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

If a married individual dies during a tax year beginning before 2018 and after 2025, and his or her surviving spouse files a joint return (¶ 152), the surviving spouse may claim the personal exemption for the deceased spouse unless he or she remarries during the same tax year. The determination of the survivor's filing status is made at the time of the spouse's death, rather than at the end of his or her tax year. If the surviving spouse remarries before the end of the tax year, his or her marital status is determined on the last day of the tax year. If a taxpayer and his or her spouse divorce or are declared legally separated, then the taxpayer cannot claim the exemption for the former spouse (IRS Pub. 17 (2017)).

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

137. Dependent Defined. A dependent of a taxpayer is a person other than the taxpayer or the taxpayer's spouse who entitles the taxpayer to claim certain tax credits and deductions. A dependent is defined as an individual who is a qualifying child (¶ 137A) or qualifying relative (¶ 137B) of the taxpayer for the tax year (Code Sec. 152; Prop. Reg. § 1.152-1). The following general requirements must be met with respect to both a qualifying child and qualifying relative to be claimed as a dependent:

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

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

An individual who qualifies as another taxpayer's dependent cannot claim a personal exemption for tax years before 2018 and after 2025 on his or her own return, regardless of whether the other taxpayer claims the dependency exemption. A dependent's basic standard deduction is also reduced. In addition, a dependent, whether a qualifying child or a qualifying relative, who has earned income on which tax has been withheld should file a return even though he or she is claimed as a dependent by another. The return will serve as a claim for refund of the tax withheld if the dependent incurs no tax liability (¶ 2670). If a dependent child of the taxpayer has earned income or unearned income in excess of the filing threshold amounts (¶ 101), a return must be filed whether or not the child is claimed as a dependent.

In a community property state (¶ 710), if a child's support is derived from community income, he or she may be claimed as a dependent by either spouse on a separate

return by agreement. A single exemption amount before 2018 and after 2025 may *not* be divided between them (IRS Pub. 555 (2016)).

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

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

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

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

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

- *Age.* The individual must be younger than the taxpayer, and either under the age of 19 at the end of the calendar year, or under the age of 24 at the end of the calendar year and a full-time student. An individual who is totally and permanently disabled (¶ 1402) at any time during the year satisfies the age requirement regardless of his or her age. An individual is a full-time student if enrolled or registered for at least part of five calendar months in a year at a qualified educational institution or on-farm training program.

- *Residency or Abode.* The individual must have the same principal place of abode as the taxpayer for more than one-half of the year. Temporary absences for illness, school, vacation, or military service may count as time living with the taxpayer. Special rules apply in the case of a child of divorced or separated parents (¶ 139A). A child who is born or dies during the tax year is considered living with the taxpayer for the entire year if the taxpayer's home was the child's home for the entire time he or she was alive (Prop. Reg. § 1.152-4(c) and (d)). A special rule also applies for kidnapped or missing children (Prop. Reg. § 1.152-4(e)).

- *Support.* The individual must *not* provide more than one-half of his or her own support for the year (¶ 147). For this purpose, if the individual is the taxpayer's child and a full-time student, amounts received as scholarships are not considered support.

- *Joint Return.* The individual cannot have filed a joint return with his or her spouse except as a claim for refund.

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

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

137B. Qualifying Relative Definition. An individual may claim a qualifying relative as a dependent (¶ 137) on his or her return for purposes of certain tax benefits (for example, child tax credit and head of household filing status). The following requirements must be met for an individual to be considered a qualifying relative of the taxpayer (Code Sec. 152(d) and (f); Reg. § 1.152-2(b) and 1.152-2(e); Prop. Reg. § 1.152-3).

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

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

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

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

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

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

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

• *Gross Income.* The individual's gross income for the calendar year must be less than the exemption amount for the year ($4,300 for 2020; projected to be $4,300 for 2021) (¶ 133). Gross income includes all income in the form of money, property, and services that is not exempt from tax. Deductions are not taken into account. Thus, it includes gross sales, rents, share of partnership gross income, etc., without reduction for expenses or determining net income. Any income excludable from the claimed dependent's gross income (for example, tax-exempt interest) is disregarded, as well as income received by a permanently and totally disabled individual at a sheltered workshop school.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- contributions to an accident or health plan by a parent's employer on behalf of the child (¶ 2013);
- the child's use of a fringe benefit that qualifies as a no-additional-cost service or qualified employee discount (¶ 2087 and ¶ 2088, respectively);
- the child's deductible medical expense (¶ 1015); and
- the child's qualified medical expenses paid from distributions from a health savings account (HSA) (¶ 2035) or Archer medical savings account (MSA) (¶ 2037) that are excludable from gross income (Rev. Proc. 2008-48).

147. Support Test for Dependent. An individual may be claimed as dependent by a taxpayer only if:

- the individual does not provide over one-half of his or her own support in the calendar year in order to be the taxpayer's qualifying child (¶ 137A), or
- the taxpayer furnishes over one-half of the individual's support for the calendar year in order to be the taxpayer's qualifying relative (¶ 137B).

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

Multiple Support Agreement. An exception also applies for a qualifying relative if there is a multiple support agreement between two or more taxpayers who provide more than 50 percent of the dependent's support for the tax year, but no one person provides at least 50 percent of the support (Code Sec. 152(d)(3); Reg. § 1.152-3; Prop. Reg. § 1.152-3(d)(4)). In that case, a taxpayer who provided at least 10 percent of the dependent's support is treated as providing more than 50 percent of the support if the other taxpayers who provided at least 10 percent of the support waive any claim to the dependent for the calendar year by written declaration. The taxpayer who claims the dependent must keep these signed statements for his or her record. Form 2120 identifying each of the other persons who agreed not to claim the dependent must be attached to the return of the taxpayer claiming the dependent.

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

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

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

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

Filing Status

See CCH® AnswerConnect: *Tax Filing Status for Individuals* for more information on this topic.

152. Married Filing Jointly Filing Status. Married individuals may elect to file a joint return if they are married on the last day of the tax year, use the same tax year, agree to file jointly, and neither is a nonresident alien during the tax year. Spouses may file a joint return even though one spouse has no income or deductions (Code Sec. 6013; Reg. § 1.6013-1). Both spouses generally must sign a joint return but exceptions are provided if one spouse cannot sign due to disease, injury, or mental incompetence, or because the spouse is serving in a combat zone, qualified hazardous duty area, or contingency operation. Once a joint return has been filed for a tax year, the spouses generally may not elect to file separate returns for that year after the due date of the return.

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

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

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

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

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

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

154. Married Filing Separately Filing Status. A married individual may elect to file separately rather than filing a joint return with his or her spouse (¶ 152). A married taxpayer generally is required to file separately if his or her spouse uses a different tax year or if the spouse does not agree to file a joint return. Also, the taxpayer may file as

stream, then the payment is taxed under the annuity rules of Code Sec. 72(e) as if received before the annuity starting date and the investment in the contract used to calculate the simplified exclusion ratio for the annuity payments is reduced by the amount of the payment.

Pre-November 19, 1996, Annuities. The IRS provides an elective alternative to application of the usual annuity rules for distributions from qualified plans if the annuity starting date is before November 19, 1996 (Notice 88-118). Distributees who elected to use this method are considered to have complied with Code Sec. 72(b). Payors may also use this method to report the taxable portion of the annuity payments on Form 1099-R. The safe-harbor method may be used *only* if the following three conditions are met:

- the annuity payments depend upon the life of the distributee or the joint lives of the distributee and beneficiary;
- the annuity payments are made from an employee plan qualified under Code Sec. 401(a), an employee annuity under Code Sec. 403(a), or an annuity contract under Code Sec. 403(b); and
- the distributee is less than age 75 when annuity payments commence or, if the distributee is age 75 or older, there are fewer than five years of guaranteed payments.

Under the safe-harbor method, the total number of monthly annuity payments expected to be received is based on the distributee's age at the annuity starting date rather than on the life expectancy tables in Reg. §1.72-9. The same expected number of payments applies to a distributee whether the individual is receiving a single life annuity or a joint and survivor annuity. These payments are set forth in the following table:

Age of Distributee	*Number of Payments*
55 and under	300
56-60	260
61-65	240
66-70	170
71 and over	120

Under the safe-harbor method, the distributee recovers the investment in the contract in level amounts over the number of monthly payments determined from the above table. The portion of each monthly annuity payment that is excluded from gross income by a distributee who uses the safe-harbor method for income tax purposes is a level dollar amount determined by dividing the investment in the contract, including any applicable death benefit exclusion, by the set number of annuity payments from the above table as follows:

$$\frac{\text{Investment}}{\text{Number of monthly payments}} = \text{Tax-free portion of monthly annuity}$$

For distributees with annuity starting dates after 1986, annuity payments received after the investment is recovered, usually after the set number of payments has been received, are fully includible in gross income.

Example 2: Assume the same facts as in Example 1 above, except Jeff's annuity start date was January 1, 1996. Under the safe-harbor method, Jeff's investment in the contract is $24,000 (the after-tax contributions to the plan). The set number of monthly payments for a distributee who is age 65 is 240. The tax-free portion of each $1,000 monthly annuity payment to Jeff is $100, determined by dividing Jeff's investment ($24,000) by the number of monthly payments (240). If Jeff has not recovered the full $24,000 investment at his death, Jan will also exclude $100 from each $500 monthly annuity payment. Any annuity payments received after 240 payments have been made will be fully includible in gross income. If Jeff and Jan die before 240 payments have been made, a deduction is allowed on the survivor's last income tax return in the amount of the unrecovered investment.

The dollar amount is excluded from each monthly payment even if the annuity payment amount changes. If the amount excluded is greater than the amount of the monthly annuity, because of decreased survivor payments, each monthly annuity payment is excluded completely until the entire investment is recovered. If annuity payments cease before the set number of payments has been made, a deduction for the unrecovered investment is allowed on the distributee's last tax return. If payments are made to multiple beneficiaries, the excludable amount is based on the oldest beneficiary's age. A pro rata portion is excluded by each beneficiary.

841. Distributions in Full Discharge of Annuity Contracts. Any amount received, whether in a single sum or otherwise, under an annuity, endowment, or life insurance contract in full discharge of the obligation under the contract as a refund of the consideration paid for the contract or any amount received under such contract on its complete surrender, redemption, or maturity is includible in gross income to the extent the amounts exceed the investment in the contract (Code Sec. 72(e); Reg. §1.72-11). The remainder is taxable to the recipient, whether the recipient is the primary annuitant or a secondary annuitant under a joint annuity or joint and survivor annuity. A penalty is imposed on a policyholder who receives a premature distribution (for example, before age 59½ unless one of a number of exceptions such as death or disability applies) (Code Sec. 72(q)).

843. Installment Options for Annuity Contracts. If an insured elects under an option in an insurance contract to receive the proceeds as an annuity instead of a lump sum, and the election is made within 60 days after the day on which the lump sum first became payable, no part of it is includible in gross income under the doctrine of constructive receipt (Code Sec. 72(h); Reg. §1.72-12). The installment payments are taxed in accordance with the annuity rules (¶ 817).

845. Transfer of Annuity Contracts. If a life insurance, endowment, or annuity contract is transferred for a valuable consideration, and the proceeds of the contract are paid to the transferee for reasons other than the death of the insured (for example, on surrender, redemption, or maturity of the contract), the transferee, including a beneficiary of, or the estate of, a transferee, is treated as follows:

- if the proceeds are received as an annuity or in installments for a fixed period, the transferee computes the amount excludable from gross income under the exclusion ratio formula (¶ 819); or
- if the proceeds are received in a lump sum, the transferee includes in gross income only that portion of the proceeds in excess of the consideration paid.

Regardless of how the proceeds are received and included in gross income, the transferee's consideration paid consists of the actual value of the consideration paid for the transfer, plus the amount of premiums or other consideration paid after the transfer. This transferee rule, however, does not apply if the transferred contract has a basis for gain or loss in the hands of the transferee determined by reference to the transferor's basis, as in the case of a gift or tax-free exchange (Code Sec. 72(g); Reg. §1.72-10).

A loss realized upon the surrender or forfeiture of an annuity contract by the original purchaser is deductible as an ordinary loss under Code Sec. 165, the basis of the contract being its cost less the amounts previously excluded from gross income (Rev. Rul. 61-201). For tax years beginning before 2018 and after 2025, the loss is deducted as a miscellaneous itemized deduction subject to the two-percent-of-adjusted-gross-income limitation (¶ 1079) (IRS Pub. 575). No miscellaneous itemized deductions subject to the two-percent-AGI limit may be claimed in tax years 2018 through 2025.

Bequests and Gifts

847. Bequests Excluded from Gross Income. The value of property acquired by bequest, devise, or inheritance is excludable from gross income (Code Sec. 102; Reg. §1.102-1). The exclusion does not apply to income flowing from the property. For example, amounts received as investment income from the property or as profit from the sale of the property are not excludable. The exclusion also does not apply if the bequest consists of income from property. Thus, a bequest of annual rent from the testator's property for 10 years is taxable income to the beneficiary. The beneficiary is required to include in gross income each year the amount of the annual rent. The basis of any real or personal property acquired from a decedent is generally its fair market value on the date of the decedent's death (¶ 1633).

A bequest of a specific sum of money or specific property from an estate or trust may be excluded from the beneficiary's gross income if it is paid or credited all at once or in not more than three installments (Code Sec. 663(a)(1); Reg. §1.663(a)-1). An amount which is paid from the estate or trust income may qualify as a bequest for this purpose if the amount could have been paid from either income or principal. However, an amount that can only be paid from the estate or trust income is not treated as a bequest and thus *not* excludable from gross income even when paid in less than four installments.

849. Gifts Excluded from Gross Income. The value of a gift is excludable from gross income, but *any income* from the gift, including profit upon sale, is includible in gross income (Code Sec. 102). A gift of income from the property of an estate or trust is not excluded from gross income except in the case of a gift of a specific sum or specific property paid or credited all at once or in not more than three installments (¶ 847). The basis of any property acquired by gift is generally the same as it would be in the hands of the donor (¶ 1630).

Tips are not gifts and are therefore includible in gross income (¶ 717). Food, clothing, and rent payments furnished as strike benefits by a labor union to a needy worker participating in a strike may be considered gifts. In determining whether a gift was made, the fact that benefits were paid only to union members is not controlling (*A. Kaiser*, SCt, 60-2 ustc ¶ 9517).

The exclusion from gross income applicable to the value of property acquired by gift does not apply to any amount transferred by or for an employer to, or for the benefit of, an employee (Code Sec. 102(c)). However, certain employee achievement awards (¶ 2069) and certain fringe benefits provided by employers are excludable (¶ 2085).

Personal Injury and Disability Proceeds

See CCH® AnswerConnect: *Gross Income: Awards, Damages, Recoveries, Illegal Activities and Other* for more information on this topic.

851. Workers' Compensation and Occupational Disability Benefits. Compensation received under a workers' compensation act for personal injuries or sickness, and amounts received by a taxpayer under a policy of accident and health insurance, are excludable from gross income (Code Sec. 104(a)(1); Reg. §1.104-1). The exclusion also applies to benefits having the characteristics of life insurance proceeds paid under a workers' compensation act to the survivors of a deceased employee (Reg. §1.101-1(a)). See ¶ 2025 for a discussion of disability income plans.

Amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, the National Oceanic and Atmospheric Administration (formerly the Coast and Geodetic Survey) or the Public Health Service, or as a disability annuity payable under section 808 of the Foreign Service Act of 1980, are also excludable from gross income (Code Sec. 104(a)(4) and (b); Reg. §1.104-1). The exclusion generally is limited to amounts received for combat-related injury or illness. However, it will not be less than the maximum amount of disability compensation from the Department of Veterans Affairs to which the individual is, or would be, entitled upon application.

Benefits that are payable under state law for occupational injury or illness arising out of employment are excludable if the benefits are in the nature of workers' compensation payments (Reg. §1.104-1(b)). No fault insurance disability benefits received by a passenger injured in an automobile accident under the automobile owner's policy as compensation for loss of income or earning capacity are also excludable from gross income (Rev. Rul. 73-155).

If an otherwise excludable amount is for reimbursement of medical expenses previously deducted for tax purposes, the amount must be included in gross income to the extent of the prior deduction. The IRS has ruled that if a portion of an award is specifically allocated to future injury-related medical expenses, the future expenses must be offset by the awarded portion (Rev. Rul. 79-427). However, the Ninth Circuit Court of Appeals ruled that where there is no express allocation of a lump-sum personal injury

award to future medical expenses, no offset is required (*K.R. Niles*, CA-9, 83-2 USTC ¶ 9477).

Terrorist Attacks. Disability income received by an individual for injuries received in a terrorist attack while the individual was performing services as a U.S. employee outside the United States is also excludable from gross income (Code Sec. 104(a)(5)).

Death Benefits Received by Beneficiaries of Public Safety Officers. Death benefits or other amounts received by qualified beneficiaries or surviving dependents of a public safety officer who died as the direct and proximate result of a personal injury sustained in the line of duty are excludable from gross income (Code Sec. 104(a)(6)). There is no requirement that the amounts be received under a workers' compensation statute. See ¶ 813 for a discussion of death benefits received as an annuity by beneficiaries of public safety officers.

852. Damages for Personal Injuries or Sickness. Amounts received as damages, other than punitive damages, on account of *personal physical injuries or sickness* are excludable from gross income (Code Sec. 104(a)(2)). Damages for emotional distress, including the physical symptoms of emotional distress, may not be treated as damages on account of a personal physical injury or sickness, except to the extent of amounts paid for medical care attributable to emotional distress. For example, back pay received in satisfaction of a claim for denial of a promotion due to employment discrimination is not excludable because it is completely independent of, and *not* damages received on account of, personal physical injuries or sickness (Rev. Rul. 96-65).

Interest and Punitive Damage Awards. Interest included in an award of damages for personal injury is includible in gross income (*M. Brabson*, CA-10, 96-1 ustc ¶ 50,038). Also, punitive damages arising out of personal physical injury action are generally includible in gross income (Code Sec. 104(a)(2) and (c)). Punitive damages may be excludable from income if received in a civil action for wrongful death and the applicable state law provides that *only* punitive damages may be awarded.

Attorney's Fees. The full amount of a litigant's award, including the attorney's contingent fee, regardless of whether paid directly to the attorney or to the individual, is includible in the litigant's gross income under the anticipatory assignment of income theory (*J.W. Banks II*, SCt, 2005-1 USTC ¶ 50,155). See ¶ 973 and ¶ 1093 for a discussion of the deduction of business legal expenses and nonbusiness legal expenses, respectively.

Discharge of Debt

See CCH® AnswerConnect: *Discharge of Debt* for more information on this topic.

855. Cancellation or Discharge of Debt Income. A taxpayer generally realizes income equal to the portion of a debt that is cancelled or discharged other than as a gift or bequest (Code Sec. 61(a)(11); Reg. §1.61-12). However, income from the discharge of a debt may be excluded from gross income for:

- a debt discharge in a bankruptcy action under Title 11 of the U.S. Code in which the taxpayer is under the jurisdiction of the court and the discharge is either granted by, or is under a plan approved by, the court;
- a discharge when the taxpayer is insolvent outside bankruptcy;
- a discharge of qualified farm indebtedness;
- a discharge of qualified real property business indebtedness;
- a discharge of qualified principal residence indebtedness occurring before January 1, 2021;
- a discharge of a student loan provided the student works for a certain period of time in certain professions for any of a broad class of employers; eligible student loan discharges for students of certain closed schools (Rev. Proc. 2020-11); or for discharges of eligible student loans in 2018 through 2025, due to the student's death or total and permanent disability (Code Sec. 108, as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94)); and

Under a safe harbor, an individual may exclude from gross income any (1) federal or private student loan discharged based on the Department of Education's Closed School or Defense Repayment discharge process, or (2) private loans discharged based on a settlement of certain legal causes of action (Rev. Proc. 2020-11). The taxpayer does not have to increase gross income by the amount of tax credits or deductions related to the discharged loans. A creditor does not have to file information returns or furnish payee statements as a result of discharging the loans. Prior relief was provided to a taxpayer who took out private student loans to finance attendance at a school owned by Corinthian College, Inc. (CCI) or American Career Institutes, Inc. (ACI) if the private loans were discharged based on a settlement of a legal cause of action against CCI, ACI, and certain private lenders (Rev. Proc. 2018-39).

Deferral of Discharge of Debt Income Resulting from Reacquisition of Debt. A limited deferral was allowed for the discharge of debt income in connection with the reacquisition in 2009 or 2010 of an applicable business debt (Code Sec. 108(i)). At the election of the taxpayer, income from the discharge of the applicable business debt is includible in gross income ratably over a five-year period beginning in 2014. If the taxpayer issued a new debt instrument for the debt instrument being reacquired, and there is original issue discount (OID) with respect to the original instrument, the taxpayer can deduct the OID ratably over the same period as that for which the discharge of debt income is deferred. If a debt instrument was issued by the taxpayer and the proceeds were used to reacquire a debt instrument also issued by the taxpayer, the new instrument is treated as being issued for the instrument being reacquired. The election to defer OID income is made on an instrument-by-instrument basis, and is irrevocable once made. Special rules address the application of this rule to C corporations, S corporations, and partnerships, including, under certain circumstances, a required acceleration of any remaining items of a C corporation's deferred discharge of debt income (Reg. § 1.108(i)-2).

Paycheck Protection Program (PPP) Loans. The Paycheck Protection Program (PPP) is available through the Small Business Administration's (SBA) existing section 7(a) loan program to provide small businesses with loans to help with payroll costs, mortgage interest, rent, and utilities from February 15, 2020, through December 31, 2020. All payments of principal, interest, and fees otherwise due under the covered loans are deferred for a certain period. A small business eligible to receive a PPP loan is any trade or business if it employs 500 or fewer employees during the covered period beginning February 15, 2020, and ending December 31, 2020. A trade or business may have more than 500 employees and be eligible for a PPP loan if it meets SBA employee-based size standard for certain industries (Act Secs. 1102 and 1106 of P.L. 116-136 as amended by Paycheck Protection Flexibility Act of 2020 (P.L. 116-142)).

An eligible recipient of a PPP loan may apply for forgiveness of the loan. The forgiven amount is excluded from the gross income of the borrower and not considered cancellation of debt income for federal income tax purposes. The amount eligible for forgiveness is the sum of the payroll costs, mortgage interest, rent, and certain utilities during the period beginning on date the PPP loan originates and ending on the earlier of 24 weeks after the date the loan originates or December 31, 2020. A borrower that received a PPP loan before June 5, 2020, could elect for the covered period to end 8 weeks after the loan origination date.

The amount of any PPP loan forgiven may not exceed the full principal of the loan and any accrued interest. The amount forgiven is reduced if during the covered period the borrower reduces the number of full-time equivalent (FTE) employees or employee salary and wages. An employer is provided relief from the reduction of the forgiveness amount if it rehires employees or makes up for salary/wage reductions by December 31, 2020. A borrower must use at least 60 percent of the PPP loan amount for payroll costs to have any amount forgiven. A lender is not required to file an information return or furnish a payee statement to the borrower to report the amount of PPP loan forgiven (Announcement 2020-12).

A business whose PPP loans are forgiven and excluded from gross income may not deduct any business expenses paid for by the loan (Notice 2020-32). An employer that receives a PPP loan is not eligible from claiming the payroll tax credit for retaining employees during the COVID-19 crisis (¶ 2648).

Education and Disability Benefits

See CCH® AnswerConnect: *Interest Income: Special Rules for U.S. Savings Bonds* and *Education Expenses, Tax Credits and 529 Plans* for more information on this topic.

863. Exclusion of U.S. Savings Bond Interest for Education Expenses. An individual who redeems a qualified U.S. savings bond to pay qualified higher education expenses may exclude interest on the bond from gross income if certain requirements are met (Code Sec. 135). The exclusion is subject to a phaseout depending on the taxpayer's modified adjusted gross income (AGI) in the year that the bonds are cashed, and the qualified higher education expenses are paid. For 2020, the exclusion is reduced when modified AGI exceeds $82,350 ($123,550 if married filing jointly) and is eliminated when modified AGI reaches $97,350 ($153,550 if married filing jointly) (Rev. Proc. 2019-44). Projected for 2021, the exclusion is reduced when modified AGI exceeds $83,200 ($124,800 if married filing jointly) and is eliminated when modified AGI reaches $98,200 ($154,800 if married filing jointly).

A qualified U.S. savings bond is any Series I or EE bond issued after 1989 to an individual who has reached age 24 before the date of issuance. Qualified higher education expenses include tuition and fees required for enrollment or attendance at an eligible educational institution of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent (¶ 137). Also, a taxpayer is entitled to the exclusion if the redemption proceeds are contributed to a qualified tuition program (QTP or 529 plan) (¶ 869).

A taxpayer should keep records to verify the amount of excluded interest, including:

- a written record of each post-1989 Series EE or I U.S. savings bond that is cashed in including the serial number, issue date, face value, and total redemption proceeds including principal and interest (Form 8818 may be used for this purpose);
- documentation to show that qualified higher education expenses were paid during the tax year (canceled checks, credit card receipts, or bills from the educational institution).

The amount that may be excludable is limited when the aggregate proceeds of qualified U.S. savings bonds redeemed by a taxpayer during a tax year exceed the qualified higher education expenses paid during that year. Qualified higher education expenses must be *reduced* by the sum of any:

- qualified scholarship that is not includible in gross income (¶ 865);
- educational assistance allowance under certain chapters of title 38 of the United States Code;
- payment other than a gift or inheritance that is exempt from tax including employer-provided educational assistance (¶ 2067); or
- payment, waiver, or reimbursement under a 529 plan (¶ 869).

The amount must be further reduced by expenses taken into account for the American opportunity credit or lifetime learning credit (¶ 1403), as well as amounts taken into account in determining the exclusion for distributions from a 529 plan or Coverdell education savings account (¶ 867).

Modified AGI. For purposes of the exclusion, modified AGI is the taxpayer's AGI *after* applying the partial exclusion for Social Security and tier 1 railroad retirement benefits (¶ 716), the deduction for contributions to a traditional IRA (¶ 2157), and adjustments for limitations on passive activity losses and credits (¶ 1169). In addition, modified AGI is calculated *before* the exclusion of interest from U.S. Savings bonds, the exclusion for qualified adoption expenses (¶ 2063), the domestic production activities deduction for tax years beginning before 2018 (¶ 980A), the deduction for interest paid on qualified student loans (¶ 1011), the deduction for qualified tuition and related expenses before 2021 (¶ 1011A), the exclusion of foreign earned income (¶ 2402), and the exclusion for income from Puerto Rico and U.S. possessions (¶ 2414 and ¶ 2415). The exclusion is not available to married individuals who file separate returns. The

A replacement component which is separately depreciated because it is placed in service after the building (or section 1245 asset) is placed in service is a separate asset. If a separately depreciated component is retired then a retirement loss is claimed without regard to the partial disposition election because an entire asset has been disposed. For example, a replacement roof depreciated under MACRS is a separately depreciated asset and a retirement loss must be claimed if the entire replacement roof is again replaced. However, if the shingles on the replacement roof are replaced, a partial disposition of an MACRS asset has occurred and a loss on the remaining basis of the shingles may be claimed if the partial disposition election is made.

If a taxpayer makes a partial disposition election, the costs of related expenditures that would otherwise be deductible as repairs must be capitalized as a restoration (¶ 1313). For example, if a taxpayer makes a partial disposition election to deduct the remaining basis of shingles on an original or replacement roof, the cost of replacing the shingles is capitalized as a restoration even though without the election the cost would be deductible as a repair. If the replacement expenditures must be capitalized without regard to the partial disposition election (for example, an entire original roof is replaced), the partial disposition election carries no adverse consequence.

The partial disposition election must be made by the due date (including extensions) of the original federal tax return for the tax year in which the portion of the asset is disposed. The due date for filing any federal income tax return otherwise due on or after April 1, 2020, and before July 15, 2020, is automatically extended to July 15, 2020 (¶ 2505). No formal election statement is required. The taxpayer simply reports the loss on the disposed portion of the asset on the appropriate form (Form 4797). The election may be revoked only with IRS consent (Reg. § 1.168(i)-8(d)(2)).

1240. MACRS Depreciation Periods. The Modified Accelerated Cost Recovery System (MACRS) depreciation (recovery) period for an asset is based on its class life as of January 1, 1986, or is specifically prescribed by Code Sec. 168. The recovery periods for MACRS assets can be found in a table that appears in IRS Pub. 946. This table is an updated version of the table that appears in Rev. Proc. 87-56. Under MACRS, an asset is classified according to its class life as follows.

Three-Year Property. Three-year property includes property with a class life of four years or less. Any race horse placed in service before January 1, 2021, or any other horse over 12 years old at the time it is placed in service is classified as three-year property (Code Sec. 168(e)(1) and (e)(3)(A), as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94)). A race horse that is more than two years old when it is placed in service is three-year property (seven-year property if two years old or less when placed in service) if placed in service after December 31, 2020. Certain "rent-to-own" consumer durable property (for example, televisions and furniture) is three-year property. Breeding hogs (Asset Class 01.236) and tractor units for use over the road (Asset Class 00.26) are three-year property. A tractor unit is a highway truck designed to tow a trailer or semitrailer and that does not carry cargo on the same chassis as the engine (Reg. § 145.4051-1(e)(1)).

Five-Year Property. Five-year property generally includes property with a class life of more than four years and less than 10 years. This property includes: cars; light and heavy general-purpose trucks; qualified technological equipment; computer-based telephone central office switching equipment; research and experimentation property that is section 1245 property; semi-conductor manufacturing equipment; geothermal, solar and wind energy properties; certain biomass properties that are small power production facilities; computers and peripheral equipment; and office machinery (typewriters, calculators, etc.) (Code Sec. 168(e)(1) and (e)(3)(B)).

Furniture, appliances, window treatments, and carpeting used in residential rental property are five-year property (Announcement 99-82). Personal property used in wholesale or retail trade or in the provision of personal and professional services is five-year property if a specific recovery period is not otherwise provided (Asset Class 57.0). For example, a professional library used by an accountant or attorney is five-year property. Examples of *personal* service businesses include hotels and motels, laundry and dry cleaning establishments, beauty and barber shops, photographic studios and mortuaries. Examples of *professional* service businesses include services offered by doctors, dentists, lawyers, accountants, architects, engineers, and veterinarians (Rev. Proc. 77-10).

Five-year property also includes taxis (Asset Class 00.22), buses (Asset Class 00.23), airplanes not used in commercial or contract carrying of passengers or freight, and all helicopters (Asset Class 00.21), trailers and trailer-mounted containers (Asset Class 00.27), breeding cattle and dairy cattle (Asset Class 01.21), breeding sheep and breeding goats (Asset Class 01.21), and assets used in construction by certain contractors, builders, and real estate subdividers and developers (Asset Class 15.0).

Seven-Year Property. Seven-year property includes property with a class life of 10 years or more, but less than 16 years (Code Sec. 168(e)(1) and (e)(3)(C)). This property includes office furniture, equipment and fixtures that are not structural components (Asset Class 00.11). Desks, files, safes, overhead projectors, cell phones, fax machines and other communication equipment not included in any other class fall within this category. Seven-year property also includes: assets (except helicopters) used in commercial and contract carrying of passengers and freight by air (Asset Class 45.0); certain livestock (Asset Class 01.1); breeding or work horses 12 years old or less when placed in service (Asset Class 01.221); other horses that are not three-year property (Asset Class 01.225); assets used in recreation businesses (Asset Class 80.0); and assets used in theme and amusement parks (Asset Class 80.0). Any railroad track, motorsports entertainment complex placed in service before January 1, 2021, and any property that does not have a class life (such as a fishing vessel) and is not otherwise classified is seven-year property.

10-Year Property. Ten-year property is property with a class life of 16 years or more and less than 20 years (Code Sec. 168(e)(1) and (e)(3)(D)). This property class includes vessels, barges, tugs, and similar means of water transportation not used in marine construction or as a fishing vessel (Asset Class 00.28). Ten-year property also includes smart electric meters and qualified smart electric grid systems. MACRS deductions for trees or vines bearing fruit or nuts that are placed in service after 1988 are determined under the straight-line method over a 10-year recovery period (Code Sec. 168(b)(1)). Single purpose agricultural or horticultural structures placed in service after 1988 are 10-year property.

15-Year Property. Property with a class life of 20 years or more but less than 25 years is generally considered 15-year property (Code Sec. 168(e)(1) and (e)(3)(E)). This property class includes municipal wastewater treatment plants, telephone distribution plants and other comparable equipment used for the two-way exchange of voice and data communications, retail motor fuels outlets, and initial gas utility clearing and grading improvements to place pipelines into service.

A property qualifies as a retail motor fuels outlet (as opposed, for example, to a convenience store, which is 39-year real property) if: (1) 50 percent or more of gross revenues are derived from petroleum sales; (2) 50 percent or more of the floor space is devoted to petroleum marketing sales; or (3) the property is 1,400 square feet or less (Rev. Proc. 97-10). Fifteen-year property includes car wash buildings and related land improvements, billboards, and section 1250 real property (including service station buildings) and depreciable land improvements used in marketing petroleum and petroleum products (Asset Class 57.1). Water transportation assets (other than vessels) used in the commercial and contract carrying of freight and passengers by water are 15-year property (Asset Class 44.0).

Otherwise depreciable land improvements that are not specifically included in any other asset class are 15-year property (Asset Class 00.3). Examples include sidewalks, driveways, curbs, roads, parking lots, canals, waterways, drainage facilities, sewers (but not municipal sewers), wharves and docks, bridges, and nonagricultural fences. Landscaping and shrubbery is a depreciable land improvement if it is located near a building and would be destroyed if the building were replaced (Rev. Rul. 74-265; IRS Pub. 946). Playground equipment attached to the ground is a land improvement (LTR 8848039).

15-Year Leasehold Improvement Property. See ¶ 1234 and ¶ 1237.

15-Year Restaurant Improvements and Buildings. Qualified restaurant property placed in service after October 22, 2004, and before January 1, 2018, is a category of 15-year MACRS property, depreciable using the straight-line method and the half-year or mid-quarter convention, as applicable (Code Sec. 168(e)(3)(E)(v) and (e)(7), prior to repeal by the Tax Cuts and Jobs Act (P.L. 115-97)). The ADS recovery period is 39 years. Qualified restaurant property is removed as a category of 15-year property effective for property placed in service after 2017. 15-year qualified improvement property replaces

the 15-year qualified restaurant category, effective for property placed in service after 2017. See below, "*Qualified Improvement Property*".

Qualified restaurant property is section 1250 property that is an improvement to a building. More than 50 percent of the building's square footage must be devoted to preparation of and seating for on-premises consumption of prepared meals. For restaurant improvements placed in service before 2009, the building must also be more than three years old. A restaurant building placed in service after 2008 and before 2018 is included in the definition of qualified restaurant property and is depreciated as 15-year property using the straight-line method and half-year or mid-quarter convention if more than 50 percent of the building's square footage is devoted to preparation of and seating for the on-premises consumption of prepared meals.

The bonus depreciation deduction may not be claimed on qualified restaurant property placed in service after 2008 and before 2016 unless it meets the definition of qualified *leasehold* improvement property (¶ 1234 and ¶ 1237) (Code Sec. 168(e)(7)(B), prior to amendment by the Consolidated Appropriations Act, 2016 (P.L. 114-113); Rev. Proc. 2011-26). Qualified restaurant property placed in service in 2016 and 2017 qualifies for bonus depreciation if it meets the definitional requirements of qualified improvement property (Code Sec. 168(e)(7)(B), prior to repeal by P.L. 115-97). Qualified restaurant property is a type of qualified real property that qualifies for expensing under Code Sec. 179 if placed in service in a tax year beginning before 2018 (¶ 1208).

15-Year Qualified Retail Improvement Property. Qualified retail improvement property placed in service after 2008 and before 2018 is a separate category of MACRS 15-year property which is depreciated under MACRS using a 15-year recovery period, the straight-line method, and the half-year or mid-quarter convention (Code Secs. 168(b)(3)(I) and (e)(3)(E)(ix), prior to repeal by P.L. 115-97). The ADS recovery period is 39 years.

Qualified retail improvement property means any improvement to an interior portion of a building which is nonresidential real property if the improved portion is (1) open to the general public, (2) used in the retail trade or business of selling tangible personal property to the general public, and (3) placed in service more than three years after the date the building was first placed in service by any taxpayer. Elevators and escalators, internal structural framework of the building, structural components that benefit a common area, and improvements relating to the enlargement of a building do not qualify.

Qualified retail improvement property placed in service before 2016 is ineligible for bonus depreciation unless it also meets the definition of qualified leasehold improvement property (¶ 1234 and ¶ 1237) (Code Sec. 168(e)(8)(D), prior to amendment by P.L. 114-113; Rev. Proc. 2011-26). Qualified retail improvement property placed in service in 2016 and 2017 qualifies for bonus depreciation because it meets the definition of qualified improvement property. Qualified retail improvement property is a type of qualified real property that qualifies for expensing under Code Sec. 179 when placed in service in a tax year beginning before 2018 (¶ 1208).

Qualified Improvement Property. Qualified improvement property placed in service after December 31, 2017, is a separate category of MACRS 15-year property (Code Sec. 168(e)(3)(E)(vii), as added by the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136)). The straight-line method and half-year or mid-quarter convention apply (Code Sec. 168(b)(3)(G)). Qualified improvement property replaces the categories of 15-year qualified leasehold improvement property, 15-year qualified retail improvement property, and 15-year restaurant property effective for property placed in service after 2017.

As the result of a drafting error by the Tax Cuts and Jobs Act (P.L. 115-97) the intended 15-year recovery period for qualified improvement property placed in service after 2017 was not assigned. Thus, qualified improvement property placed in service after 2017 was depreciated as MACRS 39-year nonresidential real property. A technical correction made by P.L. 116-136 retroactively assigns the 15-year recovery period. As a result, qualified improvement property placed in service after 2017 may also qualify for bonus depreciation under the general rule that bonus depreciation applies to MACRS property with a recovery period of 20 years or less.

Taxpayers may file amended returns or a change in accounting method to change to the correct depreciation period and claim bonus depreciation (Rev. Proc. 2020-25).

Qualified improvement property is any improvement *made by the taxpayer* to an interior portion of a building which is nonresidential real property (whether or not the building is depreciated under MACRS) if the improvement is placed in service after the date the building was first placed in service. Expenditures which are attributable to the enlargement of a building, any elevator or escalator, or the internal structural framework of the building are excluded from the definition of qualified improvement property, but structural components that benefit a common area are not (Code Sec. 168(e)(6), as amended by P.L. 116-136).

20-Year Property. Twenty-year property includes property with a class life of 25 years or more, other than Code Sec. 1250 real property with a class life of 27.5 years or more. Water utility property and municipal sewers placed in service before June 13, 1996, and farm buildings (for example, barns and machine sheds) are included within this class (Code Sec. 168(e)(1) and (e)(3)(F)). Depreciable electric utility clearing and grading costs to place transmission and distribution lines into service are 20-year property.

25-Year Property. Water utility property and municipal sewers have a 25-year recovery period (Code Sec. 168(c) and (e)(5)). The straight-line depreciation method is mandatory for 25-year property (Code Sec. 168(b)(3)(F)).

27.5-Year Residential Rental Property. Residential rental property has a recovery period of 27.5 years. Residential rental property includes buildings or structures with respect to which 80 percent or more of the gross rental income is from dwelling units (Code Sec. 168(e)(2)(A)). It also includes manufactured homes that are residential rental property and elevators and escalators.

Nonresidential Real Property. Nonresidential real property is Code Sec. 1250 real property (¶ 1786) that is not residential rental property or property with a class life of less than 27.5 years (Code Sec. 168(e)(2)(B); Rev. Proc. 87-56). The cost of nonresidential real property placed in service after May 12, 1993, is recovered over 39 years. For property placed in service after 1986 and before May 13, 1993, cost is recovered over 31.5 years.

Farm Machinery and Equipment. Machinery and equipment, grain bins, and fences (but no other land improvements) used in specified agricultural activities are MACRS 7-year property and have a 10-year ADS recovery period (Asset Class 01.1). However, any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) that is used in a farming business (as defined in Code Sec. 263A(e)(4)), the original use of which commences with the taxpayer after December 31, 2017, and which is placed in service after December 31, 2017, is classified as MACRS 5-year property and has a 10-year ADS recovery period (Code Sec. 168(e)(3)(B)). The same rule applied to new machinery and equipment placed in service in 2009 (Code Sec. 168(e)(3)(B)(vii), prior to amendment by P.L. 115-97).

Indian Reservation Property. For qualified Indian reservation property placed in service after December 31, 1993, and before January 1, 2021, shortened MACRS recovery periods are provided for both regular tax and alternative minimum tax (AMT) purposes. A taxpayer may make an irrevocable election to use the regular recovery periods for any class of MACRS Indian reservation property placed in service during the tax year. No AMT adjustment is required even if an election out of a shortened recovery period is made (Code Sec. 168(j)).

Additions and Improvements. Additions and improvements, including the cost of capitalized structural components, are depreciated under MACRS in the same way that the improved property would be depreciated if it were placed in service at the same time as the addition or improvement (Code Sec. 168(i)(6)). For example, a replacement roof or other structural component added to a commercial building in 2020 is treated as 39-year MACRS nonresidential real property even if the building is depreciated under a pre-MACRS method. Any elements of an addition or improvement to a building that qualify as personal property may be depreciated over a shorter recovery period as personal rather than real property under the cost segregation rules (discussed below).

Effective for property placed in service after 2017, most improvements to the interior of nonresidential real property are depreciated over a 15-year recovery period as

qualified improvement property (Code Sec. 168(e)(6); Code Sec. 168(e)(3)(E)(vii), as added by P.L. 116-136). See above, *"Qualified Improvement Property."*

Interior improvements placed in service before 2018 may qualify for a 15-year recovery period as qualified leasehold improvement property (¶ 1234) or qualified retail improvement property (discussed above). A 15-year recovery period may also apply to qualified restaurant property (discussed above), which includes most interior and exterior improvements and restaurant buildings, placed in service before 2018.

Roofs. The replacement of an entire roof (including the sheathing and rafters) or a significant portion of a roof that has deteriorated over time is a restoration that is capitalized as an improvement (Reg. §1.263(a)-3(k)(6)(ii)(A) and (k)(7), Example 14). The replacement of a worn and leaking waterproof membrane on a roof comprised of structural elements, insulation, and a waterproof membrane with a similar but new membrane is not required to be capitalized if the membrane was not leaking when the taxpayer placed the building in service (Reg. §1.263(a)-3(j)(3), Example 13, and (k)(7), Example 15). Another IRS example dealing with removal costs (¶ 1313) assumes that the cost of replacement shingles that are similar to shingles that became leaky while the taxpayer owned the building is not capitalized (Reg. §1.263(a)-3(g)(2)(ii), Example 3). In tax years beginning after 2017, a replacement roof on nonresidential real property is a type of qualified real property which may qualify for section 179 expensing (¶ 1208).

Cost Segregation. The Tax Court has ruled that elements of a building that are treated as personal property under the former investment tax credit rules (Reg. §1.48-1(c)) may be separately depreciated under MACRS and ACRS as personal property (*Hospital Corp. of America*, 109 TC 21, Dec. 52,163). The IRS has acquiesced to the court's holding that the former investment tax credit rules apply in determining whether an item is a structural component (real property) or personal property (Notice of Acquiescence, 1999-35 I.R.B. 314). The separate depreciation of personal property elements of a building is referred to as cost segregation.

The determination of whether an item is personal property or a structural component often depends on the specific facts. One important factor is whether the item is permanently attached to the building (*Whiteco Industries*, 65 TC 664, Dec. 33,596). However, items relating to the operation and maintenance of the building are structural components even if not permanently attached. The following items are examples of structural components: bathtubs, boilers, ceilings (including acoustical ceilings), central air conditioning and heating systems, chimneys, doors, electric wiring, fire escapes, floors, hot water heaters, HVAC units, lighting fixtures, paneling, partitions (if not readily removable), plumbing, roofs, sinks, sprinkler systems, stairs, tiling, walls, and windows (Reg. §1.48-1(e)(2)).

1243. MACRS Recovery Methods. Under the Modified Accelerated Cost Recovery System (MACRS), the cost of depreciable property is recovered using the applicable depreciation method, the applicable recovery period, and the applicable convention (Code Sec. 168(a)).

The cost of property in the 3-, 5-, 7-, and 10-year classes is recovered using the 200-percent declining-balance method over three, five, seven, and ten years, respectively (the applicable recovery period), and the half-year convention (unless the mid-quarter convention applies), with a switch to the straight-line method in the year when that maximizes the deduction (Code Sec. 168(b)(1)). The cost of 15- and 20-year property is recovered using the 150-percent declining-balance method over 15 and 20 years, respectively, and the half-year convention (unless the mid-quarter convention applies), with a switch to the straight-line method to maximize the deduction (Code Sec. 168(b)(2)). The cost of residential rental and nonresidential real property is recovered using the straight-line method and the mid-month convention over 27.5- and 39-year recovery periods, respectively (Code Sec. 168(b)(3)).

A taxpayer may irrevocably elect to claim straight-line MACRS deductions over the regular recovery period in place of the applicable depreciation method (200-percent declining balance method for 3-, 5-, 7-, and 10-year property and 150-percent declining balance method for 10- and 15-year property). The election applies to all property in the MACRS class for which the election is made that is placed in service during the tax year. A taxpayer makes the election on the return for the year the property is first placed in

service (Code Sec. 168(b)(5)). For example, if the election is made for 3-year property, it applies to all 3-year property placed in service in the tax year of the election.

A taxpayer may elect to recover the cost of 3-, 5-, 7-, and 10-year property using the 150-percent declining-balance method over the regular recovery periods (the MACRS alternative depreciation system (ADS) recovery period for property placed in service before 1999) (¶ 1247) (Code Sec. 168(b)(2)(C)). This election, like the straight-line election above, is made separately for each property class placed in service during the tax year of the election. A taxpayer may also elect the MACRS ADS with respect to any class of property.

If 3-, 5-, 7-, and 10-year property placed in service before 2018 is used in the trade or business of farming, it must be depreciated under the 150-percent declining balance method, unless the taxpayer elects the MACRS straight-line method or alternative depreciation system (ADS), or the taxpayer must use ADS because the taxpayer elected to deduct preproductive period expenditures (Code Sec. 168(b)(2)(B), prior to repeal by the Tax Cuts and Jobs Act (P.L. 115-97)). Consequently, Tables 1-8, below, may not be used for such property. 3-, 5-, 7-, and 10-year farm property is depreciated using the 200-percent declining balance method if placed in service after 2017 unless an election to use the 150-percent declining balance method, straight-line method, or ADS is made, or the taxpayer elects to deduct preproductive period expenditures.

Computation of Deduction Without Tables. The MACRS deduction on personal property is computed by first determining the rate of depreciation (dividing the number one by the recovery period) (Rev. Proc. 87-57). This basic rate is multiplied by 1.5 or 2 for the 150-percent or 200-percent declining-balance method, as applicable, to determine the declining balance rate. The adjusted basis of the property is multiplied by the declining-balance rate and the half-year or mid-quarter convention (whichever is applicable) is applied in computing depreciation for the first year. The depreciation claimed in the first year is subtracted from the adjusted basis before applying the declining-balance rate in determining the depreciation deduction for the second year.

Under the MACRS straight-line method (used, for example, on real property or if ADS applies), a new applicable depreciation rate is determined for each tax year in the applicable recovery period. For any tax year, the applicable depreciation rate (in percentage terms) is determined by dividing one by the length of the applicable recovery period remaining as of the beginning of such tax year. The rate is applied to the unrecovered basis of the property in conjunction with the appropriate convention. If as of the beginning of the tax year the remaining recovery period is less than one year, the applicable depreciation rate under the straight-line method for that year is 100 percent.

Example 1: A calendar-year taxpayer buys an item of five-year property in January ("Year 1") for $10,000. The taxpayer does not claim any Code Sec. 179 expense allowance or bonus depreciation. The 200-percent declining-balance method and half-year convention apply. Depreciation computed without the use of the IRS tables is determined as follows: the declining-balance depreciation rate is determined and compared with the straight-line rate. A switch is made to the straight-line rate in the year depreciation equals or exceeds that determined under the declining-balance method. The applicable rate is applied to the unrecovered basis.

The 200-percent declining-balance depreciation rate is 40 percent (1 divided by 5 (recovery period) times 2). The straight-line rate (which changes each year) is 1 divided by the length of the applicable recovery period remaining as of the beginning of each tax year (after considering the applicable convention in determining how much of the applicable recovery period remains as of the beginning of the year). For Year 4, the straight-line rate is .40 (1 divided by 2.5), which is the same as the declining balance rate. For Year 5, the straight-line rate is .6667 (1 divided by 1.5). For Year 6, the straight-line rate is 100 percent because the remaining recovery period is less than one year.

- a qualified supplemental security income (SSI) recipient (an individual receiving SSI for any month ending during the 60-day period ending on the hiring date);

- a long-term family assistance (TANF) recipient (described below), but the maximum qualified wages is $10,000 for the first and $10,000 for the second year, and the credit percentage increases to 50 percent for the second year; or

- a long-term unemployment recipient (an individual unemployed for at least 27 weeks that includes a period when he or she was receiving unemployment compensation under state or federal law).

Certifications. An employer of a member of a targeted group must have the individual certified by an authorized local agency prior to the individual's first day of work, or apply to certify the individual within 28 days of the first day of work. The employer uses Form 8850 to pre-screen employees and to make a written request that the local agency certify an employee as being a member of a targeted group (Notice 2012-13). The due date for performing certain time-sensitive actions, including submitting Form 8850, otherwise due on or after April 1, 2020, and before July 15, 2020, was automatically extended to July 15, 2020, in response to the COVID-19 (coronavirus) crisis (Notice 2020-23; Rev. Proc. 2018-58).

TANF recipients. A long-term family assistance recipient is an individual who is certified by the designated local agency as a member of a family that:

- has been receiving TANF payments for at least the 18-month period ending on the hiring date;

- receives TANF payments for at least 18 months, if the worker's hiring date is not more than two years after the 18-month total is reached; or

- is no longer eligible for TANF payments because of a limitation imposed under federal or state law on the maximum duration such assistance is payable, if the worker's hiring date is not more than two years after eligibility expires.

Qualified Veterans. A qualified veteran is a veteran who is certified as:

- a member of a family receiving SNAP benefits for at least a three-month period ending during the 12-month period ending on the hiring date;

- unemployed for at least four weeks (consecutive or not) but less than six months during the one-year period ending on the hiring date;

- unemployed for at least six months (consecutive or not) during the one year period ending on the hiring date, but the qualified wage limit is $14,000;

- entitled to compensation for a service-connected disability and hired within one year of being discharged or released from active duty in the U.S. Armed Forces, but the qualified wage limit is $12,000; or

- entitled to compensation for a service-connected disability, and unemployed for at least six months (consecutive or not) during the one-year period ending on the hiring date, but the qualified wage limit is $24,000 (Code Sec. 51(b)(3), (d)(3), and (d)(13)(D)).

Tax-Exempt Organizations and Qualified Veterans. A tax-exempt organization, other than an exempt farmers' cooperative generally cannot claim the work opportunity credit (Code Sec. 52(c)). However, a Code Sec. 501(c) exempt organization may use Form 5884-C to claim a reduced credit of 26 percent of qualified wages paid to qualified veterans. The form is filed separately and is not attached to any other return. The credit is allowed against the organization's FICA tax obligation on wages paid to the veteran within one year of hiring (Code Sec. 3111(e)). However, the liability on the organization's employment tax return is not reduced by the credit. Instead, the credit is processed separately and the amount properly claimed is refunded to the exempt organization. This is likely to occur after the filing of the return, so an organization should not reduce its FICA obligations on returns in anticipation of the refund (Notice 2012-13).

Employee Retention Credit. An eligible employer may claim a tax credit equal to 40 percent of up to $6,000 of wages paid to each employee if the employer is affected by (1) a qualified disaster occurring from January 1, 2018, through February 18, 2020, (2) the California wildfires in 2017, or (3) Hurricane Harvey, Irma, or Maria (¶ 1465P). The

employer cannot claim the employee retention credit and the work opportunity credit for the same employee during the same period.

1465H. Employer Credit for Paid Family and Medical Leave. An eligible employer may claim a credit in tax years beginning in 2018, 2019, and 2020 for an applicable percentage of wages paid to qualifying employees for leave under the Family and Medical Leave Act (FMLA) (Code Sec. 45S, as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94); Notice 2018-71). However, any leave paid by a state or local government, or required by state or local law, is not taken in account. The credit is part of the general business credit, subject to its tax liability limitation and carryover rules (¶ 1465). The credit reduces the employer's deduction for wages and salaries (Code Sec. 280C). An employer claims the credit on Form 8994.

The credit starts at 12.5 percent of wages paid during the leave period if the rate of payment is at least 50 percent of wages normally paid. The credit percentage is increased by .25 percentage points for each percentage point that the rate of payment exceeds 50 percent of wages, up to a maximum applicable percentage of 25 percent. The credit with respect to any employee for any tax year is limited to the employee's normal hourly wage rate multiplied by the number of hours of FMLA leave taken. Wages for an employee who is not paid an hourly wage rate are prorated to an hourly wage rate. The credit covers a maximum of 12 weeks of FMLA leave.

Eligible Employer. An eligible employer must have a written policy that provides all qualifying employees at least two weeks of annual paid FMLA leave, prorated for part-time employees. Eligible FMLA leave is limited to leave for one of the following events: birth of an employee's child; placement of child with the employee for adoption or foster care; the employee's serious health condition, or care for the employee's spouse, child, or parent with a serious health condition; any qualifying exigency due to an employee's spouse, child, or parent being on active duty (or notified of an impending call to active duty) in the Armed Forces; and care for a service member who is the employee's spouse, child, parent, or next of kin.

The policy must provide a payment rate of at least 50 percent of an employee's normal wages. If the employer employs any qualifying employees who are not covered by title I of the FMLA (for example, works less than 1,250 hours), the policy must include certain noninterference language. A transitional rule for the 2018 tax year provides that a policy (or amendment to an existing policy) adopted on or before December 31, 2018, is treated as in place on the retroactive effective date. The employer may make retroactive leave payments under the policy by the end of its 2018 tax year. An employer is not required to notify employees that it has a written policy for providing paid FMLA leave, but if notice is given then all eligible employees must be notified.

Qualifying Employee. An employee must be a qualifying employee when the FMLA is taken. A qualifying employee is any employee who has been employed by the employer for at least one year and whose compensation for the preceding year does not exceed 60 percent of the threshold for a highly-compensated individual (¶ 2114). Thus, a qualifying employee's compensation cannot exceed $78,000 for 2020 ($78,000 projected for 2021) (Notice 2019-59). An employer may use any reasonable method to determine length of employment, but it cannot require employment for 12 consecutive months, require an employee to work a minimum number of hours per year, or exclude any classification of employees from eligibility for paid family and medical leave.

Wages Defined. A qualifying employee's wages are the same as for federal unemployment taxes (FUTA) without regard to the $7,000 FUTA wage limitation. They generally include all remuneration paid for employment, but not any amount taken into account to determine other business-related tax credits. Wages paid by a third-party payor (for example, insurance company, professional employer organization) to qualifying employees for services performed for an eligible employer are considered paid by the eligible employer. Wages paid through an employer's short-term disability program for family and medical leave are also taken into account if the program meets the minimum paid leave requirements.

1465HA. Small Employer Health Insurance Credit. An eligible small employer with no more than 25 full-time equivalent employees may claim a tax credit for premiums it pays toward employee health coverage during a two-year credit period (Code Sec. 45R; Reg. §1.45R-5). The credit is computed on Form 8941 as part of the general

business credit, and is subject to its tax liability limitation and carryover rules (¶ 1465). Any credit that is unused at the end of the carryforward period may be deducted in the following year (Code Sec. 196). The deduction for employer-paid premiums for qualified health plans is reduced by the amount of the credit (Code Sec. 280C(h)).

Credit Amount. The credit is generally equal to 50 percent of the lesser of:

(1) the total nonelective contributions the employer makes on behalf of its employees during the tax year under a contribution arrangement for premiums to qualified health plans offered through a state-sponsored Small Business Health Options Program (SHOP) Exchange; or

(2) the total nonelective contributions that would have been made during the tax year if each employee taken into account in item (1) had enrolled in a qualified health plan that had a premium equal to the average premium for the small group market in the rating area where the employee enrolls for coverage (Reg. § 1.45R-3).

The employer must have a contribution arrangement that requires it to make a nonelective contribution on behalf of each employee who enrolls in a qualified health plan offered by the employer. The contribution amount must be equal to a uniform percentage, but not less than 50 percent, of the premium cost. An employer contribution is nonelective so long as it is not made through a salary reduction arrangement. In addition, the contribution arrangement must offer the insurance through a SHOP Exchange.

The credit percentage for a tax-exempt eligible small employer is 35 percent, but the credit may not exceed the exempt organization's payroll taxes during the calendar year in which the tax year begins. A tax-exempt eligible small employer is a small employer that is also a Code Sec. 501(c) organization. The organization claims the credit by filing Form 990-T with Form 8941 attached.

Credit Phaseout. The credit amount is reduced, but not below zero, by the sum of:

- the credit multiplied by the number of the employer's full-time equivalent employees for the tax year in excess of 10, divided by 15; and
- the credit multiplied by the employer's average annual wages in excess of the applicable dollar amount for the tax year ($27,600 for 2020; projected to be $27,800 for 2021), divided by the applicable dollar amount (Rev. Proc. 2019-44).

Eligible Employer and Employees. An employer is an eligible small employer if during the tax year:

- the employer has 25 or fewer full-time equivalent employees;
- the average annual wages of these employees is not greater than twice the applicable dollar amount for the tax year ($55,200 for 2020; projected to be $55,600 for 2021); and
- the employer has a qualified health care arrangement in effect (Reg. § 1.45R-2).

All controlled groups, partnerships, and affiliated service groups treated as a single employer under Code Sec. 414(b), (c), (m), or (o) are treated as one employer.

The number of full-time equivalent employees during a tax year is equal to the total number of hours for which the employer paid wages to the employees, divided by 2,080. A fractional result is rounded to the next lowest whole number. Only the first 2,080 hours of each employee's wages are taken into account. For purposes of determining average annual wages and the number of full-time equivalent employees, a seasonal worker's wages and hours of service are not taken into account unless the worker works for the employer on more than 120 days during the tax year.

The following workers are not employees, and their hours, wages, and premiums are not counted when figuring the credit: the owner of a sole proprietorship (self-employed); a partner in partnership; a shareholder who owns more than two percent of an S corporation, or more than five percent of any other business; the individual's spouse; or any person who satisfies the relationship test for such an individual's qualifying relative as defined for purposes of the claiming a dependent (¶ 137B), (Reg. § 1.45R-1(a)(5)). Leased employees are considered employees.

Credit Period. The small employer health insurance credit may be claimed only during the employer's two-year credit period. The credit period is the two-consecutive-

tax-year period beginning with the first tax year in which the employer offers one or more qualified health plans to its employees through a SHOP Exchange. The credit period does not begin until the first year the employer files a return claiming the credit. An employer may be able to claim the credit if coverage is provided under a SHOP Exchange for all or part of the tax year, but the employer cannot provide a qualified health plan for the remainder of the credit period because the employer's principal business address is in a county where no SHOP plans are available (Notice 2018-27).

1465I. Biofuel Producer Credit. A producer may claim a credit for any sale or use of alcohol fuels or alcohol fuel mixtures produced in the United States and used as a fuel in the United States (including possessions) (Code Sec. 40, as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94)). The credit has several components, but currently applies only to second generation biofuel production before January 1, 2021. All other components of the credit (alcohol mixture credit, alcohol credit, and small ethanol producer credit) expired at the end of 2011. The credit is calculated on Form 6478.

The biofuel producer credit is part of the general business credit, but the tax liability limitation is calculated separately and the credit may be claimed against both regular and alternative minimum tax liability (¶ 1465). Also, the carryforward period is limited to three tax years after the relevant fuel's termination year and any carryforward that is unused at the end of the carryforward period is deductible in the following tax year (Code Sec. 196). A taxpayer may elect not to claim the credit. Any second generation biofuel claimed on Form 6478 cannot also be claimed as part of the biodiesel and renewable diesel fuels credit (¶ 1465X).

The credit is equal to $1.01 per gallon of qualified second generation biofuel produced by a qualified second generation biofuel producer before January 1, 2021 (Code Sec. 40(b)(6), as amended by P.L. 116-94). Second generation biofuel is any liquid fuel derived from qualified feedstock including lignocellulosic or hemicellulosic matter available on a renewable or recurring basis (most plants, animal waste, and municipal solid waste), and any cultivated algae, cyanobacteria, or lemna. The fuel must meet the Environmental Protection Agency registration requirements for fuel and fuel additives established under the Clear Air Act, and must not be alcohol of less than 150 proof. A producer of second generation biofuel must register with the IRS using Form 637.

The second generation biofuel must be used by the producer or sold to another person: (1) for use in a trade or business to produce a second generation biofuel mixture (other than casual off-farm production), (2) for use as a fuel in a trade or business, or (3) to sell to another person at retail and place in the retail buyer's fuel tank. The credit is recaptured on each gallon of second generation biofuel at the original credit rate if the producer does not use the fuel for the required purposes (Code Sec. 40(d)(3)). The recapture tax is reported on Form 720.

1465J. Research Credit. A taxpayer may claim a credit for incremental research expenses on Form 6765 (Code Sec. 41). The research credit is part of the general business credit and is generally subject to its tax liability limitation and carryover rules (¶ 1465). However, an eligible small business may calculate the tax liability limit for the research credit separately, and use the credit against both regular and alternative minimum tax liabilities. An eligible small business is a partnership, sole proprietorship, or corporation (without publicly traded stock) if average annual gross receipts for the three preceding tax years are less than $50 million (Code Sec. 38(c)(4) and (c)(5)). Any credit that remains unused at the end of the carryforward period is deductible in the following tax year unless the taxpayer elected to reduce the credit in order to claim a larger deduction (Code Sec. 196).

Credit Amount. Unless the taxpayer elects to use the alternative simplified credit computation (discussed below), the research credit is the sum of:

- 20 percent of the excess of qualified research expenses for the current tax year over a base period amount;
- 20 percent of the basic research payments made to a qualified organization; and
- 20 percent of the amounts paid or incurred in carrying on any trade or business to an energy research consortium for qualified energy research (Code Sec. 41(a)).

The base period must be adjusted when the major portion of a business that paid or incurred research expenses is acquired or disposed of by the taxpayer.

Base Amount. The base period amount is the product of the taxpayer's fixed-base percentage and average annual gross receipts for the four tax years preceding the credit period (Code Sec. 41(c)). The base amount may not be less than 50 percent of the qualified research expenses for the credit year. The fixed-base percentage is aggregate qualified research expenses compared to aggregate gross receipts for 1984 through 1988 tax years. It may not exceed 16 percent.

Start-Up Company. A start-up company's fixed-base percentage is three percent for each of the first five tax years that it has qualified research expenses. The fixed-base percentage for the sixth through tenth tax years it has qualified research expenses is a portion of the percentage that qualified research expenses bear to gross receipts for specified preceding years. For subsequent years, the fixed-base percentage is the whole percentage that qualified research expenses bear to gross receipts for any five years selected by the taxpayer from the fifth through tenth tax years. A start-up company includes a taxpayer who has both gross receipts and qualified research expenses for the first time in a tax year that begins after 1983.

Alternative Simplified Credit. A taxpayer may elect an alternative simplified credit method to calculate the research credit (Code Sec. 41(c)(4)). The alternative credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding tax years. If the taxpayer has no qualified research expenses for any of those years, the credit is equal to six percent of the qualified research expenses for the current tax year. An election to use the alternative simplified credit method is effective for succeeding tax years unless revoked with the consent of the IRS.

Deduction for Research and Experimental Expenditures. For expenses paid or incurred in tax years beginning before 2022, a taxpayer's deduction for research and experimental expenditures (¶ 979) is reduced by the amount of the research credit (Code Sec. 280C(c), prior to amendment by the Tax Cuts and Jobs Act (P.L. 115-97)). Capitalized expenses must also be reduced by the amount of the research credit that exceeds the amount otherwise allowable as a deduction for such expenses. The taxpayer can make an annual irrevocable election to claim a reduced research credit and thereby avoid reducing the research expense deduction or capital expenditures. An electing taxpayer must reduce the research credit by the product of the research credit computed in the regular manner and the maximum corporate income tax rate. For expenditures paid or incurred in tax years beginning after 2021, the amount capitalized and otherwise eligible for amortization over five years (15 years for foreign research) is reduced by the excess (if any) of the research credit allowed for the tax year and the amount allowable as a deduction for the tax year as qualified research expenses or basic research expenses.

Qualified Research Expenses. Qualified research expenses are the same as those for the business expense deduction for research expenses (¶ 979), other than: expenses for foreign research; research in the social sciences, arts or humanities; and subsidized research. The research must be undertaken to discover information that is technological in nature and intended to be useful in the development of a new or improved business component. The research must also relate to elements of a process of experimentation for a functional purpose (it must relate to a new or improved function, performance, reliability, or quality).

Qualified research expenses include in-house expenses for the taxpayer's own research (wages, including income from employees' exercise of stock options, for substantially engaging in or directly supervising or supporting research activities, supplies, and computer use charges) and 65 percent of amounts paid or incurred for qualified research done by a person other than an employee of the taxpayer. The percentage is increased to 75 percent of amounts paid or incurred for qualified research performed by a qualified research consortium, which is a tax-exempt organization under Code Sec. 501(c)(3) or (c)(6) that (1) operates primarily to conduct energy research, and (2) has at least five unrelated customers, with no single person accounting for more than 50 percent of the revenues of the organization.

An ACS 730 Financial Statement establishes the amount of a taxpayer's qualified research expenses for the tax year if the taxpayer has at least $10 million in assets and follows U.S. GAAP to prepare certified financial statements. This audit protection applies to original returns timely filed (including extensions) on or after September 11, 2017 (IRS News Release 2017-158; Large Business and International Directive (LB&I-04-0917-005)).

Qualified Energy Research Expenditures. The credit for expenditures to an energy research consortium applies to qualified energy research only. The percent limitation placed on outside research does not apply to energy research. Amounts paid or incurred for any energy research conducted outside of the United States, Puerto Rico, or a U.S. possession are not taken into account (Code Sec. 41(f)(6)(C)).

Pass-Through Entities. For an individual who owns an interest in an unincorporated trade or business, or is a partner in a partnership, a beneficiary of an estate or trust, or an S corporation shareholder, the research credit is limited to the amount of tax attributable to the individual's interest in the trade, business, or entity. The individual's passed-through credit that exceeds this limit may be carried to other tax years (Code Sec. 41(g)).

Payroll Tax Credit in Lieu of Research Credit. A qualified small business may elect to apply a portion of its research credit against the 6.2-percent payroll tax imposed on an employer's wage payments to employees (Code Sec. 41(h); Notice 2017-23). A taxpayer is a qualified small business for a tax year if its gross receipts are less than $5 million and it did not have gross receipts in any tax year preceding the five-tax-year period that ends with the tax year of the election. If the taxpayer is a partnership or a corporation (including an S corporation), these tests apply to the entity's receipts. Otherwise, these tests apply to the taxpayer's receipts from all of its trades or businesses.

The taxpayer may make the election for any five tax years. The taxpayer uses Form 6765 to make the election and identify how much of the research credit to apply toward payroll tax liability. The election is then completed on Form 8974 and attached to Form 941 or other applicable payroll tax return each quarter that the credit is claimed. The election deadline is on or before the due date (including extensions) of the qualified small business's income tax return or information return. The election may be revoked only with IRS consent. A transition rule allows a taxpayer that did not make the election on its timely filed return for a tax year beginning after 2015 to make the election on an amended return filed before January 1, 2018.

1465K. Low-Income Housing Credit. A taxpayer may claim a credit for each low-income unit in qualified low-income buildings in qualified low-income housing projects (Code Sec. 42). The credit is computed on Form 8586 and is part of the general business credit, subject to its tax liability limitation and carryover rules (¶ 1465).

A qualified low-income housing project is a housing project or residential rental property that is subject to MACRS depreciation, and meets requirements for low-income tenant occupancy, gross rent restrictions, state credit authority, and IRS certification. The project must continue to meet these requirements for 15 years, or the taxpayer may have to recapture a portion of the credit on Form 8611. Unless the housing project is financed by tax-exempt bonds subject to the volume cap (¶ 729), the credit is limited to the amount that a state or local housing credit agency allocates on Form 8609.

The owner of a qualified low-income housing project that is constructed, rehabilitated, or acquired may claim the credit over a 10-year period in an amount equal to the applicable credit percentage appropriate to the type of project, multiplied by the qualified basis allocable to the low-income units in each qualified low-income building. The taxpayer begins to claim the credit in the tax year the project is placed in service. However, the taxpayer can elect to start claiming the credit in the next tax year if the building is a qualified low-income building at the end of the first year of the 10-year credit period. The first-year credit is reduced to reflect any time the qualified low-income unit is unoccupied, but the reduction amount is allowed as a credit in the first year after the credit period ends. The credit cannot be claimed unless the owner of the qualified building is subject to an enforceable 30-year low-income use agreement with the housing credit agency. The credit is not limited or disallowed by the hobby loss rules (¶ 1195) (Reg. § 1.42-4).

or incurred for services performed within the zone by residents of the zone (Code Sec. 1396). Empowerment zones designations are effective through December 31, 2020. The credit is computed on wages paid during the calendar year that ends within the employer's tax year. The credit is calculated on Form 8844 and is part of the general business credit, but the tax liability limitation is calculated separately and the credit may offset up to 25 percent of alternative minimum tax liability. The taxpayer's deduction for wages and salaries is reduced by the amount of the credit (Code Sec. 280C).

1465P. Employee Retention Credit. An eligible employer affected by a qualified disaster occurring from January 1, 2018, through February 18, 2020, may claim a tax credit equal to 40 percent of up to $6,000 of qualified wages paid or incurred with respect to each eligible employee. The credit is claimed on Form 5884-A and is part of the general business credit, subject to its tax liability limitation and carryover rules except that the employee retention credit may not be carried back to a tax year prior to the tax year in which the credit was first available (¶ 1465). The credit may not be claimed for an employee during any period that the employer claims the work opportunity credit (¶ 1465G) with respect to the employee (Act Secs. 201 and 203 of the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94)).

An employer is eligible for the qualified disaster employee retention credit if it conducted an active trade or business in a qualified disaster zone at any time during the incident period of a qualified disaster. The trade or business must have been inoperable at any time during the period beginning on the first day of the disaster's incident period and ending on December 20, 2019, because of damages sustained by reason of the disaster.

The credit applies to qualified wages paid or incurred (1) beginning on the date the business became inoperable at the employee's principal place of employment; and (2) ending on the earlier of the date significant operations are resumed or 150 days after the last day of the incident period. Qualified wages are those paid or incurred with respect to an eligible employee during the period when the trade or business becomes inoperable because of the qualified disaster. Wages qualify for the credit even if the employee performs no services for the employer, performs services for the employer at a different place of employment, or performs services at the principal place of employment before significant operations resume. An eligible employee is an employee whose principal place of employment with the employer immediately before the disaster was in the qualified disaster zone.

Qualified Disaster. A qualified disaster is any major disaster declared between January 1, 2018, and February 18, 2020, by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act if the incident period of the disaster begins on or before December 20, 2019. The incident period is the period specified by the Federal Emergency Management Agency as the period that the disaster occurred, except it is not treated as beginning before January 1, 2018, or ending after January 19, 2020. For a list of disaster declarations and incident periods, see https://www.fema.gov/disasters/year, or the instructions for Form 5884-A.

The 2017 California wildfire disaster, as well as Hurricanes Harvey, Irma, and Maria in 2017, are not qualified disasters for purposes of this credit. Instead, an eligible employer affected by these disasters may use Form 5884-A to claim a separate credit equal to 40 percent of up to $6,000 of qualified wages paid or incurred with respect to an eligible employee (Act Secs. 20101 and 20103 of the Bipartisan Budget Act of 2018 (P.L. 115-123); Act Secs. 501 and 503 of the Disaster Tax Relief and Airport and Airway Extension Act (P.L. 115-63)).

1465Q. Indian Employment Credit. An employer may claim a credit for certain wages and health insurance costs paid or incurred in tax years beginning before January 1, 2021, for qualified employees and their spouses who are enrolled members of an Indian tribe (Code Sec. 45A, as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94)). The credit is calculated on Form 8845 and is part of the general business credit, subject to its tax liability limitation and carryover rules (¶ 1465). Any unused credit at the end of the carryforward period is deductible in the following year (Code Sec. 196). The taxpayer's deduction for wages and salaries is reduced by the amount of the credit (Code Sec. 280C).

The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs paid or incurred during a tax year over the amount of the costs paid or incurred during 1993. The credit is available only for the first $20,000 of qualified wages and health insurance costs paid for each qualified employee. Qualified wages are wages paid or incurred by an employer for services performed by a qualified employee, excluding wages for which the work opportunity credit (¶ 1465G) is allowed. Qualified health insurance costs are costs paid or incurred by an employer for a qualified employee, except for costs paid under a salary reduction agreement.

An individual is a qualified employee for any period only if: (1) the individual is, or is married to, an enrolled member of an Indian tribe; (2) substantially all of the employee's services performed for the employer are within an Indian reservation; and (3) the employee's principal place of abode while performing the services is on or near the reservation on which the services are performed. Also, more than 50 percent of the employee's wages from the employer for the tax year must be for services performed in a trade or business of the employer. Employees whose wages exceed $50,000 for 2020 are not eligible employees.

1465R. FICA Tip Credit (for Employer-Paid FICA Taxes on Employee Cash Tips). An employer in the food and beverage industry may claim an income tax credit for a portion of its Social Security and Medicare taxes (FICA taxes) paid or incurred on employee tips (Code Sec. 45B). Employee tip income is treated as employer-provided wages for purposes of FICA taxes (Code Sec. 3121(q)). The FICA tip credit is claimed on Form 8846 and is part of the general business credit, but the tax liability limitation is calculated separately and the credit may be claimed against both regular and alternative minimum tax liability (¶ 1465).

The credit is equal to the employer's FICA obligation to an employee attributable to excess tips treated as wages for purposes of satisfying the minimum wage provisions of the Fair Labor Standards Act. The credit cannot be claimed for the employer's portion of FICA taxes on tips used to meet a federal minimum wage rate of $5.15 per hour. The credit is allowed for tips received from customers in connection with providing, delivering, or serving food or beverages for consumption, if tipping by customers is customary. The credit is available whether or not the employee reported the tips and regardless of where the services were performed. The employer may not deduct any amount considered in determining the credit. The employer may elect not to apply the credit.

1465S. Orphan Drug Credit. A taxpayer that invests in the development of drugs to diagnose, treat, or prevent qualified rare diseases and conditions that affect fewer than 200,000 persons in the United States can claim an orphan drug tax credit equal to 25 percent of qualified clinical testing expenses incurred or paid during the development process (50 percent of qualified expenses for tax years beginning before 2018) (Code Sec. 45C). The credit is claimed on Form 8820 and is part of the general business credit, subject to its tax liability limitation and carryover rules (¶ 1465). A taxpayer's amortization or deduction of qualified expenses is generally reduced by the amount of the credit claimed, but the taxpayer may elect a reduced credit amount after 2017 in lieu of reducing the amortization or deduction of the expenses (Code Sec. 280C(b)).

1465T. New Markets Tax Credit. The new markets tax credit may be claimed for equity investments made in low-income communities through a qualified community development entity (CDE) (Code Sec. 45D, as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94)). The investment must be made within five years after the CDE receives an allocation of the national credit limitation amount for the calendar year ($5 billion for 2020). The credit is equal to five percent of the investment for the first three allowance dates, and six percent of the investment for the next four allowance dates. The total credit available is equal to 39 percent of the investment over seven years.

A CDE receiving returns on investments (including principal repayments from amortizing loans) must reinvest those proceeds into other qualified low-income community investments during the seven-year credit period; otherwise, the taxpayer may have to recapture the credit. The due dates for making investments, making reinvestments, and expending amounts for construction of real property that are due to be performed or expended on or after April 1, 2020, and before December 31, 2020, were postponed to December 31, 2020, as result of the COVID-19 (coronavirus) pandemic (Notice 2020-49).

in effect, and (4) adding the two amounts determined in (3). The sum of these two amounts is the RIC's income tax for the fiscal year that includes January 1, 2018 (Notice 2018-38).

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

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

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

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

Excise Taxes. A nondeductible excise tax is generally imposed on a RIC that does not satisfy minimum distribution requirements (Code Sec. 4982). The tax is four percent of the excess of any required distribution for the calendar year over the amount actually distributed for the calendar year. For this purpose, the required distribution is the sum of 98 percent of the corporation's ordinary income for the year, plus 98.2 percent of its net capital gain income for the one-year period ending October 31 of the calendar year. Special rules apply for how a RIC treats post-October 31 capital gains and foreign currency losses.

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

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

gains for the tax year over the amount of any capital gains dividends paid during the year (Code Sec. 852(b)(3)).

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

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

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

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

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

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

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

The aggregate amount that the RIC can report as dividends eligible for the dividends-received deduction is limited to its aggregate dividends received from domestic corporations for the tax year. The aggregate amount that the RIC can report as qualified dividend income is limited to its qualified dividend income for the tax year (Code Sec. 854(b)(1)(C)). Additionally, within 60 days after the close of its tax year, a RIC must report and notify its shareholders of the portion of distributions made during the tax year that is designated as undistributed capital gain (Code Sec. 852(b)(3)(D)).

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

If a publicly offered RIC (¶ 2315) makes a qualifying distribution of stock to shareholders who have the option to receive cash or stock, then the distribution is treated as a dividend under Code Sec. 301 (Rev. Proc. 2017-45; Rev. Proc. 2020-19). This treatment applies only if each shareholder has a cash or stock election with respect to any part of the distribution and at least 20 percent of the declared distribution consists of cash (10 percent for distributions declared between April 1, 2020, and December 31, 2020). The value of the stock received by any shareholder in lieu of cash is considered equal to the amount of cash for which the stock is substituted. If a shareholder participates in a dividend reinvestment plan, the stock received by that shareholder pursuant to the reinvestment plan is treated as received in exchange for cash received in the distribution.

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

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

A distribution that is not out of a RIC's earnings and profits is a return of the shareholder's investment. Return-of-capital distributions are generally not subject to tax and reduce the shareholder's basis in the RIC shares. On the other hand, distributions that are automatically reinvested by the shareholder into more shares of the fund are

taxed as if they had actually been received by shareholder in cash. Thus, reinvested ordinary dividends and reinvested capital gain distributions are generally includible in gross income, reinvested exempt-interest dividends are not reported as income, and reinvested return-of-capital distributions are reported as a return of capital (IRS Pub. 550).

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

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

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

A RIC's earnings and profits are generally computed under the rules that apply to an ordinary corporation. However, a RIC does not reduce its current earnings and profits by any amount it is unable to claim as a deduction from taxable income in that year (Code Sec. 852(c)(1)). A net capital loss for the tax year is also not taken into account in determining earnings and profits. Deductions disallowed in computing the RIC's taxable income with respect to tax-exempt interest are allowed in calculating its current earnings and profits (but not accumulated earnings and profits).

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

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

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

A USRPI generally does not include the stock of a REIT held directly, or indirectly through partnerships, by a publicly traded qualified shareholder entity. Additionally, distributions to the qualified shareholder will not be treated as gain from the sale or exchange of a USRPI to the extent that the stock of the REIT held by the qualified shareholders is not treated as a USRPI under this rule (Code Sec. 897(k)(2)).

Distributions of USRPIs. If a foreign corporation distributes a USRPI with respect to its stock, then the corporation recognizes gain (but not loss) to the extent the fair market value of the property at the time of distribution exceeds its adjusted basis (Code Sec. 897(d); Temp. Reg. §1.897-5T(c)). A foreign corporation may avoid recognizing gain if at the time of the distribution, the distributee would be subject to U.S. taxation on a subsequent disposition of the property and if the fair market value of the distributed property in the hands of the distributee is no greater than its basis increased by any amount of gain recognized by the distributing corporation. The foreign corporation is required to file a U.S. income tax return to report the distribution, even if it has no tax liability.

Nonrecognition Exchanges. Nonrecognition provisions of the Code apply to the exchange of a USRPI by a nonresident alien or foreign corporation if the property is exchanged for another USRPI that would be subject to U.S. tax upon its subsequent disposition and the transferor meets certain filing requirements (Code Sec. 897(e); Temp. Reg. §1.897-6T). Nonrecognition provisions for this purpose include like-kind exchanges (¶ 1721), involuntary conversions (¶ 1713), contributions and distributions related to partnerships (¶ 443 and ¶ 453), and corporate liquidations and reorganizations (¶ 2205 and ¶ 2253). The transfer of a USRPI in exchange for stock in a foreign corporation may also qualify for nonrecognition treatment. This includes contributions to capital or as paid in surplus (Code Sec. 897(j)).

Withholding. In order to ensure that a foreign investor will pay taxes on gain realized on the sale or disposition of a USRPI, the transferee is generally required to withhold and deduct a tax equal to 15 percent of the amount realized on the disposition (Code Sec. 1445; Reg. §§1.1445-1 and 1.1445-2). Special rules and withholding rates apply for distributions and other transactions by corporations, partnerships, estates, trusts, and qualified investment entities.

There are certain exemptions and exceptions from withholding. For example, an exemption from withholding applies if the amount realized on the disposition of a residence does not exceed $300,000. The withholding rate is 10 percent for amounts realized in excess of $300,000, but not in excess of $1 million, and 15 percent for amounts in excess of $1 million.

If the transferee fails to withhold the required tax, then it may be held liable for the tax, as well as any applicable penalties or interest. The transferee must file Form 8288 and Form 8288-A to report and transmit the amount withheld to the IRS within 20 days of the transfer of the property. However, the due date for performing certain time-sensitive actions, including reporting and transmitting withheld taxes on Form 8288 and Form 8288-A, otherwise due on or after April 1, 2020, and before July 15, 2020, was automatically extended to July 15, 2020, in response to the COVID-19 (coronavirus) crisis (Notice 2020-23; Rev. Proc. 2018-58).

2444. Look-Through Rules for Disposition of U.S. Real Property Interests. Any distribution by a qualified investment entity to a nonresident alien (¶ 2409), foreign corporation, or other qualified investment entity to the extent attributable to gain from the sale or exchange of a U.S. real property interest (USRPI) (¶ 2442), is treated by the recipient as gain from the sale or exchange of a USRPI (Code Sec. 897(h)). A qualified investment entity includes any real estate investment trust (REIT) (¶ 2326) and any regulated investment company (RIC) (¶ 2301) that is a U.S. real property holding company (USRPHC). However, in determining whether a RIC is a USRPHC, the regularly traded stock exception in defining a USRPHC does not apply. In addition, the RIC must include its interest in any other domestically controlled REIT or RIC that is a USRPHC.

The look-through rule does not apply to any distribution from a qualified investment entity with respect to a class of stock that is regularly traded on an established securities

market in the United States if the foreign distributee did not own more than 10 percent of the class of stock at any time within one year of the distribution (Code Sec. 897(k)(1)). To the extent this exception applies, the distribution from the qualified investment entity is treated as a dividend, and not as income effectively connected with a U.S. trade or business.

An interest in a domestically controlled qualified investment entity (less than 50 percent of the stock's value is held by foreign persons) is not treated as a USRPI and any gain from the sale of the interest does not pass through to a nonresident alien or foreign corporation. However, the gain is passed through if a wash sale transaction is involved. For this purpose, a wash sale transaction is one in which:

- the interest in a domestically controlled qualified investment entity is disposed of within 30 days prior to a distribution by the qualified entity that would be treated as gain from the sale or exchange of a USRPI, and
- a substantially identical interest is reacquired within 61 days of the distribution.

For purposes of the exception for domestically controlled qualified investment entities, a number of rules and presumptions are applied to determine if the stock owner is a U.S. or foreign person (Code Sec. 897(h)(4)(E)).

2446. Taxable Income of Nonresident Aliens and Foreign Corporations. A nonresident alien (¶ 2409) and foreign corporation are subject to U.S. income tax on income effectively connected with a U.S. trade or business (¶ 2429) and fixed, determinable, annual, periodical (FDAP) income from U.S. sources (¶ 2431). All exclusions from gross income permitted to a U.S. citizen and domestic corporation generally may be excluded by a nonresident alien and foreign corporation (Code Secs. 872 and 883). Earnings on certain categories of cross-border transactions may also be excluded, such as compensation paid by a foreign employer to an exchange student, teacher, trainee, or specialist (¶ 2448), gambling winnings derived from a legal wager initiated outside the United States, and earnings from the international operation of a ship or aircraft.

A nonresident alien or foreign corporation may only claim deductions and tax credits related to effectively connected income in determining taxable income (Code Secs. 873, 874 and 882(c)). This includes the foreign tax credit subject to the same limitations that apply to U.S. citizens and domestic corporations (¶ 2479) (Code Sec. 906). Deductions and credits are generally not allowed in determining the tax on U.S. sourced FDAP income. However, a charitable contribution deduction can be claimed whether or not related to effectively connected income. Similarly, a nonresident alien may deduct one personal exemption for tax years beginning before 2018 and after 2025 (with certain exceptions) and casualty or theft losses (so long as the property is located in the United States). A nonresident alien and foreign corporation may elect to treat income from U.S. real property interests as effectively connected income in order to claim the deductions associated with the property (¶ 2432).

A nonresident alien and foreign corporation must file an accurate and timely return to claim any allowable deduction or credit. If a return is not filed, then the IRS may prepare one for the taxpayer but no deductions and credits will be allowed other than the credits for withheld taxes, gasoline and special fuels, and for nonresident aliens for taxes paid by a regulated investment company on undistributed capital gains (¶ 2305).

2448. Foreign Students, Teachers, or Trainees. A nonresident alien (¶ 2409) who is not otherwise engaged in a U.S. trade or business but who is temporarily present in the United States under immigration laws on a F, J, M, or Q visa as a visiting student, teacher, trainee, or specialist is considered to be engaged in a U.S. trade or business (Code Sec. 871(c)). This means that any portion of a scholarship or fellowship grant from U.S. sources (including incidental expenses) that is not excludable from gross income (¶ 865) is income effectively connected with the conduct of a U.S. trade or business (¶ 2429). The income is subject to a special withholding rate of 14 percent (¶ 2455) (Code Sec. 1441(b); Reg. §1.1441-4(c)). Compensation paid by a foreign employer to a person in the United States as a visiting student, teacher, trainee, or specialist is exempt from tax (Code Sec. 872(b)(3)).

2450. Tax Treaties. The United States has negotiated a network of tax treaties with other countries to avoid the double taxation of taxpayers on the same income and to prevent taxpayers from evading taxation. In addition, the United States has enacted strict anti-abuse rules to prevent individuals from treaty shopping, and has incorporated exchange of information clauses in many tax treaties to facilitate the enforcement of these rules. These anti-abuse rules deny treaty benefits to nonresidents of either the United States or its treaty partner that funnel income through the treaty country only to take advantage of reduced tax rates.

The Code generally is to be applied to a taxpayer with "due regard" to treaty obligations of the United States (Code Sec. 894). In instances where a U.S. taxpayer takes the position that a treaty overrules or modifies the Code or regulations, disclosure of the position must generally be made with the taxpayer's tax return on Form 8833 (Code Sec. 6114; Reg. §301.6114-1). If a return is not otherwise required to be filed, a return must nevertheless be filed for purposes of making the required disclosure. The determination of whether a treaty-based return position is required to be reported is made by comparing the taxpayer's tax liability under current law to that same tax liability as it would exist if the relevant treaty positions did not exist. Any difference must be reported. Failure to disclose the difference may result in a penalty (Code Sec. 6712).

Tax treaties between the United States and foreign countries generally reduce the tax rate for income paid. Some countries allow the withholding of tax at the treaty-reduced rate. Other countries withhold tax at their statutory tax rate and refund any difference upon receiving proof of residency. To apply for certification of U.S. residency to receive the benefits under a tax treaty, a taxpayer must file Form 8802 at least 45 days before the certificate is needed. If the application is approved, the IRS will provide the residency certification to the taxpayer on Form 6166.

A nonresident alien or foreign corporation is not entitled under any U.S. income tax treaty to any reduced rate of withholding on an item of income derived through an entity treated as a partnership (or other fiscally transparent entity) if:

- the income is not treated by the treaty partner as an item of income of such foreign person,
- the foreign country does not impose tax on a distribution of the item by the U.S. entity to the foreign person, and
- the treaty does not contain a provision addressing its applicability in the case of an item of income derived through a partnership (Code Sec. 894(c)).

2452. Corporate Inversions. Special rules apply for the tax treatment of corporate inversion transactions where a U.S. corporation reincorporates in a foreign jurisdiction and thereby replaces the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations.

In any case, if former shareholders of a U.S. corporation hold 80 percent or more (by vote or value) of the stock of a foreign corporation after the transaction, the foreign corporation will be treated as a domestic corporation for U.S. tax purposes (Code Sec. 7874). If the former shareholders hold at least 60 percent but less than 80 percent of the stock of the foreign corporation after the transaction, then the inversion transaction is respected but any applicable corporate-level tax imposed as a result of the transaction cannot be offset by tax attributes such as a net operating loss (NOL) or foreign tax credit.

An inversion transaction for this purpose is a transaction in which, pursuant to a plan or a series of related transactions, the following requirements are met:

- the foreign corporation (surrogate corporation) must acquire substantially all of the properties of the domestic corporation or that constitute the trade or business of a domestic partnership;
- the former U.S. shareholders must hold 60 percent or more (by vote or value) of the stock of the foreign corporation after the transaction (ownership fraction); and

- the expanded affiliated group (EAG) must not conduct substantial business activities in the foreign country in which the foreign acquiring entity is created or organized, compared to the total business activities of the expanded affiliated group (Reg. §1.7874-12).

An EAG has substantial business activities in the relevant foreign country only if at least 25 percent of the group employees, group assets, and group income are located or derived in the relevant country, and the foreign acquiring country corporation is subject to tax as a resident of the relevant foreign country (Reg. §1.7874-3).

Dividends paid by surrogate foreign corporations after December 22, 2017, that are not treated as domestic corporations are ineligible for the reduced rate of tax on qualified dividends (¶ 1736) (Code Sec. 1(h)(11)(C)(iii)).

Stock compensation received by insiders in an expatriated corporation is subject to a 20 percent excise tax, effective for corporations that first became expatriated after December 22, 2017 (Code Sec. 4985(a)(1)).

A number of rules apply to disregard certain stock of the foreign acquiring corporation in determining the ownership fraction. For example, the stock may be disregarded under a modified statutory public offering rule or if it is attributable to passive assets (Reg. §§1.7874-4 and 1.7874-7). Rules also describe the effect of transfers of the foreign acquiring corporation stock after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of a trade or business of a domestic partnership (Reg. §1.7874-5).

2455. Withholding of Tax on Nonresident Aliens and Foreign Corporations. A foreign person is generally subject to U.S. tax on U.S. source income received during the tax year (¶ 2425). To ensure collection and payment, the tax must be withheld from the payment of the U.S. source income to the foreign person by a withholding agent (Code Secs. 1441 and 1442).

Most types of U.S. source income received by a foreign person are subject to a 30-percent withholding rate. However, different rates may apply to wages paid to a nonresident alien employee (including pensions paid for personal services), scholarship or fellowship grants of a foreign exchange student (¶ 2448), dispositions of U.S. real property interests (¶ 2442), a foreign partner's distributive share of effectively connected income of a partnership, gross investment income paid to foreign private foundations (¶ 631), and dividends paid to a Puerto Rican corporation. Reduced rates of withholding may also apply, including an exemption, under a tax treaty or convention with the foreign person's country of residence (¶ 2450).

Persons Subject to Withholding. All nonresident aliens and foreign corporations, foreign partnerships, foreign trusts, and foreign estates are subject to withholding on U.S. source income. Withholding also applies to the foreign branch of a U.S. financial institution that furnishes an intermediary withholding certificate on Form W-8IMY to the withholding agent (Reg. §1.1441-1(b) and (c)).

A nonresident alien is any individual who is not a U.S. citizen or resident alien and includes any bona fide resident of Puerto Rico, Guam, the Northern Mariana Islands, the U.S. Virgin Islands, or American Samoa. A nonresident alien who elects resident status for income tax purposes (¶ 2410) is still considered a foreign person for nonresident alien withholding purposes on all income except wages.

Withholding may also be required for payments made to certain foreign financial institutions (FFIs) (¶ 2469) and nonfinancial foreign entities (NFFEs) (¶ 2473) if certain requirements are not met. Under coordination rules, withholding does not apply if there is withholding under these provisions.

Income Subject to Withholding. U.S. source income subject to the withholding requirements includes:

- fixed, determinable, annual, or periodical (FDAP) income (¶ 2431),
- certain gains on the disposal of timber, coal, or domestic iron ore, and
- gains relating to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property.

If the source of the income cannot be determined at the time of payment (¶ 2427), it is treated as U.S. source income (Code Sec. 1441(b); Reg. § 1.1441-2(a)). In addition, income payable for personal services performed in the United States is treated as from sources within the United States, regardless of where the location of the contract for the services was entered, the place of payment, or residence of payer.

Income effectively connected with the conduct of a U.S. trade or business is not subject to the withholding requirements for foreign persons, including income received as wages (¶ 2429). Instead, such income is generally subject to the tax and withholding rules as if the foreign person were a U.S. citizen, resident, or domestic entity. However, special rules require withholding by a partnership on the effectively connected income of the partnership (foreign or domestic) that is allocable to its foreign partners, including withholding upon the disposition of certain partnership interests (¶ 434) (Code Sec. 1446). The withholding tax is a partnership item for purposes of partnership-item adjustments (*Ya Global Investments, LP*, Dec. 61,237, 151 TC No. 2).

Withholding Agent. The withholding agent is the person or entity required to deduct, withhold, and pay any tax on income paid to a foreign person (Reg. § 1.1441-7; Prop. Reg. § 1.1441-7). The duty is imposed on all persons (acting in whatever capacity) that have control, receipt, custody, disposal, or payment of any items of income which are subject to withholding. Thus, the withholding agent may be any individual, corporation, partnership, trust, or other entity (including a foreign intermediary or partnership). A withholding agent may designate an authorized agent on its behalf.

The withholding agent is personally liable for any tax required to be withheld except in the case of certain conduit financing arrangements (Code Sec. 1461). This liability is independent of the tax liability of the foreign person for whom the tax was withheld from a payment of income. Even if the foreign person pays the tax, the withholding agent may still be liable for any interest, penalty, or addition to tax for failure to withhold (Code Sec. 1463). A refund or credit of any overpayment is made to the withholding agent unless the tax was actually withheld (Code Sec. 1464). The withholding agent is indemnified against any person claiming any tax properly withheld.

A withholding agent is not required to withhold any amount if the payee is a U.S. person or a foreign person that is the beneficial owner of the income and is entitled to a reduced rate of withholding. Absent actual knowledge or reason to know, the withholding agent must obtain valid documentation from the payee that it is either a U.S. payee or beneficial owner.

A U.S. payee is generally any person required to furnish Form W-9. While such persons are not subject to withholding as a foreign person, they may be subject to Form 1099 reporting and withholding requirements. A beneficial owner is any foreign person or entity that is required to furnish Form W-8BEN, Form W-8BEN-E, Form W-8ECI or Form W-8EXP. Payment to an intermediary (whether qualified or not), flow-through entity, or U.S. branch of a foreign entity may be treated as a payee for these purposes so long as valid documentation is provided on Form W-8IMY. In all cases in which valid documentation cannot be provided, the withholding agent may presume a person to be a U.S. payee or beneficial owner under specified rules.

Returns. A withholding agent must file an annual information return on Form 1042-S to report income paid to a foreign person during the tax year that is subject to withholding, unless an exception applies (Reg. § § 1.1461-1 and 1.6302-2). A separate Form 1042-S must be filed for each recipient, as well as for each type of income that is paid to the same recipient. A copy of Form 1042-S must also be provided to the recipient and may be provided electronically, if certain requirements are met. Form 1042 is used by the withholding agent to report and pay the taxes withheld from the payments of income. The forms are also used by withholding agents making payments to foreign financial institutions (FFIs) (¶ 2469) and non-financial foreign institutions (NFFEs) (¶ 2473).

Both forms must be filed by March 15 of the year following the calendar year the income was paid. An automatic six-month extension for filing Form 1042 can be obtained by filing Form 7004. The extension of time to file does not extend the time to pay the withheld tax. An automatic 30-day extension for filing Form 1042-S can be obtained by

filing Form 8809. A second extension request may be submitted by filing a second Form 8809 before the end of the initial extended due date. Form 1042-S *must* be filed electronically if 250 or more returns are filed or if the returns are filed by a financial institution (¶ 2503) (Reg. § § 1.1461-1(c)(5) and 301.1474-1(a)). Paper Forms 1042-S must be accompanied by Form 1042-T.

The amount of tax required to be withheld will determine whether the withholding agent must deposit the taxes prior to the due date for filing the returns and how frequently such amounts must be deposited. Penalties may be imposed for failure to file, failure to provide complete and correct information, as well as failure to pay any taxes.

Reporting Foreign Assets of U.S. Taxpayers

2465. FBAR Reporting (Foreign Financial Assets). A U.S. person is required to disclose any financial interests in, signature authority, or other authority over foreign financial accounts if the aggregate value of the accounts exceeds $10,000 at any time during the calendar year (31 CFR Reg. § 1010.350). The information is reported electronically on FinCEN Report 114 (commonly referred to as FBAR) through the Treasury's Financial Crimes Enforcement Network (FinCEN) BSA E-Filing System. The filing of the FBAR does not relieve a taxpayer of the requirement to file Form 8938 to report specified foreign financial assets (¶ 2570 and ¶ 2572).

2467. FATCA Reporting of Specified Foreign Financial Assets (Form 8938). Under the Foreign Account Tax Compliance Act (FATCA), an individual is required to disclose his or her interest in a specified foreign financial asset during the tax year if the aggregate value of all of the assets exceeds an applicable threshold amount. The reporting requirement also applies to any domestic entity that is "formed or availed of" for purposes of holding, directly or indirectly, specified foreign financial assets (¶ 2572) (Code Sec. 6038D; Reg. § § 1.6038D-2 and 1.6038D-6). The information is reported on Form 8938.

The filing of Form 8938 does not relieve an individual of the requirement to file the FBAR or FinCEN Report 114 (¶ 2570) for disclosing foreign financial accounts. Similarly, the filing of the FBAR does not relieve an individual of the requirement to file Form 8938. An individual may be required to file both Form 8938 and FBAR to report the same information on certain foreign accounts. The FBAR, however, is not filed with the individual's federal income tax return.

2469. FATCA Reporting and Withholding Obligations for Foreign Financial Institutions (FFIs). Under the Foreign Account Tax Compliance Act (FATCA), a foreign financial institution (FFI) is required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold substantial ownership interests (Code Sec. 1471; Reg. § 1.1471-2(a)). If an FFI fails to meet the FATCA requirements, a U.S. withholding agent must deduct and withhold a tax equal to 30 percent on any withholdable payment made to the FFI, unless the withholding agent can reasonably rely on documentation that the payment is exempt from withholding.

The withholding requirement applies without regard to whether the FFI receives a withholdable payment as a beneficial owner or as a qualified intermediary (QI). No withholding is required if an FFI enters into an agreement with the IRS to provide the required information (participating FFI). An FFI may also be deemed to meet the requirements of the agreement (deemed-compliant FFI) (¶ 2471).

Foreign Financial Institutions. An FFI is a foreign entity that accepts deposits in the ordinary course of a banking business, holds financial assets for the account of others as a substantial part of its business (mutual fund), or is an entity whose gross income is primarily attributable to investing, reinvesting, or trading in financial assets (hedge fund, private equity fund, etc.) (Code Sec. 1471(d)(4); Reg. § 1.1471-5(d) and (e)). In the case of an entity that is resident in a country that has in effect a Model 1 or Model 2 Intergovernmental Agreement with the United States (Model 1 IGA or Model 2 IGA), an FFI is any entity that is treated as an FFI pursuant to the Model 1 or Model 2 IGA.

Withholdable Payment. A withholdable payment includes any payment of U.S. source fixed or determinable, annual or periodical (FDAP) income (¶ 2431) (Code Sec.

- Alaska Native Settlement Trusts may elect to have special income tax rules apply to the trust and its beneficiaries using Form 1041-N (¶ 2396) (Code Sec. 6039H);

- donors making noncash donations must file Form 8283 if the amount of the charitable deduction for all noncash gifts is more than $500 (¶ 1070A);

- dispositions by charitable donees within three years of donated property with a value in excess of $5,000 are reported on Form 8282 by the donee (¶ 627) (Code Sec. 6050L(a));

- charitable organizations that receive or accrue net income from a qualified intellectual property contribution must file Form 8899 and provide a copy to the donor (¶ 1062A) (Code Sec. 6050L(b));

- employer-owned life insurance contracts (also known as company-owned life insurance (COLI) contracts) must be reported by the policyholder on Form 8925 (¶ 804) (Code Sec. 6039I);

- acquisitions of life insurance contracts and the seller's investment in the contracts and surrender amount in reportable policy sales are reported on Form 1099-LS and Form 1099-SB, and payments of reportable death benefits are reported on Form 1099-R (¶ 807) (Code Sec. 6050Y);

- charges or payments made for qualified long-term insurance contracts under combined arrangements are reported on Form 1099-R (Code Sec. 6050U); and

- federal executive agencies must report information about persons with whom they have entered certain contracts for products or services on Form 8596 and Form 8596-A, as well file Form 1099-NEC if in the course of a trade or business they pay remuneration of $600 or more in a calendar year to any person for services provided by that person (Code Secs. 6041A and 6050M).

2567. Health Care Coverage Reporting. A employer is required to disclose the aggregate cost of employer-sponsored health insurance coverage provided to an employee on Form W-2 (Code Sec. 6051(a)(14); Notice 2012-9). The aggregate cost of the coverage reported includes both the portion of coverage paid by the employer and the employee, as well as any portion of the cost of coverage that is includible in the employee's gross income for the employee's spouse, dependent, or child under the age of 27. It does not include salary reduction contributions to a health savings account (HSA) (¶ 2035), Archer medical savings account (MSA) (¶ 2037), or flexible spending arrangement under a cafeteria plan (¶ 2041).

Reporting the cost of health care coverage on Form W-2 does not mean that the coverage is taxable. An employer is not required to provide Form W-2 solely to report the value of the coverage for retirees or former employees. Pending further guidance, the reporting requirement is optional for an employer who is required to file fewer than the applicable number of Forms W-2 for the preceding calendar year, based on the rule for the electronic filing of returns (¶ 2503). Transitional relief is also available for certain other types of coverage and situations (Notice 2012-9).

Offers of Coverage. An applicable large employer (¶ 2001) must report on Form 1094-C and Form 1095-C whether full-time employees and their dependents are offered the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, along with other related information (Code Sec. 6056; Reg. §§ 301.6056-1 and 301.6056-2; Notice 2013-45). The returns must be filed with the IRS on or before February 28 (March 31 if filed electronically) of the year following the calendar year to which they relate. A copy of Form 1095-C is generally required to be furnished to each full-time employee by January 31 of the following calendar year, except the due date is extended to March 2, 2021, for the 2020 calendar year (Notice 2020-76). An applicable large employer that is self-insured may combine this reporting with an insurer's reporting (discussed below) on Form 1095-C. Failure to file the returns may subject the employer to a penalty (¶ 2816 and ¶ 2823).

Insurer Reporting. Every insurer who provides minimum essential health care coverage to an individual during a calendar year, including an employer who self-insures, is required to file Form 1094-B and Form 1095-B reporting such coverage (Code Sec. 6055; Reg. § 1.6055-1; Prop. Reg. § 1.6055-1; Notice 2013-45). The returns must be filed with the IRS on or before February 28 (or March 31 if filed electronically) of the year following the calendar year to which they relate. Self-insured employers that are also applicable large employers subject to shared responsibility reporting can instead combine insurance provider reporting. A copy of Form 1095-B is generally required to be furnished to each full-time employee by January 31 of the following calendar year, except the due date is extended to March 2, 2021, for the 2020 calendar year (Notice 2020-76). The statement may be furnished electronically if affirmative consent is given. Failure to file the returns may subject the employer to a penalty (¶ 2816 and ¶ 2823). The IRS will not assert the penalty for failing to furnish a Form 1095-B to responsible individuals for the 2020 calendar year if certain conditions are met.

2570. Reporting Foreign Financial Accounts (FBAR). A U.S. person is required to disclose any financial interests in, or signature authority or other authority over, foreign financial accounts if the aggregate value of the accounts exceeds $10,000 at any time during the calendar year (31 CFR §§ 1010.306(c) and 1010.350). The information is reported electronically on FinCEN Report 114 (commonly referred to as the FBAR) through the Treasury's Financial Crimes Enforcement Network (FinCEN) BSA E-Filing System. The filing of the FBAR does not relieve a taxpayer of the requirement to file Form 8938 to report specified foreign financial assets (¶ 2572).

The FBAR for a calendar year is required to be filed by the due date for filing federal income tax returns (April 15 of the succeeding year), with a maximum extension of six months. Any penalty for failure to timely file a request for an extension to file the FBAR may be waived by the IRS for first-time filers (Act Sec. 2006(b)(11) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41)). FinCEN allows all FBAR filers an automatic filing extension to October 15, and does not require specific requests for this extension (FinCEN Form 114 Instructions, Release Date January 2017 (v. 1.4)). Relief from FBAR reporting is provided for certain individuals who have signature authority over, but no financial interest in, one or more foreign financial accounts. Under this relief, the deadline for filing the FBAR for signature authority held during the 2019 calendar year (as well as the reporting deadlines previously extended for 2011 through 2018) is extended to April 15, 2021 (FinCEN Notice 2019-1).

U.S. persons subject to FBAR reporting are U.S. citizens, resident aliens, and entities created, organized, or formed under U.S. laws, including but not limited to domestic corporations, partnerships, limited liability companies (LLCs), trusts, and estates. The federal tax treatment of a person or entity does not determine whether an FBAR filing is required. For example, an entity disregarded for federal tax purposes must still file an FBAR if otherwise required. Participants and beneficiaries in qualified retirement plans, including individual retirement accounts (IRAs), are not required to file FBARs with respect to a foreign financial account held by or on behalf of the plan. A beneficiary of a trust in which a U.S. person has a greater than 50 percent present beneficial interest in the assets or income of the trust for the calendar year is not required to file FBAR if the trust, trustee, or agent of the trust is a U.S. person that files an FBAR for the trust's foreign financial assets.

FinCEN Form 114a, Record of Authorization to Electronically File FBARs, is used by a U.S. person to authorize a third party preparer (CPA, enrolled agent, or attorney) to file the FBAR on his or her behalf, or to jointly file the FBAR with his or her spouse. Form 114a is not filed with the Treasury, but must be maintained by the foreign account holder and the filer and made available upon request by the Treasury or IRS.

2572. Reporting Specified Foreign Financial Assets (Form 8938). Under the Foreign Account Tax Compliance Act (FATCA), any individual who holds an interest in a specified foreign financial asset during the tax year must attach Form 8938 to his or her tax return to report certain information for each asset if the total value of all such

mines in published guidance that the transaction is not subject to the reporting requirements. The IRS may make a determination by individual letter ruling.

2592. Disclosure of Reportable Transactions by Taxpayers. Every taxpayer that is required to file a tax return and has participated directly or indirectly in a reportable transaction (¶ 2591) must disclose its participation in the transaction (Reg. § 1.6011-4(a)). The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.

Form 8886 is used to disclose information for each reportable transaction in which the taxpayer has participated. A taxpayer generally must file a separate Form 8886 for each reportable transaction, but a single form can be filed for transactions that are the same or substantially similar. The form must be attached to the taxpayer's tax return for each tax year for which the taxpayer participates in a reportable transaction. A copy must be sent to the Office of Tax Shelter Analysis (OTSA) at the same time that any disclosure statement is first filed with the taxpayer's tax return (Reg. § 1.6011-4(d) and (e)). If a reportable transaction results in a loss that is carried back to a prior year, Form 8886 is attached to the taxpayer's application for tentative refund or amended tax return for the prior year.

In the case of a taxpayer that is a partnership, S corporation, or trust, Form 8886 must be attached to the partnership's, S corporation's, or trust's tax return for each tax year in which the entity participates in the transaction. A taxpayer who is a partner, S corporation shareholder, or beneficiary of a trust who receives a Schedule K-1 less than 10 calendar days before the due date of its return, including extensions, has a 60-day extension to file Form 8886 with the OTSA if the taxpayer determines from the Schedule K-1 that it has participated in a reportable transaction.

A taxpayer that fails to file Form 8886 regarding a reportable transaction is subject to a penalty (¶ 2594). Special reporting rules apply to listed transactions, transactions of interest, and loss transactions. Also, in some cases, taxpayers must make multiple disclosures of a reportable transaction (Reg. § 1.6011-4(e)).

A taxpayer may submit a request to the IRS for a ruling as to whether a transaction is subject to the disclosure requirements (Reg. § 1.6011-4(f)). If a taxpayer requests a ruling on the merits of a specific transaction on or before the date that disclosure would otherwise be required and receives a favorable ruling, the disclosure rules are satisfied. The ruling request must fully disclose all relevant facts relating to the transaction. If a taxpayer is uncertain whether a transaction must be disclosed, the taxpayer may make a protective disclosure. The taxpayer must disclose the transaction and indicate on the disclosure statement that the taxpayer is uncertain whether the transaction is required to be disclosed and that the disclosure statement is being filed on a protective basis. The taxpayer must retain a copy of all documents and other records related to a transaction subject to disclosure (Reg. § 1.6011-4(g)). The retained documents and records are those that are material to an understanding of the tax treatment or tax structure of the transaction.

2593. Disclosure of Reportable Transactions by Material Advisors. Each material advisor is required to timely file an information return with the IRS for any reportable transaction (¶ 2591) (Code Sec. 6111; Reg. § 301.6111-3). The disclosure is made on Form 8918 and generally must be filed with the Office of Tax Shelter Analysis (OTSA) by the last day of the month that follows the calendar quarter in which the advisor became a material advisor with respect to the reportable transaction or in which circumstances occur to require an amended disclosure statement.

The material advisor's disclosure on Form 8918 must include: (1) information identifying and describing the transaction; (2) information describing any potential tax benefits expected to result from the transaction; and (3) any other information the IRS may require. This includes enough information about the transaction to identify if any other person that the material advisor knows or has reason to know acted as a material advisor with respect to the transaction. A single Form 8918 may be filed for transactions that are the same or substantially similar. An amended form must be filed if information previously provided is no longer accurate, additional information becomes available, or

there are material changes to the transaction. If a potential material advisor is uncertain whether a transaction must be disclosed, a protective disclosure may be made. Any material advisor that fails to file Form 8918 when required or files a false or incomplete form is subject to a penalty (¶ 2595).

A material advisor is any person that: (1) provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction; and (2) directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction that provides substantially all of the tax benefits to individuals) for that aid, assistance, or advice. If more than one material advisor is required to disclose a reportable transaction, the material advisors may designate by written agreement a single material advisor to disclose the transaction.

2594. Penalty for Failure to Disclose Reportable Transaction. A penalty is imposed on any taxpayer that fails to disclose its participation in a reportable transaction that is required to be included on the taxpayer's return (¶ 2592) (Code Sec. 6707A; Reg. § 301.6707A-1). The penalty is generally equal to 75 percent of the decrease in tax shown on the return as a result of the transaction, or that would have resulted from the transaction if the transaction had been respected for federal tax purposes. The *minimum* penalty is $10,000 ($5,000 in the case of an individual). The maximum penalty is $50,000 ($10,000 in the case of an individual), but in circumstances involving listed transactions, the maximum penalty is $200,000 ($100,000 in the case of an individual). The penalty for failure to disclose is imposed in addition to any other penalty, including a special accuracy-related penalty for an understatement of tax resulting from a reportable transaction (¶ 2870).

For reportable transactions other than listed transactions, the penalty can be rescinded only in exceptional circumstances, and rescinding the penalty must promote compliance with the tax laws and effective tax administration. Factors considered in deciding whether to grant rescission include:

- the taxpayer filed a complete and proper, although untimely, Form 8886 upon becoming aware that it failed to properly disclose a reportable transaction;
- the failure to properly disclose was due to an unintentional mistake of fact that existed despite the taxpayer's reasonable attempts to determine the correct facts;
- the taxpayer generally has an established history of properly disclosing reportable transactions and complying with tax laws;
- the failure to include information required to be disclosed arose from events beyond the taxpayer's control;
- the taxpayer cooperates with the IRS; and
- assessment of the penalty weighs against equity and good conscience, and the taxpayer demonstrates that it acted in good faith with respect to the failure.

Any person seeking rescission of a penalty must make a written request within 30 days after the date that the IRS sends notice and demand for payment of the penalty. If the penalty is paid (not including interest) prior to the date that notice and demand is sent, the written request must be made within 30 days from the date of payment. In order to request rescission, the person must have either exhausted the administrative remedies available within the IRS Independent Office of Appeals or agreed in writing to the assessment of the penalty and not to file or prosecute a claim for refund or credit of the penalty. The IRS has provided guidance on the information required to be included with any rescission request, as well as factors considered in granting or denying the request (Rev. Proc. 2007-21; Announcement 2016-1). The IRS's collection efforts are not suspended because a rescission request has been made.

2595. Material Advisor Penalty for Reportable Transactions. A penalty is imposed on any material advisor who fails to timely file an information return or who files a false or incomplete information return regarding a reportable transaction (¶ 2593) (Code Sec.