

Filing 2010 Returns

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¶ 1 Tax Legislation

2010 Tax Legislation. *Small business incentives.* The Small Business Jobs Act of 2010, (P.L. 111-240), signed by President Obama on September 27, 2010, is designed to increase lending to small businesses and create incentives for small business investment.

Some of the provisions in the small business bill are highlighted below:

(1) The Code Sec. 179 dollar limitation is \$500,000 and the investment limitation is \$2,000,000 for tax years beginning in 2010 and 2011 (see ¶ 1208).

(2) The Code Sec. 168(k) 50-percent bonus depreciation allowance is extended an additional year to apply to qualifying property acquired by a taxpayer after December 31, 2007, and placed in service before January 1, 2011 (see ¶ 1237).

(3) For tax years beginning in 2010, the amount of trade or business start-up expenses that may be deducted by a taxpayer is \$10,000, and the threshold amount for reducing the limit is \$60,000 (see ¶ 904).

(4) Self-employed individuals may deduct the cost of health insurance incurred in 2010 for themselves and their family members in the calculation of their 2010 self-employment tax (see ¶ 908).

(5) The percentage of gain that a noncorporate taxpayer may exclude on the sale or exchange of qualified small business stock held for more than five years is increased to 100 percent for stock acquired after September 27, 2010, and before January 1, 2011 (see ¶ 1736).

Health care reform. On March 30, 2010, President Obama signed the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152). The legislation modifies a number of provisions in the Patient Protection and Affordable Care Act (P.L. 111-148), enacted on March 23, 2010, and includes additional provisions as well. The modifications to the tax provisions of the Patient Protection Act include increasing the limits on the excise tax on certain health plans, an expansion of the increase in the Medicare tax for higher income individuals to apply to investment income, changes to the penalty for failing to carry health insurance, codification of the economic substance doctrine and adjustments to corporate estimated tax payments.

The following highlights some of the provisions in the health care reform legislation:

(1) After December 31, 2013, certain large employers that fail to offer health care coverage to their full-time employees may be assessed a shared responsibility payment (see ¶ 853).

(2) After March 30, 2010, children under the age of 27 will be considered dependents for purposes of the general exclusion for reimbursements for medical care expenses of an employee, spouse, and dependents under an employer-provided accident or health plan (see ¶ 853).

(3) After March 30, 2010, children under the age of 27 will be considered dependents for purposes of the deduction for the health insurance costs of a self-employed person, spouse, and dependents (see ¶ 908).

(4) For tax years beginning after December 31, 2012, the threshold for the itemized deduction for unreimbursed medical expenses is increased to 10 percent of adjusted gross income (AGI) (see ¶ 1684).

(5) After December 31, 2010, certain small employers are allowed to provide a simple cafeteria plan for their employees under which the nondiscrimination rules for regular cafeteria plans would be treated as satisfied (see ¶ 861A).

Jobs bill. The Hiring Incentives to Restore Employment Act (P.L. 111-147) was signed by President Obama on March 18, 2010. The legislation features a payroll tax forgiveness provision for newly-hired workers, a \$1,000 credit for employee retention, and an extension of the Code Sec. 179 expensing allowance. The bill contains revenue offsets that include a package of foreign account compliance provisions, a further delay in worldwide interest allocations, and an acceleration of estimated tax payments for large corporations.

The following provisions are included in the Jobs bill:

(1) For wages paid after March 18, 2010, qualified employers are exempt from paying their share of OASDI taxes for newly-hired employees who were formerly unemployed (see ¶ 923).

(2) Qualified employers may claim a credit up to \$1,000 for retaining newly-hired employees for at least one year (see ¶ 1365FF).

Haiti charitable contributions. On January 22, 2010, President Obama signed Legislation to Accelerate the Income Tax Benefits for Charitable Cash Contributions for the Relief of Victims of the Earthquake in Haiti (P.L. 111-126) which allows individuals to claim a deduction on their 2009 returns for qualified cash contributions made after January 11 and before March 1, 2010. The contributions would have to be made to U.S. charities actively involved in Haiti earthquake relief efforts (see ¶ 1070A).

Planning for Change. In 2001, a decade of tax cuts began with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16), which reflected Congressional compromises on tax rate reduction, estate tax repeal, marriage penalty relief, education incentives, child tax credit increase, pension reform, and alternative minimum tax relief. However, to meet budgetary constraints, provisions were phased in and out over 10 years, with an anticipated sunset in 2011 that would reinstate the Internal Revenue Code as it was prior to the enactment of this legislation.

Subsequent legislation, such as the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (P.L. 108-27) and Working Families Tax Relief Act of 2004 (P.L. 108-311), accelerated and expanded some of EGTRRA's changes.

In the months before the sunset is scheduled to occur, it is unclear whether Congress will extend some of the 2001 and 2003 tax breaks, along with other tax incentive provisions, or let them expire. Tax practitioners will need to remain aware of the impact of these changes when discussing tax planning with their clients. The reduced tax rates that are set to expire after 2010 may effect a client's withholding (¶ 2601) and estimated taxes (¶ 2682). Some investment decisions may need to be reconsidered in light of the expiration of the reduced rates on capital gains (¶ 1736) and dividends (¶ 733). Moreover, the alternative minimum tax (AMT) continues to play a role as the regular tax liability amounts decreased without a corresponding decrease in AMT rates. Although the impact of AMT was lessened by temporary increase in the AMT exemption amounts through 2009, absent further Congressional action, the AMT exemption amounts are scheduled to revert back to the amounts that applied in 2000 (¶ 1401 and ¶ 1405).

Expiring provisions in 2010. The following provisions will expire after 2010 absent further Congressional action:

(1) The temporary increases in the marginal tax rates for noncorporate taxpayers are scheduled to expire after 2010. Thus, the tax rates for individuals, estates and trusts will be 15, 18, 31, 36 and 39.6 percent, and the 10-percent tax rate for individuals will disappear (see ¶ 126).

(2) The increase in the 15-percent tax bracket for married taxpayers filing joint returns to twice the corresponding rate bracket for single taxpayers is scheduled to expire after 2010 (see ¶ 126).

(3) The increased standard deduction amounts for married taxpayers based on the amount allowed for single taxpayers are scheduled to expire after 2010. Thus, the basic standard deduction will be \$5,000 for joint filers, and \$2,500 for married taxpayers filing separately, both as adjusted annually for inflation (see ¶ 126).

(4) The limitation on the amount of allowable itemized deductions for higher income individuals is scheduled to be reinstated after 2010. Taxpayers with adjusted gross income in excess of the applicable thresholds will have to reduce the amount of itemized deductions they actually deduct (see ¶ 1014).

(5) The elimination of the phaseout of personal exemptions for higher-income taxpayers is scheduled to expire after 2010 (see ¶ 133).

(6) The child tax credit is scheduled to revert to \$500 for tax years beginning after 2010 (see ¶ 1305).

(7) An employee's annual exclusion of up to \$5,250 in employer-provided educational assistance is scheduled to expire after 2010 (see ¶ 871).

(8) After 2010, the earned income credit phaseouts will be based on modified adjusted gross income, earned income will no longer be limited to amounts included in gross income and the earned income credit will be reduced by the taxpayer's alternative minimum tax liability (see ¶ 1322).

(9) The above-the-line deduction for qualified tuition and related expenses expires after 2009 (see ¶ 126).

(10) The alternative minimum tax (AMT) exemption amount for individuals for tax years beginning after 2009 are \$45,000 for married individuals filing a joint return and surviving spouses; \$33,750 for unmarried individuals; and \$22,500 for married individuals filing separate returns (see ¶ 1405).

(11) The reductions in the maximum tax rates for noncorporate taxpayers' capital gains rates are scheduled to expire after 2010. The maximum rate will be 20 percent (10 percent for taxpayers in the 15-percent income tax bracket) (see ¶ 1736).

(12) Dividends received by noncorporate taxpayers are scheduled to be taxed as ordinary income, rather than as capital gains, after 2010 (see ¶ 733).

(13) The tax rate on corporate accumulated earnings is scheduled to revert to 39.6 percent after 2010 (see ¶ 251).

(14) The one-year repeal of the federal estate and generation-skipping transfer taxes is scheduled to expire. The federal estate and generation-skipping transfer taxes will again apply to the estates of decedents dying after 2010 (see ¶ 2901).

(15) The increases in the estate tax applicable exclusion amount and the generation-skipping transfer tax exemption amount are scheduled to expire. Thus, the estate tax applicable exclusion amount for decedent dying and the generation-skipping transfers made after 2010 will be \$1,000,000 (see ¶ 2943).

For information on further legislative developments after 2010, visit the *U.S. Master Tax Guide's* website at <http://tax.cchgroup.com/mig>.

¶ 2 What's New on 2010 Returns

The *Guide* reflects all of the important administrative and judicial developments or 2010 . . . final regulations, major court decisions, and important rulings of the Internal Revenue Service. Legislative highlights are at ¶ 1. Below are additional highlights of the changes in 2010 with the greatest impact on individuals and businesses.

Individuals

Income levels at which individuals must file income tax returns have increased for 2010	¶ 101
Basic standard deduction amounts have increased for 2010	¶ 126
The deduction for each personal exemption is \$3,650 for 2010	¶ 133
Inflation-adjusted income amounts that trigger the reduction of allowable itemized deductions and personal exemptions for high-income taxpayers are repealed for 2010	¶ 3, ¶ 133, ¶ 1014
"Kiddie" tax amount is \$1,900 for 2010	¶ 706
The standard mileage rate for all business use of a car is 50 cents per mile for 2010	¶ 947
Per diem rates under the high-low method of substantiating travel expenses are at \$233 for high-cost localities and \$160 for low-cost localities for travel on or after 10/01/10	¶ 954A
Student loan interest, up to \$2,500 in 2010, may be deducted "above-the-line" by qualifying taxpayers	¶ 1082
The transportation fringe benefit exclusion amount for employer-provided transit passes or vehicles and the exclusion amount for employer-provided parking is \$230 per month for 2010	¶ 863

Depreciation, Amortization and Depletion

The maximum Code Sec. 179 deduction for 2010 is \$500,000	¶ 1208
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Tax Credits

For 2010, the maximum earned income credit for eligible taxpayers with no qualifying children is \$457, with one qualifying child is \$3,050, with two qualifying children is \$5,036, and with three or more qualifying children is \$5,666	¶ 87, ¶ 1322
The child tax credit is \$1,000 for 2010	¶ 1305
The education tax credits (Hope and Lifetime Learning) are \$2,500 and \$2,000, respectively, for 2010	¶ 1303

Withholding

The 2010 OASDI wage base for FICA and self-employment tax purposes is \$106,800	¶ 47, ¶ 49, ¶ 2648, ¶ 2670
The 2010 wage threshold for "Nanny Tax" reporting is \$1,700	¶ 2650

¶ 3 AGI Phaseout Thresholds

Adjusted gross income (AGI) levels in excess of certain phaseout thresholds limit the following deductions, credits and other tax benefits. This chart provides the beginning point for the 2010 thresholds and the ending point of the phaseout (where applicable).

Tax Item	Taxpayers Affected	Phaseout—Begin	Phaseout—End	
Itemized Deductions (Overall Limit)	single, head of household, joint filers	repealed	N/A	
	married filing separate	repealed	N/A	
	7.5% Floor on Medical Deductions	those itemizing medical expenses	7.5% of AGI	N/A
2% Floor on Misc. Itemized Deductions	those itemizing misc. expenses	2% of AGI	N/A	
10% Floor on Casualty Loss	those itemizing casualty loss	10% of AGI	N/A	
Personal Exemption	single	repealed	N/A	
	head of household	repealed	N/A	
	joint filers	repealed	N/A	
	married filing separate	repealed	N/A	
Child Tax Credit*	single, head of household	\$75,000	phaseout varies by taxpayer	
	married filing separate	\$55,000	phaseout varies by taxpayer	
	joint filers	\$110,000	phaseout varies by taxpayer	
Dependent Care Credit*	joint filers, head of household, single	35% credit if AGI not over \$15,000	20% credit if AGI over \$43,000	
Elderly and Disabled Credit	single, head of household	\$7,500	\$17,500	
	joint filers	\$10,000	\$20,000 if one qualifying spouse; \$25,000 if two qualifying spouses	
	married filing separate	\$5,000	\$12,500	
Adoption Credit*	all filers	\$182,250	\$222,520	
Adoption Assistance Programs*	all filers	\$182,250	\$222,520	
Earned Income Credit*	single, head of household, no child	\$7,480	\$13,460	
	single, head of household, one child	\$16,450	\$35,535	
	single, head of household, two children	\$16,450	\$40,363	
	single, head of household, three or more children	\$16,450	\$43,352	
	joint filers, no child	\$12,490	\$18,470	
	joint filers, one child	\$21,460	\$40,545	
	joint filers, two children	\$21,460	\$45,373	
	joint filers, three or more children	\$21,460	\$48,362	
	Hope Credit*	single, head of household	\$50,000	\$60,000
		joint filers	\$100,000	\$160,000
Lifetime Learning Credit*	single, head of household	\$50,000	\$60,000	
	joint filers	\$100,000	\$160,000	

Tax Item	Taxpayers Affected	Phaseout—Begin	Phaseout—End
Student Loan Interest Deduction*	single, head of household	\$60,000	\$75,000
	joint filers	\$120,000	\$150,000
Savings Bonds Interest Exclusion	single, head of household	\$70,100	\$85,100
	joint filers	\$105,100	\$135,100
Coverdell Education Accounts (formerly Education IRAs)	single, head of household, married filing separate	\$95,000	\$110,000
	joint filers	\$190,000	\$220,000
IRA Deduction	single, head of household	\$56,000	\$66,000
	joint filers	\$89,000	\$109,000
	married filing separate	\$0	\$10,000
Roth IRA Eligibility	single, head of household	\$105,000	\$120,000
	joint filers	\$167,000	\$177,000
	married filing separate	\$0	\$10,000
First-time DC Homebuyer Credit*	single, head of household, married filing separate	\$70,000	\$90,000
	joint filers	\$110,000	\$130,000
Rental Real Estate Passive Losses	single, head of household, joint filers	\$100,000	\$150,000
	married filing separate	\$50,000	\$75,000
	all filers	AGI relative to area median income	N/A

* Modified AGI, as defined by the relevant Code Sections, is used instead of AGI.

¶ 4 Where to File Returns

Individuals. Listed below are the mailing addresses for filing your own individual income tax return. See ¶ 122. Tax professionals who are filing returns for their clients should use the second set of mailing addresses listed below. See also ¶ 2701 for a discussion of service centers.

Note: The IRS has reorganized its processing of tax returns. As a result of these efforts, many taxpayers *may* have different filing service centers than those used previously.

□ Per the IRS, if an addressed envelope came with your return, please use it. If you do not have one, or if you moved during the year, mail your return to the Internal Revenue Service Center for the place where you live. No street address is needed. The chart below indicates the address with the ZIP Code and extension for filing Form 1040. To facilitate processing for residents of the 50 states and the District of Columbia, each form (1040, 1040A, 1040EZ) uses a different ZIP+4 ZIP Code extension. Also, different extensions are used if you are making a payment or not. If you are filing Form 1040A and are not making a payment, use the address in the middle column but with the ZIP Code extension, -0015. If you are filing Form 1040A and are making a payment, use the address in the last column but with the ZIP Code extension, -0115. If you are filing Form 1040EZ and are not making a payment, use the address in the middle column but with the ZIP Code extension, -0014. If you are filing Form 1040EZ and are making a payment, use the address in the last column but with the ZIP Code extension, -0114. Be sure to check your particular form's instructions for the proper extension and address.

<i>If you are filing Form 1040 and are located in:</i>	<i>And are not enclosing a payment, mail your return to:</i>	<i>And are enclosing a payment, mail your return to:</i>
Florida, Georgia	Atlanta, GA 39901-0002	Atlanta, GA 39901-0102
Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia	Kansas City, MO 64999-0002	Kansas City, MO 64999-0102
Alabama, Kentucky, Louisiana, Mississippi, Tennessee, Texas	Austin, TX 73301-0002	Austin, TX 73301-0102
Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Utah, Washington, Wisconsin, Wyoming	Fresno, CA 93888-0002	Fresno, CA 93888-0102

portion of any ESBT that consists of stock in one or more S corporations is treated as a separate trust. See ¶ 305 and ¶ 516.

Qualified Domestic Trusts. A qualified domestic trust (QDOT) is a trust that meets certain requirements and is subject to a special estate tax (Code Sec. 2056A). Property that is transferred from a citizen decedent to a nonresident alien spouse will not qualify for the usual marital deduction, for purposes of estate and gift taxes, unless it is transferred from the decedent to a QDOT. See ¶ 2926 and ¶ 2940.

502. Business and Investment Trusts. A "business" or commercial trust is a trust created as a means of carrying on a profit-making business, usually using capital or property supplied by the beneficiaries. The trustees or other designated persons are, in effect, managers of the undertaking, whether appointed or controlled by the beneficiaries. This arrangement more closely resembles an association, which may be taxed as a corporation or a partnership and is distinguishable from the type of trust discussed at ¶ 501. The fact that the trust property is not supplied by beneficiaries is not sufficient in itself to avoid the trust being classified and taxed as a business entity (Reg. § 301.7701-4(b)).³

An "investment" trust may also be taxed as an association, rather than a trust, if there is a power under the trust agreement to vary the investment of the certificate holders (Reg. § 301.7701-4(c)).⁴ However, if this power is lacking, the arrangement is taxed as a trust. Unit investment trusts, as defined in the Investment Company Act of 1940, that are set up to hold mutual fund shares for investors are also not taxed as trusts. Instead, their income is taxed directly to the investors (Reg. § 1.851-7).⁵

503. Liquidating Trust. A liquidating trust formed for the primary purpose of liquidating and distributing the assets transferred to it is taxed as a trust, and not as an association, despite the possibility of profit. All activities of the trust must be reasonably necessary to, and consistent with, accomplishing the primary purpose of liquidation and distribution. If the liquidation is unreasonably prolonged, or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to have been lost or abandoned, the arrangement is no longer a liquidating trust (Reg. § 301.7701-4(d)).⁶

504. Return for Persons Under a Disability. Generally, a guardian is required to file a tax return as an agent for a minor or legally disabled person if the individual would otherwise be required to file a return. However, a minor can file a return for himself or herself or have someone else file it, relieving the guardian of this obligation (Code Sec. 6012(b)(2); Reg. § 1.6012-3(b)(3)).⁷ For the tax year during which an incompetent person is declared competent and the fiduciary is discharged, the former incompetent person must file the tax return. The estate of an incompetent person is not a separate taxable entity from the incompetent person. Thus, no fiduciary return on Form 1041, U.S. Income Tax Return for Estates and Trusts, is required (Reg. § 1.641(b)-2(b)).⁸ However, an agent filing a return for another person should file Form 2848, Power of Attorney and Declaration of Representative, with the taxpayer's return. Both the agent and the taxpayer for whom the return is made may be liable for penalties (Reg. § 1.6012-1(a)(5)).⁹ One spouse may execute a valid return on behalf of his or her mentally incompetent or disabled spouse prior to appointment of a legal guardian, even without formal power of attorney (Rev. Rul. 56-22).¹⁰

505. Trustees in Bankruptcy of Individual Debtors. Property held by a trustee in bankruptcy for an individual under Chapter 7 (liquidation) or Chapter 11 (business reorganization) of the Bankruptcy Code is considered the estate of the debtor. Such an estate is treated as a separate taxable entity (Code Sec. 1398).¹¹

A separate taxable entity is not created when the case is brought under Chapter 13 of the Bankruptcy Code, which involves adjustment of debts of an individual with regular income. Further, no separate taxable entity is considered to have been created if a

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

³ ¶ 43,090

⁴ ¶ 43,090

⁵ ¶ 26,407

⁶ ¶ 43,090

⁷ ¶ 35,142, ¶ 35,146

⁸ ¶ 24,265

⁹ ¶ 35,143

¹⁰ ¶ 35,150.734

¹¹ ¶ 32,410

Chapter 7 or Chapter 11 case is dismissed (Code Sec. 1398(b)(1)). A separate taxable entity also is not created when an individual is in receivership (Reg. § 1.641(b)-2(b)).¹²

The fiduciary of a Chapter 7 or Chapter 11 bankruptcy estate is obligated to file the estate's return. If the bankruptcy plan creates a liquidating trust, the fiduciary must file the trust's return (Code Sec. 6012(b)(4)).¹³ The bankruptcy trustee must file a Form 1041 for the bankruptcy estate for any tax year in which the estate in bankruptcy has gross income that equals or exceeds the sum of the personal exemption amount (¶ 133) plus the basic standard deduction for married persons filing separately (\$9,350 for 2010) (¶ 126) (Code Sec. 6012(a)(8)). The tax year for which the fiduciary files a return begins on the date of the filing of the petition in bankruptcy. The return may be for a calendar year or a fiscal year. A trustee in bankruptcy has no authority to file a return on Form 1040 for a bankrupt individual. The individual must file an individual return.

Comment: Absent further legislation, the basic standard deduction for married persons filing separately no longer equals the basic standard deduction for single individuals for tax years beginning after December 31, 2010.

506. Receiver, Trustee in Bankruptcy of Corporate Debtors. The commencement of bankruptcy proceedings for a partnership or corporation does not create a separate taxable entity (Code Sec. 1399).¹⁴ Thus, there is no obligation imposed upon the bankruptcy trustee to file a Form 1041 on behalf of the estate.

However, a receiver, trustee in dissolution, trustee in bankruptcy, or assignee who, by order of a court, has possession of or holds title to all or substantially all the property or business of a corporation must file the income tax return for such corporation on Form 1120, U.S. Corporation Income Tax Return. The receiver, trustee, or assignee must file the return whether or not it is operating the property or business of the corporation. A receiver in charge of only a *small part* of the property of a corporation, such as a receiver in mortgage foreclosure proceedings, need not file the return (Reg. § 1.6012-3(b)(4)).¹⁵ Bankrupt partnerships must file their returns on Form 1065, U.S. Return of Partnership Income.

507. Termination of Estates and Trusts. An estate is recognized as a taxable entity only during the period of administration or settlement (i.e., the period actually required by the executor or administrator to perform the ordinary duties of administration, such as collection of assets, payment of debts and legacies, etc.). This is true whether the period is longer or shorter than that specified under local law for the settlement of estates. However, the administration of an estate may not be unduly prolonged. For federal tax purposes, the estate will be considered terminated after the expiration of a reasonable period for the performance of the duties of administration, or when all the assets of the estate have been distributed except for a reasonable amount set aside in good faith for the payment of contingent liabilities and expenses. If the estate has joined in making a valid election to treat a qualified revocable trust as part of the estate (see ¶ 516), then it does not terminate prior to the termination of the election period (Reg. § 1.641(b)-3(a)).¹⁶

A trust is recognized as a taxable entity until trust property has been distributed to successors, plus a reasonable time after this event necessary for the trustee to complete the administration of the trust. Further, like an estate, a trust is considered terminated when all the assets have been distributed except for a reasonable amount set aside in good faith to pay contingent liabilities and expenses (other than a claim by a beneficiary in that capacity) (Reg. § 1.641(b)-3(b)).¹⁷

Once an estate or trust is considered terminated for tax purposes, its gross income, credits, and deductions subsequent to termination are considered to be the gross income, credits, or deductions of the persons who succeed to the property (Reg. § 1.641(b)-3(d)).¹⁸

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹² ¶ 24,265

¹³ ¶ 35,142

¹⁴ ¶ 32,420

¹⁵ ¶ 35,146

¹⁶ ¶ 24,266

¹⁷ ¶ 24,266

¹⁸ ¶ 24,266

Fiduciary Return

510. Return of Estate or Trust by Fiduciary. A fiduciary must file a return on Form 1041, U.S. Income Tax Return for Estates and Trusts, for an estate or trust if: (1) the estate has gross income of \$600 or more for the tax year; (2) the trust (other than a trust exempt under Code Sec. 501(a)) has for the tax year any taxable income, or gross income of \$600 or more regardless of the amount of taxable income; (3) any beneficiary of the estate or trust is a nonresident alien (unless the trust is exempt under Code Sec. 501(a)); or (4) an individual's bankruptcy estate under Chapter 7 or Chapter 11 of the Bankruptcy Code has gross income equal to or greater than the sum of the personal exemption amount plus the basic standard deduction amount for married individuals filing separately (see ¶ 505) (Code Sec. 6012(a); Reg. § 1.6012-3).¹⁹

When there is more than one fiduciary, the return can be filed by any one of them. However, when an estate has both domiciliary and ancillary representatives, each representative must file a return (Reg. § 1.6012-3(a)(1) and (3)).²⁰ A trustee of two or more trusts must file a separate return for each trust, even though the trusts were created by the same grantor for the same beneficiaries (Reg. § 1.6012-3(a)(4)).²¹ However, see ¶ 515 for when two or more trusts may be treated as one trust.

The return must be filed on or before the 15th day of the fourth month following the close of the tax year (Code Sec. 6072(a)).²² An estate or trust can apply for an automatic five-month extension of time for filing the fiduciary return by submitting Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns. The application must be filed on or before the due date for Form 1041 and must show the properly estimated income tax amount for the tax year. The automatic extension does not extend the time for payment of any tax due on the return. In addition, the extension to file does not extend the time for a beneficiary of the estate or trust to file its income tax return or to pay any tax on the beneficiary's return (Temporary Reg. § 1.6081-6T).²³ A trust will be granted an extension even if it cannot pay the full amount of tax due (Instructions to Form 7004).

The fiduciary of an estate or trust need not file a copy of the will or trust instrument with the estate or trust income tax return unless requested by the IRS. If requested, the fiduciary should file a copy (including any amendments), accompanied by a written declaration of truth and completeness and a statement indicating the provisions of the will or trust instrument that determine the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor (Reg. § 1.6012-3(a)(2)).²⁴

An estate or trust that is obligated to file an income tax return must furnish a copy of Schedule K-1 (Form 1041) to each beneficiary (1) who receives a distribution from the estate or trust for the year, or (2) to whom any item with respect to the tax year is allocated. This statement must contain the information required to be shown on the return and be furnished on or before the date on which the return is to be filed (Code Sec. 6034A).²⁵ In addition, a copy must be attached to Form 1041. For each failure to file a correct information return or payee statement, a \$50 penalty may be assessed (Code Secs. 6721 and 6722).²⁶

Comment: For estates of decedents dying in 2010, the executor of a decedent's estate must file an information return with the IRS, generally due with the decedent's last income tax return (see ¶ 180), for transfers involving (1) property acquired from a decedent with a fair market value over \$1.3 million; or (2) appreciated property acquired from a decedent that the decedent had acquired for less than adequate consideration within the three years ending on the date of death and for which a gift tax return was required to be filed. The executor must also provide property recipients with similar statements regarding the transferred property (Code Sec. 6018(b), (c) and (e); Code Sec. 6075(a)).²⁷ Absent further legislation, these reporting requirements will not apply to estates of decedents dying after December 31, 2010.

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹⁹ ¶ 35,142, ¶ 35,146
²⁰ ¶ 35,146
²¹ ¶ 35,146

²² ¶ 36,720
²³ ¶ 36,797
²⁴ ¶ 35,146

²⁵ ¶ 35,460
²⁶ ¶ 40,210, ¶ 40,230
²⁷ ¶ 35,222.01, ¶ 36,740.01,
¶ 34,940

Accounting Period. In filing its first return, an estate may choose the same accounting period as the decedent, or it may choose a calendar tax year or any fiscal tax year. If it chooses the decedent's accounting period, its first return will be for a short period to cover the unexpired term of the decedent's regular tax year (Code Secs. 441 and 443).²⁸ An exemption of \$600 is allowed on a short-period return, without proration (see ¶ 534) (Reg. § 1.443-1(a)(2)).²⁹ However, if the estate gets approval from the IRS to change the accounting period, the exemption on the short-period return may be prorated (Reg. § 1.443-1(b)(1)(v)).³⁰

Trusts (other than trusts exempt from tax under Code Sec. 501 and wholly charitable trusts under Code Sec. 4947(a)) must adopt a calendar tax year (Code Sec. 644).³¹ Thus, a trust must generally file Form 1041 on or before April 15 following the close of the tax year (April 18, 2011, for the 2010 calendar tax year, due to a legal holiday in the District of Columbia). An existing trust that is required to change its tax year must annualize any income earned in the short year. In addition, the trust must obtain IRS approval to change its annual accounting period to a calendar year (see ¶ 1513).

Payment of Tax and Estimated Tax. The entire income tax liability of an estate or trust must be paid on or before the due date for its return (Code Sec. 6151).³² In addition, estates that have been in existence for more than two years and both new and existing trusts must pay estimated tax in the same manner as individuals. See ¶ 518.

512. Personal Liability of Fiduciary. Any fiduciary (other than a trustee acting under Chapter 11 of the Bankruptcy Code) who pays any debt due by the decedent or the estate, in whole or in part, before federal tax obligations are satisfied becomes personally liable for the tax of the estate to the extent of such payments. However, the fiduciary is not liable for amounts paid out for debts that have priority over the federal taxes due and owing on the estate, such as a decedent's funeral expenses or probate administration costs (Reg. § 1.641(b)-2; 31 U.S.C. § 3713).³³ Further, an executor or administrator who pays other debts is not personally liable unless the executor or administrator has either personal knowledge of a tax due the United States or knowledge that would put a reasonably prudent person on notice that such tax debts exist.³⁴ Discharge of the fiduciary does not terminate the fiduciary's personal liability for the payment of other debts of the estate without satisfying prior tax claims.

Method of Taxing Estate or Trust

514. Estate or Trust as Separate Entity. An estate or trust is a separate taxable entity (see ¶ 501). In general, its entire income for its tax year must be reported on Form 1041, which must be filed by the fiduciary (see ¶ 510). If income is required to be distributed currently or is properly distributed to a beneficiary, the estate or trust is regarded as a conduit with respect to that income. It is allowed a deduction for the portion of gross income that is currently distributable to the beneficiaries or is properly paid or credited to them (see ¶ 545). Generally, the beneficiaries are taxed on the part of the income currently distributed, and the estate or trust is taxed on the portion that it has accumulated. The income allocated to a beneficiary retains the same character in the beneficiary's hands that it had in the hands of the estate or trust (Reg. §§ 1.652(b)-1 and 1.662(b)-1).³⁵

515. Multiple Trusts. One grantor may create several trusts, and the income may be taxed separately for each trust. When there is intent to create separate trusts for multiple beneficiaries, the fact that the corpus of each trust is kept in one fund will not necessarily defeat the grantor's intent. Although it is not necessary to divide the corpus physically in order to carry out the intent of the parties, it is necessary to comply literally with the terms of the trust instrument in other respects.³⁶

However, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of the trusts is the avoidance of income

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

²⁸ ¶ 20,302, ¶ 20,500
²⁹ ¶ 20,501
³⁰ ¶ 20,501

³¹ ¶ 24,350
³² ¶ 37,080
³³ ¶ 24,265, ¶ 40,730

³⁴ ¶ 40,735.25
³⁵ ¶ 24,383, ¶ 24,425
³⁶ ¶ 24,267.67

tax (Code Sec. 643(f)).³⁷ A special safe-harbor provision applies to any trust that was irrevocable on March 1, 1984, except to the extent that corpus is contributed to the trust after that date.

516. Tax Rates. An estate or trust computes its tax liability by using the separate estate and trust income tax rate schedule at ¶ 19. The taxable income of an estate or trust for purposes of the regular income tax is determined by subtracting from its gross income (¶ 520) allowable deductions (¶ 528), amounts distributable to beneficiaries (to the extent of distributable net income) (¶ 543), and the proper exemption (¶ 534) (Code Sec. 641; Reg. §§ 1.641(a)-1 and 1.641(b)-1).³⁸ See ¶ 64.

The alternative minimum tax (AMT) of an estate or trust is computed by determining distributable net income (DNI) under the general rules (see ¶ 543), subject to further adjustments under the minimum tax rules. The AMT is computed on Part III of Schedule I, Form 1041. See ¶ 1401.

Grantor and employees' trusts are subject to special tax treatment. See ¶ 571 and ¶ 2101.

Qualified Revocable Trusts. A trustee of a qualified revocable trust (QRT) and the executor, if any, of a decedent's estate may join in an election to treat the revocable trust as part of the estate (Code Sec. 645; Reg. § 1.645-1).³⁹ Such an election allows the revocable trust to enjoy certain income tax treatment that would otherwise be accorded only to the decedent's estate, such as claiming the unlimited deduction for amounts permanently set aside for charity without first actually paying the amount (¶ 537), waiving the active participation requirement under the passive loss rules for two years after the decedent's death (¶ 2063), and qualifying for amortization of reforestation expenditures (¶ 530). A QRT is any trust or portion of a trust that, on the date of death of the decedent, is treated as owned by the decedent as grantor by reason of a power to revoke the trust (¶ 582), but without regard to powers held by the decedent's spouse (¶ 578). The election is made on Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, which must be filed by the due date (including extensions) of the Form 1041 for the first tax year of the related estate or filing trust. The election period begins on the date of the decedent's death, and ends either (1) two years after the date of death, if no federal estate tax return is required, or (2) six months after the final determination of estate tax liability, if a federal estate tax return must be filed.

Electing Small Business Trust. An electing small business trust (ESBT) (see ¶ 501) is taxed in a different manner than other trusts (Code Sec. 641(c)).⁴⁰ First, the portion of the ESBT that consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. This portion of the trust's income is taxed at the highest rate imposed on estates and trusts, and includes:

- (1) the items of income, loss, deduction or credit allocated to the trust as an S corporation shareholder;
- (2) gain or loss from the sale of the S corporation stock;
- (3) any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock; and
- (4) any interest expense paid or accrued on debt incurred to acquire S corporation stock.

Capital losses are allowed in computing an ESBT's income only to the extent of capital gains. Moreover, no deduction is allowed for amounts distributed to beneficiaries, and, except as described above, no additional deductions or credits are allowed. Also, the ESBT's income is not included in the DNI of the trust and, therefore, is not included in the beneficiaries' income. Furthermore, no item relating to the S corporation stock is apportioned to any beneficiary. The trust's AMT exemption amount is zero. Special rules apply upon termination of all or a part of the ESBT. See ¶ 305.

Gifts from Expatriates. A domestic trust that receives property, directly or indirectly, by gift, devise, bequest or inheritance from a "covered expatriate" (¶ 2412) after the date

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

³⁷ ¶ 24,320

³⁹ ¶ 24,355, ¶ 24,356

³⁸ ¶ 24,260, ¶ 24,262, ¶ 24,264

⁴⁰ ¶ 24,260

of expatriation must pay a tax equal to the value of such "covered gift or bequest" multiplied by the greater of the highest federal estate tax rate or the highest federal gift tax rate in effect. Similarly, a covered gift or bequest made to a foreign trust is subject to the tax, but only at the time a distribution of income or principal is made to a U.S. citizen or resident from the trust and is attributable to the covered gift or bequest. A foreign trust can elect to be treated as a domestic trust for these purposes; the election can be revoked with IRS consent. See ¶ 2946 for more information.

517. Medicare Contribution Tax. Effective for tax years beginning after December 31, 2012, an estate or trust must pay a 3.8 percent unearned income Medicare contribution tax on the lesser of: (1) its undistributed net investment income for the tax year (see ¶ 129), or (2) any excess of its adjusted gross income determined under Code Sec. 67(e) (see ¶ 528) over the dollar amount at which the highest tax bracket for estates and trusts begins for the tax year (see ¶ 19) (Code Sec. 1411(a)(2), added by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152)).⁴¹ The tax does not apply to any trust whose unexpired interests are devoted to religious, charitable, scientific, literary, and/or educational purposes, to foster national or international amateur sports competition (provided no part of its activities involve the provision of athletic facilities or equipment), and/or to the prevention of cruelty to children or animals (Code Sec. 1411(e)(2), added by P.L. 111-152).

518. Estimated Tax. In general, estates and trusts are required to make quarterly estimated tax payments in the same manner as individuals (see ¶ 2682). However, estates and grantor trusts that receive the residue of a probate estate under the grantor's will are only required to make estimated tax payments for tax years that end two or more years after the decedent's death (Code Sec. 6654(l)).⁴²

Estates or trusts with a short tax year must pay installments of tax on or before the 15th day of the fourth, sixth and ninth months of the tax year and the 15th day of the first month of the following tax year (see ¶ 2685). The amount of each installment in a short tax year is determined by dividing the required annual payment by the number of payments required for that year (Notice 87-32).⁴³

Estates and trusts generally have 45 days (rather than the 15 days allowed individuals) to compute the payments under the estimated tax annualization rules. The payment due dates are unchanged (Code Sec. 6654(l)).⁴⁴ First-time filers must file Form 1041-ES, Estimated Income Tax for Estates and Trusts, which includes vouchers to be included with quarterly payments. After the first payment, the IRS should provide pre-printed vouchers. A fiduciary paying estimated tax for more than one trust should submit a separate Form 1041-ES and a separate check for each trust. However, a fiduciary may submit a single check for multiple trusts provided that a separate estimated tax voucher is submitted for each trust (Announcement 87-32).⁴⁵

The trustee of a trust, or the fiduciary of an estate whose tax year is reasonably expected to be its last tax year, may elect to treat any or all of an estimated tax payment as a payment made by the beneficiary and credited toward the beneficiary's tax liability. If elected, the payment is not treated as an estimated tax payment made by the estate or trust. The election is made on Form 1041-T, Allocation of Estimated Tax Payments to Beneficiaries, and must be filed on or before the 65th day after the close of the tax year (March 7, 2011, for calendar tax year 2010, because March 6, 2011 is a Sunday) (Code Sec. 643(g)).⁴⁶

519. Withholding on Distributions to Expatriates. If a "covered expatriate" (¶ 2412) is a beneficiary of a nongrantor trust on the day before the individual's expatriation date, and receives a direct or indirect distribution of any property from the trust, then the trustee must deduct and withhold 30 percent of the taxable portion of the distribution (Code Sec. 877A(f)).⁴⁷ Additionally, if the fair market value of the property distributed exceeds the adjusted basis in the hands of the trust, the trust must recognize gain as if the property were sold to the expatriate at its fair market value. These provisions apply to individuals whose expatriation date is on or after June 17, 2008.

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁴¹ ¶ 32,602

⁴⁴ ¶ 39,550

⁴⁷ ¶ 27,430

⁴² ¶ 39,550, ¶ 39,560.82

⁴⁵ ¶ 39,560.82

⁴³ ¶ 39,560.82

⁴⁶ ¶ 24,320

The taxable portion of the distribution is that portion which would be includible in the covered expatriate's gross income had the expatriate continued to be subject to tax as a U.S. citizen or resident. A "nongrantor trust" is the portion of any trust of which the individual is not considered the owner under the grantor trust rules (see ¶ 571) as determined immediately before the expatriation date.

Items subject to withholding are taxed according to the rules that apply to nonresident aliens (see ¶ 2429 and ¶ 2431). The withholding rules apply in a manner similar to those that apply to nonresident aliens (see ¶ 2447), but the distribution item is not subject to the nonresident alien withholding tax itself or the withholding tax on wages (see ¶ 2601). Further, the covered expatriate is treated as having waived any claim to a withholding reduction under any treaty with the United States, unless the expatriate agrees to other treatment that the IRS deems appropriate.

Gross Income of Estate or Trust

520. Gross Income of Estate or Trust. The gross income of an estate or trust is generally determined in the same manner as that of an individual (Code Sec. 641(b); Reg. § 1.641(a)-2).⁴⁸ It includes all items of income received during the tax year, including:

- (1) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;
- (2) income accumulated or held for future distribution under the terms of the will or trust;
- (3) income that is to be distributed currently by the fiduciary to the beneficiaries, and income collected by the guardian of an infant that is to be held or distributed as the court may direct;
- (4) income received by the estate of a deceased person during the period of administration or settlement of the estate; and
- (5) income that, at the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

Although all the items above are includible in gross income, the tax liability may rest on either the beneficiary or the estate or trust as a separate entity. See ¶ 542 for tax consequences of distributions to beneficiaries.

The allocation of income and deductions between a decedent's estate and the surviving spouse in community property states depends on state community property laws. In most states, the surviving spouse is taxable on one-half of the income flowing from the community property of the estate.⁴⁹

522. Income from Real Estate. State law determines whether income from real estate during the period of administration is taxable to the decedent's estate or to the heirs or devisees. The IRS has ruled that, where state law provides that real property is subject to administration, income derived from the property is taxable to the estate even though legal title may pass directly to the heirs or devisees. However, where the administrator is not entitled to possession or control of real property, income from the property is taxable to the heirs or devisees and not to the estate. Even if the property is not subject to the administrator's control, all or a part of the gain from a sale of property is taxable to the estate to the extent that the property was sold, under state law, to raise funds for its administration (Rev. Ruls. 57-133 and 59-375).⁵⁰

523. Income from Personal Property. Income from personal property, including a gain from the sale or exchange of such property, is taxable to the estate. This is because title to personal property vests in the administrator or executor immediately upon appointment and does not pass to the heirs or legatees until the estate is fully administered and distribution is ordered or approved by the courts, and notwithstanding the fact that the basis of the property distributed relates back to the date of the decedent's death.⁵¹

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁴⁸ ¶ 24,260, ¶ 24,263

⁴⁹ ¶ 2350.2473

⁵⁰ ¶ 24,267.5204

⁵¹ ¶ 24,267.515

524. Sale of Property by Estate or Trust. The computation of the gain or loss realized upon the sale of property acquired by an estate, trust or beneficiary is made under special basis rules, the applicability of which is dependent upon the method of acquisition and the nature of the property sold. See ¶ 1601 and ¶ 1701.

Comment: For decedents dying in 2010, the decedent's estate, a qualified revocable trust (¶ 516), or an heir may be able to exclude from gross income the gain on the sale of the decedent's personal residence (Code Sec. 121(d)(11)).⁵² See ¶ 1705 for general discussion of the personal residence gain exclusion. Absent further legislation, this exclusion will not be available for estates of decedents dying after December 31, 2010.

526. Gain on Transfer to Beneficiary. Generally, gain or loss is realized by an estate or trust, or by the other beneficiaries, by reason of a distribution of property in kind if the distribution satisfies a beneficiary's right to receive a specific dollar amount, specific property other than that which is distributed, or other income if the income is required to be distributed currently (Reg. § 1.661(a)-2(f)).⁵³ For estates of decedents dying before 2010, a special rule limits gain on transfers to qualified heirs of property for which a special use valuation election under Code Sec. 2032A was made (see ¶ 2922). For estates of decedents dying in 2010, during which the federal estate tax is repealed, this rule limits gain on exchanges that satisfy pecuniary bequests with appreciated property (Code Sec. 1040).⁵⁴

Comment: Absent further legislation, the rule limiting gain on transfers to qualified heirs of property for which a special use valuation election has been made will apply for estates of decedents dying after December 31, 2010.

For this purpose, a marital deduction trust (established for a spouse to take advantage of the estate tax marital deduction; see ¶ 2926) comprising a portion of the residuary estate and measured by a percentage of the value of the adjusted gross estate is considered as being for a fixed dollar amount. Upon a distribution of property to such a trust, the estate realizes gain or loss measured by the difference between the fair market value at the date of distribution and the federal estate tax value of the property (Rev. Rul. 60-87).⁵⁵

Distribution of a stated percentage of trust corpus to the beneficiary before termination of the trust is not considered a satisfaction of an obligation of the trust for a definite amount of cash or equivalent value in property. Instead, it is treated as a partial distribution of a share of the trust principal. Thus, there is no sale or exchange, and neither the trustee nor the beneficiary realizes taxable income (Rev. Rul. 55-117).⁵⁶ However, a trustee or executor may elect to recognize gain or loss on the distribution of noncash property to a beneficiary as if the property had been sold to the beneficiary at its fair market value (Code Sec. 643(e)(3)).⁵⁷ The election is made on the return for the year of distribution and applies to all distributions made by the estate or trust during its entire tax year. Thus, an election to recognize gain or loss cannot be made separately for each distribution.

In the event the election is made, the beneficiary's basis in the distributed property is the estate's or trust's adjusted basis just prior to the distribution, adjusted by the gain or loss recognized by the estate or trust. If the election is not made, the beneficiary's basis will be the same as the trust's or estate's, and any gain or loss will be recognized by the beneficiary when the beneficiary disposes of the property. See ¶ 519 for gain recognition on certain property distributions to expatriates.

527. Foreign Estates. The estate of a nonresident alien is taxed on its income received from U.S. sources, including capital gains and dividends (see ¶ 2409 and ¶ 2940). However, the estate is allowed a deduction for distributions to both nonresident aliens and U.S. beneficiaries to the extent that these distributions are not in excess of its distributable net income (DNI). The portion of the distribution allocated to capital gains is not includible in the gross income of nonresident alien beneficiaries if they have not resided in the United States for a period of at least 183 days (see ¶ 2435). The portion of a distribution that represents dividends is, however, includible in the gross income of

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁵² ¶ 7260

⁵³ ¶ 24,402

⁵⁴ ¶ 29,779

⁵⁵ ¶ 24,267.5281

⁵⁶ ¶ 24,267.5281

⁵⁷ ¶ 24,320

companies, however, must ratably amortize any G&G costs over five years (Code Sec. 167(h)(5)).¹⁰⁹

Musical Compositions and Copyrights. A taxpayer may elect five-year ratable amortization of capitalized expenses paid or incurred in creating or acquiring a musical composition (including the accompanying words) or a copyright to a musical composition if the expenses are not exempt from capitalization as the qualified creative expenses of an individual (§ 990A), the expenses are not amortizable under Code Sec. 197 because acquired as part of the acquisition of a trade or business, or the taxpayer uses a simplified UNICAP method for property acquired for resale (§ 995) (Code Sec. 167(g)(8)). The provision is effective for expenses paid or incurred with respect to property placed in service in tax years beginning after December 31, 2005. It terminates in tax years beginning after December 31, 2010.

1288. Amortization of Section 197 Intangibles. The capitalized cost of goodwill and most other intangibles used in a trade or business or for the production of income are ratably amortized over a 15-year period generally beginning in the month of acquisition (Code Sec. 197).¹¹⁰ Intangibles amortizable under this provision are referred to as "section 197 intangibles."

The following intangibles are section 197 intangibles: (1) goodwill, going concern value, and covenants not to compete entered into in connection with the acquisition of a trade or business (§ 1743); (2) workforce in place; (3) information base; (4) a patent, copyright, formula, design, or similar item; (5) any customer-based intangible; (6) any supplier-based intangible; (7) any license, permit, or other right granted by a governmental unit or agency; and (8) any franchise, trademark, or trade name (Code Sec. 197(d)).¹¹¹

Generally, self-created intangibles are not amortized under Code Sec. 197 unless created in connection with the acquisition of a trade or business. Exceptions are provided for government-granted licenses, permits, and rights, covenants not to compete entered into in connection with the purchase of a business, and franchises, trademarks, and trade names (Code Sec. 197(c)(2)).¹¹² However, certain self-created intangibles without an ascertainable useful life may be amortized over 15-years under Reg. § 1.167(a)-3(b). See ¶ 1288A.

The following intangibles are specifically excluded from the definition of a section 197 intangible: (1) interests in a corporation, partnership, trust, or estate; (2) interests under certain financial contracts; (3) interests in land; (4) computer software not acquired in connection with the purchase of a business or which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified (§ 980); (5) certain separately acquired rights and interests, including an interest in a patent or copyright or an interest in a film, sound recording, videotape, book, or similar property; (6) interests under existing leases of tangible property; (7) interests under existing indebtedness; (8) sports franchises acquired on or before October 22, 2004; (9) residential mortgage servicing rights not acquired in connection with the acquisition of a business; and (10) professional fees and transaction costs incurred in a corporate organization or reorganization (Code Sec. 197(e)).¹¹³

No loss may be claimed when an amortizable section 197 intangible is disposed of if any other section 197 intangibles acquired in the same transaction are retained. The bases of the retained section 197 intangibles are increased by the amount of the unrecognized loss (Code Sec. 197(f)).¹¹⁴

Generally, Code Sec. 197 applies to acquisitions made after August 10, 1993, or, on an elective basis, to all property acquired after July 25, 1991.¹¹⁵ However, anti-churning rules prevent the provision from applying to section 197 intangibles that were not amortizable under prior law, if held or used by a taxpayer or a related person before the effective date and in certain other circumstances.¹¹⁶

1288A. 15-Year Safe-Harbor Amortization for Certain Self-Created Intangibles. A taxpayer is permitted to amortize certain created intangibles that do not have readily

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹⁰⁹ ¶ 11,009.047

¹¹⁰ ¶ 12,450, ¶ 12,455

¹¹¹ ¶ 12,450, ¶ 12,455.023

¹¹² ¶ 12,450, ¶ 12,455.033

¹¹³ ¶ 12,450, ¶ 12,455.034

¹¹⁴ ¶ 12,450, ¶ 12,455.035

¹¹⁵ ¶ 12,455.06

¹¹⁶ ¶ 12,455.044

ascertainable useful lives over a 15-year period using the straight-line method and no salvage value (Reg. § 1.167(a)-3(b); Rev. Proc. 2006-12, as modified by Rev. Proc. 2006-37, providing change of accounting method procedures).¹¹⁷ For example, amounts paid to acquire memberships or privileges of indefinite duration, such as a trade association membership, are covered by this safe harbor.

A taxpayer may use the 15-year amortization period on any intangible other than (1) any intangible acquired from another person; (2) created financial interests; (3) any intangible that has a useful life that can be estimated with reasonable accuracy; or (4) an intangible asset for which an amortization period or useful life is specifically prescribed or proscribed by the Code, regulations, or other published IRS guidance. In addition, amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other similar transactions described in Reg. § 1.263(a)-5 do not qualify. The 15-year amortization period is extended to 25 years for an intangible benefit described in Reg. § 1.263(a)-4(d)(8). These are intangibles created by transferring ownership of real property to another person or by making a monetary contribution for the acquisition or improvement of real property owned by another person. However, for the treatment of impact fees, see Rev. Rul. 2002-9, which requires developers to allocate the cost of impact fees to the basis of the buildings constructed.

What Is Depletion?

1289. Deduction for Depletion. A deduction for depletion is allowed in determining the taxable income from natural resources. The deduction is similar to depreciation in that it allows the taxpayer to recover the cost of an asset over the resources' productive life. "Depletion" is the exhaustion of natural resources, such as mines, wells, and timberlands, as a result of production. The right to a depletion allowance is based upon the taxpayer's economic interest in the property (Reg. § 1.611-1(b)(i)).¹¹⁸ An economic interest exists if the taxpayer (1) has acquired by investment any interest in minerals in place or in standing timber and (2) looks to the income from the extraction of the minerals or severance of the timber for a return on investment.¹¹⁹

The basic method of computing depletion is "cost depletion" (Code Sec. 612).¹²⁰ The basis upon which the deduction is allowed is the adjusted basis of the property (Reg. § 1.612-1).¹²¹ Determination of cost depletion first requires an estimate of the number of units (tons, barrels, etc.) that make up the deposit. Then that part of the cost or other adjusted basis of the property that is allocable to the depletable reserves is divided by the number of units. The quotient is the cost depletion per unit. This amount, multiplied by the number of units extracted and sold during the year, determines the cost depletion deductible for the year. Each year the "cost basis" of the property is reduced, but not below zero, by the amount of depletion deducted for that year, whether cost or percentage depletion was used. The remaining basis is used in computing cost depletion for the next year.

An alternative method of computing depletion, known as percentage depletion, may be used for almost all depletable property. However, timber is excluded from this method (Reg. § 1.611-1(a)(1)).¹²² Under this method, a flat percentage of *gross income* from the property is taken as the depletion deduction. The percentage depletion deduction may not exceed 50 percent (100 percent in the case of oil or gas properties) of the *taxable income* from the property (see ¶ 1294 for special rules concerning independent producers and royalty owners) computed without regard to the depletion allowance or the manufacturing deduction under Code Sec. 199. In computing taxable income, the deductible mining expenses must be decreased by the amount of Sec. 1245 gains allocable to the property (Code Sec. 613(a)).¹²³ If cost depletion results in a greater deduction, cost depletion must be used (Reg. § 1.613-1).¹²⁴

Ordinarily, the lease of a mineral property requires the lessee to make an advance payment, known as a bonus or advance royalty. In such a case, the lessor's cost depletion allowance must be allocated between the advance lump-sum payment and the

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹¹⁷ ¶ 11,009.045

¹¹⁸ ¶ 23,922

¹¹⁹ ¶ 23,924.027

¹²⁰ ¶ 23,940, ¶ 23,942

¹²¹ ¶ 23,941, ¶ 23,942.021

¹²² ¶ 23,922, ¶ 29,960,

¶ 23,963

¹²³ ¶ 23,960, ¶ 23,963

¹²⁴ ¶ 23,961, ¶ 23,963.01

royalties received during the period of extraction (Reg. § 1.612-3).¹²⁵ Unlike bonuses or advance royalties, "shut-in" oil payments and delay rentals are not depletable.¹²⁶

Coal and iron ore royalties retained upon the disposition of coal and iron ore generally held for more than one year before mining are eligible for percentage depletion for any tax year in which the maximum rate of tax imposed on net capital gain equals or exceeds the maximum rate for ordinary income (Code Sec. 631(c)).¹²⁷

Depletion is subject to recapture as ordinary income upon the sale or other disposition of an oil, gas, geothermal, or other mineral property at a gain (Code Sec. 1254).¹²⁸ Recapture is limited to the amount by which the depletion deduction reduced the adjusted basis of the disposed property.

Mineral Production Payments

1291. Mineral Production Payments. A mineral production payment is treated as a loan by the owner of the production payment to the owner of the mineral property (Code Sec. 636).¹²⁹ Thus, a carved-out mineral production payment—created when the owner of a mineral property sells or carves out a portion of the future production with payment secured by an interest in the minerals—is treated as a mortgage loan on the mineral property rather than as an economic interest in the property. All the income from the property is taxed to the seller (owner of the working interest) and is subject to depletion by him. The owner of the production payment does not get depletion.

When the owner of a mineral interest sells the working interest, a retained production payment is treated as a purchase money mortgage loan and not as an economic interest in the mineral property. Accordingly, all the income from the property is taxed to the purchaser and is subject to depletion by him. The seller who retains the production payment is not entitled to depletion.

Percentage Depletion

1294. Oil and Gas Production. A 22 percent depletion rate is allowed for oil and gas production in the case of regulated natural gas and natural gas sold under a fixed contract (but not certain casinghead gas contracts¹³⁰); a 10 percent rate applies to geopressurized methane gas wells (Code Sec. 613A(b)).¹³¹

A 15 percent depletion rate applies to independent producers and royalty owners with limitations based on average daily production (Code Sec. 613A(c)).¹³² The rate applies to an average daily production of 1,000 barrels of oil and six million cubic feet of gas. The percentage depletion deduction is generally limited to the lesser of 65 percent of the *taxable income* before the depletion allowance (Code Sec. 613A(d)(1))¹³³ or 100 percent of the *taxable income from the property* before the depletion allowance (see ¶ 1289). For purposes of the 65 percent limit, taxable income is computed without regard to any net operating loss carryback, capital loss carryback, or manufacturing deduction under Code Sec. 199. Any portion of a depletion allowance disallowed under the 65 percent limit may be carried over. Percentage depletion is also denied for lease bonuses, advance royalty payments, or other amounts payable without regard to actual production from an oil, gas or geothermal property (see ¶ 1296) (Code Sec. 613(e)(3) and Code Sec. 613A(d)(5)).¹³⁴

For tax years (1) beginning after December 31, 1997, and before January 1, 2008 or (2) beginning after December 31, 2008, and before January 1, 2010, the 100-percent taxable income limit on percentage depletion deductions for oil and gas properties is suspended for marginal properties (Code Sec. 613A(c)(6)(H), as amended by P.L. 110-343).¹³⁵ Thus, the limitation is not suspended for tax years beginning in 2008 or 2010 but is suspended for tax years beginning in 2009.

The 15 percent depletion rate for marginal oil or gas production properties held by independent producers or royalty owners increases by one percent (up to a maximum 25 percent rate) for each whole dollar that the reference price for crude oil for the

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹²⁵ ¶ 23,946, ¶ 23,948.01

¹²⁶ ¶ 23,963.60

¹²⁷ ¶ 24,150, ¶ 24,156.021

¹²⁸ ¶ 31,060, ¶ 31,066

¹²⁹ ¶ 24,170, ¶ 24,176

¹³⁰ ¶ 23,924.039, ¶ 23,988.01

¹³¹ ¶ 23,980, ¶ 23,988.021

¹³² ¶ 23,980, ¶ 23,988.024

¹³³ ¶ 23,980, ¶ 23,988.024

¹³⁴ ¶ 23,960, ¶ 23,980,

¶ 23,988.036

¹³⁵ ¶ 23,980, ¶ 23,988.044

preceding calendar year is less than \$20 per barrel (Code Sec. 613A(c)(6)).¹³⁶ The allowance for depletion is computed using the increased rate with respect to the portion of the taxpayer's average daily marginal production of domestic crude oil and natural gas that does not exceed the taxpayer's depletable quantities of those products. An election may be made to have this rule apply to the pro rata portion of marginal production. The applicable percentage for marginal production for tax years beginning in 2001 through 2009 is 15 percent (Notice 2009-74).

1296. Geothermal Deposits. Geothermal deposits (geothermal reservoirs consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure)) are eligible for a 15 percent depletion allowance (Code Sec. 613(e)).¹³⁷

1298. Coal or Other Minerals. Percentage depletion is allowed, under Code Sec. 613(b),¹³⁸ at the following percentages of "gross income from the property":

(a) 22%—sulphur and uranium; and, if from deposits in the United States, anorthosite, clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium and zinc.

(b) 15%—if from deposits in the United States, gold, silver, copper, iron ore, and oil shale (except shale described in (e) below).

(c) 14%—metal mines (other than metals from deposits in the United States to which the 22 percent rate in (a) applies), rock asphalt, and vermiculite; if (a) above and (e) and (f) below do not apply, ball clay, bentonite, china clay, sagger clay, and clay used or sold for use for purposes dependent on its refractory properties.

(d) 10%—asbestos from deposits outside the United States, brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(e) 7½%—clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale, and slate used or sold for use as sintered or burned lightweight aggregates.

(f) 5%—gravel, peat, pumice, sand, scoria, shale (except shale described in (b) and (e) above) and stone (except stone falling within the general 14 percent group described in (g)); clay used, or sold for use, in the manufacture of drainage and roofing tile, flower pots, and kindred products; also, if from brine wells, bromine, calcium chloride, and magnesium chloride.

(g) 14%—all other minerals not included in any of the categories listed above. For purposes of this paragraph, the term "all other minerals" does not include (A) soil, sod, dirt, turf, water, or mosses; (B) minerals from sea water, the air, or similar inexhaustible sources; or (C) oil and gas wells.

"Gross income from the property," on which percentage depletion is based, is that amount of income which comes from the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation (Code Sec. 613(c)).¹³⁹ Mining processes include certain specified treatment processes. In general, it can be said that the percentage depletion allowance is based on the mined product after application of those treatment processes applied by "ordinary" miners. Hence, an integrated miner-manufacturer computes gross income from mining at the point when the non-integrated miner disposes of the product. Gross income is computed by use of the representative market or field price. However, when it is impossible to determine such a field price, and where the IRS does not determine that a more appropriate method should be used, the proportionate profits method must be used (Reg. § 1.613-4(d)).¹⁴⁰

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹³⁶ ¶ 23,980, ¶ 23,988.044

¹³⁷ ¶ 23,960, ¶ 23,965.03

¹³⁸ ¶ 23,960, ¶ 23,965.01

¹³⁹ ¶ 23,960, ¶ 23,968.04

¹⁴⁰ ¶ 23,967, ¶ 23,968.04

Chapter 13

TAX CREDITS

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Nonrefundable Credits

1301. Child and Dependent Care Credit. A nonrefundable credit is allowed for a portion of qualifying child or dependent care expenses paid for the purpose of allowing the taxpayer (and the taxpayer's spouse, if married filing a joint return) to be gainfully employed (Code Sec. 21).¹ The credit is computed on Form 2441, Child and Dependent Care Expenses, for filers of Form 1040 and 1040A. The credit cannot be claimed on Form 1040EZ. To be eligible for the credit, the taxpayer must incur employment-related expenses in providing care for one of the following qualified individuals:

- (1) a dependent of the taxpayer as defined in Code Sec. 152(a)(1) (a qualifying child) who has not attained the age of 13 (§ 137—§ 137B);
- (2) a dependent of the taxpayer as defined under Code Sec. 152 (determined without regards to whether the individual may be claimed as a dependent by another taxpayer, has income in excess of the dependency exemption amount, or files a joint return with his or her spouse) who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than half of the year; or
- (3) the taxpayer's spouse, if the spouse is physically or mentally incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than half of the year.

Amount of Credit. The maximum amount of employment-related expenses to which the credit may be applied is \$3,000 if one qualifying individual is involved or \$6,000 if two or more qualifying individuals are involved (less excludable employer dependent care assistance program payments) (Code Sec. 21(c)). The credit amount is equal to the applicable percentage, as determined by the taxpayer's adjusted gross income (AGI), times the qualified employment expenses paid. Taxpayers with an AGI of \$15,000 or less use the highest applicable percentage of 35 percent. For taxpayers with an AGI over \$15,000, the credit is reduced by one percentage point for each \$2,000 of AGI (or fraction thereof) over \$15,000 (Code Sec. 21(a)(2)). The minimum applicable percentage of 20 percent is used by taxpayers with an AGI greater than \$43,000. Thus, the maximum dependent care credit amount for one qualifying dependent is \$1,050 and \$2,100 for two or more qualifying dependents.

Comment: Absent further legislation, the child and dependent care expense credit will decrease for tax years beginning after December 31, 2010, to pre-2001 levels. Thus, for tax years beginning on or after January 1, 2011, the amount of the credit allowed will be 30 percent of qualifying child or dependent care expenses. The maximum amount of qualifying expenses to which the credit may be applied will be \$2,400 for individuals with one qualifying child or dependent (for a maxi-

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹ § 3502

mum credit of \$720), or \$4,800 for individuals with two or more qualifying children or dependents (for a maximum credit of \$1,440). For taxpayers with adjusted gross income (AGI) between \$10,000 and \$28,000, the 30-percent credit rate will be reduced by one percentage point for each \$2,000 of AGI until the credit percentage is 20 percent for taxpayers with AGI of \$28,000.

Example: A widower paid a housekeeper \$5,000 during the year to take care of his home and 10-year-old daughter while he is working. His adjusted gross income was \$25,000. Since there is only one qualifying child, the maximum credit he can claim is \$900 (30 percent of \$3,000).

Qualifying Expenses. Qualifying expenses include expenses paid for household services and for the care of a qualifying individual that allow the taxpayer (and the taxpayer's spouse if filing a joint return) to work or look for work. Services outside the home qualify if they involve the care of a qualified child under the age of 13 or any other qualifying individual who regularly spends at least eight hours a day in the taxpayer's home. Payments to a relative may also be qualifying expenses unless the taxpayer claims a dependency exemption for the relative or if the relative is the taxpayer's child and is under age 19. However, no expenses incurred to send a child or other dependent to an overnight camp are considered qualifying expenses for credit purposes.

Qualifying employment-related expenses are considered in determining the credit only to the extent of earned income—wages, salary, remuneration for personal services, net self-employment income, etc. For married taxpayers, expenses are limited to the earned income of the lower-earning spouse. Generally, if one spouse is not working, no credit is allowed. However, if the nonworking spouse is physically or mentally incapable of caring for himself or herself or is a full-time student at an educational institution for at least five calendar months during the year, the law assumes an earned income amount—for each month of disability or school attendance—of \$250 if there is one qualifying individual, or of \$500 if there are two or more qualifying individuals (Code Sec. 21(d)(2)).

Claiming the Credit. Generally, a married taxpayer *must* file a joint return to claim the credit. For this purpose, a married person living apart from his or her spouse under the circumstances described at § 173 is considered unmarried. Also, a divorced or legally separated taxpayer having custody of a child who is disabled or under the age 13 is entitled to the credit even though he or she has released the right to a dependency exemption for the child (Code Sec. 21(e)(5)). Taxpayers must provide each qualifying individual's taxpayer identification number (generally a Social Security number) in order to claim the credit as well as an identifying number of the dependent care service provider; either their Social Security number or their employer identification number (EIN) (Code Sec. 21(e)(9) and (10)).

1302. Credit for the Elderly or the Permanently and Totally Disabled. A tax credit is available to individuals who are: (1) 65 years of age before the close of the tax year, or (2) under age 65 but are retired and were permanently and totally disabled when they retired (Code Sec. 22).² Married taxpayers must file a joint return to claim the credit, unless the spouses live apart throughout the tax year. The credit is computed on Schedule R of Form 1040.

The credit is 15 percent of an applicable initial amount based on an individual's filing status and reduced by certain income. For individuals age 65 or older, the applicable initial amount is as follows:

Single individual	\$5,000
Married individuals, joint return, one spouse is a qualified individual	5,000
Married individuals, joint return, both spouses are qualified individuals	7,500
Married individual, separate return	3,750

This initial amount is then reduced by amounts received as pension, annuity or disability benefits that are excludable from gross income and are payable under the Social Security Act (Title II), the Railroad Retirement Act of 1974, or a Veterans Administration program or that are excludable under a non-Code provision. However, no

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

² § 3550

reduction is made for pension, annuity or disability benefits for personal injuries or sickness payable from a Veterans Administration program.

The maximum amount determined above is further reduced by one-half of the excess of the taxpayer's adjusted gross income (AGI) over the following levels, based on filing status (Code Sec. 22(d)):

Single taxpayer	\$ 7,500
Married taxpayers, combined AGI on joint return	10,000
Married individual filing separately	5,000

For permanently and totally disabled individuals under age 65, the applicable initial amount noted above may not exceed the amount of disability income for the tax year. In determining their initial amounts, special rules apply to a married couple filing a joint return where both spouses qualify for the credit and at least one of them is under age 65. Disability income means the total amount that is includable in an individual's gross income for the tax year under Code Secs. 72 or 105(a) to the extent the amount constitutes wages (or payments in lieu of wages) for periods during which the individual is absent from work due to permanent and total disability (Code Sec. 22(c)(2)(B)).

An individual is considered permanently and totally disabled for this purpose if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of not less than 12 months. This impairment should be substantiated by a letter from a certified physician kept in the taxpayer's records (Code Sec. 22(a)(3)).

Example: Alex, age 66 and single, has AGI of \$9,000 for the year and receives \$4,000 of nontaxable Social Security benefits for the year. To determine his credit, he would make the following computation:

Initial amount	\$5,000
Less: Social security benefits	4,000
Reduced initial amount	\$1,000
Less: One-half of AGI above \$7,500	750
Amount eligible for credit	\$250
Credit: \$250 × 15%	\$38

1303. Credits for Higher Education Tuition. There are three education-related credits: the Hope scholarship credit, the American Opportunity (modified Hope) credit and the lifetime learning credit. These credits may be claimed on Form 8863, Educational Credits (American Opportunity, Hope and Lifetime Learning Credits), by individuals for qualified tuition expenses incurred by students pursuing college or graduate degrees, or vocational training (Code Sec. 25A).³ The credits are elective, nonrefundable, and cannot be claimed using the same expenses for which another tax benefit is also received. The credits are also not permitted to be claimed by more than one taxpayer in the same year (i.e., either the parents or the dependent child (§137A)). Higher income parents whose adjusted gross income (AGI) would result in the phaseout of the dependency exemption may waive claiming the dependency exemption to allow their student dependent to claim an educational credit assuming the student child has a sufficient tax liability to be offset by an educational credit (Reg. §1.25A-1(f)(1)). However, this does not entitle the student dependent to claim a personal exemption on his or her tax return (§135).

American Opportunity Credit. The American Opportunity credit is a modification of the Hope scholarship credit for tax years beginning after December 31, 2008, but before January 1, 2011 (Code Sec. 25A(i)).⁴ The credit amount is the sum of 100 percent of the first \$2,000 of qualified tuition and related expenses plus 25 percent of the next \$2,000 of qualified tuition and related expenses, for a total maximum credit of \$2,500 per eligible student per year. The credit is available for the first four years of a student's postsecondary education. Up to 40 percent of the credit amount is refundable should the taxpayer's tax liability be insufficient to offset the nonrefundable credit amount. The credit amount phases out ratably for taxpayers with modified AGI between \$80,000 and

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

³ ¶ 3820

⁴ ¶ 3820

\$90,000 (\$160,000 and \$180,000 for joint filers) (Code Sec. 25A(i)(4); Rev. Proc. 2009-50). Modified AGI is the taxpayer's AGI with any amounts excluded under the provisions for foreign or U.S. possessions earned income and foreign housing expenses. The American opportunity credit may not be taken by married taxpayers who file separate returns (Code Sec. 25A(g)).

Hope Scholarship Credit. For tax years other than 2009 and 2010, the Hope scholarship credit amount per eligible student is equal to 100 percent of the first \$1,000 of qualified tuition expenses and 50 percent of the second \$1,000 of qualified tuition paid during the year, indexed for inflation. An eligible student for the Hope credit is any individual who:

- (1) has not elected to claim the Hope credit in any two earlier years,
- (2) has not completed the first two years of postsecondary education before the beginning of the current tax year,
- (3) is enrolled at least half-time in a program that leads to a degree, certificate, or other recognized educational credentials, and
- (4) has not been convicted of any Federal or State felony class drug offense for possession or distribution.

Lifetime Learning Credit. The lifetime learning credit is equal to 20 percent of the amount of qualified tuition expenses paid on the first \$10,000 of tuition, an amount which is not inflation adjusted. In contrast to the Hope credit, the lifetime learning credit maximum is calculated per taxpayer and does not vary based on the number of eligible students in the taxpayer's family. A student is eligible for the lifetime learning credit if the student is enrolled in one or more courses at a qualified educational institution. The allowable amount of the lifetime learning credit is reduced for taxpayers who have modified AGI above certain amounts. The phaseout of the credits begins for single taxpayers in 2010 when modified AGI reaches \$50,000 and completely phases out when modified AGI reaches \$60,000. For joint filers, the phaseout range is \$100,000 to \$120,000 in 2010 (Code Sec. 25A(d); Rev. Proc. 2009-50). The lifetime learning credit may not be taken by married taxpayers who file separate returns (Code Sec. 25A(g)).

Qualified Expenses. The Hope and lifetime learning credits are available for qualified tuition and related expenses incurred for the taxpayer, the taxpayer's spouse, or the taxpayer's dependent who is an eligible student at a qualified educational institution (Code Sec. 25A(b)(3) and (f)). In general, "qualified tuition and related expenses" do not include room and board, books (unless required for enrollment), student health fees, or transportation. However, for purposes of claiming the American opportunity credit, qualifying expenses include qualified tuition, fees, and course materials. The amount of qualified tuition and related expenses paid with any tax-free funds (i.e., scholarships or Pell grants) reduces the amount available for claiming the credits. A qualified educational institution is defined as any postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education (Code Sec. 25A(j)(5)).

Schools Located in the Midwestern Disaster Area (Expired). The Hope and the lifetime learning credits were temporarily expanded for students attending (enrolled and paying tuition at) an eligible education institution located in the Midwestern disaster area (§1179) during 2008 and 2009 (Code Sec. 14000).⁵ Specifically, the amount of qualified tuition expenses eligible for the Hope scholarship credit was doubled. The lifetime learning credit rate was also doubled from 20 percent to 40 percent of eligible expenses for eligible students. The maximum Hope credit amount was \$3,600 and the lifetime learning credit was \$4,000. Finally, the definition of qualified tuition and expenses is expanded to follow the definition of qualified higher education expenses used for qualified tuition programs (§697), which includes room and board.

Coordination with Other Provisions. To coordinate the education credits with other provisions of the Code, educational expenses eligible for the credits must first be reduced by tax-free educational assistance such as scholarships or fellowships, veterans' educational assistance allowance, employer-provided educational assistance, or any other educational assistance excluded from gross income, other than gifts, bequests,

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁵ ¶ 32,488

(except deductible contributions to IRAs (see ¶ 2609)), insurance, etc., or those for liabilities of the employee paid by the employer.¹⁶

Employers required to withhold tax with respect to non-cash fringe benefits may deem those benefits paid at any time on or after the date on which they are provided but no later than the last day of the calendar quarter in which they are provided (Temp. Reg. § 31.3501(a)-1T).¹⁷ Withholding on payments, other than wages, to nonresident aliens is governed by special rules covered at ¶ 2447.

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 (see ¶ 2197A) (Code Sec. 3401(a)).

Differential wage payments. Differential wage payments are included in the definition of wages paid by the employer to the employee for purposes of the federal income tax withholding rules (Code Sec. 3401(h)).¹⁸ A differential wage payment is any payment that: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days and (2) represents all or a portion of the wages the individual would have received from the employer if the individual were performing service for the employer. Differential wage payments are considered supplemental wages and, therefore, are subject to the special rules applicable to such payments (¶ 2639). Differential wage payments, however, are not treated as wages for purposes of the Federal Insurance Contributions Act (FICA) (¶ 2648) or the Federal Unemployment Tax Act (FUTA) (¶ 2661) (Rev. Rul. 2009-11).

2604. Included and Excluded Wages. If an employee works on two jobs for the same employer, and only a part of the remuneration is "wages" (e.g., a construction worker who also works on his employer's farm (exempt employment)), all of the remuneration is treated alike, either (1) all is subject to withholding if more than half of the time is spent performing services for which wages are received or (2) all is excluded if more than half of the time spent is in exempt services, provided the payroll period is not longer than 31 consecutive days (Reg. § 31.3402(e)-1).¹⁹

An employer is required to withhold income tax from "wages" paid for "employment" regardless of the circumstances under which the employee is employed or the frequency or size of amounts of the individual wage payments.²⁰ Tax must be withheld from the wages paid for each payroll period.²¹ However, see ¶ 2634 as to an employee's possible exemption from withholding.

When a retail commission salesperson is occasionally paid other than in cash, the employer is not required to withhold income tax for the noncash payments (Reg. § 31.3402(j)-1).²² 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 by the employee during the calendar year.²³

Withholding is also available, if the payee so requests, for wage continuation payments (i.e., sick pay) received from a third party pursuant to a health or accident plan in which the employer participates (Code Sec. 3402(o); Reg. § 31.3402(o)-3).²⁴ Payments of sick pay made directly by employers to their employees are automatically subject to withholding.²⁵ 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.²⁶

2607. Certain Gambling Winnings. Certain gambling winnings are subject to withholding. An amount equal to the product of the third lowest rate of tax applicable to single filers is required to be withheld. For 2010, the applicable tax rate is 25 percent (Code Sec. 3402(q))²⁷ (see IRS Pub. 505). This withholding requirement is imposed on winnings of more than \$5,000 from sweepstakes, wagering pools, and lotteries. With-

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

¹⁶ ¶ 33,506.023

¹⁷ ¶ 33,661, ¶ 33,662.058

¹⁸ ¶ 33,502

¹⁹ ¶ 33,551

²⁰ ¶ 33,593.165

²¹ ¶ 33,544.20

²² ¶ 33,574

²³ ¶ 33,575.01, ¶ 33,575.20

²⁴ ¶ 33,542, ¶ 33,584

²⁵ ¶ 33,542, ¶ 33,585.021

²⁶ ¶ 33,584, ¶ 33,585.021

²⁷ ¶ 33,542

holding is generally imposed on other types of gambling winnings (including pari-mutual pools with respect to horse races, dog races and jai alai) only if the winnings exceed \$5,000 and at least 300 times the wager. In addition, the payor of gambling winnings from these activities must report winnings of more than \$600 by filing Form W-2G (Certain Gambling Winnings). Backup withholding (see ¶ 2645) is required if the winner of reportable amounts does not furnish his TIN to the payor. No withholding is required on winnings from bingo, keno, or slot machines. However, for winnings of \$1,200 or more from a bingo game or slot machine and for winnings of \$1,500 or more from a keno game, the payor must file Form W-2G (Code Secs. 3402(g) and 6041; Reg. § 1.6041-1).²⁸ Withholding is imposed on proceeds from wagering transactions other than bingo, keno or slot machines at the rate stated above if such proceeds exceed \$5,000, regardless of the odds of the wager.

Comment: Absent further legislation, the third lowest rate of tax applicable to single filers will not apply to gambling winnings withholding for tax years beginning after December 31, 2010. If this occurs, gambling winnings will be subject to withholding at the statutory rate of 28 percent for 2011 and thereafter.

2609. Exempt Remuneration of Employees. Some types of salaries or wages are specifically excluded by law from the definition of "wages" for income tax withholding purposes (Code Sec. 3401(a)). Specifically excluded are amounts paid for or for the services of:

- newspaper carriers under age 18 delivering to customers,
- newspaper and magazine vendors buying at fixed prices and retaining excess from sales to customers,
- agricultural workers who are not subject to FICA withholding,
- domestic workers,
- cash or noncash tips of less than \$20 per month,
- moving expenses,
- 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.

The employer's cost of group-term life insurance, including any amount in excess of \$50,000 coverage, which is taxable to the employee as compensation is exempt from withholding (Code Secs. 79(a)(1) and 3401(a)(14); Reg. § 31.3401(a)(14)-1).²⁹ 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).³⁰ An employer's reimbursement of an employee's moving expenses is also exempt if it is reasonable to believe a moving expense deduction will be allowable to the employee under Code Sec. 217 (Code Sec. 3401(a)(15)).³¹ In addition, the value of any meals or lodging excludable by the employee from gross income under Code Sec. 119 (see ¶ 873) is exempt from withholding (Reg. § 31.3401(a)-1(b)(9)).³²

Benefits provided by an employer to an employee in the form of certain educational assistance (see ¶ 871),³³ dependent care assistance, fellowship or scholarship grants, National Health Service Corps loan repayments or nontaxable fringe benefits (such as working condition fringe benefits (see ¶ 863)) are not subject to withholding if it is reasonable to believe that the employee is entitled to exclude the payment from income

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

²⁸ ¶ 33,542, ¶ 35,820, ¶ 35,821,
¶ 35,835

³⁰ ¶ 36,441

³¹ ¶ 33,502, ¶ 33,506.207

³² ¶ 33,503, ¶ 33,506.1880

³³ ¶ 7353.01

²⁹ ¶ 6360, ¶ 33,502, ¶ 33,527

(Code Sec. 3401(a)). 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 (Code Sec. 3401(a)(20)).³⁴ Amounts paid to, or on behalf of, an employee or his beneficiary to an individual retirement plan pursuant to a simplified employee pension are not wages subject to withholding if it is reasonable to believe that the employee will be entitled to an exclusion for such payments (Code Sec. 3401(a)(12)) (see IRS Pub. 15-B).³⁵

Effective for stock acquired pursuant to an option exercised after October 22, 2004, withholding is not required on a disqualifying disposition of stock acquired through exercise of either an incentive stock option or through an employee stock purchase plan (ESPP) (Act Sec. 251(b) and (c) of P.L. 108-357). Neither is withholding required when compensation is recognized in connection with an ESPP discount under Code Sec. 423(c).

In many cases, however, employee and employer may enter into a mutual agreement to withhold from the employee's remuneration (Code Sec. 3402(p)).³⁶ To effectuate this agreement, the employee must submit Form W-4 to the employer, and the employer must begin withholding.

Certain Federal Payments. Taxpayers may request voluntary withholding from certain federal payments. The payments include social security benefits, crop disaster payments, Commodity Credit Corporation loans, and any other payment to be specified in regulations by the IRS (Code Sec. 3402(p)(1)).³⁷

Unemployment Benefits. Similarly, states are required to permit voluntary withholding on unemployment compensation at a rate of 10 percent (Code Sec. 3402(p)(2)).³⁸

2611. Other Payments Not Subject to Withholding. Generally, withholding does not apply to payments made to physicians, lawyers, dentists, veterinarians, contractors, public stenographers, auctioneers, and others pursuing an independent trade, business or profession in which their services are offered to the public because they are not considered employees (Reg. § 31.3401(c)-1(c)).³⁹

Payments of supplemental unemployment compensation are treated as wages, but withholding applies only to the extent that such benefits are includible in the employee's gross income (Code Sec. 3402(o)).⁴⁰ Guaranteed annual wage payments made during periods of unemployment pursuant to a collective bargaining agreement are "wages" subject to withholding.⁴¹ However, strike benefits (other than hourly wages received for strike-related duties) paid by a union to its members are not subject to withholding.⁴²

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.⁴³

Benefits paid under workers' compensation laws (other than nonoccupational disability benefits) are not taxable compensation for services performed and are not subject to withholding⁴⁴ nor are amounts received by employees as reimbursements for medical care or as payments for permanent injury or for loss of bodily function (Code Sec. 3401(a)(20)).⁴⁵ Also, employer-provided health insurance coverage paid for by salary reduction does not constitute wages for withholding purposes.⁴⁶

Any state and local tax benefits and limited payments provided to volunteer emergency response personnel and excludable from their gross income (see ¶ 896A) are not subject to withholding for tax years beginning after 2007 and before 2011 (Code Sec. 3401(a)(23)).⁴⁷

For more information concerning amounts paid to employees as advances or reimbursements for traveling, meals, etc., see ¶ 2662 and ¶ 2663.

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

³⁴ ¶ 33,502
³⁵ ¶ 33,502
³⁶ ¶ 33,542
³⁷ ¶ 33,542
³⁸ ¶ 33,542

³⁹ ¶ 33,536
⁴⁰ ¶ 33,542
⁴¹ ¶ 33,506.3683
⁴² ¶ 33,506.3678
⁴³ ¶ 33,506.1856

⁴⁴ ¶ 33,506.035
⁴⁵ ¶ 33,502
⁴⁶ ¶ 33,506.1871
⁴⁷ ¶ 33,502

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

- (1) calculate the employee's wages for the applicable payroll period,
- (2) determine the payroll period, such as weekly, biweekly or monthly,
- (3) determine the number of the employee's allowances from the filled-out Form W-4, Employee's Withholding Allowance Certificate, and
- (4) choose the withholding method, generally the percentage (¶ 2616) or wage-bracket (¶ 2619) method (Code Sec. 3402(a)).

Other factors to consider in the calculation 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.

Methods of Withholding

2614. Major Methods of Withholding. The law provides two methods of computing the tax to be withheld: (1) the "percentage" method (see ¶ 2616) and (2) the "wage bracket" method (see ¶ 2619) (Code Sec. 3402(b), (c) and (h)).⁴⁸ For other permissible methods of withholding, see ¶ 2627.

Regardless of which method is used, the amount of withholding will depend upon the amount of wages paid, the number of exemptions claimed by the employee on the withholding exemption certificate (see ¶ 2634), the employee's marital status, and the payroll period of the employee (see ¶ 2621) (Code Sec. 3402(a), (f) and (g)).⁴⁹

See Employer's Tax Guide (Circular E), IRS Publication 15, for additional information.

2616. Percentage Method. If the employer selects the percentage method of withholding, the employer must:

- (1) multiply the amount of one withholding exemption for the payroll period by the number of exemptions claimed on the employee's Form W-4,
- (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(a)).⁵⁰

Each withholding exemption is equal to one personal exemption as provided in Code Sec. 151(b) prorated to the payroll period (Code Sec. 3402(a)(2)). Thus, if the payroll period is monthly and the personal exemption is \$3,650 in 2010, then the amount of one withholding exemption is \$3,650 divided by 12 or \$304.

Percentage method withholding tables for both single (including heads of household) and married employees for each of the payroll periods are provided for use in determining the amount of tax to be withheld (Code Sec. 3402(a)).⁵¹ The IRS has approved and issued alternative formula tables for percentage method withholding that were devised for computing withheld tax under different payroll systems and equipment.⁵²

2619. Wage Bracket Method. The wage bracket tables provided by the IRS for graduated withholding cover weekly, biweekly, semimonthly and monthly payroll periods.⁵³ Separate tables for each period are provided for single persons (including heads of household) and married persons. The proper columns to be used by the employer are determined by the total number of exemptions claimed on the employee's withholding exemption certificate. These tables produce about the same result as the percentage method tables and are designed to accommodate different payroll systems and equipment (see IRS Pub. 15).

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁴⁸ ¶ 33,542
⁴⁹ ¶ 33,542

⁵⁰ ¶ 33,542
⁵¹ ¶ 151-¶ 152, ¶ 33,542

⁵² ¶ 153
⁵³ ¶ 154

If the wage bracket method is used, wages in excess of the highest wage bracket in the tables may, at the election of the employer, be rounded off to the nearest dollar (Reg. § 31.3402(c)-1(e)).⁵⁴

2621. Payroll Period. The employee's correct "payroll period" (the period of service for which a payment of wages is ordinarily made to an employee) will determine the exemption amount (see ¶ 2616 and ¶ 2619) to be used if the employer uses the percentage method or the correct table to be used if the employer uses the wage bracket method. 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 (see ¶ 2624).

2624. Computation of Withholding Allowance. If an employee has an established payroll period, the amount of the withholding allowance (for the percentage method) 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 exemption (or the amount withheld, if the wage bracket method is used) 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)(2)).⁵⁵

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) which have elapsed since (1) the date of the last payment of wages by the employer during the calendar year, (2) the date of commencement of employment with the employer during such year, or (3) January 1 of such year, whichever is later (Code Sec. 3402(b); Reg. § 31.3402(c)-1(c)(3)).⁵⁶

2627. Alternative Methods of Withholding. An employer may withhold on the basis of average wages by using estimated quarterly wages, annualized wages, cumulative wages, or any method which produces substantially the same amount of withholding as the percentage or wage bracket method (Code Sec. 3402(h); Reg. §§ 31.3402(h)(1)-1—31.3402(h)(4)-1).⁵⁷

2629. Employee Requests to Increase Withholding. An employee may request on Form W-4 that the employer withhold additional amounts (Code Sec. 3402(i); Reg. §§ 31.3402(i)-1 and 31.3402(i)-2).⁵⁸

In addition, amounts may be voluntarily withheld from certain types of income that are not subject to mandatory withholding (see ¶ 2609). Thus, for example, magazine vendors, domestic workers, etc., may enter into an agreement with their employer to have income tax withheld (Code Sec. 3402(p); Reg. § 31.3401(a)-3).⁵⁹

Withholding Exemptions

2632. Claiming Withholding Exemptions. Every employee is entitled to his or her own withholding exemption and one for each dependent. A married employee may claim a withholding exemption for his or her spouse if the latter does not claim one. An employee who can be claimed as a dependent on another person's tax return, such as a parent's return, may not claim a withholding exemption (Code Sec. 3402(f)(1)).⁶⁰ No withholding exemption is allowed for unborn children even though the birth is expected to occur within the tax year. Employees with more than one job may not claim an exemption that is currently in effect with another employer (Code Sec. 3402(f)(7)).⁶¹

In order to avoid excess withholding, a standard deduction allowance may be claimed by an employee, provided that the employee does not have a spouse who is receiving wages subject to withholding and does not have withholding certificates in effect with more than one employer. The standard deduction allowance is equivalent to

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁵⁴ ¶ 33,547

⁵⁵ ¶ 33,542, ¶ 33,547

⁵⁶ ¶ 33,542, ¶ 33,547

⁵⁷ ¶ 33,542, ¶ 33,566—

¶ 33,569

⁵⁸ ¶ 33,542, ¶ 33,571, ¶ 33,572

⁵⁹ ¶ 33,508, ¶ 33,542

⁶⁰ ¶ 33,542

⁶¹ ¶ 33,542

one withholding exemption (or more than one if regulations so prescribe) (Code Sec. 3402(f)(1)(E)).⁶²

Additional withholding allowances are available to an employee who can show that he or she will have large itemized deductions, deductible alimony payments, moving expenses, employee business expenses, retirement contributions, net losses from Schedules C, D, E, and F of Form 1040, or tax credits. An eligible employee should file Form W-4 with the employer (Code Sec. 3402(m); Reg. § 31.3402(m)-1).⁶³

2634. Withholding Exemption Certificate. Before an employee is allowed any withholding exemptions, he must file a withholding exemption certificate, Form W-4, with his employer showing the number of exemptions to which he is entitled (Code Sec. 3402(f)(2); Reg. § 31.3402(f)(2)-1).⁶⁴ Otherwise, withholding must be computed as if the employee were single and claiming no other exemptions. A widow or widower may claim "married" status for purposes of withholding if he qualifies as a surviving spouse (Code Sec. 3402(l)(3)).⁶⁵ See ¶ 175.

An employee who certifies to his employer that he had no income tax liability for his preceding tax year and anticipates none for the current tax year may be exempt from the withholding provisions (Code Sec. 3402(n); Reg. § 31.3402(n)-1).⁶⁶ Form W-4 should be used, and should be renewed annually, by any employee claiming this exemption.

Most Forms W-4 are retained by the employer. Employers need only submit withholding certificates to the IRS if directed to do so by the Service. Further, the IRS may issue a notice to the employer that specifies the maximum number of withholding exemptions the employee may claim. Generally, the employer is bound by this determination until otherwise advised by the IRS (Reg. § 31.3402(f)(2)-1(g)).⁶⁷ A \$500 civil penalty may be assessed against any individual who decreases his rate of withholding by claiming excess withholding allowances on Form W-4 (Code Sec. 6682).⁶⁸ In addition, a criminal penalty may be imposed against any individual who willfully supplies false withholding information or fails to supply withholding information (Code Sec. 7205).⁶⁹

2637. Change in Status. When any change occurs that affects the number of withholding exemptions to which an employee is entitled, the employee may file a new exemption certificate if the number of exemptions increases. However, the employee must file a new certificate within 10 days if the number of exemptions decreases after the occurrence of any of the following events (Code Sec. 3402(f)(2)(B); Reg. § 31.3402(f)(2)-1(b)).⁷⁰

(1) The spouse for whom the employee has been claiming an exemption is divorced or legally separated from the employee or claims his or her own exemption on a separate certificate.

(2) The support of a claimed dependent is taken over by someone else, and the employee no longer expects to claim that person as a dependent.

(3) The employee discovers that a dependent (other than a qualifying child) for whom an exemption was claimed will receive sufficient income of his own for the calendar year to disqualify him as a dependent (see ¶ 137).

(4) Circumstances have changed so that the employee is no longer entitled to claim an exemption based on one of the deduction or credit items listed at ¶ 2632.

An employee who claimed "no liability" (see ¶ 2634) must file a new Form W-4 within 10 days from the time he anticipates that he will incur liability for the year or before December 1 if he anticipates liability for the next year (Reg. § 31.3402(f)(2)-1(c)).⁷¹

The death of a spouse or dependent does not affect the withholding exemption for that year (Reg. § 31.3402(f)(2)-1(b)(1)(ii)) unless the employee's tax year is not a

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁶² ¶ 33,542

⁶³ ¶ 33,542, ¶ 33,579

⁶⁴ ¶ 33,542, ¶ 33,554

⁶⁵ ¶ 33,542

⁶⁶ ¶ 33,542, ¶ 33,580

⁶⁷ ¶ 33,554

⁶⁸ ¶ 39,845

⁶⁹ ¶ 41,325

⁷⁰ ¶ 33,542, ¶ 33,554,

¶ 33,560.03

⁷¹ ¶ 33,554

calendar year and the death occurs in that part of the calendar year preceding the employee's tax year.⁷²

An employee may file an amended withholding exemption certificate, increasing the number of exemptions, at any time that he becomes eligible for an additional dependency or an extra exemption based on one of the deduction or credit items listed at ¶ 2632.

A withholding exemption certificate furnished to the employer that replaces an existing certificate can be effective for the first payment after the certificate is received if so elected by the employer. However, the replacing certificate must be effective for the first payroll period that ends on or after the 30th day after the day on which the new certificate is furnished (Code Sec. 3402(f)(3)(B)).⁷³

Supplemental Wages

2639. Supplemental Payments and Tips. Special rules apply when the employee is paid supplemental wages (bonus, overtime pay, commissions, etc.).

If supplemental wages are paid at the same time as regular wages, the two are added together and the withholding tax 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. Under an alternative method, the employer may treat the supplemental wages as wholly separate from regular wages and withhold at a flat rate on the supplemental wage payment without any allowance for exemptions and without reference to any regular payment of wages. The flat rate is 28 percent or the corresponding rate in effect for the tax year under Code Sec. 1(i)(2) (25 percent for tax years beginning in 2010). Once the total of supplemental wage payments made to an employee, within a calendar year, exceeds \$1,000,000, the excess will be subject to withholding at the highest income tax rate (35 percent for tax years beginning in 2010). This rule applies regardless of the method otherwise used to withhold supplemental wages paid to the employee (Reg. § 31.3402(g)-1;⁷⁴ Act Sec. 904(b) of P.L. 108-357; IRS Pub. 15; IRS Pub. 505).

Comment: Absent further legislation, the corresponding rate under Code Sec. 1(i)(2) will not apply, and the highest tax rate will be 39.6 percent, for tax years beginning after December 31, 2010. If this occurs, for 2011, supplemental wage payments under the alternative method will be subject to withholding at the 28-percent rate and excess supplemental wage payments exceeding \$1,000,000 will be subject to withholding at the 39.6-percent rate.

A vacation allowance is subject to withholding as if it were a regular wage payment for the vacation period. If the vacation allowance is paid in addition to the regular wage, it is a "supplemental payment" (Reg. § 31.3402(g)-1(c)).⁷⁵

An employer must collect both income tax and employee social security or railroad retirement tax on tips reported by an 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 for 2010) without allowance for exemptions, 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.⁷⁶

Comment: Absent further legislation, the corresponding rate under Code Sec. 1(i)(2) will not apply for tax years beginning after December 31, 2010. If this occurs, for 2011, tips may be treated as if they were supplemental wage payments subject to the 28-percent flat withholding rate.

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁷² ¶ 33,554

⁷⁴ ¶ 33,561

⁷⁶ ¶ 33,506.056

⁷³ ¶ 33,542

⁷⁵ ¶ 33,561

Withholding on Certain Government Payments

2641. Government Payments. Applicable to payments made after December 31, 2011, the federal government, every state and local government and their political subdivisions and instrumentalities (including multi-state agencies) are required to withhold tax at the rate of three percent on certain payments to persons providing any property or services (Code Sec. 3402(t)).⁷⁷ Any payment made in connection with a government voucher or certificate program that acts as a payment for services or property is subject to the withholding requirement. Withholding is required even if the government entity making the payment is not the recipient of the property or services. The withholding requirement does not apply to payments determined by a needs or income test, such as food stamps or welfare payments.

Withholding on Pensions, Interest and Dividends

2643. Pensions, Annuities and Certain Deferred Income. In the case of taxable payments from an employer-sponsored pension, annuity, profit-sharing, stock bonus or other deferred compensation plan, withholding is required unless the recipient elects not to have tax withheld (Code Sec. 3405).⁷⁸ 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 revoked. The payor must notify the recipient that an election may be made and of the right to revoke such election. The election is generally not available with respect to foreign-delivered payments to persons subject to U.S. tax on their world-wide income. "Foreign-delivered," for this purpose, means outside the U.S. or its possessions.⁷⁹

Amount Withheld. 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 was a payment of wages for the appropriate payroll period and, if the recipient does not have a withholding exemption certificate (Form W-4P) in effect, he is treated as a married individual claiming three exemptions. However, these exemptions are not available to a payee failing to file a certificate if the payee fails to furnish a taxpayer identification number (TIN) to a payor or if the IRS notifies the payor that the payee's TIN is incorrect (Code Sec. 3405(a) and (e)(12)). Under the general rule, the withholding rate on nonperiodic distributions is 10 percent (Code Sec. 3405(b)).⁸⁰ Special withholding rules apply to distributions that were eligible for rollover but not directly transferred from the distributing plan to an eligible transferee plan. The withholding rate on such distributions is 20 percent instead of 10 percent. The withholding requirement is mandatory and distributees cannot elect to forego withholding on rollover eligible distributions (Code Sec. 3405(c)).⁸¹

Qualified Recovery Assistance Distributions. Qualified recovery assistance distributions received by residents in the 2008 Midwestern disaster area are treated as received in an eligible rollover distribution for some purposes but are not subject to 20-percent withholding (Code Sec. 1400Q(a)). Qualified distributions must be received from an eligible retirement plan on or after the applicable disaster date and before January 1, 2010. See the discussion of the definition and taxation of qualified recovery assistance distributions at ¶ 2124A.

2645. Backup Withholding. A backup withholding system requires a payor to deduct and withhold income tax from reportable payments, such as interest or dividends, if:

- (1) the payee fails to furnish his TIN to the payor in the manner required;⁸²
- (2) the IRS notifies the payor that the TIN furnished by the payee is incorrect;⁸³

Footnote references are to paragraphs of the 2011 Standard Federal Tax Reports.

⁷⁷ ¶ 33,542

⁸⁰ ¶ 33,620

⁸³ ¶ 33,654.30

⁷⁸ ¶ 33,620

⁸¹ ¶ 33,620

⁷⁹ ¶ 33,620.75

⁸² ¶ 33,654.034