Home Mortgage Interest. The itemized deduction for home mortgage interest (¶ 1047) is allowed for AMT, except that it is limited to interest paid on acquisition debt for a house, apartment, condominium, or mobile home (qualified housing interest).

Investment Interest. Investment interest expenses are deductible for AMT to the same extent as regular tax liability (¶ 1057). However, investment interest does not include qualified housing interest for AMT purposes even if it is otherwise allocable to property held for investment. In addition, tax-exempt interest on private activity bonds is included in investment income for AMT purposes, and interest expended to carry the bonds is included in investment interest expenses.

Miscellaneous Itemized Deductions. The miscellaneous itemized deductions subject to the two-percent of AGI limit (¶ 1079) are not allowed for AMT purposes.

Standard Deduction. The standard deduction (¶ 131) is not allowed in computing AMTI, including the additional standard deduction for elderly and blind taxpayers. However, an additional standard deduction amount may be claimed in computing AMTI for net disaster losses arising from: a qualified federal disaster declared during the period from January 1, 2020, to February 25, 2021 and a qualified federal disaster declared during the period from January 1, 2018, to February 18, 2020 (¶ 1131).

Personal Exemptions. Personal and dependency exemption deductions (¶ 133) may not be claimed against AMTI, including the personal exemption deduction allowed to a decedent's estate or a trust (¶ 534).

Incentive Stock Options. An individual does not recognize gain or loss for regular tax purposes when an incentive stock option (ISO) is granted or exercised (¶ 1925). However, an adjustment is made for AMT purposes by the amount that the stock's fair market value exceeds the option price at the time it is freely transferable and not subject to a substantial risk of forfeiture. This generally occurs when the option is exercised, but the taxpayer may make a Code Sec. 83(b) election to take the AMT adjustment into account when the stock is received (¶ 713).

There is no AMT adjustment if the option is exercised and the stock is disposed of in the same tax year. The basis of the stock acquired is increased for AMT purposes by the amount of the AMT adjustment unless the stock is nontransferable and subject to a substantial risk of forfeiture. Although the exercise of an ISO can trigger an AMT liability, a taxpayer may be able to recover the liability through the AMT credit in future years (¶ 1409).

Depreciation. Assets other than section 1250 property placed in service after 1998 are generally depreciated for AMT purposes over the modified accelerated cost recovery system (MACRS) class life using 150-percent declining balance method (¶ 1243). The class lives for AMT are listed in Rev. Proc. 87-56. For assets placed in service before 1999, depreciation is refigured for AMT using the alternative depreciation system (ADS). No AMT adjustment of depreciation is required for:

- residential rental property placed in service after 1998;
- nonresidential real property with a class life of 27.5 years or more placed in service after 1998 that is depreciated for the regular tax using the straight line method;
- other section 1250 property placed in service after 1998 depreciated for regular tax using the straight line method;
- property (other than section 1250 property) placed in service after 1998 that is depreciated for the regular tax using the 150 percent declining balance method or the straight line method;
- property the taxpayer elected to use the ADS for the regular tax;
- any qualified property that is or was eligible for bonus depreciation or special depreciation allowance (¶ 1237);
- any portion of property expensed under Code Sec. 179 (¶ 1208);
- motion picture films, videotapes, or sound recordings;

- property depreciated under unit-of-production method or any other method not expressed in a term of years; and
- Indian reservation property and natural gas gathering lines.

Net Operating Losses (NOLs). The alternative tax NOL (ATNOL) is generally computed in the same manner as for regular tax purposes (¶ 1145) except that all AMT adjustments and preferences are taken into account first. The ATNOL may not offset more than 90 percent of AMTI, determined without regard to the ATNOL deduction. Unused ATNOLs are carried over similar to regular NOLs (¶ 1149) except the amount of ATNOLs carried over is reduced by 90 percent of the AMTI for any year to which they are carried, whether or not the taxpayer is liable for the AMT in that year.

Disposition of Property. Certain AMT adjustments are taken into account in determining property's adjusted basis for AMT purposes (for example, depreciation, incentive stock options, etc.). Thus, gain or loss from the disposition of the property may be different for AMT purposes than for regular tax purposes. The difference is a negative adjustment in calculating AMTI if the AMT gain is less than the regular tax gain, the AMT loss is more than the regular tax loss, or there is an AMT loss and a regular tax gain.

Passive Activity and Loss Limits. The limits on losses that apply for regular tax purposes also apply for AMT purposes with certain modifications (¶ 192). This includes the limit on passive activities, at-risk activities, partnership losses claimed by partners, and S corporation losses claimed by shareholders. The limits are applied separately, taking into account all AMT adjustments and preferences first. A taxpayer cannot deduct any losses from tax-shelter farming activities (Code Sec. 59(h)).

Long-Term Contracts. A taxpayer must use the percentage-of-completion method of accounting (¶ 1551) to determine AMTI from long-term contracts (other than home construction contracts). The percentage-of-completion is determined using simplified cost allocation procedures for construction contracts of certain small contractors if the contract has an estimated duration of less than two years.

Mining Costs. Mining exploration and development costs that are expensed or amortized for regular tax liability purposes (¶ 987) are amortized over a 10-year period for AMT purposes. If a tax loss is incurred from a mine, the deduction is the lesser of the loss allowed for the costs had they remained capitalized or all expenses that have been capitalized but not yet amortized.

Research, Experimental, and Circulation Costs. Research and experimental costs that are expensed for regular tax purposes (¶ 979) are amortized over a 10-year period for AMT purposes. The adjustment applies only to an individual who does not materially participate (¶ 1165) in the activity that generated the expenses. Circulation costs that are expensed for regular tax purposes (¶ 971) are amortized for over a three-year period for AMT purposes. If a loss is sustained on property that generated the research, experimental, or circulation expenses, a deduction is allowed equal to the lesser of the unamortized expenses or the amount that would be allowed as a loss had the expenses remained capitalized.

Other Adjustments. Additional AMT adjustments must be made for: items passed through an estate, trust, partnership, or S corporation and reported on the individual's Schedule K-1; certain patronage distributions received by a cooperative; income from certain installment sales before 1987; and pollution control facilities.

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the corporation must each attach to their tax return a complete statement of all the facts pertinent to the exchange, including:

- the name and employer identification number (if any) of the transferee corporation (for the significant transferor's statement), or the name and taxpayer identification number (if any) of every significant transferor (for the transferee corporation's statement);
- the date(s) of the transfer(s) of assets;
- the fair market value and basis of the property transferred by the significant transferor (for the significant transferor's statement) or received by the transferee corporation (for the transferee corporation's statement) in the exchange, determined immediately before the transfer and aggregated as follows:

  — importation property transferred in a loss importation transaction (a transaction subject to the anti-loss importation rule of Code Sec. 362(e)(1));

  — loss duplication property transferred in a loss duplication transaction (a transaction subject to the anti-loss duplication rule of Code Sec. 362(e)(2));

  — property with respect to which any gain or loss is recognized on the transfer (without regard to whether such property is also identified above); and

  — property not described above.

- the date and control number of any private letter ruling(s) issued by the IRS in connection with the section 351 exchange (Reg. § 1.351-3).

The transferee corporation does not have to file a statement if a significant transferor's statement that includes the required information is attached to the same return for the same section 351 exchange. For this purpose, a significant transferor is a person that owns, immediately after the exchange, at least five percent of the corporation's outstanding stock if the stock owned is publicly traded, or at least one percent of the corporation's outstanding stock if the stock owned is not publicly traded.

Contributions to Capital. Contributions to a corporation's capital are generally excluded from the corporation's gross income, except for (1) contributions in aid of construction or any other contribution as a customer or potential customer, and (2) contributions by a governmental entity or civic group other than as a shareholder (Code Sec. 118; Reg. § 1.118-2).

205. Debt-Equity Rules. For instruments issued by a corporation and advances made to a corporation, a question can arise as to whether such instruments and advances are treated as bona fide debt of the corporation or as an equity interest in the corporation. If they are treated as a bona fide debt, the corporation can deduct interest payments as a business expense and the shareholders can receive principal payments as a tax-free return of capital. If they are treated as stock, the corporation cannot deduct payments made with respect to such instruments.

The Code lists five factors that may be considered in making the debt-equity determination (Code Sec. 385):

- if there is a written, unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
- if there is subordination to or preference over any debt of the corporation;
- the ratio of debt to equity of the corporation;
- if there is convertibility into the stock of the corporation; and
- the relationship between holdings of stock in the corporation and holdings of the interest in question.

The courts have developed other guidelines to be used in making a debt-equity determination (*Stinnett's Pontiac Service, Inc.*, CA-11, 84-1 USTC ¶ 9406).

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The Treasury Department is authorized to make loans, loan guarantees, and other investments in the aggregate of up to $500 billion to provide liquidity to eligible businesses, states, and municipalities related to losses incurred as a result of the COVID-19 (coronavirus) crisis (Act Sec. 4003 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136)). Any emergency relief loan made by or guaranteed by the Treasury Department under the program is treated as debt for federal tax purposes.

Code Sec. 385 Debt-Equity Regulations. Final regulations under Code Sec. 385 address related-party debt and recharacterize related-party debt as stock in certain situations (Reg. §§ 1.385-1, 1.385-3, and 1.385-4). The Code Sec. 385 regulations generally apply to debt instruments issued between related corporations that are members of an expanded group. An expanded group is defined by reference to the term affiliated group in Code Sec. 1504(a), subject to certain modifications, and generally includes all corporations connected to a common parent that owns, directly or indirectly, 80 percent of the vote or value of each such corporation.

Foreign issuers, S corporations, non-controlled regulated investment companies (RICs), and non-controlled real estate investment trusts (REITs) are excluded from the application of the section 385 regulations. In addition, the regulations generally do not apply to debt instruments issued by partnerships, but contain certain anti-abuse provisions intended to prevent the use of controlled partnerships to avoid the rules. Intercompany obligations issued between members of a consolidated group are also outside the scope of the regulations.

The debt recharacterization rules of the section 385 regulations recharacterize a purported debt instrument as stock if the instrument is issued between expanded group members as part of a transaction that does not finance new investment in the operations of the issuer (Reg. §§ 1.385-3 and 1.385-4). Subject to a variety of exceptions for more ordinary course transactions, the debt recharacterization rules apply to instruments distributed from a U.S. issuer to a parent corporation, or other highly-related entity. The debt recharacterization rules also apply to the use of instruments, other than certain qualified short-term debt instruments, to fund acquisitions of related-party stock and internal asset reorganizations, as well as multi-step transactions that have an economically similar result.

A taxpayer can exclude the first $50 million of debt that otherwise would be recharacterized as stock under these rules. The debt recharacterization rules generally do not apply to debt instruments issued by dealers in securities or by regulated financial or insurance companies. Other exceptions, such as a subsidiary stock exception, an earnings and profits exception, and a net equity contribution exception, also apply. Debt instruments issued before April 5, 2016, are not subject to the debt recharacterization rules.

Return and Paying of Tax

See CCH® AnswerConnect: *Filing Corporate Income Tax Return and Paying Tax* for more information on this topic.

211. C Corporation Income Tax Return. A C corporation must file an income tax return using Form 1120 series, even if it has no income or no tax is due (Code Sec. 6012(a)(2); Reg. § 1.6012-2). The return must be filed electronically if the corporation has assets of $10 million or more and is required to file at least 250 returns during a calendar year before 2021, 100 returns during calendar year 2021, or 10 returns during a calendar year after 2021 (¶ 2503).

Form 1120 series generally must be filed on or before the 15th day of the *fourth* month following the close of the corporation's tax year (April 15 for a calendar-year corporation) (Code Sec. 6072; Reg. § 1.6072-2(a)). A C corporation with a fiscal tax year ending on June 30 and beginning before January 1, 2026, must file a return on or before the 15th day of the *third* month following the close of its tax year. If the last day of a corporation's tax year does not end on the last day of a month (as in the case of a dissolved corporation whose tax year ends on the date of dissolution), the return is due

dends. On the other hand, distributions in complete liquidation of a corporation other than a personal holding company are included as part of the deduction. Distributions in complete liquidation of a personal holding company can be included depending on whether the distributee is a noncorporate or corporate shareholder. For a RIC, the deduction is computed without regard to capital gain dividends and exempt-interest dividends (¶ 2303). For a REIT, the deduction is computed without regard to excluded net income from foreclosure property (¶ 2329).

Consent Dividend. A consent dividend is any dividend that a shareholder agrees to include in taxable income, even though the corporation does not make an actual distribution (Code Sec. 565). The consent dividend is treated as paid by the corporation on the last day of its tax year and immediately contributed as paid-in capital by the shareholder. A consent dividend may be paid only with respect to consent stock, which is either common stock or preferred stock with unlimited participation. Thus, the consent dividend must not be a preferential dividend. Shareholders consent on Form 972, which the corporation includes with Form 973 when filing its return to claim the dividends-paid deduction for consent dividends.

261. Accumulated Earnings Credit. For a corporation other than a holding or investment company, the accumulated earnings credit allowed in computing accumulated taxable income (¶ 253) is an amount equal to the part of the earnings and profits of the tax year retained for the reasonable needs of the business, reduced by the net capital gain (which is itself reduced by the amount of income tax attributable to it). A minimum amount of $250,000 ($150,000 for personal service corporations (¶ 219)) may be accumulated from past and present earnings combined by all corporations, including holding or investment companies. This minimum amount is the only credit allowable to a holding or investment company (Code Sec. 535(c)). Only one $250,000 accumulated earnings credit is allowed to a controlled group of corporations (¶ 291) (Code Sec. 1561(a)). The single credit is to be divided equally among the corporations, unless the regulations allow an unequal allocation.

263. Basis of Liability for Accumulated Earnings Tax. Although the accumulated earnings tax is computed as a percentage of the corporation's accumulated taxable income (¶ 253), liability for the tax hinges on whether the corporation was formed or availed of to avoid the income tax on income otherwise receivable by its shareholders. A corporation can be subject to the accumulated earnings tax for a year in which it has accumulated taxable income on hand even though, because of a stock redemption, no earnings and profits were accumulated for the tax year (*GPD, Inc.*, CA-6, 75-1 USTC ¶ 9142).

The courts have shifted the focus of attention from earnings and profits to liquidity (*Smoot Sand & Gravel Corp.*, CA-4, 60-1 USTC ¶ 9241). The reason for this change in emphasis is that the earnings-and-profits figure often is no indication of the funds available to the corporation to meet its business needs and pay dividends to its shareholders. Whether a corporation can be subjected to the accumulated earnings tax is therefore determined by comparing the reasonable needs of its business (¶ 265) to its total liquid assets at the end of the year. Liquid assets include the corporation's cash and marketable securities.

265. Reasonable Needs of the Business for Accumulation of Income. In order to justify an accumulation of income (¶ 251), a corporation must have a reasonable business need for it and a definite plan for its use. Since a corporation is given a credit (¶ 261) for its reasonable business needs (including reasonably anticipated needs) in figuring the accumulated earnings tax, the resolution of most disputes hinges on this issue (¶ 267).

The Code does not contain a comprehensive definition of reasonable business needs. However, a number of acceptable and unacceptable grounds for accumulating income are listed in the regulations (Code Sec. 537(b); Reg. § 1.537-2). Acceptable grounds include: (1) business expansion and plant replacement; (2) acquisition of a business through purchase of stock or assets; (3) debt retirement; (4) working capital; and (5) investments or loans to suppliers or customers necessary to the maintenance of

the corporation's business. The self-insurance of product liability risks is also a business need for which earnings and profits may be accumulated to a reasonable extent.

Unacceptable grounds include: (1) loans to shareholders and expenditures for their personal benefit; (2) loans to relatives or friends of shareholders or to others who have no reasonable connection with the business; (3) loans to a commonly controlled corporation; (4) investments that are not related to the business; and (5) accumulations to provide against unrealistic hazards.

Courts have used an operating-cycle approach to determine the amount of working capital a corporation needs. An operating cycle consists of an inventory cycle (conversion of cash and raw materials into inventory), a receivables cycle (conversion of inventory into accounts receivable and cash), and, possibly a credit cycle (accounts payable turnover) (*Bardahl Mfg. Corp.*, Dec. 27,494(M), 24 TCM 1030).

A stock redemption under Code Sec. 303 to pay death taxes and expenses (¶ 745) and a redemption of stock in order to bring a private foundation within the 20-percent excess business holdings limit (¶ 640) are good cause for an accumulation of income (Code Sec. 537(a)). Although other types of stock redemptions are not accorded this certainty, accumulations to redeem a minority interest (or the interest of one of two 50-percent stockholders) have been approved where they would eliminate dissent, would prevent the minority interest from falling into hostile hands, or were an essential ingredient of an employee incentive plan. Court decisions in this area show that except in rare circumstances, the redemption of a majority interest is not good cause for accumulating income (*Wilcox Manufacturing Co., Inc.*, Dec. 35,936(M), 38 TCM 378).

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267. Burden of Proof of Reasonable Business Needs for Accumulation of Income. On the issue of whether a corporation has accumulated income in excess of the reasonable needs of its business (¶ 265), the burden of proof in the Tax Court is on the government in two instances (Code Sec. 534; Reg. § 1.534-2). First, the burden is on the government if, in advance of a formal deficiency notice, it does not notify the corporation by certified or registered mail of its intention to assess a deficiency based in whole or in part on the accumulated earnings tax or fails to state the tax years at issue. Second, in the event of such notification, the burden falls on the government if the corporation responds within 60 days with a statement of the grounds on which it relies to establish the reasonableness of all or any part of its accumulation of income. In other courts, the burden of proof is wholly on the corporation.

269. Tax Avoidance Intent for Accumulated Earnings Tax. One of the conditions that must exist before a corporation can be subject to the accumulated earnings tax (¶ 251) is an intent to avoid the income tax on its shareholders (Code Sec. 533). If the corporation accumulates income beyond the reasonable needs of its business (or if it is a mere holding or investment company), a presumption of tax avoidance intent arises. This presumption can be overcome by showing that tax avoidance was not one of the purposes of the accumulation of income (*Donruss Co.*, 69-1 USTC ¶ 9167; *Shaw-Walker*, 69-1 USTC ¶ 9198).

Personal Service Corporation

273. Personal Service Corporations. A personal service corporation (PSC) is a corporation that furnishes personal services performed by employee-owners (Code Secs. 269A and 280H; Prop. Reg. § 1.269A-1(a)). An employee-owner is an employee who owns, directly or indirectly, more than 10 percent of the outstanding stock of the corporation on any day during the corporation's tax year.

The IRS may allocate income, deductions, credits, exclusions, or other allowances between the PSC and its employee-owners in order to prevent tax evasion or avoidance or to clearly reflect the income of both if:

- substantially all of the services of a PSC are performed for, or on behalf of, one other corporation, partnership, or other entity, and
- the principal purpose for forming or using the PSC is the avoidance or evasion of income tax by reducing the income of any employee-owner or securing

the subsidiary are not treated as passive investment income to the extent they are attributable to earnings and profits derived from the active conduct of a trade or business.

An S corporation election may be revoked with the consent of shareholders holding more than 50 percent of the outstanding shares of stock (voting and nonvoting) on the day the revocation is made. A revocation may designate a prospective effective date (Code Sec. 1362(d)(1); Reg. § 1.1362-2(a)). If no date is specified, a revocation made on or before the 15th day of the third month of a corporation's tax year is effective on the first day of the tax year. A revocation made after this date is effective on the first day of the following tax year.

If an election is terminated or revoked, the corporation may not re-elect S corporation status without IRS consent until the 5th year after the year in which the termination or revocation became effective (Code Sec. 1362(g); Reg. § 1.1362-5). An S corporation whose status as a qualified subchapter S subsidiary (QSSS or QSub) (¶ 304) has ended also cannot elect to be treated as a QSub until the 5th year after the year in which the termination was effective (Code Sec. 1361(b)(3)(D)).

In addition to formally filing an election to terminate S corporation status, an S corporation can simply create a situation that bars it from being an S corporation. This can help it avoid any delay in the effective date of the termination. For instance, S corporation status terminates immediately if the corporation creates another corporation and transfers one share of S corporation stock to the new corporation, because corporations cannot be S corporation shareholders.

Reorganizations. A corporation's subchapter S election does not terminate merely because it is a party to a reorganization (¶ 2221) if it continues to meet the S corporation eligibility requirements (Rev. Rul. 71-266). Typically, this issue arises because the reorganization results in an ineligible shareholder owning stock of the S corporation. For example, the IRS ruled that the S election of a corporation that was acquired by another corporation in a stock-for-stock type B reorganization terminated on the date of acquisition. On the other hand, the IRS has ruled that type A, C, and F reorganizations did not cause the S elections of the respective corporations to terminate when all owners of the corporations after the transaction were eligible S corporation shareholders.

Frequently, reorganizations can involve transfers of the same corporate stock several times to different parties as part of the transaction. The intermediate parties may be deemed to hold the stock only for an instant before transferring it to its ultimate holder. The question arises whether a corporation's subchapter S election terminates where one or more of these intermediate parties is not an eligible S corporation shareholder. This issue is not addressed by the Code or regulations. However, the IRS has privately ruled that having shareholders who acquire a corporation's stock only to immediately transfer it to another party does not cause the corporation's S election to terminate (LTR 200453007 and LTR 9010042).

Correction of Inadvertent Terminations. If a corporation's subchapter S election is inadvertently terminated or invalid when made, and the corporation makes a timely correction, the IRS can waive the termination or permit the election (Code Sec. 1362(f); Reg. § 1.1362-4). The IRS can also provide a waiver where an election to treat family members as one shareholder or to treat a corporation as a QSub is invalid when made or inadvertently terminated. To obtain a waiver, the corporation must correct any condition that either barred it from qualifying as a subchapter S corporation or otherwise made an election invalid, and must obtain any required shareholder consents. All shareholders must also agree to make such adjustments as may be required by the IRS.

Election to End Tax Year. If a shareholder terminates their interest in an S corporation and all affected shareholders consent, the tax year can be treated as two tax years, the first of which ends on the date of termination (Code Sec. 1377(a)(2)). Affected shareholders include the shareholder whose interest is terminated and all shareholders to whom that shareholder transferred shares during the tax year.

S Corporation Shareholders

See CCH® AnswerConnect: ***Treatment of S Corporation Shareholders*** **for more information on this topic.**

309. Taxation of S Corporation Shareholders. Each shareholder of an S corporation separately accounts for their pro rata share of corporate items of income, deduction, loss, and credit in their tax year in which the corporation's tax year ends (Code Sec. 1366(a); Reg. §§ 1.1366-1(a) and 1.1377-1). Certain items must be separately stated if they could affect the shareholder's individual tax liability (¶ 320). A shareholder's share of each item generally is based on the number of shares held on each day of the corporation's tax year.

The character of an item included in a shareholder's pro rata share of S corporation income is generally determined as if the shareholder realized the item directly from the same source or incurred it in the same manner as the corporation, subject to exceptions (Code Sec. 1366(b); Reg. § 1.1366-1(b)). Thus, when income passes through from the S corporation to the shareholder, the character of that income passes through as well. For example, if an S corporation makes a charitable contribution to a qualifying organization, a shareholder's pro rata share of the contribution is characterized as made to a qualifying organization.

Similarly, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain is also characterized as a capital gain, regardless of whether the item would be a capital asset in the shareholder's hands. However, the general rule for capital gains does not apply if the S corporation is formed or availed of for a principal purpose of selling or exchanging contributed property that would not have produced capital gain if sold or exchanged by the shareholder independently.

The same exception applies when the S corporation is formed or availed of for a principal purpose of selling or exchanging contributed property that would have produced capital loss if sold or exchanged by the shareholder. Any loss recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder exceeded the fair market value of the property.

Duty of Consistency. A shareholder must treat a subchapter S item in a manner consistent with the treatment of that item on the S corporation's return (Code Sec. 6037). Any shareholder who does not treat the item consistently must file a statement identifying the inconsistency.

At-Risk and Passive Activity Rules. The at-risk rules disallow losses that exceed an investor's amount at risk (¶ 1155). The amount at risk is generally the amount of investment that an investor could lose. The at-risk rules apply to all individuals, including S corporation shareholders, and are applied at the shareholder level (Code Sec. 465). The at-risk amount is determined at the close of the S corporation's tax year. Thus, an S corporation shareholder who realizes that their at-risk amount is low, and wishes to deduct an anticipated S corporation net loss, can make additional contributions to the corporation.

Likewise, passive activity loss (PAL) rules generally are applied at the shareholder level (¶ 1169) (Code Sec. 469). However, several determinations that affect the application of the PAL rules must be made at the corporate level. For example, the determination of whether an activity constitutes a trade or business, as opposed to a rental activity, is made at the corporate level. The distinction between portfolio and nonportfolio income is also made at the corporate level. This information is conveyed on schedules (generally Schedule K-1 (Form 1120-S)) that the S corporation provides to its shareholders. The shareholder then uses the information to apply the PAL and at-risk limitations when preparing their own individual tax return.

Since a qualified subchapter S trust (QSST) (¶ 304) is treated as the shareholder when it disposes of S corporation stock, the application of the at-risk and PAL rules would normally be determined at the trust level, not the beneficiary level. However, to

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arising in a tax year in which the S corporation was a C corporation can offset the built-in gains tax (Code Sec. 1374(b)(3)(B); Reg. § 1.1374-6).

339. LIFO Recapture by S Corporation. A C corporation that maintains inventory using the last-in, first-out (LIFO) method (¶ 1565) for its last tax year before an S corporation election becomes effective must include in gross income a LIFO recapture amount when it converts to S corporation status (Code Sec. 1363(d); Reg. § 1.1363-2). LIFO recapture is also required for transfers of inventory from a C corporation to an S corporation in a tax-free reorganization. The LIFO recapture amount is the amount, if any, by which the amount of the inventory assets using the first-in, first-out (FIFO) method (¶ 1564) exceeds the inventory amount of such assets under the LIFO method.

The tax attributable to the inclusion in income of any LIFO recapture amount is payable by the corporation in four equal installments. The first payment is due on or before the due date of the corporate tax return for the electing corporation's last tax year as a C corporation. The three subsequent installments are due on or before the respective due dates of the S corporation's returns for the three succeeding tax years. No interest is payable on installments that are paid by their due dates.

341. Passive Investment Income of S Corporation. An S corporation with accumulated earnings and profits that also has passive investment income totaling more than 25 percent of gross receipts is subject to an income tax computed by multiplying excess net passive income by the highest corporate income tax rate (Code Sec. 1375; Reg. § 1.1375-1). Passive investment income is gross receipts derived from royalties, rents, dividends, annuities, and interest (excluding interest on installment sales of inventory to customers and gross receipts from certain lending and financing businesses) (Code Sec. 1362(d)(3)(C); Reg. § 1.1362-2(c)(5)). Passive investment income is determined without taking into account any recognized built-in gain or loss during the recognition period (¶ 337).

Income derived by an S corporation in the ordinary course of its trade or business is generally excluded from the definition of passive investment income. For an S corporation bank (including a bank holding company and a depository institution holding company), passive investment income does not include interest earned by the bank or any dividends received on assets that the bank is required to hold. The exception for assets applies to stock in the Federal Reserve Bank, the Federal Home Loan Bank, and the Federal Agriculture Mortgage Bank, and participation certificates issued by a Federal Intermediate Credit Bank.

Excess net passive income is the amount that bears the same ratio to net passive income as the amount of passive investment income that exceeds 25 percent of gross receipts bears to passive investment income (Code Sec. 1375(b); Reg. § 1.1375-1(b)). Net passive income is passive investment income reduced by any allowable deduction directly connected with the production of such income except for the net operating loss (NOL) deduction (¶ 1145) and the special deductions allowed to corporations in computing taxable income (¶ 221—¶ 237). Excess net passive income cannot exceed the corporation's taxable income for the tax year computed without regard to any NOL deduction or the special deductions allowed to corporations, other than the deduction for organizational expenditures (¶ 237).

The tax on excess net passive income reduces each item of passive income by the amount of tax attributable to it, and thereby reduces the amount of passive investment income that each shareholder must take into account in computing gross income (Code Sec. 1366(f)(3)). The only credits allowable against the passive investment income tax are those for certain uses of gasoline and special fuels (¶ 1429) (Code Sec. 1375(c); Reg. § 1.1375-1(c)).

The IRS may waive the tax on excess net passive income if the S corporation establishes:

- that it made a good-faith determination that it had no C corporation earnings and profits at the close of the tax year; and

- within a reasonable time after determining that it did have C corporation earnings and profits at the close of the tax year, those earning and profits were distributed (Code Sec. 1375(d); Reg. § 1.1375-1(d)).

349. Foreign Income of S Corporation. Foreign taxes paid by an S corporation pass through to shareholders who can elect to treat them as deductions or credits on their individual returns (Code Sec. 1373). An S corporation is treated as a partnership rather than a corporation. The foreign loss recapture rules apply to an S corporation that previously passed foreign losses through to the shareholders and subsequently terminates its S corporation status. For the purpose of computing the amount of foreign losses that must be recaptured, the making or termination of an S corporation election is treated as a disposition of a trade or business.

Returns and Tax Year

See CCH® AnswerConnect: *S Corporation Return Requirements* for more information on this topic.

351. S Corporation Return (Form 1120-S). An S corporation must file Form 1120-S for each tax year its S corporation election is in effect (¶ 303), regardless of whether it has taxable income for that year (Reg. § 1.6012-2(h)). The return must be filed electronically if the corporation has assets of at least $10 million or more reported on Schedule L and the corporation is required to file at least 250 returns during a calendar year before 2021 (¶ 2503). Under proposed regulations, a corporation must file electronically if it is required to file at least 10 returns during a calendar year beginning after the date the regulations become final (Proposed Reg. § 301.6037-2).

Form 1120-S is due on or before the 15th day of the third month following the close of the tax year (March 15th for a calendar-year S corporation) (Code Sec. 6072(b); Reg. § 1.6072-2(a)). An S corporation may obtain an automatic six-month filing extension by filing Form 7004 on or before the due date of its return (Reg. § 1.6081-3(a)).

An S corporation must provide to each shareholder a copy of the information shown on Schedule K-1 (Form 1120-S). The information must be provided on or before the day the corporation files Form 1120-S (Code Sec. 6037(b)). Beginning with the 2021 tax year, an S corporation with items of international tax relevance may also have to complete Schedule K-2 (Form 1120-S) and Schedule K-3 (Form 1120-S) with its return. The schedules replace and supplement the reporting of certain items that used to be reported on Schedules K and K-1. The S corporation must provide a copy of Schedule K-3 to its shareholders according the same deadline as Schedule K-1.

Penalties. An S corporation that fails to file a timely and complete Form 1120-S is liable for an inflation-adjusted penalty on a per shareholder, per month basis for a maximum of twelve months (Code Sec. 6699). The penalty is $210 per shareholder for each month or fraction of a month for returns required to be filed in 2021 or 2022 (Rev. Proc. 2019-44; Rev. Proc. 2020-45). An S corporation may not contest the penalty assessment in the Tax Court but can pay the entire penalty and then sue for a refund. No penalty will be imposed if the failure is due to a reasonable cause and not willful neglect.

An S corporation may also be subject to penalties for failure to furnish Schedule K-1 and Schedule K-3 to its shareholders (¶ 2823). However, the IRS will not impose the penalty for failure to file a correct information return for incorrect or incomplete reporting on Schedules K-2 and K-3 for tax years beginning in 2021 if the corporation made a good faith effort to comply with the requirements and to file and/or furnish the schedules (Notice 2021-39).

355. Tax Year of S Corporation. The tax year of an S corporation must be a permitted year. Permitted years include the calendar year, a tax year elected under Code Sec. 444 (¶ 1501), a 52-53 week tax year ending with reference to the calendar year or a tax year elected under Code Sec. 444, or any other tax year for which the corporation establishes a business purpose to the satisfaction of the IRS (Reg. § 1.1378-1(a)). The procedures for an S corporation to establish a business purpose are contained in Rev. Proc. 2006-46.

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of the building are excluded from the definition of qualified improvement property. However, structural components that benefit a common area are not (Code Sec. 168(e)(6)).

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).

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)).

Indian Reservation Property. For qualified Indian reservation property placed in service after December 31, 1993, and before January 1, 2022, 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), as amended by (P.L. 116-136)).

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 2021 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 (discussed above) (Code Sec. 168(e)(3)(E)(vii) and (e)(6)). Interior improvements placed in service before 2018 may qualify for a 15-year recovery period as qualified leasehold improvement property (¶ 1234), qualified retail improvement property (discussed above), or qualified restaurant property (discussed above).

Roofs. In tax years beginning after 2017, a replacement roof on nonresidential real property may qualify for section 179 expensing (¶ 1208). Otherwise, the cost of replacing an entire roof is capitalized and depreciated over 39 years (nonresidential) or 27.5 years (residential rental property) (Code Sec. 168(c)). For example, 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).

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)).

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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 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.

Year	*Method*	*Rate*		*Unrecovered Basis*			*Depreciation*
1	DB	.40	×	$ 10,000 × .5 (half-yr. conv.)			= $ 2,000
2	DB	.40	×	(10,000 – 2,000)	=	$8,000 . .	= 3,200
3	DB	.40	×	(8,000 – 3,200)	=	4,800 . .	= 1,920
4	DB	.40	×	(4,800 – 1,920)	=	2,880 . .	= 1,152
5	SL	.6667	×	(2,880 – 1,152)	=	1,728 . .	= 1,152
6	SL	1.000	×	(1,728 – 1,152)	=	576 . .	= 576
						0	
						Total . .	$10,000

Rev. Proc. 87-57 provides a detailed discussion of computing MACRS without tables.

Computation of Deduction Using Tables. Instead of using the rules above, taxpayers may compute depreciation using MACRS depreciation tables that contain the annual percentage depreciation rates to be applied to the unadjusted basis of property in each tax year (Rev. Proc. 87-57). The tables incorporate the appropriate convention and a switch from the declining-balance method to the straight-line method in the year that the latter provides a depreciation allowance equal to, or larger than, the former. The tables may be used for any item of property that qualifies for MACRS. Selected MACRS depreciation tables are reproduced below.

An MACRS depreciation table that is used to compute the annual depreciation allowance for any item of property generally must be used throughout the entire recovery period. However, a taxpayer may not continue to use a table if there are any adjustments to the basis of the property for reasons other than (1) depreciation allowances, or (2) an addition or improvement to the property that is subject to depreciation as a separate item of property. The MACRS depreciation table percentages may not be used in short tax years (¶ 1244).

Example 2: Depreciation on five-year property purchased by a calendar-year taxpayer in January of the current tax year at a cost of $10,000 is computed under the general MACRS 200-percent declining-balance method over a five-year recovery period using the half-year convention. No amount is expensed under Code Sec. 179 or claimed as a bonus depreciation deduction.

If the depreciation tables provided by the IRS are used, depreciation is computed as follows: the applicable depreciation rate in Table 1 under the column for a five-year recovery period for the applicable recovery year is applied to the cost of the property.

Year	*Rate*	*Unadj. Basis*	*Depreciation*	*Basis*
1	.20 ×	$ 10,000 =	$ 2,000	($10,000 – $2,000) = $8,000
2	.32 ×	10,000 =	3,200	(8,000 – 3,200) = 4,800
3	.192 ×	10,000 =	1,920	(4,800 – 1,920) = 2,880
4	.1152 ×	10,000 =	1,152	(2,880 – 1,152) = 1,728
5	.1152 ×	10,000 =	1,152	(1,728 – 1,152) = 576
6	.0576 ×	10,000 =	576	(576 – 576) = 0
		Total	$10,000	

12 DEPRECIATION

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immediately after the acquisition, the acquirer and the target are related within the meaning of Code Sec. 267(b) or Code Sec. 707(b), and

• a reorganization described in Code Sec. 368(a)(1)(A), (B), or (C), or a reorganization described in Code Sec. 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under Code Sec. 354 or Code Sec. 356 (whether the taxpayer is the acquirer or the target in the reorganization).

Costs to investigate or pursue a covered transaction are inherently facilitative (and, therefore, capitalized regardless of when paid or incurred) if paid to (Reg. § 1.263(a)-5(e)(2)):

• secure an appraisal, formal written evaluation, or fairness opinion related to the transaction (general due diligence costs are not inherently facilitative),

• structure the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of Code Sec. 368),

• prepare and review the documents that effectuate the transaction (for example, a merger agreement or purchase agreement),

• obtain regulatory approval of the transaction, including preparing and reviewing regulatory filings,

• obtain shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders), or

• convey property between the parties to the transaction (for example, transfer taxes and title registration costs).

Success-Based Fees. The IRS will not challenge a taxpayer's allocation of a success-based fee between activities that facilitate a covered transaction and activities that do not facilitate the covered transaction if the taxpayer (1) treats 70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction; (2) capitalizes the remaining 30 percent as an amount that does facilitate the transaction; and (3) attaches a statement to its original federal income tax return for the tax year the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized. An election applies only to the transaction for which the election is made and, once made, is irrevocable. The election applies with respect to all success-based fees paid or incurred by the taxpayer in the transaction for which the election is made (Rev. Proc. 2011-29). This safe harbor is in lieu of the documentation otherwise required by Reg. § 1.263(a)-5(f).

Uniform Capitalization Rules (UNICAP)

See CCH® AnswerConnect: *Uniform Capitalization Rules (UNICAP)* for more information on this topic.

1330. Uniform Capitalization Rules (UNICAP). A taxpayer subject to the uniform capitalization (UNICAP) rules must capitalize all direct costs and an allocable portion of most indirect costs that are associated with production or resale activities. The uniform capitalization rules generally apply to:

• real or tangible personal property produced by the taxpayer for use in a trade or business or in an activity engaged in for profit;

• real or tangible personal property produced by the taxpayer for sale to customers; and

• real or personal property, both tangible and intangible, acquired by the taxpayer for resale (Code Sec. 263A).

Property acquired for resale includes stock in trade of the reseller or other property which is includible in the reseller's inventory if on hand at the close of the tax year and property held primarily for sale to customers in the ordinary course of the reseller's trade or business (Code Sec. 263A(b)(2); Reg. § 1.263A-3(a)(1)).

Costs attributable to producing or acquiring property generally are capitalized by charging them to capital accounts or basis. Costs attributable to property that is inventory in the hands of the taxpayer generally are capitalized by including them in inventory (Reg. § 1.263A-3(c)(3)).

Costs Excepted from Rules. Among the costs excepted from the UNICAP rules are (Code Sec. 263A(c)):

• cost of property produced by the taxpayer for its own use other than in a trade or business or in an activity conducted for profit;

• research and experimental expenditures (¶ 979);

• geological and geophysical expenses (¶ 1360), intangible drilling and development costs (¶ 989), and mine development and exploration costs (¶ 987);

• cost of property produced by the taxpayer under a long-term contract (¶ 1551);

• any costs incurred in raising, growing or harvesting trees (including the costs associated with the underlying real property) other than trees bearing fruit, nuts, or other crops and ornamental trees (ornamental evergreen trees are subject to UNICAP if six years or less when severed from the roots);

• amounts allowable as a deduction relating to the optional ten-year write-off of certain tax preferences under the alternative minimum tax (AMT) rules, with respect to mining exploration and development costs, research and experimental expenditures, and intangible drilling costs (60-month write-off for IDCs), but not circulation expenditures (¶ 194); and

• bonus depreciation deduction on specified plants claimed in year of grafting or planting (¶ 1237).

The Code Sec. 179 expense deduction (¶ 1208) is not capitalized under the UNICAP rules or the general capitalization rules (Reg. § 1.179-1(j)).

Small Producer or Reseller Exception. A producer or reseller is exempt from the UNICAP rules if it meets the small business taxpayer gross receipts test for using the cash method of accounting (¶ 1515) (Code Sec. 263A(i); Reg. § 1.263A-1(j)). A taxpayer meets the small business test for the tax year if its average annual gross receipts for the three prior tax years do not exceed $26 million for 2021 and projected to be $27 million for 2022 (Rev. Proc. 2020-45). A sole proprietorship applies the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership. A tax shelter that is not allowed to use the cash method of accounting does not qualify for the small business exception.

A taxpayer making a change in accounting method to apply this UNICAP exception should treat the change as initiated by the taxpayer and made with the IRS's consent for Code Sec. 481 adjustment purposes (¶ 1531). An automatic change in accounting method procedure allows a small business taxpayer to change to a method of accounting that no longer capitalizes costs under the UNICAP rules (Rev. Proc. 2018-40).

1332. Direct and Indirect Expenses Subject to UNICAP Rules. Direct material and labor costs and indirect costs generally must be capitalized under the uniform capitalization (UNICAP) rules (¶ 1330) with respect to property that is produced or acquired for resale (Code Sec. 263A(a)(2); Reg. § 1.263A-1(e)). Direct material costs include the costs of materials that become an integral part of the subject matter and materials that are consumed in the ordinary course of the activity. Direct labor costs include the cost of labor that can be identified or associated with a particular activity such as basic compensation, overtime pay, vacation pay, and payroll taxes.

Indirect costs include all costs other than direct material and labor costs. Indirect costs require a reasonable allocation to determine the portion of such costs that are attributable to each activity of the taxpayer. This includes: repair and maintenance of equipment or facilities; utilities; rental of equipment, facilities, or land; indirect labor and contract supervisory wages; indirect materials and supplies; depreciation, amortization and cost recovery allowance on equipment and facilities (to the extent allowable as

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maintenance costs may be incurred on property other than the damaged property if the acreage does not exceed the acreage of the damaged property.

A temporary exception to the UNICAP rules allows a person other than the taxpayer to deduct certain costs paid or incurred before December 23, 2027, in connection with replanting citrus plants lost to casualty. The exception applies if the taxpayer has at least a 50-percent equity interest in the replanted citrus plants at all times during the tax year when the replanting costs were paid or incurred, and the other person holds any part of the remaining interest in the replanted plants. It also applies if the other person acquired all of the taxpayer's equity interest in the land on which plants were located at the time of the casualty, and replanting is on that land. The IRS has provided procedures to obtain automatic consent to change accounting methods for this purpose (Code Sec. 263A(d)(2)(C); Reg. § 1.263A-4(e)(5); Rev. Proc. 2019-43).

A farming business is a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (Code Sec. 263A(e)(4)). Examples include: a nursery or sod farm; the raising of ornamental trees (including evergreen trees six years old or less when severed from their roots); the raising or harvesting of trees bearing fruit, nuts, or other crops; and the raising, shearing, feeding, caring for, training, and managing of animals.

Any farmer, other than a corporation, partnership, or tax shelter required to use the accrual method, may elect not to apply the UNICAP rules to any plant produced in the farming business (may elect to deduct preproductive expenditures) (Code Sec. 263A(d)(3) and (e); Reg. § 1.263A-1(b)(3)). The election may not be made for any costs incurred within the first four years in which any almond or citrus trees were planted.

If the election is made the farmer must use the Modified Accelerated Cost Recovery System (MACRS) alternative depreciation system (ADS) to depreciate farm property placed in service in the election year and any subsequent year that the election remains in effect. Furthermore, preproductive expenditures that are not capitalized are subject to recapture under the section 1245 recapture rules (Code Sec. 263A(e)).

Unless IRS consent is obtained, a farmer may elect out of the UNICAP rules only for the first tax year in which the taxpayer is otherwise required to capitalize preproductive costs (Code Sec. 263A(d)(3)(D); Reg. § 1.263A-4(d)(3)). Once the election is made, it is revocable only with the consent of the IRS.

Farmers who qualify as small business taxpayers (¶ 1330) are exempt from the uniform capitalization rules and may receive automatic consent to revoke a prior election. If the election is revoked, then the MACRS change in use rules (Reg. § 1.168(i)-4) are used to switch depreciating property placed in service while the election was in effect from ADS to the MACRS general depreciation system (GDS). Farmers who no longer qualify for the exemption may also make the election to deduct preproductive costs in the first tax year in which the farmer exceeds the section 448 average annual gross receipts amount (Rev. Proc. 2020-13). These changes are not changes in accounting method (Reg. § 1.263A-4(d)(5); Reg. § 1.263A-4(d)(6)).

1344. Exception to Uniform Capitalization Rules for Production of Creative Property. The uniform capitalization (UNICAP) rules (¶ 1330) do not apply to expenses paid or incurred by a self-employed individual, including expenses of a corporation owned by a free-lancer and directly related to the activities of a qualified employee-owner, in the business of being a writer, photographer, or artist whose personal efforts create or may reasonably be expected to create the product (Code Sec. 263A(h)). Expenses for producing jewelry, silverware, pottery, furniture, and similar household items are generally not exempt.

Amortization

See CCH® AnswerConnect: *Intangible Property and IRC § 197* for more information on this topic.

1360. Property Subject to Amortization. Amortization is the recovery of certain capital expenditures, that are not ordinarily deductible, in a manner that is similar to

straight-line depreciation. That portion of the basis of property that is recovered through amortization deductions may not also be depreciated.

Pollution Control Facilities. Taxpayers may elect to amortize over a 60-month period the cost of certified pollution control facilities added to or used in connection with a plant in operation before 1976. The amortization deduction is available only for the portion of the facility's basis attributable to the first 15 years of its recovery period if it has a recovery period under the Modified Accelerated Cost Recovery System (MACRS) in excess of 15 years. The remaining basis is depreciable. An air pollution control facility placed in service after April 11, 2005, in connection with a coal-fired plant placed in operation after 1975 qualifies for an 84-month amortization period. The 60-month amortization period continues to apply to an air pollution facility placed in service after April 11, 2005, in connection with a coal-fired plant placed in operation before 1976 (Code Sec. 169).

Architectural and Transportation Barriers. Business taxpayers can elect to deduct up to $15,000 of the costs of removing certain architectural and transportation barriers for handicapped or elderly persons in the year paid or incurred instead of capitalizing and depreciating such costs (Code Sec. 190).

Reforestation Expenditures. A taxpayer (other than a trust) may elect to expense up to $10,000 of qualified reforestation expenditures each tax year for each qualified timber property. Any taxpayer, including a trust or estate, may elect to amortize over 84 months amounts for which a current deduction is not elected (Code Sec. 194; Notice 2006-47).

Start-Up and Organizational Costs. A taxpayer who enters into a trade or business can elect to expense up to $5,000 of start-up costs, reduced dollar for dollar when the start-up expenses exceed $50,000. Any remaining balance is amortized over the 180-month period (Code Sec. 195) (¶ 904). See ¶ 237 for corporate organization fees. See ¶ 477 and ¶ 481 for costs of organizing a partnership.

Oil and Gas Geological and Geophysical Expenditures. Geological and geophysical (G&G) expenditures paid or incurred in connection with oil and gas exploration or development in the United States must be amortized ratably over a 24-month period beginning on the mid-point of the tax year that the expenses were paid or incurred. If a property or project is abandoned or retired during the 24-month amortization period, any remaining basis must continue to be amortized (Code Sec. 167(h)). However, major integrated oil companies must ratably amortize any G&G costs over seven years.

1362. Amortization of Section 197 Intangibles. The capitalized cost of goodwill and many other intangibles acquired by a taxpayer and held in connection with a trade or business or for the production of income are ratably amortized over a 15-year period generally beginning in the month of acquisition (Code Sec. 197). Intangibles that are amortizable under this provision are referred to as amortizable section 197 intangibles and include:

- goodwill, going concern value, and covenants not to compete entered into in connection with the acquisition of a trade or business (¶ 1743);
- workforce in place;
- information base;
- a patent, copyright, formula, design, or similar item;
- any customer-based intangible;
- any supplier-based intangible;
- any license, permit, or other right granted by a governmental unit or agency; and
- any franchise, trademark, or trade name (Code Sec. 197(d)).

In order for a section 197 intangible to be amortizable it generally must be separately acquired for use in a trade or business or acquired as part of the acquisition of a trade or business. For example, goodwill that is created through a taxpayer's own

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benefits, as well as other benefits that are excludable from gross income. However, the initial amount is not reduced for any pension, annuity, or disability benefits for personal injuries or sickness resulting from active military service.

The initial amount is further reduced by one-half of the excess of the taxpayer's adjusted gross income (AGI) over the following levels:

Single	$7,500
Married filing jointly	10,000
Married filing separately	5,000

The credit is effectively eliminated once AGI exceeds: $17,500 for a single individual; $20,000 for a joint return with one qualifying spouse; $25,000 for a joint return with two qualifying spouses; and $12,500 for a married individual filing a separate return.

The applicable initial amount for a permanently and totally disabled individual under age 65 may not exceed the individual's disability income for the tax year. Disability income is the total amount that is included in the individual's gross income under the rules for annuities (¶ 817) or accident and health plans (¶ 2015) to the extent the amount constitutes wages, or payments in lieu of wages, for periods during which the individual is absent from work due to permanent and total disability. If both spouses filing a joint return are qualified individuals and one spouse has reached age 65 before the close of the tax year, the initial amount cannot exceed $5,000 plus the disability income for the spouse who is not 65.

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

1403. Education Credits (American Opportunity and Lifetime Learning Credits). An individual may claim two types of educated-related tax credits, the American Opportunity tax credit (AOTC) and the lifetime learning credit, for qualified tuition and related expenses paid or incurred during the tax year (Code Sec. 25A; Reg. § 1.25A-1; Prop. Reg. § 1.25A-1). Up to 40 percent of the AOTC may be refunded; otherwise, the credits are nonrefundable.

Both education credits are calculated on Form 8863. The credits cannot be claimed by a married individual filing separately or by a person who qualifies as another taxpayer's dependent (¶ 137). Qualified expenses paid by a student are treated as paid by the taxpayer who could claim the student as a dependent. The taxpayer's return must include the student's name and taxpayer identification number (TIN). For the AOTC, the TIN must be issued before the taxpayer files the return. The taxpayer also must receive a copy of Form 1098-T from the eligible educational institution before claiming either credit.

For tax years beginning after 2020, both credits phase out ratably for a taxpayer with modified adjusted gross income (MAGI) between $80,000 and $90,000 (or $160,000 and $180,000 for joint filers). These thresholds are not adjusted for inflation. MAGI is AGI determined without regard to the exclusions for foreign earned income (¶ 2402), foreign housing expenses (¶ 2403), and U.S. possession income (¶ 2414 and ¶ 2415).

American Opportunity Tax Credit (AOTC). The AOTC is the sum of 100 percent of the first $2,000 of qualified tuition and related expenses paid by the taxpayer for an eligible student, plus 25 percent of the next $2,000 of qualified expenses paid. Thus, the maximum credit is $2,500 per eligible student per year (Code Sec. 25A(b)(1) and (d)). Up to 40 percent of the credit amount is refundable if it exceeds the taxpayer's regular tax and alternative minimum tax (AMT) liability. However, if the student is subject to the kiddie tax (¶ 115), then no portion of the credit is refundable (Code Sec. 25A(i)).

An eligible student for the AOTC is any individual who:

- has not completed the first four years of post-secondary education at an eligible institution before the beginning of the current tax year;

- is enrolled at least half-time in an academic program during the calendar year or the first three months of the following calendar year that leads to a degree, certificate, or other recognized educational credentials; and
- has not been convicted of any federal or state felony class offense for possession or distribution of a controlled substance as of the end of the year (Code Sec. 25A(b)(2) and (b)(3)).

Lifetime Learning Credit. The lifetime learning credit is equal to 20 percent of up to $10,000 in qualified tuition and related expenses paid by the taxpayer for eligible students during the tax year (Code Sec. 25A(c) and (d), as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (P.L. 116-260)). The credit is calculated on a per-taxpayer rather than a per-student basis. An eligible student must be enrolled in at least one course at an eligible educational institution. For tax years beginning before 2021, the credit amount phased out when MAGI exceeded an inflation-adjusted threshold. For 2020, the credit began to phase out when MAGI reached $59,000 ($118,000 for joint returns), and was completely phased out when MAGI reached $69,000 ($138,000 for joint returns) (Rev. Proc. 2019-44). For tax years beginning after 2020, the income threshold for claiming the lifetime learning credit is increased and is the same as for the AOTC.

Qualified Tuition and Related Expenses. The education credits may be claimed for qualified tuition and related expenses required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent as an eligible student at an eligible educational institution of higher education (Code Sec. 25A(f); Reg. § 1.25A-2; Prop. Reg. § 1.25A-2). Qualified expenses include course materials such as books, supplies, or equipment required for enrollment. They do not include room and board, insurance, student health fees, transportation costs, or expenses that relate to any education that involves sports, games, or hobbies unless part of the student's degree program. Qualified expenses paid during the year for an academic period that begins in the first three months of the following year can be used in figuring the credits for the current year. The same expenses cannot be used for more than one of the credits.

Coordination with Other Education Benefits. Qualified expenses for any student must first be reduced by any tax-free educational assistance received, including scholarships or fellowships (¶ 865), veterans' educational assistance allowances, employer-provided educational assistance (¶ 2067), and any other educational assistance excluded from gross income (for example, Pell grants), other than gifts, bequests, devises, or inheritances (Code Sec. 25A(g)(2) and (g)(5); Reg. § 1.25A-5(c) and (d)). However, a qualified emergency financial aid grant related to the coronavirus (COVID-19) pandemic (¶ 887) does not reduce the amount of qualified tuition expenses even though the grant is excluded from gross income (Act Sec. 277(a) of COVID-related Tax Relief Act (P.L. 116-260)). Tuition and related expenses that are deducted under any other Code Section also do not qualify for the education credits (¶ 1011A).

Expenses used to claim the education credits cannot be taken into account when determining excludable distributions from Coverdell educational savings accounts (ESAs) (¶ 867) and qualified tuition programs (QTPs) (¶ 869). The 10-percent additional tax for excess distributions from Coverdell ESAs or QTPs is waived if the excess is caused by claiming an educational credit. After eligible expenses are reduced by an educational credit and distributions from Coverdell ESAs or QTPs, the remaining expenses may be used to determine the excludable amount of Series EE United States Savings Bonds interest (¶ 730) (Code Secs. 135(d)(2), 529(c)(3)(B), and 530(d)(2)(C)).

Fraudulent, Reckless, or Improper Claims. A taxpayer who fraudulently or recklessly claims the AOTC is temporarily prohibited from claiming the credit in subsequent tax years. If the credit is reduced or denied in a deficiency procedure, the taxpayer's next return that claims the credit must include Form 8862 (Code Sec. 25A(b)(4)).

Paid Preparer's Due Diligence. A penalty may be imposed on a paid tax return preparer who fails to comply with due diligence requirements for any return claiming the AOTC. The preparer must include Form 8867 with the taxpayer's return or claim for refund (¶ 2807).

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Eligible Individuals and Dependents. An eligible individual is any individual other than an individual who qualifies as another taxpayer's dependent for a tax year beginning during the calendar year in which the individual's tax year begins, a nonresident alien, or an estate or trust. An eligible individual's dependent is defined by reference to Code Sec. 152 (¶ 137), so the credit applies to both qualifying children and qualifying relatives. An eligible individual's tax return must include a valid identification number (a social security number (SSN) valid for employment in the U.S., or an adoption taxpayer identification number (ATIN)) for each eligible individual and dependent.

Economic Impact Payments. The IRS made advanced refunds of the credit via economic impact payments (EIPs) in 2021. The payments were based on the eligible individual's 2020 or 2019 income tax return, or other information available to the IRS. An individual who was not required to file a 2020 return could file a simplified return to receive EIPs (Rev. Proc. 2021-24). An eligible individual who died before 2021 was not eligible to receive EIPs unless the decedent served in the military during the tax year and filed a joint return that included the decedent's valid SSN. Similarly, no advance refund was allowed with respect to a dependent who died before 2021.

A taxpayer calculates the Recovery Rebate credit on their 2021 tax returns as a refundable credit against 2021 taxes. An EIP reduces the amount of the credit, but not below zero. Thus, a taxpayer does not have to repay any of an EIP that exceeds the amount of the 2021 credit calculated on the return. For example, a taxpayer does not have to repay an EIP attributable to a dependent claimed on a 2020 return who is not claimed for 2021. An eligible individual may claim an additional credit on a 2021 return if it exceeds the EIPs received during the year (for example, when a dependent is born or adopted during 2021). One half of any advance payment or refund made on a joint return is treated as paid to each spouse.

2020 Recovery Rebate Credits. An eligible individual was allowed two similar 2020 Recovery Rebate Credits which were also paid in advance via EIPs based on 2019 or 2018 returns. The first 2020 credit was up to $1,200 for each eligible individual, plus $500 for each qualifying child as defined for purposes of the child tax credit (¶ 1405) (Code Sec. 6428). The additional 2020 credit was up to $600 for each eligible individual and qualifying child (Code Sec. 6428A, as added by the COVID-related Tax Relief Act of 2020 (P.L. 116-260)). The maximum amount of each credit was reduced (but not below zero) by five percent of AGI over $150,000 for joint filers and surviving spouses, $112,500 for heads of household, and $75,000 for other taxpayers. EIPs for the original credit had to be issued before 2021, and EIPs for the additional credit had to be issued by January 15, 2021. Taxpayers claimed the credits on their 2020 returns, as reduced (but not below zero) by the EIPs. Taxpayers did not have to repay EIPs that exceeded credits claimed on 2020 returns, but they were entitled to refunds of credits that exceeded their EIPs.

1421. Credit for Taxes Withheld on Wages. An individual is allowed a credit against income tax liability for income taxes withheld from salary or wages (Code Sec. 31). The credit is claimed on Form 1040 or 1040-SR.

A taxpayer is also allowed a refund of any Social Security (or railroad retirement) taxes that were overwithheld from wages. The maximum amount of these taxes that may be withheld is 6.2 percent of the wage base. Thus, these taxes might be overwithheld if an individual works for more than one employer and earns more than the wage base in total. The wage base is $142,800 for 2021 and $147,000 for 2022 (¶ 2648). Medicare taxes cannot be over withheld since they are not limited to a wage base. A taxpayer uses Schedule 3 (Form 1040) to claim a credit for the overwithheld taxes. An individual who is not required to file an income tax return may file a refund claim on Form 843 (Reg. § 31.6413(c)-1).

A nonresident alien (or foreign corporation) is allowed a credit against income tax liability for taxes withheld on U.S. source income that is not effectively connected with a U.S. trade or business (Code Sec. 33). See ¶ 2455 for the withholding of tax on payments other than wages to nonresident aliens.

1422. Earned Income Credit. The earned income credit (EIC or EITC) is a refundable tax credit based on the taxpayer's earned income up to a threshold amount,

and number of qualifying children (Code Sec. 32). An individual who does not have a qualifying child is eligible for the credit if:

- the individual's principal residence is in the United States for more than half of the tax year;
- the individual, or the spouse if married filing jointly, is an eligible age; and
- the individual is not a dependent of another taxpayer.

The EIC for taxpayers with no qualifying children (the childless EIC) is normally available only if the taxpayer (or spouse on a joint return) is between the ages of 25 and 65 at the close of the tax year. However, for tax years beginning in 2021, there is no maximum age, and the minimum age drops to: (1) 19 for most taxpayers; (2) 18 for a qualified former foster youth or a qualified homeless youth; and (3) 24 for a specified student. A qualified former foster youth is an individual who was in foster care after reaching the age of 14. A qualified homeless youth is an individual who certifies, in a manner provided by the IRS, that he or she is an unaccompanied youth who is homeless child or youth; or is unaccompanied, at risk of homelessness, and self-supporting. A specified student is an individual who, for at least five months during the tax year, is an eligible student as defined for purposes of the American Opportunity credit (¶ 1403) (Code Sec. 32(n), as added by the American Rescue Plan Act (P.L. 117-2)).

The EIC may not be claimed if the taxpayer is a qualifying child of another taxpayer, elects to exclude foreign earned income or housing expenses (¶ 2402 and ¶ 2403), is a nonresident alien who has not elected to be a resident alien (¶ 2410), or has excessive investment income. The credit may be claimed only for a full 12-month tax year, unless a short year results from the taxpayer's death. The IRS will not refund the EIC until the 15th day of the second month following the close of the tax year (February 15 for calendar year taxpayers) (Code Sec. 6402(m)).

Married individuals generally must file a joint return to claim the credit. However, a married individual living apart from the spouse for the last six months of the tax year may qualify for head of household filing status and claim the credit on a separate return (¶ 173). For tax years beginning after 2020, a separated spouse may also be treated as unmarried if he or she does not file a joint return; lives with a qualifying child for more than one-half of the tax year; and either does not share a principal place of abode with the other spouse for the last six months of the tax year, or has a separation decree, instrument, or agreement (other than a divorce decree) and is not a member of the other spouse's household at the end of the tax year (Code Sec. 32(d), as amended by P.L. 117-2).

A taxpayer with at least one qualifying child completes Schedule EIC (Form 1040) to claim the credit. The return must include a valid Social Security number (SSN) for the taxpayer (and spouse on a joint return), and each qualifying child. The SSN must be issued before the due date of the taxpayer's return (including extensions) and be valid for work in the United States. An individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN) may not be used. For tax years beginning after 2020, taxpayers who fail to provide identifying numbers for their qualifying children may claim the childless EIC. However, for tax years beginning before 2021, such taxpayers cannot claim the EIC at all (Code Sec. 32(c)(1)(F) prior to being stricken by P.L. 117-2).

Credit Amount. The amount of the EIC is the taxpayer's earned income up to an inflation-adjusted level (the earned income amount) multiplied by a credit percentage that depends on the number of the taxpayer's qualifying children (one, two, three or more, or none). The credit phases out as adjusted gross income (AGI) or, if greater, earned income increases. The IRS provides an EIC Worksheet and EIC Tables with the Instructions for Form 1040 and Form 1040-SR. The tables are at ¶ 87. An eligible taxpayer may ask the IRS to calculate the credit.

For 2021, the relevant income, earned income, and credit amounts (including increases for the childless EIC) are as follows (Rev. Proc. 2021-23):

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after the due date of the return (not including extensions) (Code Sec. 911(e); Reg. § 1.911-7).

Once made, the election will remain in effect for the current tax year and all subsequent years unless revoked. A taxpayer who revokes the election will be prohibited from making a new election for at least five tax years without IRS approval. If both a taxpayer and his or her spouse qualify for the exclusions, each must file a separate Form 2555 regardless of whether they file a joint return or separate returns. A self-employed taxpayer does not have to make an election in order to claim the foreign housing deduction. An eligible individual must provide Form 673 to his or her employer to claim an exemption from U.S. income tax withholding on foreign earned income that may be excluded from gross income.

An individual who claims either the foreign earned income or foreign housing exclusion may not claim the foreign tax credit or deduction (¶ 2475) for any income excluded. If a taxpayer attempts to claim the foreign tax credit or deduction, then the election for the foreign earned income and foreign housing exclusions is considered revoked (IRS Pub. 54). In addition, a taxpayer cannot claim either of the exclusions, and the earned income tax credit (¶ 1422) or the additional child tax credit (¶ 1405).

2409. Resident Aliens. A resident alien is generally taxed in the same manner as a U.S. citizen. For this purpose, residency is determined under the lawful permanent residence test (green card test) or the substantial presence test (Code Sec. 7701(b)(1)). An alien who does not qualify under either test is generally treated as a nonresident alien for federal income, employment, and excise tax purposes (but not estate and gift tax purposes).

Some individuals may be eligible to elect resident status (¶ 2410). In addition, an individual can have a dual-status tax year and be both a resident and nonresident alien during the year (¶ 2411). In the case of an individual who is considered both a U.S. resident and a resident of a foreign country during the year (dual resident taxpayer), a tax treaty may override the normal treatment of the individual as a resident alien for all purposes under the treaty. The green card test and substantial presence test determine whether an alien is a resident of a U.S. possession or territory whose income tax laws mirror those of the United States. They do not determine whether an individual is a bona fide resident of other U.S. possessions or territories (¶ 2414) (Reg. § 301.7701(b)-1(d)).

Green Card Test. An alien who is a lawful permanent resident of the United States under U.S. immigration laws (receives a "green card") is considered a resident alien for federal tax purposes (Reg. § 301.7701(b)-1(b)). Resident status begins in the first calendar year in which the alien is a lawful resident and is physically present in the United States for at least one day (¶ 2411). Resident status continues until permanent resident status is terminated or abandoned (¶ 2412).

Substantial Presence Test. An alien is considered a U.S. resident if the individual is physically present in the United States for at least 31 days during the calendar year and 183 days for the current and two preceding calendar years (¶ 2411). For purposes of the 183-day requirement, each day present in the United States during the current calendar year counts as a full day, each day in the first preceding year as ⅓ of a day, and each day in the second preceding year as ⅙ of a day (Code Sec. 7701(b)(3); Reg. § 301.7701(b)-1(c)).

There are exceptions as to what days an alien is considered to be physically present in the United States, including days for:

- regular commuters from Canada or Mexico,
- days in transit between two places outside the United States,
- medical conditions preventing departure,
- exempt individuals including teachers, trainees, and students on temporary visas, as well as professional athletes competing in a charitable event,
- crew members of foreign vessels, and
- foreign government workers.

Form 8843 must be completed to exclude days of physical presence in the United States due to a medical condition or as an exempt individual. Presence in U.S. territories or possessions does not count as presence in the United States.

An individual who otherwise meets the substantial presence test may still be treated as a nonresident alien if the individual has a tax home in a foreign country during the tax year, has a closer connection to the foreign country, and was physically present in the United States for less than 183 days during the year. An alien must fully complete Form 8840 and attach it to his or her return for the relevant tax year to prove that he or she satisfies the closer connection exception.

2410. Elective Resident Status. There are two ways alien individuals are permitted to elect resident status if they do not otherwise qualify as a resident alien (¶ 2409). First, an individual who otherwise fails to meet the green card or substantial presence test may elect to be a resident alien for part of the current year (Code Sec. 7701(b)(4); Reg. § 301.7701(b)-4(c)(3)). To qualify for the election, the individual:

- must not be a resident alien in the prior calendar year;
- must meet the substantial presence test in the calendar year following the election year;
- must be present in the United States for at least 31 consecutive days in the election year; and
- must be present in the United States for at least 75 percent of the days during the period from the first day of the 31-day presence period through the end of the election year.

If these requirements are met, the individual's election to be treated as a U.S. resident alien is effective for that portion of the year that begins on the first day of the earliest testing period that the 31-day and 75 percent requirements are met. The election is made by attaching a signed statement to the individual's tax return for the election year indicating that the individual meets the election requirements. The election cannot be made before the individual has met the substantial presence test for the calendar year following the election year. Once made, the election can be revoked only with IRS consent.

The second way an alien may elect resident status is if the individual is married to a U.S. citizen or resident alien at the end of the tax year—then the election may be made in order to file a joint return (Code Sec. 6013(g) and (h)). The taxpayer may be either a nonresident or resident alien at the end of the tax year for the election to be made.

Both spouses must join in the election by attaching a statement to a joint return for the first tax year for which the election applies. It is effective for the entire tax year and all subsequent tax years for federal income tax and withholding purposes, unless neither spouse is a U.S. citizen or resident alien at any time during the year. The election may also be jointly revoked by the couple or terminated by reason of death, separation, or divorce, or by the IRS for failure of the couple to keep adequate records. Once terminated, the election may not be made again by the couple.

2411. Dual-Status Tax Years. An individual can be both a resident and nonresident alien during the same tax year (¶ 2409). This usually occurs the year of arrival in, or departure from, the United States. An individual who is a dual-status alien has a dual-status tax year. Thus, the individual's income tax liability is computed as a resident alien for the period of residence and as a nonresident alien for the period of nonresidence (¶ 2425) (Reg. § 1.871-13).

If an alien individual is filing a tax return for a dual-status year, then head of household filing status may not be used, the standard deduction cannot be claimed, and the deduction for personal and dependency exemptions for tax years beginning before 2018 and after 2025 cannot exceed taxable income for the period the individual is a resident alien. A married individual may also not use joint filing status and tax rates for joint filers for the period of residency unless he or she is married to a U.S. citizen or resident alien and the election to be treated as a resident alien for the year is made (¶ 2410) (IRS Pub. 519). The education credits, earned income credit, and the elderly or

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disabled credit may also not be claimed unless the individual is married and elects to be treated as a resident alien by filing a joint return.

Residency Starting Date and Termination Date. If an alien meets the green card test, residency starts the first day the individual is physically present in the United States while a lawfully admitted resident. If an alien meets the substantial presence test, residency starts the first day the individual is physically present in the United States during the calendar year. A *de minimis* exception allows up to 10 days to be disregarded in determining the residency starting date under the substantial presence test if the individual has a closer connection to a foreign country. For an alien that satisfies both tests, residency starts on the earlier date when either test is satisfied (Reg. § 301.7701(b)-4).

If the individual was a resident alien in the previous tax year, then residency begins on the first day of the current tax year regardless of whether residency status is determined under the green card test or substantial presence test. Residency status may terminate before the end of the tax year under either test, but only if the individual is not a U.S. resident alien at any time during the following tax year.

Departure Requirements. No alien (whether resident or nonresident) is generally permitted to depart the United States or a U.S. possession without first obtaining a certificate of compliance from the IRS (a sailing or departure permit). The certificate is proof that the individual has discharged all of his or her U.S. income tax liability (Code Sec. 6851(d); Reg. § 1.6851-2). The certificate must be obtained at least two weeks before the individual leaves the United States.

A resident alien (whether he or she has taxable income or not) and a nonresident alien having no taxable income for the tax year must file Form 2063 to obtain the certificate. A nonresident alien with taxable income for the tax year must file Form 1040-C to obtain the certificate. The forms do not constitute an individual's final tax return, and Form 1040 or Form 1040-NR must still be filed after the individual's tax year ends. Payment of any tax is not required prior to departure if it is determined that tax collection will not be jeopardized by the alien's departure. An individual who abandons U.S. citizenship or long-term residency for tax avoidance purposes is subject to special rules (¶ 2412).

2412. Expatriation to Avoid Tax. An individual who is a covered expatriate is subject to a mark-to-market tax regime under which he or she is taxed on the unrealized gain in his or her property to the extent it exceeds $744,000 in 2021, projected to be $767,000 in 2022 (Code Sec. 877A; Notice 2009-85; Rev. Proc. 2020-45). For this purpose, a covered expatriate is considered to own any interest in property that would generally be taxable as part of his or her gross estate for federal estate tax purposes (¶ 2912) if the individual died on the day before the expatriation date. For example, an installment obligation held by a covered expatriate is property subject to tax because it would be included in the expatriate's estate (*G. Topsnik*, Dec. 60,501, 146 TC No. 1).

Special rules apply for deferred compensation items, specified tax deferred accounts, and interests in nongrantor trusts (¶ 566). A U.S. citizen or resident alien is also subject to a special transfer tax upon receipt of property by gift, devise, bequest, or inheritance from a covered expatriate (¶ 2948).

The exclusion amount must be allocated among all built-in gain property that is subject to the mark-to-market regime and is owned by the covered expatriate on the day before the expatriation date. Gain is determined as if a sale of the property for fair market value had taken place on the day before the expatriation date without regard to other Code provisions. Losses from the deemed sale are generally taken into account as otherwise provided in the Code, except that the wash sale rules do not apply (¶ 1935). The taxpayer must make adjustments to the basis of any property by the amount of gain or loss taken into account.

Covered Expatriate. A covered expatriate is any U.S. citizen who relinquishes citizenship, or any long-term U.S. resident who ceases to be a lawful permanent resident of the United States (¶ 2409), if the individual:

- has an average annual net income tax liability for the five preceding years ending before expatriation that exceeds $172,000 for 2021, projected to be $178,000 for 2022,
- has a net worth of $2 million or more on the expatriation date, or
- fails to certify under penalties of perjury that he or she has complied with all U.S. tax obligations for the preceding five years or fails to submit evidence of compliance required by the IRS on Form 8854 (Code Sec. 877A(g); Notice 2009-85; Rev. Proc. 2019-44; Rev. Proc. 2020-45).

Dual citizens and minors may be excepted from the tax liability and net worth requirements.

Election to Defer Tax. A covered expatriate may make an irrevocable election to defer payment of the mark-to-market tax that would otherwise be imposed on the deemed sale of property (Code Sec. 877A(b); Notice 2009-85). The election cannot be made without providing adequate security such as a bond or letter of credit to ensure payment of the tax. In addition, no election can be made unless the individual makes an irrevocable waiver of any rights under an income tax treaty that would preclude assessment or collection of the tax.

The election is made on an asset-by-asset basis. The tax for each piece of property is determined by multiplying the total mark-to-market tax by the ratio of the gain on the deemed sale of the property over the total gain taken into account with respect to all property deemed sold. The election defers payment of the tax until the due date for the return for the tax year in which the property is disposed of or the taxpayer's death. Payment may not be extended beyond the due date for the return for the tax year in which the covered expatriate dies.

Reporting Requirements. A covered expatriate must file an information return on Form 8854 in each tax year he or she is subject to the mark-to-market tax (Code Sec. 6039G; Notice 2009-85). The return is also to be used to provide notice that the individual has relinquished his or her U.S. citizenship or long-term residency status. The IRS has provided procedures that allow expatriated individuals to come into compliance with their U.S. tax and filing obligations, if certain requirements are met (IRS FAQs on Relief Procedures for Former Citizens).

2414. Resident of U.S. Possessions. An individual who is a bona fide resident of a U.S. possession during the tax year is generally subject to U.S. taxation as a U.S. citizen or resident alien (¶ 2409), rather than as a nonresident alien (Code Sec. 876). A U.S. possession for this purpose includes American Samoa, Guam, the Northern Mariana Islands, and Puerto Rico. Separate rules apply to a bona fide resident of the U.S. Virgin Islands (¶ 2416).

An individual is a bona fide resident of a U.S. possession if the person is physically present in the possession for a certain number of days during the tax year, does not have a tax home outside the possession, and does not have a closer connection to the United States or a foreign country than to the possession during the tax year (Code Sec. 937; Reg. § 1.937-1). An individual with worldwide gross income of more than $75,000 must file Form 8898 for the tax year in which the individual becomes or ceases to be a bona fide resident of a U.S. possession. A spouse's income is not included when calculating an individual's worldwide gross income for this purpose. Thus, if married individuals are each required to file Form 8898, a separate Form 8898 must be filed by each spouse regardless of whether a joint return is filed.

A U.S. citizen or resident alien who is a bona fide resident of American Samoa for the entire tax year may exclude from gross income for U.S. tax purposes any income derived from sources within the possession or that is effectively connected with a trade or business by the individual in the possession (Code Sec. 931). The exclusion does not apply to income that is received for services performed as an employee of the United States. The individual may also not claim a tax credit or deduction that is attributable to the amount of excluded income. Form 4563 is used to claim the exclusion and must be attached to a Form 1040 filed with the IRS. A similar rule applies to a bona fide resident of Puerto Rico (¶ 2415).

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withholding agent with Form W-8BEN or other statement certifying that the beneficial owner is not a U.S. person (with exceptions for certain foreign-targeted obligations issued before January 1, 2016). For obligations issued on or before March 18, 2012, the portfolio interest exemption applies if the obligation is in bearer or registered form.

Exempt portfolio interest does not include contingent interest or interest received by a nonresident alien or foreign corporation that is a 10-percent shareholder. Interest is generally contingent if it is determined by reference to any receipts, income, or change in value of property of the debtor or a related person (¶ 432 and ¶ 1717). Other types of contingent interest may be identified by the IRS to prevent tax avoidance. A 10-percent shareholder is any person who owns 10 percent or more of the total combined voting power of all classes of stock in a corporation or 10 percent or more of a capital or profits interest in a partnership.

Other Interest and Dividend Income. FDAP does not include a portion of any dividend received by a nonresident alien or foreign corporation paid by a U.S. corporation primarily engaged in an active trade or business in a foreign country (80/20 company), but only if the corporation was an 80/20 company before 2011 (Code Secs. 871(i), (l), and 881(d)). Payments made by a corporation not in existence as of January 1, 2011, are not eligible for the exemption. A grandfathered corporation must meet a modified 80-percent foreign business requirement for each subsequent tax year (rather than over a three year period). The grandfathered corporation must also not have a substantial new line of business after August 10, 2010.

FDAP income of a nonresident alien and foreign corporation does not include other types of interest and dividends, including: (1) interest paid on bank deposits not effectively connected with a U.S. trade or business; (2) income derived by a foreign bank of central issue from bankers' acceptances; and (3) the portion of a dividend that is paid by a foreign corporation and treated as U.S. source income (Code Secs. 871(i)(2) and 881(d)). It also does not include certain interest-related dividends and short-term capital gain dividends received from a regulated investment company (RIC) (¶ 2301) (Code Sec. 871(k)).

U.S. Possession Corporations. A corporation created or organized in, or under the laws of, Guam, American Samoa, the Northern Mariana Islands, or the U.S. Virgin Islands is not considered a foreign corporation and thus is not subject to the tax on FDAP income if certain requirements are met. However, U.S. source dividends paid to a Puerto Rico corporation are considered FDAP income and subject to U.S. taxation and withholding at a 10-percent rate (Code Sec. 881(b)).

2432. Election to Treat Real Property Income as Effectively Connected Income. A nonresident alien (¶ 2409) and foreign corporation may elect to treat income from U.S. real property interests (¶ 2442) held for investment purposes as effectively connected with the conduct of a U.S. trade or business (Code Secs. 871(d) and 882(d)). The election is available where the income would not otherwise qualify as effectively connected income (¶ 2429), thus allowing the taxpayer to claim deductions associated with the property (¶ 2446).

The election applies to all income of the taxpayer from all U.S. real property interests, including rents or royalties from mines, wells, or other natural deposits, as well as certain timber, iron ore, and coal royalties. It does not include mortgage interest, dividends from a real estate investment trust (¶ 2331), income from personal property, and income of a nonresident alien from real property which is not held for the production of income, such as a personal residence (Reg. §§1.871-10 and 1.882-2).

The election is made by attaching a statement to the taxpayer's timely filed return or amended return (¶ 2505). Once made, the election applies to the current tax year and all subsequent tax years until revoked by filing a timely amended return for all affected years. If the election is revoked, the taxpayer may not make a new election for five years without the IRS's consent.

2433. Branch Profits Tax. A foreign corporation that operates a trade or business in the United States may be required to pay a branch profits tax and a branch-level interest tax in addition to the tax on income effectively connected with the conduct of a

U.S. trade or business (¶ 2429). The branch profits tax is 30 percent (or lower if permitted by a tax treaty) of the foreign corporation's dividend equivalent amount (Code Sec. 884). This is the amount of the foreign corporation's effectively connected after-tax earnings that are not reinvested in a U.S. trade or business by the close of the tax year or disinvested in a later tax year.

The branch interest tax is 30 percent (or lower if permitted by a tax treaty) of the amount of interest paid by a U.S. branch of a foreign corporation with respect to a liability and notional excess interest amounts. If there is a conflict between the branch profits tax or branch-level interest tax with any U.S. income tax treaty, special rules are provided to determine the extent to which the treaty takes priority.

2435. Capital Gains of Nonresident Aliens and Foreign Corporations. U.S. sourced capital gains of a nonresident alien (¶ 2409) or foreign corporation may be completely exempt from U.S. taxation if they are *not*:

- effectively connected with the conduct of a U.S. trade or business (¶ 2429),
- gains from the sale of U.S. real property interests (¶ 2442), or
- fixed, determinable, annual, or periodical (FDAP) income (¶ 2431) (Code Secs. 871(a)(2) and 881(a)).

In the case of a nonresident alien, net capital gains that do not fall into one of these three categories are exempt from U.S. tax if the individual is not present in the United States for at least 183 days (whether or not consecutive) during the tax year. If the 183-day limitation is exceeded, the individual's net capital gains not effectively connected to conduct of a U.S. trade or business are subject to a flat 30-percent tax rate, or lower treaty rate. For purposes of this rule, gains and losses are determined without regard to the exclusion of gain from the sale of qualified small business stock (¶ 1905) or the carryover of capital losses (¶ 1754).

2438. Community Income of Nonresident Aliens. If a nonresident alien (¶ 2409) is married to a U.S. citizen or resident and does not elect to be treated as a resident (¶ 2410), then any community income is to be treated as follows:

- earned income (other than from a trade or business or the distributive share of partnership income) is treated as income of the spouse who earned it;
- trade or business income (other than from a partnership) is treated as the separate income of the spouse carrying on the trade or business (unless carried on jointly);
- a distributive share of partnership income is treated as the income of the spouse who is the partner with no portion attributed to the other spouse; and
- all other community income from separate property of one spouse is treated as the income of that spouse (Code Sec. 879).

2442. Sale or Disposition of U.S. Real Property Interest. The gain or loss derived by a nonresident alien (¶ 2409) or foreign corporation from the sale, exchange, or other disposition of a U.S. real property interest (USRPI) is treated as gain or loss effectively connected with the conduct of a U.S. trade or business (¶ 2429) (Code Sec. 897). Income from a USRPI held for investment purposes is not considered income effectively connected with a U.S. trade or business. However, a nonresident alien and foreign corporation may elect to treat income from a USRPI held for investment purposes as effectively connected income in order to claim deductions associated with the property (¶ 2446). A foreign corporation that holds a USRPI may also elect to be treated as a domestic corporation for this purpose if, under any treaty obligation of the United States, it is entitled to nondiscriminatory treatment for USRPIs.

Cash or property received by a nonresident alien or foreign corporation in exchange for an interest in a partnership, trust, or estate is considered received from the sale or disposition of USRPIs to the extent attributable to the sale or disposition of USRPIs by the entity. A coordination rule applies when the entity that holds the USRPIs is engaged in a trade or business in the United States or when certain nonrecognition rules apply (¶ 434) (Code Sec. 897(g); Reg. §§1.864(c)(8)-1(d) and 1.897-7(c)). Similarly, special look-through rules apply for distributions by qualified investment entities

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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

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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)). Proposed regulations would reduce the threshold for Forms 1042-S filed by non-financial institutions to 100 returns, for returns filed during calendar year 2022, and to 10 returns, for returns filed after calendar year 2022 (Prop. Reg. § 301.6011-2). Paper Forms 1042-S must be accompanied by Form 1042-T. Proposed regulations would also require Form 1042 filers (but not individuals, estates, or trusts) to file the form electronically if they are required to file 10 or more returns of any type during the calendar year. Financial institutions, as well as partnerships with more than 100 partners, would be required to file Forms 1042 electronically regardless of the number of returns required to be filed during the calendar year (Prop. Reg. §§ 301.6011-15 and 301.1474-1).

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

See CCH® AnswerConnect: *Foreign Bank and Financial Account Report (FBAR)* and *FATCA (Foreign Account Tax Compliance Act)* for more information on this topic.

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

2476. Election of Foreign Tax Credit or Deduction. The election to claim the foreign tax credit or deduction (¶ 2475) is made on an annual basis. It may be made or changed anytime within 10 years from the due date for filing a return for the year in which the taxes were actually paid or accrued, unless the period is extended by agreement with the IRS (Code Sec. 6511(d)(3); Reg. § 1.901-1(d) and (e)). For partnerships and S corporations, the election is made by the individual partners and shareholders, respectively (Code Secs. 702(a)(6), 703(b)(3), and 1366(a)(1)). Corporations in an affiliated group make the election and compute the credit on a consolidated basis for a consolidated return year (Reg. § 1.1502-4).

A taxpayer claims the foreign tax credit by filing Form 1116 (for individuals, estates, and trusts) or Form 1118 (for corporations) with the taxpayer's income tax return. An individual may elect to claim the foreign tax credit without filing Form 1116 by entering the credit directly on his or her tax return if: (1) all of the individual's foreign source income is passive income; (2) all of the income and any foreign taxes paid on the income is reported on a qualified payee statement (Form 1099); and (3) the total creditable foreign taxes is less than $300 ($600 if married filing jointly) (Code Sec. 904(j)).

If an individual makes the election, then the foreign tax credit limitations do not apply, but the individual cannot carry over any excess credit to another tax year (¶ 2479). The election is not available to estates, trusts, or corporations. An election to take the credit or deduction on a joint return applies to the qualifying foreign taxes paid or accrued by both spouses. If married taxpayers file separate returns, either may take the credit or deduction without regard to the other.

Credit vs. Deduction. Generally, it is more advantageous for a U.S. taxpayer to elect the foreign tax credit rather than the deduction because the credit is taken against the taxpayer's U.S. liability on a dollar-for-dollar basis. In contrast, a deduction for foreign taxes merely reduces a taxpayer's income subject to tax. In addition, an individual who deducts foreign taxes must claim the taxes as an itemized deduction.

The election to claim the credit or deduction applies to all creditable foreign taxes paid or incurred by the taxpayer during the tax year for which a U.S. return is required (¶ 2477). A taxpayer cannot claim a credit for some creditable foreign taxes and a deduction for other creditable foreign taxes in the same tax year. Partial credits and partial deductions are not permitted except in limited circumstances (Code Sec. 275(a)(4)).

2477. Creditable Foreign Taxes. A U.S. taxpayer is allowed a foreign tax credit or deduction (¶ 2475) against U.S. income tax liability for any income tax, including war profits, and excess profits taxes, paid or accrued to a foreign country or U.S. possession during the tax year on foreign source income. This includes taxes paid or accrued in lieu of income taxes imposed by the foreign country or U.S. possession (Code Secs. 901 and 903; Reg. § 1.901-2; Prop. Reg. § 1.901-2). For tax years beginning before January 1, 2018, a U.S. corporation is also allowed a foreign tax credit for creditable foreign taxes paid by a foreign subsidiary in which it owns at least 10 percent of the voting stock and from which it receives a dividend (¶ 2485).

A creditable foreign tax is a levy the predominant character of which is that of a compulsory income tax according to U.S. tax principles. A penalty, fine, interest payment, customs duty, or similar obligation is not a tax; nor is any payment to a foreign government in exchange for a specific economic benefit that is not available on substantially the same terms to all persons. A foreign tax paid for retirement, unemployment, or disability benefits is generally not a payment for a specific economic benefit. However, no credit or deduction is allowed for social security taxes paid or accrued to a foreign country with which the United States has a social security agreement.

The IRS may disallow foreign tax credits generated in transactions it views as abusive such as structured passive investment arrangements. The foreign tax credit or deduction is also not available for the withholding of otherwise creditable foreign taxes on dividends and other items of gain or income from property unless certain holding period requirements are met (Code Sec. 901(k) and (l)).

The foreign tax credit or deduction can only be claimed by the taxpayer upon whom the foreign law imposes legal liability, and who actually pays or accrues the tax. In the case of combined income of two or more persons, foreign law is considered to impose legal liability on each person on a pro rata basis (Reg. § 1.901-2(f)). This includes the combined income of a husband and wife, or a corporation and one or more of its subsidiaries. However, income which is subject to a special tax rate, exempt from tax, or for which certain deductions or credits are allowed under the foreign law must be allocated only to the person(s) with that type of income. The income subject to preferential treatment must be computed separately and the tax on that income allocated separately.

A U.S. taxpayer may not claim the foreign tax credit or deduction for any foreign taxes paid or accrued on income excluded from U.S. gross income. This includes income excluded under the foreign earned income or foreign housing exclusions (¶ 2402 and ¶ 2403), or income from a U.S. possession (¶ 2414). The taxpayer may also not claim a credit or deduction for foreign taxes paid or accrued to the extent that:

- the taxpayer is certain to receive a refund or credit, or the tax is used as a subsidy,
- the liability is dependent on the availability of a foreign tax credit in another jurisdiction,
- the taxes are paid or accrued to a country with which the United States does not conduct diplomatic relations or which is designated as supporting acts of international terrorism, or
- the taxes are attributable to boycott income (¶ 2496).

The amount of foreign taxes a taxpayer may claim is reduced if the taxpayer controls a foreign corporation (CFC) or partnership that fails to file Form 5471 or Form 8865, respectively (¶ 2487 and ¶ 2494).

Covered Asset Acquisitions. In the case of a covered asset acquisition, a taxpayer may not take into account in determining the foreign tax credit the disqualified portion of any foreign income tax determined with respect to income or gain attributable to the relevant foreign assets (Code Sec. 901(m); Reg. § 1.901(m)-2). A covered asset acquisition includes:

- a qualified stock purchase under Code Sec. 338 (¶ 2265),
- any transaction that is treated as the acquisition of assets for U.S. tax purposes and as the acquisition of stock (or is disregarded) for foreign tax purposes,
- any acquisition of an interest in a partnership that has an election in effect under Code Sec. 754 (¶ 459), and
- any other transaction as determined by the IRS, including:
  - — transactions treated as an acquisition of assets for U.S. tax purposes and as an acquisition of an interest in a fiscally transparent entity for foreign tax purposes,
  - — certain transactions treated as a partnership distribution of one or more assets, if the transaction results in an increase in the U.S. basis of one or more assets, and
  - — transactions treated as an acquisition of assets for both U.S. and foreign tax purposes, if there is an increase in the U.S. basis, without a decrease in the foreign basis of one or more assets.

The disqualified portion of any covered asset acquisition for any tax year is generally the aggregate basis difference allocable to the tax year with respect to all relevant foreign assets (RFAs), divided by the income on which the foreign income tax is determined (Code Sec. 901(m)(3); Reg. §§ 1.901(m)-4 and 1.901(m)-5(c)). The basis difference with respect to any RFA is taken into account for a U.S. tax year (allocated basis difference), under an applicable U.S. cost recovery method or as a result of a disposition.

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of the requirement to file the FBAR or FinCEN Report 114 (¶ 2570) for disclosing foreign financial accounts. Similarly, filing the FBAR does not relieve the filer of the requirement to file Form 8938. An individual or entity may be required to file both Form 8938 and the FBAR to report the same information on certain foreign accounts.

The value of a specified foreign financial asset for determining whether the individual or entity has met the applicable threshold for filing Form 8938 is the asset's fair market value as determined in U.S. dollars using the Treasury's currency exchange rate on the last day of the tax year (Reg. § 1.6038D-5). A specified domestic entity must file Form 8938 if the total value of specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year.

For an individual, the applicable threshold amount depends on the individual's filing status and whether he or she lives in the United States or abroad (Reg. § 1.6038D-2; Instructions for Form 8938). The applicable threshold amounts for individuals are as follows:

- Unmarried individuals living in the United States, and married individuals living in the United States and filing separate income tax returns, must file Form 8938 if the total value of specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year.
- Married individuals living in the United States and filing a joint income tax return must file Form 8938 if the value of specified foreign financial assets is more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.
- Unmarried individuals living abroad, and married individuals living abroad and filing separate returns, must file Form 8938 if the total value of specified foreign assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the year.
- Married individuals living abroad and filing a joint return must file Form 8938 if the value of specified foreign assets is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the year.

The filer must disclose the asset's maximum value during the tax year and provide specific information based on the asset type. For a financial account, the filer must provide the name and address of the financial institution in which the account is maintained, and the account number. For stock or security, the filer must provide the issuer's name and address, and any other information needed to identify the asset's class or issue. For any other instrument, contract, or interest, the filer must provide any information needed to identify the asset, and the names and addresses of all issuers and counterparties. An individual or entity that fails to furnish the required information in a timely manner will be subject to a penalty. Additionally, a 40-percent accuracy-related penalty (¶ 2864) may be imposed for any underpayment of tax attributable to an undisclosed foreign financial asset, and the statute of limitations for tax assessment may be extended or suspended depending on the circumstances (¶ 2726 and ¶ 2734).

2579. Taxpayer Identification Numbers (TINs). A taxpayer or other entity required to file a return, statement, or other document with the IRS must include their taxpayer identification number (TIN) on such items (Code Sec. 6109(a); Reg. § 301.6109-1). A person may also be required to furnish a TIN to another person or request an identifying number from another person using Form W-9 for filing information returns (¶ 2565). TINs that may be used include:

- *Social Security Number (SSN)* — An individual's SSN generally is his or her identifying number for tax purposes unless otherwise provided in the regulations. An individual who needs an SSN must file an application on Form SS-5 with the Social Security Administration (SSA).
- *Individual Taxpayer Identification Number (ITIN)* — An ITIN is the identifying number available through the IRS for a nonresident alien individual, as well as his or her spouse and dependents, who is not eligible for an SSN. Form W-7 is used to apply for an ITIN and generally must be filed with the individual's original tax return for which the ITIN is needed. Form W-7 packets may be submitted by mail, by private delivery service, or in person at a designated IRS Taxpayer

Assistance Center. Individuals may also submit the Form W-7 packets to an acceptance agent (AA) or a community-based certifying acceptance agent (CAA). Until further guidance is issued, all applicants may continue to submit their Form W-7 packets to CAAs under existing procedures (Notice 2016-48; Rev. Proc. 2006-10). ITINs that are not used on a federal tax return at least once in the last three tax years will expire and must be renewed by the taxpayer.

- *Adoption Taxpayer Identification Number (ATIN)* — An ATIN is a temporary nine-digit number issued by the IRS to individuals who are in the process of legally adopting a U.S. citizen or resident alien child but who cannot get an SSN for that child in time to file their tax return (Reg. § 301.6109-3; Prop. Reg. § 301.6109-3). Application for an ATIN must be made on Form W-7A.
- *Employer Identification Number (EIN)* — An EIN is also known as a federal tax identification number and is used to identify a business entity including a corporation, partnership, trust, estate, tax-exempt organization, and similar nonindividual persons. An individual who is engaged in a trade or business as a sole proprietor uses both his or her SSN and EIN of the business when supplying a TIN on returns, statements, or other documents, depending on which number is required by the IRS. Any person needing an EIN must file an application on Form SS-4 (Reg. § 301.6109-1(d)(2)).
- *Preparer Taxpayer Identification Number (PTIN)* — A tax return preparer who is required to sign a tax return or claim for refund must include his or her tax identification number on the return or refund claim (¶ 2517). A PTIN is a number issued by the IRS to paid tax return preparers for this purpose (Reg. § 1.6109-2).
- *Truncated Taxpayer Identification Number (TTIN)* — A TTIN is a truncated version of a person's identification number (SSN, ITIN, ATIN, or EIN) that may be used to reduce the risk of identity theft on any statement or other document that the Code requires to be furnished to another person. A TTIN cannot be used on any form filed with the IRS or the Social Security Administration (Reg. § 301.6109-4).
- *Identity Protection Personal Identification Number (IP PIN)* —The IP PIN is an identifying number assigned to an individual to help prevent identity theft and the fraudulent misuse of personal identification numbers on federal income tax returns. An IP PIN is valid for only one year and the taxpayer must obtain a new IP PIN each filing season. Beginning in the 2021 calendar year, all taxpayers can voluntarily opt into the IP PIN program. Any individual who has a SSN or ITIN and can verify his or her identity is eligible to obtain an IP PIN at https://www.irs.gov/identity-theft-fraud-scams/get-an-identity-protection-pin. See also FAQs about the Identity Protection Personal Identification Number (IP PIN).

A penalty of $50 per failure applies to a person that omits its own TIN from a required return, statement, or document. Failure to furnish one's TIN to another person when so required, or to include another person's TIN in any document for information reporting purposes, will also give rise to a $50 penalty. The maximum penalty per calendar year for failure to include TINs is $100,000 (Code Secs. 6723 and 6724(d)(3)).

Reportable Transactions and Tax Shelters

See CCH® AnswerConnect: *Tax Shelter Penalties* for more information on this topic.

2591. Reportable Transactions. Reporting and disclosure requirements apply to taxpayers (¶ 2592) and material advisors (¶ 2593) with respect to reportable transactions. A reportable transaction is any transaction for which information must be included with a return or statement because the IRS has determined under regulations that this type of transaction has a potential for tax avoidance or evasion (Code Sec. 6707A(c)(1)).

There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest (Reg. § 1.6011-4(b)). A transaction is not considered a reportable transaction, or is excluded from any individual category of reportable transaction, if the IRS determines in published guidance that the transaction is not subject to the reporting requirements. The IRS may make a determination by individual letter ruling.

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Only one penalty applies in the case of a transaction that is both a listed transaction and a reportable transaction. The penalty that applies in these cases is the higher penalty for listed transactions. If there is a failure with respect to more than one reportable or listed transaction, a material advisor will be subject to a separate penalty for each transaction. The penalty with respect to reportable transactions other than listed transactions may be rescinded only in exceptional circumstances similar to those for rescission of the penalty for failure to disclose reportable transactions by taxpayers (¶ 2594). The penalty with respect to a listed transaction cannot be waived.

Each material advisor must maintain a list that identifies each person for whom that advisor acted as a material advisor with respect to a reportable transaction, and contains any other information required by the IRS (Code Sec. 6112; Reg. § 301.6112-1). Regulations set forth the requirements for preparing and maintaining advisee lists, such as the persons required to be included on lists, the contents of the list, definitions, and the requirements for retention and furnishing of the lists. Information that is required to be included in the advisee lists must be retained for seven years. Any person required to maintain advisee lists that receives a written request from the IRS, but fails to make the lists available within 20 business days, may be assessed a $10,000 penalty for each day of failure after the 20th business day (Code Sec. 6708; Reg. § 301.6708-1).

2597. Abusive Tax Shelters Penalty. A penalty is imposed against any person that organizes, assists in organizing, or participates in the sale of any interest in a tax shelter if the person makes or furnishes, or causes another person to make or furnish: (1) a statement concerning the allowability of any tax benefit obtained through participation in the tax shelter that the person knows or has reason to know is false or fraudulent; or (2) a gross valuation overstatement concerning any matter that is material to the tax shelter (Code Sec. 6700). The penalty is 50 percent of the gross income derived, or to be derived, from the abusive plan or arrangement activities engaged in, other than promotion activities involving gross valuation overstatements. The penalty for promotion of activities involving gross valuation overstatements is equal to the lesser of $1,000 or 100 percent of the gross income derived, or to be derived, by the promoter from the activity.

In applying the penalty, promotion of each entity or activity is a separate activity, and each sale of an interest in the shelter is a separate activity. The penalty is imposed in addition to all other penalties that may be imposed, but will not be imposed on a person with respect to any documents if an aiding and abetting penalty is imposed on that person with respect to the same document (¶ 2807).

2598. Injunctions Related to Tax Shelters. An injunction may be obtained with respect to the following acts: (1) promoting an abusive tax shelter (¶ 2597); (2) aiding and abetting someone in understating a tax liability in a return or other document (¶ 2807); (3) failing to furnish information about a reportable transaction (¶ 2593); or (4) failing to maintain a list of advisees (¶ 2595) (Code Sec. 7408). Once a court has enjoined a person from engaging in one or more of these activities, the court may expand the injunction to include any other activity that is subject to a penalty under tax law.

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Chapter 26

WITHHOLDING ☐ SELF-EMPLOYMENT TAX

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Withholding on Wages

See CCH® AnswerConnect: *Withholding—Employment Taxes: Income Tax Withholding on Wages* for more information on this topic.

2601. Withholding of Income Tax on Wages. An employer generally must deduct and withhold income taxes from wages actually or constructively paid to each employee (Code Sec. 3402(a); Reg. § 31.3402(a)-1). Wages include all remuneration (other than fees paid to a public official) for services performed by an employee for an employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash (¶ 2604). Thus, salaries, fees, bonuses, commissions on sales or insurance premiums, taxable fringe benefits, pensions, and retirement pay (unless taxed as an annuity) are subject to income tax withholding if paid as compensation for services.

An "employer" is generally any person for whom an individual has performed any service as an employee, regardless of the nature of the service. If the person for whom services are performed does not have legal control over the payment of wages, then the employer is the person actually controlling the payment of the wages (Code Sec. 3401(d); Reg. § 31.3401(d)-1). The services do not need to be continuing at the time the wages are paid in order for employer status to exist.

An employer includes not only individuals and organizations engaged in trade or business, but also tax-exempt organizations and federal, state, and local government units, including the District of Columbia and Puerto Rico. An employer also includes any person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States or Puerto Rico.

An individual is an "employee" if the employer for whom the services are performed has the right to control and direct the individual not only as to the result to be accomplished by the work, but also as to the details and the means by which that result is accomplished (Code Sec. 3401(c); Reg. § 31.3401(c)-1). An employee also includes any officer, employee, or elected official of a federal, state, or local government unit, as well as an officer of a corporation, but not a director. Professionals such as physicians, lawyers, contractors, and others who follow an independent trade, business, or profession in which they offer their services to the public generally are not employees. If an employer-employee relationship exists, it does not matter what the parties call it (independent contractor, agent, etc.). It also does not matter how wages are measured, or whether the employee works full time or part time (¶ 2602).

claim if the understatement is willful or reckless (Code Sec. 6694(b); Reg. § 1.6694-3; CCA 201519029). A preparer willfully attempts to understate liability if he or she disregards information furnished by the taxpayer in an attempt to wrongfully reduce the taxpayer's liability.

A preparer recklessly or intentionally disregards a rule or regulation if he or she takes a position on the return or claim for refund that is contrary to a rule or regulation the preparer knows of, or is reckless in not knowing of the rule or regulation in question. A preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation is adequately disclosed and has a reasonable basis.

Aiding or Abetting Understatement. A penalty of $1,000 may also be imposed on persons for aiding or abetting in an understatement of tax liability on a return, claim, or other document. The penalty increases to $10,000 for aiding or abetting an understatement of liability on a corporate return (Code Sec. 6701). Only one penalty may be imposed per taxpayer per period, but the tax period may not necessarily be a tax year. For instance, understatements on quarterly employment tax returns may give rise to four separate penalties for a calendar year. According to the Sixth and Eighth Circuit Courts of Appeals, no statute of limitations applies to bar the penalty. The penalty generally may be imposed in addition to other penalties, except that the IRS may not assess both the aiding and abetting penalty and the penalty for an understatement due to unreasonable positions. Similarly, the penalty for promoting abusive tax shelters (¶ 2597) will not be imposed with respect to any document if the aiding and abetting penalty is also imposed with respect to the same document.

Administrative Penalties. A tax return preparer who fails to meet certain administrative requirements with respect to a taxpayer's return (¶ 2517) may be assessed the following penalties, unless the failure is due to reasonable cause and not to willful neglect:

- $50 for returns filed in 2021 or 2022 for each failure to sign a return, to furnish an identifying number, or to furnish the taxpayer with a copy of the prepared return, up to a maximum penalty per calendar year of $27,000 for returns filed in 2021 or 2022;

- $50 for returns filed in 2021 or 2022 for each failure to retain and make available a copy of prepared returns or a list of taxpayers for whom returns were prepared, and the name of the individual preparer required to sign the return, up to a maximum penalty per return period of $27,000 for returns filed in 2021 or 2022; and

- $50 for returns filed in 2021 or 2022 for each failure to retain and make available a record of preparers employed, or each failure to include an item required in such record, up to a maximum penalty per return period of $27,000 for returns filed in 2021 or 2022.

A preparer who endorses or negotiates a taxpayer's refund check is also subject to a penalty of $540 for returns filed in 2021 or $545 for returns filed in 2022. The penalty will not apply to a bank preparer who negotiates customers' refund checks for bank account deposits (Code Sec. 6695; Reg. § 1.6695-1; Rev. Proc. 2019-44; Rev. Proc. 2020-45).

Lack of Due Diligence. A tax return preparer must comply with due diligence requirements for returns or refund claims asserting eligibility for the earned income credit, the child tax credit, the additional child tax credit, American Opportunity tax credit, as well as head of household filing status (Code Sec. 6695(g); Reg. § 1.6695-2). Among the requirements, a tax return preparer must file, or submit to the taxpayer for filing, Form 8867 with any federal return claiming any of the credits or head of household filing status. Each failure to meet the requirements regarding the amount of, or eligibility for, the credits or filing status will result in a penalty of $540 for returns filed in 2021 or $545 for returns filed in 2022 (Rev. Proc. 2019-44; Rev. Proc. 2020-45). The penalty is in addition to any other penalty imposed.

2811. Frivolous Return Penalty. A $5,000 penalty is imposed upon any person (including an individual, trust, estate, partnership, association, company, or corporation) who files a purported tax return (income or otherwise) if:

- the return fails to contain sufficient information from which the substantial correctness of the amount of tax liability can be judged, or contains information that on its face indicates that the amount of tax shown is substantially incorrect; and

- such conduct arises from a frivolous position or from a desire to delay or impede administration of the federal tax laws.

The penalty is imposed in addition to any other penalties imposed on the taxpayer (Code Sec. 6702; Notice 2010-33).

A $5,000 civil penalty may also be imposed on any person who files a specified frivolous submission. A specified submission is a request for a collection due process hearing or an application for an installment agreement, offer in compromise, or taxpayer assistance order. The submission is frivolous if either it is based on a position that has been identified as frivolous by the IRS or reflects a desire to delay or impede the administration of federal tax laws. If a person withdraws a submission within 30 days after receiving notice that the return is a specified frivolous submission, the penalty will not be imposed.

The IRS has issued procedures outlining limited circumstances under which a frivolous return penalty, along with a frivolous submission penalty, may be reduced to $500 regardless of the number of penalties assessed (Rev. Proc. 2012-43). A person must satisfy all eligibility criteria under the procedure, including filing all tax returns and paying all outstanding taxes, penalties (other than the frivolous return penalty), and related interest. Any employer applying for relief must deposit all employment taxes for the current quarter and the prior two quarters.

A list of frivolous positions may be found in Notice 2010-33. The list is not conclusive and is periodically revised. Returns or submissions that contain positions not described in the Notice, but that on their face have no basis for validity in existing law, or which have been deemed frivolous in a published opinion by the U.S. Tax Court or other court of competent jurisdiction may also be subject to the $5,000 penalty.

The Tax Court may assess a penalty (up to $25,000) against a taxpayer who institutes or maintains proceedings primarily for delay or on frivolous grounds, or who unreasonably fails to pursue available administrative remedies. Other courts may require a taxpayer to pay a penalty of up to $10,000 if the taxpayer's action against the IRS for unauthorized collection activities appears to be a frivolous or groundless proceeding (Code Sec. 6673).

2813. Abatement of Penalties and Interest. The IRS must abate certain penalties that result from reliance on incorrect IRS advice if: (1) the advice was furnished in writing in response to a specific written request from the taxpayer, and (2) the taxpayer reasonably relied upon the advice (Code Sec. 6404(f); Reg. § 301.6404-3). Penalties will be abated only if the taxpayer furnished adequate and accurate information in making the request. A taxpayer entitled to abatement should file Form 843 with copies of the relevant written documents attached. The IRS also will abate the interest that would otherwise accrue if the due date for filing any income, estate, gift, employment, or excise tax return and paying any tax due for a taxpayer located in a federally declared disaster area is extended (¶ 2537) (Code Secs. 6404(i) and 7508A).

The accrual of penalties and interest is also suspended after 36 months unless the IRS sends the taxpayer a notice of the penalty following the later of: (1) the original due date of the return (without regard to extensions), or (2) the date on which a timely return is filed (Code Sec. 6404(g)). The suspension of penalties and interest is available only for individuals and only for income taxes. The suspension does not apply to the failure-to-file a return (¶ 2801) and failure-to-pay tax (¶ 2805) penalties. It also does not stop the accrual of any interest, penalty, or other addition to tax in a case involving fraud, with respect to any liability shown on the return, any gross misstatement, any reportable transaction or listed transaction (¶ 2591), or any criminal penalty (¶ 2598).

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