Employer information reporting simplified. The mandatory employer and insurer reporting requirements for some businesses have been postponed for an additional year, until 2016. The IRS has also issued final regulations that aim to substantially simplify and streamline the employer reporting requirements - especially for employers that offer highly affordable coverage to all or virtually all of their full-time employees. It also offers a single reporting form for employer and insurer reporting provisions in certain circumstances.

Delay of annual information reporting requires delay of employer mandate penalties. On July 2, 2013, the Obama Administration announced that it delayed, until 2015, enforcement and associated reporting requirements relating to potential employer penalties under ACA. On July 11, 2013, the IRS released Notice 2013-45, which provides transition relief for 2014 from:

1. The information reporting requirements applicable to insurers, self-insuring employers, and certain

other providers of minimum essential coverage under § 6055,
2. The information reporting requirements applicable to applicable large employers under §6056, and
3. The §4980H(a) $2,000 and §4980H(b) $3,000 employer shared responsibility penalty provisions.

§6055 - Insurance Companies and Self-Insuring Employers Must Report Employee's Health Insurance Coverage to the IRS (PPACA 2010) - Effective in *2015*

Reporting requires employee information. The first information returns will be filed in 2016. Information returns reporting minimum essential coverage must contain:

1. The name, address, and taxpayer identification number of the primary insured and each other individual covered under the policy or plan,
2. The dates each individual was covered under minimum essential coverage during the calendar year,
3. In the case of health insurance coverage, whether the coverage is a qualified health plan offered through the Marketplace,
4. If the coverage is a qualified health plan offered through the Marketplace, the amount (if any) of any advance payment of the premium assistance credit under or of any cost-sharing for each covered individual, and
5. Other information that the Secretary requires (§6055(b)(1)).

Health insurance company report includes employer information. Every health insurance issuer, sponsor of a self-insured health plan, government agency that administers government-sponsored health insurance programs and other entity that provides minimum essential coverage must file annual returns reporting information for each individual for whom minimum essential coverage is provided (§6055(a)). Information returns for minimum essential coverage provided by a health insurance issuer through an employer's group health plan must also include the name, address, and employer identification number of the employer maintaining the plan, the portion of the premium to be paid by the employer, and any other information that the Secretary may require for administering the small employer health insurance credit (§6055(b)(2)).

Report must be provided to employee. Entities filing information returns reporting minimum essential coverage must furnish a written statement to each individual listed on the return no later than January 31 following the calendar year that shows the following information that must be reported to the IRS for that individual (§6055(c)(1)):

- The applicable large employer's name and address,
- The applicable large employer's contact information (including a contact phone number), and
- The information relating to coverage provided to that employee (and dependents) that is required to be reported on the §6056 return.

§6056 - Employers Must Report Employee's Health Insurance Coverage to the IRS (PPACA 2010) - Effective in *2015*

Expanded information required. Beginning in 2015, each ***applicable large employer*** subject to the employer responsibility provisions of new §4980H and each "offering employer" must report certain health insurance coverage information both to its full-time employees and to the IRS (§6056(c)(1)).

Non-plan calendar years must use reasonable method to report portion of 2014 plan year falling in 2015. Employers eligible for the transition guidance for plans with non-calendar year plan years remain subject to the reporting requirements under §6056 for the entire 2015 calendar year. Because no §4980H liability applies whether or not a full-time employee is offered coverage during the portion of the 2014 plan year falling in 2015, the large employer may determine the full-time employees for that period for purposes of the §6056 reporting requirements after the period has ended, using actual service data or using the look-back measurement method, and use those determinations for the reporting required for the period during 2015 that precedes the start of the 2015 plan year. In addition, the employer should be able to determine whether the coverage offered provides MV and the employee portion of the applicable premium in time to complete the required reporting for 2015 (that is, for §6056 returns furnished to employees and filed with the IRS in 2016). Because this reporting is needed by the employee and the IRS for the administration of the premium assistance credit, large employers are required to report this information for the entire 2015 calendar year, even if during some calendar months in 2015 §4980H liability will not apply by reason of the transition guidance for non-calendar year plan years. The §6056 return instructions will provide additional information on how to report for 2015 (Preamble XV.D.1.e).

Employer's Must Give Notice of Health Coverage to New and Existing Employees (Technical Release No. 2013-02); FAQ on Notice of Coverage Options)

An applicable employer must provide each employee at the time of hiring (or with respect to current employees, not later than October 1, 2013), a written notice:

1. **Information about the state Marketplace.** Informing the employee of the existence of the Marketplace including a description of the services provided by the Marketplace, and the manner in which the employee may contact the Marketplace to request assistance;
2. **If employer's plan isn't "adequate coverage" and, therefore, employee may be eligible for premium assistance credit from the state Marketplace.** If the employer plan's share of the total allowed costs of benefits provided under the plan is less than 60% of such costs, that the employee may be eligible for a premium assistance credit under §36B if the employee purchases a qualified health plan through the Marketplace; AND
3. **Potential repercussions if employee goes to the state Marketplace after turning down employer's plan.** If the employee purchases a qualified health plan through the Marketplace, the employee may lose the employer contribution (if any) to any health benefits plan offered by the employer and that all or a portion of such contribution may be excludable from income for Federal income tax purposes (Section 18B of the Fair Labor Standards Act (FLSA), as added by section 1512 of the Affordable Care Act, generally provides that, in accordance with regulations promulgated by the Secretary of Labor).

Timing and delivery of notice. Employers are required to provide the notice to each new employee at the time of hiring beginning October 1, 2013. For 2014, the Department will consider a notice to be provided at the time of hiring if the notice is provided within 14 days of an employee's start date. With respect to employees who are current employees before October 1, 2013, employers are required to provide the notice not later than October 1, 2013. The notice is required to be provided automatically, free of charge. The notice must be provided in writing in a manner calculated to be understood by the average employee. It may be provided by first-class mail. Alternatively, it may be provided electronically if the requirements of the Department of Labor's electronic disclosure safe harbor at 29 CFR 2520.104b-1(c) are met.(Technical Release No. 2013-02, III,D).

An employer cannot be fined for failing to provide employees with notice about the Affordable Care Act's new Health Insurance Marketplace. Even though employers are required to provide this written notice to its employees about the Health Insurance Marketplace by October 1, 2013, there is no fine or penalty under the law for failing to provide the notice. The U.S. Department of Labor has two model notices to help employers comply. There is one model for employers who do not offer a health plan and another model for employers who offer a health plan to some or all employees. Employers may use one of these models, as applicable, or a modified version.

W-2 Reporting Rules for Employers Who Sponsor Health Insurance Not Delayed (§6051(a)(14); Notice 2012-9, W-2 Information Reporting, Notice 2011-28, Notice 2010-69)

IRS's chart clarifies W-2 reporting. ACA requires employers to report the aggregate cost of employer-sponsored health plan coverage on the employees' W-2s. ***The reporting requirement began for 2012 W-2s.*** The IRS chart describes various types of coverage and indicates "report on W-2," "do not report on W-2," or "optional reporting."

Report, in Box 12 of Form W-2 using Code DD, the cost of employer-sponsored health coverage (if sponsored by the employer). Employers will report the cost of health insurance in Box 12 of Form W-2, using Code DD. ***The amount reported with Code DD is not taxable.*** The amount reported does not affect tax liability, as the value of the employer contribution to health coverage continues to be excludable from an employee's income.

Report the "aggregate cost" of employer-sponsored health insurance —both the portion paid by the employee *and* the portion paid by the employer. The aggregate cost of applicable employer-sponsored coverage is the total cost of coverage under all applicable employer-sponsored coverage provided to the employee. Applicable employer-sponsored coverage means, with respect to any employee, coverage under any group health plan made available to the employee by an employer that is excludable from the employee's gross income under §106 or would be so excludable if it were employer-provided coverage. The aggregate reportable cost generally includes both the portion of the cost paid by the employer ***and*** the portion of the cost paid by the employee, regardless of whether the employee paid for that cost through pre-tax or after-tax contributions.

Small employer exception. Employers who issue fewer than 250 W-2s in the prior year are exempt from the health insurance reporting requirement. This exemption will stay in effect until the IRS issues further guidance (Notice 2012-9, Q-3).

Chart: Reporting Requirements in ACA Relating to Private Health Insurance Coverage (CRS Report R43150 - Delay in Implementation of Potential Employer Penalties Under ACA, July 22, 2013)

IRC §	ACA Provision Description
§6055(a), §6724(d)	Requires certain entities to file annual returns to the IRS reporting information for each individual for whom minimum essential coverage is provided. The entities include: every health insurance issuer, sponsor of self-insured health plan, government agency that administers government-sponsored health insurance programs and other entities that provide minimum essential coverage.
§6055(b)(1)	Provides that all information returns reporting minimum essential coverage are to contain (1) the name, address, and taxpayer identification number of the primary insured and each other individual covered under the policy or plan, (2) the dates each individual was covered under minimum essential coverage during the calendar year, (3) in the case of health insurance coverage, whether the coverage is a qualified health plan offered through Exchange, the amount (if any) advance payment of the premium assistance credit and any cost-sharing reduction.
§6055(b)(2)	Provides that information returns for minimum essential coverage through an employer's group health plan also include the name, address, and employer identification number of the employer maintaining the plan, the portion of the premium paid by the employer, and any other information that the Secretary (of Treasury) may require for administering the small business tax credit (§45R).
§6055(c)(1)	Directs the entity filing an information return reporting minimum essential coverage to furnish a written statement to each individual listed on the return that shows the information that must be reported to the IRS.
§4980H(a), §4980H(b)	Imposes a penalty on large employers (50+ FTEs) who (1) do not offer coverage for all of their full-time employees, offer unaffordable minimum essential coverage, or offer plans with high out-of-pocket costs and (2) have at least one full-time employee certified as having purchased health insurance through an Exchange and who was eligible for a tax credit or subsidy.
§6056(a), §6724(d)	Directs every applicable "large" employer (50 or more full-time equivalent employees within the meaning of §4980H(c)(2) employer shared responsibility provision) during a calendar year to file a return with the service that reports the terms and conditions of the health care coverage provided to the employer's full-time employees.
§6056(b)	Provides that the return used to satisfy the requirements under this section must include: • The name and employer identification number of the applicable large employer, • The date the return is filed, • Certification as to whether the applicable large employer offers its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, • The number of full-time employees for each month of the calendar year, • For each full-time employee, the name, address, and taxpayer identification number, and the months the full-time employee (and any dependents) were covered by employer-sponsored coverage. • Other such information as may be required by the Secretary of the Treasury.

§6051	Requires employers to disclose the value of the employee's health insurance coverage sponsored by the employer on the annual Form W-2.

ACCIDENT AND HEALTH PLANS §35; §105, §106 & §125

Health-Related Fringe Benefits/Deductions

Several IRC sections provide preferential medical-related deductions, employee tax-free fringe benefits, income exclusions, and other tax incentives to encourage employers to provide medical benefits to employees and to create parity for employers regardless of which entity type they chose. §104, §105, §106, §125, §162(l) and §223 all have provisions impacting employers and/or employees in regards to their respective medical expenses. The discussion that follows addresses the various Code sections and their impact to employees, Schedule C and F owners, S corporation and C corporation shareholder employees, and partners in partnerships.

BUSINESS-RELATED HEALTH BENEFITS

What Health Benefits Apply to Owners?

	Sch C	Sch F	1065	1120S*	1120
SE health insurance	X	X	X	X	NA
SE tax deduction?				X	NA
Tax-free health insurance				X	X
Medical reimbursement					X
Simple Cafeteria Plan					X
FSAs	No	No	No	No	X
HSAs	X	X	X	X	X
* If S corp shareholder is not an employee (e.g., no W-2 wages), there is no SE health insurance deduction.					

Deducting Health Insurance for the Self-employed

Self-employed deduct health insurance "above-the-line." The deduction for self- employed health insurance includes premiums payments for the self-employed taxpayer and the taxpayer's spouse, dependents, and any child who is not 27 by the end of the taxable year. §162(l) permits 100% of the health insurance premiums to be deductible "above-the-line" (before AGI) with the following limitations:

- Deduction is limited to that business's earned income. The income from two businesses cannot be aggregated for income limits, although each business could pay different specific health insurance plans (CCA 200524001).
- Deduction is limited when taxpayer is ***eligible*** to participate in a subsidized health plan maintained by his or her employer ***or the spouse's employer*** (§162(l)(2)(A) & (B)).
- For years other than 2010, the deduction isn't available for self-employment tax purposes (§162(l)(4)).

Maximize the tax benefits and reduce the after tax cost of health insurance premiums by taking out the insurance in the correct name.

ENTITY	HEALTH PLAN IN NAME OF	REFERENCE
Sole proprietor	individual	LTR 200623001
Single member LLC (disregarded entity)	individual	LTR 200623001
Partnership or LLC	partner or company	Rev. Rul. 91-26
S corporation	shareholder or company	Notice 2008-1, §106
C corporation	company	§106
	company	HRA, §105 non-discriminatory reimbursement plan

Chief Counsel Advice Says All Medicare Premiums Qualify for SE Health Insurance Deduction; Amended Returns Permitted (CCA 201228037; Pub 535)

Maybe it is not news but now it is official. Medicare insurance premiums are insurance for purposes of the self-employed health insurance deduction. A small change in Publication 535 stated that "Medicare B premiums can be used to figure the (self-employed health insurance) deduction."

A Chief Counsel Advice clarifies what's included:

1. All Medicare Parts (B and D) for the self-employed individual and spouse are insurance that constitutes medical care under §162(l).
2. A partner in a partnership may pay the premiums directly and be reimbursed by the partnership, or the premiums may be paid by the partnership. In either case, the premiums must be reported to the partner as guaranteed payments, and the partner must report the guaranteed payments as gross income on his or her Form 1040. A 2% shareholder-employee in an S corporation may pay the premiums directly and be reimbursed by the S corporation or the premiums may be paid by the S corporation. In either case, the premiums must be reported to the 2% shareholder-employee as wages on Form W-2, and the 2% shareholder-employee must report this amount as gross income on his or her Form 1040. A sole proprietor must pay the Medicare premiums directly.
3. If all the requirements of §162(l) are satisfied, Medicare premiums may be deducted under §162(l)

for coverage of the self-employed individual's spouse, dependent or a child (as defined in §152(f)(1) who as of the end of the taxable year has not attained age 27).

4. Self-employed individuals who failed to deduct Medicare premiums for prior (open) years may file an amended return to claim the deduction.

Example. Mary, a self-employed architect, pays $1,200 of Medicare B premiums in 2014. Tom, Mary's husband, is retired and also pays $1,200 of Medicare B premiums. Mary may deduct $2,400 as self-employed health insurance in 2014, and she may also amend any open years to add the Medicare premiums paid on her and Tom's behalf to her self-employed health insurance deduction.

Health Insurance Plan in Name of 2% S Corporation Owner Can Qualify for Self-Employed Health Insurance Deduction (Notice 2008-1)

Self-employed health insurance deduction allowed even if the plan is in the name of the shareholder. A plan providing medical care coverage for a 2% shareholder-employee in an S corporation is *established* by the S corporation if it makes the health insurance premium payments for the policy covering the 2% shareholder-employee in the current taxable year, or if the 2% shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and it then reimburses the shareholder-employee for the premium payments in the current taxable year. No deduction is allowed if the S corporation does not make or reimburse the premium payments.

Premium payments are taxable wages – but not subject to FICA or FUTA. In order for the 2% shareholder-employee to deduct the amount of the health insurance premiums, the S corporation must report the health insurance premiums paid or reimbursed as wages on the 2% shareholder-employee's Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his or her Form 1040. Even though the premium payments are to be included in wages, they are not wages subject to Social Security and Medicare taxes if the requirements for exclusion under §3121(a)(2)(B) are satisfied.

Checklist to qualify S corporation shareholder for self-employed health insurance deduction	
S corporation paid or reimbursed health insurance premiums	
Health insurance premiums paid or reimbursed by the S corporation are added to the W-2 of the shareholder-employee.	
Health insurance premium payments or reimbursements included in the shareholder-employee's W-2 are deducted on line 29 of the shareholder's Form 1040 as self-employed health insurance.	

No Problems for C Corporations

C corporations can deduct 100% of the health insurance and medical reimbursement for all employees (including shareholder/employees) "above-the-line" (§105(b) & §106), with the additional benefit that such reimbursement is "tax-free" to the employee (§1.162-10(a)).

Health Reimbursement Arrangements (HRAs) (§105; Rev. Rul. 2002-41; Notice 2002-45)

Overview. Health reimbursement arrangements (a.k.a. HRAs or 105 plans) are self-insured medical reimbursement plans funded solely by employers. HRAs reimburse employees for medical care expenses incurred by the employee, spouse, dependents, and any children under age 27 as of the end of the taxable year up to a set maximum dollar amount for a coverage period. HRA reimbursements are normally excluded from the employee's income. Employees may, but are not required to, carry over unused amounts to the following year. In addition:

- HRAs must comply with the non-discrimination rules of §105(h) and §1.105-11 (i.e., no favorable treatment allowed for highly compensated employees);
- HRA contributions are taxable to all participants if any person has a right to take cash other than a reimbursement of qualified medical expenses;
- HRAs can reimburse employees for the purchase of health insurance;
- HRAs may provide that a Flexible Spending Account (FSA) funded with salary reductions reimburses expenses before the HRA; and
- HRAs are group health plans subject to the COBRA continuation requirements.

> **Example.** Shark Inc. sponsors high-deductible medical insurance for all of its employees. Shark also sponsors an HRA under which participating employees may be reimbursed for medical care expenses of up to $1,000. Any unused reimbursement amounts left at the end of a year are carried forward and added to the employer contribution in the following year. If an employee retires or otherwise terminates employment, any unused reimbursement amount remaining in the HRA is forfeited. Shark's contributions to employee HRAs are deductible for Shark and are an excludable fringe benefit for its employees.

HRAs as group health plans. Historically, employers have offered employees group medical insurance, HRAs, both, or neither. HRAs are generally considered to be a group health plan (§9832(a); ERISA §733(a); Public Health Service Act (PHS Act) §2791(a)). Accordingly, HRAs are subject to all the same rules that apply to other group health plans.

HRAs and ACA Market Reforms Collide (Notice 2013-54)

Affordable Care Act (ACA) market reforms terminate many stand-alone HRAs. ACA implemented several market reforms (required provisions) to health insurance policies. Most significant of these market reforms was the elimination of annual limits on the dollar amount of benefits for any individual (Public Health Service Act §2711). Because HRAs are considered a group health plan and are therefore subject to the ACA market reforms, and as HRAs without an annual dollar limit are impractical for employers, essentially the ACA market reforms have eliminated HRAs as a viable tax-free fringe benefit for plan years beginning in 2014 and after.

> **Example.** Manufacturer INU does not offer its employees any type of group major medical insurance but it does offer an HRA. Under the HRA, INU allows its employees to be reimbursed for out-of-pocket medical expenses of up to $1,000 per year. Any amounts left over at the end of the year may be carried forward to the following year and added to INU's latest $1,000 contribution. For

years beginning in 2014 and after, INU's HRA does not qualify as a group health plan because of the $1,000 annual benefit limit. As a result, any HRA benefits received by INU employees are fully taxable.

Relief for carry over HRA balances. HRA participants that have unused amounts in their HRAs that was credited before January 1, 2014 and consist of amounts credited before January 1, 2013, and amounts that are credited in 2013 under the terms of an HRA as in effect on January 1, 2013, may use the carry over amounts after December 31, 2013 to reimburse medical expenses.

Exceptions to ACA market reforms for some HRAs. The market reforms required by ACA do not apply to group health plans that: 1) have fewer than two participants who are current employees on the first day of the plan year; 2) only provide excepted benefits such as accident-only coverage, disability income, certain dental and vision benefits, certain health FSAs, etc.; and, 3) group health plans that are limited to retirees only.

> **Example.** Sid is a farmer who employs Gina, his wife, to help with various activities on the farm. Sid has no other employees. Sid implements an HRA employee benefit plan that reimburses Gina up to $5,000 for medical expenses of her and her family. Because Sid has fewer than 2 employees, the HRA is exempt from the market reforms required under ACA. Assuming all other qualifications are met, any amounts paid under the HRA are fully deductible on Sid's Sch. F and completely tax- free for Gina.
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> **Variation.** Sid hires three other full-time employees to help on the farm. He does not offer any group health insurance to his employees but he does offer an HRA plan to reimburse employees for out of pocket medical expenses of up to $5,000 each. Sid amends his HRA so that the HRA reimbursements are limited to expenses for vision, dental, disability, and long term care premiums only. Sid's HRA is still allowed and the payments to employees are tax free.

Integration with group health insurance may save some HRA plans (See DOL FAQs about ACA Implementation Part XI). In some cases, HRAs may be integrated with primary health coverage as part of a group health plan. If the plans are integrated, and the primary health coverage alone meets the annual dollar limit requirement, limiting the HRA benefit amount would not make the HRA violate the annual dollar limit rule because the combined benefit satisfies the requirement. To integrate an HRA with an employer's primary health coverage, the HRA must only be available to employees who are covered under an employer's primary group health coverage which has no annual dollar limit. HRA integration is accomplished using either of two integration methods: Minimum Value Not Required or Minimum Value Required.

> **Preparer note.** Neither integration method requires that the HRA and the coverage with which it is integrated share the same plan sponsor, the same plan document, the same governing instruments, or, if applicable, file a single Form 5500.

#1 - Integration method: minimum value not required. An HRA is integrated with a group health plan if: 1) the employer offers a group health plan (other than the HRA) to employees that does not consist solely of excepted benefits; 2) employees receiving HRA benefits are actually enrolled in a group health plan, regardless of whether the employer sponsors the plan (non-HRA group coverage); 3) the HRA is available only to employees who are enrolled in non-HRA group coverage, regardless of whether the employer sponsors the non-HRA group coverage; 4) the HRA is limited to reimbursement of co-payments, co-insurance, deductibles, premiums under the non-HRA group coverage and medical care that does not constitute essential health benefits; and 5) the HRA, allows employees (and former employees) at least annually to permanently opt out of and waive future HRA reimbursements and, upon termination of employment, the remaining amounts in the HRA are forfeited or the employee is permitted to permanently opt out of and waive future HRA reimbursements.

> **Example.** Azure LLC sponsors a group health insurance plan and an HRA for its employees. Azure's HRA meets the five requirements outlined above. After he is hired by Azure, Adam chooses to enroll in group health coverage sponsored by his spouse's employer, Grand Kay LLC, rather than enrolling in Azure's group health plan. Adam attests to Azure that he is covered by Grand Kay's non-HRA group coverage. When Adam seeks reimbursement under Azure's HRA, he attests that the expense for which he seeks reimbursement is a co-payment, co-insurance, deductible, or premium under Grand Kay's non-HRA group coverage or medical care. Azure's HRA is integrated with Grand Kay's non-HRA group coverage.

#2 - Integration method: minimum value (MV) required. An HRA may also be integrated with a group health plan if: 1) the employer offers a group health plan to employees that provides minimum value (pursuant to §36B); 2) employees who receive HRA benefits are actually enrolled in a group health plan that provides minimum value, regardless of whether the employer sponsors the plan; 3) the HRA is available only to employees who are actually enrolled in non-HRA MV group coverage; and 4) the HRA allows employees (or former employees) at least annually to permanently opt out of and waive future reimbursements from the HRA, and, upon termination of employment, the remaining amounts in the HRA are either forfeited or the employee is permitted waive future HRA reimbursements.

HRAs cannot be integrated with individual policies. An employer-sponsored HRA cannot be integrated with individual policies or individual market coverage provided under an employer payment plan. HRAs used to purchase coverage on the individual market fail the annual dollar limit prohibition. Also, any HRA that provides benefits to an individual who is not enrolled in primary coverage through the employer fails to comply with the annual dollar limit prohibition and it cannot be integrated.

> **Example.** MLI establishes an HRA to reimburses employees for their substantiated individual insurance policy premiums. MLI's HRA fails to comply with the annual dollar limit prohibition because its HRA plan imposes an annual limit up to the cost of the individual market coverage purchased through the arrangement. The HRA cannot be integrated with individual health insurance policies purchased under the arrangement.

Deducting Spouse's Health Insurance and Medical Reimbursement on Schedule C (ISP, effective 3/29/99; Rev. Rul. 71-588; LTR 9409006)

Potential tax-saving strategy: Hire spouse and deduct 100% of employer-provided health coverage with no W-2 income to spouse! Sole proprietors (and single member LLC owners) who hire their spouse as an employee may be allowed to deduct 100% of the cost of the spouse's accident and health coverage, including medical expense reimbursements, as a business expense. The employee-spouse must be a ***bona fide employee*** of the business or otherwise provide services to the business for which the accident and health coverage is ***reasonable compensation***. The cost of the health-related benefits are excludable from the employee spouse's income under §105(b) and §106 as tax-free fringe benefits.

Do we need to adopt a written agreement and plan document? A written plan is not required for the payment of health insurance premiums under §106, but if a self-insured medical expense reimbursement plan is adopted under §105(b), the business must be able to show that the employee-spouse is eligible to participate, including satisfying any waiting periods, etc. which requires a written plan.

> **Preparer note**. Employees, including spouses, cannot receive tax-free reimbursements under a medical expense reimbursement plan for expenses incurred before the plan is adopted. The IRS cites as its authority for this position *American Family Mutual Insurance Company*, 93-1 USTC ¶50025 and Rev. Rul. 71-403.

If spouse is covered, do all other employees also have to be covered? If the service requirement has not been consistently applied to all employees, the medical expense reimbursement plan is discriminatory under §105(h). The health insurance discrimination rules in §106 are more liberal.

Bona fide employee requirement. Whether the "employee-spouse" is a bona fide employee is determined on a case-by-case basis, using the common law rules (see Rev. Rul 87-41 and IRS's training manual 3320-102 (Revised 10-96), "Independent Contractor or Employee?"). The extent and nature of the spouse's involvement in the business operations is critical. A part-time worker may still qualify as a bona fide employee, although the performance of nominal or insignificant services that have no economic substance or independent significance may be challenged.

Reasonable compensation requirement. The total of any cash wages plus the value of any fringe benefits must be "reasonable compensation." Factors used in determining the reasonableness of compensation include:

1. Employee's role in the company
2. External comparison with other companies
3. Character and condition of the company
4. Internal consistency in compensation
5. Potential conflicts of interest/hypothetical independent investor (*Elliotts, Inc. v. Commissioner* (83-2 USTC ¶9610), 716 F.2d 1241 (9th Cir. 1983))

Also see:

- *Milo L. Shellito; Sharlyn K Shellito v. Comm.*, (10th Cir) No. 10-9002, where the 10th Circuit reversed the Tax Court (TCM 2010-41) and ruled that spouse was an employee of a self employed farmer. The Court ruled that extensive or perfect documentation is not required to prove spouse is an employee in small family businesses.
- *Ralph E. & Erika C. Frahm v. Comm.*, TCM 2007-351, *Peter & Maureen Speltz v. Comm.*, TCS 2006-25,where taxpayer were allowed to treat spouse as employee and deduct family medical expenses on Schedule C or F.
- *Leo and Shawn M. Stephens v. Comm.*, TCS 2008-18, *Darwin J. Albers*, TCM 2007-144, and *Ivan G. and Rosemary J. Snorek v. Comm.*, TCM 2007-34, *Ronald and Judith Francis v. Comm.*, TCM

2007-33, where the Courts ruled ***against*** the taxpayers because they didn't treat spouses as bona fide employees or pay the spouse's medical expenses out of a separate account.

Preparer note. If these losing cases had been tried *after* the 10th Circuit's decision, it is likely that the Tax Court would have been more lenient and perhaps at least some of these taxpayers would have prevailed.

Partners and Spouses of Partners Can Use This Rule (LTR 200704017)

Partners (including LLC members) who hire their spouses are treated the same as sole proprietors, i.e., employees who are also spouses of partners/members may be provided tax-free health benefits, as long as the spouses themselves are not also partners/members (see Rev. Rul. 88-76).

Checklist for Family Employee Benefit Programs

Factors to Consider	**Yes**	**No**
Is the compensation paid to the family member:		
1. Reasonable, e.g., valued at fair market?		
2. Evidenced by a written check, e.g., properly documented?		
3. For medical expenses deducted in the year reimbursed by the business?		
4. Redeposited into the business checking account?		
Is there documentation of the benefit plan, such as:		
1. Written employee benefit plan?		
2. Employee time records?		
3. Employment contract? Job description?		
4. Filed employment tax returns (941s, W-2s, etc)?		
5. Having the medical insurance plan in the name of (and are premiums paid by) the business or employee (not the proprietor/owner)?		
6. Adherence to nondiscrimination rules for non-family employees?		
Other items:		
1. Is money paid by employee spouse for medical expenses?		
2. Is money paid to employee spouse as a reimbursement or does business pay expenses directly?		
3. Is insurance in employee spouse's name?		

CAFETERIA PLANS §125

What is a cafeteria plan? A §125 cafeteria plan (a.k.a. flexible spending account, FSA, 125 Plan) is an employer-sponsored plan under which employees can choose either taxable cash or tax-free benefits. Qualified benefits are generally excludable from gross income by statute, they being:

- Coverage under an employer-provided accident or heath plan (§105 and §106)
- Elective contributions under a qualified cash or deferred arrangement (§401(k))
- Contributions to HSAs
- Disability benefits
- Adoption assistance (§137)
- Dependent care assistance (§129)
- Up to $50,000 in group-term life insurance benefits (§79)
- Premiums for life insurance on the life or lives of a spouse or dependent with a benefit of up to $50,000 (§125(f); §1.125-1(a)(3); Notice 89-110)

Highly-compensated participants. This plan must be written and, most importantly, the plan benefits may not discriminate in favor of highly compensated participants. A highly compensated participant is:

1. An officer or spouse or dependent of an officer of the employer,
2. A stockholder or spouse or dependent of a stockholder owning more than 5% (determined by voting power or value) of all classes of the stock of the employer, or
3. Highly compensated, that being an employee (or spouse or dependent of a highly compensated employee) making more than $115,000[16] (in 2013) (§125(e)).

Can't have greater benefits flowing to the highly-compensated. A cafeteria plan is considered discriminatory if it provides greater benefits to highly compensated participants than to non-highly compensated participants. The IRS will determine if discrimination exists based upon either the benefits available to be elected by the participants, by the benefits actually elected by the participants, or by the amount contributed by the employer for the benefits (PR §1.125-7(c)).

Key employees. A cafeteria plan may not favor key employees, who are: 1) officers with compensation in excess of $165,000 (in 2013)[17]; 5% owners; or 1% owners with compensation in excess of $150,000 (not adjusted for inflation) (§125(b)(2); §416(i)(1)).

Can't have more than 25% of benefits flowing to key employees. A cafeteria plan favors key employees if more than 25% of the nontaxable qualified plan benefits are provided to key employees (§125(b)(2)).

Penalty for violation applies only to the highly-compensated participants or key employees. Violation of the nondiscrimination rules by either highly compensated participants or key employees will not invalidate the §125 cafeteria plan for all participants, just the highly compensated participants or key employees. In these cases, the highly compensated participants or key employees will be subject to tax on the benefits

[16] This number is inflation-adjusted annually.

[17] This number is inflation-adjusted annually.

received (§125(b)(1), (2)).

Because most small business have a substantially higher percentage of highly compensated participants or key employees than larger businesses, small employers find little personal incentive to offer cafeteria plans to their employees.

Health FSAs May Allow Carryovers of Unused Amounts to Future Years (Notice 2013-71)

New carryover allowed but not required. At the plan sponsor's discretion, §125 cafeteria plans may, but are not required to, offer plan participants a carryover of up to $500 from a health FSA from the current year to the following plan year. While carryovers were not previously allowed, §125 plans could allow employees to carry amounts from a previous year (including amounts remaining in a health FSA) to pay expenses incurred for qualified benefits for up to two months and 15 days immediately following the end of the plan year (the "grace period").

> **Preparer note.** §125 cafeteria plans may offer the $500 carryover or the 2½ month grace period but may not offer both.

Carryover does not reduce current year allowable amount. The carryover of up to $500 does not affect the maximum amount of salary reduction contributions that the participant is permitted to make under §125(i) ($2,500 for 2014).

Simple Cafeteria Plans

Nondiscrimination rules waived for small employer simple cafeteria plans. Effective for taxable years beginning after December 31, 2010, certain small employers are provided a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for the specified qualified benefits offered under a cafeteria plan.

But only small employers who average 100 or fewer employees are eligible to use the new simple cafeteria plans. An eligible small employer is any employer who employed an average of 100 or fewer employees during either of the two preceding years, but a year may only be taken into account if the employer was in existence throughout the year. If an employer was not in existence throughout the preceding year, the determination is based on the average number of employees it is reasonably expected such employer will employ on business days in the current year (§125(j)(5)(A) & (B)).

Once eligible, firm can grow to an average of 200 or fewer employees. If an employer was an eligible employer for any year and maintained a simple cafeteria plan for its employees for such year, then, for each subsequent year during which the employer continues, without interruption, to maintain the cafeteria plan, the employer is deemed to be an eligible small employer until the employer employs an average of 200 or more employees on business days during any year preceding any such subsequent year (§125(j)(5)(C)(ii)).

The determination of whether an employer is an eligible small employer is determined by applying the controlled group rules of §52(a) and (b) under which all members of the controlled group are treated as a single employer. The definition of employee includes leased employees within the meaning of §414(n) and (o)[18].

Three employee requirements for simple cafeteria plans. Under the simple cafeteria plan safe harbor, a cafeteria plan and the specified qualified benefits are treated as meeting the specified nondiscrimination rules if the cafeteria plan satisfies:

- Minimum eligibility requirements
- Minimum participation requirements
- Minimum contribution requirements

All employees must be allowed to participate. The eligibility requirement is met only if:

- All employees (other than excludable employees) are eligible to participate, and
- Each employee eligible to participate is able to elect any benefit available under the plan (subject to the terms and conditions applicable to all participants).

Exceptions to eligibility requirements. A cafeteria plan will not fail the eligibility requirement merely because the plan excludes employees who:

1. Have not attained age 21 (or a younger age provided in the plan) before the close of a plan year
2. Have fewer than 1,000 hours of service for the preceding plan year
3. Have not completed one year of service with the employer as of any day during the plan year
4. Are covered under an agreement that the Secretary of Labor finds to be a collective bargaining agreement if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer
5. Are nonresident aliens working outside the United States as described at §410(b)(3)(c))

An employer may have a younger age or shorter service requirement, but only if such shorter service or younger age applies to all employees.

Minimum contribution requirement: two methods available to prove contributions are the same for both nonhighly and highly compensated employees. An employer must meet strict contribution requirements when using the simple cafeteria plan. The minimum contribution requirement is met if the employer provides a minimum contribution for each nonhighly compensated employee (employee who is not a highly compensated employee or a key employee (within the meaning of §416(i))) in addition to any salary reduction contributions made by the employee. The minimum must be available for application toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan. The minimum contribution is permitted to be calculated under either the nonelective contribution method or the matching contribution method, but the same method must be used for calculating the minimum contribution for all

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[18] §52(b) provides that, for specified purposes, all employees of all corporations that are members of a controlled group of corporations are treated as employed by a single employer. However, §52(b) modifies certain control group rules including substituting 50% ownership for 80% ownership as the measure of control. There is a similar rule in §52(c) under which all employees of trades or businesses (whether or not incorporated) which are under common control are treated as employed by a single employer. §414(n) provides rules for specified purposes when leased employees are treated as employed by the service recipient and §414(o) authorizes the Treasury to issue regulations to prevent avoidance of the requirements of §414(n).

nonhighly compensated employees.

Nonelective contribution method. The minimum contribution under the nonelective contribution method is an amount equal to a uniform percentage (not less than 2%) of each eligible employee's compensation for the plan year, determined without regard to whether the employee makes any salary reduction contribution under the cafeteria plan.

Matching contribution method. The minimum matching contribution is the lesser of 200% of the amount of the salary reduction contribution elected to be made by the employee for the plan year or 6% of the employee's compensation for the plan year (§125(j)(3)(A)). Compensation for these purposes is compensation with the meaning of §414(s).

A simple cafeteria plan is permitted to provide for the matching contributions in addition to the minimum required, but only if matching contributions with respect to salary reduction contributions for any highly compensated employee or key employee are not made at a greater rate than the matching contributions for any nonhighly compensated employee. Nothing prohibits an employer from providing qualified benefits under the plan in addition to the required contributions.

MISCELLANEOUS FRINGE BENEFITS §132

Qualified Transportation Fringe Benefits (§1.132-1, 5, 9; Rev. Proc. 2013-35; Notice 2013-8)

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

Tax-free qualified parking and transit passes. There are three categories of qualified transportation fringes for purposes of determining the amount that is excludable from gross income: 1) transportation in a commuter highway vehicle (e.g., VanPool) and transit passes, 2) qualified parking, and 3) a qualified bicycle commuting reimbursement fringe benefit. A statutory monthly limit is imposed on the value of excludable benefits from each category.

Monthly	2013	**2014**	2015	
Parking	$245	**$250**		Inflation adjusted
Transit pass	$245	**$130**		Equal to parking in 2010 - 2013, not in 2014
Bicycling	$20	**$20**	$20	Not inflation adjusted

Preparer note. The employer must purchase the pass. The employee can't purchase the pass and be reimbursed!

PER DIEM ARRANGEMENTS - 2014 UPDATE[19]

[19] Meal, lodging and Incidental per diem rates are updated every October 1, not January 1. Mileage per diem rates are updated every January 1.

2013-2014 Federal Lodging and Meal Per Diems

For fiscal year 2013-14, the per diem options available for 1) employee reimbursements and deductions and 2) self-employed deductions (GSA Per Diem Files; GSA 2014 Highlights)

Meals/Lodging Per Diem Rates	FY 2012 - 13 (Notice 2012-63)	FY 2013 - 14 (Notice 2013-65)
Meals, Lodging & Incidentals	$123 to $366 (Manhattan)	**$129 to $303 (Manhattan)**
High/Low M&IE Rate	$163/$242	**$170/$251**
Meals	$46/$51/$56/$61/$66/$71	**$46/$51/$56/$61/$66/$71**
Truckers Flat Rate Meals	$59	**$59**
Incidental Expenses only	$5	**$5**

The meals per diem deduction is available to both employees and the self-employed but not any per diem deductions containing lodging. Employees who wish to deduct per diem as an expense on their personal Form 2106 ***and*** self-employed individuals who wish to deduct per diem on their business returns may use the meal and incidental rate to substantiate travel meals but cannot use any Federal per diem method containing lodging (e.g., the $123 to $303, M&IE rates or the high/low method). Methods containing the lodging per diem of $83 to $257 are available exclusively to businesses (employers, its agents or a third party) reimbursing employees for travel away-from-home expenses. Therefore, to deduct lodging on their personal returns, both employees and the self-employed must have actual receipts (Rev. Proc. 2010-39, Sec. 1). Both employees and self-employed individuals may always use actual allowable expenses, instead of per diems, to compute the deductible costs of business lodging, meals, and incidental expenses paid while traveling away from home as long as they maintain adequate records (or other sufficient evidence).

The requirements to use the per diem option. An employee receiving a fixed allowance (e.g., reimbursement varies in proportion with miles driven or days away from home) will be allowed a deemed above-the-line deduction by not including the payments in W-2 income only if the following requirements are met:

1. **Major misunderstanding! "Adequate accounting" to the employer required**. The employee must timely substantiate to the employer "the elements necessary to determine the amount of the allowance (e.g., the number of miles driven *or* the number of days away from home, AND the time, place and business purpose of the travel)" (Rev. Proc. 2011-47; Sec. 7.01). The per diem must be paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer (Rev. Proc. 2011-47, Sec. 3.01). If the employee does not timely substantiate to the employer, the per diem becomes taxable income and expenses are not deductible on Form 2106 (*B.J. Baugh*, TCM 1996-70; *R. L. Evans v. Comm., pro se*, TCM 2010-7).

2. **Per diem cannot be more than the IRS-specified rates (www.gsa.gov).** The employee may only receive or deduct a per diem amount at or below the "IRS-specified standard rates" as enumerated

in the above chart. Any excess per diem creates W-2 income. The IRS-specified per diem rates are updated every October 1, not January 1. But, businesses may choose either the prior year rate or the current year rate for the last three months of the year.

Preparer note. The term "incidental expenses" has the same meaning as in the Federal Travel Regulations, 41 C.F.R. 300-3.1. The Federal Travel Regulations currently include as incidental expenses fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries; transportation between places of lodging or business and places where meals are taken, if suitable meals can be obtained at the temporary duty site; and the mailing cost associated with filing travel vouchers and payment of employer-sponsored charge card billings (Rev. Proc. 2010-39; Sec. 3.02(3)).

3. **Must return any per diem not substantiated**. The employee must be required to return any portion of such an allowance which relates to days, miles, or travel not substantiated.

Per diem rates available on the Internet. ***Domestic*** per diem rates can be found at "www.gsa.gov." GSA's per diem mobile app is also available and allows travelers to look up Federal government per diem rates by city/state and ZIP code in locations throughout the United States and its territories. For ***foreign*** per diem rates, go to "http://aoprals.state.gov/web920/per_diem.asp." Converting foreign dollars to U.S. dollars for expense purposes can be done at "http://www.oanda.com/convert/classic."

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

DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES - §274; §162

50% of Meal and Entertainment Expenses Not Deductible (§274(n))

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

80% of business meals deductible for transportation employees. Individuals may deduct a higher percentage of the cost of food and beverages while away from home during, or incident to, a period of duty subject to the hours-of-service limitations of the Department of Transportation. Individuals subject to these limitations include:

1. Certain air transportation employees such as ***pilots, crew***, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations;
2. Interstate ***truckers*** and interstate ***bus drivers*** pursuant to Department of Transportation regulations;
3. Certain railroad employees, such as engineers, conductors, train crews, dispatchers, and control operations personnel pursuant to Federal Railroad Administration regulations; and
4. Certain ***merchant mariners*** pursuant to Coast Guard regulations.

Exceptions to the 50% Reduction Rule (i.e., These Are 100% Deductible Meals and Entertainment!)

There are ten exceptions to the 50% limitation rule:

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

How the Reimbursement Rules Apply to Independent Contractors Who Report and Substantiate Expenses to Clients and Customers.

If the independent contractor does NOT adequately account to the client/customer for the travel expenses, to the extent not so substantiated, the reimbursement must be included in the independent contractor's income (§1.274-5T(h)). If the independent contractor *does* adequately account to the client/customer, the reimbursed expenses **cannot** be included in the independent contractor's income (§1.274-5T(h)(2)).

But, even if the independent contractor doesn't properly substantiate to the client or customer, isn't it simply a wash as the independent contractor can deducted the travel expenses "above the line?"

> **Tax planning.** The independent contractor who buries the expenses in his or her fee is stuck with the 50% limitation of meals and entertainment expenses. Additionally, the client/customer must report the expenses as income on the Form 1099 sent to the independent contractor.
>
> **Example.** Some consultants charge a "flat fee" for airfare and travel expenses, e.g., $1,000 per trip. "Flat fee" arrangements do **not** qualify as an accountable plan as the independent contractor has not provided proper substantiation to the client.

Final Regulations Promulgated That Accountable Plan Rules Apply to Independent Contractor Expense Account Reimbursement Plans (T.D. 9625; Final Reg. §1.274-2(f))

Reimbursement arrangements involving persons that are not employees. In the case of an expense for entertainment, amusement, recreation, food, or beverages of a person who is not an employee (referred to as an independent contractor) in performing services for another person (a client or customer) under a reimbursement or other expense allowance arrangement with the person, the disallowance of deduction for certain expenses for entertainment, amusement, recreation, or travel limitations and the 50% disallowance rule (§274(n)(1)) apply to the party expressly identified in an agreement between the parties as subject to the limitations. If an agreement between the parties does not expressly identify the party subject to the limitations, the limitations apply:

1. To the independent contractor to the extent the independent contractor does not properly account (see §274(d) substantiation rules) to the client or customer; or
2. To the client or customer if the independent contractor properly accounts to the client or customer (see also §1.274-5; §1.274-2)(f)(2)(iv)(C)).

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

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

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

Fire Investigator Entitled to Unreimbursed Employee Vehicle Expense Deduction (*Mark Pelot v. Comm. pro se*, TCS 2014-23) Court, but not IRS auditor, impressed with extensive auto log. Mark Pelot, a Michigan fire investigator employed by Certified Investigations International, Inc., was required to travel to locations away from CII's main office to examine the site of a fire or interview relevant parties. CII did not reimburse Mark for transportation, vehicle, or any other related expenses. He also maintained a log containing information about fires he investigated during 2010, the year at issue, which included the address of each fire and the investigator assigned to it. Mark also maintained a contemporaneously prepared log of his daily activities that included (in part) the file number of each fire, the street name, the activity performed, and his start and end times on each activity and his odometer readings. Mark claimed $13,929 of vehicle expenses on Form 2016. The IRS disallowed ALL of Mark's miscellaneous itemized deductions for lack of substantiation. The Court concluded that Mark's records adequately substantiated that he drove 21,058 business miles at 50¢ a mile (so he was allowed $10,529). However, he was only allowed $622 of his claimed $5,019 other expenses (parking fees, over-night travel expenses, meals, etc.) for lack of substantiation.

No Mileage Logs for Vehicle Expenses of Carpet Cleaning Business (*Leon E. and Margaret I. Daniels v. Comm.*, TCS 2014-16)

Leon Daniels owned and operated A1 Carpet Cleaning in Washington. He owned nine vehicles that were used to varying degrees in connection with the cleaning business. Leon estimated he used four of the vehicles for business use 75% of the time; however ,he did not keep mileage logs. Instead, Leon provided his tax return preparer with a handwritten sheet summarizing his vehicle expenses and the percentage of business use for each vehicle. Although the court had no doubt that Leon used these vehicles partially for business purposes, the court agreed with the IRS that Leon's failure to substantiate the business use of the vehicles forecloses ***any*** deduction for expenses related to the four vehicles as he did not comply with the strict substantiation requirements of §274(d).

> **Preparer note.** In addition, he did not retain any receipts for the expenses reported and *did not establish the total miles driven during the years at issue with the January 1 and December 31 odometer readings.*

Unsubstantiated Deductions Not Allowed for Kentucky Dog Trainer (*Lawrence E. Krohn and Stephanie Krohn v. Comm., pro sese*, TCS 2014-12; Larry Krohn YouTube)

During 2009, Larry Krohn worked full-time for the U.S. Department of Homeland Security. He also operated a dog training franchise business out of his Louisville home called Sit Means Sit. On his Schedule C, he reported $9,284 of gross receipts and $38,091 of total expenses. The expenses included, among other things, the following disputed amounts: $1,181 for meals and entertainment; $1,482 for travel; $10,776 for car and truck expenses; $2,283 for "Vet Bills;" $185 for "Dues and Membership;" $1,010 for "Shows;" $635 for "Boarding Fees;" $247 for "Books and Videos;" $58 for "Printing;" $49 for "Postage;" and $5,750 for "Amortization."

Bad records didn't result in loss of all deductions. Allowing his shows, boarding fees, books and videos, printing and postage expenses, the Court found Larry's testimony by itself to be credible. But the Court also found his records and testimony to be insufficient and denied his deduction for the dues and membership expenses and amortization. Larry was also unable to convince the Court that he did not keep his dogs for personal pleasure and that the vet bills were not incurred primarily for personal purposes, and it disallowed Larry's veterinary expense deduction.

Meals and entertainment: credit card statements didn't indicate either business purpose or if meals were "away-from-home." In an effort to substantiate his meal expenses, Larry submitted credit card and banking statements that showed amounts and dates of payments to various restaurants. These documents, however, failed to substantiate the *business purpose* of each meal. Moreover, Larry failed to show that he paid or incurred these expenses as part of a trip that required him to stay overnight.

> **Planning point.** By themselves, credit card statements meet all the required documentation to substantiate a business expense ***except*** for the business purpose of each expenditure or use.

Car and truck expenses: not substantiated by adequate contemporaneous logs nor did the logs record the beginning and end mileage for the year. Larry also reported $10,766 of car and truck expenses on his Schedule C. At trial, Larry conceded that he kept "extremely sloppy" notes to record data on his business trips in 2009 and that he "possibly" had these notes but was unable to produce them for trial. Larry did produce a copy of a Skilcraft notebook labeled "Mileage Log 2009" and an Excel spreadsheet labeled "Travel Expense Report" but conceded that the mileage log and the travel expense report were not made contemporaneously with or shortly after his business trips but rather were made after the IRS started the examination. For that reason alone, the Court determined that his records did not meet the "adequate records" test. Moreover, neither the mileage log nor the travel expense report showed the total mileage, i.e., business and personal mileage, for all use of the automobile during 2009, as required by the strict substantiation requirements (see §1.274-5T(b)(6)(i)(B)). Accordingly, the Court agreed with the IRS's determination disallowing Larry's claimed deductions for his car and truck expenses.

Realtor's Auto Expenses Disallowed Because of Phony Logbook *(Toraino Hardnett and Marvell Preston-Hardnett v. Comm.,* TCS 2013-56)

Deducted 37,000 business miles and checked "NO" if she had supporting records. Ms. Preston-Hardnett reported on Schedule C that she drove 20,451 miles while conducting real estate sales for RE/MAX in the Miami area and supervising repair work on an investment property, 28,871 miles while commuting, and 8,420 miles for "other" activities. On part IV of Schedule C, she checked the box for "NO" in response to the question whether she had records to support the reported vehicle expenses. Using a standard mileage rate, Ms. Preston-Hardnett reported total vehicle expenses of $10,328.

Contemporaneous records required to claim auto expenses. Ms. Preston-Hardnett testified that she maintained an "At-A-Glance" day planner and a notebook to record the mileage that she drove for business purposes during 2008. The day planner and the notebook included entries listing the dates that Ms. Preston-Hardnett met with real estate clients, the names of the clients, and the number of miles driven for each meeting. Ms. Preston-Hardnett testified that she normally recorded information in the day planner and the notebook contemporaneously, i.e., on a daily basis after the meetings took place.

Probably not contemporaneous record keeping if 2008 records show up on 2013 day planner. Under cross-examination by the IRS attorney, Ms. Preston-Hardnett acknowledged that some of the entries in the notebook had been altered (i.e., the portion of the date indicating the year was obliterated) and that one of the entries was for a date in 2010. In addition, the day planner included an order form which provided a convenient way for the owner to purchase a new day planner for the coming year. In this case, the order form was for the calendar year 2014, a fact that completely undermined Ms. Preston-Hardnett's testimony that she recorded information in the day planner contemporaneously in 2008.

Realtor lost all vehicle deductions. Since Ms. Preston-Hardnett failed to satisfy the strict substantiation requirements for vehicle expenses imposed by § 274(d), the Court agreed with the IRS disallowance of ALL auto expense.

Real Estate Broker Denied Business Deductions without Required Logs (*Ron Niv, pro se. v. Comm.,* TCM 2013-82)

Ron Niv worked as a mortgage and real estate broker in California. He also invested in various real estate projects. In 2006 and 2007, Ron deducted thousands of dollars for travel, meals, entertainment, automobile, and computer expenses on Sch. C. While Ron was able to produce books and records proving that many of these expenses were incurred and paid, he failed to present records meeting the strict substantiation requirements of §274(d) for travel, entertainment, gifts, autos, and laptops. The only evidence he presented to support the business purpose of these expenses was his own broad self-serving testimony and uncorroborated notes. The Court determined it was under no obligation to accept uncorroborated and self-serving testimony and denied 100% of the related deductions.

Preparer note. Not coincidentally Ron did not file his 2006 and 2007 tax returns by the due date. Late filed returns are given a higher level of audit scrutiny.

Coded Vehicle Log Adequate But No Deduction for Commuting Code (*Vladimir Gorokhovsky v. Comm.*, TCM 2013-65)

Vladimir Gorokhovsky was an aviation and criminal defense attorney who practiced out of a Milwaukee office. Vladimir also maintained an office in the basement of his Mequon, Wisconsin home. Vladimir meticulously maintained coded travel logs to his travel and vehicle expense deductions claimed on 2006 and 2007 tax returns. He submitted detailed travel records at trial and explained to court that all of his log entries were categorized into one of three codes. "Code 1" represented travel from his home to his Milwaukee office; "Code 2" represented travel to a temporary work location, the Federal courthouse in Chicago; and, "Code 3" represented all other business travel neither originating nor concluding at his home. The court ruled Vladimir's records satisfied the strict reporting requirement of §274(d) and allowed the vehicle expenses related to entries labeled "Code 2" and "Code 3". However, the court also ruled that the home office was not a principal place of business and disallowed the expenses labeled "Code 1".

Reconstructed Records Okay but More Than Testimony Needed (*Carolyn Smith-Hendricks, pro se. v. Comm.*, TCS 2013-22)

Carolyn Smith-Hendricks worked for the Belleville News-Democrat as a newspaper reporter in Belleville, Illinois. Under its accountable employee expense reimbursement plan, the News-Democrat reimbursed Carolyn for 7,426 miles in 2009 and 8,299 miles in 2010 for work related use of her personal vehicle. Over and above the amount she was reimbursed, Carolyn claimed vehicle expense deductions on her tax returns of $7,079 in 2009 and $10,845 in 2010.

Records destroyed in flood. Carolyn testified that her tax records for 2009 and 2010 were destroyed when her basement flooded. Although she provided some documents at trial, she generally did not reconstruct the various records needed to substantiate expenses she deducted. The court noted that if a taxpayer's records are destroyed or lost due to circumstances beyond his or her control, the taxpayer may meet the substantiation requirements of §274(d) by reasonably reconstructing the expenditures through other credible evidence (§1.274-5T(c)(5)), but the taxpayer is required to reconstruct pertinent records to the fullest extent possible (*Yung Chong v. Comm.*, TCM 2007-12). If no other documentation is available, the Court may, but is not obliged to do so, accept credible testimony of a taxpayer to substantiate a deduction (*Leslie Freeman, Jr. v. Comm.*, TCM 2009-213). Carolyn, however, did not offer the court a mileage log, a reasonable reconstruction of the expenses, or any other secondary evidence corroborating her testimony that she incurred car and truck expenses, and the court ruled for the IRS.

Also see:

- *Keith Dunford and Ena Dunford v. Comm.*, TCM 2013-189, where laptop deduction denied because the taxpayer did not have a log or other evidence indicating the percentage of their laptop use that was for business purposes needed to satisfy the §274(d) requirements.
- *Charles Barocas v. Comm.*, TCM 2013-106, where commercial real estate agent's auto expense deduction for 14,123 business miles was disallowed because strict substantiation requirements not met.

- *Sequare Daniel-Berhe, pro se v. Comm.*, TCS 2013-33, where adjunct engineering instructor teaching part-time at five different Los Angeles-area colleges and universities was denied auto expenses because he did not meet strict substantiation requirements for listed property.
- *John and Macella McCormack v. Comm.*, TCS 2013-9, where no depreciation was allowed for vehicle absent a supporting mileage log.
- *Nicholas M. Brown, pro se. v. Comm.*, TCS 2013-21, a California electrician was denied vehicle expense deductions because no destinations were recorded in his contemporaneous notebook. Brown's testimony was not enough to satisfy the strict requirements of §274(d).
- *Thomas A. Wagoner, pro se. v. Comm.*, TCS 2013-14, where self-employed attorney's auto expenses were disallowed when his only evidence of business use was his own vague testimony.
- *Mohammed A. Rehman v. Comm.*, TCM 2013-71, where Court believed the log to "substantiate" taxpayer's auto expenses was prepared in one fell swoop long after the dates in question.

Final Regulations for Deducting Business Aircraft Used for Entertainment (T.D. 9597; REG-147171-05; Notice 2005-45)

Deduction limited to amount included in W-2 or reimbursed. When executives use business aircraft for entertainment, the deduction is limited (§274(e)(2)). Effective August 1, 2012, final regulations relating to the deduction limitation were issued. Few surprises exist from the 2007 proposed regulations. Generally, the deduction of personal entertainment use by those with control over the business's costs (called "specified individuals") is limited to the amounts included in the specified individual's income or the amount the individual reimbursed the business. Specified individuals include officers, directors, more-than-10% owners, 10% shareholders, 10% equity partners/members, and managing partners/members of a partnership/LLC. Air travel is not business entertainment air travel merely because a taxpayer-provided aircraft is used for the travel as a result of a bona fide security concern. In addition, entertainment does not include personal travel that is not for entertainment purposes. For example, travel to attend a family member's funeral is not entertainment (§1.274-10(b)(1)). The final regulations retain the occupied seat hours or miles and flight-by-flight allocation rules and contain extensive examples.

Applicable Terminal Charge and SIFL Rates for Determining Value of Noncommercial Flights on Employer-Provided Aircraft Issued (Rev. Rul. 2013-20)

For flights taken during the period from July 1, 2013, through December 31, 2013, the terminal charge was $48.54, and the SIFL rates were $.2654 per mile for the first 500 miles, $.2024 per mile 501 through 1,500 miles, and $.1946 per mile over 1,500 miles.

Deducting Travel, Meals and Lodging While Away from Home

Determining the taxpayer's "tax home." A taxpayer is allowed to deduct travel expenses, including expenditures for meals and lodging, if the expenses are reasonable and necessary, incurred "while away from home", and made in pursuit of a trade or business[20]. Although the term "home" (or "tax home") normally means a taxpayer's principal place of employment (and not the taxpayer's personal residence)[21], an exception

[20] §162(a)(2); *Comm. v. Flowers*, 326 U.S. 465, 470 (1946).

[21] See *Mitchell v. Comm.*, 74 T.C. 578, 581 (1980).

to this rule arises when a taxpayer accepts employment away from his or her personal residence and the employment is temporary rather than indefinite[22]. The purpose underlying this exception is to relieve the taxpayer of the burden of duplicate living expenses while at a temporary employment location, since it would be unreasonable to expect him to move his residence under such circumstances[23].

The Away-from-Home Requirement

Whether these expenses are deductible or not largely depends on if the taxpayer is "away from home," which means the taxpayer must first determine the location of his or her tax home. As mentioned previously, in order for traveling expenses to be deductible:

1. They must be ordinary and necessary[24],
2. They must be incurred **while away from home**, and
3. They must be incurred in the pursuit of a trade or business (that is, personal travel will never be deductible).

The taxpayer is traveling away from home if:

1. The taxpayer's duties require him or her to be away from the general area of the tax home substantially longer than an ordinary day's work, and
2. The taxpayer needs to get sleep or rest to meet the demands of his/her work while away from home (See §162(a)(2); Rev. Rul. 60-189; Rev. Rul. 83-82; *Comm. v. Flowers* 46-1 USTC 9127l Pub 463, p.2).

The "away from home" requirement is where we find the largest problems in a tax audit.

Transfer stops travel deduction: Once a taxpayer moves his or her family to a new business location (e.g., is permanently transferred), the travel deduction ceases, as the "temporary away-from-home" expense becomes an "in-town" personal expense (*Comm. v Mooneyban*, 69-USTC 9106; Rev. Rul. 75-432).

The away-from-home requirements compel answering two questions:

1. **Where is the taxpayer's home for tax purposes?**
2. **What is the period the taxpayer needs to be away?**

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[22] See *Peurifoy v. Comm.*, 358 U.S. 59, 60 (1958); *Deamer v. Comm.*, T.C. Memo. 1984-63, aff'd, 752 F.2d 337 (8th Cir. 1985).

[23] *Tucker v. Comm.*, 55 T.C. 783, 786 (1971).

[24] A basic requirement of a business expense is that it must be ordinary and necessary. a fairly easy standard to meet as: (1) an expense is "ORDINARY" if it's ordinary or customary in the taxpayer's business and (2) a "NECESSARY" expense is one which is appropriate and helpful in developing and maintaining the taxpayer's business (§162(a)).

Where Is the Home Required to Be Away From? - Determining Tax Home

It's generally the taxpayer's place of business (Test 1). Generally, a taxpayer's "home" is considered to be located:

1. At the taxpayer's regular **place of business** (it includes the **entire city or general area** according to the IRS in Pub. 463, p. 3), regardless of where the family home is maintained, **or**
2. At the taxpayer's principal place of business (e.g., a salesperson servicing a well-established route) if the taxpayer has more than one regular place of business, regardless of where the family home is maintained, **or**
3. If the taxpayer has no regular or principal place of business (e.g., construction workers), then at the taxpayer's **regular place of abode** in a real and substantial sense (Rev. Rul. 73-529; Rev. Rul. 60-189; may need spouse and children, see Rev. Rul. 71-247, 1971-1 CB 54).

   Example. This means that Alex Rodriguez cannot choose to live on the weekends with his family in Florida, work and live in New York during the week, and deduct the New York meals or apartment. New York is his "home" in spite of where his family lives, as that is where he works.

The taxpayer is only allowed travel away from home deductions if the absence from the home is temporary, not indefinite or permanent. If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually exceeds 1 year. If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes and will be treated as not temporary after that date (Rev. Rul. 99-7).

Living Away from Your Tax Home

Therefore, if you (and your family) live in an area outside your tax home (main place of work), you cannot deduct travel expenses between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home.

Strangely, if you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home.

> **Example.** Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore. Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. ***You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh*** (Pub 463, p.3).

Going Home on Days Off

But, if you go back to your tax home from a temporary assignment on you days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there.

"However, (according to IRS instructions) you can deduct your travel expenses, including meals and lodging, while traveling from the area of your temporary place of work to your hometown and back to work. You can claim these expenses up to the amount it would have cost you for meals and lodging had you stayed at your temporary place of work. If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work" (Pub. 463, p.4).

> **Preparer note.** As we will see, the italicized section seems to conflict with a number of court cases and other PLRs.

Example: 140-Mile Travel Was a Long Commute - and Nondeductible

Automobile and personal living expenses paid by a sole proprietor who stayed in motels near his *business* during the week and drove 140 miles to his *residence* on weekends were *not* deductible. The expenditures were *not* incurred while the taxpayer was "away from home" or while he was "in pursuit of the requirements of the business." The taxpayer's "tax home" was the city where his *business* was located; his *residence* was located elsewhere for "personal" rather than "business" reasons. *(Kirsch*, TC Memo 1995-451; also see: *Marc Jordan v. U.S.*, (DC MN) Civ. 04-3800 (JNE/RLE), March 23, 2006, reimbursement of pilot's travel expenses from Bemidji to Anchorage was taxable commuting expenses).

Multiple Work Locations

When there are multiple areas of business activity or places of regular employment, **the principal place of business** is treated as the tax home for the travel expense deduction (so choose one). In determining the principal place, the taxpayer should consider (1) the time spent on business activity in each area, (2) the amount of business activity in each area, and (3) the amount of the resulting financial return in each area.

Three tests to determine abode location if no place of work:

Assuming that the job is expected to last less than one year (this additional rule is discussed later in this chapter), meeting all three criteria means the IRS will recognize the home; meeting two out of three tests requires the taxpayer to additionally use the facts-and-circumstances test; meeting only one of the three tests requires the IRS to determine the taxpayer an “itinerant,” and therefore the tax home will be wherever the taxpayer happens to work (i.e., no travel deductions).

Example: The Tax Home Isn’t Always Where Taxpayer Lives - Resulting in Loss of Lodging and Meals Deduction

Travel, lodging, and meal expense reimbursements paid by a state (Mississippi) to a state supreme court justice for his sitting at various sessions of the state supreme court were *not* “business expenses” but instead were *nondeductible* “personal commuting expenses.” The justice maintained a residence in the city where the court was located, while his wife maintained a another home in the city where he also taught law school. Nevertheless, his “tax home” was determined to be the city where the court was located. His earnings as a justice *greatly exceeded* his earnings as a professor. Thus, his travel expenses were *not* incurred “while away from home” in pursuit of a trade or business (*Judge James Lawton Robertson,* 99-2 USTC ¶50,875 (CA-5)).

Again - Tax Home Isn’t Always Where Taxpayer Lives

Forensic psychiatrist Marvin Ziporyn, a Chicago resident, acted as a court psychiatrist for Los Angeles County from Wednesday through Friday, and met patients in Chicago for approximately 4 hours on Mondays. The tax court concluded that Ziporyn’s tax home was California as that he was present in California three business days each week, that he earned significantly more income from his employment in California than from his practice in Illinois, and that his employment in California was not temporary. Therefore he lost his lodging, meals, and other expenses while in California. The court did, however, allow the psychiatrist a business expense deduction for the substantiated cost of traveling between the two states, as he was traveling between two business locations (*Ziporyn,* TC Memo 1997-151).

No Work Location (the "Turtle" Rule - for Itinerant Workers)

If the taxpayer has **no** permanent place of **business (test one) or residence (test two and three),** the courts have consistently denied the taxpayer’s deduction for meals and lodging, since there is no "home" to be away from (e.g., construction workers, salesmen, some speakers.) They are considered to be “itinerants” whose “home” is located wherever they happen to be working, and thus are never "away from home" for travel expense deduction purposes (Rev. Rul 60-189; Rev. Rul. 73-529; *George H. James v. US,* 62-2 USTC ¶9735; *Robert H. Castor v. Comm.,* TC Memo 1991-307).

> **Example: Touring stage hand living in hotel could not deduct “away from home” expenses - turtle rule, e.g., had no tax home**. A *divided* Ninth Circuit has affirmed a Tax Court decision, holding that a stage hand for an ice skating show on tour was *not* “away from home” and thus was *not* allowed to deduct his travel expenses. While James Henderson traveled as a lighting technician for Walt Disney's World on Ice, he left most of his belongings at his parents’ home in Boise, Idaho. Henderson returned to Boise between tours, staying with his parents rent-free. Henderson deducted his travel expenses on his 1990 tax return, asserting that his “tax home” was his parents’ house. The IRS disallowed the deduction, and the Tax Court sustained the Service’s determination. Circuit Judge Charles Wiggins, citing *James v. United States*, 308 F.2d 204 (9th Cir. 1962), concluded that

Henderson did *not* have a “tax home” because he didn't incur "substantial, continuing living expenses in Boise that were *duplicated* by his expenses on the road." (**Also see *Jeffrey J. Pries v. Comm.***, T.C. Memo. 1991-177 where ballplayer's 7-months travel expenses not deductible as before and after the baseball season, Pries lived with his parents in California. He paid no rent to his parents for living at their home) [*James Henderson, CA-9, 98-1 USTC ¶50,375*].

Example: Dispatcher living in RV could not deduct “away from home” expenses - turtle rule. A road construction dispatcher who worked at a series of temporary jobs and who, for the year at issue, lived in her recreational vehicle near her *place of employment* and spent weekends at her *residence* could *not* deduct “away-from-home” travel, meal, and lodging expenses. She failed to establish that she was “away from home” while living near her place of employment. Even though the taxpayer owned a home, the Court determined that this was *not* her “tax home” because she did *not* establish that she had any “business prospects or ties to where her home was located, which was over 300 hundred miles away from her place of employment.” Further, the relationship with this particular employer, who was her *only employer for the last two years*, was a “continuing one,” subject only to the availability of projects requiring the taxpayer’s skills. (Also see *Neil D. Staley*, TC Memo 1991-409 where an itinerant construction worker had no tax home where he was employed on a number of job sites for short periods of time and simply towed his house trailer from site to site. Again, no away-from-home deductions were permitted.) [*G.M. Weichlein*, TC Memo 1995-553].

Minimum Period of Time Needed to Be Away

The "overnight" or "sleep or rest" rule: A taxpayer is not “away” unless his work requires him to be away from the general area of his tax home for a period substantially longer than an ordinary workday and it is reasonable for him to need sleep or rest (Rev. Rul. 75-170; Rev. Rul. 75-432).

Need not be 24 hours for lodging: Travel expenses may be deductible even though the taxpayer is away from his home for a period of less than 24 hours (Rev. Rul. 75-432; *K. Waters*, 12 TC 414, Dec. 16,873).

Meals only deductible if taxpayer away “overnight”: A stricter “overnight” test is applied to determine the deductibility of business meals. The costs of meals on one-day business trips away from home are not deductible if the trips are not overnight trips (*H.O Correll*, (Sup. Ct.) 68-1 USTC 9101, 389 U.S. 299).

Example: George M. drives from his home in Buena Park to a speech in Los Angeles and returns **the same day**. Therefore, the automobile costs, but **not the meals**, would be deductible. And if George is reimbursed for the meals, this amount must be added to his taxable income!

Maximum Time Period You Can Be Away - Temporary vs. Indefinite

Taxpayers may regularly work within their general area of their tax home and also work or conduct business at another location and find it impractical to return home from this other location at the end of each day’s work. If this assignment or job away from the main place of work is *temporary*, the tax home does not change. However, if the assignment or job is *indefinite,* that location becomes the taxpayer’s new tax home.

Temporary vs. indefinite: Only *temporary* travel expenses are deductible (e.g., if the end of the employment can be foreseen within a fixed and reasonably short time[25]). Temporary employment may become indefinite, however, if it is expected to last for a substantial, indefinite, or inderterminate duration or due to changed circumstances of the passage of time[26]. If the work assignment is for an *indefinite* period of time (e.g., the jobs end cannot be foreseen within a fixed and reasonably short period of time), the new work location also becomes the taxpayer's new "tax home," and he/she relinquishes all the "in-town" travel expenses (i.e., no deduction for travel, meals and lodging at the new location). Additionally, the taxpayer must include in his or her income any amounts received from the employer for living expenses, even if they are called travel allowances and the taxpayer accounts to the employer for them (Pub. 463, p.3). Whether an employment opportunity is temporary or indefinite normally depends on the facts and circumstances of each case, and the burden of proving that employment was temporary rests on the taxpayer (Rule 142(a); *Peurifoy v. Comm*., 358 U.S. at 60-61; *Welch v. Helvering*, 290 U.S. at 111).

Indefinite away from home travel deductions denied to professor on tenure track: A full-time assistant professor was *not* entitled to deduct travel expenses incurred during a year in which she held a tenure track position. ***Her employment was found by the Court to be indefinite, not temporary.*** Although the professor could have been terminated at the end of her nine-month appointment, there was "no indication that the college intended to limit the duration of her employment" and in the eyes of the Court "she had a reasonable expectation that her employment would continue for a substantial or indefinite period" (*E.H. Turner*, TC Memo 1997-522).

So What Is the Time Difference Between Temporary and Indefinite?

Temporary - one year or less: The Internal Revenue Code states that a taxpayer's employment shall not be treated as "temporarily away from home during any period of employment if such period exceeds 1 year" (§162(a), last sentence). The result is that when the travel period exceeds one year, the travel expenses are not deductible *starting on the first day of traveling!* Effective August 5, 1997, Federal crime investigators are exempt from the one-year away-from-home rule.

The Problem: Length of Travel Determination Must Be Made on the First Travel Day!

The problem is that this determination must be made when the taxpayer **starts** work, although the IRS won't audit it until two years later! Therefore, the **anticipated length of time** away from the business is critical to this deduction (Pub. 463, p.4).

Anticipation is the key! Here is the bizarre guidance issued by the IRS on the treatment of traveling expenses: employment in a single location away from home which is expected to and does last one year or less will be considered temporary (Rev. Rul. 93-86).

> **Example - Deductible travel with both intentions and actions good.** Will leaves home on July 1, planning to come back on April 15th of the next year. His travel expenses from July 1 through December 31 are fully deductible, as are also his expenses from January 1 to April 15.

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[25] *Norwood v. Comm.*, 66 T.C. 467, 469 (1976).

[26] *Norwood v. Comm.*, 66 T.C. 467, 469-470 (1976); *Kroll v. Comm.,* 49 TC 557, 562 (1968).

Employment expected to last more than one year will be treated as indefinite (i.e., not deductible away- from-home expenses), regardless of whether the employment exceeds one year.

> **Example - Not deductible travel with both intentions and actions bad.** Will leaves home on July 1, planning to come back on July 15 of the next year. His travel expenses, even from July 1 through December 31, are NOT deductible.

> **Example - Not deductible travel with actions good BUT intentions bad.** Will leaves home on July 1, planning to come back on July 15 of the next year *but actually coming back on June 15th*! His travel expenses from July 1 to June 15 are *not* deductible, as his beginning attitude is bad!

Employment initially expected to last one year or less that is later expected to last longer than one year will be treated as temporary until the date the expectation changes.

> **Example - Deductible travel until intentions turn bad!** Will leaves home on July 1, planning to come back on June 15th but doesn't discover that his foreign duty has been extended to July 15th until June 1. His travel expenses from July 1 through December 31 and from January 1 to June 1 are deductible. His travel expenses from June 1 to July 15th are NOT deductible. (Query: Trying to determine when Will discovered his date changed should make an interesting audit issue!)

> **Query.** Rev. Rul. 93-86 seems to change the intent of Code §162(a) by introducing the "in a single location" restriction. This author is perplexed...evidently this means that Will could go to two different locations for nine months each and deduct the entire 18 months of travel!

Individual Allowed Away-From-Home Travel for Full-Time Job Lasting Only Seven Months (*Roj C. and Patricia Snellman v. Comm. pro sese*, TCS 2014-10)

Family lived in Florida and full-time job was in Missouri. During 2009, Roj Snellman maintained a personal residence in Indialantic, Florida with his wife and four children. Roj was unemployed during the first several months of 2009, but on May 26, 2009, he began work as a project manager for U.S. Fidelis, Inc. in Wentzville, Missouri. Although Fidelis informed Roj that he would be paid an annual salary of $90,000, he understood that Fidelis expected the project to be completed no later than December 31, 2009, and that his employment would end at that time. In addition, Roj would not be reimbursed for expenses related to his employment, nor did Fidelis offer to assist Roj in moving to Missouri. On May 24, 2009, Roj drove from his home in Florida to Missouri. Roj stayed in a hotel in Missouri from May 25 to June 10, 2009, and on June 11, 2009, signed a monthly lease agreement to rent an apartment in St. Charles, Missouri, for $525 per month. Fidelis began to experience financial difficulties, and Roj's employment ended abruptly on November 2, 2009. After collecting his final paycheck, he drove back to Indialantic on November 18.

IRS denied "away-from-home" deductions, arguing tax home was where taxpayer worked. Taxpayer argued tax home was where family lived and deducted travel, meals, and lodging at temporary work location. The IRS determined that Wentzville, Missouri, his place of work, was Roj's tax home between May 24 and November 18, 2009. Roj argued that his tax home was Indialantic, Florida—his place of residence during 2009. The Court agreed with the taxpayer. In their opinion, the Court felt Roj was hired as a temporary project manager for a single project that was scheduled to end no later than December 31, 2009, approximately seven months after his date of hire. The facts showed that Roj's employment with Fidelis ended a month earlier in November 2009. The Court concluded that Roj's employment with Fidelis was temporary, as opposed to indefinite, and, therefore, his tax home for 2009 was Indialantic. The temporary status was corroborated by an apartment lease that was scheduled to expire on December 31 and he negotiated an addendum to the lease agreement to allow for termination of the contract on short notice.

> **Planning idea.** As this case illustrates, although the term "home" (or "tax home") normally means a taxpayer's principal place of employment (and not the taxpayer's personal residence), an exception exists when a taxpayer accepts employment away from his or her personal residence and the employment is temporary rather than indefinite.

Deducting $170 per day meals and lodging not permitted. IRS denied entire deduction for lack of proper substantiation, but Court allowed a meals per diem amount and estimated an actual lodging deduction. Really! On Form 2106-EZ, Roj reported expenses for travel while away from home of $27,200—an amount he derived by multiplying 160 days (the total number of days he purportedly spent in Missouri) by a per diem rate of $170 for meals, incidental expenses, and lodging. The IRS asserted that Roj spent only 136 days in Missouri for business purposes in 2009, he had failed to properly compute the deduction claimed for meal expenses, and he was not entitled to compute the amount of any deduction allowable for lodging expenses on a per diem basis. The Court allowed Roj to deduct a daily "meals and incidential expense" per diem amount and allowed him to deduct the actual lodging expenses that they *estimated,* as Roj didn't have any hotel receipts (from May 25 to June 10) but did have the monthly lease agreement (starting June 11). The Court disallowed the hotel expenditures but concluded that Roj was "entitled to a deduction for lodging expenses of $2,975, comprising a pro rata share of the monthly rental charge for June and full monthly charges for July through November," as evidenced by the lease agreement.

Taxpayer allowed one round-trip mileage without auto log. Roj deducted 7,381 miles in connection with his employment at Fidelis. But, the Court pointed out, there was no evidence that he maintained any records or notes related to his vehicle expenses at the time they were incurred. "Taxpayers lacking a contemporaneous log are expected to maintain a record created as near in time as possible to the particular expenditure or business use, supported by corroborative documentary evidence that carries with it a high degree of probative value (§1.274-5T(c)(1))." Although the mileage log itself was of little to no value to the Court, there was no question to the Court that Roj drove from Florida to Missouri and back, in May and November 2009, respectively, in connection with his employment with Fidelis, a distance of approximately 2,210 miles. The Court held that Roj was entitled to a deduction for vehicle expenses of $1,215 (at 55¢ a mile) to account for the cost of transportation to and from his temporary work location.

> **Planning idea.** An auto log isn't always required if other evidence exists and the Court is willing to say "it's only logical."

OTHER GENERAL TRADE OR BUSINESS EXPENSES

Expense Advances are Loans, Not Deductions for Law Firm (*Humphrey, Farrington & McClain, PC v. Comm.*, TCM 2013-23)

Humphrey, Farrington & McClain, PC (HFM) was a law firm from Independence, Missouri that practiced primarily in product liability, medical malpractice, consumer antitrust, and securities fraud. HFM prepared its returns using the cash method of accounting.

No guaranty-advanced expenses will be reimbursed. HFM routinely paid litigation expenses (e.g., court fees, expert witnesses, medical records, travel, etc.) on behalf of its clients. Whether HFM was reimbursed for advanced expenses depended on its agreement with its clients and the litigation results. The vast majority of HFM's cases were contingent fee arrangements, meaning HFM was paid only if there was a favorable outcome. Generally, expenses incurred during the litigation process were paid by HFM who was then reimbursed if there was a favorable outcome in the case. Occasionally, HFM entered flat fee (hourly or other) contracts where they were reimbursed for all expenses, regardless of outcome.

HFM's tax treatment of advanced expenses. HFM incurred a total of $675,713 of advanced expenses in 2005, of which it deducted $602,493 on its tax return and capitalized $73,220. To decide whether advanced expenses should be deducted or capitalized, HFM used its judgment to determine the likelihood that the expenses would be reimbursed on a case by case basis. If it determined it unlikely that they would be reimbursed in a particular case, HFM immediately deducted case related expenses. If it determined that reimbursement was likely, it capitalized the expenses. Capitalized expenses were recorded as a current asset on HFMs balance sheet.

Are advanced expenses really just loans? IRS says yes. HFM argued that advanced expenses are treated as loans only if there was an expectation of reimbursement. It also claimed that its treatment of the advanced expenses did not produce undue tax benefits because, when previously deducted expenses were reimbursed, it included the reimbursed expenses in income on its tax return for the year the reimbursements were received. The IRS countered that advanced expenses were loans to HFM clients and were not deductible if the law firm's contingent-fee arrangements provide for reimbursement upon a favorable litigation outcome. The expectation of reimbursement is irrelevant as long as the law firm had a contingent right of reimbursement. HFM was only entitled to a bad-debt deduction for unreimbursed expenses once a case was closed.

Court says even if HFM was, right it would be wrong. The courts consistently have held that advanced litigation expenses are loans, not currently deductible business expenses, even if eventual recovery is contingent (see *Hearn v. Comm.*, 36 T.C. 672 (1961), aff'd [62-2 USTC ¶9801], 309 F.2d 431 (9th Cir. 1962); *Canelo v. Comm.,* 53 T.C. 217 (1969), aff'd per curiam [71-2 USTC ¶9598], 447 F.2d 484 (9th Cir. 1971); *Silverton v. Comm.*, TCM 1977-198; *Merritt v. Comm.*, TCM 2003-187). In Merritt, the court ruled that litigation costs were not deductible even if the probability of recovery was doubtful. For HFM, the court found that even if it ignored *Merritt* and accepted HFMs argument that the ultimate recoverability should be taken into account, the evidence showed there was a significant possibility of reimbursement for the advanced expenses which HFM deducted and ruled in favor of the IRS.

Now do we need a change in method of accounting? The IRS argued that HFMs conversion from treating advance expenses as deductions to treating them as loans was an change in accounting method, requiring calculation of a §481 adjustment. The IRS conceded that it was not attempting to change HFM's overall method of accounting (from cash to accrual), but that the change in HFM's treatment of advanced expenses affects a material item and thus requires the change. The court noted that HFM's method merely accelerated the deduction of unreimbursed expenses and temporarily inflated the amounts of the deductions; the inflated deductions were then canceled out by HFM's reporting the reimbursed expenses as income. However, it ruled that the change in the treatment of HFM's advanced expenses was a change in the treatment of a material item used in HFM's overall plan of accounting, and thus a change in method of accounting. The IRS calculated §481 adjustment of $2,740,161 was therefore warranted.

Conflicting opinion in 9th Circuit. In cases involving fee arrangements where a law firm pays litigation expenses and such expenses are not subject to reimbursement ("gross fee" engagements), the 9th Circuit has ruled that the expenses are currently deductible for the law firm (*James F. and Lorraine V. Boccardo v. Comm.*, CA-9, No. 93-70850, May 26, 1995, rvsg TCM 1993-224).

Physician Entitled to Claim Deductions as Unreimbursed Employee Expenses on Form 2016, Not Schedule C (*Elizabeth A. Vitarbo v. Comm. pro se*, TCS 2014-11)

Dr. Elizabeth A. Vitarbo, a practicing neurosurgeon, conducted her medical practice as an employee of the University of Florida Health at Jacksonville, Florida, being an Assistant Professor, Department of Neurosurgery. Prior to 2008 Dr. Vitarbo had not accounted for income earned and expenses paid in her medical practice on a Schedule C. But, on her 2008 Federal income tax return, which was prepared by a paid income tax return preparer, she filed a Schedule C identifying her principal business as "MEDICAL SERVICES." This Schedule C showed a net loss of $51,454, which took into account $15,100 of income, and $66,554 of deductions. The IRS pointed out that Dr. Vitarbo did not practice medicine as a sole proprietor at any time, and therefore any income or deductions attributable to that practice were not properly reported on a Schedule C. Instead, all of the disputed deductions were properly claimed on a Schedule A, subject to reductions as provided in §67(a) and taken into account in the computation of Dr. Vitarbo's alternative minimum tax liability. The Court agreed with the IRS.

IRS Takes a Stand: Bitcoin is Anything But 'Currency'[27] (IR-2014-36; Notice 2014-21)

The Internal Revenue Service sounded a loud warning shot for all Bitcoin users: Stop calling it a virtual "currency." In the eyes of the taxman, it's anything but – and that means taxpayers must now confront a raft of ways in which Bitcoin must be reported and taxed.

In a wide-ranging Q&A, the IRS laid out a number of ways that Bitcoin can be taxed—as an asset, as income, as payment in property, as a transaction, even as self-employment income by all those "miners." No matter which approach applies, everyone puts the onus on some player to report Bitcoin activities to the IRS, creating a paper trail that enables the IRS to perform the simplest of computerized matching to generate letter "audits" asking taxpayers to explain why they failed to report a taxable event.

Practical questions for those using Bitcoin. The IRS stance builds on the assumption that Bitcoin is not a currency for a simple reason: "It does not have legal tender status in any jurisdiction." That then sets a cascade of practical questions for individual taxpayers, "miners," small businesses, brokerages, and other players to confront. For example:

- **Are you paying employees in Bitcoin?** Then pay attention to the employment taxes and withholding requirements for things like FICA – and kick out a W-2 at year's end.
- **Are you paying a contractor more than $600 in Bitcoin?** Then kick out a 1099 so the IRS can ask the recipient about their unreported income and backup withholding could apply.
- **Are your hands grubby from tunneling in search of Bitcoin?** That could constitute a trade or business and be subject to self-employment income.
- **Are you cashing in your Bitcoin at an exchange or through a brokerage?** Then you should

[27] Substantially written by Mark Schwanhausser, Javelin Strategy and Research, reprinted with permission

receive tax-filing reports at the end of the year, and then the IRS will examine your capital gain or loss.

- **Are you settling payments between merchants?** Then you've got to tell the taxman who you dealt with.

And here's the concluding warning from the IRS: Penalties could apply retroactively, not just from March 25th onward.

Preparer note. So, be on notice all you speculators who profited as Bitcoin jumped nearly tenfold to more than $1,100 in November. The IRS – and probably your state, too – want a share.

THE OFFICE-IN-HOME REQUIREMENTS - §280A

Strict Office-in-Home Rules Prevent Abuse

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

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

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

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

Being the most common method, a home office qualifies as the taxpayer's "principal place of business" if: *there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business*. This means that outside salespersons and real estate agents will often be able to deduct an office in their home.

Caution. No "investment" offices. The "principal place of *business*" rule makes personal investment activities (e.g., reading financial periodicals, clipping bond coupons, etc.) ineligible for home-office deductions, as they don't rise to the level of a "business" activity (*J.A. Moller*, CA-FC 83-2 USTC ¶9698, 721 F2d 810).

Can we deduct an office-in-home for managing a real estate rental reported on Schedule E? The court ruled in *John M. Rodriquez v. Comm.* TCM 2009-22, that John conducted a rental real-estate business in his home office and allowed a home office deduction on Schedule E.

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

Two more limitation rules apply to employees. In the case of a home office used by an employee, 1) the employee must also establish that the use of the home office is for the convenience of his or her employer (§280A(c)(1)) and 2) the employee **does not** rent all or part of the home to the employer and use the rented portion to perform services as an employee (§280A(c)(6)).

The "convenience of employer" rule. Whether the home's business use is for the employer's convenience depends on all the facts and circumstances. However, business use is not considered for the employer's convenience merely because it is appropriate and helpful.

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

> **Preparer note.** A landlord can rent real estate to an employer, whereas an employee will lose his or her deductions if she or he rents a personal residence to an employer. For example, William Cutts successfully leased 95% of his personal residence to a corporation in which he was the CEO and major shareholder (*William J. Cutts v. Comm.*, TCS 2004-8). To avoid this limitation, a written lease agreement needs to establish a landlord-tenant relationship and not an employer-employee relationship.

Calculation of Business Percentage

Previously, the business percentage was determined either by dividing the square footage of the office-in-home by the total square footage of the home (e.g., 200-square-foot office ÷ 3000-square-foot home = 6.67%) *or* by dividing the office room by the number of rooms in the house (e.g., 1 room ÷ 10 rooms = 10%) and using the percentage most advantageous to the taxpayer. No more!

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

> **Caution - make it a sensible percentage**. A tattoo artist's office occupying 59% of her home, including her entire living room and dining room, her entire bathroom, and the portion of the kitchen containing the sink, was found implausible by the court (*Karan M. Hintze v. Comm.*, TCM 2001-70). A psychologist's 400-square-foot apartment in San Francisco was considered too small to have any

space used exclusively to meet patients (*Erin Mullin v. Comm.*, TCM 2001-121). An IRS agents' claim that a home office was 42% of residence was reduced by the court to 13% (*Henry J. And Patricia K. Langer v. Comm.*, TCM 2008-255).

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

The IRS allows an optional safe harbor method for home office users to calculate their deductible home office expenses. The safe harbor method is an alternative to the calculation, allocation, and substantiation of actual expenses currently required under §280A and is effective for years beginning after Dec. 31, 2012.

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

> **Preparer note.** All other home office requirements apply (e.g., exclusive use, principal place of business, etc.).
>
> **Example.** Danielle is a writer who primarily works from her 2,000 square foot home. Danielle's home includes a 400 square foot office that is used exclusively for her writing business. As an alternative to deducting prorated actual expenses for her home office, Danielle may deduct $1,500 (300 sq. ft. maximum x $5) as her home office expense deduction and is not required to substantiate any actual home office expenses.
>
> **Variation.** Suppose that Danielle's home office is 200 square feet. Her deduction under the safe harbor would be $1,000 ($5 x 200).

Election to use safe harbor made annually. Taxpayers may annually choose to deduct actual expenses or use the safe harbor method. Consistency from year to year is not required. Taxpayers who elect the safe harbor method for a taxable year cannot deduct any actual expenses related to the qualified business use of that home for that taxable year (including depreciation). The election is made by deducting home office expenses calculated under the safe harbor method on a timely filed tax return. The election, once made, is irrevocable. A change from using the safe harbor method in one year to actual expenses in a succeeding taxable year, or vice-versa, is not a change in method of accounting and does not require IRS consent.

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

> **Example.** Ben is a sole proprietor who uses a room in his residence as a qualified home office. Ben's office is 300 square feet and has a cost basis of $10,000. The office was placed in service in 2010. For 2010, 2011, and 2012, Ben depreciated the room as nonresidential real property using the straight-line depreciation method, 39-year life. The adjusted basis of the room as of Dec. 31, 2012 was $9,241. For 2013, Ben elects the home office safe harbor method and does not deduct any

depreciation for the room on his 2013 tax return. Ben's adjusted depreciable basis in the room as of December 31, 2013 remains at $9,241.

In 2014, Ben resumes deducting actual expenses for the home office. He must use the appropriate optional depreciation table for determining the 2014 home office depreciation deduction. The depreciation rate for year five using the appropriate depreciation table is 2.564%. Ben claims home office depreciation of $256 ($10,000 X 2.564%) on his 2014 tax return and his adjusted depreciable basis at the end of 2014 is reduced to $8,985 ($9,241 less $256).

Limited double dipping allowed. Taxpayers who itemize deductions and use the safe harbor method may deduct expenses related to their home that are otherwise deductible (e.g., mortgage interest, property taxes, and casualty losses). Additionally, taxpayers who use the safe harbor method are not required to recapture any depreciation upon the sale of the residence.

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

Month-by-month calculation needed for partial year home office. Taxpayers with a qualified home office for a portion of the taxable year (i.e., business begins during the taxable year), or who change the square footage for a qualified business use of a home during the taxable year, must determine the average of the monthly allowable square footage for the taxable year. In determining the average monthly allowable square footage, no more than 300 square feet may be taken into account for any one month and taxpayers shall only be treated as having a qualified business use of a home in a month in which the taxpayer had 15 or more days of a qualified business use of the home.

Example. Eric starts a new business and begins using 400 square feet of his home as a qualified home office on July 20, 2014. He continues using the home office for the rest of the year. Eric calculates his average monthly allowable square footage as 125 square feet (300 square feet (maximum allowed) for August through December divided by the number of months in the taxable year ((300 x 5)/12)).

Preparer note. Why not $1,500 x (6/12) = $750? Must be too easy!

See: IRS Summertime Tax Tip 2013-12—Simplified Option for Home Office Deduction.

No Home Office While An Employee; Home Office Doesn't Include Hallways, Bathroom and Closet (***J.M. Fontayne pro se. v. Comm.***, **TCS 2013-54**)

Jean Marie Fontayne worked part time for Vitesse as an independent contractor from her home from January to July 2008. In July 2008, Fontayne became a full-time employee of Vitesse. Fontayne's agreement with Vitesse required her to work at Vitesse's offices two or more days a week, and she was allowed to work from her home up to three days per week. On her Schedule C Fontayne reported a tentative profit of $24,728, which was entirely offset by $24,728 of home office expenses.

Home office only allowed for first half of year. It was proper for Fontayne to deduct home office expenses for the period during which she was an independent contractor. However, once she became an employee, Vitesse provided her with an office in the company offices. Fontayne's belief that she was more productive working from home did not make her home office for the convenience of the employer. Vitesse did not require or direct her to work from home; rather Fontayne was allowed to work from home at her own request and for her own convenience. The Court ruled Fontayne was not entitled to a home office expense deduction once she became an employee.

Square footage calculation wrong. Fontayne was allowed a home office deduction during the time she was an independent contractor; however, her calculation of the business use of her home included square footage for a hallway, an entryway, a room, a bathroom, and a closet. The Court determined that the bathroom and closet were not used exclusively and on a regular basis for business, nor could they be considered areas where Fontayne conducted substantial administrative or management activities of a trade or business. The IRS proposed that Mrs. Fontayne only needed an area of 9 by 11 feet (99 square feet). The Court was more generous in its calculation of square footage used for the home office, finding the IRS calculation "arbitrary."

See also:

- *Keith Dunford and Ena Dunford v. Comm.*, TCM 2013-189, where the Dunfords unsuccessfully argued that they maintained an area in their $283,494 motor home exclusively for business use. The area they put forward as the home office was the countertop that Mr. Dunford used as a desk.
- *Thornell Johnson v. Comm.*, TCM 2013-90, where Thornell Johnson, a self-employed tax preparer, claimed that his office occupied the entire bottom floor of a rented two-story duplex. The Court did not believe that Johnson, his wife, three children (sometimes five children) actually occupied as a residence only the 572 square foot top floor of the duplex.

  Planning opportunity. The Court said collaboration of the taxpayer's statements could have been a floor plan of the home and photos. Keep that in mind if you are defending a large allocation of a home as used exclusively for business.

MARK-TO-MARKET FOR DEALERS IN SECURITIES - §475

Securities Dealer vs. Trader vs. Investor - Can the Day-Trader Deduct Ordinary Losses?

Generally, for tax purposes, persons who purchase and sell stocks and securities fall into one of three distinct categories; dealers, traders, or investors. The difficulty in making this determination is that individuals may simultaneously be a dealer, a trader, and an investor for different security transactions. Tax rules are generally more favorable for dealers and/or traders than investors (i.e., ordinary vs capital or investment expenses and ordinary vs. capital losses). The problem is IRS guidelines do not exist to define the term trader, nor does the Code, so the courts have created various, and nonexclusive, facts and circumstances tests. Taxpayers may not simply elect whether or not they are to be treated as security *traders*. In general, a dealer is primarily interested in the income generated from selling securities to and buying securities from customers whereas a trader is primarily interested in the gains derived from speculating with his/her own securities, and the investor is primarily interested in income from long-term appreciation, interest, and dividends. So how does the taxpayer with large losses or expenses prove he /she is "dealing" or "trading" and not "investing"?

The Day-Trader Table

	Trader	**Investor**
Factors to Determine Whether Individual is a Trader or Investor		
Motivation (the trade or business vs. investor test)	Primary purpose must be income or profit from speculation, not appreciation, dividends, or interest.	Generally interested in appreciation, dividends, and interest.
Activity (the involved regularly and continuously test)	Almost daily trading during the entire year; few periods without activity	No particular pattern; months without any transactions; time between trades
Number of transactions (the extensive test)	The more the better (584 transactions won and 326 transactions lost). Must be active in the direct management of buying and selling.	No particular pattern; months without any transactions; time between trades
Length of holding period (the short-swing test)	Less than a day to 30 days; seldom more than 1 year	Can be both short-term and long-term holding periods.
Tax Reporting For Traders and Investors		
Self-Employment Tax Rules	Net earnings are not subject to SE tax (§1402(a)(3)(A))	Net earnings are not subject to SE tax (§1402(a)(3)(A))
Expenses	Trading expenses deductible on Schedule C as business expense	Investment expenses deductible as miscellaneous itemized deductions (subject to 2% AGI limitation and not allowed on AMT return)
Section 179 Election	Available if "taxable income" exists	Not available
Stock Trade Reporting	Each separate trade is reported on Form 8949; Form 4797 if mark-to-market elected	Each separate trade is reported on Form 8949
Capital Gain	Available for identified stocks and securities held more than one year	Available for stocks and securities held more than one year
Capital Loss	Net trading loss is subject to annual $3,000 (or $1,500) limit on net capital loss deduction unless ***mark-to-market elected***	Net trading loss is subject to annual $3,000 (or $1,500) limit on net capital loss deduction
Home office	Available if home office rules satisfied (e.g., net income?)	Not available
Margin Interest	Deductible on Schedule C as business expense	Margin interest is deductible as investment interest expense, limited to net investment income and calculated on Form 4952 (see §163(d))

The Four Criteria for Investors to Qualify as Day-Traders

The IRS presumes an individual owns stocks and securities as an investor unless his/her actions establish he/she are carrying on the business of stock trading. The §475(f) election is not available unless the taxpayer can prove he/she is a trader (Rev. Proc. 99-17, sec. 6.01). But case law has been more definitive. According to the courts, to be treated as a trader, the taxpayer's trading activity must clearly meet *all* the following four criteria (a very difficult task):

1. Be a trade or business,
2. Conducted regularly and continuously,
3. Extensively, and
4. For short-swing gain.

Test # 2: The Regular and Continuous Tests

Be involved throughout the year! The amount of time spent on trading is important to trader status as the Tax Court has held that a taxpayer must engage in the trading activity almost daily during the entire year! Sporadic trading does not constitute a trade or business (*Hart v. Comm*., TC Memo 1997-11; *Comm. v. Groetzinger*, 87-1 USTC ¶9191).

Test #3: The Extensively Test

A trader must also be engaged in a continuous volume and a minimum number of purchases and sales annually (584 transactions won and 326 transactions lost); in addition, the amount of time spent on trading is important to trader status (*J.M. Ferguson, Sr. v Comm.*, 33 TCM 1082, TC Memo. 1974-244; *Chemical Bank & Trust Co. v US*, CtCls, 37-2 USTC ¶9518, 21 FSupp 167, 85 CtCls 651).

Test #4: For Short-Swing Gain Test

The day-trader standard. The length of the holding period should range from less than a day (a day-trader) up to 30 days as a trader purchases and sells securities to catch the daily market. This period seldom is more than one year, as long-term holdings of securities indicate investor status (*C.H. Liang v Comm.*, 23 TC 1040 (1955)).

Engineer's Number of Trades Not Substantial and Frequency was Not Sufficient to Be Trader (*Fariborz Assaderaghi and Miao-Fin Lin v. Comm.*, TCM 2014-33)

535 trades and gross sales of $2.7 million over 154 days not regular, continuous, and substantial enough for activity to rise to the level of a trade or business. In determining whether a taxpayer's trading activity was substantial, the court considered the number of trades executed in a year, the amount of money involved in those trades, and the number of days on which trades were executed. Fariborz Assaderaghi, holding a PH.D. in electrical engineering and computer science from the University of California at Berkeley, executed 535 trades in 2008 and 180 trades in 2009. He had gross receipts from securities sales in 2008 of $2,659,696 and in 2009 of $349,991. Mr. Assaderaghi executed trades on 154 days in 2008 and 94 days in 2009. In 2008 Mr. Assaderaghi executed 214, or 40%, of his trades as same-day trades. In 2009 he executed 34, or 19%, of his trades as same-day trades. The court concluded that Mr. Assaderaghi's total number of trades and the amount of money involved in those trades during 2008 and 2009 were not substantial, nor did he trade with sufficient frequency to qualify as a trader. The court also concluded that the number of days on which and the frequency with which Mr. Assaderaghi executed trades did not evidence the frequency, continuity, and regularity necessary to constitute a trade or business nor could the court conclude he sought to profit from the swings in the daily market and therefore was he was limited to a $3,000 deduction of losses from the purchase and sale of securities for 2008 and 2009.

> **Preparer note.** Trading 62% of the available annual trading days (154 days out of 250 normal trading days) doesn't rise to the level of a trade or business? Really? It seems Judge Marvel focused primarily on the short-swing same-day trades, which were 40% in 2008 and 19% in 2009.

In addition, because the Court concluded that Mr. Assaderaghi's trading activity did not constitute a trade or business in 2008 or 2009, he was not eligible for a mark-to-market election under §475(f).

Also see:

- *Richard Kay, Jr. v. Comm.*, TCM 2011-159, conducting trading activity on just 29%, 7%, and 8% of the possible trading days in each year respectively is not "continuity." In addition, the majority of the stocks he purchased and sold in each of the years at issue were held for over 30 days (sounded like an investor to the IRS).
- *Stanley C. Cameron v. Comm.*, TCM 2007-260, two months of stock trading didn't rise to level of a trade or business.

How to Make the §475(f) "Day Trader" Election

Rev. Proc. 99-17 sets forth the "exclusive procedure" for making the §475(f) mark-to-market election (a sample §475(f) election statement is provided later). As the election is a "method of accounting," this also requires existing taxpayers to file Form 3115 for a change in method of accounting. Taxpayers may make both the §475(f) election and the change to the mark-to-market method of accounting without the consent of the IRS, but the elections, once made, cannot be revoked without the consent of the IRS (Rev. Proc. 99-17, sec. 2, sec. 4).

For taxpayers converting to "mark-to-market" accounting method. If a trader is making the §475(f) election for the first time, a statement must be timely attached to the taxpayer's return that describes the election being made, the first taxable year for which it is effective, and the trade or business to which it applies. In addition, the original Form 3115, "Application for Change in Accounting Method," must be attached to a timely filed return (including extensions) and a copy must be filed with the IRS National Office prior to the filing of the return. Any required §481(a) adjustment[28] must be calculated and generally reported over a four-year spread (see Rev. Proc. 99-17, sec. 6.03). If the amount of the adjustment is under $25,000, the taxpayer may elect to include the adjustment in the current year (Rev. Proc. 99-49, sec. 5.04(3)(a)).

When and how to elect §475(f) - It's too late for the Year 2011. The §475(f) election statement must be

[28] §481(a) requires a taxpayer to take into account those adjustments necessary to prevent amounts from being duplicated or omitted when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

attached either to the prior year's original Federal tax return (without regard to extensions) or the prior year's request for an extension of time to file that return (Rev. Proc. 99-17, sec. 5.03(1))

As it must be filed by April 15th of the year election desired. The §475(f) election for the Year 2011 return must have been made by April 15, 2011 and attached to the 2010 return (or attached to the extension request Form 4868 for the year 2010).

> **Example.** During the tax interview on April 15, 2012, Danielle, a trader, desired to be a qualified trader for the year 2011 but had not timely elected the §475(f) method of accounting. Therefore, the §475(f) method of accounting is not available for her 2011 return. Additionally, for the §475(f) election to be effective for the year 2012 Danielle must attach the §475(f) election statement to her 2011 return and file the return by April 15, 2012 or, alternatively, attach the election statement to her Form 4868 extension request for her 2011 return. Having made the mark-to-market election for the year 2012, Danielle has changed her method of accounting and must also timely file a Form 3115. A §481(a) adjustment may also be required.

Sample §475(f) election statement:

Taxpayer hereby elects, under the automatic consent procedure outlined in Rev. Proc. 99-17, to mark his (or her) stock holdings to market at the end of each tax year (§475(f)). Form 3115 will be attached to the timely filed return, including any required §481(a) adjustments.

Election being made: Election to use the mark-to-market method of accounting under Code Section 475(f)

First taxable year for which election is effective: January 1, 201_

Trade or business for which election is being made: Danny DayTrader; Form 1040, Schedule C

How new taxpayers file §475(f) election. A new taxpayer is a taxpayer for whom no Federal income tax return was required to be filed for the taxable year immediately preceding the election year; therefore, they are initially adopting an accounting method, not changing from a previous one. A new taxpayer (for instance, a new S corporation or partnership) makes the §475(f) election by placing in its books and records within the first 2 months and 15 days (i.e., March 15th for calendar year taxpayers), the previously mentioned "Sample §475(f) election statement." To notify the Service that the election was made, the new taxpayer must attach a copy of the statement to its original Federal income tax return for the election year (Rev. Proc. 99-17, sec. 5.03(2)).

> **Comment.** So what is a new taxpayer? Is it the teenager filing for the first time? Because our client has previously filed a Form 1040, is he/she *not* a new taxpayer, and therefore cannot use the "new taxpayer" filing option? It is believed that the IRS will interpret, for this purpose, new taxpayers to be those who are not converting existing investment securities to trading securities and are filing their original Schedule C trading business. Until the IRS issues this in an official pronouncement, the safe approach will be to use the above "conversion" procedure instead of the "new taxpayer" procedure.

- *Shahrooz S. & Shida S. Jamie v. Comm.,* TCM 2007-22; West Virginia day-trader failed to make mark-to-market election on $2.6 million of losses

- *Sankarshan Acharya v. Comm.* 2007-1 USTC ¶50,300, 7th Cir. 06-3377, February 23, 2007; election not attached to timely filed return or timely filed extension
- *Steven A. And Patricia A. Knish v. Comm.*, TCM 2006-268, election not attached to timely filed return or timely filed extension

Extension of Time for Making Elections

The IRS Commissioner has discretion to grant a reasonable extension of time for making an election or application for relief with respect to income taxes (see §301.9100-1 through §301.9100-3). These regulations provide a means to place taxpayers in the same position they would have been in had they made their elections in a timely fashion. In addition to some automatic extensions, relief is afforded to taxpayers who reasonably and in good faith didn't make the election timely providing that granting relief would not prejudice the interests of government.

NET OPERATING LOSS DEDUCTION - §172

Carryback of Net Operating Losses (§172(b))

When certain deductions exceed gross income, a taxpayer has a net operating loss (NOL) (§172(c)). The taxpayer is permitted to carry NOL back or forward to the extent the loss was incurred in a trade or business, from a casualty loss, or from a loss on the sale of depreciable property or real estate used in a trade or business (§172). Taxpayers subject to AMT must make special NOL computations to determine the amount of the NOL that is allowable for AMT purposes.

> **Preparer note.** The decision to carry an NOL back and get instant money or carry it forward to use against anticipated increased income is a math crunch problem.

Exceptions to 2-Year Carryback Rule

Generally, an NOL is allowed to be carried back 2 years. However, eligible losses, farming losses, qualified disaster losses, qualified GO Zone losses, and specified liability losses qualify for longer carryback periods.

Eligible loss. The carryback period for eligible losses is 3 years. Only the eligible loss portion of the NOL can be carried back 3 years. An eligible loss is any part of an NOL that:

- Is from a casualty or theft, or
- Is attributable to a Federally declared disaster for a qualified small business or certain qualified farming businesses.

Qualified small business. A qualified small business is a sole proprietorship or a partnership that has average annual gross receipts (reduced by returns and allowances) of $5 million or less during the 3-year period ending with the tax year of the NOL. If the business did not exist for this entire 3-year period, use the period the business was in existence.

> **Preparer note**. An eligible loss does not include a farming loss, a qualified disaster loss, or a

qualified GO Zone loss.

Farming loss. The carryback period for a farming loss is 5 years. Only the farming loss portion of the NOL can be carried back 5 years. A farming loss is the smaller of:

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

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

A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by someone else. It also does not include a business in which you merely buy or sell plants or animals grown or raised by someone else.

Waiving the farming 5-year carryback. The taxpayer can choose to figure the carryback period for a farming loss without regard to the special 5-year carryback rule. To make this choice for 2014, attach to the 2014 income tax return filed by the due date (including extensions) a statement that the taxpayer is choosing to treat any 2014 farming losses without regard to the special 5-year carryback rule.

> **Preparer note**. If the return is filed by the original due date, this election can be made on an amended return filed up to 6 months after the due date of the return (excluding extensions). Attach a statement to the amended return and write "Filed pursuant to §301.9100-2" at the top of the statement. Once made, this choice is irrevocable.

Qualified disaster loss. The carryback period for a qualified disaster loss is 5 years. Only the qualified disaster loss portion of the NOL can be carried back 5 years. A qualified disaster loss is the smaller of:

- Any losses attributable to a Federally declared disaster and occurring in the disaster area plus any allowable qualified disaster expenses (even if you did not choose to treat those expenses as deductions in the current year) or
- The NOL for the tax year.

Qualified disaster expenses. A qualified disaster expense is any capital expense paid or incurred in connection with a trade or business or with business-related property that is:

- For the abatement or control of hazardous substances that were released as a result of a Federally declared disaster,
- For the removal of debris from, or the demolition of structures on, real property which is business-related property damaged or destroyed as a result of a Federally declared disaster, or
- For the repair of business-related property damaged as a result of a Federally declared disaster.

How the Statute of Limitations Applies to NOL Carryback Years

Under §6501(h), if the year in which the NOL arose is still open for assessment, then the year to which the NOL is carried back is also open for purposes of assessing a deficiency attributable to the carryback. The limitation under §6501(h) is that the deficiency must relate to the loss carryback, and the statute is not extended for items not so related.

Under §6501(k), which is much broader, the period of assessment under §6501(h) is still open to recover deficiencies attributable to the carryback ***and the assessment period is still open to recover a deficiency that is unrelated to the carryback.*** The Chief Council advises that by seeking a refund under §6411, the taxpayer opens the door for the IRS to recover a deficiency that is unrelated to the carryback. The amount the IRS can recover under §6501(k) is limited to the amount of the refund less amounts assessed under §6501(h) (deficiencies attributable to the NOL carryback). See §301.6501(m)-1(a)(2).

> **Example**. Joe elected to carry back his 2014 NOL of $50,000 to 2012. Because the 2014 tax year is still open, the 2012 tax year is considered open to the extent of the NOL carryback until the statute of limitations closes on the 2014 tax return. Thus, not only may the IRS audit the 2014 return and make adjustments to the 2014 NOL carryback, it may also audit items on the 2012 return and make adjustments up to the amount of the $50,000 NOL deduction.

What if New Deductions Are Found in the Carryback Year? (FAA 20123905F)

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

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

Statute Closes 3 Years after NOL is Used, Not 3 Years after NOL is Generated

A taxpayer claiming an NOL deduction for a taxable year must file with the tax return for that year a concise statement setting forth the amount of the NOL deduction claimed and all material and pertinent facts, including a detailed schedule showing the computation of the NOL deduction (§1.172-1(c)). Taxpayers bear the burden of establishing both the actual existence of an NOL and the amount of such NOL that may be carried to the year(s) at issue and are required to keep such permanent records as are sufficient to substantiate the amount and the purpose of any deductions (§6001; *Higbee v. Comm.*, 116 T.C. 438; *Hradesky v. Comm.*, 540 F.2d 821 (5th Cir. 1976); §1.6001-1(a)). The courts have applied this rule to NOL carryforwards (*Philip A. Lehman and Sara A. Merrick v. Comm.*, TCM 2010-74; *Allan & Judy N. Green v. Comm.*, TCM 2003-244).

NOL Carryback Automatic, Must Elect to Carryforward

Election to forego NOL carryback. Taxpayers may elect to forgo the carryback period up to the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the carryback period, then the losses are subject to the rules that otherwise would apply under §172 absent the provision (§172(j)).

> **Example.** If an election to forgo the entire carryback period is made for a 2014 calendar tax year for which a 20-year carryforward period applies, then the 2014 NOL would be deductible, until used up, beginning with the year 2015 through the year 2034. Taxpayers who anticipate high-income years in the future and experienced low-income years previously find this election beneficial.

Election procedures. Individual taxpayers who wish to waive the entire carryback period must attach a statement to a timely filed (including extensions) Form 1040 for the year of the loss. The statement must indicate that the taxpayer is waiving the entire carryback period pursuant to §172(b)(3). Corporate tax filers make the election to forgo the NOL carryback by checking the box on Form 1120, Schedule K, Line 11. Both individual and corporate taxpayers may also attach a statement to an amended return filed within six months of the due date of the original return (excluding extensions). If an amended return is filed, "Filed pursuant to §301.9100-2" should be written on the election statement. The amended return should be filed at the same address as the original return. The amended return option is only available if the original return was timely filed without making the election. Once the due date for the tax return (including extensions) has passed, no changes are allowed to the carryback or carryforward decision without IRS approval (§172(b); §1.172-4(b)(1) and (2)).

Closed Years May Be Opened for NOL-Related Refunds (FAA 20124701F)

Mitigation provisions allow extended statute of limitations for refunds (§§1311-1314). Generally the biggest problem a taxpayer encounters when they carry a NOL forward without making the proper election is by the time the IRS notifies them that they must carry the NOL back, the statute of limitations has closed on the applicable carryback years and no refunds are received. In recent advice, however, the IRS Field Attorney reminds taxpayers that meet certain requirements that the "mitigation provisions" of §§1311 - 1314 allow taxpayers who've erroneously carried an NOL forward to properly carry the NOL back to a closed year and still receive a refund.

ACCOUNTING METHODS

Long-Term Contracts Generally (§460)

Long-term contracts generally recognize income and expenses throughout the contract using the percentage of completion method (§460(a)). §460, which governs how taxpayers report income from long-term contracts, generally provides that taxpayers who receive income from long-term contracts must account for that income through the percentage of completion method (§460(a)). This method essentially requires a taxpayer to recognize income and expenses throughout the duration of a contract (§460(b)); *Tutor-Saliba Corp. v. Comm.*, 115 TC 1, 4 (2000)). But, by an amendment, the statute excepts, inter alia, home construction contracts (§460(e)(1)(A), (6)(A)).

Any contract not completed in taxable year entered into is considered completed when it *first* meets (1) the use and 95% completion test or (2) the final completion and acceptance test. A long-term contract is "any contract for the manufacture, building, installation, or construction of property if such contact is not completed within the taxable year in which such contract is entered into" (§460(f)(1)). The statute does not define completion, which is to be determined on a contract-by-contract basis (§1.460-1(f)), but the regulations provide that a contract is completed when it first meets one of two tests (§1.460-1(c)(3)(i)). These tests are commonly known as 1) the use and 95% completion test, and 2) the final completion and acceptance test.

1) the use and 95% completion test. Under the first test, the contract is completed upon "[u]se of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95% of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer"(§1.460-1(c)(3)(i)(A)).

2) the final completion and acceptance test. Under the second test, the contract is completed upon "[f]inal completion and acceptance of the subject matter of the contract" (§1.460-1(c)(3)(i)(B)). As for this latter test, "to determine whether final completion and acceptance of the subject matter of a contract have occurred, a taxpayer must consider all relevant facts and circumstances" (§1.460-1(c)(3)(iv)).

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

Home Construction Contracts

80% of estimated total contract costs attributable to 1-4 unit dwellings and "directly related to" real property "site" improvements. A taxpayer may account for income from home construction contracts under the completed contract method (§460(e)). That is because §460(e) provides that the percentage of completion method will not apply to "any home construction contract." A "home construction contract" is

> "any construction contract if 80% percent of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to — (i) dwelling units * * * contained in buildings containing 4 or fewer dwelling units * * *, and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units" (§460(e)(6)(A)). The "activities referred to in paragraph (4)" are "building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property" (§460(e)(4)).

The Problem with This Statute

"Directly related to" real property "site" improvements. As the statute is written and depending on the meaning of the word "site," qualified residential contractors can have trouble meeting the 80% requirement. This occurs because a significant portion of the contract costs may be attributable to items not "located on the site of such dwelling units" such as development infrastructure. The regulations, however, instruct a taxpayer to "include in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units" (§1.460-3(b)(2)(iii)).

Thus, at least for the purpose of determining whether the contract qualifies as a home construction contract under §460(e), the taxpayer includes, for the 80% test, costs attributable to common improvements in the manner dictated by the regulations.

> **The issue.** As the next case points out, home contractors (in this case Shea, SHI, SHLP and Vistancia) and the IRS disagreed, however, as to whether this regulation affects the tests that determine when the taxpayer completes the contract for the purposes of deciding whether it is a long-term contract (see §1.460-1(c)(3)(A) and (B)).

Homebuilders Could Apply Completed Contract Method Based on Costs of Entire Housing Development (*Shea Homes, Inc. and Subsidiaries, et al. v. Comm.*, 142 TC No. 3)

Shea Homes, Inc. (SHI), and Subsidiaries, is an affiliated group of corporations with its principal offices in Walnut, California. Shea Homes, LP (SHLP) is a limited partnership. Vistancia, LLC is an LLC. The Shea family operated a home development business for more than 40 years using several entities, including SHI, SHLP, and Vistancia. During 2004 - 2006, the years at issue, the Shea family companies were one of the largest private homebuilders in the United States, having sold homes in 114 developments. SHI, SHLP, and Vistancia were builders/developers of planned communities, ranging in size from 100 homes to more than 1,000 homes in Colorado, California, and Arizona.

Homebuilder argued that contracts completed when last road is paved and final bond is released. During 2004-2006, Shea reported income from their contracts for the sale of homes using the completed contract method of accounting. Under their interpretation of this method of accounting, their contracts were complete when they met the use and 95% test pursuant to §1.460-1(c)(3)(A), and incurred 95% of the costs of the development. Shea contended that final completion and acceptance did not occur (after excluding secondary items, if any[29]) until the last road was paved and the final bond was released (per §1.460-1(c)(3)(B)). Shea contended that because the 80% test for a home construction contract includes the allocable share of the costs of common improvements, the 95% test also must include these costs.

> **Planning point.** Shea argued (successfully as we will see) that the scope of the contracts exceeded the mere "bricks and sticks" and encompassed the development as a whole, that is, for the purposes of §460, the contract consisted of the purchase and sale agreements as well as all documents referenced or incorporated therein. This would encompass public reports, CC&Rs, publicly recorded plats and maps, public resolutions or conditions of approval, and homeowner's association documents.

IRS argued that contract was complete at closing of the sale of each home. The IRS contended that the subject matter of the contracts of Shea and its subsidiaries consisted only of the houses and the lots upon

[29] Per §1.460-1(c)(3)(B)(ii).

which the houses are built. Under the IRS's interpretation of the completed contract method, the contract for ***each home*** meets the final completion and acceptance test upon the close of escrow for the sale of ***each home***, requiring income be reported from these long-term contracts for the years in which each contract closed in escrow. Most important, the IRS also alleged that contracts entered into and closed within the same taxable year were not long-term contracts under §460, contending instead that only contracts that closed in tax years ***different*** from the taxable years they were entered into qualified as long-term contracts.

> **Preparer note.** The resolution of this issue turns on the determination of whether the home sale contracts include the development amenities or are limited to the house and the lot on which it sits.

Financial data tracking. To monitor operational performance and income tax compliance, SHI, SHLP, and Vistancia divided the total incurred direct and indirect costs by the total budgeted direct and indirect costs. Their tax department made relevant adjustments to reflect what it considered to be the requirements of §460, such as capitalization computations and tax interest analyses. If the incurred costs were equal to or greater than 95% of the budgeted costs, then they reported income for that tax year from homes that had closed in escrow up to that date. If the incurred costs did not exceed 95%, then they deferred any income from homes that closed in escrow that year.

For Federal income tax purposes during 2002 and 2003, SHLP compared the total number of homes closed in a development to the number projected to be closed by the end of the development. SHI computed the 95% test by comparing the development's total incurred direct and indirect costs to the development's total budgeted direct and indirect costs. For the 2003 and 2004 tax years, Vistancia did not mathematically determine whether either the 95% test or the final completion and acceptance test had been met, the reason being that Vistancia estimated there were no circumstances under which the 95% test would be satisfied because such a small portion of the homes in the development had been completed.

For all tax years after 2003, except as just noted, SHI, SHLP, and Vistancia used the Tract-Pie software and related documentation to compare the development's incurred direct and indirect costs to the development's total budgeted direct and indirect costs for the purposes of determining whether to report income for Federal income tax purposes under their interpretation of the completed contract method of accounting.

Court conclusion, it's the larger picture! The Court agreed with Shea that the contracts consisted of more than just the purchase and sale agreements and that the subject matter of the contracts included the costs of common improvements for the purpose of testing their completion date. Therefore, the contracts generally meet the 95% completion test before they meet the final completion and acceptance test. Under the completed contract method of accounting, SHI, SHLP, and Vistancia were entitled to defer income from their contracts until 95% of the total contract costs, allocable to the subject matter of the contract, were incurred or the development or phase of the development, as the case may be, was completed and accepted. Furthermore, the nature of the business and the contract documents also led the Court to conclude that the common improvements were not secondary items and did not have to be accounted for separately.

> **Planning point.** For large housing developers such as Shea, 95% of the ***development*** costs might not occur, and therefore the contract considered complete, until years after the project is started and the first home is closed in escrow. This ruling may allow for significant income deferral. Caution is required, however, when the development could be viewed, based on all the facts and circumstances, as completed in phases as the 95% completion test could be applied to each phase

of the development.

One last comment. Since SHI's, SHLP's, and Vistancia's method of accounting clearly reflected income, the Court ruled the IRS would not be permitted to change their method of accounting even to a method that ***more*** clearly reflects income.

§197 - INTANGIBLES

Introduction

15-year amortization. The capitalized costs of specified "section 197 intangibles" are ratably amortized over a 15-year period beginning in the month of acquisition, regardless of the actual useful life (§197). No other depreciation or amortization deduction may be claimed on a §197 intangible that is amortizable under this provision.

Contingent payments. The adjusted basis of a §197 intangible acquired from another person is determined under the principles applicable to the acquisition of tangible property. For example, if a portion of the cost of acquiring an amortizable §197 intangible is contingent, its adjusted basis is increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is amortized ratably over the remaining months in the 15-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

Treatment as depreciable property. An amortizable §197 intangible is treated as depreciable property and therefore is subject to the §1231 asset rules (and the related recapture rules of §1245) and the related party gains of §1239.

Allocating value to intangibles. If a taxpayer acquires a trade or business in a transaction treated as an asset acquisition under either §338(b)(5) or §1060, the purchase price should be allocated among the amortizable §197 intangibles using the residual method.

§197 Intangible Defined

"§197 Intangible." The term "section 197 intangible" is defined to mean:

1. Goodwill (e.g., continued customer patronage);
2. Going-concern value (i.e., it's a profitable business now);
3. Skilled workforce in place (e.g., trained staff);
4. Information base (e.g. customer and subscription lists);
5. Know-how (e.g., patent, copyright, formula);
6. Any customer-based intangible (e.g., market-share);
7. Any supplier-based intangible (e.g., favorable contracts);
8. Any license, permit, or other right granted by a governmental unit or agency;
9. Any covenant not to compete (or similar arrangement) entered into in connection with the acquisition of a trade or business or a substantial portion of a trade or business; and
10. Any franchise, trademark, or trade name.

Covenants not to compete. The 15-year amortization rule also applies, usually detrimentally, to a covenant not to compete which is entered into in connection with the direct or indirect acquisition of an interest in a trade or business or a substantial portion of a trade or business. Amounts paid after the tax year in which the covenant is entered into are amortized ratably over the remaining years and months in the 15-year amortization period regardless of how long the covenant lasts.

Disguised purchase plan won't work. Covenants not to compete even exist through the direct purchase of businesses assets or by purchasing stock or partnership interests. An arrangement similar to a covenant not to compete may also be a §197 intangible (e.g., excessive compensation or rental paid to a former owner of a business for continuing to perform services or provide the use of property may be considered an amount paid for a covenant not to compete if the services or property benefits the trade or business). But an amount paid under a covenant not to compete which actually represents the additional purchase price of corporate stock is not a §197 intangible and must be added to the basis of the acquired stock.

Specific exclusions. The following intangible assets are specifically excluded from the definition of a §197 intangible:

1. Interests in acquiring a corporation, partnership, trust, or estate interest;
2. Interests under certain financial contracts;
3. Interests in land;
4. Certain computer software;
5. Certain separately acquired rights and interests;
6. Interests under existing leases of tangible property;
7. Interests under existing indebtedness;
8. Sports franchises;
9. Certain residential mortgage servicing rights; and
10. Certain corporate transaction costs.

Miscellaneous Section 197 Rules

Early dispositions. A taxpayer who disposes of a §197 intangible that was acquired in a transaction but retains other §197 intangibles acquired in the same transaction (or a series of related transactions) may not claim a loss deduction as a result of the disposition. Instead, the bases of the retained section 197 intangibles are increased by the amount of the unrecognized loss.

Similarly, no loss is recognized if a §197 intangible is abandoned or becomes worthless and other §197 intangibles acquired in the same transaction are retained. Again, the bases of the remaining intangibles are increased by the unrecognized loss.

Want Capital Gain Income and Ordinary Deductions: Sell Your CPA Firm and Buy It Back 5 Months Later (*Donald R. And Brenda T. Fitch v. Comm.*, TCM 2012-358)

Upon receiving his CPA license in 1993, Donald Fitch started his own accounting practice in San Francisco. After spending nearly a decade developing the CPA practice, he suffered a brain aneurism in May 2003. He was hospitalized for a week, underwent surgery, and slowly recuperated.

Medical issues force sale. Due to his medical condition, Fitch sold his CPA practice in June 2003 for $900,000 to Mark Gronke, a CPA who worked for Fitch sporadically from 1996 through 2003. Fitch and Gronke executed a sale agreement providing that the $900,000 would be paid to Fitch within 1 year. Fitch reported the $900,000 as a capital gain on his 2003 tax return.

New medical issues force the practice to be sold again. Approximately 4½ months after the sale, Mark Gronke suffered a seizure and was rushed to the hospital. Five days later, in consideration of his new medical issues, Gronke sold the CPA practice back to Fitch for $900,000. They executed another agreement (repurchase agreement) containing the same payment terms as the sale agreement. As a result of the repurchase transaction, Fitch began amortizing the $900,000 cost basis in his newly acquired CPA practice, claiming an amortization deduction of $45,000 in 2005, 2006, 2007. The IRS audited Fitch and disallowed the deduction for amortization expense.

> **Preparer note.** Yes, you are correct —the annual amortization deduction on $900,000 amortized over 15 years should be $60,000, not $45,000. The record did not offer any explanation of the discrepancy.

IRS says sale transactions were sham. The IRS adamantly argued that the sale and repurchase did not create an intangible asset in Donald Fitch's hands, and no amortization expense should be allowed. Specifically, the IRS centered its arguments in 3 areas:

1. ***Fitch and the alleged sales agreements were untrustworthy and neither sale actually took place.*** The IRS contended that Fitch presented false testimony and fabricated documents in an attempt to prove that the transactions were real. The IRS also attacked the sale agreements for their brevity, arguing that they lacked details that would be present in any authentic sales contract of nearly $1 million. The court disagreed, not only finding Fitch's testimony credible and persuasive, but also noting that the circumstances surrounding the sale and repurchase transactions justified the somewhat skimpy documentation. Fitch and Gronke put the basic elements of their agreement into writing and left the details to be sorted out later. When Gronke suffered the seizure, they signed a similar agreement to effect a quick repurchase. The IRS did not argue that the agreements were not valid or enforceable under state law, and the court ruled that Fitch proved that the sale and repurchase transactions actually took place.
2. ***The original sale was rescinded.*** The court dismissed this argument, ruling that the repurchase agreement, by its own terms, effected a sale of the CPA practice from Gronke to Fitch and not an unwinding of the earlier sale. There was no evidence that Fitch and Gronke intended to abrogate, cancel, or void the original sale agreement.
3. ***Fitch reacquired a self-created an intangible asset.*** No amortization is available for self-created intangibles that are repurchased as part of a series of related transactions (§197(c)(2)). The IRS, however, ignored their own Regulations, which provide that amortization is allowed if a taxpayer disposes of a self-created intangible and subsequently reacquires the intangible from a seller (in whose hands the intangible is amortizable) in an unrelated transaction (§1.197-2(d)(2)(iii)(C)). The court ruled that the sale and repurchase transactions were the result of separate business exigencies, namely Fitch's anuerysm and Gronke's seizure, and noted "It is hard to believe these medical conditions could have been predicted or the transactions necessitated by them preplanned."

Last chance - IRS the business advisors. The IRS Hail Mary argument was to question Fitch's wisdom in repurchasing the CPA practice. Now the IRS wants to help us decide what makes business sense! Fortunately the court was a little more reasonable, stating "it is beyond this Court's purview to second-guess Mr. Fitch's business judgment or the manner of operations of his business."

Payment to Terminate a Franchise Agreement Is a Capitalized Intangible (PLR 201317003)

Taxpayer and Franchisee agreed to terminate their existing contractual relationship. In accordance with the termination agreement, Taxpayer was required to pay the Termination Payment for, among other reasons, the termination of all contractual agreements previously entered into by Taxpayer and Franchisee.

Payment created an intangible. Taxpayers must capitalize amounts paid to another party to terminate certain agreements such as a lease of real or tangible personal property between the taxpayer and that party; an agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services to conduct the taxpayer's business; or an agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party. For a taxpayer who terminated its two franchise agreements the termination payment made by the taxpayer to its franchisee created new intangible assets under §1.263(a)-4(d)(7)(i)(B)).

Amortize under §197. Taxpayer was not allowed to expense the payment or depreciate the intangible asset over the remaining life of the franchise. Rather, taxpayer, if it could establish that the asset had a limited useful life, could depreciate the termination payment as a new §197 intangible.

FARM TOPICS

Tax Tips for Farm Tax Returns (IRS Tax Tip 2014-44)

Here are 10 things about farm income and expenses that the IRS lists to help with a farmer's tax return. Links to IRS website information are provided in the digital manual to various explanations of special farmer's tax provisions.

1. **Crop insurance proceeds.** Insurance payments from crop damage count as income. Generally, the farmer should report these payments in the year he or she received them.
2. **Deductible farm expenses.** Farmers can deduct ordinary and necessary expenses they paid for their business.
3. **Employees and hired help.** Farmers can deduct reasonable wages paid to the farm's full and part-time workers. Social Security, Medicare and income taxes must be withheld from the wages.
4. **Foreign agricultural workers**. In general, employers must pay all related payroll taxes (i.e., FICA) on wages paid to nonresident alien employees. However, foreign agricultural workers temporarily admitted into the United States on H-2A visas are exempt from FICA taxes on compensation paid to them for services performed in connection with the H-2A visa. See Publication 51, Agricultural Employers Tax Guide, for more information.
5. **Sale of items purchased for resale.** If the farmer sold livestock or items that were bought for resale, the sale must be reported. Basis is usually the cost of the item. But cost may also include other amounts paid such as sales tax and freight.
6. **Repayment of loans.** A farmer can only deduct the interest paid on a loan if the loan is used for the

farming business. The farmer can't deduct interest paid on a loan that was used for personal expenses.

Prepare note. The refinance of the farm property requires the tracing of the proceeds to its various uses.

7. **Weather-related sales.** Weather anomalies such droughts or floods may force the farmers to sell more livestock in a particular year than normal. If such circumstances, farmers may be able to delay reporting gains from the sale of the extra animals.
8. **Net operating losses.** If farm expenses are more than income for the year, the farmer may have a net operating loss; farm-generated NOLs may be carried back up to five years.
9. **Farm income averaging.** Farmers may be able to average some or all of their current year farm income by spreading it out over the past three years. This may lower the farmer's taxes if the farm income is high in the current year and low in one or more of the past three years. This is an election made on Schedule J of the Form 1040. See the instructions to Schedule J for more information.
10. **Fuel and road use.** The farmer may be able to claim a tax credit or refund of excise taxes paid on fuel used on the farm for farming purposes.
11. **Farmers Tax Guide.** For more details on various farming related topics see Publication 225, Farmer's Tax Guide.

Only Interest Portion of "Keepseagle" Payments to Indian Farmers/Ranchers Subject to Tax (Notice 2013-55; Notice 2013-1)

The class action lawsuit, *Keepseagle v. Vilsack* [30](DC D.C., Civil Action No. 1:99CV03119), claimed that the USDA denied thousands of Indian farmers and ranchers the same opportunities to get farm loans or loan servicing given to non-Indian farmers and ranchers. It also claimed the USDA did not do proper outreach to provide Indian farmers and ranchers technical assistance needed to prepare applications for loans and loan servicing. A preliminary settlement was approved in 2010 and has now been made final. Indian farmers and ranchers may receive between $50,000 to $250,000 and loan forgiveness. 63 Indian tribes participated in this class action lawsuit (see Notice 2013-55 for a list of the Tribes). If an Indian tribe received proceeds under the settlement agreement, invests the proceeds in a private bank account that earns interest, and subsequently distributes the entire amount of the bank account as per capita payments, then a member of the tribe excludes from gross income that portion of the member's per capita payment attributable to the settlement proceeds but must include the prorated interest in gross income.

Replacement of Livestock in Like-Kind Exchange (CCA 201333010, CCA 201333011)

Chief Counsel addressed the accuracy of a paragraph in IRS Publication 225, Farmer's Tax Guide. "A taxpayer can replace livestock with "other property … used for farming" under section 1033(f), if replacing the livestock with "property similar or related in use" is not feasible due to weather-related conditions or environment contamination. A taxpayer can't replace livestock with "other property … used for farming" because of market conditions, for example." "But, the paragraph from Pub 225 is inaccurate. It says that the reason you sell has to be because of weather-related conditions. §1033(f) says the reason you

[30] The lawsuit was brought by Native American farmers and ranchers, including Marilyn and George Keepseagle of Fort Yates, North Dakota.

can't replace the converted property with similar or related-use property is because of weather-related conditions. §1033(e) looks at why you sold the livestock. §1033(f) looks at why you can't replace it with property similar or related in use. Also, couldn't the taxpayer not be able to replace converted livestock because of environmental contamination?"

More Plants Exempt From §263A - But Accounting Method Change May Be Required (Notice 2013-18)

Generally, businesses, including farming businesses, must capitalize direct costs and an allocable share of indirect costs of producing real or tangible personal property (§263A). Qualified farmers, however, are not required to capitalize costs incurred: 1) to produce animals, or 2) to produce plants with a preproductive period of 2 years or less (§263A(d)&(e)). Qualified farmers may also elect out of §263A, even for costs incurred to produce plants with a preproduction period greater than 2 years (§263A(d)(3) and §1.263A-4(d)). This election does not apply to almonds or citrus plants (§263A(d)(3)).

Blackberries, raspberries and papaya plants determined crops with 2 year or less preproduction period. After gathering information provided by the U.S. Dept. of Agriculture, the IRS publishes a nonexclusive list of plants having a nationwide weighted average preproductive period in excess of 2 years. The original list was published in 2000 (Notice 2000-45) and has been updated in 2013 (Notice 2013-18). The updated list of plants that require a preproductive period of greater than 2 years includes almonds, apples, apricots, avocados, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, tangelos, tangerines, tangors, and walnuts. Removed from the list were blackberries, raspberries and papaya plants.

Accounting method change needed (Rev. Proc. 2013-20)? Farmers who have been capitalizing the preproduction costs of producing one or more plants that were removed from the list of plants with a preproduction period of 2 or more years are no longer required to capitalize such costs. This change, however, is a change in accounting method that the IRS will treat as an automatic change (Rev. Proc. 2013-20, modifying Rev. Proc. 2011-14).

BUSINESS CREDITS §38 - 45R

Health Insurance Credit for Small Employers Who Provide Health Insurance Coverage (Fact Page; §45R; PR §1-45R-0, et. seq.)

IRS Website Provides Detailed Guidance for Small Business Health Credit (Small Business Health Care Tax Credit for Small Employers)

The IRS revamped its web page on Small Business Health Care Tax Credit for Small Employers to provide explanations of the credit's various provisions. The IRS also expanded its FAQ s on the Small Business Health Care Tax Credit (Small Business Health Care Credit - FAQ) to answer a variety of questions in 4 broad categories:

1. Who Gets the Tax Credit;

2. Calculating the Credit;
3. Determining FTEs and Average Annual Wages; and
4. How to Claim the Credit.

New Small Employer Health Credit Requirements for 2014 and Beyond (§45R; NPRM REG-113792-13)

Basic Requirements for the Small Employer Health Care Credit	
Employer has fewer than 25 full-time employee equivalents (FTEs)	
Employer is not a member of a controlled group with more than 24 FTEs	
Average annual wages for FTEs are less than $50,000 (inflation adjusted after 2013)	
Employer pays 50% or more of the cost of employer offered qualified health plan (QHP)	
Employer offered QHP is offered through a SHOP Exchange (for years after 2013)	
The employer has not previously claimed the credit in two consecutive years after 2013	

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

1. Have fewer than 25 full-time equivalent employees ("FTEs") for the tax year;
2. Have average annual wages of its employees below $50,000 per FTE (as adjusted for inflation for years after 2013);
3. Pay the premiums under a "qualifying arrangement;" and
4. Starting in 2014, purchase the qualifying health insurance through a Small Business Health Options Program (SHOP) Exchange.

Members of controlled groups (e.g., businesses with the same owners) or affiliated service groups (e.g., related businesses of which one performs services for the other) are treated as a single employer for purposes of the credit. All employees of the controlled group or affiliated service group and all wages paid to employees by the controlled group or affiliated service group are counted in determining whether any member of the controlled group or affiliated service group is a qualified employer. Controlled groups and affiliated service groups are defined at §414(b), (c), (m), or (o).

Tax exempt organizations can be qualified employers. The definition of a "qualified employer" applies to organizations described in §501(c) that are exempt from tax under §501(a). Also included are farmers' cooperatives (§521) which are subject to tax under §1381. Special rules apply when calculating the credit for tax-exempt employers (discussed later).

> **Preparer note.** Employers that are agencies or instrumentalities of a local, state or the Federal government, or of an Indian tribal government, generally do not qualify for the credit.

Household employers also qualify (NPRM REG-113792-13, Explanations I.A.). The term "eligible small employer" includes employers who are not operating a trade or business. For example, an individual that otherwise satisfies the requirements of §45R who employs a household employee is an eligible small employer for purposes of the credit.

Credit increased to 50% in 2014 and beyond. The Small Employer Health Care credit was increased to 50% (35% for tax-exempt organizations) of qualified premiums for years beginning in 2014 and thereafter. For tax years beginning in 2010 through 2013, the credit was 35% of premiums (25% for tax-exempt organizations). The credit is limited to 50% of ***the lesser of***:

1. The total amount of nonelective health insurance premiums the employer contributes for its employees through an Exchange or
2. The total amount of nonelective contributions that would have been made for each employee in #1 above at a premium determined by HHS for the small group market in the employer's state or the area within the state (§45R(a), (b) and (g)).

Preparer note. In other words, an employer is prevented from claiming the credit on the employer-paid premiums exceeding the average premium available in the state's small group market. These average premium amounts are provided annually in the Form 8941 instructions.

Example. Annie owns and operates a bakery where she employees nine full-time employees whose average annual wage is $23,000. Annie pays 100% of her employees' health insurance premiums, which totaled $72,000 in 2014 (which did not exceed the average premium for the small group market in her state). Annie otherwise meets the requirements for the credit. Annie's credit is $36,000 (50% x $72,000).

Tax-exempt employer maximum credit increased to 35%. Qualifying tax-exempt organizations are eligible for a credit of up to 35% of qualified health premiums. The credit amount, however, is limited to the total amount of income and Medicare tax the employer is required to withhold from employees' wages for the year and the employer's share of Medicare tax on employees' wages.

Example. Go Green, Inc., a qualified tax-exempt employer, has 10 FTEs whose average annual wages are $21,000. Go Green pays $80,000 in health care premiums for its employees (which does not exceed the average premium for the small group market in its state) and otherwise meets the requirements for the credit. The total amount of the employees' income tax and Medicare tax withholding plus Go Green's share of the Medicare tax equals $25,000. The credit is calculated as follows:

Initial amount of credit determined before any reduction	35% x $80,000 = $28,000
Go Green Inc.'s withholding and Medicare taxes	$25,000
Total tax credit is $25,000	The lesser of $25,000 or $28,000

Unique rules apply to members of clergy (PR §1.45R-1(a)(5(vi)). Whether a clergy member is an employee or independent contractor is determined under the common law standard for determining worker status. If, under the common law standard, a member of the clergy is determined to be an employee, and the employer otherwise qualifies for the small employer health insurance credit, then the clergy member's hours worked are included in determining the organization's FTEs and any premiums paid for the clergy member's health insurance are taken into account when computing the credit.

BUT, clergy wages not included in average wage calculation. The performance of services by a clergy member in the exercise of his or her clergy, even if deemed to be an employee under the common law standard, is not treated as employment for purposes of the Federal Insurance Contributions Act (FICA). Any compensation paid to the minister is not wages as defined under §3121(a), and, therefore, is not counted as wages for purposes of computing an employer's average annual wages for purposes of calculating the health insurance credit.

> **Preparer note.** Because the clergy member is, in most cases, the highest paid employee in the organization, eliminating their income from the average wage calculation should significantly reduce the average wage. However, the IRS will not allow a member of the clergy, on whose wages FICA and Federal income tax is not required to be withheld, to voluntarily withhold taxes and use the withheld amount in the computation of the church's total payroll tax in order to receive a greater credit (§45R(f)(3)(A)).

Use Form 8941 to calculate the Health Care Tax Credit. Both small businesses and tax-exempt organizations use Form 8941 to calculate the health insurance premium credit.

Small businesses claim the credit by attaching Form 8941 and the General Business Credit Form 3800. A small business will then include the amount of the credit as part of the general business credit on its income tax return.

Tax-exempt organizations claim the credit by attaching Form 8941 to Form 990-T. While Form 990-T is normally used by tax-exempt organizations to report and pay the tax on unrelated business income, it is also be used to claim the small employer health care tax credit regardless if the taxpayer has unrelated business income.

Credit may only be claimed for two consecutive years starting in 2014. For tax years beginning in 2014 or after, eligible employers are limited to claiming the credit for only two consecutive years. The employer may choose when to claim the credit, but once it files Form 8941 to actually claim the credit, the credit will only be allowed for that year and the next successive year. For example, an eligible employer who files Form 8941 to claim the credit in 2015 may only claim it in 2015 and 2016. Even if the employer is not eligible to claim the credit for 2016, the filing of Form 8941 in 2015 begins the two-consecutive-taxable year credit period.

> **Example.** In 2014, Cinder Winery, a calendar year taxpayer, begins to offer health insurance to its 4 employees and otherwise qualifies for the credit. None of Cinder's employees enroll. In mid-2015, all 4 employees enroll in Cinder's health plan but Cinder chooses not to file Form 8941 or claim the credit in 2015. In 2016, Cinder business has grown and it now has 20 employees, all of whom are enrolled its health plan. Cinder files Form 8941 with its 2016 tax return and claims the credit. Cinder's two-year credit period is 2016 and 2017.

Planning point. Cinder determined that the credit would be more valuable if it waited to claim it in 2016 and 2017 because of the additional employees and higher health insurance costs in those years. However, 2017 will count as the second consecutive year regardless of whether or not Cinder claims the credit.

What about successor organizations (PR §1.45R-3(f))? Taxpayers cannot avoid the two consecutive year limitation through the use of successor entities. Generally, an entity that would be treated as a successor employer for employment tax purposes will also be treated as a successor employer for purposes of the two-consecutive-taxable year credit period under §45R.

What premiums count in calculating the credit (PR §1.45R-1(a)(15); Notice 2010-44)? Only premiums paid by the employer under an arrangement meeting certain requirements (a "qualifying arrangement") are counted in calculating the credit. The term "qualifying arrangement" means an arrangement that requires an eligible small employer to make a nonelective contribution on behalf of each employee who enrolls in a qualified health plan (QHP) offered to employees by the employer through a SHOP Exchange in an amount equal to a "uniform percentage" (not less than 50 percent) of the premium cost of the QHP.

Defining "uniform percentage" (PR §1.45R-4). Determining whether or not an employer meets the "uniform percentage" requirement depends on whether: a) the employer offers one or more QHPs (e.g, Silver, Gold, etc.); b) more than one tier (e.g., self-only, self plus one, and family coverage) of coverage is offered; c) whether composite (insurer charges a uniform premium for each of employee) or list (separate premium for each employee based on age or other factors) premiums are used; and, d) State and local law requirements.

Employers offering one QHP, self-only coverage, composite billing. Employers who offer self-only coverage and pay composite premiums satisfy the uniform percentage requirements if they pay the same amount toward the premium for each employee receiving self-only coverage and the payment equals at least 50% of the premium amount.

Employers offering one QHP, multiple tiers of coverage, composite billing. For employers who offer a QHP under a composite billing system with different tiers of coverage for which different premiums are paid, the uniform percentage requirement is satisfied if the eligible small employer either:

1. Pays the same amount for each employee enrolled in the that tier of coverage (not less than 50%); or
2. Pays an amount for each employee that is the same for all employees and is no less than the amount that the employer would have contributed toward self-only coverage for that employee (and is equal to at least 50% of the premium for self-only coverage).

Example. Marshall Inc. offers a QHP which uses composite billing. The annual premiums are $5,000 for self-only coverage and $10,000 for family coverage. Employees can elect self-only or family coverage and Marshall will pay $3,000 (60% of the premium) toward self-only coverage and $6,000 (60% of the premium) toward family coverage. Marshall's contributions of 60% of the premium for each tier of coverage satisfy the uniform percentage requirement.

Variation. Assume Marshall Inc. pays $3,000 (60% of the premium) for all covered employees, regardless of coverage tier. Although 60% of the self-only premiums are paid, only 30% of the family coverage premiums are paid. Because Marshall contributes the same dollar amount for all employees (and the contribution is equal to at least 50% of the self only coverage premiums) it satisfies the uniform percentage requirement.

Employers offering one QHP, self-only coverage, list billing. Employers who only offer self-only coverage and pay list premiums satisfy the uniform percentage requirement if the employer:

1. Pays an amount equal to a uniform percentage (not less than 50%) of the premium charged for each employee; or
2. Determines an "employer-computed composite rate" and, if any employee contribution is required, each enrolled employee pays a uniform amount toward the self-only premium that is no more than 50 percent of the employer-computed composite rate for self-only coverage.

Preparer note. The "employer-computed composite rate" is the average rate determined by totaling the premiums for each tier of coverage for all employees covered under such tier and dividing by the total number of employees under that tier whether covered or not (PR §1.45R-1(a)(6)).

Employers offering one QHP, multiple tiers of coverage, list billing. For employers who offer a QHP with list billing and that have different tiers of coverage (e.g., self-only, self plus one, and family coverage) for which different premiums are paid, the uniform percentage requirement is satisfied if the employer:

1. Pays toward the premium for each employee covered under each tier an amount equal to or exceeding the amount the employer would have contributed with respect to that employee for self-only coverage, calculated either based on the actual premium for that employee for self-only coverage or based on the employer computed composite rate for self-only coverage, and the employer premium payments within the same tier are uniform in percentage or amount; or
2. Meets the uniform percentage requirement separately for each tier of coverage and substituting the employer-computed composite rate for that tier of coverage for the employer-computed composite rate for self-only coverage.

Employers offering more than one plan. If an employer offers more than one QHP, the uniform percentage requirement may be satisfied in one of two ways:

1. On a plan-by-plan basis, meaning that the employer's premium payments for each plan must individually satisfy the uniform percentage requirement. The amounts or percentages of premiums paid toward each QHP do not have to be the same but they must each satisfy the uniform percentage requirement if each QHP is tested separately; or
2. Using the reference plan method, the employer designates one of its QHPs as a reference plan. The employer then either determines a level of employer contributions for each employee such that, if all eligible employees enrolled in the reference plan, the contributions would satisfy the uniform percentage requirement as applied to that reference plan, or the employer allows each employee to apply the minimum amount of employer contribution determined necessary to meet the uniform percentage requirement toward the reference plan or toward coverage under any other available QHP.

Example. Johnstone Inc. offers two QHPs, Silver and Gold, both of which use composite billing. The annual Silver plan premiums are $5,000 for self-only and $10,000 for family coverage. The annual Gold plan premiums are $7,000 for self-only coverage and $13,000 for family coverage. Employees may elect self-only or family coverage under either plan. Johnstone pays $3,000 (60% of the premium) for each employee electing self-only coverage and $3,000 (30% of the premium) for each employee electing family coverage under the Silver plan. It pays $3,500 (50% of the premium) for each employee electing self-only coverage under and $3,500 (27% of the premium) for each employee electing family coverage under the Gold plan. Johnstone's contributions to the QHPs satisfy the uniform percentage requirement on a QHP-by-QHP basis, and therefore, the employer's contributions to both plans satisfy the uniform percentage requirement.

Variation. Assume the same facts as above except that Johnstone designates Silver as the reference QHP. Johnstone pays $2,500 (50% of the premium) for each employee electing self-only coverage under Silver and pays $2,500 of the premium for each employee electing family coverage under Silver or either self-only or family coverage under Gold. Johnstone's contribution of 50% ($2,500) toward the premium of each employee enrolled under Silver or Gold satisfies the uniform percentage requirement.

Special rules regarding employer compliance with applicable State or local law. Employers will be treated as satisfying the uniform percentage requirement if the failure to otherwise satisfy the requirement is attributable solely to additional employer contributions made to certain employees to comply with an applicable State or local law.

Example. Massachusetts Mineral Inc. (MMI) has five employees and is located in a state that requires employers to pay 50% of employees' premium costs, but also requires that an employee's contribution not exceed a certain percentage of the employee's monthly gross earnings from that employer. MMI offers to pay 50% of the premium costs for all its employees, but to comply with the State law, it contributes more than 50% of the premium costs for two of its employees. In this circumstance, even though the contributed percentage is not uniform for all employees, MMI satisfies the uniform percentage requirement because its failure to follow the uniform percent rules was solely attributable to complying with applicable State or local law.

Preparer note. Only the portion of the premiums actually paid by the employer, not any amounts paid by the employee, are used to calculate the credit. Any premium paid pursuant to a salary reduction arrangement under a §125 cafeteria plan is not treated as paid by the employer.

QHP must be purchased through SHOP Exchange starting in 2014 (§45R(b)(1)). Beginning in 2014, only premiums paid on behalf of employees enrolled in a qualified health plan offered through a Small Business Health Options Program (SHOP) Marketplace qualify for the credit. Employers may either: 1) offer coverage to all of its eligible employees through the SHOP whose service area includes the employer's principal business address; or 2) offer coverage to each eligible employee through the SHOP whose service area includes that employee's primary worksite (HHS Reg. 45 CFR 155.710(b)(3)). Under either approach, an employer may offer SHOP coverage to employees whose primary worksite is at its principal business address only if that address is located within the service area of the SHOP.

2014 transitional rules apply (PR §1.45R-3(i)). If: 1) as of Aug. 26, 2013, a small employer offers coverage in a plan year that begins on a date other than the first day of its taxable year, 2) the employer offers coverage during the period before the first day of the plan year beginning in 2014 that would have qualified the employer for the credit under the rules otherwise applicable to the period before January 1, 2014, and 3) the employer begins offering coverage through a SHOP Exchange as of the first day of its plan year that begins in 2014, then it will be treated as offering coverage through a SHOP Exchange for its entire 2014 taxable year.

> **Example.** Huntington Inn, a calendar year taxpayer, has a health plan year that begins July 1st and ends June 30th. Huntington offers a QHP through a SHOP Exchange beginning July 1, 2014. For Jan. 1, 2014 through June 30, 2014, Huntington offered health insurance that would have qualified for a §45R credit using the rules applicable to taxable years beginning before Jan. 1, 2014. Huntington is allowed to claim the credit at the 50% rate for the entire 2014 taxable year for all premiums paid, including those not paid through a SHOP Exchange.

Additional transitional relief available in limited locations (Notice 2014-6). Some otherwise eligible Washington and Wisconsin small employers are located in counties where QHPs were not available through a SHOP Exchange. The IRS determined that an affected eligible small employer may calculate its 2014 credit by treating health insurance coverage provided for the 2014 health plan year as qualifying coverage provided that the coverage would have qualified under the rules applicable before Jan. 1, 2014. In addition, such eligible small employers with a group health plan year that begins on a date in 2014 other than the first day of the employer's taxable year is not required to begin offering coverage through a SHOP Exchange as of the first day of its plan year that begins in 2014. Instead, such an employer is required to continue offering health insurance coverage for the plan year that begins in 2014 that would have qualified for a tax credit under §45R under the rules applicable before Jan. 1, 2014. The relief is available only to businesses located in specific counties in Washington and Wisconsin (see Notice 2014-6 for a complete listing).

Dental, vision, and other insurances qualify for credit. As long as the employer provides basic medical coverage, qualifying "health insurance coverage" also includes:

1. Limited scope dental or vision coverage
2. Long-term or nursing home care, home health care, community-based care, etc.
3 Disease or illness specific overage, hospital indemnity, or other fixed indemnity insurance
4. Medicare supplemental health insurance

Different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement requirement. For example, if an employer offers a major medical insurance plan and a stand-alone vision plan, the employer must separately satisfy the requirements for a qualifying arrangement with respect to each type of coverage (e.g., pay at least 50% of the premiums for the vision plan).

> **Example.** Windpower, Inc., an eligible small employer, offers major medical health insurance and dental insurance to its employees. Windpower pays 50% of the premium cost for all employees enrolled in the major medical plan and 50% of the premium cost for all employees enrolled in the dental plan. For purposes of calculating the credit, Windpower may take into consideration the premiums it paid for both the major medical and the dental plan.

> **Variation.** Assume the same facts as above, except that Windpower pays 60% of the premium costs

for employees enrolled in major medical but only 40% of the premium cost for employees enrolled in the dental plan. Although Windpower pays more than 50% of the combined cost of the major medical and dental plan premiums, it pays less than 50% of the dental coverage premiums. The dental plan is not a qualifying arrangement and the premiums paid are not eligible for the credit.

Employer premium payments limited to state small group market averages. For example, if an eligible small employer pays 80% of the premiums for coverage provided to employees (and employees pay the other 20%), the premiums taken into account for purposes of the credit are the lesser of 80% of the total actual premiums paid or 80% of the premiums that would have been paid for the coverage if the average premium for the small group market in the state were substituted for the actual premium.

Preparer note. The average premiums for the small group market in a state (or an area within the state) are determined by the Dept. of Health and Human Services (HHS) and published annually in the instructions for Form 8941.

Full-time equivalent (FTE) defined. The number of an employer's FTEs is determined by dividing:

1. The total hours for which the employer pays wages to employees during the year (but not more than 2,080 hours for any employee) by
2. 2,080 (§45R(d)(2)(A)).

Preparer note. In other words, only the first 2,080 hours of each employee's wages are taken into account, and the hours in excess of 2,080 are not counted (§45R(d)(2)(B)).

Preparer note. Hours of service include hours where services are not performed (e.g., vacation, holiday, illness, etc.). No more than 160 hours are counted for any single continuous period.

The result, if not a whole number, is then rounded down to the next lowest whole number.

Example. WindPower, Inc. pays five employees' wages for 2,080 hours each, three employees' wages for 1,040 hours each, and one employee's wages for 2,300 hours. WindPower's FTEs would be calculated as follows:

Total hours not exceeding 2,080 per employee is the sum of:	10,400 hours 3,120 hours 2,080 hours 15,600 hours	*for the 5 employees paid for 2,080 hours each (5 x 2,080) *for the 3 employees paid for 1,040 hours each (3 x 1,040) *for the 1 employee paid for 2,300 hours (lesser of 2,300 and 2,080)
FTEs	7	15,600 divided by 2,080 = 7.5, rounded to the next lowest whole number

Employers given three options to calculate annual hours worked (PR §1.45R-2(d); Notice 2010-44). These methods are chosen on an employee by employee basis and include:

1. Determine actual hours of service from records of hours worked (i.e., time cards).

2. Use a days-worked equivalency whereby the employee is credited with 8 hours of service for each day the employee earned at least one hour of pay.
3 Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week the employee earned at least one hour of pay.

An employer with 25 or more employees can qualify for the credit if some of its employees are part-time. Because the limitation on the number of employees is based on FTEs, an employer with 25 or more employees could qualify for the credit if some of its employees work part-time.

> **Example**. Karen owns a deli and has 46 half-time employees (meaning they are paid wages for 1,040 hours). She has 23 FTEs and therefore may qualify for the credit.

Some employees of the business are not counted in FTEs (PR §1.45R-1(a)(5)(iii)). The following individuals are not considered employees for these purposes:

1. ***Seasonal workers,*** unless the seasonal worker works for the employer more than 120 days during the tax year. However, while seasonal workers are excluded from the calculation of FTEs and average annual wages, any health insurance premiums paid on their behalf are included when determining the amount of the credit (Notice 2010-44).
2. ***A self-employed sole proprietor***
3. ***A partner in a partnership***
4. ***A 2% shareholder of an eligible small business which is an S corporation***
5. ***Any 5% owner of an eligible small business***
6. ***A family member*** of any of the business owners or partners, or a member of such a business owner's or partner's household described in # 2 through #5 above. For this purpose, a family member is defined as a child (or descendant of a child), a sibling or step-sibling; a parent (or ancestor of a parent), a step-parent, a niece or nephew, an aunt or uncle, or a son-in-law, daughter- in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law. "Family member" also includes any other member of the household who qualifies as a dependent under §152(d)(2)(H) (§45R(e)(1))

> **Preparer note.** Leased employees (as defined in §414(a)) are considered employees (§45R(e)(1)).

Determining average annual wages (PR §1.45R-2(f)). The amount of average annual wages is determined by first dividing (1) the total wages paid by the employer to employees during the employer's tax year by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000 (if not otherwise a multiple of $1,000). For this purpose, wages means wages as defined for FICA purposes (without regard to the wage base limitation).

> **Example**. Joe, a gas station owner, pays $224,000 in wages and has 10 FTEs. Joe's average annual wages would be $22,000 ($224,000 divided by 10 = $22,400, rounded down to the nearest $1,000).

Calculating the reduced credit if the number of FTEs exceeds 10 or average annual wages exceed $25,000 (PR §1.45R(c)). The health care insurance premium credit is available only to the small employer and phases out as the employer's FTE ***or*** average salary climbs above a ceiling. In other words, two phase-outs apply:

First, if the number of FTEs exceeds 10, the amount of the credit is reduced (but not below zero). The reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.

Second, if average annual wages exceed $25,000, the credit is also reduced. The reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed $25,000 and the denominator of which is $25,000.

In both cases, the result of the calculation is subtracted from the otherwise applicable credit to determine the credit to which the employer is entitled. For an employer with more than 10 FTEs ***and*** average annual wages in excess of $25,000, the reduction is the sum of the amount of the two reductions. The sum may reduce the credit to zero for some employers with fewer than 25 FTEs and average annual wages of less than $50,000.

Number of employees exceeding 10 reduction. The reduction of the credit amount required for having more than 10 full-time equivalent employees is equal to 6.667% for each qualified employee in excess of 10. For example, if an employer has 25 or more full-time employees, the credit is reduced to zero (6.667% X 15 employees (the number in excess of 10) = a 100% reduction). Result: no credit is available even when the average annual wages do not exceed the $25,000 applicable dollar amount.

Average wage exceeding $25,000 reductions. The reduction of the credit amount required for having average annual wages in excess of $25,000 (the applicable dollar amount in 2010-2013) is equal to 4% for each $1,000 of wages in excess of $25,000. Therefore, if average annual wages are $50,000 or greater, the credit amount is reduced to zero ($50,000 X 4% × 25 equals a 100% reduction), even if the employer has fewer than 25 full-time employees.

Deduction for health insurance fringe benefits must be reduced by the amount of the credit (PR§1.45R-5(c)). No deduction under §162 is allowed for the eligible small employer for that portion of the health insurance premiums that is equal to the amount of the health insurance credit. So how much is this credit really worth?

> **Example.** Everdeen Inc. has 8 unrelated full-time employees for whom it paid 100% of their health insurance. There are no other employees. In 2014, when its tax bracket was 35%, Everdeen paid $60,000 for health insurance premiums. The net benefit received by Everdeen as a result of the health insurance credit was $19,500, calculated:

Credit ($60,000 x 50%)	$30,000
Tax increase due to credit ($30,000 x 35%)	(10,500)
Net benefit	$19,500

General Business Credit

The general business credit is the sum of various business tax credits (e.g., investment tax credit, research and development credit, disabled access credit, etc.) for the current year plus any general business credits carried forward from prior years. Excess general business credits are allowed to be carried back one year and carried forward up to 20 years.

General Business Credit Carryback Five Years for Eligible Small Businesses, AMT Limitations Waived (Form 3800; Form 3800 Inst)

5-year carryback for eligible small businesses. For years beginning after December 31, 2009, eligible small businesses are allowed to carry back general business credits up to 5 years (§39(a)(4)). The general carryforward period remains 20 years.

AMT limitations waived. For taxable years beginning before January 1, 2010, certain underlying component credits of the general business credit were not allowed against alternative minimum tax. For years beginning in **2010 only**, eligible small businesses may use 100% of the general business credit against regular and alternative minimum tax, regardless of what underlying credits make up the general business credit (§38(c)(5)).

Eligible small business. For these purposes, an eligible small business is defined as a corporation, the stock of which is not publicly traded, a partnership or a sole proprietorship whose average annual gross receipts for the 3 prior years were less than $50 million (§38(c)(5)(c)). Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits.

Research Tax Credit Extended Through December 31, 2013 (§41; American Taxpayer Relief Act of 2012 (P.L. 112-312)

The research credit has been extended through December 31, 2013. The research tax credit has never been a permanent provision of the Federal tax code and since its original enactment in 1981, it has been extended 19 times. While the credit is often thought of as a single unified credit, it currently has four components: 1) a regular credit, 2) an alternative simplified credit (ASIC), 3) a basic research credit, and 4) an energy research credit. All but the energy research credit are incremental in that the credit applies only to qualified research spending above a base amount. Stay tuned for extension information.

Proposed Regulations on Research and Development Clarify Definitions ((NPRM REG-124148-05)

New Regulations propose the following revisions to the current regulations and provide additional examples to further clarify the statute.

1. To counter an interpretation that §174 eligibility can be reversed by a subsequent event, the proposed regulations provide that the ultimate success, failure, sale, or other use of the research or property resulting from research or experimentation is not relevant to a determination of eligibility under §174.
2. The proposed regulations amend § 1.174-2(b)(4) to provide that the Depreciable Property Rule is an application of the general definition of research or experimental expenditures provided for in §1.174-2(a)(1) and should not be applied to exclude otherwise eligible expenditures.
3. The proposed regulations define the term “pilot model” as any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or a component of a product (to the extent the “shrinking-back” provision applies).
4. The proposed regulations clarify the general rule that the costs of producing a product after

uncertainty concerning the development or improvement of a product is eliminated are not eligible under §174 because these costs are not for research or experimentation.

Example. Where a $30,000 total cost expended on a machine includes $20,000 of research-related labor and materials and, after all uncertainties related to the machine are resolved, $10,000 of construction-related labor and materials, the $10,000 of construction-related labor and materials is not a §174 expenditure because that cost was not a research or experimental cost within the meaning of § 1.174-2(a).

5. The proposed regulations provide a "shrinking-back" provision, similar to the rule provided in §1.41-4(b)(2), to address situations in which the requirements of § 1.174-2(a)(1) are met with respect to only a component part of a larger product and are not met with respect to the overall product itself.

Example. The design of an automobile may be certain except for the appropriateness of design of its braking system. The IRS believes that it is inappropriate to deny §174 eligibility with respect to the development and design of the braking system simply because there is not uncertainty with respect to the automobile's general design.

Qualified Research Expenses Did Not Include Executive Salaries (*Basim Shami et al. v. Comm.*, CA-5th, No. 12-60727, Jan. 23, 2014)

Farouk Systems, Inc. (FSI), an S corporation, developed, manufactured, and sold hair care and other cosmetic products. FSI contracted with alliantgroup LP[31] to calculate its 2003, 2004 and 2005 credit for increasing research and experimentation activities (R&D credit). During these years, FSI had several hundred employees, including between eighteen and twenty-seven employees on its R&D staff. As a result of a study prepared by alliantgroup LP, FSI claimed:

	2003	2004	2005
Qualified R&E Wages	$16,325,517	$11,530,159	$4,016,456
Qualified R&E Supplies	$431,489	$ 0	$3,769
Total Qualified R&E expenses (QRE)	$16,757,006	$11,530,159	$4,020,226
R&D credit claimed	$1,072,170	$749,460	$261,315

Vast majority of QRE wages were paid to corporate officers. Although FSI claimed that dozens of its employees were engaged in qualified research, more than 80% of the QRE wages it claimed in 2003, 2004, and 2005 were paid to just two employees: Farouk Shami and John McCall. Shami served as chairman of FSI's board of directors in each of these years and was FSI's president and CEO in 2003. McCall held the title of co-chairman of FSI's board of directors in 2003 and 2004. Neither Shami nor McCall had any formal

[31] alliantgroup LP is a national consulting firm headquartered in Houston, TX that provides specialty tax services such as R & D tax credit calculations. Former IRS Commissioner Mark Everson and former Acting Commissioner Steve Miller currently serve as directors for alliantgroup LP.

education or training in chemistry or engineering.

Insufficient documentation dooms FSI's credit. FSI offered laboratory records and the testimony of Shami, McCall, and two other FSI employees to substantiate the amount of time Shami and McCall spent performing qualified services. The Tax Court concluded that FSI had not carried its burden of proving how much of Shami's and McCall's wages could be allocated to qualified services, if any. It explicitly found the testimony offered by Shami and McCall noncredible and disallowed their wages as QRE wages. The Appellate Court found that the Tax Court's exclusion of Shami and McCall's wages from QRE was correct and upheld the Tax Court's ruling in favor of the IRS.

> **Planning note.** It is clear from this case and the related appeal that it is crucial that detailed and accurate time records are kept to substantiate qualifying wages for the R&D credit. This is especially true for officers and shareholders, who regularly have significant administrative duties, the highest wages, and the least documentation for the time they spend.

Work Opportunity Tax Credit §51

Work opportunity tax credit extended (American Taxpayer Relief Act of 2012). The work opportunity credit has been extended to cover individuals who begin work for an employer before January 1, 2014. The credit is applicable for employees of all targeted groups who are hired after December 31, 2011.

General provisions of the Work Opportunity Tax Credit. The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Qualified wages. Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

Certification rules - Form 8850. Before any employer may claim the WOTC for hiring any member of a targeted group, the individual must be certified by the state employment security agency (SESA) as a member of a targeted group. To qualify: 1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or 2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. Normally, an eligible employer must file Form 8850 with the state workforce agency (SWA) within 28 days after the eligible worker begins work. A designated local agency will certify a qualified veteran as meeting the required periods of unemployment if the individual received unemployment compensation under state or Federal law for the required period of time.

Filing of Form 8850 with electronic signatures. In an effort to streamline the certification requirements, employers' may use electronic signatures when gathering the Form 8850 for transmission to state workforce agencies. Notice 2012-13 confirms that employers can transmit the Form 8850 electronically and also allows employers to transmit the Form 8850 via fax, subject to the ability of the state workforce agencies to accept submissions in those formats.

Claim as a business credit. The amount of the credit depends on a number of factors, including the length of the veteran's unemployment before hire, hours a veteran works and the amount of first-year wages paid. Employers who hire veterans with service-related disabilities may be eligible for the maximum credit. After the required certification is secured, the credit is calculated on Form 5884 and then becomes part of the general business credit claimed on Form 3800. As the credit is limited to the tax, any excess is carried forward.

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