month extension runs concurrently with the automatic six-month extension. The maximum extension is only six months (October 15 for a calendar-year individual), unless the individual files Form 2350 to qualify for the foreign earned income or foreign housing expense.

Decedent. The final income tax return of a decedent for a fractional part of a year is due on the same date as would apply had the taxpayer lived the entire year (¶ 180).

Amended Return. An individual may correct an error in a return, without incurring interest or penalties, by filing an amended return (Form 1040X) and paying any additional tax due on or before the last day prescribed for filing the original return.

109. Taxpayer Identification Number (TIN) for Individuals. An individual filing any income, employment, or excise tax return, document, or statement must include his or her own taxpayer identification number (TIN) (Code Sec. 6109(a); Reg. §301.6109-1).[2] This is generally the individual's Social Security number (SSN), Individual Taxpayer Identification Number (ITIN), or Adoption Taxpayer Identification Number (ATIN) (¶ 2579).

If the return or statement is made with respect to another person, that other person's TIN also must be included. For example, a taxpayer must provide TINs for dependents and qualifying children for the purpose of claiming a dependency exemption before 2018 and after 2025 (¶ 133), the earned income tax credit (¶ 1422), the child care credit (¶ 1401), the adoption credit (¶ 1407), and the child tax credit (¶ 1405). In the case of the earned income credit and child tax credit, the TIN must be issued before the due date of the taxpayer's return. The parent of any child to whom the rules governing taxation of unearned income of minor children apply must provide his or her TIN to the child for inclusion on the child's tax return (¶ 115).

A penalty is imposed for each failure by a taxpayer to include his or her identifying number on a return or statement, unless he or she can show that the failure was due to reasonable cause (¶ 2833). Failure to include a correct TIN is treated as a mathematical or clerical error, as are instances in which the information provided differs from the information on file with the IRS that is obtained from the Social Security Administration (Code Sec. 6213(g)(2)(F)).[3]

Computation of Tax Liability

111. Taxable Income of Individuals. An individual generally computes federal income tax liability for a tax year by multiplying his or her taxable income by the applicable income tax rate and subtracting allowable tax credits. The computation of taxable income starts with the taxpayer's gross income (¶ 701), from which certain deductions are subtracted to determine the taxpayer's adjusted gross income (AGI) (¶ 1005) (Code Sec. 63).[4]

After AGI is determined, certain other deductions are subtracted from the taxpayer's AGI to determine his or her taxable income. This includes the deduction for personal and dependency exemptions for tax years beginning before January 1, 2018 (¶ 133), the standard deduction (¶ 131) or the taxpayer's itemized deductions (¶ 1014), and any deduction for qualified business income (QBI) for tax years beginning after 2017 and before 2026 (¶ 980P).

Once taxable income is determined, the taxpayer's tax liability is generally computed by applying the appropriate tax rates based on the taxpayer's filing status (single, married filing jointly, head of household, surviving spouse, or married filing separately). Subject to certain exceptions, a taxpayer *must* use either the tax rate tables or tax schedules issued by the IRS to compute his or her income tax liability (¶ 113).

113. Income Tax Rates and Tables for Individuals. An individual determines his or her income tax liability by applying the appropriate tax rate to his or her taxable income (¶ 111). There are seven tax rates for an individual with each rate applied to a

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[2] ¶ 36,960, ¶ 36,961; § 1,335 [3] ¶ 37,545; § 1,335 [4] ¶ 6020; § 1,010

different level of taxable income (Code Sec. 1(i) and (j)).[5] For tax years beginning after 2017 and before 2026, the seven graduated tax rates are 10, 12, 22, 24, 32, 35, and 37 percent. For tax years beginning before 2018 and after 2025, the seven graduate tax rates are 10, 15, 25, 28, 33, 35, and 39.6. The income levels at which the seven tax brackets apply depend on the taxpayer's filing status and are adjusted annually for inflation (Rev. Proc. 2018-18).

An individual generally uses either the tax rate tables or tax schedules issued by the IRS to compute his or her income tax liability (Code Sec. 3).[6] A taxpayer uses:

- the tax tables produced by the IRS (¶ 25) if his or her taxable income is less than $100,000;
- the Tax Computation Worksheet in the Instructions to Form 1040 (¶ 20) if his or her taxable income is $100,000 or more.

The Tax Computation Worksheet is based on the tax rate schedules at ¶ 11 if single or unmarried, ¶ 13 if married filing jointly or surviving spouse, ¶ 15 if married filing separately, and ¶ 17 if head of household. An individual may *not* use the tax tables if he or she files a short-period return because of a change in his or her annual accounting period (¶ 1507).

Capital Gains and Qualified Dividends. An individual's capital gains and qualified dividend income may be subject to a reduced rate of tax depending on the type of gain, the taxpayer's taxable income, and the taxpayer's regular income tax rate (¶ 1736). The tax on capital gains and qualified dividends is calculated on the Qualified Dividends and Capital Gain Tax Worksheet in the Instructions to Form 1040 or the Schedule D Tax Worksheet in the Instructions to Schedule D (Form 1040), whichever applies.

Kiddie Tax. The unearned income of a child is taxed at the income tax rates applicable to trusts and estates for tax years beginning after 2017 and before 2026. A child subject to kiddie tax (¶ 115) uses Form 8615 to calculate the tax.

Foreign Earned Income. An individual who excludes foreign earned income and housing expenses from gross income (¶ 2402 and ¶ 2403) applies the tax rates as if the exclusion has not been claimed. The taxpayer uses the Foreign Earned Income Tax Worksheet in the Form 1040 Instructions to calculate the individual's income tax liability for this purpose.

115. Kiddie Tax on Unearned Income of Child. A child's income tax liability is generally computed in the same manner as for any other individual taking into account the limits on the standard deduction (¶ 131) and personal exemptions in tax years before 2018 (¶ 135). However, a child's net unearned income is subject to the "kiddie tax" if it exceeds $2,100 in 2018 (projected to be $2,200 for 2019) (Code Sec. 1(g) and (j)(4); Rev. Proc. 2017-58).[7]

For tax years 2018 through 2025, a child's net unearned income is taxed at the tax rates applicable to trusts and estates (¶ 19). For tax years beginning before 2018 and after 2026, a child's net unearned income is taxed at the greater of the child's or parent's top income tax rate. Special rules apply for parents with more than one child or who are married filing separately, divorced, or legally separated. In either case, the kiddie tax applies only if it results in a higher tax than would apply at the child's normal tax rate. Form 8615 is used to figure the kiddie tax.

Who is Subject to Kiddie Tax. A child is subject to the kiddie tax if:

- the child is required to file a tax return and he or she does not file a joint return for the year;
- the child's unearned or investment income is more than $2,100 for 2018 (projected to be $2,200 for 2019);
- either parent of the child is alive at the end of the year; and

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[5] ¶ 3260; § 1,015 [6] ¶ 3345; § 1,015 [7] ¶ 3260; § 1,510.05

- the child is:

  — under age 18 at the end of the tax year;

  — age 18 at the end of the tax year and does not provide more than one-half of his or her own support with earned income; or

  — at least age 19 and under age 24 at the end of the tax year, a full-time student, and does not provide more than one-half of his or her own support with earned income.

A child for this purpose includes adopted children and stepchildren as long as one of the child's parents is alive at the end of the tax year. Also, the kiddie tax rules apply regardless of whether the child is a dependent of the parent.

A child's unearned income is generally all income other than salaries, wages, and other payments received for work. It includes taxable interest, dividends, capital gains, social security and pension payments, certain distributions from trusts, and unemployment compensation. It also includes income produced by property the child obtained with earned income or by gift. Unearned income does not include nontaxable income.

Parent's Election. The parents of a child may elect to include on their return the unearned income of a child to avoid the kiddie tax. The election is made by filing Form 8814 and can only be made if:

- the child is required to file a tax return and would otherwise be subject to the kiddie tax;
- the child's only income for the tax year is from interest and dividends, including Alaska Permanent Fund dividends;
- the income was more than $1,050 but less than $10,500 for 2018 (projected to be $1,100 and $11,000, respectively, for 2019);
- no estimated tax payments were made for the year in the child's name and Social Security number, including any overpayment of tax from the previous tax year; and
- the child is not subject to backup withholding.

If the election is made, the child does not have to file a tax return or make estimated tax payments for the tax year. The income of the child is added to the electing parent's income with some adjustments. A separate Form 8814 must be filed for each child of the parents.

117. Net Investment Income Tax. An individual is subject to a 3.8 percent tax on the lesser of net investment income for the tax year, or modified adjusted gross income (MAGI) exceeding a threshold amount ($250,000 if married filing jointly, $125,000 if married filing separately, and $200,000 if single or head of household) (Code Sec. 1411; Reg. § 1.1411-2).[8] The net investment income tax (NIIT) is calculated using Form 8960.

The NIIT is an addition to the regular income tax liability, and is taken into account for purposes of calculating estimated tax payments and underpayment penalties (¶ 125). It applies to any individual subject to U.S. taxation other than a nonresident alien. Additional rules apply to a U.S. taxpayer who is married to a nonresident alien, as well as a bona fide resident of a U.S. territory but only if he or she is required to file a U.S. tax return. The NIIT also applies to an estate and trust (¶ 517).

Net investment income is the excess of the sum of the following items, less any otherwise allowable deductions properly allocable to such income or gain (Reg. § 1.1411-4):

- gross income from interest, dividends, annuities, royalties, rents, and substitute interest and dividend payments, but not to the extent this income is derived in the ordinary course of an active trade or business;

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[8] ¶ 32,602, ¶ 32,603H; § 1,022.10

- other gross income from a passive activity (¶ 1169) or from a trade or business of a trader trading in financial instruments or commodities; and
- net gain included in computing taxable income that is attributable to the disposition of property, but not to the extent the property was held in an active trade or business.

Any item that is excluded from gross income for regular income tax purposes is also excluded from net investment income and MAGI (for example, excludable gain on the sale of a taxpayer's personal residence, veterans' benefits, and tax-exempt bond interest).

Net investment income generally does not include income and gain derived in the ordinary course of a trade or business, unless the trade or business is a passive activity or that of a trader of financial instruments or commodities. If an individual owns or engages in a trade or business directly (or indirectly through owning a disregarded entity), the determination of whether gross income is derived in a trade or business is made at the individual level. If an individual owns an interest in a trade or business through one or more pass-through entities such as a partnership or S corporation, the determination of whether gross income is derived in a passive activity is made at the owner level. The determination of whether gross income is derived in the trade or business of a trader trading in financial instruments or commodities is made at the entity level.

Similar rules apply for determining whether net gain is attributable to property held in a trade or business. For purposes of determining net gain, a disposition is a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition. Net gain cannot be less than zero, and losses from dispositions of capital assets are allowed to offset gains, unless the asset's disposition is subject to the NIIT. The $3,000 deduction ($1,500 if married filing separately) for capital losses (¶ 1752) may not be taken against losses on capital assets but may be taken against other net investment income. Losses deductible under Code Sec. 165, including losses attributable to casualty, theft, and abandonment or other worthlessness (¶ 1101), are applied to calculate net gains. Any excess losses are applied as properly allocable deductions against investment income.

Property held in a trade or business generally does not include an interest in a partnership or stock in an S corporation, so gain from the disposition of the interest or stock is usually treated as net gain. However, special rules apply upon the disposition of an active interest in a partnership or S corporation (Prop. Reg. § 1.1411-7).

The NIIT rules might cause a taxpayer to reconsider the way he or she previously grouped activities for passive activity loss purposes under Code Sec. 469. Thus, a taxpayer subject to the NIIT is provided a one-time election to regroup activities under Code Sec. 469 to allow for realignment of grouped activities to properly reflect the interaction of the Code Sec. 469 rules and income for NIIT purposes (¶ 1175). Further, regrouping may be done on an amended return if the taxpayer was not subject to NIIT on the original return (Reg. § 1.469-11(b)(3)(iv)).[9]

Net investment income includes any income, gain, or loss that is attributable to an investment of working capital (Reg. § 1.1411-6). Net investment income does not include a distribution from qualified employee benefit plans or arrangements, including: a qualified pension, profit sharing, and stock-bonus plan; qualified annuity plan under Code Sec. 403(a) or (b); a traditional or Roth IRA; or a Code Sec. 457 plan of a government or tax-exempt organization (Reg. § 1.1411-8). However, a distribution from a qualified plan or arrangement that is includible in gross income is taken into account for determining the taxpayer's MAGI in the NIIT calculation.

Special rules are provided for self-employed individuals (Reg. § 1.1411-9) and controlled foreign corporations and passive foreign investment companies (Reg. § 1.1411-10).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[9] ¶ 21,965F; § 17,415.05

119. Individual Health Care Coverage Mandate. An individual is subject to a penalty for failing to maintain minimum essential health care coverage for each month of a tax year beginning before January 1, 2019 (Code Sec. 5000A; Reg. § 1.5000A-1; Notice 2018-84).[10] The penalty (referred to as a shared responsibility payment) is reported on the individual's income tax return for the year, and includes the penalty for the taxpayer's spouse if filing jointly, and any dependent claimed on the return. The penalty is calculated using the worksheets in the Instructions to Form 8965 and for any month is the lesser of:

- the monthly national average premium for bronze-level coverage offered through a Health Benefit Exchange (Marketplace) (for 2018, $283 per individual and $1,415 for a family with five or more members; for 2017, $272 per individual and $1,360 for a family with five or more members) (Rev. Proc. 2018-43; Rev. Proc. 2017-48); or
- 1/12 of the greater of: 2.5 percent of the taxpayer's household income over his or her filing threshold or a flat dollar amount ($695 per adult and $347.50 per child, but limited to 300 percent of the amount).

Applicable Individual. An applicable individual is subject to the penalty unless he or she has a coverage exemption. Form 8965 is used to report a coverage exemption granted by an Exchange or claim an exemption on the tax return. An individual is exempt from the penalty if any of the following apply:

- coverage is unaffordable, meaning the individual's required contribution for coverage under an employer-sponsored plan or the lowest cost bronze plan available through an Exchange exceeds a percentage of his or her household income (8.16 percent for 2017; 8.05 percent for 2018) (Rev. Proc. 2016-24; Rev. Proc. 2017-36);
- the individual has household income below the threshold for filing an income tax return for the tax year (¶ 101);
- the individual lacked minimum essential coverage for a continuous period of less than three months (short coverage gap) without regard to the calendar year, but only the first lapsed period during the year is counted; or
- the individual experiences a hardship with respect to the capability to obtain coverage under a qualified health plan and receives a hardship exemption certificate from an Exchange or as provided by the IRS (e.g., residing in state that did not expand Medicaid eligibility) (Notice 2014-76; Notice 2017-14).

An individual is also not subject to the penalty for failing to maintain minimum essential coverage if he or she is: (1) a member of an Indian tribe (¶ 1465Q); (2) a member of a religious sect or division who has obtained a religious conscience exemption to Social Security taxes; (3) a member of a tax-exempt health-care sharing ministry; (4) an individual who is not U.S. citizen or national, or not lawfully present in the United States; and (5) an individual who is incarcerated unless waiting for disposition of charges.

Minimum Essential Coverage. Minimum essential coverage means health care coverage under a government-sponsored program (Medicare, Medicaid, CHIP, etc.), an eligible employer-sponsored plan, a health insurance plan offered in the individual market, a group health plan in which the individual was enrolled on March 23, 2010, an eligible expatriate health plan (for plans issued or modified on or after July 1, 2015), or any other coverage recognized by the IRS. If an applicable individual, spouse, or dependent had minimum essential coverage during the calendar year, the provider of that coverage is required to provide Form 1094-A, Form 1095-B, or Form 1095-C listing the individuals who were enrolled in the coverage and the months of coverage.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[10] ¶ 34,962, ¶ 34,962D; § 42,001

Minimum essential coverage does not include health insurance coverage that consists of excepted benefits, such as accident or disability benefits, liability insurance, workers compensation, credit-only insurance, automobile medical payments, or coverage for on-site medical clinics. Certain government-sponsored limited benefit coverage (e.g., line of duty coverage for inactive service members, Medicaid coverage for the medically needy, etc.) does not constitute minimum essential coverage. If benefits are provided under a separate policy, certificate, or insurance contract, then excepted benefits also include: (1) limited scope dental or vision benefits, benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof, and other similar limited benefits; (2) coverage only for a specified disease or illness; (3) hospital indemnity or other fixed indemnity insurance; and (4) Medicare supplemental health insurance, coverage supplemental to the medical and dental coverage provided to military personnel, and similar supplemental coverage provided to coverage under a group health plan.

125. Estimated Taxes for Individuals. An individual may need to pay a portion of his or her tax liability through estimated tax payments over the course of the tax year rather than when his or her income tax return is filed. Estimated taxes are generally used to pay tax on income that is not subject to withholding and if the amount of tax being withheld from wages or other income is not enough. Estimated taxes not only cover the individual's liability for income tax but also liability for self-employment taxes, the 3.8 percent net investment income tax (¶ 117), the 0.9 percent Additional Medicare Tax (¶ 2648), and income from an estate, trust, partnership, and S corporation.

The Code does not directly impose an obligation to pay estimated taxes, but it does impose a penalty (addition to tax) for failure to pay enough tax either through withholding or estimated taxes (Code Sec. 6654).[11] If an individual expects to owe at least $1,000 in taxes after subtracting withholding and refundable tax credits, the penalty may be avoided if he or she makes required installment payments of estimated taxes. A required installment is 25 percent of the lesser of:

- 90 percent of the tax shown on the individual's tax return for the current year; or
- 100 percent of the tax shown on the prior year's return (110 percent in the case of an individual with adjusted gross income in excess of $150,000; $75,000 for a married individual filing separately), unless the prior year was not a 12-month period.

An individual uses Form 1040-ES to figure his or her required installments. In calculating estimated tax payments, taxes withheld from an individual's wages or other income are treated as payments of estimated tax. A lower required installment payment may be made if the individual annualizes his or her tax at the end of each payment period based on a reasonable estimate of income, deductions, and credits. The annualized installment method may be used if the taxpayer does not receive income evenly throughout the year. Special rules also apply for farmers and fishermen. Regardless of whether an individual uses the regular or annualized installment method, each required installment must be paid by its due date (¶ 127).

Married Taxpayers. Married individuals may make joint estimated tax payments unless they are legally separated under a divorce decree or separate maintenance agreement, either spouse is a nonresident alien, or the spouses have different tax years. Individuals who cannot make joint estimated tax payments must apply the estimated tax rules to their separate estimated income. If married individuals make joint estimated tax payments or separate estimated payments, it does not affect their ability to file jointly or separately (Reg. § 1.6654-2(e)(5)).[12]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[11] ¶ 39,550; § 1,401

[12] ¶ 39,553; § 1,415

Household Employees. An employer of domestic workers who fails to satisfy FICA and FUTA withholding obligations (¶ 2652) through regular estimated tax payments or increased tax withholding from their own wages, may be liable for estimated tax penalties (IRS Pub. 926).

Exceptions to Penalty. A U.S. citizen or resident alien is not subject to the penalty for failing to pay estimated taxes if he or she had no tax liability for the preceding tax year, provided the year was a 12-month period. The penalty may also be waived under certain other circumstances or hardship, or following an individual's retirement or disability (Code Sec. 6654(e)).[13]

Calculation of Penalty. The penalty for underpayment of estimated taxes is computed on Form 2210 and attached to the individual's income tax return; farmers and fishermen use Form 2210-F. If the form is not completed and attached to the individual's return, the IRS will compute the penalty for the taxpayer. If the IRS computes the penalty, it will investigate any reason why the penalty should be waived.

127. Estimated Tax Payment Due Dates for Individuals. The due date for required installment payments of estimated taxes by an individual (¶ 125) is generally broken down into four payment periods (Code Sec. 6654(c)(2)).[14] If the due date falls on a Saturday, Sunday, or legal holiday in the District of Columbia (¶ 2549), the individual has until the next succeeding business day to make the payment. For the 2019 tax year, a calendar-year individual is required to pay estimated tax in four installments as follows:

Installment	*Due date*
First	April 15, 2019 (April 17, 2019 for residents of Maine and Massachusetts)
Second	June 17, 2019
Third	September 16, 2019
Fourth	January 15, 2020

Estimated tax payments for a fiscal-year individual are due on the 15th day of the 4th, 6th, and 9th months of the tax year and the 1st month of the following tax year.

The fourth (last) tax installment for the tax year does not need to be made by the normal due date if the taxpayer files Form 1040 and pays the balance of the tax on or before January 31 of the following calendar year, or for a fiscal year on or before the last day of the month following the close of the fiscal year. Filing a final 2018 return by January 31, 2019, with payment of any tax due does not avoid an addition to tax for underpayment of any of the first three installments that were due for the year (Code Sec. 6654(h); IRS Pub. 505).[15]

If an individual is not liable for estimated tax on March 31, 2019, but his or her tax situation changes so that he or she becomes liable for estimated tax at some point after March 31, then the individual must make estimated tax payments as follows:

- If the individual becomes required to pay estimated tax after March 31 and before June 1, then he or she should pay 50 percent of estimated tax on or before June 17, 2019, 25 percent on September 16, 2019, and 25 percent on January 15, 2020.
- If the individual becomes required to pay estimated tax after May 31 and before September 1, then he or she should pay 75 percent of estimated tax on or before September 16, 2019, and 25 percent on January 15, 2020.
- If the individual becomes required to pay estimated tax after August 31, then he or she should pay 100 percent of estimated tax by January 15, 2020 (Form 1040-ES; IRS Pub. 505).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[13] ¶ 39,550; § 1,435.05 [14] ¶ 39,550; § 1,410 [15] ¶ 39,550; § 1,410

Farmer or Fisherman. An individual who expects to receive at least two-thirds of his or her gross income for the tax year from farming or fishing, or who received at least two-thirds of gross income for the previous tax year from farming or fishing, may pay estimated tax for the year in one installment on the last installment due date (January 15, 2019, for the 2018 tax year; January 15, 2020, for the 2019 tax year). The entire amount of the estimated tax for the tax year generally must be paid at that time. The payment date may be ignored if the farmer or fisherman files his or her income tax return for the year and pays the entire tax due by March 1.

The penalty for underpayment of estimated tax does not apply unless a farmer or fisherman underpays the tax by more than one-third (Code Sec. 6654(i); IRS Pub. 505).[16] If a joint return is filed, a farmer or fisherman must consider his or her spouse's gross income in determining if at least two-thirds of gross income is from farming or fishing.

Nonresident Alien. A nonresident alien who does *not* have wages subject to federal income tax withholding must pay estimated taxes for 2019 in three installments (June 17, 2019, September 16, 2019, and January 15, 2020). Fifty percent of the annual payment must be made on the first installment due date and 25 percent on each of the remaining two installment due dates (Code Sec. 6654(j)).[17]

Standard Deduction and Exemptions

131. Standard Deduction. An individual may elect to claim a standard deduction or itemized deductions (¶ 1014) in calculating taxable income (¶ 111), whichever will result in a higher deduction. The standard deduction is the sum of the basic standard deduction amount, plus an additional standard deduction amount if the taxpayer is age 65 or older, or blind, or both (Code Sec. 63(c)).[18]

Basic Standard Deduction. The basic standard deduction amount varies according to the taxpayer's filing status and is adjusted annually for inflation. The basic standard deduction amount for 2018 is (Rev. Proc. 2018-18):

Filing status	*2018 standard deduction amount*
Married filing jointly and surviving spouses	$24,000
Head of household filers	18,000
Married filing separately	12,000
Single filers	12,000

The basic standard deduction amount for 2019 is projected to be:

Filing status	*2019 standard deduction amount*
Married filing jointly and surviving spouses	$24,400
Head of household filers	18,350
Married filing separately	12,200
Single filers	12,200

Dependents. A taxpayer who can be claimed as a dependent on another taxpayer's return (¶ 137) is limited to a smaller standard deduction regardless of whether the individual actually is claimed as a dependent. The dependent's basic standard deduction may not exceed the greater of:

- $1,050 for 2018 (projected to be $1,100 for 2019); or
- the sum of $350 and the individual's earned income, up to the applicable standard deduction amount (e.g., for single filers: $12,000 for 2018; projected to be $12,200 for 2019).

The limit applies to the basic standard deduction and not to any additional amount for elderly or blind taxpayers. A scholarship or fellowship grant that is *not* excludable from the dependent's gross income (¶ 865) is considered earned income for this purpose (IRS Pub. 501).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[16] ¶ 39,550; § 36,510.05 [17] ¶ 39,550; § 1,420 [18] ¶ 6020; § 1,010.15

Aged and/or Blind Taxpayers. An individual who is age 65 or older, blind, or both, at the end of the tax year receives an additional standard deduction amount that is added to the basic standard deduction shown in the table above (Code Sec. 63(f), Prop. Reg. § 1.63-3; Reg. § 1.151-1; Rev. Proc. 2018-18).[19] The additional amount is:

- $1,300 for 2018 (projected to be $1,300 for 2019) if married filing jointly, married filing separately, or surviving spouse; and
- $1,600 for 2018 (projected to be $1,650 for 2019) if single, unmarried, or head of household.

Two additional standard deduction amounts are allowed to an individual who is both over 65 and blind at the end of the tax year. Thus, married individuals filing jointly, both of whom are over 65 and blind, can claim four of the additional standard deduction amounts.

A taxpayer claiming the additional standard deduction must be either age 65, blind, or both, before the close of the tax year. An individual who reaches age 65 on January 1st of any year is deemed to have reached that age on the preceding December 31st. A taxpayer claiming the additional amount for blindness must obtain a certified statement from a doctor or registered optometrist. The statement, which should be kept with the taxpayer's records, must state either that: (1) the individual cannot see better than 20/200 in the better eye with glasses or contact lenses; or (2) the individual's field of vision is 20 degrees or less.

A married individual filing separately may claim the additional amounts for a spouse who had no gross income for the year and was not claimed as a dependent by another taxpayer (Code Sec. 151(b)). A taxpayer who claims a dependency exemption for an individual who is either age 65 or older, blind, or both may *not* claim the additional standard deduction amounts for that individual.

Taxpayers Ineligible for Standard Deduction. If married individuals file separate returns, both spouses should either itemize deductions or claim the standard deduction. If one spouse itemizes and the other does not, the non-itemizing spouse's standard deduction amount is zero, even if that spouse is age 65 or older, or blind, or both. This rule does not apply if one spouse qualifies to file as head-of-household. A zero standard deduction amount also applies to an individual with a short tax year, as well as a nonresident alien, estate, trust, common trust fund, and partnership (Code Sec. 63(c)(6)).[20] A taxpayer who itemizes even though his or her itemized deductions are less than the standard deduction must check the box on the last line of Schedule A (Form 1040) to make this election.

Net Disaster Losses. An individual may claim an additional standard deduction amount for net qualified disaster losses reported on Form 4684 in computing regular taxable income and alternative minimum tax (AMT) liability (Act Sec. 20104(b) of the Bipartisan Budget Act of 2018 (P.L. 115-123); Act Sec. 11028(c) of the Tax Cuts and Jobs Act (P.L. 115-97); Act Secs. 501 and 504(b)(1) of the Disaster Tax Relief and Airport and Airway Extension Act of 2017 (P.L. 115-63)). A net qualified disaster loss is personal casualty losses over personal casualty gains, due to losses arising in a designated disaster area attributable to the 2017 California wildfires, Hurricanes Harvey, Irma, or Maria, and a federally declared disaster in 2016 (¶ 1131).

133. Personal and Dependency Exemption Amount. For tax years beginning before 2018 and after 2025, an individual may claim a personal exemption deduction (¶ 135) and an exemption deduction for each dependent claimed on his or her tax return (¶ 137). The exemption amount is adjusted annually for inflation and is $4,050 for 2017 (Code Sec. 151(d); Rev. Proc. 2016-55).[21]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[19] ¶ 6020, ¶ 6022G, ¶ 8001; § 1,010.15

[20] ¶ 6020; § 1,010.15

[21] ¶ 8000; § 1,205

The exemption amount is zero (-$0-) for tax years beginning in 2018 through 2025. No deduction may be claimed for personal and dependency exemptions during these years, but the rules for determining who is a dependent of the taxpayer are applicable for claiming other tax benefits (e.g., child tax credit). In determining who is a dependent for these other tax benefits, the exemption amount is $4,150 for 2018 and adjusted for inflation in future years (Notice 2018-70).

For tax years beginning before 2018 and after 2025, a taxpayer whose adjusted gross income (AGI) exceeds an applicable threshold amount based on filing status must reduce the amount of his or her otherwise allowable exemption deduction. The applicable threshold amounts are also adjusted annually for inflation.

135. Personal Exemption. For tax years beginning before 2018 and after 2025, an individual may claim a personal exemption deduction on Form 1040 for himself or herself in calculating taxable income equal to the exemption amount for the year ($4,050 for 2017; $0 for 2018 through 2025) (¶ 133) on his or her tax return (Code Sec. 151(b); Reg. § 1.151-1; Prop. Reg. § 1.151-1).[22] No personal exemption may be claimed by an individual who is eligible to be claimed as a dependent on another taxpayer's return (¶ 137). For example, a student who works part-time during the year may *not* claim a personal exemption on a return if any other taxpayer (i.e., a parent) is *entitled* to claim him or her as a dependent on a return. If a dependent who is not allowed his or her own personal exemption has gross income in an amount not exceeding $1,050 in 2018 (projected to be $1,100 for 2019), he or she will *not* be taxed on that amount and need *not* file an income tax return for the year (¶ 101).

Married individuals may claim two personal exemptions for tax years before 2018 and after 2025 if filing a joint return, even if one spouse has no income. If spouses file a joint return, neither can be claimed as a dependent on the return of any other taxpayer. If married individuals file separate returns (or one qualifies as head of household), each spouse must claim his or her own personal exemption on their respective return. However, if one of the spouses has no gross income and is *not* the dependent of another taxpayer, then the spouse with gross income may claim the personal exemption for the other spouse on his or her separate return. A married taxpayer who files a separate return may *not* claim two exemptions for his or her spouse, one as a spouse and one as a dependent.

Death or Divorce. If a married individual dies during a tax year beginning before 2018 and after 2025, and his or her surviving spouse files a joint return (¶ 152), the surviving spouse may claim the personal exemption for the deceased spouse unless he or she remarries during the same tax year. The determination of the survivor's filing status is made at the time of the spouse's death, rather than at the end of his or her tax year. If the surviving spouse remarries before the end of the tax year, his or her marital status is determined on the last day of the tax year. If a taxpayer and his or her spouse divorce or are declared legally separated, then the taxpayer cannot claim the exemption for the former spouse (IRS Pub. 17).

Resident and Nonresident Aliens. A resident alien may claim his or her own personal exemption for tax years beginning before 2018 and after 2025. If a resident alien files a joint return, he or she may also claim a personal exemption for his or her spouse. However, the filing of a joint return is *not* permissible if either spouse was a nonresident alien at any time during the tax year unless the taxpayer elects to be treated as a resident alien (¶ 2410) (Code Sec. 6013(a)(1); Reg. § 1.6013-1(b)).[23]

137. Dependency Exemption. For tax years beginning before 2018 and after 2025, an individual may claim an exemption deduction in calculating taxable income for each dependent claimed on his or her tax return (Code Sec. 151(c); Reg. § 1.151-1; Prop. Reg. § 1.151-1).[24] The exemption amount is adjusted annually for inflation and is $4,050 for 2017 (¶ 133).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[22] ¶ 8000, ¶ 8001, ¶ 8001B; § 1,210.05

[23] ¶ 35,160, ¶ 35,161; § 37,125.15

[24] ¶ 8000, ¶ 8001, ¶ 8001B; § 1,201

The exemption amount is zero (-$0-) for tax years beginning in 2018 through 2025. No deduction may be claimed for dependency exemptions during these years, but the rules for determining who is a dependent of the taxpayer are applicable for claiming other tax benefits. In determining who is a dependent for these other tax benefits, the exemption amount is $4,150 for 2018 and adjusted for inflation in future years (Notice 2018-70).

A dependent is defined as an individual who is a qualifying child (¶ 137A) or qualifying relative (¶ 137B) of the taxpayer for the year (Code Sec. 152; Prop. Reg. § 1.152-1).[25] Both a qualifying child and a qualifying relative must meet the following general requirements to be claimed as a dependent:

- The taxpayer claiming the dependent must include the dependent's taxpayer identification number (TIN) (¶ 109) on his or her return (Code Sec. 151(e)).
- The dependent must be a U.S. citizen or national, or a resident of the United States, Canada, or Mexico for some part of the year, but an exception may apply to certain adopted children of the taxpayer.
- A dependent cannot claim any dependent on his or her own return.
- A married individual cannot be claimed as a dependent if he or she files a joint return with his or her spouse, unless the joint return was only filed as a claim for refund of estimated or withheld taxes and neither spouse would have a tax liability if they had filed separately.

Special rules apply for claiming a dependent child whose parents are divorced or legally separated (¶ 139A). Also, tie-breaking rules apply to claim a dependent if a child meets the requirements to be a qualifying child of more than one taxpayer (¶ 139).

If a parent is barred from claiming a child as a dependent because that child fails to meet either the qualifying child (¶ 137A) or qualifying relative (¶ 137B) requirements, the child may claim a personal exemption before 2018 and after 2025 on his or her own return. Also a dependent, whether a qualifying child or a qualifying relative, who has earned income on which tax has been withheld should file a return even though he or she is claimed as a dependent by another. The return will serve as a claim for refund of the tax withheld if the dependent incurs no tax liability (¶ 2670). If a dependent child of the taxpayer has earned income or unearned income in excess of certain threshold amounts (¶ 101), a return must be filed whether or not the child is claimed as a dependent.

In a community property state (¶ 710), if a child's support is derived from community income, he or she may be claimed as a dependent by either spouse on a separate return by agreement. A single exemption amount before 2018 and after 2025 may *not* be divided between them.[26]

137A. Qualifying Child Definition. An individual may claim a qualifying child as a dependent (¶ 137) on his or her return for purposes of certain tax benefits (e.g., child tax credit). The following requirements must be met for an individual to be considered a qualifying child of the taxpayer (Code Sec. 152(c) and (f); Prop. Reg. § 1.152-2).[27]

- *Relationship.* The individual must bear one of the following relationships to the taxpayer:

  — a son, daughter, stepson, stepdaughter, or a descendant of such child; or

  — a brother, sister, stepbrother, stepsister, or a descendant of such relative.

  The relationship test includes foster and adopted children. An eligible foster child is a child who is placed with the taxpayer by an authorized placement agency or by a decree issued by the courts. An eligible adopted child includes both a legally adopted child and a child legally placed for adoption (Prop. Reg. § 1.152-1(b)).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[25] ¶ 8007, ¶ 8008; § 1,201 [26] ¶ 8005.23; § 1,201 [27] ¶ 8007, ¶ 8052B; § 1,215.05

- *Age.* The individual must be younger than the taxpayer, and either under the age of 19 at the end of the calendar year, or under the age of 24 at the end of the calendar year and a full-time student. An individual who is totally and permanently disabled (¶ 1402) at any time during the year satisfies the age requirement regardless of his or her age. An individual is a full-time student if enrolled or registered for at least part of five calendar months in a year at a qualified educational institution or on-farm training program.
- *Residency or Abode.* The individual must have the same principal place of abode as the taxpayer for more than one-half of the year. Temporary absences for illness, school, vacation, or military service may count as time living with the taxpayer. Special rules apply in the case of a child of divorced or separated parents (¶ 139A). A child who is born or dies during the tax year is considered living with the taxpayer for the entire year if the taxpayer's home was the child's home for the entire time he or she was alive (Prop. Reg. § 1.152-4(c) and (d)). A special rule also applies for kidnapped or missing children (Prop. Reg. § 1.152-4(e)).
- *Support.* The individual must *not* provide more than one-half of his or her own support for the year (¶ 147). For this purpose, if the individual is the taxpayer's child and a full-time student, amounts received as scholarships are not considered support.
- *Joint Return.* The individual cannot have filed a joint return with his or her spouse except as a claim for refund.

A child who is a qualifying child of divorced or separated parents generally may be claimed as a dependent of the parent who has primary custody, but the custodial parent may waive claiming the dependent (¶ 139A). If an individual may be claimed as a qualifying child of two or more taxpayers, they may decide between themselves who will claim the individual as a dependent. If the taxpayers cannot agree, certain tie-breaking rules apply (¶ 139).

If the individual fails to meet all the requirements to be considered a qualifying child, the individual may still be claimed as a dependent if he or she meets all the requirements for a qualifying relative (¶ 137B).

137B. Qualifying Relative Definition. An individual may claim a qualifying relative as a dependent (¶ 137) on his or her return for purposes of certain tax benefits (e.g., child tax credit). The following requirements must be met for an individual to be considered a qualifying relative of the taxpayer (Code Sec. 152(d) and (f); Prop. Reg. § 1.152-3).[28]

- *Relationship.* The individual must bear one of the following relationships to the taxpayer (a relationship does not terminate due to divorce or death of a spouse):

  — a child, stepchild, adopted child, eligible foster child, or a descendant of such child (see ¶ 137A for the definition of adopted and foster child; a special rule also applies for kidnapped or missing children (Prop. Reg. § 1.152-4(e));

  — a brother, sister, stepbrother, stepsister, half brother, or half sister;

  — a parent, grandparent, or other direct ancestor (other than foster parent), as well as any stepparent;

  — a brother or sister of the taxpayer's parent (aunt or uncle), and any son or daughter of the taxpayer's brother or sister (niece or nephew);

  — a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law; or

  — an individual who, for the entire year, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household (temporary absences for illness, school, vacation, or military service are permitted).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[28] ¶ 8007, ¶ 8100B; § 1,220.05

- *Gross Income.* The individual's gross income for the calendar year must be less than the exemption amount for the year ($4,050 for 2017; $4,150 for 2018) (¶ 133). Gross income includes all income in the form of money, property, and services that is not exempt from tax. Deductions are not taken into account. Thus, it includes gross sales, rents, share of partnership gross income, etc., without reduction for expenses or determining net income. Any income excludable from the claimed dependent's gross income (e.g. tax-exempt interest) is disregarded, as well as income received by a permanently and totally disabled individual at a sheltered workshop school.

- *Support.* Over one-half of the individual's total support for that calendar year must have been furnished by the taxpayer (¶ 147). If an individual provides more than one-half of his or her own support for the tax year, then generally no taxpayer can meet the support test and the individual cannot be a qualifying relative.

- *Not A Qualifying Child.* The individual must *not* be the qualifying child of the taxpayer or of any other taxpayer for the tax year (¶ 137A). An unrelated child who lives with, and is supported by a taxpayer, may be claimed as a qualifying relative if the other individual for whom the child is a qualifying child does not file a return or files a return solely to claim a refund (Prop. Reg. § 1.152-3(e); Notice 2008-5)

A child who is a qualifying relative of divorced or separated parents generally may be claimed as a dependent of the parent who has primary custody, but the custodial parent may waive claiming the dependent (¶ 139A).

139. Tie-Breaking Rules for Claiming Qualifying Child as Dependent. An individual may meet the requirements to be a qualifying child of more than one taxpayer (¶ 137A), but only one taxpayer can claim the individual as a dependent (¶ 137). If an individual may be claimed as a qualifying child by two or more taxpayers, the taxpayers generally may decide between themselves who may claim the child as a dependent.

If the taxpayers cannot agree and more than one taxpayer is entitled to claim the individual as a qualifying child, regardless of whether a return is filed and the qualifying child is claimed, the IRS will disallow all but one of the claims based on the following tie-breaking rules (Code Sec. 152(c)(4); Prop. Reg. § 1.152-2(g); Notice 2006-86):[29]

- If only one of the taxpayers is the child's parent, then the child is the qualifying child of the parent.

- If the child's parents do not file a joint return, then the child is the qualifying child of the parent with whom the child lived the longest during the year.

- If the child resided with both parents equally during the year and the parents do not file a joint return, then the child is the qualifying child of the parent with the highest adjusted gross income (AGI).

- If none of the taxpayers claiming the child is the child's parent, then the child is the qualifying child of the person with the highest AGI.

- If the parents may claim the child as a qualifying child, but do not actually do so, then the child may be the qualifying child of any other taxpayer but only if the other taxpayer's AGI is higher than the AGI of either parent. In the case of parents who file jointly, their AGI is divided equally to make this determination.

When applying the tie-breaking rules, the taxpayer is allowed to claim the child as a dependent for purposes of claiming a dependency exemption before 2018 and after 2025 (¶ 137), head-of-household filing status (¶ 173), the child tax credit (¶ 1405), the dependent care credit (¶ 1401), the earned income credit (¶ 1422), and the exclusion for dependent care benefits (¶ 2065). The tax benefits cannot be divided among the taxpayers.

See ¶ 139A for separate tie-breaker rules for divorced and separated parents.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[29] ¶ 8007, ¶ 8052B; § 1,215.35

139A. Dependent of Divorced or Separated Parents. A child who is a qualifying child (¶ 137A) or qualifying relative (¶ 137B) of divorced or separated parents generally may be claimed as a dependent of the parent who has primary custody of the child for the calendar year. The custodial parent is determined by the number of nights that the child resided with the parent (Code Sec. 152(e); Reg. § 1.152-4; Prop. Reg. § 1.152-5(e)).[30] If the child spends an equal amount of time with each parent, the parent with the higher adjusted gross income (AGI) is allowed to claim the child as a dependent.

The custodial parent may waive claiming the dependent, and the child may be claimed as a dependent of the noncustodial parent if all of the following requirements are met:

- the parents are divorced or legally separated under a decree of divorce or separate maintenance, separated under a written separation agreement, or lived apart at all times during the last six months of the calendar year, including parents who were never married and who do not live together;

- one or both parents provided more than one-half of the child's total support for the calendar year determined without regard to any multiple support agreement (¶ 147); if a parent has remarried, support received from the parent's spouse is treated as received from the parent (Code Sec. 152(d)(5)(B));

- one or both parents have legal custody of the child for more than one-half of the calendar year; and

- the custodial parent makes a written declaration on Form 8332 that he or she will not claim the child as a dependent and the noncustodial parent attaches the declaration to his or her original or amended return for each year the dependent is claimed.

If all of the above requirements are met, the noncustodial parent may claim the child as a dependent for purposes of the dependency exemption before 2018 and after 2025 (¶ 137), the child tax credit (¶ 1405), and any education credits attributable to educational expenses made for the child by the noncustodial parent (¶ 1403). Even if the custodial parent waives claiming the dependent, the custodial parent may still claim the child as a dependent for purposes of the head of household filing status (¶ 173), earned income credit (¶ 1422), dependent care credit (¶ 1401), and the exclusion of dependent care benefits (¶ 2065) (Reg. § 1.152-4(f); Notice 2006-86).

Also, so long as the first three requirements listed above are met, regardless of whether the custodial parent waives claiming the dependent, if the child is the qualifying child or qualifying relative of one of the parents, he or she can be treated as a dependent of both parents for purposes of:

- the child's receipt of benefits under a parent's employer-provided health care plan (¶ 2015);

- contributions to an accident or health plan by a parent's employer on behalf of the child (¶ 2013);

- the child's use of a fringe benefit that qualifies as a no-additional-cost service or qualified employee discount (¶ 2087 and ¶ 2088, respectively);

- the child's deductible medical expense (¶ 1015); and

- the child's qualified medical expenses paid from distributions from a health savings account (HSA) or Archer medical savings account (MSA) that are excludable from gross income (¶ 2035 and ¶ 2037, respectively) (Rev. Proc. 2008-48).

147. Support Test for Dependent. An individual may be claimed as dependent by a taxpayer only if: (1) the individual does not provide over one-half of his or her own support in the calendar year in order to be the taxpayer's qualifying child (¶ 137A), or (2) the taxpayer furnishes over one-half of the individual's support for the calendar year

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[30] ¶ 8007, ¶ 8150, ¶ 8151; § 1,215.40

in order to be the taxpayer's qualifying relative (¶ 137B). If an individual provides one-half of his or her own support for the calendar year, then no other taxpayer can generally claim that individual as a dependent except in the case of certain divorced parents (¶ 139A).

Multiple Support Agreement. An exception also applies for a qualifying relative if there is a multiple support agreement between two or more taxpayers who provide more than one-half of the dependent's support for the tax year, but no one person provides at least one-half of the support (Code Sec. 152(d)(3); Reg. § 1.152-3; Prop. Reg. § 1.152-3(d)(4)).[31] In that case, a taxpayer who provided at least 10 percent of the dependent's support is treated as providing more than one-half of the support if the other taxpayers who provided at least 10 percent of the support waive any claim to the dependent for the calendar year by written declaration. The taxpayer who claims the dependent must keep these signed statements for his or her record. Form 2120 identifying each of the other persons who agreed not to claim the dependent must be attached to the return of the taxpayer claiming the exemption

Support Defined. Support includes amounts spent to provide food, shelter, clothing, medical and dental care, education, transportation, and similar necessities. Expenses not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. Support does not include the individual's income, Social Security, or Medicare taxes paid from the individual's own income or assets, or life insurance premiums, funeral expenses, or scholarships received. In addition, alimony payments are not treated as payments by the payor for the support of any dependent. In the case of remarriage, a child's support that is provided by a parent's spouse is treated as provided by the parent (Code Sec. 152(d)(5) and (f)(5); Prop. Reg. § 1.152-4(a); IRS Pub. 501).[32]

In determining support for a dependent for a calendar year, the amount of support provided by a taxpayer or by the dependent themselves is generally compared to the total amount of the dependent's support from all sources, including amounts that are excludable from gross income such as tax-exempt interest. The amount of any item of support is the amount of expense paid or incurred to furnish the item of support, except for property or lodging in which case the amount of the item of support is the fair market value of the item. An amount paid in a calendar year after the calendar year in which the liability is incurred is treated as paid in the year of payment.

Governmental payments and subsidies provided to the needy are generally considered support provided by a third party (i.e., provided by the state). Examples include low-income housing assistance, foster care maintenance payments, adoption assistance benefits, payments of Temporary Assistance for Needy Families (TANF), and Supplemental Nutrition Assistance Program (SNAP) benefits. Governmental payments and subsidies that are used by the recipient to support another person are considered support of that other person provided by the recipient, rather than support provided by the state. For example, if a mother receives TANF and uses the TANF payments to support her children, the mother is treated as having provided that support.

Medical insurance premiums are treated as support, including premiums for Medicare Parts A, B, C, and D. Medical insurance proceeds are not treated as items of support and are disregarded in determining the amount of the individual's support. Similarly, services provided to an individual under the medical and dental care provisions of the Armed Forces Act are not treated as support and are disregarded in determining the amount of the individual's support.

Filing Status

152. Married Filing Jointly Filing Status. Married individuals may elect to file a joint return if they are married on the last day of the tax year, use the same tax year, agree to file jointly, and neither is a nonresident alien during the tax year. Spouses may

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[31] ¶ 8007, ¶ 8100, ¶ 8100B; § 1,220.20

[32] ¶ 8007, ¶ 8151; § 1,220.20

file a joint return even though one spouse has no income or deductions (Code Sec. 6013; Reg. § 1.6013-1).[33] Both spouses generally must sign a joint return but exceptions are provided if one spouse cannot sign due to disease, injury, or mental incompetence, or because the spouse is serving in a combat zone, qualified hazardous duty area, or contingency operation. Once a joint return has been filed for a tax year, the spouses generally may not elect to file separate returns for that year after the due date of the return.

If a spouse dies during the year, the taxpayers are considered married for the whole year and the surviving spouse may elect to file a joint return for the decedent's final year (¶ 180). However, the executor or administrator of the decedent's estate may elect to change from a joint to a separate return within one year of the due date of the return.

Items of gross income, deductions, and credits of both spouses are combined on a joint return and the tax is computed on the spouses' aggregate taxable income. The tax calculated on a joint return is usually lower than the combined tax than if the spouses filed separately (¶ 154) because certain tax benefits may not be claimed if married filing separately (¶ 156). The spouses are jointly and severally liable for the tax due on a joint return (¶ 162).

Marital Status. Whether a marriage is recognized for federal tax purposes depends on state law. If taxpayers are married in compliance with the laws of the state in which they are married, then the marriage is recognized for federal tax purposes, even if they later reside in another state. This includes common law and same-sex marriages. A marriage conducted in a foreign jurisdiction is also recognized if that marriage would be recognized in at least one state, possession, or territory of the United States, regardless of where the individuals are domiciled. A marriage for federal tax purposes does not include registered domestic partnerships, civil unions, or other similar relationships recognized under state law that are not denominated as a marriage under that state's law (Reg. § 301.7701-18; Rev. Rul. 58-66).[34]

Even though married persons are not living together on the last day of the tax year, they may still file a joint return if they are *not* legally separated under a decree of divorce or separate maintenance on that date (Reg. § 1.6013-4).[35] Spouses who are separated under an interlocutory decree of divorce are considered married and entitled to file a joint return until the decree becomes final. However, certain married individuals living apart may file separate returns as heads of households (¶ 173).

Nonresident Alien. A U.S. citizen or resident alien married to a nonresident alien generally must file as married filing separately. However, the couple may file a joint return if the nonresident alien elects to be taxed as a resident alien (¶ 2410).

Spouse in Combat Zone. Spouses of military personnel serving in a combat zone and missing in action may file a joint return for any tax year until the tax year beginning two years after the termination of combat activities in the combat zone (Code Sec. 6013(f)).[36]

154. Married Filing Separately Filing Status. A married individual may elect to file separately rather than filing a joint return with his or her spouse (¶ 152). A married taxpayer generally is required to file separately if his or her spouse uses a different tax year or if the spouse does not agree to file a joint return. Also, the taxpayer may file as head of household if he or she is considered unmarried, lives apart from his or her spouse for the last six months of the tax year, and meets certain other tests (¶ 173). Spouses that file separate returns will generally have a higher combined tax than spouses that file a joint return because certain tax benefits may not be claimed if married filing separately (¶ 156).

If married individuals file separate returns for a tax year, they can change filing status and elect to make a joint return for that year by filing an amended return on Form 1040X within three years of the due date for the separate return (without regard to extensions) (Code Sec. 6013(b)).[37] A separate return for this purpose includes a return

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[33] ¶ 35,160, ¶ 35,161; § 1,320.05

[34] ¶ 43,116; § 46,951

[35] ¶ 35,165; § 1,320.10

[36] ¶ 35,160; § 1,320.10

[37] ¶ 35,160; § 1,320.25

filed claiming married filing separately, single, or head of household filing status. All payments, credits, refunds, or other repayments relating to the separate returns are applied to the joint return. Any election made on a separate return must also be made on the joint return if the election would have been irrevocable on an original joint return. The change to a joint return cannot be made in certain circumstances.

Once a joint return has been filed for a tax year, the spouses may *not* elect to file separate returns for that year after the due date of the return. However, if either spouse dies during the tax year, the executor or administrator of the decedent's estate may elect to change from a joint to a separate return within one year of the due date of the return (¶ 180).

156. Joint Return v. Separate Return. It is generally more beneficial for married taxpayers to file a joint return (¶ 152) as differences in the tax rate brackets for joint and separate returns result in higher tax rates for married individuals filing separately. Unlike with separate returns, taxable income (¶ 111) on a joint return is the entire taxable income amount of the couple. Although there are two taxpayers on the joint return, income and deductions on a joint return are computed on an aggregate basis (Reg. § 1.6013-4).[38]

Example: For 2018, Joe has taxable income in the amount of $14,500, and his wife, Trisha, has taxable income in the amount of $38,800. If they elect to file a joint return, they will not be subject to the 22-percent tax rate because their combined taxable income of $53,300 does not exceed the $77,400 threshold amount for 2018 (¶ 13). If they elect to file separate returns, Trisha's taxable income exceeds the threshold for the 22 percent bracket by $100 for the year (¶ 15).

Spouses who file separate returns generally have a higher combined tax because the standard deduction is one-half the amount allowed on joint return (¶ 131), and if one spouse itemizes deductions the other spouse must also itemize deductions. A married individual filing separately also may *not* claim the credit for the elderly or permanently disabled (¶ 1402), the child and dependent care credit (¶ 1401), the earned income credit (¶ 1422), the exclusion or credit for adoption expenses (¶ 1407), or the educational credits (¶ 1403), as well as the exclusion of any interest income from qualified U.S. savings bonds used for higher education expenses (¶ 863).

There are circumstances under which married taxpayers might reduce their tax liability by filing separate returns. Because taxpayers who file joint returns are jointly and severally liable for the tax on the return, filing separately may be preferable if one spouse does not want to be held liable for the other spouse's tax liability. For example, a spouse whose medical expenses are high, but not high enough to exceed the adjusted gross income (AGI) threshold reported on a joint return, may exceed the AGI threshold on a separate return (¶ 1015).

Actual tax comparisons should be made using both joint and separate returns if there is doubt as to which return produces a more favorable result. Considerations other than tax savings might enter into the decision to file a separate rather than a joint return.

162. Innocent Spouse Relief from Joint Return. Married individuals filing joint return are liable jointly and individually for the entire amount of tax, penalties, and interest arising from the return (¶ 152). Relief from joint liability is generally available under three circumstances to an electing spouse: liability relief (commonly referred to as innocent spouse relief), separation of liability relief, or equitable relief (Code Sec. 6015).[39]

A spouse must generally request one of these types of relief on Form 8857 within two years of the IRS beginning collection of a tax deficiency or assessment. However, equitable relief requests may be requested within the limitations period for filing any

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[38] ¶ 35,165; § 1,320.05 [39] ¶ 35,185; § 39,040.05

claim for refund (¶ 2763) or for the collection of tax (¶ 2735) (Notice 2011-70). Any determination by the IRS regarding any type of relief may be reviewable in the Tax Court.[40]

Innocent Spouse Relief. To qualify for innocent spouse relief, the electing taxpayer must:

- file a joint return for the tax year that has an *understatement of tax* due to *erroneous items* of the other spouse;
- establish that at the time of signing the tax return the taxpayer did not know, or have reason to know, there was an understatement of tax; and
- show that it would be unfair to hold the innocent spouse liable for the understatement of tax, taking into account all the facts and circumstances (Code Sec. 6015(b)).[41]

A key element for the IRS in granting innocent spouse relief is whether the electing spouse received any substantial benefits, or later was divorced or separated from, or deserted by, the other spouse.

Separation of Liability Relief. Alternatively, a spouse may elect to obtain relief by separation of liabilities (Code Sec. 6015(c)).[42] To qualify, an individual must have filed a joint return, and either:

- be no longer married to, or be legally separated from, the spouse with whom the joint return was filed, or
- must *not* have been a member of the same household with the other spouse for a 12-month period ending on the date of the filing of Form 8857.

The burden of proof for determining income and deductions is on the taxpayer who elects relief under separation of liability.

Equitable Relief. If an individual fails to qualify for either of the first two types of relief, he or she may still obtain relief from joint liability by electing equitable relief (Code Sec. 6015(f); Rev. Proc. 2013-34).[43] The taxpayer must show that, under *all* facts and circumstances, it would be unfair to be held liable for the understatement or underpayment of taxes.

163. Injured Spouse Relief from Joint Return. If married taxpayers file a joint return (¶ 152) and one spouse owes certain past-due amounts (e.g., child support, alimony, student loans), all or part of the tax overpayment shown on the joint return may be used to satisfy the past-due debt. The nonobligated spouse may be considered an injured spouse and entitled to a refund of his or her part of the overpayment if he or she:

- is not required to pay the past-due amount;
- received and reported income such as wages, taxable interest, etc., on the joint return; and
- made and reported payments on the joint return, including withheld federal income taxes or estimated taxes (Financial Management Service Reg. § 285.3).[44]

The injured spouse should file Form 8379 either with the married couple's jointly filed return (with "Injured Spouse" in the upper left corner) or by itself if filing after the joint return has already been filed. A separate Form 8379 must be filed for each tax year. An injured spouse claim is different from an innocent spouse relief from joint liability (¶ 162).

173. Head of Household Filing Status. An individual who qualifies to file as head of household is generally entitled to a higher standard deduction (¶ 131) and lower tax rates than a single individual (Code Sec. 2(b)).[45] A taxpayer qualifies as head of household if:

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[40] ¶ 35,192.815; § 39,040.05 [42] ¶ 35,185; § 39,040.15 [44] ¶ 38,527; § 40,015.15
[41] ¶ 35,185; § 39,040.10 [43] ¶ 35,185; § 39,040.20 [45] ¶ 3310; § 1,115.05

sale may be depreciable for the period before the sale if the individual is seeking a profit based on post-conversion appreciation in value. Placing a property for sale immediately or shortly after the time of its abandonment as a residence is strong evidence that the property is not held for post-conversion appreciation in value. MACRS must be used to depreciate a residence converted to business use after 1986. See ¶ 961 for computation of depreciation when a home is used partly for business or rental purposes. See ¶ 1203 for basis for depreciation.

Estates and Trusts. See ¶ 530 for depreciation by an estate or trust.

Inventory and Land. Depreciation is allowed for tangible property, but not for inventories, stock in trade, land apart from its improvements, or a depletable natural resource (Reg. § 1.167(a)-2).[7]

Farmers. Farm buildings and other physical farm property (except land) are depreciable. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in inventory (Reg. § 1.167(a)-6(b)).[8]

Intangibles. An intangible business asset that is not amortizable over 15 years under Code Sec. 197 (¶ 1362) may be amortized under Code Sec. 167, generally using the straight-line method, provided that it has an ascertainable value and useful life that can be measured with reasonable accuracy.[9] Certain intangibles with no ascertainable useful life that are created by a taxpayer may be amortized over 15 years (¶ 1364).

Software. Computer software that is not an amortizable Code Sec. 197 intangible (¶ 1362) may be depreciated using the straight-line method over 36 months beginning on the first day of the month the software is placed in service (¶ 980) (Code Sec. 167(f)(1); Reg. § 1.167(a)-14(b); Rev. Proc. 2000-50).[10] However, the cost of software developed for internal use or sale may be currently deducted as a research and development expense, amortized using the straight-line method over 60 months beginning on the date its development is complete, or amortized over 36 months from the date it is placed in service. Expenditures paid or incurred in tax years beginning after 2021 for developing software must be amortized over 60 months as research and development expenditures (¶ 979). Off-the-shelf computer software may be expensed under Code Sec. 179 (¶ 1208). Software included as part of the purchase price of a computer that has no separately stated cost is depreciated as part of the cost of the computer over a five-year recovery period.

Web Site Development Costs. The IRS has not issued formal guidance on the treatment of web site development costs, but informal internal IRS guidance suggests that one appropriate approach is to treat these costs like an item of software and depreciate them over three years. It is clear, however, that taxpayers who pay large amounts to develop sophisticated sites have been allocating their costs to items such as software development (currently deductible like research and development costs under Code Sec. 174) and currently deductible advertising expense.[11]

Residential Mortgage-Servicing Rights. Depreciable residential mortgage-servicing rights that are not Code Sec. 197 intangibles may be depreciated under the straight-line method over 108 months (Code Sec. 167(f)(3)).[12]

Term Interests. The purchaser of a term interest in property held for business or investment is generally entitled to recover its cost over its expected life. However, no depreciation or amortization deduction is allowed for certain term interests in property for any period during which the remainder interest is held directly (or indirectly) by a related person (Code Sec. 167(e)).[13]

Form 4562. Form 4562 is generally used to claim the depreciation or amortization deduction. Individuals and other noncorporate taxpayers (including S corporations) need not complete Form 4562 if their only depreciation or amortization deduction is for

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[7] ¶ 11,006; § 11,005
[8] ¶ 11,015; § 36,320
[9] ¶ 11,008; § 11,005
[10] ¶ 11,002; § 11,535
[11] ¶ 13,720.01; § 11,005
[12] ¶ 11,002; § 11,540
[13] ¶ 11,002; § 11,005

property (other than listed property (¶ 1211)) placed in service before the current tax year. Form 4562 also must be filed if a section 179 deduction (including a carryover) is claimed in the current tax year.

Basis for Depreciation

1203. Cost or Other Basis Recoverable Through Depreciation. The cost of a depreciable asset is recovered through depreciation, after being reduced by any amount claimed as an expense deduction under Code Sec. 179 (¶ 1208) or as first-year bonus depreciation (¶ 1237). Other downward adjustments to cost prior to depreciation may also be necessary to prevent a duplication of benefits from credits and deductions claimed with respect to the property in the tax year of purchase. See ¶ 1465A for the effect of the investment credit on depreciable basis.

If property held for personal use, such as a residence, is converted to business or income-producing use, the basis for depreciation is the lesser of the property's fair market value or adjusted basis on the date of conversion (Reg. § 1.167(g)-1; Reg. § 1.168(i)-4(b)).[14] In the case of a residence converted to business use after 1986, the Modified Accelerated Cost Recovery System (MACRS) must be used (¶ 1236).

If a building and land are acquired for a lump sum, only the building is depreciated. The basis must be allocated between the land and the building in proportion to their relative fair market values at the time of acquisition (Reg. § 1.167(a)-5). If property is subject to both depreciation and amortization, depreciation is allowable only for the portion that is not subject to amortization and may be taken concurrently with amortization.[15]

Section 179 Expense Election

1208. Code Sec. 179 Expense Election. A taxpayer other than an estate, trust, and specified noncorporate lessor may elect to expense the cost of qualifying section 179 property placed in service during the tax year rather than treating the cost as a capital expenditure (Code Sec. 179).[16] The election is made on Form 4562. A taxpayer may also make, revoke, or change an election without IRS consent on an amended return filed during the period prescribed for filing an amended return (Code Sec. 179(c)(2); Reg. § 1.179-5(c)).[17]

De Minimis Expensing Rule. A separate rule allows a taxpayer to elect to deduct amounts paid or incurred to acquire materials and supplies, and amounts paid or incurred to acquire or produce units of property costing less than a prescribed amount, if specific requirements are met (¶ 1311).

Dollar Limitation. The maximum amount that a taxpayer may elect to expense under Code Sec. 179 is $1 million for tax years beginning in 2018 (projected to be $1.02 million for tax years beginning in 2019) (Code Sec. 179(b)(1) and (b)(6); Rev. Proc. 2018-18).[18] The dollar limit is $510,000 for tax years beginning in 2017 and $500,000 for tax years beginning in 2010 through 2016. See ¶ 1214 for a discussion of the $25,000 section 179 deduction limit for any tax year on sport utility vehicles, short-bed trucks, and certain vans that are exempt from the luxury car depreciation caps.

Investment Limitation. The maximum dollar limitation is reduced by the cost of section 179 property placed in service during the tax year that exceeds an investment limitation. The investment limitation is $2.5 million for tax years beginning in 2018 (projected to be $2.55 million for tax years beginning in 2019). The investment limitation is $2.03 million for tax years beginning in 2017, $2.01 million for tax years beginning in 2016, and $2 million for tax years beginning 2010 through 2015. Any reduction in the dollar limitation attributable to the investment limitation is not carried over (Code Sec. 179(b)(2) and (b)(6); Reg. § 1.179-2(b)(2); Rev. Proc. 2018-18).[19]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[14] ¶ 11,046; § 16,101
[15] ¶ 11,012, ¶ 11,014.021; § 11,001
[16] ¶ 12,120; § 9,801
[17] ¶ 12,120; § 9,830
[18] ¶ 12,120; § 9,815.05
[19] ¶ 12,120, ¶ 12,122; § 9,815.05.

Example 1: ZYX Corp. is a calendar year corporation that places in service section 179 property in 2018. ZYX may not claim a deduction under Code Sec. 179 if the amount placed in service is more than $3.5 million for the year ($3.5 million – $2.5 million = $1 million).

Taxable Income Limitation. The total cost of section 179 property for which an election to expense is made that may be deducted cannot exceed the total amount of taxable income derived from the active conduct of the taxpayer's trades or businesses during the tax year, including salary and wages received as an employee (Code Sec. 179(b)(3); Reg. § 1.179-2(c)).[20]

Carryforwards. The amount elected to be expensed after any reduction on account of the investment limitation and that is disallowed as a deduction as a result of the taxable income limitation is carried forward for an unlimited number of years (Code Sec. 179(b)(3); Reg. § 1.179-3).[21]

Example 2: ABC Corp., a calendar-year taxpayer, places $2.06 million of section 179 property in service in 2017. The $510,000 expensing limit for 2017 is reduced under the investment limit by $30,000 ($2.06 million – $2.03 million). ABC may elect to expense up to $480,000 ($510,000 – $30,000) of the cost of the section 179 property placed in service in 2017. The $30,000 reduction in the expensing limit is not carried forward to 2018. If ABC elects to expense the full $480,000 and it's 2017 taxable income from the active conduct of its trade or business during the year is $450,000, then ABC's section 179 deduction for 2017 is limited to $450,000. The $30,000 disallowed deduction is carried forward to 2018.

The amount allowable as a section 179 deduction in a carryforward year is increased by the lesser of (1) the aggregate amount of unused carryforwards for all prior tax years, or (2) the amount of any unused section 179 expense allowance for the carryforward year. The amount of the unused section 179 expense allowance for the carryforward year equals the excess (if any) of (1) the maximum cost of section 179 property that the taxpayer may deduct for the carryforward year after applying the investment limitation and taxable income limitation, over (2) the amount of section 179 property that the taxpayer actually elects to expense in the carryforward year.

Example 3: Assume the same facts as in Example 2 above, except that in 2018 ABC places $995,000 of section 179 property in service. No reduction in the $1 million expensing limit for 2018 is required under the investment limit because ABC did not place more than $2.5 million of section 179 property in service. ABC may only elect to expense up to $995,000 in 2018 since the $995,000 cost of the section 179 property placed in service is less than the $1 million expensing limit after application of the investment limit.

If ABC's 2018 taxable income is $1 million, it may claim a $995,000 expense deduction for the section 179 property placed in service in 2018 since its taxable income exceeds the $995,000 expensing limit for the property placed in service during the year. ABC's unused section 179 allowance is $5,000. Therefore, ABC may deduct $5,000 of the $30,000 2017 carryforward in 2018. The remaining $25,000 carryforward from 2017 is carried to 2019. None of the carryforward would have been deductible in 2018 if ABC's taxable income had been $995,000 and ABC elected to expense $995,000.

Carryforwards are considered used from the earliest year in which a carryforward arose. To the extent a carryforward is attributable to multiple properties placed in service in the same tax year, a taxpayer may select the properties and apportionment of cost for purposes of determining the source of the carryforward. This selection, however, must be recorded on the taxpayer's books and records in the tax year the property was placed in service and followed consistently in subsequent tax years. If no selection is made the carryover is apportioned equally among the items of section 179 property that were expensed in the tax year that the carryforward arose. For this purpose, allocations of a section 179 expense from a partnership or S corporation are treated as a single item of section 179 property (Reg. § 1.179-3(e)).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[20] ¶ 12,122; § 9,815.05 [21] ¶ 12,123; § 9,825.05

Basis Reduction. The basis of an expensed property for purposes of computing depreciation is reduced by the full amount elected to be expensed (after application of the investment limitation) even if a portion of the elected amount is disallowed as a deduction under the taxable income limitation and carried forward. If the property is sold, disposed of, or transferred in a nonrecognition transaction (including transfers at death) before the carryforward is deducted, the basis of the property is increased immediately before the transfer by the carryforward attributable to the property that was not deducted. The unused carryforward that increases the basis of the property is not deducted by the transferor or transferee (Reg. § 1.179-3(f)(1)).[22]

Short Tax Year. The computation of the section 179 deduction is not affected by a short tax year (Reg. § 1.179-1(c)(1)).

Married Taxpayers. Married individuals filing jointly are treated as one taxpayer for purposes of applying the dollar, investment, and taxable income limitations regardless of which spouse placed the qualifying property in service (Reg. § 1.179-2(b)(5)(i) and (c)(7)(i)). Married individuals filing separately may allocate the dollar limitation after any reduction by the investment limitation between themselves or, in the absence of an allocation agreement, divide it equally. Separate filers aggregate section 179 property for purposes of applying the investment limitation (Code Sec. 179(b)(4); Reg. § 1.179-2(b)(6)). The taxable income limitation is applied individually to separate filers (Reg. § 1.179-2(c)(8)).[23]

Partnerships and S Corporations. The dollar limitation, investment limitation, and taxable income limitation are applied separately at the partnership and partner levels (Code Sec. 179(d)(8); Reg. § 1.179-2(b)(3), (b)(4), (c)(2), and (c)(3)).[24] In applying the investment limitation, the cost of section 179 property placed in service by the partnership is not attributed to any partner. A similar rule applies to an S corporation and its shareholders.

For purposes of applying the taxable income limitation at the partnership or S corporation level, taxable income (or loss) derived by the partnership or S corporation from the active conduct of a trade or business is computed by aggregating the net income (or loss) from all the trades or businesses actively conducted by the entity during the tax year.

A partner's or S corporation shareholder's taxable income includes net distributable profit or loss from the pass-through entity in which the taxpayer is an active participant. A partner and S corporation shareholder is required to reduce the basis of their partnership or S corporation interest by the full amount of an expense deduction allocated to them even though part of the deduction must be carried over because of the partner's or S corporation shareholder's taxable income limitation or disallowed because of the dollar limitation (Reg. § 1.179-3(h)(1); Rev. Rul. 89-7).

Controlled Groups. Members of a controlled group on December 31 are treated as a single taxpayer for purposes of the dollar, investment, and taxable income limitation even if a consolidated return is not filed (Code Sec. 179(d)(6)). The allowable expense deduction may be allocated among members in any manner, but the amount allocated to any member may not exceed the cost of section 179 property actually purchased and placed in service during the tax year by the member (Reg.§ 1.179-2(b)(7)).[25]

Noncorporate Lessors. A lessor, other than a corporation, may not claim the section 179 deduction on leased property unless the property was manufactured or produced by the lessor, or the term of the lease is less than one-half of the property's class life (i.e. MACRS alternative depreciation system (ADS) period). In addition, for the 12-month period following the date that the leased property is transferred to the lessee, the total ordinary and necessary business deductions allowed to the lessor for the property must exceed 15 percent of the rental income produced by the property (Code Sec. 179(d)(5); Reg. § 1.179-1(i)(2)).[26]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[22] ¶ 12,123; § 9,825.10. [23] ¶ 12,122; § 9,815.10 [24] ¶ 12,120, ¶ 12,122, ¶ 12,123; § 9,815.15 [25] ¶ 12,122; § 9,815.20 [26] ¶ 12,121; § 9,805.

Exemption from UNICAP and Section 263 Capitalization. The section 179 deduction is an indirect cost that is not required to be capitalized under the uniform capitalization (UNICAP) rules (Reg. §§1.179-1(j) and 1.263A-1(e)(3)(iii)). Amounts expensed under Code Sec. 179 are also not required to be capitalized under Code Sec. 263 (Code Sec. 263(a)(1)(G); Reg. §1.179-1(j)).[27]

Section 179 Property Defined. Section 179 property is tangible section 1245 property (new or used) depreciable under the Modified Accelerated Cost Recovery System (MACRS) and acquired by purchase for use in the active conduct of a trade or business (Code Sec. 179(d)).[28] Property used predominantly outside of the United States and property used by tax-exempt organizations (unless the property is used predominantly in connection with an unrelated business income activity) do not qualify as section 179 property (Code Sec. 50(b)).

In tax years beginning before 2018, property used with respect to lodging, such as apartment buildings but not hotels and motels, does not qualify for expensing (Code Sec. 179(d)(1), prior to amendment by the Tax Cuts and Jobs Act (P.L. 115-97)).

Depreciable off-the-shelf computer software may be expensed under Code Sec. 179 (Code Sec. 179(d)(1)(A)).[29] This is software described in Code Sec. 197(e)(3)(A)(i) that is readily available for purchase by the general public, is subject to a nonexclusive license, has not been substantially modified, and is depreciable over three years.

Portable air conditioning and heating units placed in service in tax years beginning after 2015 may also qualify as section 179 property (Rev. Proc. 2017-33).

Qualified Real Property. A taxpayer may elect to treat the cost of qualified real property placed in service during the tax year as section 179 property (Code Sec. 179(d)(1)(B)(ii) and (e); Notice 2013-59).[30] The maximum amount of qualified real property that may be expensed in a tax year beginning in 2010 through 2015 was limited to $250,000. The cost of qualified real property that is expensed reduces the annual dollar limitation.

Example 4: A calendar-year taxpayer places $1.6 million of qualified real property in service in 2018 and elects to treat it as section 179 property. The taxpayer also places $400,000 of other section 179 property in service in 2018. The $1 million expensing limit for 2018 is not subject to reduction under the investment limit because the taxpayer did not place more than $2.5 million of section 179 property in service in 2018. The taxpayer may elect to expense up to $1 million of the cost of its qualified real property. If it elects to expense $1 million of the qualified real property, then it may not elect to expense any other section 179 property in 2018 since the full $1 million expensing limit has been used. If the taxpayer elected to expense only $600,000 of qualified real property, it could elect to expense up to $400,000 of its other section 179 property.

In tax years beginning after 2017, qualified real property is defined as:

- qualified improvement property (¶ 1240); and
- any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems (Code Sec. 179(e)).

In tax years beginning before 2018, qualified real property is defined as: qualified leasehold improvement property (¶ 1234 and ¶ 1237); qualified restaurant property (¶ 1240); and qualified retail improvement property (¶ 1240) (Code Sec. 179(f), prior to amendment by P.L. 115-97). These three types of property have a 15-year recovery period under MACRS if placed in service before 2018.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[27] ¶ 12,121; ¶ 13,811
[28] ¶ 12,120; § 9,810
[29] ¶ 12,120; § 9,810
[30] ¶ 12,120; § 9,810

No amount of a section 179 deduction attributable to qualified real property that is disallowed under the taxable income limitation may be carried forward to a tax year beginning after 2015 (Code Sec. 179(f)(4), prior to repeal by the Consolidated Appropriations Act, 2016 (P.L. 114-113)).

The amount of qualified real property that is expensed under Code Sec. 179 is subject to the section 1245 ordinary income recapture rules (¶ 1785) (Code Sec. 1245(a)(3)(C)). If only a portion of the cost of a qualified real property is expensed, a taxpayer may use any reasonable method to determine the amount of gain on the disposition of the property that is attributable to section 1245 property and section 1250 property, including a pro rata allocation and gain allocation methodology (Notice 2013-59). The section 1245 recapture amount is limited to the gain allocated to the section 1245 property.

Purchase Defined. Section 179 property is acquired by purchase unless it: (1) is acquired from a related person (¶ 432 and ¶ 717); (2) is acquired by one member of a controlled group of corporations from another member (substituting 50 percent for the 80 percent that would otherwise apply with respect to stock ownership requirements); (3) has a basis in the hands of the acquiring taxpayer determined in whole or in part by reference to the adjusted basis of the person from who the property was acquired (e.g., a gift); (4) has a basis determined under Code Sec. 1014(a) relating to inherited or bequeathed property; (5) is acquired by a corporation in a transaction to which Code Sec. 351 applies; (6) is acquired by a partnership through a Code Sec. 723 contribution or is acquired from a partnership in a distribution that has a carryover basis (Code Sec. 179(d)(2); Reg. §1.179-4(c)).[31]

Carryover Basis in Trade-Ins and Involuntary Conversions. The portion of the basis of property that is attributable to the basis of property that was previously held by the taxpayer (e.g., carryover basis under Code Sec. 1031 and 1033) does not qualify for the expense deduction (Code Sec. 179(d)(3); Reg. §1.179-4(d)).

Recapture Upon Sale or Disposition. The Code Sec. 179 expense deduction is treated as depreciation for recapture purposes (¶ 1779) (Code Sec. 1245(a)(2)(C)). Thus, gain on a disposition of section 179 property that is section 1245 property is treated as ordinary income to the extent of the section 179 expense allowance claimed plus any depreciation claimed. Qualified real property and certain land improvements are section 1250 property. Nevertheless, a section 179 expense deduction for qualified real property and section 1250 land improvements is also subject to recapture as ordinary income under the rules that apply to section 1245 property (¶ 1785) (Code Sec. 1245(a)(3)(C)).

Recapture Upon Decline in Business Use. If business use of section 179 property does not exceed 50 percent during any year of the property's depreciation period, a portion of the amount expensed is recaptured as ordinary income (Code Sec. 179(d)(10); Reg. §1.179-1(e)).[32] The recapture amount is the difference between the expense claimed and the depreciation that would have been allowed on the expensed amount for prior tax years and the tax year of recapture. However, the recapture rules that apply to listed property such as passenger automobiles used less than 50 percent for business (¶ 1211) take precedence over this section 179 recapture rule. Recapture is reported on Form 4797.

Alternative Minimum Tax. The Code Sec. 179 expense deduction is allowed in full for alternative minimum tax (AMT) purposes (Instructions to Form 6251).

Empowerment Zones. The section 179 annual dollar limitation is increased an additional $35,000 for section 179 property placed in service in designated empowerment zones by an enterprise zone business (Code Sec. 1397A).[33] The $35,000 increase is subject to recapture if the property is removed from the empowerment zone. In general, the qualifying property must be placed in service in the empowerment zone before January 1, 2018 (¶ 1799B).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[31] ¶ 12,124; § 9,810
[32] ¶ 12,121; § 9,840
[33] ¶ 32,397; § 9,815.05

Limitations on Automobiles and Other Listed Property

1211. Business Usage Requirement for Listed Property. Depreciation deductions for "listed property" are subject to special rules (Code Sec. 280F).[34] Listed property includes: passenger automobiles (¶ 1214); other forms of transportation, if the property's nature lends itself to personal use (e.g., airplanes, boats, vehicles excluded from the definition of a passenger automobile); entertainment, recreational and amusement property; computers and peripheral equipment if placed in service before 2018; and any other property specified by regulation. Computers and related peripheral equipment are not listed property if placed in service after 2017.

If an item of listed property is not used more than 50 percent for business, depreciation under the Modified Accelerated Cost Recovery System (MACRS) on the property must be determined under the alternative depreciation system (ADS) (¶ 1247). In addition, if the more-than-50-percent business use test is not satisfied in the tax year the property is placed in service, the property does not qualify for the Code Sec. 179 expensing election (¶ 1208) or the bonus depreciation deduction (¶ 1237).

If the listed property satisfies the more-than-50-percent business use requirement in the tax year it is placed in service but fails to meet that test in a later tax year that occurs during any year of the property's ADS recovery period, depreciation deductions (including any section 179 deduction and bonus depreciation) previously taken are subject to recapture (Code Secs. 168(k)(2)(F)(ii), 280F(b)(2), and (d)(1)). MACRS depreciation for years preceding the year in which the business use falls to 50 percent or less is recaptured to the extent that the MACRS depreciation (including the section 179 deduction and bonus depreciation) for such years exceeds the depreciation that would have been allowed under ADS computed as if the section 179 allowance and bonus depreciation had not been claimed. Depreciation thereafter must be computed using ADS. For example, if a taxpayer expenses the entire cost of a listed property, the difference between the amount expensed and the ADS deductions that would have been allowed on that amount prior to the recapture year is recaptured as ordinary income. Part IV of Form 4797 is used to calculate any recapture amount.

See ¶ 1214 for additional limits on passenger automobiles.

1214. Depreciation Limits on Automobiles, Trucks, SUVs, and Vans. The maximum depreciation deductions under the Modified Accelerated Cost Recovery System (MACRS) (including the Section 179 expensing deduction (¶ 1208) and bonus depreciation deduction (¶ 1237)) that may be claimed for a passenger automobile other than a truck, including an SUV treated as a truck, or van placed in service in calendar year 2011 or later are shown in the chart below (Code Sec. 280F).[35] See IRS Pub. 463 for earlier years.

For Cars Placed in Service		*Depreciation Allowable in—*				
After	*Before*	*Year 1*	*Year 2*	*Year 3*	*Year 4, etc.*	*Authority*
12/31/10	1/01/12	11,060 * 3,060	4,900	2,950	1,775	Rev. Proc. 2011-21
12/31/11	1/01/13	11,160 * 3,160	5,100	3,050	1,875	Rev. Proc. 2012-23
12/31/12	1/01/14	11,160 * 3,160	5,100	3,050	1,875	Rev. Proc. 2013-21
12/31/13	1/01/15	11,160 * 3,160	5,100	3,050	1,875	Rev. Proc. 2014-21, modified by Rev. Proc. 2015-19
12/31/14	1/01/16	11,160 * 3,160	5,100	3,050	1,875	Rev. Proc. 2015-19, modified by Rev. Proc. 2016-23
12/31/15	1/01/17	11,160 * 3,160	5,100	3,050	1,875	Rev. Proc. 2016-23
12/31/16	1/01/18	11,160 * 3,160	5,100	3,050	1,875	Rev. Proc. 2017-29
12/31/17	1/01/19	18,000 * 10,000	16,000	9,600	5,760	Rev. Proc. 2018-25

* The higher first-year limit applies if the vehicle qualifies for bonus depreciation (¶ 1237) and no election out is made.

If a vehicle is acquired before September 28, 2017, and placed in service in 2018, the first-year cap is $16,400 ($10,000 + $6,400) if bonus depreciation is claimed. If a vehicle is acquired after September 27, 2017, and placed in service in 2018, the first year cap is $18,000 ($10,000 + $8,000) if bonus depreciation is claimed (Code Sec. 168(k)(2)(F)(iii); Rev. Proc. 2018-25).

Assuming that the 200-percent declining balance method and half-year convention apply, a car placed in service in 2017 on which bonus depreciation is claimed is subject to the first-year cap if the cost of the vehicle exceeds $18,600 ($9,300 bonus + (9,300 remaining basis × 20 percent) = $11,160).

Trucks (including SUVs treated as trucks) and vans are subject to their own set of depreciation caps if placed in service after 2002. These caps (reproduced in the table below) reflect the higher costs associated with such vehicles. However, trucks and vans that have a gross vehicle weight rating greater than 6,000 pounds are not subject to any caps (discussed below). Also, certain trucks and vans are not subject to the caps if, because of their design, they are not likely to be used for personal purposes (discussed below).

For Trucks and Vans Placed in Service		*Depreciation Allowable in—*				
After	*Before*	*Year 1*	*Year 2*	*Year 3*	*Year 4, etc.*	*Authority*
12/31/10	1/01/12	11,260 * 3,260	5,200	3,150	1,875	Rev. Proc. 2011-21
12/31/11	1/01/13	11,360 * 3,360	5,300	3,150	1,875	Rev. Proc. 2012-23
12/31/12	1/01/14	11,360 * 3,360	5,400	3,250	1,975	Rev. Proc. 2013-21
12/31/13	1/01/15	11,460 * 3,460	5,500	3,350	1,975	Rev. Proc. 2014-21, modified by Rev. Proc. 2015-19
12/31/14	1/01/16	11,460 * 3,460	5,600	3,350	1,975	Rev. Proc. 2015-19 modified by Rev. Proc. 2016-23
12/31/15	1/01/17	11,560 * 3,560	5,700	3,350	2,075	Rev. Proc. 2016-23
12/31/16	1/01/18	11,560 * 3,560	5,700	3,450	2,075	Rev. Proc. 2017-29
12/31/17	1/01/19	18,000 * 10,000	16,000	9,600	5,760	Rev. Proc. 2018-25

* The higher first-year limit applies if the vehicle qualifies for bonus depreciation and no election out is made (¶ 1237).

If a vehicle is acquired before September 28, 2017, and placed in service in 2018, the first-year cap is $16,400 ($10,000 + $6,400) if bonus depreciation is claimed. If a vehicle is acquired after September 27, 2017, and placed in service in 2018, the first year cap is $18,000 ($10,000 + $8,000) if bonus depreciation is claimed (Code Sec. 168(k)(2)(F)(iii); Rev. Proc. 2018-25).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[34] ¶ 15,100; § 11,301

[35] ¶ 15,100; § 11,330.05

Assuming that the 200-percent declining balance method and half-year convention apply and that bonus depreciation is claimed, a truck or van placed in service in 2017 is subject to the first-year cap if the cost of the vehicle exceeds $19,266 ($9,633 bonus + ($9,633 remaining basis × 20 percent) = $11,560).

The 2018 caps for cars (Table I) and for SUVs, trucks, and vans (Table II) are identical. However, in 2019, separate inflation adjustments will apply to each category and the table amounts for each category should once again differ.

The above maximum annual limits (often referred to as the luxury car limits) are based on 100-percent business use. If business use is less than 100 percent, the limits must be reduced to reflect the actual business use percentage.

Passenger Automobile Defined. For purposes of the depreciation caps, a passenger automobile includes any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways that has an *unloaded* gross vehicle weight rating (GVWR) (i.e., curb weight fully equipped for service but without passengers or cargo) of 6,000 pounds or less (Code Sec. 280F(d)(5)).[36] A truck or van is treated as a passenger automobile subject to the caps only if it has a GVWR (i.e., maximum total weight of a loaded vehicle as specified by the manufacturer) of 6,000 pounds or less. A truck or van, therefore, is not subject to the depreciation caps if its GVWR exceeds 6,000 pounds. A sport utility vehicle (SUV) is generally treated as a truck (even if built on a unibody or car chassis) and if its GVWR is in excess of 6,000 pounds and as such it is also exempt from the caps.[37] Ambulances or hearses and vehicles used directly in the trade or business of transporting persons or property for hire (e.g., taxis and limousines) are not considered passenger automobiles subject to the caps regardless of their weight.

Luxury Car Depreciation Examples. The depreciation deduction that is claimed on the return for any tax year during a vehicle's recovery (depreciation) period is the lesser of the depreciation deduction for the tax year (computed as if there were no depreciation caps) or the cap that applies for the tax year.[38]

If, after the recovery period for a passenger automobile ends, the taxpayer continues to use the car in its trade or business, the unrecovered basis (referred to as "section 280F unrecovered basis") may be deducted at the maximum annual rate provided in the chart above for the fourth and succeeding years. This rule permits depreciation deductions beyond the recovery period. Unrecovered basis is the difference between the cost of the vehicle and the amount of depreciation claimed on the return during the recovery period (or that would have been claimed on the return if business use had been 100 percent). The MACRS recovery period for a passenger automobile is five full years from the date the vehicle is deemed placed in service under the applicable half-year or mid-quarter convention (¶ 1245). Due to operation of the applicable convention, depreciation deductions are claimed over the six tax years that the five-year recovery period falls within.

The following example illustrates how depreciation is computed if the bonus depreciation allowance is not claimed.

Example 1: On April 5, 2018, a calendar-year taxpayer purchased a car for $70,000. Business use of the car each year is 100 percent. Depreciation is computed under the general MACRS 200-percent declining-balance method over a five-year recovery period using a half-year convention subject to the luxury car limitations. An election out of bonus depreciation is made. Allowable depreciation during the regular recovery period (2018 through 2023) is computed as follows:

Year	*100% Business-Use MACRS Depreciation*	*Luxury Car Limit*	*Deduction: Lesser of Col. 2 or 3*	*Sec. 280F Unrecovered Basis*
2018	$14,000	$10,000	$10,000	$60,000
2019	22,400	16,000	16,000	44,000
2020	13,440	9,600	9,600	34,400

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[36] ¶ 15,100; § 840 [37] ¶ 15,108.022; § 840 [38] ¶ 15,108.40; § 11,330.10

Year	*100% Business-Use MACRS Depreciation*	*Luxury Car Limit*	*Deduction: Lesser of Col. 2 or 3*	*Sec. 280F Unrecovered Basis*
2021	8,064	5,760	5,760	28,640
2022	8,064	5,760	5,760	22,880
2023	4,032	5,760	4,032	18,848

The unrecovered basis is computed by subtracting the depreciation that would have been allowed (taking the applicable cap into consideration) if business use was 100 percent, even if business use is less than 100 percent. Thus, for example, the unrecovered basis at the close of 2018 is $60,000 ($70,000 – $10,000). The $18,848 unrecovered basis at the close of the regular recovery period is deducted in the post recovery period years at the rate of $5,760 per year assuming 100-percent business use continues. The unrecovered basis is reduced by $5,760 each year regardless of the percentage of business use.

The following example shows how luxury car depreciation is computed if the 50-percent bonus deduction is claimed.

Example 2: On April 5, 2017, a calendar-year taxpayer purchased a new car for $30,000. Business use of the car each year is 100 percent. Depreciation is computed under the general MACRS 200-percent declining-balance method over a five-year recovery period using a half-year convention subject to the luxury car limitations. Allowable depreciation during the regular recovery period (2017 through 2022) is computed as follows:

Year	*100% Business-Use MACRS Depreciation*	*Luxury Car Limit*	*Deduction: Lesser of Col. 2 or 3*	*Sec. 280F Unrecovered Basis*
2017	$18,000	$11,160	$11,160	$18,840
2018	4,800	5,100	4,800	14,040
2019	2,880	3,050	2,880	11,160
2020	1,728	1,875	1,728	9,432
2021	1,728	1,875	1,728	7,704
2022	864	1,875	864	6,840

Beginning in 2023, the unrecovered basis is the $6,840 difference between the $30,000 cost and the sum of the return deductions claimed in 2017 through 2022. The unrecovered basis is deducted at the rate of $1,875 per year assuming that 100-percent business use continues. The unrecovered basis is reduced by $1,875 each year regardless of the percentage of business use.

Safe-harbor for 100 percent bonus depreciation. The IRS plans to issue a safe harbor that will allow taxpayers who claim the 100 percent first-year bonus deduction on a vehicle subject to the luxury car caps to claim regular depreciation deductions during the remaining years of the vehicle's recovery (depreciation) period. Without the safe harbor, taxpayers claiming the 100-percent bonus deduction may not claim any depreciation deductions on the unrecovered basis (cost less first-year cap ($18,000 in 2018)) until after the end of the vehicle's regular recovery period. This is because the vehicle is considered to have a basis of zero (cost less the 100 percent bonus allowance) for purposes of computing depreciation in the remaining years of the regular recovery period even though the 100 percent bonus is limited to the first-year cap (Code Sec. 280F(a)(1)(B)). A safe harbor was issued by the IRS when the 100 percent bonus depreciation rate last applied in 2011 and 2012 that allowed depreciation deductions to be computed after the first recovery year on the cost in excess of the first-year cap. In general, these depreciation deductions were computed as if a 50 percent bonus rate applied to the vehicle. See Section 3.03(5)(c) of Rev. Proc. 2011-26. The new safe harbor will provide similar but not necessarily identical relief.

$25,000 Section 179 Expensing Cap on SUVs, Trucks, and Vans Exempt from Luxury Car Depreciation Caps. The maximum amount of the cost of an SUV that may be expensed under Code Sec. 179 if the SUV is exempt from the luxury car caps (e.g., has a GVWR in excess of 6,000 pounds) is limited to $25,000. The $25,000 limitation also applies to exempt trucks with an interior cargo bed length of less than six feet and

exempt passenger vans that seat fewer than ten persons behind the driver's seat. Exempt cargo vans are generally not subject to the $25,000 limitation (Code Sec. 179(b)(5)). The $25,000 amount is adjusted for inflation in tax years beginning after 2018 (Code Sec. 179(b)(6)).

Exclusion from Depreciation Caps for Trucks and Vans Used for Nonpersonal Purposes. A truck or van that is a qualified nonpersonal use vehicle as defined in Reg. §1.274-5(k) is excluded from the definition of a passenger automobile and is not subject to the annual depreciation limits (Reg. §1.280F-6(c)(3)(iii)).[39] A qualified nonpersonal use vehicle generally is one that has been specially modified in such a way that it is not likely to be used more than a *de minimis* amount for personal purposes.

Reporting. The allowable depreciation deduction for any listed property, including automobiles, is reported on Form 4562 (Part V).

1215. Leased Listed Property Inclusion Amounts. The lessee of a passenger automobile (¶ 1214) used for business must include an additional amount in income to offset rental deductions for each tax year during which the vehicle is leased (Code Sec. 280F(c)(2); Reg. §1.280F-7).[40] The inclusion amount is based on the cost of the vehicle and generally applies to a vehicle with a fair market value exceeding an inflation-adjusted dollar amount. The inclusion amount is not required on trucks, vans, and sport utility vehicles (SUVs) that would be exempt from the depreciation caps if owned by the lessee (e.g., an SUV treated as a truck with a gross vehicle weight rating (GVWR) in excess of 6,000 pounds).

Lease inclusion tables are issued annually by the IRS. The appropriate table is based on the calendar year that the vehicle was first leased. The same table is used for each year of the lease term. Each year has a separate lease inclusion table for passenger automobiles and a lease inclusion table for trucks and vans (including SUVs treated as trucks). However, for vehicles first leased in 2018, the same inclusion table applies to passenger automobiles and trucks and vans. The inclusion tables are issued annually in the same revenue procedure that provides the annual depreciation caps. The 2018 lease inclusion table is provided in Rev. Proc. 2018-25.

A lessee's inclusion amount for each tax year that the vehicle is leased is computed as follows: (1) use the fair market value of the vehicle on the first day of the lease term to find the appropriate dollar (inclusion) amounts on the IRS table; (2) prorate the dollar amount from the table for the number of days of the lease term included in the tax year; and (3) multiply the prorated amount by the percentage of business and investment use for the tax year. For the last tax year during any lease that does not begin and end in the same tax year, the dollar amount for the preceding tax year should be used.

> **Example:** A car costing $61,000 is leased for four years by a calendar-year taxpayer beginning on April 1, 2018, and is used 100 percent for business. The annual dollar amounts from the table contained in Rev. Proc. 2018-25 for leases beginning in 2018 are: $30 for the first tax year during the lease, $66 for the second tax year, $98 for the third tax year, $118 for the fourth tax year, and $135 for the fifth and following tax years. In 2018, the inclusion amount is $22.60 (275/365 × $30). The inclusion amounts for 2019, 2020, and 2021 are $66, $98, and $118, respectively, since the vehicle is leased for the entire year during these tax years. In 2022, the inclusion amount is $29.10 (90/365 × $118 (the dollar amount for 2021, the preceding tax year, is used in the last year of the lease).

Listed Property Other Than Passenger Automobiles. Lessees of listed property other than passenger automobiles (¶ 1211) are required to include in income a usage-based inclusion amount in the first tax year that the business use percentage of such property is 50 percent or less (Code Sec. 280F(c); Reg. §1.280F-7(b)).[41]

Reporting. The inclusion amount is reported on Form 2106 by employees, Schedule C (Form 1040) by the self-employed, and Schedule F (Form 1040) by farmers.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[39] ¶ 15,107; § 11,305

[40] ¶ 15,100, ¶ 15,107; § 11,330.05

[41] ¶ 15,100, ¶ 15,107; § 11,330.05

Depreciation Methods

1216. Methods of Computing Depreciation. Most tangible property placed in service after 1986 must be depreciated using the Modified Accelerated Cost Recovery System (MACRS) (¶ 1243). Depreciation for tangible property placed in service after 1980 and before 1987 is computed under ACRS (¶ 1252).

For tangible property placed in service before 1981, depreciation may be computed under the straight-line method (¶ 1224), the double declining-balance method (¶ 1226), the sum-of-the-years-digits method (¶ 1228), and other consistent methods (¶ 1231), depending on the taxpayer's election in the year the property was placed in service (former Code Sec. 167(b)).[42] However, accelerated depreciation for pre-1981 realty is limited (former Code Sec. 167(j)).

For an asset purchased before 1981, only a part of a full year's depreciation was allowed in the year it was placed in service. The allowable deduction was computed by multiplying the first full year's depreciation allowance by the months the property was owned and dividing by 12. The same rule applies in the year of sale.

1218. Methods for Depreciating Real Estate. Real property placed in service after 1986 is depreciated under the Modified Accelerated Cost Recovery System (MACRS) (¶ 1236). Real property placed in service after 1980 and before 1987 is depreciated under the Accelerated Cost Recovery System (ACRS) (¶ 1252). Additions and improvements to a building, including structural components of a building, placed in service after 1986 are depreciated under MACRS (¶ 1240). Post-1986 rehabilitation expenditures are also depreciated using MACRS. Elements of a building that qualify as personal property may be separately depreciated under the cost segregation rules using shortened MACRS recovery periods. Real property that is converted from personal use to residential rental property or nonresidential real property is depreciated as MACRS 27.5-year residential rental property or MACRS 39-year nonresidential real property respectively even if the property was acquired for personal use prior to 1987.

1221. Change in Depreciation Method—Accounting Method Changes. A change in the method of computing depreciation is generally a change in accounting method that requires the consent of the IRS and the filing of Form 3115 (Reg. §1.167(e)-1).[43] If the change from an impermissible accounting method to a permissible accounting method results in a negative section 481(a) adjustment, the adjustment is taken into account in a single tax year (¶ 1531). A positive section 481(a) adjustment is taken into account over four tax years—one-year if the positive adjustment is less than $50,000 and the taxpayer makes an election to include it in income in one year. No section 481(a) adjustment is allowed when a taxpayer changes from one permissible method to another permissible method. These changes are applied on a "cut-off" basis.[44] Reg. §1.446-1(e)(2)(ii)(d)(2) and (3) list changes in depreciation or amortization that are or are not considered a change in accounting method.

Although a taxpayer has not adopted an accounting method unless two or more returns have been filed, the IRS allows a taxpayer who has only filed one return that claimed incorrect depreciation to either file Form 3115 and claim a section 481(a) adjustment on the current-year return or file an amended return. The asset must have been placed in service in the tax year immediately preceding the tax year of the change (Rev. Proc. 2007-16).

For changes that are not a change in accounting method, such as mathematical or posting errors, a taxpayer may only file amended returns for open years. Changes in accounting method are generally made by filing Form 3115. Procedures for changing from an impermissible method (e.g., where incorrect or no depreciation was claimed, including bonus depreciation) to a permissible method are generally governed by the automatic consent procedures of Section 6.01 of Rev. Proc. 2018-31, effective for Forms 3115 filed on or after May 9, 2018, for a year of change ending on or after September 30, 2017. Numerous additional types of automatic accounting method changes for depreciation

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[42] ¶ 11,037.021; § 10,301

[43] ¶ 11,042; § 11,025

[44] ¶ 11,043.021; § 11,025

tion are provided in Section 6. For changes not listed in Section 6, the advance consent procedures of Rev. Proc. 2015-13 are followed.[45]

A taxpayer who has sold depreciable property without claiming any depreciation or all of the depreciation allowable may claim the depreciation by filing Form 3115 during the limitations period for filing an amended return for the year of the sale. The Form 3115 may be filed with the original federal tax return for the tax year in which the depreciable property is disposed (Rev. Proc. 2007-16; Rev. Proc. 2018-31, Section 6.07).[46]

For depreciable property placed in service in a tax year ending before December 30, 2003, the IRS will not assert that a change in computing depreciation is a change in accounting method (Chief Counsel Notice 2004-007, January 28, 2004, as clarified by Chief Counsel Notice 2004-24, July 14, 2004).[47]

1224. Straight-Line or Fixed-Percentage Method of Depreciation. The "straight-line" method of computing the depreciation deduction assumes that the depreciation sustained is uniform during the useful life of the property. The cost or other basis, less estimated salvage value, is deductible in equal annual amounts over the estimated useful life (Reg. §1.167(b)-1).[48] An asset may not be depreciated below its salvage value. Straight-line depreciation under the Modified Accelerated Cost Recovery System (MACRS) (¶1243) and the Accelerated Cost Recovery System (ACRS) (¶1252) is generally computed in this manner, except that a recovery period is used instead of the useful life and salvage value is not considered (Code Sec. 168(b)(4)).[49]

1226. Declining-Balance Method of Depreciation. Under the declining-balance depreciation method, depreciation is greatest in the first year and smaller in each succeeding year (Reg. §1.167(b)-2).[50] The depreciable basis (e.g., cost) is reduced each year by the amount of the depreciation deduction, and a uniform rate of 200 percent of the straight-line rate (double-declining balance or 200-percent declining balance method) or 150 percent of the straight-line rate (150-percent declining balance method) is applied to the resulting balances (Reg. §1.167(b)-2).[51] Under the Modified Accelerated Cost Recovery System (MACRS), the 200-percent declining balance method is used to depreciate 3-, 5-, 7-, and 10-year property and the 150-percent declining balance method is used to depreciate 15- and 20-year property (¶1243).

1228. Sum-of-the-Years-Digits Method of Depreciation. Under the sum-of-the-years-digits method of depreciation, changing fractions are applied each year to the original cost or other basis, less salvage value. The numerator of the fraction each year represents the remaining useful life of the asset and the denominator, which remains constant, is the sum of the numerals representing each of the years of the estimated useful life (the sum-of-the-years digits). The taxpayer may elect this method for group, classified, or composite accounts (Reg. §1.167(b)-3).[52]

1229. Income Forecast Method of Depreciation. The income forecast method of depreciation may be used only for film, videotape, sound recordings, copyrights, books, patents, and other property identified by IRS regulations. The income forecast method may not be used to depreciate intangible property that is amortizable under Code Sec. 197 (¶1362) or consumer durables subject to rent-to-own contracts (¶1240) (Code Sec. 167(g)(6); Rev. Rul. 60-358).[53]

Under the income forecast method, the cost of an asset (less any salvage value) is multiplied by a fraction, the numerator of which is the net income from the asset for the tax year and the denominator of which is the total net income forecast to be derived from the asset before the close of the 10th tax year following the tax year in which the asset is placed in service. The unrecovered adjusted basis of the property as of the

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[45] ¶11,043.021; §11,025
[46] ¶11,043.285; §11,025
[47] ¶11,043.015
[48] ¶11,033; §11,130
[49] ¶11,250; §11,130
[50] ¶11,034; §11,130
[51] ¶11,034; §11,130
[52] ¶11,035; §11,025
[53] ¶11,002; §11,205

beginning of the 10th tax year is claimed as a depreciation deduction in the 10th tax year following the tax year in which the asset was placed in service.

If the income forecast changes during the 10-year period, the unrecovered depreciable cost of the asset at the beginning of the tax year of revision is multiplied by a fraction. The numerator is the net income from the asset for the tax year of revision. The denominator is the revised forecasted total net income from the asset for the year of revision and the remaining years before the close of the 10th tax year following the tax year in which the asset was placed in service.

During the 3rd and 10th tax years after the asset is placed in service, a taxpayer is generally required to pay or may receive interest based on the recalculation of depreciation using actual income figures. This look-back rule does not apply to property that has a cost basis of $100,000 or less, or if the taxpayer's income projections were within 10 percent of the income actually earned.

Residuals and participations may be included in the adjusted basis of a property in the tax year that it is placed in service or excluded from adjusted basis and deducted in the year of payment (Code Sec. 167(g)(7); Notice 2006-47).

Reporting. Form 8866 is used to compute the look-back interest due or owed.

Creative Property Costs of Film Makers. A taxpayer may choose to amortize creative property costs ratably over 15 years beginning on the first day of the second half of the tax year in which the cost is written off for financial accounting purposes in accordance with Statement of Position 00-2 (SOP 00-2), as issued by the American Institute of Certified Public Accountants (AICPA) on June 12, 2000 (Rev. Proc. 2004-36).[54] Creative property costs are costs to acquire and develop for purposes of potential future film development, production, and exploitation. If the election is not made, these costs are generally recovered under the income forecast method only if a film is actually produced. If a film is not made, the costs generally are not deductible as a loss (Rev. Rul. 2004-58).

Election to Expense First $15 Million of Film Costs. For qualified film and television productions commencing before January 1, 2018, and for live theatrical productions commencing after December 31, 2015, and before January 1, 2018, a taxpayer may elect to expense the first $15 million of production costs ($20 million for productions in low income communities or distressed areas) (Code Sec. 181; Reg. §1.181-2).[55]

> **Comment:** Absent further legislation, the election to expense qualified film, television, and live theatrical productions has expired effective for productions commencing after December 31, 2017. For the latest legislative updates, visit our website www.CCHCPELink.com/taxupdates.

1231. Other Consistent Depreciation Methods. In addition to the general depreciation methods (¶1216), a taxpayer may use any other consistent method, such as the sinking fund method, if the total deductions during the first two-thirds of the useful life are not more than the total allowable under the declining-balance method (Reg. §1.167(b)-4).[56]

Leased Property

1234. Lessee/Lessor Improvements, Lease Acquisition Costs. The cost of an addition or improvement made by a lessee or lessor to real property is generally depreciated under the Modified Accelerated Cost Recovery System (MACRS) in the same manner as real property unless the improvement was placed in service before 2018 and is eligible for a 15-year recovery period as qualified leasehold improvement property (discussed below), qualified retail improvement property (¶1240), or qualified restaurant property (¶1240) (Code Sec. 168(i)(6) and (8)(A); Reg. §1.167(a)-4).[57] For example, replacement windows installed in a commercial building (structural components)

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[54] ¶20,620.6305; §11,555
[55] ¶12,144, ¶12,145B; §10,235
[56] ¶11,036; §11,025
[57] ¶11,250, ¶11,010; §11,105

are separately depreciated as 39-year real property beginning in the month that the windows are placed in service using the mid-month convention, assuming the replacement is not considered a repair expense.

Comment: Absent further legislation, qualified improvement property (i.e., interior improvements to nonresidential real property) placed in service after 2017 has a 39-year recovery period rather than a 15-year recovery period (¶ 1240). For the latest legislative updates, visit our website www.CCHCPELink.com/taxupdates.

Leasehold additions and improvements that are section 1245 property (i.e., personal as opposed to real property) are generally depreciated over a shortened MACRS recovery period under cost segregation principles. If, upon termination of the lease, a lessee does not retain an improvement (paid for by the lessee), the lessee's loss is computed by reference to the improvement's adjusted basis at the time of the lease termination. A lessor that disposes of or abandons a leasehold improvement (paid for by the lessor) upon termination of the lease may use the adjusted basis of the improvement at such time to determine gain or loss (Code Sec. 168(i)(8)(B); Reg. § 1.168(i)-8(c)(3)).

15-Year Qualified Leasehold Improvement Property. Qualified leasehold improvement property placed in service after October 22, 2004, and before January 1, 2018, is depreciated under MACRS over 15 years using the straight-line method and the half-year or mid-quarter convention, as applicable (Code Sec. 168(b)(3)(G) and (e)(3)(E)(iv), prior to repeal by the Tax Cuts and Jobs Act (P.L. 115-97)). The alternative depreciation system (ADS) recovery period is 39 years. Qualified leasehold improvement property is generally an improvement made to the interior portion of nonresidential real property that is more than three years old by the lessor or lessee under or pursuant to the terms of a lease. Elevators and escalators, internal structural framework of the building, structural components that benefit a common area, and improvements relating to the enlargement of a building do not qualify. A lease between related persons is not considered a lease (Code Sec. 168(e)(6), prior to amendment by P.L. 115-97).

Lease Acquisition Costs. The cost of acquiring a lease is amortized over the lease term. A renewal period is counted as part of the lease term if less than 75 percent of the acquisition cost is attributable to the unexpired lease period (not counting the renewal period) (Code Sec. 178).[58]

If property subject to a lease is acquired, the value of the lease is not separately amortized. Instead it is depreciated as part of the cost of the property (Code Sec. 167(c)).

Construction Allowances. A lessor must depreciate improvements made by the lessee with a qualified construction allowance as nonresidential real property (Code Sec. 110) (¶ 764).

1235. Sale v. Lease of Depreciable Property. Whether a transaction is treated as a lease or as a purchase is important in determining who is entitled to claim depreciation and other deductions for related business expenses.[59] In most situations, the rules for determining whether a transaction is a lease or a purchase evolved from court decisions and IRS rulings. The rules generally look to the economic substance of a transaction, not its form, to determine who owns property that the parties characterize as leased (Rev. Proc. 2001-28, Rev. Proc. 2001-29).

Motor Vehicle Leases. A qualified motor vehicle lease agreement that contains a terminal rental adjustment clause (a provision permitting or requiring the rental price to be adjusted upward or downward by reference to the amount realized by the lessor upon the sale of the vehicle) is treated as a lease if, but for the clause, it would have been treated as a lease for tax purposes (Code Sec. 7701(h)).[60] This provision applies only to qualified agreements with respect to a motor vehicle (including a trailer).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[58] ¶ 12,100; § 11,515 [59] ¶ 8754.022; § 11,015 [60] ¶ 43,080; § 11,015

Modified Accelerated Cost Recovery System (MACRS)

1236. MACRS in General. The Modified Accelerated Cost Recovery System (MACRS) is mandatory for most tangible depreciable property placed in service after December 31, 1986, unless transitional rules apply (Code Sec. 168).[61] Under MACRS, the cost of eligible property is recovered over a 3-, 5-, 7-, 10-, 15-, 20-, 27.5-, 31.5-, or 39-year period, depending upon the type of property (¶ 1240) by using statutory recovery methods (¶ 1243) and conventions (¶ 1245). Special transferee rules apply to property received in specified nonrecognition transactions (¶ 1248).

1237. MACRS Bonus Depreciation. Under the Modified Accelerated Cost Recovery System (MACRS), a bonus depreciation deduction is allowed for qualifying MACRS property placed in service before January 1, 2027 (Code Sec. 168(k)).[62] The original use of the qualifying property must begin with the taxpayer. However, used property acquired by purchase (as defined in Code Sec. 179(d)(2)) will also qualify for bonus depreciation, effective for property acquired and placed in service after September 27, 2017 (discussed below).

Bonus Rate. The bonus rate for property acquired and placed in service after September 27, 2017, is 100 percent for property placed in service in 2017 through 2022, 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. Property acquired pursuant to a written binding contract entered into before September 28, 2017, is treated as acquired before that date (Code Sec. 168(k)(6); Prop. Reg. § 1.168(k)-2(b)(5)).

The bonus rate for property acquired before September 28, 2017, is 50 percent if placed in service before 2018, 40 percent in 2018, and 30 percent in 2019 (Code Sec. 168(k)(8)).

Example 1: ABC signs a binding contract to purchase a vehicle on September 1, 2017, and placed it in service on December 1, 2018. The bonus rate is 40 percent because the vehicle is considered acquired before September 28, 2017, and placed in service in 2018.

A taxpayer may elect to apply the 50-percent rate instead of the 100-percent rate for all qualified property placed in service during the taxpayer's first tax year that includes September 28, 2017 (Code Sec. 168(k)(10); Instructions to Form 4562; Prop. Reg. § 1.168(k)-2(e)(3)). The election applies to all qualified bonus depreciation property placed in service during the tax year and is not made separately for each property class.

Computation. The bonus depreciation deduction is claimed on the cost of the property after reduction by any portion of the basis for which an election to expense under Code Sec. 179 is made (¶ 1208). Regular MACRS deductions are computed on the cost as reduced by the amount of the expense election and bonus depreciation.

Example 2: Amanda purchases qualifying five-year MACRS property subject to the half-year convention for $1,500 and elects to expense $600 under Code Sec. 179. Using the 50-percent rate, bonus depreciation is $450 (($1,500 – $600) × 50 percent). Regular MACRS depreciation deductions are computed on a depreciable basis of $450 ($1,500 – $600 – $450). The regular first-year MACRS allowance is $90 ($450 × 20 percent (first-year table percentage)).

Unlike the section 179 expensing allowance, there is no taxable income or investment limitation on the bonus depreciation allowance. There is also no limit on the overall amount of bonus depreciation that may be claimed on qualifying property. The length of the tax year or date during the tax year that the qualifying property is placed in service does not affect the amount of the otherwise allowable bonus depreciation deduction.

Long Production Property. The placed-in-service-deadline is extended one year (before January 1, 2028) for long production property that is acquired and placed in service after September 27, 2017 (Code Sec. 168(k)(2)(B)).[63] Long production property is MACRS property that: (1) is subject to the uniform capitalization rules; (2) has a

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[61] ¶ 11,250, ¶ 11,279; § 11,101 [62] ¶ 11,250; § 11,225 [63] ¶ 11,250; § 11,225.25

production period greater than one year and a cost exceeding $1 million; (3) has a MACRS recovery period of at least 10 years or is transportation property (i.e., property used in the trade or business of transporting persons or property for hire, such as commercial aircraft); and (4) is acquired by the taxpayer (or acquired pursuant to a binding written contract entered into) after September 27, 2017, and before January 1, 2027. Only pre-January 1, 2027, progress expenditures are taken into account in computing the bonus deduction if the extended placed-in-service deadline applies. The extended placed-in-service deadline also applies to certain noncommercial aircraft acquired by purchase (Code Sec. 168(k)(2)(C)). Unlike long production property, however, progress expenditures made in 2027 on qualifying noncommercial aircraft placed in service before January 1, 2028, are eligible for bonus depreciation.

The bonus rate for long production property acquired after September 27, 2017, is 100 percent if placed in service in 2017 through 2023, 80 percent in 2024, 60 percent in 2025, 40 percent in 2026, and 20 percent in 2027 (Code Sec. 168(k)(6)(B)).

Long production property and noncommercial aircraft acquired before September 28, 2017, and placed in service before 2021 are eligible for a 50 percent rate if placed in service in 2017 or 2018, 40 percent in 2019, and 30 percent in 2020 (Code Sec. 168(k)(8)). Progress expenditures made in 2020 for long production property acquired before September 28, 2017 are not eligible for bonus depreciation.

Recapture. Bonus depreciation is subject to the section 1245 and section 1250 recaptures rules (¶ 1779) (Reg. § 1.168(k)-1(f)(3); Prop. Reg. § 1.168(k)-2(f)(3)). If bonus depreciation is claimed on section 1250 property (e.g., a section 1250 land improvement), the bonus deduction is treated as an accelerated depreciation deduction for recapture purposes and the difference between the bonus deduction and the amount of straight-line depreciation that could have been claimed on the bonus deduction prior to the recapture year is subject to recapture.

Constructed, Manufactured, Produced Property. Property constructed, manufactured, or produced by a taxpayer is deemed acquired when work of a significant physical nature begins. Under an elective safe-harbor, work of a significant physical nature begins when more than 10 percent of the total cost of a project has been paid for by a cash basis taxpayer or incurred by an accrual basis taxpayer (Reg. § 1.168(k)-1(b)(4)(iii); Prop. Reg. § 1.168(k)-2(b)(5)(iv)).[64]

Qualifying Property. The bonus depreciation allowance is available only for the following types of property:

- property which is depreciable under MACRS and has a recovery period of 20 years or less;
- qualified improvement property (discussed below) placed in service after 2015 and before 2018;
- qualified leasehold improvement property (discussed below) placed in service before 2016;
- MACRS water utility property;
- computer software depreciable over three years under Code Sec. 167(f) (¶ 980); and
- a qualified film, television show, or theatrical production placed in service after September 27, 2017, if it qualifies for the Code Sec. 181 expense election without regard to the $15 million expensing limit or the December 31, 2017, expiration date (Code Sec. 168(k)(2)(A)).

The original use of qualifying property must begin with the taxpayer or, in the case of used property, the property must be acquired by purchase after September 27, 2017. Intangible property does not qualify for bonus depreciation, except for computer software and film, television, and theatrical productions as described above.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[64] ¶ 11,277E; § 11,225.25

Rate-regulated utilities may not claim bonus depreciation, effective for property placed in service in tax years beginning after 2017. (Code Sec. 168(k)(9) and (j)(7)(A)(iv); Prop. Reg. § 1.168(k)-2(b)(2)(F)). Property used in a trade or business that has had floor plan financing indebtedness does not qualify for bonus depreciation if the floor plan financing interest on the indebtedness was taken into account under the rules that limit the business interest deduction, effective for property placed in service in tax years beginning after 2017 (¶ 937) (Code Sec. 168(k)(9) and (j)(9); Prop. Reg. § 1.168(k)-2(b)(2)(G)). Floor plan financing indebtedness is debt used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory acquired. A motor vehicle is any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; a boat; or farm machinery or equipment.

Property that must be depreciated using the MACRS alternative depreciation system (ADS) (¶ 1247) also does not qualify. However, if ADS is elected, then the property remains eligible for bonus depreciation (Code Sec. 168(k)(2)(D)(i)).

Listed property (¶ 1211), such as a passenger automobile (¶ 1214), that is used 50 percent or less for business, does not qualify for bonus depreciation because such property must be depreciated using ADS (Code Sec. 168(k)(2)(D)(ii)). If business use of a listed property falls to 50 percent or less, bonus depreciation and any amount deducted under Code Sec. 179 (¶ 1208) must be recaptured under the listed property recapture rules (Code Sec. 168(k)(2)(F)(ii)).

Used Property. Effective for property acquired and placed in service after September 27, 2017, property previously used by an unrelated person may qualify for bonus depreciation (Code Sec. 168(k)(2)(A)(ii) and (E)(ii); Prop. Reg. § 1.168(k)-2(b)(3)(iii)). The taxpayer or predecessor must not have used the property at any time before acquiring it and the taxpayer must acquire the property by "purchase" within the meaning of Code Sec. 179(d)(2) (¶ 1208). Property is considered previously used by a taxpayer or predecessor if the taxpayer or predecessor previously had a depreciable interest in the property. The basis of used property determined by reference to the basis of other property held at any time by the taxpayer does not qualify for bonus depreciation.

Qualified Improvement Property. Effective for property placed in service in 2016 and before 2018, qualified improvement property is a separate category of bonus depreciation property and qualifies for bonus depreciation regardless of the length of the recover period for such property (Code Sec. 168(k)(3), prior to repeal by the Tax Cuts and Jobs Act (P.L. 115-97)). Qualified improvement property is any improvement to an interior portion of a building which is nonresidential real property (whether or not the building is depreciated under MACRS) if the improvement is placed in service after the date the building was first placed in service by any taxpayer. Expenditures which are attributable to the enlargement of a building, any elevator or escalator, or the internal structural framework of the building are excluded from the definition of qualified improvement property, but structural components that benefit a common area are not (Code Sec. 168(e)(6)).

Any 15-year qualified leasehold improvement property (¶ 1234) and 15-year qualified retail improvement property placed in service after 2015 and before 2018 (¶ 1240) meets the definition of qualified improvement property for bonus depreciation purposes. Any 15-year qualified restaurant property placed in service after 2015 and before 2018 may only qualify for bonus depreciation if it meets the definition of qualified improvement property (Code Sec. 168(e)(7)(B), prior to repeal by P.L. 115-97).

The separate MACRS recovery periods for 15-year qualified leasehold and retail improvement property and 15-year restaurant property are eliminated effective for property placed in service after 2017. Qualified improvement property is eliminated as a separate category of bonus depreciation property, effective for property placed in service after 2017 (Code Sec. 168(k)(3), prior to repeal by P.L. 115-97).

Comment: Absent further legislation, qualified improvement property (i.e., interior improvements to nonresidential real property) placed in service after 2017 has a 39-year recovery period rather than a 15-year recovery period and will not

qualify for bonus depreciation since it does not have a recovery period of 20 years of less (¶ 1240). For the latest legislative updates, visit our website www.CCHCPELink.com/taxupdates.

Qualified Leasehold Improvement Property. In the case of property placed in service before January 1, 2016, qualified leasehold improvement property is a separate category of bonus depreciation property (Code Sec. 168(k)(3), prior to repeal by P.L. 114-113). Qualified leasehold improvement property is defined as an improvement to an interior portion of nonresidential real property (whether or not depreciated under MACRS) by a lessor or lessee under or pursuant to a lease. The improvement must be placed in service more than three years after the building was first placed in service. The lessor and lessee may not be related persons. Expenditures for (1) the enlargement of a building, (2) any elevator or escalator, (3) any structural component that benefits a common area, or (4) the internal structural framework of the building do not qualify. Any 15-year qualified retail improvement property and 15-year qualified restaurant improvements placed in service before January 1, 2016, must satisfy the definition of qualified leasehold improvement property in order to qualify for bonus depreciation (Code Sec. 168(e)(7)(B), prior to amendment by the Consolidated Appropriations Act, 2016 (P.L. 114-113); Code Sec. 168(e)(8)(D), prior to repeal by P.L. 114-113).

Luxury Car Depreciation Caps. If the taxpayer does not elect out of bonus depreciation, the first-year Code Sec. 280F depreciation cap (¶ 1214) for a vehicle that qualifies for bonus depreciation is increased by $8,000. However, if the vehicle is acquired before September 28, 2017, and placed in service in 2018, the increase is limited to $6,400 and if the vehicle is acquired before September 28, 2017, and placed in service in 2019, the increase is limited to $4,800 (Code Sec. 168(k)(2)(F)).

Alternative Minimum Tax. Bonus depreciation is allowed in full for alternative minimum tax (AMT) purposes. Effective for property placed in service after 2015, if property qualifies for bonus depreciation, then no AMT adjustment is required on the regular MACRS deductions (i.e., the deductions are allowed in full for AMT purposes) even if the election out of bonus depreciation is made (Code Sec. 168(k)(2)(G) and (k)(7)). For property placed in service before 2016, no AMT adjustment is required on regular depreciation deductions if bonus depreciation was claimed on the property (Code Sec. 168(k)(2)(G), prior to amendment by P.L. 114-113; Code Sec. 168(k)(2)(D)(iii), prior to repeal by P.L. 114-113; Reg. §1.168(k)-1(d)(iii); Rev. Proc. 2017-33).

Election Out of Bonus Depreciation. A taxpayer may elect out of bonus depreciation with respect to any class of MACRS property placed in service during the tax year (Code Sec. 168(k)(7)).

Accelerated Bonus Depreciation Allowance for Specified Plants. Effective for specified plants that are planted or grafted onto a planted plant after 2015 and before 2027, a taxpayer may make an annual election to claim bonus depreciation on the adjusted basis of the specified plant in the tax year in which it is planted or grafted in the ordinary course of the taxpayer's farming business as defined in Code Sec. 263A(e)(4) (Code Sec. 168(k)(5)).[65] This accelerates the regular bonus depreciation deduction from the tax year that the specified plant was placed in service (i.e., became productive) to the earlier tax year of planting or grafting.

The bonus rate is 50 percent for plantings and graftings after 2015 and prior to September 28, 2017. In the case of a plant which is planted or grafted after September 27, 2017, and before January 1, 2023, the bonus rate is 100 percent. The bonus rate is 80 percent for plantings and graftings in 2023, 60 percent for 2024, 40 percent for 2025 and 20 percent for 2026 (Code Sec. 168(k)(6)(C)). The accelerated bonus deduction reduces the adjusted basis of the specified plant. If the accelerated bonus deduction is claimed, the regular bonus depreciation deduction under Code Sec. 168(k) may not be claimed in the tax year that the specified plant is placed in service.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[65] ¶ 11,250; § 11,225.10

A specified plant is (1) any tree or vine which bears fruits or nuts, and (2) any other plant which will have more than one yield of crops or fruits or nuts and which generally has a pre-productive period of more than two years from the time of planting or grafting to the time at which the plant begins bearing a marketable crop or yield of fruits or nuts (Code Sec. 168(k)(5)(B)).

If the accelerated bonus deduction is claimed, neither the accelerated bonus deduction nor any regular depreciation deductions on the specified plant are subject to AMT adjustments (i.e., the deductions are claimed in full for AMT purposes) (Code Sec. 168(k)(5)(E)). The accelerated bonus deduction is not subject to capitalization under the uniform capitalization rules (Code Sec. 263A(c)(7)).

Corporation's Election to Forgo Bonus Depreciation and Claim AMT Credit Carryforward. For tax years beginning before 2018, a corporation may make an election on an annual basis to forgo bonus depreciation on property placed in service during its tax year and claim unused AMT credits based on the amount of bonus depreciation that is forgone (Code Sec. 168(k)(4), prior to repeal by P.L. 115-97).[66] The computation of the refundable AMT credit is made on a worksheet provided with Form 8827. The AMT is repealed for corporations in tax years beginning after 2017 and corporations will be able to recover their unused AMT credits in tax years 2018 through 2021 (¶ 1409). If a regular election out of bonus depreciation is made for a class of property, then an election to forgo bonus depreciation in favor of an AMT credit does not apply to the class of property for which the regular election out was made (Act Sec. 101(d)(4) of the Consolidated Appropriations Act, 2018 (P.L. 115-141)).

For any tax year for which the election to forgo bonus depreciation is made, bonus depreciation may not be claimed on qualified property placed in service during the tax year (i.e., property for which bonus depreciation could otherwise be claimed). The election for a tax year is revocable only with IRS consent. Depreciation on the qualified property is computed using the straight-line method over the regular recovery period.

The Code Sec. 53(c) limitation on the amount of unused AMT credits that may be claimed in a tax year (i.e., the limitation that allows unused AMT credits to be claimed against regular tax liability in excess of tentative minimum tax liability) is increased by the bonus depreciation amount computed for the tax year. This is, for each asset placed in service in a tax year, 20 percent of the difference between (1) the first year depreciation (including bonus depreciation) that could be claimed on the asset if the bonus is claimed, and (2) the first-year depreciation that could be claimed on the asset if bonus depreciation is not claimed.

The bonus depreciation amount is computed using the regular depreciation method that would otherwise apply to the property. Elections made to use the MACRS straight-line method, 150 percent declining balance method, and ADS are ignored. The total bonus depreciation amounts computed for a tax year may not exceed the lesser of:

- 50 percent of the corporation's minimum tax credit under Code Sec. 53(b) for the corporation's first tax year ending after December 31, 2015, or
- the minimum tax credit for the tax year, determined by taking into account only the adjusted net minimum tax for tax years ending before January 1, 2016 (determined by treating credits as allowed on a first-in, first-out basis).

All corporations treated as a single employer (Code Sec. 52(a)) are treated as a single taxpayer for purposes of the election. If any corporation in a group of corporations that are treated as a single employer makes the election all corporations in the group are treated as having made the election (Code Sec. 168(k)(4)(B)(iii), prior to repeal by P.L. 115-97). The aggregate increase in credits allowable by reason of the increased limitation resulting from the election is treated as refundable. Special rules apply in computing the limitation above for corporation with a fiscal tax year beginning before January 1, 2016, and ending after December 31, 2015 (Act Sec. 143(b)(7)(B) of P.L. 114-113).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[66] ¶ 11,250; § 11,225.25c

year by (1) calculating its tax for the entire tax year using the graduated corporate income tax rates in effect for tax years beginning before 2018, (2) calculating its tax for the tax year using the 21-percent rate for tax years beginning after 2017, (3) proportioning each tax amount in (1) and (2) based on the number of days in the tax year when the different rates were in effect, and (4) adding the two amounts determined in (3). The sum of these two amounts is the RIC's income tax for the fiscal year that includes January 1, 2018 (Notice 2018-38).[4]

Investment company taxable income is computed on Form 1120-RIC in the same manner as the taxable income of an ordinary corporation (¶ 221) with the following adjustments:

- gross income is the corporation's ordinary income (net capital gains are not included);
- a deduction is allowed for any ordinary dividends paid (¶ 259), but no deduction is allowed for dividends of capital gains or tax-exempt interest;
- no deduction is allowed for dividends received;
- no deduction is allowed for net operating losses (NOLs);
- taxable income of a short tax year is not annualized;
- if the corporation elects, taxable income is computed by disregarding the short-term discount obligation rules of Code Sec. 454(b); and
- a deduction is allowed for the tax imposed on the corporation if it fails to meet the asset test or gross income test (¶ 2301).

For purposes of the dividends-paid deduction, dividends declared and payable by a RIC in October, November, or December of a calendar year are treated as paid on December 31 of that year if they are actually paid in January of the following calendar year (Code Sec. 852(b)(7)).[5] See ¶ 2323 for the treatment of certain dividends declared after the close of the RIC's tax year.

A RIC, other than a publicly offered RIC, generally may not claim a deduction for dividend distributions if it singles out one class of shareholders or one or more members of a class of shareholders for special dividend treatment, unless such treatment was originally intended when the dividend rights were created (Code Sec. 562(c); Rev. Rul. 89-81).[6] The IRS has issued guidance describing the conditions under which distributions to RIC shareholders may vary and nevertheless be deductible, including the treatment of distributions to shareholders that differ as a result of the allocation and payment of fees and expenses (Rev. Proc. 99-40).[7]

Excise Taxes. A nondeductible excise tax is generally imposed on a RIC that does not satisfy minimum distribution requirements (Code Sec. 4982). The tax is four percent of the excess of any required distribution for the calendar year over the amount actually distributed for the calendar year. For this purpose, the required distribution is the sum of 98 percent of the corporation's ordinary income for the year, plus 98.2 percent of its net capital gain income for the one-year period ending October 31 of the calendar year. Special rules apply for how a RIC treats post-October 31 capital gains and foreign currency losses. For excise tax purposes, amendments made in 2010 to the capital loss carryover rules (¶ 2305) apply beginning with any net capital loss recognized in the period that determines a RIC's required distribution for calendar year 2011 (Rev. Rul. 2012-29).[9]

Built-in Gains Tax. A RIC may be subject to a modified version of the built-in gains tax imposed on an S corporation (¶ 337) if property owned by a C corporation becomes property of the RIC when the corporation qualifies as a RIC, or if property of a C corporation is transferred to the entity (Reg. § 1.337(d)-7; Temp. Reg. § 1.337(d)-7T).[10]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[4] ¶ 3375.10, § 26,010
[5] ¶ 26,420; § 19,205.50
[6] ¶ 23,470, ¶ 26,433.50
[7] ¶ 26,433.28
[8] ¶ 34,640; § 19,201, § 45,430.05
[9] ¶ 34,642.10; § 19,201, § 45,430.05
[10] ¶ 16,241H, ¶ 16,241HK

The tax does not apply if the corporation makes a deemed sale election to recognize gain and loss as if it sold the converted property to an unrelated person at fair market value. The tax also does not apply if the corporation otherwise recognizes gain or loss on the conversion transaction, or if the corporation's gain is not recognized in a like-kind exchange or involuntary conversion.

2305. Capital Gains and Losses of Regulated Investment Companies (RICs). A regulated investment company (RIC) (¶ 2301) may avoid corporate level tax on its net capital gains by distributing such gains to shareholders. If the corporation elects to retain some of its net capital gains, then it is subject to tax at the 21-percent corporate income tax rate for tax years beginning after 2017 or at the alternative tax rate on net capital gains for tax years beginning before 2018 (¶ 1738) on the excess of its net capital gains for the tax year over the amount of any capital gains dividends paid during the year (Code Sec. 852(b)(3)).[11]

Form 2438 is used to figure and report the RIC's capital gains. Although the fund is taxed on its undistributed net capital gains, it may elect to designate to its shareholders some or all of its undistributed gains and the tax paid on those gains. Form 2439 is used to notify each shareholder of his or her portion of the undistributed capital gains and tax paid for the year (¶ 2309 and ¶ 2311). The RIC must also report any undistributed long-term capital gains not designated to shareholders and any net short-term capital gain on Form 8949 and Schedule D (Form 1120).

Capital Loss Carryovers. If a RIC has a net capital loss for a tax year, any excess of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss arising on the first day of the next tax year, and any excess of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss arising on the first day of the next tax year (Code Sec. 1212(a)(3)(A)).[12] There is no limit to the number of tax years that a net capital loss of a RIC may be carried over.

If a net capital loss under the general corporate capital loss carryback and carryover rules (¶ 1756) is carried over to a tax year of a RIC, amounts treated as a long-term or short-term capital loss arising on the first day of the next tax year under the capital loss carryover rules for RICs (discussed above) are determined without regard to amounts treated as a short-term capital loss under the general corporate capital loss carryover rule. Further, in determining the reduction of a carryover by capital gain net income for a prior tax year under the general corporate capital loss carryover rule, any capital loss treated as arising on the first day of the prior tax year under the capital loss carryover rules for RICs is taken into account in determining capital gain net income for the prior year (Code Sec. 1212(a)(3)(B)). Capital gain net income is the excess of gains from the sale or exchange of capital assets over losses from such sales or exchanges (Code Sec. 1222(9)).[13]

2307. Tax-Exempt Interest of Regulated Investment Companies (RICs). A regulated investment company (RIC) (¶ 2301) may pay tax-exempt interest earned on state or local bonds to its shareholders in the form of exempt-interest dividends, but only if the bonds represent at least 50 percent of the value of the corporation's assets at the close of each quarter of its tax year (Code Sec. 852(b)(5)).[14] Form 1099-INT is used to inform shareholders of dividends identified as tax-exempt interest dividends (¶ 2309 and ¶ 2311).

An upper-tier RIC that is a qualified fund of funds may pass through exempt-interest dividends to its shareholders without having to meet the 50-percent asset requirement (Code Sec. 852(g)).[15] A qualified fund of funds is a RIC if, at the close of each quarter of the tax year, at least 50 percent of the value of its total assets is represented by interests in other RICs.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[11] ¶ 26,420; § 19,205.05, § 45,430.10
[12] ¶ 30,400; § 16,535
[13] ¶ 30,440; § 16,535
[14] ¶ 26,420; § 19,205.05, § 45,430.10
[15] ¶ 26,420; § 19,205.35

If a RIC shareholder receives an exempt-interest dividend with respect to any share of the corporation held for six months or less, then any loss on the sale or exchange of the share is generally disallowed to the extent of the exempt-interest dividend (Code Sec. 852(b)(4)).[16] However, the disallowance of a loss on the sale or exchange of RIC shares on which exempt-interest dividends have been paid does not apply, except as otherwise provided by regulations, to a regular dividend paid by a RIC that declares exempt-interest dividends on a daily basis in an amount not less than 90 percent of its net tax-exempt interest and distributes such dividends on a monthly or more frequent basis.

2309. Designation of Regulated Investment Companies (RICs) Distributions. A regulated investment company (RIC) (¶ 2301) must report in written statements furnished to its shareholders the portions of distributions made during the tax year that are capital gains dividends (¶ 2305) and exempt-interest dividends (¶ 2307), as well as any foreign tax credits (¶ 2320), tax credit bond credits (¶ 2320), dividends that qualify for the dividends-received deduction (¶ 223), and passed-through ordinary dividends eligible for the reduced tax rate for qualified dividends (¶ 2311) (Code Secs. 852(b)(3)(C) and (5), 853(c), 853A(c), and 854(b)).[17] Capital gain dividends, dividends received from a tax-exempt corporation, and dividends received from a qualified real estate investment trust (REIT) (¶ 2326) are not eligible for the dividends-received deduction (Code Sec. 854(a) and (b)(2)). The aggregate amount that the RIC can report as dividends eligible for the dividends-received deduction is limited to its aggregate dividends received from domestic corporations for the tax year. The aggregate amount that the RIC can report as qualified dividend income is limited to its qualified dividend income for the tax year (Code Sec. 854(b)(1)(C)).

Additionally, within 60 days after the close of its tax year, a RIC must report and notify its shareholders of the portion of distributions made during the tax year that is designated as undistributed capital gain (Code Sec. 852(b)(3)(D)).

2311. Taxation of Regulated Investment Company (RIC) Distributions. The tax treatment of a distribution received from a regulated investment company (RIC) (¶ 2301) depends on how the distribution is designated (¶ 2309). Distributions not designated as capital gain dividends are generally included in gross income by shareholders as ordinary income to the extent of the fund's earnings and profits. However, all or a portion of the distribution of an ordinary dividend may be a qualified dividend eligible to be taxed at capital gains rates (¶ 733) if the aggregate amount of qualified dividends received by the fund during the year is less than 95 percent of its gross income (Code Sec. 854(b)(1)(B)).[18] Distributions reported as tax-exempt interest dividends may generally be excluded from the shareholder's gross income (Code Sec. 852(b)(5)(B)).[19] Exempt-interest dividends derived from private activity bonds constitute tax preference items for alternative minimum tax (AMT) purposes (¶ 239).

If a publicly offered RIC (¶ 2315) makes a qualifying distribution of its stock to shareholders who have the option to receive cash or stock, the distribution is treated as a Code Sec. 301 distribution that generally results in a dividend (Rev. Proc. 2017-45).[20] This treatment applies to distributions declared on or after August 11, 2017, if, among other requirements, each shareholder has a cash or stock election with respect to part or all of the distribution and at least 20 percent of the aggregate declared distribution consists of money. The value of the stock received by any shareholder in lieu of cash is considered to be equal to the amount of cash for which the stock is substituted. If a shareholder participates in a dividend reinvestment plan, the stock received by that shareholder pursuant to the reinvestment plan is treated as received in exchange for cash received in the distribution.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[16] ¶ 26,420; § 19,230.10
[17] ¶ 26,420, ¶ 26,440, ¶ 26,448, ¶ 26,460; § 19,205.05
[18] ¶ 26,460; § 19,205.10, § 19,205.15
[19] ¶ 26,420; § 19,205.35
[20] ¶ 26,433.26; § 50,310.05

Distributions received from a RIC reported as capital gain dividends may be treated as long-term capital gains by the shareholder for income and AMT purposes, regardless of how long the shareholder held the shares (Code Sec. 852(b)(3)(B)).[21] Similarly, capital gains that the fund elects to pass through to the shareholder are treated as long-term capital gains (¶ 2305). The shareholder is entitled to a credit or refund for its portion of any capital gain taxes paid by the RIC on the undistributed capital gains (Code Sec. 852(b)(3)(D)). In addition, the shareholder may increase the basis of its shares by the difference between the undistributed capital gains and its deemed portion of taxes paid. The RIC must designate distributions as undistributed capital gain dividends, reporting the designation and providing shareholders a written notice within 60 days of the end of its tax year (¶ 2309).

If a shareholder receives a capital gain dividend or has capital gain passed through by the fund with respect to any share or beneficial interest, and holds the share for six months or less, then any loss on the sale of that share is treated as a long-term capital loss to the extent of any long-term capital gain (Code Sec. 852(b)(4)).[22] The amount of loss that may be claimed must also be reduced by the amount of any exempt-interest dividend received on the shares. These rules do not apply to losses incurred on the disposition of RIC shares or beneficial interests pursuant to a plan that provides for the periodic liquidation of such shares or interests. For purposes of determining whether a taxpayer has held RIC shares for six months or less, rules similar to those for the dividends-received deduction are applied (¶ 223). A RIC shareholder may also not claim a loss from the sale or exchange of shares if the wash sale rules apply (¶ 1935).

A distribution that is not out of a RIC's earnings and profits is a return of the shareholder's investment. Return-of-capital distributions are generally not subject to tax and reduce the shareholder's basis in the RIC shares. On the other hand, distributions that are automatically reinvested by the shareholder into more shares of the fund are taxed as if they had actually been received by shareholder in cash. Thus, reinvested ordinary dividends and reinvested capital gain distributions are generally includible in gross income, reinvested exempt-interest dividends are not reported as income, and reinvested return-of-capital distributions are reported as a return of capital (IRS Pub. 550).

Deferral of Late-Year Losses. A RIC can elect to defer certain post-October capital losses for a tax year, as well as certain late-year ordinary losses for that year, to the first day of the following tax year (Code Sec. 852(b)(8); Notice 2015-41).[23] The corporation makes the election by giving effect to the deferral in computing its capital gains and losses for the tax year in question, and completing its income tax return (including any necessary schedules) for that year according to the instructions for those items that apply to the election.

Capital Gains Tax Rates. The IRS has provided guidance that a RIC and its shareholders must use in applying the net capital gain tax rates (¶ 1736) to capital gain dividends (Notices 97-64, 2004-39, and 2015-41).[24]

2313. Earnings and Profits of Regulated Investment Companies (RICs). Dividends from a regulated investment company (RIC), just like dividends from most other corporations, must be paid out of earnings and profits (¶ 747—¶ 757) (Code Secs. 301, 312, 316, 561, 562(a), and 852(a)(1)).[25] Thus, a RIC must maintain sufficient current or accumulated earnings and profits to satisfy annual dividend distribution requirements. There should also be enough earnings and profits to avoid the excise tax on the undistributed income (¶ 2303).

A RIC's earnings and profits are generally computed under the rules that apply to an ordinary corporation. However, a RIC does not reduce its current earnings and profits by any amount it is unable to claim as a deduction from taxable income in that year

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[21] ¶ 26,420; § 19,205.20, § 19,205.25
[22] ¶ 26,420; § 19,230.15
[23] ¶ 26,420, ¶ 26,433.16
[24] ¶ 26,433.16; § 19,205.20
[25] ¶ 15,302, ¶ 15,600, ¶ 15,702, ¶ 23,450, ¶ 23,470, ¶ 26,420; § 26,601

(Code Sec. 852(c)(1)).[26] A net capital loss for the tax year is also not taken into account in determining earnings and profits. In addition, deductions disallowed in computing the RIC's taxable income with respect to tax-exempt interest are allowed in calculating its current earnings and profits (but not accumulated earnings and profits).

If a RIC that is not a calendar-year taxpayer makes distributions to its shareholders with respect to any class of stock of the company in excess of the sum of its current and accumulated earnings and profits (i.e., a portion of the distribution constitutes return of capital or capital gain), its current earnings and profits must be allocated first to distributions during the RIC's tax year that are made before January 1 (Code Sec. 316(b)(4)).[27] If a RIC has more than one class of stock, this rule applies separately to each class of stock, so that distributions made during the RIC's tax year are considered to be made to the shares with higher priority before they are made to shares with lower priority (Rev. Rul. 69-440).[28]

A company that has failed to qualify as a RIC because it has not purged itself of non-RIC earnings and profits may still qualify if it distributes those earnings and profits with interest to its shareholders (Code Sec. 852(e)).[29] In order to qualify, distributions must be specifically designated as non-RIC distributions and take place within the 90-day period that begins on the date the corporation is determined not to be a RIC (¶ 2317). This option is not available if the corporation was determined not to be a RIC because it engaged in fraudulent tax evasion.

2315. Redemption of Regulated Investment Company (RIC) Stock. A redemption of stock by a corporation, including a regulated investment company (RIC) (¶ 2301), is generally treated as an exchange of stock if the redemption falls within one of four categories of transactions (Code Sec. 302):[30] (1) a redemption that is not essentially equivalent to a dividend; (2) a substantially disproportionate redemption; (3) a redemption that terminates the shareholder's interest in the corporation; or (4) a partial liquidation, in the case of a noncorporate shareholder. Redemptions of corporate stock are discussed in ¶ 742—¶ 745. Because transactions that fall within one of these four categories are treated as exchanges of stock, they normally result in capital gain treatment to the shareholder. If the redemption does not fall within any of these categories, it is treated as a Code Sec. 301 distribution of property that generally results in dividend treatment.

Special rules apply to redemptions of RIC shares. A distribution in redemption of stock of a publicly offered RIC is treated as an exchange for stock if the redemption is upon the demand by the stockholder and the RIC issues only stock that is redeemable upon the demand of the stockholder. A publicly offered RIC is a fund whose shares are: (1) continuously offered pursuant to a public offering; (2) regularly traded on an established securities market; or (3) held by or for no fewer than 500 persons at all times during the tax year (Code Sec. 67(c)(2)(B)).[31] Additionally, the loss disallowance and deferral rules for transactions between related persons (¶ 1717) do not apply to any redemption of stock of a fund-of-funds RIC if the RIC issues only stock that is redeemable upon the demand of the stockholder and the redemption is upon the demand of another RIC (Code Sec. 267(f)(3)(D)).[32]

2317. Deficiency Dividends of Regulated Investment Companies (RICs). If there is a determination that adjustments are needed to certain amounts that a regulated investment company (RIC) (¶ 2301) reports for a tax year, and if the adjustments could cause the entity to lose its status as a RIC, the RIC may avoid disqualification by making deficiency dividend distributions, and may claim a deduction for such dividends paid (Code Sec. 860; Reg. §§ 1.860-1—1.860-5).[33] A deficiency dividend is a distribution of property (including money) that would have been includible in calculating the entity's dividends-paid deduction had the property been distributed during the tax year. The

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[26] ¶ 26,420; § 19,201
[27] ¶ 15,702
[28] ¶ 15,704.755
[29] ¶ 26,420
[30] ¶ 15,325; § 26,301
[31] ¶ 6060; § 19,210.07
[32] ¶ 14,150; § 19,210.07
[33] ¶ 26,580, ¶ 26,581—¶ 26,585

distribution must be made within 90 days after the determination date, and before the entity files a deficiency dividend deduction claim, which must be filed on Form 976 within 120 days after the determination date.

For a RIC, an adjustment can be: (1) an increase in its investment company taxable income, determined without regard to the dividends-paid deduction; (2) an increase in the amount of the excess of its net capital gain over its deduction for capital gain dividends paid; or (3) a decrease in its dividends-paid deduction (determined without regard to capital gains dividends). A determination is a final decision by a court, a closing agreement, an agreement between the IRS and the entity relating to its tax liability, or a statement by the entity attached to its amendment or supplement to a tax return for the relevant tax year. Filing Form 8927 is treated as a self-determination by the entity for these purposes (Rev. Proc. 2009-28).[34]

The deficiency dividend deduction is not available if part of the adjustment is due to fraud with intent to evade tax or willful failure to file a timely income tax return.

2318. Basis in Regulated Investment Company (RIC) Shares. A shareholder's basis in the shares of a regulated investment company (RIC) (¶ 2301) is usually the cost to purchase the shares, including any fees or load charges incurred to acquire or redeem them (¶ 1975). Fees or load charges are not added to the shareholder's original basis if the shareholder acquires a reinvestment right, disposes of the shares within 90 days of being purchased, and acquires new shares in the same (or another) RIC for which the fee or load charge is reduced or waived because of the reinvestment right (Code Sec. 852(f)).[35] In such cases, the omission of the load charge from basis applies to the extent the charge does not exceed the reduction in the load charge for the new investment. To the extent that a load charge is not taken into account in determining the purchaser's gain or loss, it is treated as incurred in connection with the acquisition of the second-acquired shares.

This treatment of load charges applies only if the original RIC stock is disposed of within 90 days after the date it was originally acquired, and the taxpayer acquires stock in the same or another RIC during the period beginning on the date of the disposition of the original stock, and ending on January 31 of the calendar year following the calendar year that includes the date of such disposition.

The original basis of RIC shares acquired by reinvesting distributions (even exempt-interest dividends) is the amount of the distributions used to buy each full or fractional share (¶ 1975). A shareholder's original basis in shares acquired by gift is generally the donor's adjusted basis (¶ 1630). However, if the fair market value of the shares was more than the donor's adjusted basis, then the shareholder's basis is the donor's adjusted basis at the time of the gift, plus all or part of any gift tax paid. A shareholder's basis in RIC shares that are inherited is generally the fair market value of the shares at the decedent's death (or the alternate valuation date if the estate chooses) (¶ 1633). No matter how a shareholder's original basis is determined, it must be adjusted for post-acquisition occurrences such as reinvestment of distributions and return of capital distributions (¶ 2311).

2320. Tax Credit Elections of Regulated Investment Companies (RICs). A regulated investment company (RIC) (¶ 2301) may elect to have its foreign tax credit (¶ 2475) claimed by its shareholders on their tax returns instead of its own. The election can only be made if more than 50 percent of the value of the RIC's total assets at the close of the tax year consists of stock or securities in foreign corporations and it has distributed at least 90 percent of its investment company taxable income (¶ 2303) and net tax-exempt interest (¶ 2307) for the year (Code Sec. 853).[36]

An upper-tier RIC that is a qualified fund of funds may pass through foreign tax credits to its shareholders without having to meet the 50-percent asset requirement

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[34] ¶ 42,625.435
[35] ¶ 26,420; § 19,215.05
[36] ¶ 26,440; § 19,240.10

(Code Sec. 852(g)).[37] A qualified fund of funds is a RIC at least 50 percent of the total value of whose assets (as measured at the close of each quarter of its tax year) is represented by interests in other RICs.

A RIC may also elect to pass through to its shareholders credits attributable to tax credit bonds (¶ 1471) held by the RIC (Code Sec. 853A).[38]

2323. After-Tax Year Distributions of Regulated Investment Companies (RICs). A regulated investment company (RIC) (¶ 2301) may declare and pay spillover dividends after the close of a tax year that are considered made out of its earnings and profits for that year (Code Sec. 855; Reg. § 1.855-1).[39] Spillover dividends are included in the calculation of the RIC's taxable income for that year and are considered in determining whether the fund met its distribution requirements for the year.

Spillover dividends must be declared no later than the 15th day of the ninth month following the close of the tax year to which the dividend relates, or the extended due date for the RIC's return for the tax year, whichever comes later. The dividend must be paid to shareholders in the 12-month period after the close of the tax year to which the dividend relates, but no later than the date of the first dividend payment *of the same type of dividend* (e.g., capital gains or ordinary) after the declaration.

The shareholder generally must treat such a dividend as received in the tax year in which the distribution is made. This does not apply, however, to dividends declared in October, November, or December that are treated as paid on December 31 of a calendar year even though they are actually paid in January of the following calendar year (¶ 2303).

Real Estate Investment Trusts

2326. Qualification as Real Estate Investment Trusts (REIT). A corporation, trust, or association that acts as an investment agent specializing in real estate and real estate mortgages may elect to be a real estate investment trust (REIT) (Code Sec. 856).[40] A REIT may escape corporate taxation because, unlike an ordinary corporation, it is entitled to claim a deduction for dividends paid to shareholders against ordinary income and net capital gains (¶ 259). An entity qualifies as a REIT if it makes an election to be treated as such by filing Form 1120-REIT, and it meets certain requirements as to ownership and organization, source of income, investment of assets, and distribution of income to shareholders. The REIT election may be revoked voluntarily, but the organization will be prohibited from making a new REIT election for the four tax years after revocation. An organization may elect REIT status even if it fails the ownership test in the first year.

Ownership and Organization Requirements. To be eligible for REIT status, an entity must be taxable as a domestic corporation (Code Sec. 856(a)). A foreign corporation, trust, and association, as well as a financial institution such as a bank or insurance company, is not eligible. An eligible entity must be managed by one or more trustees or directors during the entire tax year. It must also adopt a calendar-year accounting period (Code Sec. 859).[41] An entity making a REIT election may change its accounting period to a calendar year without seeking IRS approval.

Beneficial ownership in a REIT must be evidenced by transferable shares or certificates of interest. The REIT must have at least 100 beneficial owners for at least 335 days of a 12-month tax year (Code Sec. 856(a) and (b)). Ownership cannot be closely held as determined under the personal holding company rules (¶ 285) (Code Sec. 856(h)).[42] However, attribution to another partner in a partnership is ignored. In addition, a pension trust generally is not treated as a single owner, but any REIT shares or certificates of interest held by the trust are treated as directly held by its beneficiaries. The look-through rule does not apply if persons disqualified from dealings with the

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[37] ¶ 26,420; § 19,240.10
[38] ¶ 26,448; § 14,505
[39] ¶ 26,480, ¶ 26,481
[40] ¶ 26,500; § 19,201, § 45,440.05
[41] ¶ 26,560; § 38,135.10
[42] ¶ 26,500

pension trust own five percent or more of the value of the REIT and the REIT has accumulated earnings and profits attributable to a year it did not qualify as a REIT.

A corporation that was either a distributing or controlled corporation in a Code Sec. 355 distribution (¶ 2201) on or after December 7, 2015, is generally not eligible to make a REIT election during the 10-year period after the date of distribution (Code Sec. 856(c)(8)).[43]

Income Requirements. An entity must satisfy the following income tests each tax year in order to qualify as a REIT (Code Sec. 856(c)(2) and (3)):[44]

- at least 95 percent of the entity's gross income must be from rents from real property, gain from the disposition of real property, dividends, interest, gains from dispositions of stock and securities, abatements and refunds of real property taxes, income and gain from foreclosure property, consideration received or accrued for agreeing to make loans secured by real property mortgages or interests or to purchase or lease real property, and certain mineral royalty income earned from real property owned by a timber REIT; and

- at least 75 percent of the entity's gross income, excluding income from prohibited transactions (¶ 2329), must be from real property sources, which include rents from real property, interest on real property mortgages, gain from the disposition of a real estate asset (other than a nonqualified publicly offered REIT debt instrument), dividends and gain from the disposition of shares in other qualifying REITs, abatements and refunds of real property taxes, income and gain from foreclosure property, consideration received or accrued for agreeing to make loans secured by real property mortgages or interests, or to purchase or lease real property, and qualified temporary investment income.

For both tests, an entity's gross income does not include the gross income from prohibited transactions, foreign currency gains in the form of passive foreign exchange gains, or real estate foreign exchange gains (Code Sec. 856(n)).[45] It also does not include gains from hedging transactions (including counteracting hedges in tax years after December 31, 2015) entered into by the entity to reduce the risk of debt incurred to acquire or hold real estate or to manage the risk of currency fluctuations (Code Sec. 856(c)(5)(G)).[46] The IRS has the authority to designate income as not constituting gross income for purposes of the REIT income tests. Alternatively, the IRS may designate nonqualified income as qualified income (Code Sec. 856(c)(5)(J)).[47]

Real property is defined for these purposes as land and improvements to land. For tax years beginning after August 31, 2016, real property includes land, inherently permanent structures, and structural components of inherently permanent structures (Reg. § 1.856-10).[48] Rents from real property generally include: rents from interests in real property; amounts received for customary services (utilities, maintenance), even if separate charges are made for such services; and rent attributable to personal property incidental to rental of real property if the amount allocable to personal property is 15 percent or less of the total rent (Code Sec. 856(d)).[49]

Rents from real property do *not* include amounts received from: (1) any noncorporate person in which the REIT owns 10 percent or more in that person's assets or profits; (2) a corporation, if the REIT owns 10 percent or more of either the voting stock or the value of all shares issued by the corporation; or (3) amounts received based on income or profits of a tenant or debtor (unless certain conditions are met). Rents from real property also generally do not include rents that depend on income or profits derived by any person from the property.

Amounts paid to a REIT by a taxable REIT subsidiary (¶ 2340) are treated as rents from real property if at least 90 percent of the property at issue is rented to unrelated

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[43] ¶ 26,500
[44] ¶ 26,500; § 45,440.05
[45] ¶ 26,500
[46] ¶ 26,500
[47] ¶ 26,500
[48] ¶ 26,510F
[49] ¶ 26,500

dividends only. For tax years beginning before 2018, if a REIT has any net capital gains in the tax year, the tax imposed on REIT taxable income is the lesser of (1) the regular corporate tax on REIT taxable income, or (2) the regular corporate tax on REIT taxable income, determined by excluding net capital gains and by computing the deduction for dividends paid without capital gain dividends, plus 35 percent on the excess of the net capital gain minus any capital gain dividends paid (Code Sec. 857(b)(3), prior to amendment by the Tax Cuts and Jobs Act (P.L. 115-97)).

A REIT may avoid tax on its net capital gains by distributing the gains to its shareholders (¶ 2331). The REIT must designate any distributions as capital gain dividends in a written notice to the shareholders or beneficiaries with its annual report or within 30 days of the end of the tax year. For purposes of determining the maximum amount of capital gain dividends that a REIT may pay for a tax year, the REIT may not offset its net capital gains with the amount of any net operating losses (NOLs) (¶ 1145). In addition, the REIT must increase the amount of any NOL carryover to the extent it pays capital gains dividends in excess of its net income.

If the REIT does retain any net capital gains, it may elect to designate to its shareholders some or all of those undistributed amounts and the tax it paid on those gains. For this purpose, undistributed capital gains is the excess of net capital gain over the deduction for dividends paid for capital gain dividends only. The REIT must make the designation in a written notice to its shareholders at any time before the end of the 60-day period after the close of its tax year, or mailed with its annual report for the tax year. The REIT uses Form 2438 to report and determine its tax on undistributed capital gains, and Form 2439 to inform each shareholder of his or her portion of the undistributed gains and any tax paid. Form 2439 must be provided within 60 days of the close of the REIT's tax year. The REIT must also report any undistributed long-term capital gains not designated to shareholders and any net short-term capital gain on Form 8949 and Schedule D (Form 1120).

Net Operating Losses. NOLs sustained by a REIT in tax years ending after 2017 may not be carried back, but may be carried forward indefinitely. However, NOLs sustained in tax years beginning after 2017 may only reduce 80 percent of the REIT's taxable income (Code Sec. 172(a) and (b)(1)(A)).[62] NOLs sustained by a REIT in tax years ending before 2018 may not be carried back, and only may be carried forward 20 years. NOLs arising from a non-REIT year ending before 2018 cannot be carried back to a REIT year (¶ 1151) (Code Sec. 172(b)(1)(B), prior to being stricken by P.L. 115-97).

Built-in Gains Tax. A REIT may be subject to a modified version of the built-in gains tax imposed on an S corporation (¶ 337) if property owned by a C corporation becomes property of the REIT when the corporation qualifies as a REIT (¶ 2326) or is transferred to the REIT, or if a C corporation engages in a conversion transaction involving a REIT (Reg. § 1.337(d)-7; Temp. Reg. § 1.337(d)-7T).[63] The tax does not apply if the corporation makes a deemed sale election to recognize gain and loss as if it sold the converted property to an unrelated person at fair market value. The tax also does not apply if the corporation otherwise recognizes gain or loss on the conversion transaction, or if the corporation's gain is not recognized in a like-kind exchange or an involuntary conversion.

The Treasury Department has identified the Code Sec. 337 regulations as significant tax regulations that impose an undue financial burden on U.S. taxpayers and/or add undue complexity to the federal tax laws, pursuant to Executive Order 13789 (issued April 21, 2017) (Notice 2017-38). The Treasury has proposed to revise these regulations such that they will prevent the inappropriate recognition of excess gain and more closely reflect the intent of Congress (Treasury Department's Second Report to the President on Identifying and Reducing Tax Regulatory Burdens (Executive Order 13789) (October 2, 2017)).[64]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[62] ¶ 12,002 [63] ¶ 16,241H, ¶ 16,241HK [64] ¶ 16,242.20

Other Taxes. In addition to the tax on its taxable income, a REIT may be subject to the following additional taxes:

- a tax for failure to meet the REIT asset or income requirements for the tax year (¶ 2326);
- a tax at the highest corporate rate (21 percent for tax years beginning after 2017) on net income from foreclosure property (Code Sec. 857(b)(4));[65]
- a 100-percent tax on the net income derived from a prohibited transaction (e.g., disposition of property, other than foreclosure property, that is held for sale to customers in the ordinary course of business) (Code Sec. 857(b)(6));[66]
- a four-percent excise tax on the amount of any taxable income that is undistributed at the end of the tax year, and calculated and paid on Form 8612 (Code Sec. 4981);[67] and
- a 100-percent tax on the excess portion of rents, deductions, and interest that must be reduced to clearly reflect income if a REIT and taxable REIT subsidiary (¶ 2340) engage in transactions other than those at arm's length (Code Sec. 857(b)(7)).[68]

2331. Taxation of REIT Distributions. Distributions received from a real estate investment trust (REIT) (¶ 2326) not designated as capital gain dividends are generally treated by shareholders as ordinary income to the extent of the REIT's earnings and profits. However, all or a portion of the distribution of an ordinary dividend may be a qualified dividend eligible to be taxed at capital gains rates (¶ 733). The amount a REIT can designate as qualified dividend income is limited to the sum of: (1) the REIT's qualified dividend income for the tax year; (2) the excess of the sum of REIT taxable income for the preceding tax year and the income subject to tax under the Code Sec. 337(d) regulations for that preceding tax year, over the taxes payable by the REIT under the REIT rules (¶ 2329) and the Code Sec. 337(d) regulations for that preceding tax year; and (3) the amount of earnings and profits that were distributed by the REIT for the tax year and accumulated in tax years in which the entity was not a REIT. The amount of qualified dividends must be specified by the REIT in a written notice to shareholders no later than 60 days after the close of the tax year (Code Sec. 857(c)(2)).[69]

If a publicly offered REIT makes a qualifying distribution of stock to shareholders who have the option to receive cash or stock, the distribution is treated as a Code Sec. 301 distribution that generally results in a dividend (Rev. Proc. 2017-45).[70] This treatment applies to distributions declared on or after August 11, 2017, if, among other requirements, each shareholder has a cash or stock election with respect to part or all of the distribution and at least 20 percent of the aggregate declared distribution consists of money. The value of the stock received by any shareholder in lieu of cash is considered to be equal to the amount of cash for which the stock is substituted. If a shareholder participates in a dividend reinvestment plan, the stock received by that shareholder pursuant to the reinvestment plan is treated as received in exchange for cash received in the distribution.

Distributions in excess of the REIT's earnings and profits (other than deficiency dividends (¶ 2337)) constitute a return of the shareholder's basis (¶ 735). Dividends received from a REIT do not qualify for the dividends-received deduction for corporations (¶ 223).

Distributions designated as capital gain dividends are treated as long-term capital gains by the shareholders, regardless of how long they held their interests in the REIT (Code Sec. 857(b)(3)).[71] This includes any undistributed capital gains designated by the REIT (¶ 2329). Shareholders are entitled to a credit or refund for their portion of any capital gain taxes paid by the REIT on the undistributed capital gains. In addition, a

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[65] ¶ 26,520 [66] ¶ 26,520 [67] ¶ 34,620 [68] ¶ 26,520 [69] ¶ 26,520; § 19,205.05, § 45,440.10 [70] ¶ 26,533.25; § 50,425.05 [71] ¶ 26,520; § 19,205.20, § 45,440.10

shareholder must increase the basis of his or her REIT shares by the difference between his or her portions of the undistributed capital gains and the deemed taxes paid. Certain capital gain distributions from REITs to foreign investors are treated as REIT dividends that are not capital gains.

If a shareholder receives a capital gain dividend or the REIT has designated undistributed capital gains with respect to any share or beneficial interest, and the shareholder holds the share for six months or less, then any loss on the sale of that share is treated as a long-term capital loss to the extent of the long-term capital gain dividend (Code Sec. 857(b)(8)).[72] This rule does not apply to losses incurred on the disposition of REIT stock or a beneficial interest under a plan that provides for the periodic liquidation of such shares or interests. For purposes of determining whether a taxpayer has held REIT stock or a beneficial interest for six months or less, rules similar to those for the dividends-received deduction are applied (¶ 223).

Capital Gains Tax Rates. The IRS has provided guidance that a REIT and its shareholders must use in applying the net capital gain tax rates (¶ 1736) to capital gain dividends (Notices 97-64 and 2004-39).[73]

2337. Deficiency Dividends of REITs. If there is a determination that adjustments are needed to certain amounts that a real estate investment trust (REIT) (¶ 2326) reports for a tax year, and if the adjustments could cause the entity to lose its REIT status, the REIT may avoid disqualification by making deficiency dividend distributions, and may claim a deduction for the dividends paid (Code Sec. 860; Reg. §§ 1.860-1—1.860-5).[74] For a REIT, an adjustment can be: (1) an increase in the sum of its taxable income (determined without regard to its dividends-paid deduction and excluding any net capital gain), plus the excess of its net income from foreclosure property minus the tax on the foreclosure property net income; (2) an increase in the amount of the excess of its net capital gain over its deduction for capital gain dividends paid; or (3) a decrease in its dividends-paid deduction (determined without regard to capital gains dividends). See ¶ 2317 for the deficiency dividend procedure, which is the same as that for regulated investment companies (RICs).

2339. After-Tax Year Distributions of REITs. A real estate investment trust (REIT) (¶ 2326) that declares a dividend (including a capital gain dividend) before the due date for filing its return for a tax year (including extensions), but distributes the dividend after the close of the tax year, can treat the dividend as having been paid during the tax year if the entire declared dividend is paid within the 12-month period following the close of the tax year and no later than the date of the first regular dividend payment after the declaration (Code Sec. 858; Reg. § 1.858-1).[75] The shareholder must generally treat the dividend as received in the tax year in which the distribution is made. This rule does not apply, however, to dividends declared in October, November, or December that are treated as paid on December 31 of a calendar year even if they are actually paid in January of the following calendar year (¶ 2329).

2340. REIT Subsidiaries. A real estate investment trust (REIT) (¶ 2326) may own a qualified REIT subsidiary and treat all of the subsidiary's assets, liabilities, and items of income, deduction, and credit as its own (Code Sec. 856(i)).[76] A qualified subsidiary is any corporation other than a taxable REIT subsidiary, all of the stock of which is held by the REIT. A taxable REIT subsidiary is any corporation that is owned, in whole or in part, by the REIT and that both entities jointly elect using Form 8875 to treat as a taxable REIT subsidiary (Code Sec. 856(l)). A taxable REIT subsidiary can be used by the REIT to provide noncustomary services to its tenants or to manage and operate properties without causing the amounts received or accrued to be disqualified as rents from real property. The election to be treated as a taxable REIT subsidiary can only be revoked with the consent of both the REIT and the subsidiary.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[72] ¶ 26,520; § 19,230.15, § 45,440.10
[73] ¶ 26,433.16; § 19,205.20
[74] ¶ 26,580, ¶ 26,581—¶ 26,585
[75] ¶ 26,540, ¶ 26,541
[76] ¶ 26,500

Real Estate Mortgage Investment Conduits

2343. Qualification as Real Estate Mortgage Investment Conduit (REMIC). A real estate mortgage investment conduit (REMIC) is an entity that holds a fixed pool of mortgages and issues multiple classes of interests to investors (Code Sec. 860D; Reg. § 1.860D-1).[77] A REMIC is treated like a partnership for federal tax purposes with its income passed through to its interest holders (¶ 2344). Thus, a REMIC is not subject to taxation on its income, although it is subject to taxes on prohibited transactions (¶ 2355), income from foreclosure property (¶ 2356), and on certain contributions received after its start-up day (¶ 2357). It also may be required to withhold taxes on amounts paid to foreign holders of regular or residual interests (¶ 2367).

An entity qualifies as REMIC if it makes an irrevocable election to be treated as such by filing Form 1066 during its first tax year of existence, and if it meets certain requirements as to its investors (¶ 2344) and assets (¶ 2345). If an entity ceases to qualify as a REMIC at any time during the tax year, it will not be treated as a REMIC for that or any later tax year. A REMIC is required to file an information return with the IRS on Form 8811 within 30 days of its start-up day (and 30 days from any change of information provided in a previously-filed Form 8811) identifying its representative for reporting tax information (Reg. § 1.6049-7).[78]

2344. Investors' Interests in REMICs. In order to qualify as a real estate mortgage investment conduit (REMIC) (¶ 2343), all of the interests in the entity must be either regular interests or residual interests, and there must be only one class of residual interests (Code Sec. 860D; Reg. § 1.860D-1).[79] However, a *de minimis* interest that is neither a regular nor a residual interest can be created to facilitate the REMIC creation.

A regular interest is any interest that is issued on the start-up day of the REMIC with fixed terms and that is designated as a regular interest (Code Sec. 860G(a)(1); Reg. § 1.860G-1).[80] A regular interest may be issued in the form of debt, stock, interest in a partnership or trust, or any other form permitted by state law, as long as it unconditionally entitles the holder to receive a specific principal amount and interest based on a fixed rate (or permitted variable rate). An interest-only regular interest may also be issued that entitles the holder to receive interest payments determined by reference to the interest payable on qualified mortgages, rather than a specified principal amount.

An interest does not fail to qualify as a regular interest merely because the timing of principal payments may be contingent on the prepayments on qualified mortgages or the amount of income from permitted investments (¶ 2345). In addition, an interest does not fail to be a regular interest solely because the specified principal amount may be reduced as a result of a nonoccurrence of a contingent payment with respect to a reverse mortgage loan held by the REMIC if the REMIC's sponsor reasonably believes on the start-up day that all principal and interest due under the regular interest will be paid at or prior to the REMIC's liquidation. The REMIC must file Form 1099-INT for each regular interest holder (and furnish a copy to the interest holder) that has been paid or to which has accrued $10 or more of interest during the calendar year (Reg. § 1.6049-7).[81] If the REMIC is also reporting original issue discount (OID) (¶ 1952), it can report both the interest and OID on Form 1099-OID.

A residual interest is an interest issued on the REMIC's start-up day that is not a regular interest and that is designated as a residual interest (Code Sec. 860G(a)(2)).[82] There may be only one class of residual interests, and any distribution with respect to such interests must be pro rata. A REMIC must have reasonable arrangements to ensure that residual interests are not held by certain disqualified organizations (governments, exempt organizations, cooperatives) (Code Sec. 860D(a)(3) and (6)).[83] For each quarter of its tax year, a REMIC must send a Schedule Q (Form 1066) to residual interest holders reporting their share of the REMIC's income or loss (Reg. § 1.860F-4(e)).[84]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[77] ¶ 26,660, ¶ 26,661; § 45,445.05
[78] ¶ 36,036
[79] ¶ 26,660, ¶ 26,661; § 45,445.05
[80] ¶ 26,720, ¶ 26,720A; § 45,445.10
[81] ¶ 36,036; § 39,110.10
[82] ¶ 26,720
[83] ¶ 26,660
[84] ¶ 26,701

REMIC Interests as Assets in Other Contexts. Regular and residual interests in a REMIC are treated as real estate assets for purposes of determining if an organization qualifies as a real estate investment trust (REIT) (¶ 2326). However, if for any calendar quarter less than 95 percent of the REMIC's assets are real estate assets, the REIT is treated as holding directly its proportionate share of the assets and income of the REMIC (Code Sec. 856(c)(5)(E); Reg. § 1.856-3(b)).[85]

If one REMIC owns interests in another REMIC, then the character of the second REMIC's assets flow through for purposes of making this determination. Any regular or residual interest in a REMIC can also qualify as an asset for purposes of determining whether an organization is a domestic building and loan association (Code Sec. 7701(a)(19); Reg. § 301.7701-13A).[86] If 95 percent or more of REMIC assets qualify as an asset for this purpose, then the entire interest in the REMIC can qualify as an asset.

2345. Qualified Mortgages and Permitted Investments of REMICs. In order to qualify as a real estate mortgage investment conduit (REMIC) (¶ 2343), substantially all of an entity's assets must consist of qualified mortgages and permitted investments at the close of the third month beginning after the start-up day and all times thereafter (Code Sec. 860D(a)(4)).[87] A qualified mortgage is any obligation that is principally secured by an interest in real property and that:

- is transferred to the REMIC on the start-up day in exchange for a regular or residual interest;
- is purchased by the REMIC within three months after the start-up day pursuant to a fixed price contract in effect on the start-up day; or
- represents an increase in the principal under the original terms of the obligation, if the increase (1) is attributable to an advance made to the obligor under the terms of a reverse mortgage or other obligation, (2) occurs after the start-up day, and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the start-up day (Code Sec. 860G(a)(3)).[88]

A qualified mortgage may also include any qualified replacement mortgage, or a regular interest in another REMIC transferred on the start-up day in exchange for a regular or residual interest.

Permitted investments include cash-flow investments of amounts received under qualified mortgages for a temporary period, intangible property held for payment of expenses as part of a qualified reserve fund, and foreclosure property acquired in connection with the default of a qualified mortgage (Code Sec. 860G(a)(5)).[89]

2349. Transfer of Property to REMICs. No gain or loss is recognized if property is transferred to a real estate mortgage investment conduit (REMIC) in exchange for a regular or residual interest (¶ 2344) (Code Sec. 860F(b); Reg. § 1.860F-2(b)).[90] The basis of a regular or residual interest received in the exchange is equal to the total adjusted basis of the property transferred, plus any organizational expenses. If the transferor receives more than one interest in the REMIC (both a regular and residual interest), then the basis must be allocated among the interests in accordance with their respective fair market values. The basis of the property received by the REMIC in exchange for a regular or residual interest is its fair market value immediately after the transfer.

The issue price of a regular or residual interest is generally determined under the same rules as for determining the issue price for the original issue discount (OID) of debt instruments (¶ 1952) (Code Sec. 860G(a)(10)).[91] If the issue price of a regular

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[85] ¶ 26,500, ¶ 26,504
[86] ¶ 43,080, ¶ 43,109
[87] ¶ 26,660; § 45,445.05
[88] ¶ 26,720; § 45,445.05
[89] ¶ 26,720; § 45,445.05
[90] ¶ 26,700, ¶ 26,700B
[91] ¶ 26,720

interest in a REMIC exceeds its adjusted basis, then the excess is included in the transferor's gross income as if it were a market discount bond (¶ 1958) (Code Sec. 860F(b)(1)(C); Reg. § 1.860F-2(b)(4)).[92] If the issue price of a residual interest exceeds its adjusted basis, then the excess is included in the transferor's gross income ratably over the anticipated weighted average life of the REMIC. If the adjusted basis of a regular interest exceeds the issue price, then the excess is allowable as a deduction to the transferor under the rules similar to those governing amortizable bond premiums (¶ 1967) (Code Sec. 860F(b)(1)(D); Reg. § 1.860F-2(b)(4)). If the adjusted basis of a residual interest exceeds the issue price, then the excess is allowed as a deduction to the transferor over the anticipated weighted average life of the REMIC.

2352. Taxable Income or Loss of REMICs. A real estate mortgage investment conduit (REMIC) (¶ 2343) is not generally taxed on its income (Code Sec. 860A).[93] However, its taxable income must still be determined for purposes of the taxation of residual interest holders (¶ 2361). REMIC taxable income is determined in the same manner as that of an individual, except that it must use the accrual method of accounting and make the following adjustments:

- Regular interests in the REMIC are treated as debt.
- Market discount on any bond is included in gross income as the discount accrues.
- No item of income, gain, loss, or deduction from a prohibited transaction is taken into account (¶ 2355).
- The deductions for personal exemptions, foreign taxes, charitable contributions, net operating losses (NOLs), itemized deductions for individuals (except ordinary and necessary expenses paid or incurred for the production of income), and depletion are not allowed.
- The amount of any net income from foreclosure property is reduced by the amount of tax imposed on that income.
- Gain or loss from the disposition of assets, including qualified mortgages and permitted investments, is treated as ordinary gain or loss rather than gain or loss from a capital asset.
- Interest expenses (other than the portion allocable to tax-exempt interest) may be deducted without regard to the investment interest limitation.
- Debts owed to the REMIC are not treated as nonbusiness debts for purposes of the bad debt deduction.
- The REMIC is not treated as carrying on a trade or business, and ordinary and necessary operating expenses may only be deducted as expenses incurred for the production of income (¶ 1085) (Code Sec. 860C(b); Reg. § 1.860C-2).[94]

A REMIC's net loss is determined by subtracting its gross income from allowable deductions, taking into account the same modifications listed above.

2355. Prohibited Transactions of REMICs. A real estate mortgage investment conduit (REMIC) (¶ 2343) is required to pay a 100-percent tax on its *net income* from a prohibited transaction; losses are not taken into account for this purpose (Code Sec. 860F(a)).[95] The disposition of any qualified mortgage is considered a prohibited transaction unless the disposition is due to:

- the substitution of a qualified replacement mortgage for a qualified mortgage (or the repurchase in lieu of substitution of a defective obligation);
- the bankruptcy or insolvency of the REMIC;
- a disposition incident to foreclosure or default of a mortgage; or
- a qualified liquidation.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[92] ¶ 26,700, ¶ 26,700B
[93] ¶ 26,600; § 45,445.10
[94] ¶ 26,640, ¶ 26,640B
[95] ¶ 26,700

A significant modification of a mortgage is considered a disposition (Reg. §1.860G-2(b)).[96] The IRS has issued procedures that set forth conditions under which modifications of certain mortgage loans, as well as subprime mortgage loans, will not be considered a disposition of a qualified mortgage and a prohibited transaction of a REMIC or investment trust that holds the loans (Rev. Proc. 2010-30; Rev. Proc. 2009-45; Rev. Proc. 2009-23).[97]

Prohibited transactions of a REMIC also include: the receipt of any income from an asset that is neither a qualified mortgage nor a permitted investment (¶ 2345); the receipt of any amount that represents a fee or compensation for services; and the receipt of gain from the disposition of any cash flow investment, unless the disposition is made pursuant to a qualified liquidation. A disposition is not treated as a prohibited transaction if it is required to prevent default on a regular interest where the threatened default results from a default on one or more qualified mortgages, or is undertaken to facilitate a cleanup call.

2356. Net Income from Foreclosure Property. A real estate mortgage investment conduit (REMIC) is subject to tax at the highest applicable corporate income tax rate (21 percent for tax years beginning after 2017) (¶ 219) on its *net income* from foreclosure property for the tax year (Code Sec. 860G(c)).[98] For this purpose, net income from foreclosure property is the excess of gain from the sale or other disposition of foreclosure property as described in Code Sec. 1221(a)(1) (i.e., stock in trade or property held by the REMIC for sale to customers in the ordinary course of trade or business), plus the gross income derived from foreclosure property during the tax year, over deductions derived from the production of such income (Code Sec. 857(b)(4)(B)).[99]

Foreclosure property is any interest in real property, and personal property incident to the real property, acquired by a REMIC as a result of a default of a lease on the property or a debt securing the property. A REMIC must elect to treat property as foreclosure property by the due date (including extensions) of its annual return for the year in which it acquires the property. Property ceases to be foreclosure property: (1) as of the close of the third tax year after the tax year in which it is acquired, unless an extension is granted, or (2) if the property's foreclosure property status terminates prior to that date (Code Sec. 856(e)).[100]

2357. Post-Startup Contributions to REMICs. A real estate mortgage investment conduit (REMIC) (¶ 2343) that receives contributions of property after its start-up day is subject to a tax equal to the full value of the contribution (Code Sec. 860G(d)).[101] Exceptions to the tax are provided for cash contributions that are: made to facilitate a cleanup call or a qualified liquidation; in the nature of a guarantee; made during the three-month period that begins on the start-up day; made by a holder of a residual interest in the REMIC to a qualified reserve fund; or permitted under regulations.

2358. Taxation of Regular Interests. Holders of regular interests in a real estate mortgage investment conduit (REMIC) (¶ 2344) are taxed as if their interests were debt instruments, except that income derived from their interests must be computed under the accrual method of accounting (Code Sec. 860B).[102] Gain on the disposition of a regular interest is treated as ordinary income to the extent of unaccrued original issue discount (OID) (¶ 1952), computed at 110 percent of the applicable federal rate (AFR) effective at the time the interest was acquired. The REMIC must report interest payments of $10 or more to regular interest holders and the IRS on Form 1099-INT.

2361. Taxation of Residual Interests. A holder of a residual interest in a real estate mortgage investment conduit (REMIC) (¶ 2344) must take into account daily portions of the taxable income or net loss of the REMIC (¶ 2352) for each day during the tax year on which the interest is held (Code Sec. 860C; Reg. §1.860C-1).[103] The daily portion is

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[96] ¶ 26,720B
[97] ¶ 26,721.70
[98] ¶ 26,720
[99] ¶ 26,520
[100] ¶ 26,500
[101] ¶ 26,720
[102] ¶ 26,620; § 45,445.10
[103] ¶ 26,640, ¶ 26,640A; § 45,445.10

determined on the basis of quarterly computations of the REMIC's taxable income or net loss with such amounts being allocated among all residual interests in proportion to their respective holdings on each day during the quarter (reported on Schedule Q (Form 1066)).

The holder treats the daily portion of taxable income and net loss as ordinary income or loss. However, the amount of loss that the holder may take into account in any calendar quarter cannot exceed the holder's adjusted basis in the residual interest (as determined without regard to any required basis decreases for the daily portions of the REMIC's net loss). Any allocated loss that is disallowed may be carried forward to succeeding calendar quarters indefinitely, but it may only be used to offset income from the same REMIC.

Distributions made by the REMIC to a holder of a residual interest are received tax free to the extent that they do not exceed that holder's adjusted basis in his or her interest. Any excess is treated as gain from the sale or exchange of the interest. The basis of a holder's residual interest is increased by the daily portion of REMIC taxable income allocated to the interest. The holder's basis is decreased, but not below zero, by the amount of any distribution received and the daily portion of the REMIC net loss allocated to the interest holder. If a residual interest in a REMIC is disposed of by the holder, these adjustments are treated as occurring immediately before the disposition.

Income in Excess of Daily Accruals. A holder of a residual interest may not reduce taxable income (or alternative minimum taxable income (AMTI)) for the tax year below his or her excess inclusion for the year (Code Sec. 860E; Reg. §1.860E-1).[104] A holder's excess inclusion is equal to the excess of the net income passed through to the holder each calendar quarter over a deemed interest component referred to as the "daily accrual." The effect is to prevent a holder from offsetting his or her excess inclusion by any net operating losses (NOLs) (¶ 1145) or in calculating alternative minimum tax (AMT) (¶ 190). Excess inclusions are also treated as unrelated business taxable income for tax-exempt holders (¶ 655). If a residual interest is held by a regulated investment company (RIC), real estate investment trust (REIT), common trust fund, or cooperative, a portion of the dividends paid by the organization to its shareholders are treated as excess inclusions.

Application of Wash Sale Rules. Except as provided in the regulations, the wash sale rules (¶ 1935) apply to dispositions of residual interests where a seller of the interest acquires any residual interest in any REMIC (or any interest in a taxable mortgage pool (¶ 2368) that is comparable to a residual interest) within a period beginning six months before the date of sale or disposition and ending six months after that date (Code Sec. 860F(d)).[105]

Residual Interests Held by Disqualified Organizations. If a disqualified organization (government, exempt organization, cooperative) holds a residual interest in a REMIC at any time during the tax year, then an excise tax is imposed against the person or entity that has transferred the interest to the organization (Code Sec. 860E(e); Reg. §1.860E-2).[106] The tax is the highest applicable corporate income tax rate (21 percent for tax years beginning after 2017) (¶ 219) imposed on the present value of the total excess inclusion that is anticipated for the interest after the transfer takes place. If the transfer is through an agent of the disqualified organization, the agent must pay the tax.

Noneconomic Interests. The transfer of a noneconomic residual interest is disregarded for federal tax purposes if a significant purpose of the transfer was to impede the assessment or collection of tax (Reg. §1.860E-1(c)).[107] A noneconomic residual interest is one for which anticipated distributions are insufficient to meet anticipated tax liabilities.

2367. Foreign Holders of REMIC Interests. If the holder of a residual interest in a real estate mortgage investment conduit (REMIC) (¶ 2361) is a nonresident alien or

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[104] ¶ 26,680, ¶ 26,680A
[105] ¶ 26,700
[106] ¶ 26,680, ¶ 26,680B
[107] ¶ 26,680A

foreign corporation, then for withholding and income tax purposes (¶ 2425): (1) amounts includible in the holder's gross income are taken into account when paid or distributed, or when the interest is disposed; and (2) no exemption from the 30-percent tax imposed on U.S.-source income not effectively connected with a U.S. business applies to any excess inclusion (¶ 2431) (Code Sec. 860G(b)).[108]

2368. Taxable Mortgage Pools. If a mortgage pool does not elect to be or qualify as a real estate mortgage investment conduit (REMIC) (¶ 2343) or as a financial asset securitization investment trust (FASIT) formed prior to January 1, 2005 (¶ 2394), it may qualify as a taxable mortgage pool. An entity is a taxable mortgage pool if:

(1) substantially all the assets of which consist of debt obligations (or interests therein) and more than 50 percent of the obligations (or interests) consist of real estate mortgages;

(2) the entity is the obligor under debt obligations with two or more maturities; and

(3) under the terms of the entity's debt obligations, payments on the obligations referred to in (2) are related to payments on the obligations or interests referred to in (1) (Code Sec. 7701(i)).[109]

A taxable mortgage pool is taxed as a separate corporation and may not join with any other corporation in filing a consolidated return. Any portion of an entity that meets the requirements above is treated as a taxable mortgage pool. However, no domestic savings and loan association can qualify to be a taxable mortgage pool.

Insurance Companies

2370. Taxation of Life Insurance Companies. For tax years beginning after 2017, a life insurance company is generally taxed on its life insurance company taxable income, including any net capital gains, at the 21-percent corporate income tax rate (¶ 219) (Code Sec. 801).[110] A life insurance company with a fiscal year that includes January 1, 2018, pays federal income tax using a blended tax rate under the Code Sec. 15 tax proration rules. More specifically, a life insurance company determines its federal income tax for the fiscal year by (1) calculating its tax for the entire tax year using the graduated corporate income tax rates in effect for tax years beginning before 2018, (2) calculating its tax for the tax year using the 21-percent rate for tax years beginning after 2017, (3) proportioning each tax amount in (1) and (2) based on the number of days in the tax year when the different rates were in effect, and (4) adding the two amounts determined in (3). The sum of these two amounts is the life insurance company's income tax for the fiscal year that includes January 1, 2018 (Notice 2018-38).[111]

In tax years beginning before 2018, if a life insurance company has net capital gains, the company is taxed at the 35-percent corporate capital gain rate (¶ 1738) on its net capital gain, and at regular corporate tax rates on the excess of its life insurance company taxable income minus the net capital gain, if this results in a lower tax amount (Code Sec. 801(a)(2), prior to being stricken by the Tax Cuts and Jobs Act (P.L. 115-97)).

Life insurance company taxable income for this purpose is the sum of the life insurance company's net premiums, net decreases in reserves, and other items of income, minus deductions for the following: claims, benefits, and losses accrued; net increases in various reserves (¶ 2372); policyholder dividends (¶ 2373); dividends received (subject to limitations); operational losses in tax years beginning before 2018 (¶ 2377); net operating losses in tax years beginning after 2017; consideration paid for another person's assumption of the company's insurance and annuity liabilities; and dividend reimbursements paid to another insurance company (Code Secs. 803, 804, and 805).[112] All other deductions allowed to a corporation are also permitted, subject to some modifications. A life insurance company uses Form 1120-L to figure and report its taxable income.

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[108] ¶ 26,720
[109] ¶ 43,080
[110] ¶ 25,710
[111] ¶ 3375.10, § 26,010
[112] ¶ 25,730, ¶ 25,750, ¶ 25,770

For tax years beginning before 2018, small life insurance companies (with gross assets of less than $500 million at the close of a tax year) may claim an additional deduction based on their tentative taxable income (Code Sec. 806, prior to being stricken by P.L. 115-97).[113]

A business entity qualifies as a life insurance company if: (1) more than half of its business activities consist of issuing life insurance or annuity contracts, or reinsuring risks underwritten by other insurance companies; and (2) more than half of its total reserves for paying off insurance obligations consist of life insurance reserves, plus unearned premiums, and unpaid losses on noncancellable life, accident, or health policies that are not included in life insurance reserves (Code Sec. 816).[114]

2372. Net Change in Reserves of Life Insurance Companies. A life insurance company (¶ 2370) may deduct the net increase in certain reserves and must include in income the net decrease in such reserves that have occurred during the tax year (Code Sec. 807).[115] The net increase or decrease is generally computed by comparing the closing balance for the company's reserves to the opening balance of the reserves. The closing balance is reduced by the policyholders' shares of tax-exempt interest and shares of the increase in cash values of insurance and annuity contracts for the year.

Items that must be taken into account in determining whether reserves have had a net increase or decrease include:

- life insurance reserves;
- unearned premiums and unpaid losses (Code Sec. 846);[116]
- discounted amounts necessary to satisfy obligations arising under contracts that did not involve life, accident, or health contingencies;
- dividend accumulations and other amounts held in connection with insurance and annuity contracts;
- advanced premiums and liabilities for premium deposit funds; and
- reasonable special contingency reserves for group term life insurance or group accident and health contracts.

For tax years beginning before 2018, insurance companies that are required to discount unpaid losses could claim an additional deduction up to the excess of undiscounted unpaid losses over related discounted unpaid losses (Code Sec. 847, prior to being stricken by the Tax Cuts and Jobs Act (P.L. 115-97)).[117]

2373. Policyholder Dividends of Life Insurance Companies. A life insurance company (¶ 2370) may claim a deduction in calculating taxable income for dividends or similar distributions paid or accrued to policyholders during the tax year (Code Sec. 808).[118] A policyholder dividend includes excess interest, premium adjustments, experience-rated refunds, and any amount paid or credited to policyholders not based on a fixed amount in the contract but dependent on the experience rate of the company or the discretion of management. The policyholder dividends deduction must be reduced by the amount by which the deduction was accelerated due to a change in the life insurance company's business practice.

2377. Net Operating Loss Deduction of Life Insurance Companies. Life insurance companies (¶ 2370) are allowed a net operating loss (NOL) deduction (¶ 1145) for losses arising in tax years beginning after 2017 the same as other corporations. NOLs are not taken into account in determining a life insurance company's limitations on the dividends-received or charitable contribution deductions (Code Sec. 805).[119]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[113] ¶ 25,790
[114] ¶ 25,990
[115] ¶ 25,810
[116] ¶ 26,330
[117] ¶ 26,350
[118] ¶ 25,830
[119] ¶ 25,770

For losses arising in tax years beginning before 2018, a life insurance company could claim an operations loss deduction in calculating taxable income, which equaled the sum of operations loss carryovers and carrybacks to the tax year. The company's loss from operations for a tax year was the excess of its life insurance deductions over its life insurance gross income (subject to limitations). An operations loss could be carried back three years and carried forward 15 years (Code Sec. 810, prior to being stricken by the Tax Cuts and Jobs Act (P.L. 115-97)).[120]

2378. Taxation of Other Insurance Companies. An insurance company that does not meet the definition of a life insurance company (¶ 2370) (property and casualty companies) is subject to taxation at regular corporate income tax rates (¶ 219) on its taxable income (Code Secs. 831(a) and 832).[121] However, the company is exempt from tax if its gross receipts for the tax year do not exceed $600,000 and more than 50 percent of gross receipts consist of premiums ($150,000 and 35 percent, respectively, for a mutual insurance company) (Code Sec. 501(c)(15)).[122]

A property and casualty insurance company may elect to be taxed only on its taxable investment income if it has net written premiums for the tax year (or direct written premiums if greater) that do not exceed $2.3 million for 2018 (projected to be $2.3 million for 2019). The company's net written premiums is its gross investment income less deductions for tax-free interest, investment expenses, real estate expenses, depreciation, paid or accrued interest, capital losses, trade or business deductions, and certain corporate deductions (Code Secs. 831(b) and 834(e); Rev. Proc. 2017-58).[123]

For tax years beginning after December 31, 2016, a property and casualty insurance company must also meet a diversification requirement to be eligible to be taxed on only its taxable investment income. There are two methods of meeting this requirement. The primary method—the "risk diversification test"—is to have no more that 20 percent of the company's net written premiums (or direct written premiums if greater) attributable to one policyholder in a tax year.

A small insurance company that fails to meet this test may be able to meet the alternative "relatedness test." This requires that no person who holds (directly or indirectly) an interest in the company be a "specified holder" with aggregate interests in the company (held directly or indirectly) that are a higher percentage of the entire interests in that insurance company than a *de minimis* percentage of interests in the relevant specified assets with respect to the company held (directly or indirectly) by the specified holder.

For tax years beginning after December 31, 2016, a small insurance company with an election in effect to be taxed on its taxable investment income is required to meet any information and substantiation reporting requirements regarding the diversification test as may be established by the IRS (Code Sec. 831(d)).[124]

2380. Foreign Insurance Companies. A foreign company carrying on an insurance business within the United States that would otherwise qualify as an insurance company if it were a domestic company is taxable as an insurance company on its income effectively connected with the conduct of any U.S. trade or business (¶ 2429) and is taxable on its remaining income from U.S. sources (¶ 2431) (Code Sec. 842).[125]

Other Special Entities

2383. Banks and Other Financial Institutions. A bank or other financial institution is generally subject to the same tax rules as a corporation except that a bank is not subject to capital loss limitations with respect to the worthlessness of debt securities (¶ 1916). Instead, a bank may treat these losses as bad debt losses. In addition, if one bank directly owns at least 80 percent of each class of stock of another bank, the first bank's losses on worthless stock and stock rights in the second bank are not treated as losses from the sale or exchange of capital assets (Code Sec. 582).[126]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[120] ¶ 25,870
[121] ¶ 26,130, ¶ 26,150
[122] ¶ 22,602; § 33,005.05
[123] ¶ 26,130, ¶ 26,190, ¶ 26,135.355
[124] ¶ 26,130
[125] ¶ 26,250
[126] ¶ 23,608

The method that is used to deduct bad debts of a bank depends on the type and size of the institution in question (Code Sec. 585; Reg. § § 1.585-1—1.585-8).[127] A small bank (average adjusted basis of all assets of $500 million or less) may add to its bad debt reserves an amount based on its actual experience as shown by losses for the current and preceding five tax years. A thrift institution that would be treated as a small bank may utilize this method as well. A large bank is generally required to use either a specific charge-off method in which its debt reserves are recaptured over a four-year period, or the cutoff method in which recoveries and losses are reflected as adjustments to the bank's reserve account.

Definition of a Bank. For this purpose, a bank is defined as a corporation with a substantial part of its business consisting of either receiving deposits and making loans or exercising fiduciary powers similar to those permitted to national banks. This includes a commercial bank and trust company, mutual savings bank, building and loan association, cooperative bank, and federal savings and loan association (Code Sec. 581; Reg. § 1.581-2).[128] However, a corporation that is one of these other type of entities is allowed a deduction for dividends paid or credited to depositors (Code Sec. 591).[129]

Sale or Exchange of Securities. In the case of certain financial institutions, the sale or exchange of a bond, debenture, note, certificate, or other evidence of indebtedness is not considered a sale or exchange of a capital asset (Code Sec. 582(c)).[130] Instead, net gains and losses from such transactions are treated as ordinary income and losses. A financial institution includes a commercial bank, mutual savings bank, domestic building and loan association, cooperative bank, business development corporation, and small business investment company (¶ 2392).

2389. Common Trust Funds. A common trust fund is an investment vehicle established by a bank in the form of a state-law trust to handle the investment and reinvestment of money contributed to it in its capacity as a trustee, executor, administrator, guardian, or as a custodian of a Uniform Gifts to Minors account (Code Sec. 584).[131] For tax purposes, a common trust fund is treated in a manner similar to that of a partnership. Instead of the trust being subject to tax, each participant that invests in the trust fund must include his or her proportionate share of the trust fund's income or loss on his or her own return. This includes a participant's share of dividends received by the fund that are eligible for the reduced tax rate on qualified dividends (¶ 733). The admission and withdrawal of a participant does not result in a gain or loss to the common trust fund.

2392. Small Business Investment Companies. A small business investment company (SBIC) is a private corporation that operates under the Small Business Investment Act of 1958 to provide capital to small business concerns through the purchase of convertible debentures. An SBIC is generally treated as a corporation for federal tax purposes with a few exceptions. First, an SBIC may claim an ordinary loss deduction for any loss on the sale or exchange of stock of a small business concern if the stock was received under the conversion privilege of a debenture acquired on the providing of equity capital to small business concerns (Code Sec. 1243).[132] Second, an SBIC may deduct 100 percent of the dividends it receives from taxable domestic corporations (Code Sec. 243(a)(2)).[133] See ¶ 1913 for the treatment of losses on SBIC stock and ¶ 1909 for the rollover of gain from the sale of publicly traded securities before 2018 into stock or a partnership interest in a specialized SBIC.

2394. Financial Asset Securitization Investment Trusts. Prior to January 1, 2005, a qualified entity could elect to be treated as a financial asset securitization investment trust (FASIT) (Code Secs. 860H—860L, prior to repeal by the American Jobs Creation Act of 2004 (P.L. 108-357)).[134] A FASIT is a passthrough entity used to securitize debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT must be entirely owned by a taxable C corporation. Any residual income of the FASIT is

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[127] ¶ 23,650, ¶ 23,651—¶ 23,661
[128] ¶ 23,602, ¶ 23,604
[129] ¶ 23,690
[130] ¶ 23,608
[131] ¶ 23,630
[132] ¶ 30,770; § 18,245
[133] ¶ 13,051; § 26,505
[134] ¶ 26,730—¶ 26,738

(independent contractor, agent, etc.); it also does not matter how wages are measured, or whether the employee works full time or part time (¶ 2602).

An employer that is required to deduct and withhold income taxes from an employee's wages is generally liable for paying the taxes, even if the taxes are not withheld (Code Sec. 3403).[4] If an employer's agent pays or controls the payment of wages, both the agent and the employer are liable (Code Sec. 3504).[5] Any third party who pays wages directly to employees of an employer or to the employee's agent is liable for any required withholding on those wages (Code Sec. 3505).[6] A certified professional employer organization (CPEO) is treated as the sole employer of an employee performing services for a customer of the CPEO (¶ 2660).

2602. Employee v. Independent Contractor. Employees must be distinguished from independent contractors because an employer does not generally have employment tax obligations for independent contractors. For many years, the IRS applied a 20-factor test to determine whether individuals are employees or independent contractors (Rev. Rul. 87-41).[7] The IRS now examines three key factors: behavioral control, financial control, and relationship of the parties (IRS Pub. 15-A). A worker who may be an independent contractor under this analysis may nevertheless be treated as an employee for FICA and FUTA tax purposes if the worker is classified as a statutory employee (¶ 941B). Either an employer or employee, with or without the other's knowledge or assent, may file Form SS-8 to request that the IRS determine whether or not a particular worker is an employee.

If an employer erroneously classifies an employee as an independent contractor and has no reasonable basis for doing so, the employer is liable for taxes under the income tax withholding (¶ 2601), FICA, and FUTA tax provisions (¶ 2648 and ¶ 2649). An employer may be eligible for reduced rates with respect to income tax withholding (1.5 percent of employee's wages) and the employee's share of FICA tax (20 percent of the amount otherwise due) (Code Sec. 3509).[8] These rates are doubled if the employer failed to file forms consistent with the employer's treatment of the worker as an independent contractor. The reduced rate for FICA taxes is not available for statutory employees. If the employer had a reasonable basis for not treating an individual as an employee, the employer may be relieved of liability for employment taxes for that individual if the employer has consistently treated the worker as a nonemployee (Section 530 of the Revenue Act of 1978).[9]

The IRS's Voluntary Classification Settlement Program allows an eligible business to voluntarily reclassify some or all of its workers as employees for future tax periods while limiting employment tax liability for past nonemployee treatment (Announcement 2012-45, modifying Announcement 2011-64).[10] Form 8952 is used to apply for the program.

An employee who has been misclassified as an independent contractor uses Form 8919 to figure and report the employee's share of uncollected Social Security and Medicare taxes due on his or her compensation.

2604. Wages Subject to Income Tax Withholding. Wages subject to income tax withholding (¶ 2601) generally include all remuneration (other than fees paid to a public official) for services performed by an employee for an employer (Code Sec. 3401(a); Reg. § 31.3401(a)-1(a)).[11] It includes salaries, fees, bonuses, and commissions. Withholding is based on *gross* wage payments before deductions such as those for federal or state unemployment insurance, pensions (except deductible contributions to IRAs), insurance, etc., or liabilities of the employee paid by the employer. An employer must withhold income tax from wages paid for employment regardless of the circumstances

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[4] ¶ 33,591; § 22,105.15
[5] ¶ 33,720; § 22,105.15
[6] ¶ 33,740; § 22,205.25
[7] ¶ 33,538.66; § 22,015.05
[8] ¶ 33,820; § 22,020.10
[9] ¶ 33,538.5056; § 22,020.15
[10] ¶ 33,538.5057; § 22,020.22
[11] ¶ 33,502, ¶ 33,503; § 22,110.05

under which the employee is employed or the frequency or size of the individual wage payments.[12] Tax must be withheld from wages paid for *each* payroll period.[13]

If an employee works on two jobs for the same employer, and only a part of the remuneration is wages—for example, a construction worker who also works on his employer's farm (exempt employment)—all of the remuneration is treated alike. Thus, either: (1) all of the wages are subject to withholding if more than one-half of the time is spent performing services for which wages are received; or (2) all the remuneration is excluded from wages if more than one-half of the time spent is in exempt services, provided the payroll period is no longer than 31 consecutive days (Code Sec. 3402(e); Reg. § 31.3402(e)-1).[14]

Compensation. Other forms of compensation besides salaries, fees, bonuses, and commissions are subject to withholding, including tips and other gratuities (¶ 2605), reimbursed employee expenses paid through a nonaccountable plan (¶ 2607), other supplemental wages such as fringe benefits (¶ 2606), employee expenses in excess of per diem rates (¶ 2608), and payments for the stoppage of work such as severance payments and strike benefits (Reg. § 31.3401(a)-1).[15] Some types of compensation are specifically excluded from the definition of wages for income tax withholding purposes (¶ 2609).

Supplemental unemployment compensation benefit (SUB) payments are treated as wages for income tax withholding purposes, but withholding applies only to the extent that such benefits are includible in the employee's gross income (Code Sec. 3402(o)).[16] SUB payments are also wages for FICA purposes, but may be excluded from wages for FICA (¶ 2648) and FUTA (¶ 2649) tax purposes if payable based upon state unemployment benefits (*In re Quality Stores, Inc.*, SCt, 2014-1 USTC ¶ 50,228; Rev. Rul. 90-72).[17] Guaranteed annual wage payments made during periods of unemployment under a collective bargaining agreement are wages subject to withholding.[18] However, strike benefits (other than hourly wages received for strike-related duties) paid by a union to its members are not subject to withholding.[19]

Although the value of noncash compensation generally must be included in wages, if a retail commission salesperson is occasionally paid other than in cash, then the employer is not required to withhold income tax for the noncash payments (Code Sec. 3402(j); Reg. § 31.3402(j)-1).[20] However, the fair market value of the noncash payments (such as prizes) must be included on the Form W-2 furnished to the employee as part of the total pay earned during the calendar year.

Withholding is available if the payee requests it for sick pay (i.e., wage continuation payments) received from a third party under a health or accident plan in which the employer participates (Code Sec. 3402(o); Reg. § 31.3402(o)-3).[21] Payments of sick pay made directly by employers to their employees are automatically subject to withholding. Employers who are third-party payors of sick pay are not required to withhold income taxes from payments unless the employee has requested withholding on Form W-4S. Sick pay is exempt for FICA and FUTA tax purposes after six calendar months following the month the employee last worked for the employer (Code Secs. 3121(a)(4) and 3306(b)(4)).

Wages subject to withholding include amounts received under a nonqualified deferred compensation plan that are includible in an employee's gross income under Code Sec. 409A for the year of inclusion (¶ 2197) (Code Sec. 3401(a)).

Differential Wage Payments. Differential wage payments are treated as wages for federal income tax withholding purposes (Code Sec. 3401(h)).[22] A differential wage payment is any payment that: (1) is made by an employer to an individual for any period

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[12] ¶ 33,593.165; § 22,110.05
[13] ¶ 33,544.20; § 22,110.05
[14] ¶ 33,542, ¶ 33,551; § 22,105.10
[15] ¶ 33,503; § 22,110.05
[16] ¶ 33,542; § 22,110.40
[17] ¶ 33,506.3683; § 22,210.40, § 22,310.40
[18] ¶ 33,506.3683; § 22,110.40
[19] ¶ 33,506.3678; § 22,110.40
[20] ¶ 33,542, ¶ 33,574; § 22,105.10
[21] ¶ 33,542, ¶ 33,584; § 22,125.10
[22] ¶ 33,502; § 22,110.45

during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days, and (2) represents all or a portion of the wages the individual would have received from the employer if the individual were performing services for the employer. Differential wage payments are considered supplemental wages and subject to the special rules that apply to such payments (¶ 2606). They are not treated as wages for FICA and FUTA tax purposes (Rev. Rul. 2009-11).

Qualified Equity Grants. Qualified stock for which a Code Sec. 83(i) election is made (¶ 1933) is treated as wages received on the earliest date possible under Code Sec. 83(i)(1)(B), and in the amount included as income. If the employee must include the deferred amount in gross income, tax must be withheld at the maximum income tax rate (37 percent for tax years 2018 through 2025), and the stock is treated as a noncash fringe benefit for tax collection purposes (Code Secs. 3401(i) and 3402(t)).[23]

2605. Tips and Gratuities Subject to Withholding. An employee must account for cash tips paid directly to him or her by a customer and charged tips paid over to the employee (¶ 717). The employee must furnish a written statement to the employer on or before the 10th day of the month following the month when the tips are received (Code Sec. 6053(a)).[24] The employee reports the tips on Form 4070 or similar statement. If tips received in the course of his or her employment for a single employer are less than $20 in a calendar month, then the employee is not required to report the tips. The employer uses the employee's report to figure the amount of income tax to withhold for the pay period on both wages and reported tips (Code Sec. 3401(a)(16)).[25] The report is also used to figure the amount of FICA and FUTA taxes to withhold for the pay period (Code Secs. 3121(a)(12) and 3306(s)). A service charge added to a bill or fixed by the employer that the customer must pay is not a tip. A payment is a tip rather than wages only if it is made free from compulsion, the amount is freely determined by the customer, the payment is not negotiated or dictated by the employer, and the customer decides who receives the payment (Rev. Rul. 2012-18).

A large food and beverage establishment (one normally with more than 10 employees on a typical business day and in which tipping is customary) must file an annual information return using Form 8027 (¶ 2565). The return must report gross food and beverage sales receipts, employee-reported tip income, total charge receipts, and total charge tips (Code Sec. 6053(c); Reg. § 31.6053-3).[26] The employer must allocate during the payroll period among its employees who customarily receive tip income an amount equal to the excess of eight percent of gross receipts over reported tips. The allocation is not required if the employees voluntarily report total tips equal to at least eight percent of gross sales. If it can be shown that average tips are less than eight percent of gross sales, the employer or a majority of its employees may apply to the IRS to have the allocation reduced, but not to below two percent.

2606. Supplemental Wages Subject to Withholding. Special withholding rules apply if an employee is paid supplemental wages (e.g., bonus, overtime pay, back pay, commissions, vacation allowance, taxable fringe benefits, etc.). If supplemental wages are paid at the same time as regular wages, the two are added together and income tax withholding is computed on the total as a single wage payment. If the supplemental wages are not paid at the same time as the regular wages, the supplemental wages may be added either to the regular wages for the preceding payroll period or for the current payroll period within the same calendar year (Reg. § 31.3402(g)-1).[27]

Under an alternative method, the employer may treat supplemental wages as wholly separate from regular wages, and withhold at a flat rate equal to the third lowest income tax rate (25 percent before 2018, 22 percent after 2017 and before 2026) without regard to any allowances or reference to any regular payment of wages. Once the total of supplemental wage payments made to an employee within a calendar year exceeds $1 million, the excess is subject to withholding at the highest income tax rate (39.6 percent

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[23] ¶ 33,502, ¶ 33,542; § 22,110.15
[24] ¶ 36,460; § 21,310
[25] ¶ 33,502; § 21,310, § 21,315.05, § 21,320
[26] ¶ 36,460, ¶ 36,463; § 21,305.20
[27] ¶ 33,561; § 22,120.50

before 2018, 37 percent after 2017 and before 2026). This rule applies regardless of the method otherwise used to withhold supplemental wages paid to the employee (Reg. § 31.3402(g)-1; Notice 2018-14; IRS Pubs. 15 and 505).

An employer must collect both income tax and an employee's share of Social Security or railroad retirement tax on tips reported by the employee from wages due the employee or other funds that the employee makes available. Tips may be treated as if they were supplemental wages subject to the flat withholding rate (25 percent before 2018, 22 percent after 2017 and before 2026) without regard to any allowances, provided that income tax has been withheld on the employee's regular wages. Otherwise, the tips must be treated as part of the current or preceding wage payment of the same calendar year and are subject to the regular graduated withholding rates (Rev. Rul. 66-190).[28]

2607. Employee Expense Reimbursements Subject to Withholding. An employer's withholding obligations for amounts paid to employees under an expense allowance or reimbursement arrangement depend on whether the amounts are paid under an accountable plan or a nonaccountable plan (¶ 943 and ¶ 952A). Amounts paid under an accountable plan may be excluded from an employee's gross income to the extent of the employee's substantiated expenses, and are not required to be reported on the employee's Form W-2. Thus, the payments are exempt from employment tax obligations (income tax withholding, FICA, FUTA, railroad retirement, and railroad unemployment taxes) (Reg. §§ 1.62-2 and 31.3401(a)-4).[29] Amounts paid under a nonaccountable plan are included in the employee's gross income, reported on Form W-2, and are subject to withholding as supplemental wages (¶ 2606). If expenses are reimbursed under an accountable plan, but either the expenses are not substantiated within a reasonable time period or amounts in excess of substantiated expenses are not returned within a reasonable time period, the unsubstantiated or excess amounts are treated as paid under a nonaccountable plan and are subject to withholding no later than the first payroll period following the end of the reasonable time period.

Expense reimbursements that are subject to withholding may be added to the employee's regular wages for the appropriate payroll period, and withheld taxes may be computed on the total. Alternatively, the employer may withhold at the flat rate that applies to supplemental wages (¶ 2606) if the expense reimbursement or allowance is separately paid or separately identified (Reg. § 31.3401(a)-4(c)).

2608. Per Diem Allowances Subject to Withholding. If an employee's business expenses are substantiated using an IRS-approved per diem allowance, any amounts paid by the employer to the employee exceeding the amounts deemed substantiated are treated as paid under a nonaccountable plan (¶ 2607) and subject to income tax withholding and other employment taxes (Reg. §§ 1.62-2(h)(2)(i)(B) and 31.3401(a)-4(b)(1)(ii)).[30] See ¶ 947 for standard mileage rate and FAVR allowances for automobile expenses, and see ¶ 954 for per diem methods relating to meal and lodging expenses.

For per diem or mileage allowances paid in advance, withholding on any excess must occur no later than the first payroll period following the payroll period in which the employee substantiates the expenses paid (i.e., the days or miles of travel). For a per diem or mileage allowance paid as a reimbursement, the excess amounts reimbursed are subject to withholding when paid.

2609. Compensation Not Subject to Withholding. Some types of compensation are excluded from the definition of wages for income tax withholding purposes (¶ 2601). This includes amounts paid for or for the services of:

- newspaper carriers under age 18 delivering to customers;
- newspaper and magazine vendors who buy at fixed prices and retain the excess from sales to customers;

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[28] ¶ 33,506.3687; § 22,120.50
[29] ¶ 6004, ¶ 33,508A; § 22,110.45, § 22,210.45, § 22,310.45
[30] ¶ 6004, ¶ 33,508A; § 10,120.10

- agricultural workers who are not subject to FICA withholding;
- household employees;
- cash or noncash tips of less than $20 per month;
- certain employer contributions to IRAs and deferred compensation plans;
- individuals not working in the course of the employer's business (less than $50 paid and less than 24 days worked during the current or preceding quarter);
- employees of foreign governments and international organizations;
- armed forces personnel serving in a combat zone;
- foreign earned income if excludable from gross income; and
- members of a religious order performing services for the order or associated institution (Code Sec. 3401(a)).[31]

Fringe benefits are generally included in supplemental wages. However, certain qualified employee fringe benefits—such as no-additional-cost services, qualified employee discounts, working condition fringe benefits, *de minimis* fringe benefits, qualified transportation fringe benefits, qualified moving expense reimbursements (generally before 2018 and after 2025 (¶ 2092)), qualified retirement planning services, qualified military base realignment and closure fringe benefits, and certain employer-provided cell phones—are not subject to income tax withholding if it is reasonable to believe the recipient will be able to exclude them from gross income (¶ 2085) (Code Sec. 3401(a)(19); IRS Pub. 15-B).[32] Accident and health insurance premiums paid by a partnership on behalf of a partner, and premiums paid by an S corporation on behalf of a two-percent shareholder-employee, are not excludable from gross income (Rev. Rul. 91-26). Thus, they are wages subject to income tax withholding, but not for FICA and FUTA purposes (Code Secs. 3121(a)(2)(B) and 3306(b)(2)(B)).

An employer's cost of group-term life insurance, including any amount in excess of $50,000 coverage that is taxable to the employee as compensation (¶ 2055), is exempt from income tax withholding (Code Sec. 3401(a)(14); Reg. § 31.3401(a)(14)-1).[33] However, the employer must report the cost of the insurance coverage includible in the employee's gross income on Form W-2 (Reg. § 1.6052-1).[34] An employer's reimbursement of an employee's moving expenses is exempt from income tax withholding if it is reasonable to believe a moving expense deduction will be allowable to the employee (generally before 2018 and after 2025) (¶ 1073) (Code Sec. 3401(a)(15)).[35] Certain moving expense reimbursements that an employee receives in 2018 for a move occurring in 2017 may be exempt (Notice 2018-75). In addition, the value of any meals or lodging excludable by the employee from gross income (¶ 2089) is exempt from income tax withholding (Reg. § 31.3401(a)-1(b)(9)).[36] See ¶ 2607 and ¶ 2608 for information concerning amounts paid to employees as advances or reimbursements for traveling, meals, etc.

Benefits provided by an employer to an employee in the form of certain educational assistance (¶ 2067), dependent care assistance (¶ 2065), fellowship or scholarship grants (¶ 865), National Health Service Corps loan repayments, employee achievement awards (¶ 2069), or qualified military benefits for dependent care assistance and for certain travel (¶ 896) are not subject to income tax withholding if it is reasonable to believe that the employee is entitled to exclude the payment from income (Code Sec. 3401(a)(18) and (19)).[37] Benefits provided by the employer in the form of medical care reimbursement made to, or for the benefit of, an employee under a self-insured medical reimbursement plan are excluded from wages for withholding purposes (¶ 2015) (Code Sec. 3401(a)(20)).[38] Benefits paid under workers' compensation laws (other than nonoccupational disability benefits) are not taxable compensation for services performed and

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[31] ¶ 33,502; § 22,110.05
[32] ¶ 33,502; § 22,110.10
[33] ¶ 33,502, ¶ 33,527; § 22,110.10
[34] ¶ 36,441; § 21,005.45
[35] ¶ 33,502; § 22,110.10
[36] ¶ 33,503; § 22,110.10
[37] ¶ 33,502; § 22,110.10
[38] ¶ 33,502; § 22,110.10

are not subject to withholding for income, FICA, or FUTA tax purposes (Code Secs. 104, 3121(a)(2)(A), and 3306(b)(2)(A)).[39]

An employee's elective contributions to a traditional Code Sec. 401(k) retirement plan, simplified employee pension (SEP), Code Sec. 403(b) annuity plan, or SIMPLE retirement account are not included in wages for income tax withholding purposes, but they are wages for FICA and FUTA tax purposes (Code Secs. 3401(a)(12), 3121(a)(5), and 3306(b)(5)).[40]

Death benefit payments to beneficiaries or to the estates of deceased employees, and payments to such persons of compensation due but unpaid at the time of the decedent's death, are not subject to withholding.[41]

Effective for stock acquired under an option exercised after October 22, 2004, withholding is not required on a disqualifying disposition of stock acquired through exercise of an incentive stock option (¶ 1925) or through an employee stock purchase plan (ESPP) (¶ 1929) (Code Sec. 421(b)).[42] Further, no withholding is required if compensation is recognized in connection with an ESPP discount (Code Sec. 423(c)).[43]

Voluntary Withholding. If remuneration is taxable to the employee but exempt from withholding, the employee may voluntarily request that the employer increase the amount withheld from the employee's other compensation. In many cases, the employee and employer may enter into a mutual agreement for the employer to withhold from remuneration that would be otherwise exempt from withholding (¶ 2629).

Computation of Withholding on Wages

2612. Calculation of Income Tax Withholding. To calculate an employee's income tax withholding (¶ 2601), an employer should follow a few basic steps:

- determine the payroll period, such as weekly, biweekly, or monthly (¶ 2621);
- calculate the employee's wages for the applicable payroll period (¶ 2604);
- determine the number of withholding allowances from the employee's filled-out Form W-4 (¶ 2634); and
- choose the withholding method (¶ 2614).

Other factors to consider include whether the employee is a recent hire or only works part-time, whether the employee has more than one employer, and whether the employee receives any supplemental wage payments (¶ 2606).

2614. Methods of Income Tax Withholding. An employer will generally elect to use one of the two primary methods of computing income tax to be withheld from wages: the percentage method (¶ 2616) or the wage bracket method (¶ 2619) (Code Sec. 3402; Reg. § 31.3402(a)-1).[44] See ¶ 2627 for other permissible withholding methods. Regardless of which method is used, the amount of withholding depends upon the amount of wages paid (¶ 2604), the number of allowances claimed by the employee on his or her Form W-4 (¶ 2632 and ¶ 2634), the employee's marital status, and the employee's payroll period (¶ 2621) (IRS Pub. 15).

2616. Percentage Method of Income Tax Withholding. If the employer selects the percentage method of withholding (¶ 2614), the employer must:

(1) multiply the amount of one withholding allowance for the payroll period by the number of allowances claimed on the employee's Form W-4 (¶ 2634);

(2) subtract the amount determined in (1) from the employee's wages; and

(3) apply the appropriate percentage rate table to the resulting figure to determine the amount of withholding (Code Sec. 3402(b)).[45]

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[39] ¶ 6660; § 3,705.05
[40] ¶ 33,502; § 22,110.20
[41] ¶ 33,506.1856; § 22,110.45
[42] ¶ 19,602; § 22,110.15
[43] ¶ 19,900; § 22,110.15
[44] ¶ 33,542, ¶ 33,543; § 22,120.05
[45] ¶ 33,542; § 22,120.10

For tax years beginning after December 31, 2017, withholding is determined based on the amount by which the wages exceed the taxpayer's withholding allowance, prorated to the payroll period (¶ 2621) (Code Sec. 3402(a)(2)). For tax years beginning in 2018 through 2025, the personal exemption amount is zero (¶ 133). For 2018, however, the IRS can administer the wage withholding rules without regard to the amendments made to these rules (Act Sec. 11041(f)(2) of the Tax Cuts and Jobs Act (P.L. 115-97)). The IRS has determined that one withholding allowance amount on an annual basis is $4,150 for 2018. For example, if the payroll period is monthly, the withholding allowance is $345.80 ($4,150/12) (IRS Pub. 15). For tax years beginning before January 1, 2018, one withholding exemption was equal to one personal exemption for the year, prorated to the payroll period.

Percentage method withholding tables are provided for determining the amount of tax to be withheld, and each payroll period has a separate table for single individuals (including heads of household) and married individuals. The IRS also provides alternative formula tables for percentage method withholding that are designed for use under different payroll systems. See IRS Pub. 15.

2619. Wage Bracket Method of Income Tax Withholding. The wage bracket method of withholding (¶ 2614) is based on the employee's marital status, pay period, and claimed withholding allowances. Unlike the percentage method (¶ 2616), the wage bracket method generally does not require the employer to make separate computations. Instead, the actual withholding amounts are pre-calculated in wage bracket tables covering daily, weekly, biweekly, semimonthly, and monthly payroll periods (Code Sec. 3402(c)).[46] Separate tables for each period are provided for single individuals (including heads of household) and married individuals. The proper columns for the employer to use are determined by the total number of allowances claimed on the employee's withholding allowance certificate (¶ 2634). The wage bracket method tables produce results similar to those of the percentage method tables, and are designed to accommodate different payroll systems. If the wage bracket tables cannot be used because wages are more than the amount shown in the last bracket of the table, the employer should use the percentage method tables. See IRS Pub. 15.

2621. Payroll Period. For calculating income tax withholding (¶ 2612), the employee's payroll period, or the period of service for which a payment of wages is ordinarily made to an employee, determines the withholding allowance that the employer uses under the percentage method (¶ 2616) or the correct table that the employer uses under the wage bracket method (¶ 2619). Daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, and annual payroll periods have separate tables for the percentage computation. Any other payroll period is a miscellaneous payroll period. Wages may also be paid for periods that are not payroll periods (¶ 2624).

2624. Calculation of Income Tax Withholding Allowance. If an employee has an established payroll period (¶ 2621), the amount of the withholding allowance for the percentage method (¶ 2616) is determined by the payroll period, without regard to the time the employee is actually engaged in performing services during such period. If the payment is for a period that is not a payroll period, such as when wages are paid upon completion of a particular project, the withholding allowance under the percentage method or the amount withheld under the wage bracket method (¶ 2619) is computed based on a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to those in the period covered by the payment (Code Sec. 3402(b); Reg. §31.3402(c)-1(c)).[47] If the wages are paid without regard to any period, the tax to be withheld is the same as for a miscellaneous payroll period containing the number of days equal to the days (including Sundays and holidays) that have elapsed

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[46] ¶ 33,542; § 22,120.15

[47] ¶ 33,542, ¶ 33,547; § 22,115.05

since the later of: (1) the date of the last payment of wages by the employer during the calendar year, (2) the date employment began with the employer during such year, or (3) January 1 of such year.

2627. Alternative Methods of Income Tax Withholding. An employer may withhold income taxes based on average wages (using estimated quarterly wages paid to an employee), annualized wages, cumulative wages, or any method which produces substantially the same withholding amount as the percentage method or the wage bracket method (¶ 2614) (Code Sec. 3402(h)).[48] See IRS Pub. 15-A.

2629. Voluntary Income Tax Withholding. An employee may request on Form W-4 that the employer withhold additional amounts of income from the employee's wages. An employer must comply with the request, but only to the extent the additional withholding amount does not reduce the employee's net pay (after other deductions required by law) below zero (Code Sec. 3402(i); Reg. §§31.3402(i)-1 and 31.3402(i)-2).[49]

An employee and employer may also enter into an agreement for the employer to withhold from certain types of income that are not subject to mandatory withholding (¶ 2609). For example, magazine vendors, domestic workers, etc., may enter into an agreement with their employer to have income tax withheld. To effectuate this agreement, the employee must submit Form W-4 to the employer, and the employer must begin withholding (Code Sec. 3402(p); Reg. §31.3402(p)-1).[50] Taxpayers may use Form W-4V to request voluntary withholding from certain federal payments, including Social Security benefits, crop disaster payments, Commodity Credit Corporation loans, and unemployment compensation.

2632. Claiming Withholding Allowances. An employee must furnish his or her employer with a Form W-4 (¶ 2634) showing the number of withholding allowances to which the employee is entitled (Code Sec. 3402(f); Reg. §31.3402(f)(1)-1).[51] For tax years beginning after December 31, 2017, an employee can claim a withholding allowance that is based on the following:

(1) if the employee is a dependent of another taxpayer (¶ 137);

(2) if the employee is married, whether the employee's spouse is entitled to an allowance under (1) above or (4) below (or would be if the spouse were an employee), but only if the spouse does not have a withholding allowance certificate in effect claiming the allowance;

(3) the number of individuals for whom the employee may reasonably be expected to be allowed a child tax credit for the tax year (¶ 1405);

(4) any additional amounts the employee elects to claim under Code Sec. 3402(m), but only if his or her spouse does not have a withholding allowance certificate in effect making the election;

(5) the standard deduction allowable to the employee (one-half of the standard deduction if the employee is married and his or her spouse is an employee receiving wages subject to withholding) (¶ 131); and

(6) if the employee has withholding allowance certificates in effect with more than one employer (Code Sec. 3402(f)(1)).

For the 2018 tax year, the IRS could administer Code Sec. 3402 without regard to amendments made to the personal and dependency exemption rules (¶ 133), or to the wage withholding rules (¶ 2616) (Act Sec. 11041(f)(2) of the Tax Cuts and Jobs Act (P.L. 115-97)).

For tax years beginning before 2018, every employee was entitled to a withholding exemption for himself or herself, as well as one for each dependent (¶ 137). A married employee could claim a withholding exemption for his or her spouse if the latter did not claim one. An employee who could be claimed as a dependent on another individual's

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[48] ¶ 33,542; § 22,120.45

[49] ¶ 33,542, ¶ 33,571, ¶ 33,572; § 22,125.05

[50] ¶ 33,542, ¶ 33,586; § 22,125.25

[51] ¶ 33,542, ¶ 33,553; § 22,115.10, § 22,115.15

tax return, such as a parent's return, could not claim an exemption for himself or herself. No exemption was allowed for unborn children, even if the birth was expected to occur within the same tax year. Employees with more than one job could not claim an exemption that was currently in effect with another employer. An employee could claim a standard deduction allowance equal to one withholding exemption if the employee: (1) did not have a spouse who was receiving wages subject to withholding; and (2) did not have withholding certificates in effect with more than one employer. These restrictions did not apply if the wages earned by the spouse or by the employee from another employer were $1,500 or less, combined.

Additional Allowances. An employee can claim an additional withholding allowance or additional reductions in withholding based on age or blindness, estimated itemized deductions, the estimated deduction for qualified business income (QBI) after 2017, alimony payments (generally for divorce or separation instruments executed before January 1, 2019), moving expenses (generally before 2018 and after 2025), employee business expenses, retirement contributions, net losses from Schedule C, Schedule D, Schedule E, and Schedule F of Form 1040, or tax credits (Code Sec. 3402(m); Reg. §31.3402(m)-1).[52]

2634. Employee's Withholding Allowance Certificate (Form W-4). Before an employee is allowed any withholding allowances (¶2632), he or she must furnish the employer with a withholding allowance certificate on Form W-4, showing the number of allowances to which the employee is entitled (Code Sec. 3402(f)(2); Reg. §31.3402(f)(2)-1).[53] Otherwise, withholding must be computed as if the employee were single and claiming no withholding allowances. A widow or widower may claim married status for withholding purposes if he or she qualifies as a surviving spouse (¶175) (Code Sec. 3402(l)(3)).

An employee who certifies to the employer that he or she had no income tax liability for the preceding tax year and anticipates none for the current tax year may be exempt from wage withholding (Code Sec. 3402(n); Reg. §31.3402(n)-1).[54] An employee claiming exemption from withholding for a tax year must give the employer a new Form W-4 by February 15 each year to continue the exemption. A special rule allowed Forms W-4 claiming exemption for 2017 to be furnished by February 28, 2018 (Reg. §31.3402(f)(4)-2(c); Notice 2018-14).[55]

A $500 civil penalty may be assessed against any individual who decreases his or her withholding by claiming allowances on Form W-4 without a reasonable basis (Code Sec. 6682).[56] In addition, a criminal penalty may be imposed against any individual who willfully supplies false or fraudulent withholding information, or willfully fails to supply information that would increase the amount withheld (Code Sec. 7205).[57]

Most Forms W-4 are retained by the employer and only need to be submitted to the IRS if directed to do so. The IRS may issue a notice to the employer that specifies the maximum number of withholding allowances a particular employee may claim. The employer is generally bound by this determination until otherwise advised by the IRS (Reg. §31.3402(f)(2)-1(g)).[58]

2637. Changes to Withholding Allowances. An employee furnishes his or her employer with a new withholding allowance certificate (¶2634) to alter the number of withholding allowances claimed (¶2632). An employee may provide a new Form W-4 at any time that he or she becomes eligible for an additional allowance. However, an employee must furnish a new certificate within 10 days if an event occurs that decreases the number of allowances that the employee is entitled to claim (Code Sec. 3402(f)(2)(B); Reg. §31.3402(f)(2)-1(b)).[59] Events that may reduce the number of allowances include:

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[52] ¶33,542, ¶33,579; §22,115.15
[53] ¶33,542, ¶33,554; §22,115.25
[54] ¶33,542, ¶33,580; §22,115.20
[55] ¶33,557; §22,115.20
[56] ¶39,845; §22,115.25
[57] ¶41,325; §22,115.25
[58] ¶33,554; §22,115.25
[59] ¶33,542, ¶33,554; §22,115.25

- the employee divorces or legally separates from his or her spouse for whom the employee has been claiming an allowance, or the employee's spouse claims his or her own allowance on a separate Form W-4;
- the support of a claimed dependent is taken over by someone else, and the employee no longer expects to claim that individual as a dependent;
- the employee discovers that a dependent (other than a qualifying child) for whom an allowance was claimed will receive sufficient income of his or her own for the calendar year to disqualify that individual as a dependent (¶137); or
- other circumstances have changed so that the employee is no longer entitled to claim an allowance based on one of the deduction or credit items.

Under temporary relief, employees experiencing a change in status that reduced their withholding allowances did not have to furnish a new withholding allowance certificate until 30 days after the IRS released the 2018 Form W-4 (i.e., by Friday, March 30, 2018). Further, employees whose allowances were reduced due solely to the changes made by the Tax Cuts and Jobs Act (P.L. 115-97) did not have to furnish new certificates to their employers during 2018 (Notice 2018-14).[60]

An employee who claimed "no liability" must furnish a new Form W-4 within 10 days from the time the employee anticipates that he or she will incur liability for the year, or before December 1 if the employee anticipates liability for the next year (Reg. §31.3402(f)(2)-1(c)).

The death of a spouse or dependent does not affect the withholding allowance for that year unless the employee's tax year is not a calendar year and the death occurs in that part of the calendar year preceding the employee's tax year (Reg. §31.3402(f)(2)-1(b)(1)(ii)).[61]

A Form W-4 furnished to the employer that replaces an existing certificate can be effective for the first payment after the form is received if so elected by the employer. The replacement certificate must be effective for the first payroll period that ends on or after the 30th day after the day on which the new Form W-4 is furnished (Code Sec. 3402(f)(3)(B)).[62]

Withholding on Non-Wage Payments

2642. Withholding on Certain Gambling Winnings. Income tax withholding is required at a flat rate of 24 percent for tax years beginning after 2017 and before 2026 (25 percent for tax years beginning before 2018) for winnings of more than $5,000 from sweepstakes, wagering pools, and lotteries, and other types of gambling (including pari-mutuel pools on horse races, dog races, and jai alai) if the winnings are at least 300 times the wager. No withholding is required on winnings from bingo, keno, or slot machines (Code Secs. 1(j)(2)(F) and 3402(q)).[63]

The payor must report gambling winnings to the taxpayer and the IRS on Form W-2G if the winnings are subject to withholding or if the winner receives: $1,200 or more from a bingo game or slot machine; $1,500 or more from keno; more than $5,000 from a poker tournament; or for other gambling winnings of $600 or more and at least 300 times the amount of the wager (Reg. §1.6041-10).[64] If reporting is required, backup withholding must occur if the winner does not furnish his or her taxpayer identification number (TIN) to the payor (¶2645). All withheld income reported on Form W-2G must also be reported on Form 945.

2643. Withholding on Pensions, Annuities, and Certain Deferred Income. For taxable payments from an employer-sponsored pension, annuity, profit-sharing, stock bonus, or other deferred compensation plan, income tax withholding is required unless the recipient elects not to have tax withheld (Code Sec. 3405).[65] The same rule applies to an IRA or an annuity, endowment, or life insurance contract issued by a life insurance company. The recipient's election not to have withholding apply remains in effect until

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[60] ¶33,560.25; §22,115.25
[61] ¶33,554; §22,115.10
[62] ¶33,542; §22,115.25
[63] ¶33,542; §39,435
[64] ¶35,835; §39,435
[65] ¶33,620; §22,140

revoked. The payor must notify the recipient of his or her right to make or revoke such election. The election is generally not available for payments delivered outside the United States or a U.S. possession, unless the recipient certifies to the payor that he or she is not a U.S. citizen, a U.S. resident alien, or a tax-avoidance expatriate.

The amount withheld depends on whether the distributions are periodic payments or nonperiodic payments. For periodic payments (annuity and similar periodic payments), withholding is made as though the payment were a payment of wages for the appropriate payroll period. For tax years beginning after December 31, 2017, if a withholding certificate (Form W-4P) is not in effect for a periodic payment, the amount withheld is to be calculated under IRS rules (Code Sec. 3405(a)(4)). For the 2018 tax year, the payee is treated as a married individual claiming three withholding allowances if no withholding certificate is furnished (Notice 2018-14).[66] For tax years beginning before January 1, 2018, a payee who did not have a withholding certificate in effect was treated as a married individual claiming three exemptions. The payee is treated as single with no withholding allowances if the payee fails to provide his or her social security number to a payor, or if the IRS notifies the payor that the payee's social security number is incorrect (Instructions for Form W-4P; IRS Pub. 505).

The withholding rate on nonperiodic distributions is 10 percent. The withholding rate on distributions that were eligible for rollover but not directly transferred from the distributing plan to an eligible transferee plan is 20 percent. Withholding is mandatory, and distributees cannot elect to forego withholding on rollover eligible distributions.

IRA Payment to Unclaimed Property Fund. A trustee's payment of an individual's interest in a traditional IRA to a state unclaimed property fund, as required by state law, is a designated distribution subject to federal income tax withholding and IRA reporting requirements (Rev. Rul. 2018-17).[67]

2645. Backup Withholding. The backup withholding system requires a payor to deduct and withhold income tax at a flat rate of 24 percent for tax years beginning after 2017 and before 2026 (28 percent for tax years beginning before 2018) from reportable payments, such as interest or dividends, if:

- the payee fails to furnish a correct taxpayer identification number (TIN) to the payor in the manner required;
- the IRS notifies the payor that the TIN furnished by the payee is incorrect;
- the IRS notifies the payor that the payee has underreported reportable payments; or
- the payee is required, but fails, to certify that he or she is not subject to withholding (Code Sec. 3406).[68]

Backup withholding is reported on Form 945.

FICA and FUTA Taxes

2648. FICA Tax. Under the Federal Insurance Contributions Act (FICA), an employer must withhold an employee's share of Social Security and Medicare taxes from FICA wages paid to the employee during the year, and pay a matching amount as the employer's share of these taxes (Code Secs. 3101, 3111, and 3121(a)).[69] Even if an employee claims exemption from income tax withholding, the employer must withhold FICA taxes. The employer must report FICA taxes withheld (¶ 2650) and deposit the amounts paid and withheld (¶ 2651).

References are to Standard Federal Tax Reports and Practical Tax Explanations.

[66] ¶ 33,622.20; § 22,140
[67] ¶ 33,622.20
[68] ¶ 33,640; § 39,401
[69] ¶ 114; § 22,201

FICA Tax Rate and Base. The employee and employer are each subject to a 7.65-percent FICA tax on wages paid, consisting of a 6.2-percent tax for old-age, survivors, and disability insurance (OASDI) (i.e., Social Security) and a 1.45-percent tax for hospital insurance (HI) (i.e., Medicare). The Social Security tax applies only to wages paid up to the Social Security wage base limit for the year ($128,400 in 2018; $132,900 in 2019). The wage base applies separately to each common-law employer, with exceptions for successor employers and common paymasters, as well as certain motion picture project employers (Code Sec. 3512). There is no limit on wages subject to the Medicare tax.

0.9% Additional Medicare Tax. The employee's portion of the Medicare component of FICA taxes is increased by an additional 0.9 percent (to 2.35 percent) for wages in excess of $200,000 ($250,000 if married filing jointly, $125,000 if married filing separately). For a joint return, the additional tax is imposed on the couple's combined wages (Code Sec. 3101(b)(2); Reg. § 31.3102-4).

Although the employer is generally required to withhold the employee's portion from the employee's wages, the employer is not obligated to withhold the Additional Medicare Tax unless (and until) the employee receives wages from the employer in excess of $200,000. For this purpose, the employer is permitted to disregard the amount of wages received by the employee's spouse. Thus, because an employee may receive wages from more than one employer, or because the employee's spouse may receive wages, an employee may be subject to the Additional Medicare Tax without the tax being withheld from the employee's wages. The employee is responsible for any portion of the additional 0.9-percent tax that is not withheld.

If an employer fails to withhold the Additional Medicare Tax and the employee pays it, the employer is not obligated to pay the tax but may be subject to penalties and additions to tax for failing to withhold (Code Sec. 3102(f)). If the tax is overwithheld, the employee may claim a credit against income tax. The employee takes any underwithheld or overwithheld amount into account in calculating the tax on Form 8959.

Multiple Employers. If an individual works for more than one employer, each employer must withhold and pay FICA taxes on the wages paid. In such instances, the employee's FICA tax withheld for the year might exceed the maximum employee portion of the tax for the year. If this happens, the employee must take the excess as a credit against income tax liability. If the employee is not required to file an income tax return, then he or she may file a special refund claim (¶ 1421) (Reg. § § 1.31-2 and 31.6413(c)-1). The same rule applies to taxes withheld under the Railroad Retirement Tax Act.

If an individual is concurrently employed by two or more related corporations and all remuneration is disbursed to the individual through a common paymaster for the group, the common paymaster is responsible for the reporting and payment of FICA and FUTA taxes. However, the other related corporations remain jointly and severally liable for their appropriate share of the taxes (Reg. § 31.3121(s)-1).

FICA Wages. Wages for FICA tax purposes generally has the same meaning as for income tax withholding, and includes all remuneration for services performed by an employee for the employer with certain exceptions (¶ 2604). For employees performing domestic services in a private home of the employer or performing agricultural labor, if the employer pays the employee's liability for FICA taxes or state unemployment taxes without deduction from the employee's wages, those payments are not wages for FICA purposes (Code Sec. 3121(a)(6)). Other special rules apply to domestic workers (¶ 2652).

2649. FUTA Tax. The Federal Unemployment Tax Act (FUTA) imposes a tax on employers: (1) who employed one or more individuals in covered employment (10 or more individuals for agricultural labor) for at least part of one day in any 20 or more different weeks during the current or preceding calendar year; or (2) who paid wages (in covered employment) of at least $1,500 ($20,000 for agricultural labor, $1,000 for household employees) in any calendar quarter in the current or preceding calendar year. The FUTA tax on wages is 6 percent, but the employer is allowed a partial credit