BUSINESS ISSUES

13

Corrections for all chapters and the *2013 National Income Tax Workbook Update* (January 2014) are posted as they become available at www.taxworkbook.com (user name: class2013; password: class2013).

INTRODUCTION

This chapter focuses on several issues that affect business taxpayers, including a new safe harbor method for the home office deduction.

An optional simplified computation for the home office deduction ($5 per square foot, with limits) will be useful for many taxpayers. The automatic consent procedure for a change in accounting method allows taxpayers to change their treatment of certain costs as repairs or capital expenditures to comply with new regulations. This chapter also covers some retirement planning, payroll reporting, and worker reclassification issues, as well as the tax treatment of amounts received by volunteers or interns, and eligibility for the domestic production activities deduction (DPAD).

Learning Objectives

After completing this session, participants will be able to perform the following job-related actions:

1. Calculate and compare the safe harbor method for a home office deduction to the actual expense method
2. Explain the benefits of a one-participant 401(k) plan to a self-employed individual

3. Decide whether an expense is deducible as a repair cost or must be capitalized and depreciated
4. Prepare Form W-2 and correct errors on a previously filed Form W-2
5. Explain an IRS incentive for businesses to reclassify workers as employees
6. Understand the tax treatment of amounts paid to volunteers and unpaid interns
7. Help clients determine whether they may be eligible for the DPAD

ISSUE 1: HOME OFFICE DEDUCTION SAFE HARBOR

Individual taxpayers may use an optional safe harbor method to determine a home office deduction as an alternative to calculating, allocating, and substantiating actual expenses.

A taxpayer who *regularly* uses a portion of his or her home *exclusively* for trade or business may qualify to deduct business-use-of-home expenses. However, some taxpayers and tax practitioners forgo the deduction because they fear that any home office deduction may be questioned by the IRS.

In January 2013 the IRS issued Rev. Proc. 2013-13, 2013-6 I.R.B. 478, which provides an optional safe harbor method that taxpayers may use to calculate the home office deduction. This simplified computation is equal to $5 multiplied by the qualified square footage, limited to 300 square feet.

This issue discusses the basic rules for the I.R.C. § 280A business-use-of-home deduction (which apply to the safe harbor method as well as the actual expense method) and compares the results and effects of the two calculations.

Qualifying for the Deduction

Regular usage is a facts and circumstances determination; it requires more than incidental or occasional use. Most taxpayers who work at home do not have difficulty meeting this standard, but the *exclusive use* requirement poses more problems. The exclusive use requirement is not met if the home office is used solely for business during office hours and for personal use at other times. Without a conscious effort to keep the home office free of personal items, many homeowners wind up using it for extra storage or as a guest room and thus negate the exclusive use of the area for business. The test applies all day, every day.

Practitioner Note Exceptions to Exclusive Use

The exclusive use rule does not apply to areas of the home used for licensed day care or for day care that is exempt from licensing requirements. The care can be provided for children, for persons age 65 or older, or for persons who are physically or mentally unable to care for themselves [I.R.C. § 280A(c)(4)]. Areas used to store a business's inventory or product samples are exempt from the exclusive use requirement if the home is the only fixed location of the retail or wholesale business, the space is separately identifiable, and it is used for storage on a regular basis [I.R.C. § 280A(c)(2)].

Function Tests

Using a space in the home regularly and exclusively for business is only the first hurdle. Business-use-of-home expenses are not deductible unless the space also meets one of the following three function tests.

1. The space is the principal place where the business is conducted.
2. The space is used to meet with patients, clients, or customers in the normal course of business.
3. The space is in a separate structure (one that is not attached to the home) that is used in connection with the taxpayer's business.

A home office qualifies as the *principal place of business* if it is used to conduct the business's administration or management activities and there is no other fixed location where those activities are conducted. Thus a plumber who does scheduling and billing in a home office can qualify for the deduction even though the actual plumbing work is done at the customer's premises, as long as the plumber has no office space elsewhere.

A separate structure might be used as a workroom, laboratory, studio, or office–for example, by a taxpayer whose principal place of business is elsewhere.

Cross-Reference Employee's Home Office

Employees can qualify for the deduction only if they are working at home for their employer's convenience rather than their own. See page 59 in the *2010 National Income Tax Workbook* for a further discussion.

Actual Expense Method

An actual expense calculation is made using Form 8829, Expenses for Business Use of Your Home, or a worksheet included in IRS Publication 587, *Business Use of Your Home (Including Use by Daycare Providers)*.

- Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), filers calculate the deduction on Form 8829.
- Schedule F (Form 1040), Profit or Loss From Farming, filers and employees deducting business expenses on Form 2106, Employee Business Expenses, use the worksheet.

Practitioner Note Loss Carries Over

Home office expenses cannot create a deductible business loss. Excess expenses such as heating and cooling costs for the part of the home that is used for business (which would otherwise be nondeductible personal expenses) are carried forward.

Expenses incurred in a home business must be sorted into four tiers that are deducted in sequence.

1. Calculate the business's net income without considering home office expenses, but take into account the direct costs that would be incurred wherever the office was located, such as those for supplies, equipment, mileage, and secretarial help
2. Allocate to the space used for the home office a portion of the allowable itemized deductions related to the home (such as home mortgage interest and real estate taxes) that would be deductible without a home office

The expenses identified in these first two steps are not limited by the business's income, but they establish the limit for deducting the next two types of expenses.

3. Allocate the normally nondeductible household operating expenses (such as utilities, maintenance costs, and insurance on the home) that are partially incurred for the space used as the home office; deduct the allocable expenses as business expenses only to the extent net income from the business remains after step 2
4. Calculate deductions related to the home office that decrease the home's basis, such as depreciation and casualty losses, limiting these deductions to any business income that remains after the step 3 expenses are deducted

Excess expenses from steps 3 and 4 that are not currently deductible because of the business income limit carry over to the subsequent tax year and are included in determining the allowable home office deduction for the subsequent year.

Practitioner Note Allocation Methods

If the taxpayer uses a space exclusively for business, expenses are usually allocated on a square footage basis. If space regularly used for day care is not exclusively used for business, a time allocation is also required.

Safe Harbor Method

Rev. Proc. 2013-13, supra, provides an optional safe harbor method for determining the business-use-of-home deduction for tax years beginning on or after January 1, 2013. The deduction is $5 per square foot multiplied by the qualified business use square footage, limited to 300 square feet. Therefore, the maximum deduction that can be claimed under the safe harbor is $1,500 ($5 × 300).

Qualified business use for the safe harbor includes space that meets any of the three function tests or satisfies the rules for business storage use or use in providing day care services. Rental use is not a qualified business use.

Nonfarm sole proprietors who elect the safe harbor method do not complete Form 8829. A "Simplified Method Worksheet" is included in the instructions for Schedule C (Form 1040), and the deduction is reported directly on line 30 of Schedule C (Form 1040).

Practitioner Note Employee Reimbursements

Rev. Proc. 2013-13 does not apply to an employee if the employer reimburses home office expenses or provides an allowance for home office expenses under an accountable plan [Treas. Reg. § 1.62-2(c)(1)].

Year-by-Year Election

A taxpayer may elect to use the safe harbor or to calculate and substantiate actual expenses on a year-to-year basis. A taxpayer elects the safe harbor method by simply using it to compute the deduction on his or her timely filed, original income tax return. Once made, the election is irrevocable for that year. A change from using actual expenses in a prior year to using the safe harbor in a succeeding tax year, or vice versa, is not a change in accounting method.

Itemized Deductions

Taxpayers who elect the safe harbor method can deduct all of their allowable itemized deductions for qualified home mortgage interest, property taxes, and casualty losses without a reduction for qualified business use of the home.

Zero Depreciation Allowance

Taxpayers using the safe harbor method cannot deduct depreciation for the home office space for that tax year. The allowable depreciation deduction is deemed to be zero when calculating the home's basis for gain or loss on a subsequent sale.

Taxpayers who calculate actual expenses for any subsequent tax year must calculate the allowable depreciation deduction in the subsequent year using the depreciation table for the property in its placed-in-service year. The effect is a skipped year or years of depreciation deductions when the safe harbor method is elected.

Example 13.1 Depreciation Deduction

Dan Donald elected to use the safe harbor method to calculate his home office deduction for the first 3 years that he qualified for business use of his home. In year 4 he chooses to substantiate expenses. He multiplies his home's business use basis by the depreciation table percentage for year 4 to determine his allowable depreciation.

Example 13.2 Comparison of Methods

Pete Plumber, an unmarried taxpayer, meets the regular use and exclusive use tests to qualify for a home office deduction. In 2013 his gross receipts were $215,000, his expenses not related to the home office were $125,000, and his net profit before considering the home office was $90,000 ($215,000 − $125,000). He has no other income, he itemizes deductions rather than claiming the standard deduction, and he will not owe the alternative minimum tax (AMT).

Pete used 10% (310 square feet) of his home for business purposes. His mortgage interest and real property taxes totaled $14,600 in 2013, and utilities, insurance, and repairs were $7,200. Pete paid $220,000 for his home, allocating $180,000 to the home and $40,000 to the lot. The home office space is 39-year MACRS property, and the annual depreciation percentage for years 2–39 is 2.564%.

Figure 13.1 shows that Pete's allowable 2013 home office deduction is $2,642 ($1,460 + $720 + $462) using the actual expense method and $1,500 if he elects the safe harbor method. However, his itemized deductions increase by the $1,460 allocated to the home office space if he elects the safe harbor, and his income tax deduction for 50% of his self-employment (SE) tax increases, so his taxable income is actually lower using the safe harbor method.

Because his SE tax is higher, however, his total tax liability is $62 more ($24,365 − $24,303) if he elects the safe harbor method.

Because the $462 depreciation deduction reduces his basis in his home, it could trigger taxable gain (25% maximum tax rate for unrecaptured § 1250 gain) when he sells his home. The sale of a residence with a home office is discussed later in this issue.

FIGURE 13.1 Comparison of Pete's Home Office Deduction Options

Item	Actual Expense Method	Safe Harbor Method
Net profit before home office deduction	$90,000	$90,000
Home office deduction		
Mortgage interest and property taxes ($14,600 × 10%)	(1,460)	
Utilities, insurance, and repairs ($7,200 × 10%)	(720)	
Depreciation ($180,000 × 10% × 0.02564)	(462)	
Safe harbor ($5 × 300 square feet limitation)		(1,500)
Net profit after home office deduction	$87,358	$88,500
One-half SE tax ($12,343 × ½)	(6,172)	(6,253)
Adjusted gross income	$81,186	$82,247
Itemized deductions:		
Using actual expense method ($14,600 – $1,460)	(13,140)	
Using safe harbor method		(14,600)
Personal exemption deduction	(3,900)	(3,900)
Taxable income	$64,146	$63,747
Regular income tax (using 2013 tax tables)	$11,960	$11,860
SE tax (net profit after home office deduction × 0.9235 × 0.153)	12,343	12,505
Total tax liability (excluding state and local income taxes)	$24,303	$24,365

Practitioner Note Other Tax Considerations

Taxpayers should also consider the impact of the AMT, the phaseout of itemized deductions, and the additional 0.9% Medicare tax for high-income taxpayers.

Example 13.3 Electing the Safe Harbor Deduction

Pete Plumber from Example 13.2 elects to use the safe harbor method to claim his home office deduction for 2013. He reports the $1,500 deduction on line 30 of his Schedule C (Form 1040) as shown in Figure 13.2. He is not required to complete Form 8829.

FIGURE 13.2 Safe Harbor Method Reporting on Schedule C (Form 1040)

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)
► For information on Schedule C and its instructions, go to *www.irs.gov/schedulec*.
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2013
Attachment Sequence No. **09**

Name of proprietor: Pete Plumber
Social security number (SSN): 280-00-2013

29	Tentative profit or (loss). Subtract line 28 from line 7	29	90,000
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). **Simplified method filers only:** enter the total square footage of: (a) your home: 3,100 and (b) the part of your home used for business: 310. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30	1,500
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2**. (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	88,500
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both **Form 1040, line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

Deduction Limited to Gross Income

As with the actual expense method, the safe harbor deduction cannot exceed the gross income derived from the qualified business use of the home reduced by business deductions that are unrelated to the business use of a home.

No Carryover of Excess Amounts

Any safe harbor deduction amount in excess of the gross income limit is disallowed and may not be carried over and claimed as a deduction in any other tax year. In addition, a taxpayer cannot use any amount carried over from a year when he or she calculated the deduction using the actual expense method in a year when he or she uses the safe harbor method. However, carryover expenses from an actual expense year can be carried over to future years when the actual expense method is once again used.

Example 13.4 Carryover Deduction Disallowed

Gary Gershwin meets the regular use and exclusive use tests to qualify for a home office deduction. In 2013 his gross receipts were $5,000, his expenses not related to the home office were $4,000, and his net profit before considering the home office was $1,000 ($5,000 – $4,000). Gary used 250 square feet of his home for business purposes and elects the safe harbor method for his home office deduction. His safe harbor deduction calculation is $1,250 ($5 × 250 square feet), but it is limited to his $1,000 net profit. Gary may not carry over the excess $250 ($1,250 – $1,000) to any future year.

Example 13.5 Actual Expense Carryover from Prior Year

Inez Irwin meets the regular use and exclusive use tests to qualify for a home office deduction each year. She has $750 of carryover office expenses from 2012.

In 2013 her gross receipts were $10,000, her expenses not related to the home office were $6,000, and her net profit before considering the home office was $4,000 ($10,000 – $6,000). Inez used 250 square feet of her home for business purposes and elected the safe harbor method for her home office deduction. Her safe harbor deduction calculation is $1,250 ($5 × 250 square feet), which reduces her net profit to $2,750 ($4,000 – $1,250).

Inez may not use her 2012 carryover home office deduction in 2013 because she elected the safe harbor method for 2013. However, she may continue to carry the $750 forward to a future year in which she uses the actual expense method to calculate her home office deduction.

Partial Years

A taxpayer who uses part of his or her home for a qualified business use for less than the entire tax year (for example, a business that begins during the tax year or a seasonal business), or a taxpayer who changes the size of the qualified business use area during the tax year (an increase or decrease in the square footage) must determine the average monthly square footage for the tax year.

When calculating the average monthly square footage, taxpayers may include only months in which they had 15 or more days of a qualified business use of the home. No more than 300 square feet can be considered for any month.

Example 13.6 Partial-Year Business Use

On July 22, 2013, Jenny Johnson began using 400 square feet of her home from 6 a.m. to 6 p.m. 5 days a week as a day care center, and she continued that use until the end of the year. Jenny elects the safe harbor method for deducting business-use-of-home expenses. She can count only 5 months (August through December) because she had fewer than 15 days of business use in July, and she cannot count more than 300 square feet each month. Her average monthly allowable square footage is 125 square feet [300 square feet × (5 months ÷ 12 months)]. Her safe harbor method deduction for 2013 is $625 ($5 × 125). If she continues to use the same amount of space in 2014, her safe harbor deduction will be the maximum $1,500 ($5 × 300).

Shared Home

Taxpayers sharing a home (for example, roommates or spouses, regardless of filing status) may each use the safe harbor method for up to 300 square feet of qualified space, but not for qualified business use of the same portion of the home.

Example 13.7 Shared Home with Two Uses

Calvin and Coleen Cooper, a married couple, each meet the requirements for the business use of their home. They may each use the safe harbor method for a qualified business use of their home for up to 300 square feet of different portions of the home.

More Than One Business or Home

Taxpayers who have more than one qualified business use of the same home for a tax year and elect the safe harbor method must use the safe harbor method for each qualified business use of the home, and they are limited to a maximum of 300 square feet for all of their businesses combined.

Taxpayers with qualified business uses of more than one home for a tax year may use the safe harbor method for only one home for that tax year. However, a taxpayer may calculate and substantiate actual expenses for the business use of any other homes for that tax year.

Sale of Residence with Home Office

When depreciation is allowed or allowable for a home office and the home is later sold for a gain, at least some of the gain becomes taxable even if the homeowner otherwise qualifies to exclude the gain under I.R.C. § 121 (the 2-year ownership and occupancy tests). The amount of taxable gain is partially dependent upon whether the home office was within the dwelling unit or was in a separate building.

The allowable depreciation deduction for any year that a taxpayer uses the safe harbor method for deducting home office expenses is deemed to be zero, however.

Example 13.8 Sale of Home with Office

Pete Plumber from Example 13.2 sold his home July 20, 2016, for $250,000 (after selling expenses). He originally purchased the house for $220,000, allocating $180,000 to the house, and he meets the tests for the I.R.C. § 121 exclusion. He first qualified for 10% business use of his home in January 2012.

Figure 13.3 shows Pete's realized gain on the sale if he used the actual expense method for all years, and it compares this to the realized gain if he used the safe harbor method for 2013–2016. The annual MACRS percentage for depreciation over 39 years is 2.461% for year 1 for property placed in service in January and 2.564% for years 2–39. His recognized gain is taxed at a maximum rate of 25%.

Cross-Reference Additional Topics

See page 62 in the *2010 National Income Tax Workbook* for a discussion of correcting the omission of depreciation deductions and the sale of a home office located in a separate building.

FIGURE 13.3 Sale of Home with Office

Item	Actual Expense Method	Safe Harbor Method
Home purchase price	$220,000	$220,000
Depreciation allowed or allowable		
2012 ($180,000 × 10% × 2.461%)	(443)	(443)*
2013 ($180,000 × 10% × 2.564%)	(462)	
2014 ($180,000 × 10% × 2.564%)	(462)	
2015 ($180,000 × 10% × 2.564%)	(462)	
2016 [$180,000 × 10% × 2.564% × (6½ ÷ 12)]	(250)	
Adjusted basis of home	$217,921	$219,557
Selling price	$250,000	$250,000
Adjusted basis of home	(217,921)	(219,557)
Realized gain	$ 32,079	$ 30,443
Recognized gain (limited to allowable depreciation)	(2,079)	(443)
Excluded gain	$30,000	$30,000

* The safe harbor method was not available for 2012; therefore, the 2012 allowable depreciation reduced Pete's basis and is subject to the recapture rules.

ISSUE 2: ONE-PARTICIPANT 401(K) PLAN

A one-participant 401(k) plan allows a self-employed individual to save more aggressively for retirement.

Small business owners are constantly struggling to find the proper balance between their business investment and their personal financial planning. The competing calls among a business owner's current standard of living, business stability, and long-term solvency are complicated by the confusing legislation surrounding retirement plans.

Practitioner Note Self-Employed Has Wider Meaning Here

The term *self-employed* generally includes sole proprietors, partners, and members of limited liability companies (LLCs) taxed as partnerships. In this discussion, the term sometimes refers to owners of all closely held businesses, including small S and C corporations and LLCs treated as corporations, because their retirement savings concerns are similar.

Internal Revenue Code provisions for qualified retirement plans first appeared in 1942, but they were limited to common law employees. Partners and proprietors were excluded from participating in their business's plans until the Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, was enacted to allow self-employed individuals to establish qualified plans called H.R. 10 or Keogh plans (albeit with lower contribution limits), and S corporation shareholders were subject to comparable limits after 1969. Congress tried for more equality in the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. No. 97-248, explaining in a Joint Committee on Taxation report that "the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend upon whether the employer is an incorporated or unincorporated enterprise."

Even so, the costs of qualified retirement plans tended to limit options for self-employed individuals before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, was enacted.

- Defined benefit plans are typically too costly to fund and maintain for only one participant because of their high fixed costs, such as actuarial and recordkeeping costs.
- Qualified defined contribution plans, such as profit-sharing plans and money purchase pension plans, were often not practical because of a combination of their administrative costs and limited contribution amounts (discussed later in this issue).

This meant that the only economically viable options for many self-employed individuals were I.R.C. § 408 individual retirement arrangements (IRAs), such as simplified employee pension IRAs (SEP IRAs) or SIMPLE IRAs, which had lower contribution limits and lacked flexibility. (SEP IRAs and SIMPLE IRAs are not qualified plans.)

EGTRRA Change

EGTRRA opened up the options for small business owners by increasing the allowable percentage of elective salary deferrals to qualified plans from 25% of compensation to 100% of compensation and by changing the effect of elective salary deferrals on the overall contribution limits for qualified plans.

Prior to this legislation any amount that the employee contributed as part of a salary deferral arrangement reduced the employer's eligible deductible contribution. Now employees may defer up to 100% of their compensation (subject to an annual dollar limit), and the employer may deduct an additional contribution that does not exceed 25% of the employee's compensation (also subject to an annual dollar limit). Example 13.9 illustrates the effect of the EGTRRA change. See "Contribution Limits" later in this issue for a further explanation of the limits for 2013.

Example 13.9 Pre- and Post-EGTRRA Comparison

Betty Bloom, age 48, is the sole owner and sole employee of an S corporation that paid her $134,000 in 2013. Through the corporation she established a profit-sharing plan with a 401(k) provision, and she wants to contribute the maximum amount to the plan. The employer contribution is limited to $33,500 (25% × $134,000), and the 2013 maximum salary deferral for an employee under age 50 is $17,500. Before the EGTRRA rule change, her $17,500 salary deferral would have reduced the deductible employer contribution to $16,000 ($33,500 – $17,500). After the EGTRRA rule change, each limit is applied separately, thus increasing her retirement savings to $51,000 ($33,500 + $17,500), as shown in Figure 13.4.

Small business owners now have an incentive to establish a 401(k) plan instead of an IRA-based plan to increase their retirement savings. This discussion focused on the rules for a one-participant plan that covers a self-employed individual who has no employees. The business can be incorporated or unincorporated.

FIGURE 13.4 Pre- and Post-EGTRRA Limitations

	Pre-EGTRRA Rule	Post-EGTRRA Rule
Profit-sharing contribution	$33,500	$33,500
Reduction for salary deferral	(17,500)	(0)
S corporation deduction	$16,000	$33,500
2013 salary deferral	17,500	17,500
Maximum compensation deferral	$33,500	$51,000

One-Participant 401(k) Plan

A one-participant plan is for all practical purposes a full-fledged 401(k) plan. The contribution limits, plan provisions allowing loans, and required minimum distribution (RMD) rules are the same as for other qualified plans. However, the actual deferral percentage (ADP) and actual contribution percentage (ACP) nondiscrimination tests are not required because all of the participants are treated as highly compensated. Thus providers can market these plans with significantly reduced costs.

Cross-Reference Nondiscrimination Testing

See pages 59–60 in the *2011 National Income Tax Workbook* for an explanation of the ADP and ACP nondiscrimination tests.

Practitioner Note One Participant Is Not Just One Person

A one-participant 401(k) is also called a Solo-k, a Solo-401(k), a Uni-k, or a Single-k. The term itself is a misnomer because the plan may cover more than one person. Participation is limited to a married couple who own an incorporated or unincorporated business, or the partners in a business partnership and their spouses. Benefits cannot be provided to anyone else.

A minor difference between one-participant plans and other plans is in the annual reporting requirement. Other qualified plans must file an annual report electronically with the Department of Labor. The owner of a one-participant plan must file Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan, with the IRS only if the plan has $250,000 or more in assets at the end of the year. The owner of a one-participant plan with less than $250,000 in assets is exempt from filing unless the plan terminates during the year.

Planning Pointer Loans, Rollovers May Avoid $250,000 Balance

Borrowing from a plan or taking an in-service distribution that qualifies for an IRA rollover can keep the plan balance below the $250,000 filing requirement threshold.

However, the same rules apply as for other qualified plan loans. I.R.C. § 72(p)(2) allows participants to receive a nontaxable loan of up to 50% of their vested account balance, not to exceed $50,000. The loan terms must require repayment with interest within 5 years (unless the loan is for the purchase of a primary residence), and substantially level payments must be required at least quarterly. Being an owner of the plan sponsor does not affect the participant's ability to take a loan, as long as all participants are equally able to take loans under the plan's loan provisions.

In general, a 401(k) plan must restrict in-service distributions before age 59½ to hardship withdrawals [Treas. Reg. § 1.401(k)-1(d)(1)]. The plan document must specify the hardship criteria. A distribution is not considered necessary to satisfy an immediate and heavy financial need if the employee has other resources available to meet the need, including assets of the employee's spouse and minor children. A hardship distribution cannot be rolled over into an IRA or another qualified plan.

Eligible Participants

A one-participant 401(k) plan cannot be established if the business has any eligible employees other than the business owners and their spouses.

A qualified plan generally cannot exclude any employee who is at least age 21 and has completed 1 year of service for the employer (defined as working at least 1,000 hours over a 12-consecutive-month period) [I.R.C. § 410(a)(1) and (3)]. However, a plan may exclude employees who meet the age and minimum service criteria if the employees are covered by a collective bargaining agreement and there is evidence that retirement benefits were the subject of good faith bargaining between the employee representatives and the employer [I.R.C. § 410(b)(3)(A)].

Example 13.10 No Other Eligible Employees

V. J. and Elaine Vohler, a married couple, own a small marketing company in which they both work full-time. In 2012 they employed 10 college students who each worked 15 hours or less per week. No employee worked more than 750 hours during the year. Because a qualified plan may exclude these employees, V. J. and Elaine can establish a one-participant 401(k) plan and make contributions on behalf of each spouse for 2012.

Example 13.11 Newly Eligible Employee

V. J. and Elaine Vohler from Example 13.10 established a qualified plan with a calendar plan year. In 2013 they decided that their business had grown enough to warrant adding a full-time employee. They offered one of the college students, Sasha Ryman, a full-time job after she graduated in May. Sasha is age 22, and she will be an eligible participant for the retirement plan for 2012. Thus the 401(k) plan is no longer treated as a one-participant plan, and nondiscrimination testing is required.

Cross-Reference Safe Harbor 401(k) Plans

V. J. and Elaine could consider a safe harbor 401(k) plan, which has limited nondiscrimination testing. The majority of the money contributed to the 401(k) plan for Sasha's benefit would be in the form of her elective deferrals, with limited company contributions. See pages 66–68 in the *2011 National Income Tax Workbook* for an explanation of safe harbor 401(k) plan requirements.

Contribution Limits

Defined contribution plans may be either profit-sharing plans or money purchase pension plans. The difference is whether the employer is required to make a certain level of annual contributions. A profit-sharing plan allows discretionary employer contributions, so that the percentage contribution can vary from year to year, or even be zero in some years. A money purchase pension plan has a set rate (for example, 10%) for contributions that are mandatory every year. The contribution limit rules are the same for both types of defined contribution plans.

A business owner who has earned income from the business can make contributions to a 401(k) plan as both the employee and the employer:

- Employees may elect to defer up to 100% of their compensation, subject to an annual dollar limit. This is $17,500 in 2013 [I.R.C. § 402(g)(1)], but a $5,500 catch-up provision raises the limit to $23,000 if the employee is at least age 50 [I.R.C. § 414(v)(2)(B)(i)].
- Employers may deduct a contribution of up to 25% of the employee's compensation, subject to a dollar limit on total annual additions to a participant's account, which is $51,000 ($56,500 for individuals age 50 or older) in 2013 [I.R.C. § 415(c)(1) and Treas. Reg. § 1.414(v)-1(d)(1)].
- No more than $255,000 of compensation can be taken into account in determining the maximum contribution for 2013 [I.R.C. §§ 401(a)(17) and 404(l)].

Practitioner Note Contribution Rate for Self-Employed

For self-employed individuals compensation is defined as net earnings from self-employment after deducting 50% of the SE tax and the employer contribution to the plan for the self-employed individual. Because this is a circular computation, an equation is used to determine the allowable employer contribution rate: the stated plan contribution rate is expressed as a decimal and then divided by the total of 1 plus the stated plan contribution rate. For example, a 25% stated contribution rate becomes 20% (0.25 ÷ 1.25).

Example 13.12 Maximizing Plan Contributions

After Thelma Thompson, age 57, was laid off from her job at Corporate America, she began working as a self-employed consultant. Her severance pay from Corporate America is enough to cover her living expenses in the short term, so she wants to maximize her retirement plan contributions for 2013.

Thelma has $50,000 of net SE income in 2013 and is considering a SEP IRA or a SIMPLE IRA. Tex Proff, her tax practitioner, compared the IRA choices with a 401(k) plan to show her an option that allows a much greater contribution amount.

A salary reduction SEP (SARSEP) can no longer be established (although participants may continue to contribute to SARSEPs established before 1997), so the employer contribution is the only amount that can be contributed to a new SEP IRA. The maximum salary deferral to a SIMPLE IRA is $12,000, and the catch-up contribution limit for a SIMPLE IRA is $2,500 instead of the $5,500 allowed for a qualified plan.

Figure 13.5 shows the comparison.

FIGURE 13.5 SEP IRA, SIMPLE IRA, and 401(k) Contribution Comparison

		SEP IRA	SIMPLE IRA	401(k)
Net business profit	$50,000			
SE tax deduction [($50,000 × 0.9235 × 0.153) = $7,065 × ½]	(3,533)			
Adjusted net profit	$46,467			
Employer contribution				
$46,467 × 0.20[1]		$ 9,293		$ 9,293
$46,175 × 0.03[2]			$ 1,385	
Salary deferral		0	12,000	17,500
Catch-up deferral		0	2,500	5,500
Maximum contribution		$ 9,293	$15,885	$32,293

[1] Based on a 25% employer contribution [0.25 ÷ (1 + 0.25)]
[2] Employer contribution is 3% of earnings used for SE tax calculation: $50,000 × 0.9235 = $46,175

Practitioner Note 401(k) Designated Roth Account

Another feature that can be included in a 401(k) plan is a designated Roth account. Only elective deferrals can be contributed to the Roth 401(k) account. If Thelma's plan includes a designated Roth account, her $23,000 deferral could be designated for the Roth account, but the employer's $9,293 contribution would go into a traditional 401(k) account. Thelma could also choose to divide her $23,000 contribution between pre-tax and after-tax (Roth) contributions to her 401(k) plan.

Planning Pointer Contributions from Savings

Individuals in their 50s may realize that that their retirement savings are inadequate. CDs that are earning less than 1% may provide a money source that will permit a more aggressive retirement contribution. However, before making this decision, individuals should consider the early withdrawal penalty if they may need the funds before age 59½.

Practitioner Note Compare 401(k) Plan and SEP IRA

The advantages of a small business 401(k) over a SEP IRA are

- higher contribution limits;
- the larger catch-up provision for individuals who are at least age 50;
- the loan feature; and
- the Roth 401(k) feature.

The advantages of the SEP IRA are

- the ability to establish it after the tax year ends (up to the extended due date of the employer's tax return), whereas a qualified plan must be established by the last day of the tax year;
- no Form 5500-EZ reporting requirement regardless of the plan balance (the trustee or custodian of the SEP IRA files Form 5498, IRA Contribution Information); and
- often, lower administrative fees.

Cross-Reference Rollover Chart and Contribution Limitations

See the "Tax Rates and Useful Tables" chapter of this book for IRA and retirement plan contribution limits and a rollover chart for the various retirement plan options.

ISSUE 3: REPAIRS AND CAPITAL EXPENDITURES

Final regulations create several new safe harbors for distinguishing repairs and capital expenditures. To comply with the new rules, taxpayers can file Form 3115, Application for Change in Accounting Method, to obtain the IRS's automatic consent for changes.

New final regulations [T.D. 9636, 78 F.R. 57685 (September 19, 2013)] that provide a framework for distinguishing capital expenditures from deductible business expenses retain many provisions of the temporary and proposed regulations, but they also clarify and simplify several rules and create a number of new safe harbors. The new rules

- increase the ceiling for treating the cost of certain items as nonincidental materials and supplies;
- revise and simplify the de minimis safe harbor for deducting rather than capitalizing some costs of acquiring or producing property used in the taxpayer's business;

- extend the de minimis safe harbor to taxpayers without an applicable financial statement (AFS);
- add a small taxpayer safe harbor to the rules governing improvements to tangible property;
- extend the routine maintenance safe harbor to buildings; and
- refine several criteria for defining betterments and restorations to tangible property.

In addition, the regulations finalize temporary regulations under I.R.C. § 167 regarding accounting for and retirement of depreciable property. They also finalize temporary regulations under I.R.C. § 168 regarding accounting for MACRS property other than general asset accounts.

However, the regulations do not finalize the rules under Treas. Reg. §§ 1.168(i)-1T and 1.168(i)-8T addressing the definition of disposition for property subject to I.R.C. § 168. Instead, the IRS proposed revised regulations [REG-110732-13, 78 F.R. 57547] concurrently with T.D. 9636 [https://federalregister.gov/a/2013-21756 and https://federalregister.gov/a/2013-21753].

Background

I.R.C. § 263(a) generally requires capitalization of amounts paid to acquire, produce, or improve tangible property, whereas I.R.C. § 162 allows a deduction for ordinary and necessary business expenses paid or incurred during the tax year, including the costs of supplies, repairs, and maintenance. The determination of whether an expense may be deducted as a repair or must be capitalized generally requires an examination of all of a taxpayer's particular facts and circumstances.

The subjective nature of many decisions as to whether work performed qualified as a repair or resulted in an improvement gave rise to considerable controversy over many years, which the IRS hoped to reduce through proposed regulations issued in 2006.

- After considering comments, the IRS replaced the 2006 rules with new proposed regulations in 2008.
- After considering comments, the IRS replaced the 2008 rules with new temporary and proposed regulations issued December 27, 2011, that were to be effective for tax years beginning on or after January 1, 2012.
- After considering comments, the IRS issued Notice 2012-73, 2012-51 I.R.B. 713, on November 20, 2012, changing the applicability date of the 2011 rules to tax years beginning on or after January 1, 2014, while permitting taxpayers to choose to apply the 2011 rules to tax years beginning on or after January 1, 2012, and before the applicability date of final regulations.
- The final regulations published in the *Federal Register* on September 19, 2013, apply to tax years beginning on or after January 1, 2014, but in general a taxpayer may choose to apply the new rules to tax years beginning on or after January 1, 2012.

Transitional Rule

Transition relief allows taxpayers who choose to apply the final regulations to tax years beginning on or after January 1, 2012, and who did not make required elections on their timely filed original federal tax return for their 2012 or 2013 tax years, to make elections. A taxpayer can make these elections by filing an amended federal tax return (including any applicable statements) for the applicable year on or before 180 days from the extended due date of the taxpayer's federal tax return for the applicable tax year, even if the taxpayer did not extend the due date.

Practitioner Note Extended Due Date

A 6-month automatic extension of time to file is generally available for federal income tax returns. An individual taxpayer whose 2012 return was due April 15, 2013, begins counting the 180-day period on October 15, 2013 (the extended due date for individual taxpayers who requested the automatic extension). Note that 180 days is shorter than 6 months. For example, October 15 is day 288 and April 13 is day 103 if neither year is a leap year. Therefore, April 13, 2014, is 180 days (288 + 180 – 365 = 103) after October 15, 2013.

A taxpayer may also choose to apply the 2011 temporary regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014. The temporary regulations cannot be applied to amounts paid or incurred in tax years beginning on or after January 1, 2014.

Practitioner Note 4,000,000 Taxpayers

T.D. 9636 states that 4,000,000 taxpayers are expected to elect to use one of the safe harbors or to elect to capitalize repair and maintenance costs, with an estimated 1,100,000-hour total annual reporting burden. The per taxpayer time requirement is estimated to be 15 to 30 minutes.

General Format

The final regulations distinguishing repairs and improvements adopt the same general format as the 2011 temporary regulations:

- Treas. Reg. § 1.162-3 provides rules for materials and supplies.
- Treas. Reg. § 1.162-4 addresses repairs and maintenance.
- Treas. Reg. § 1.263(a)-1 provides general rules for capital expenditures.
- Treas. Reg. § 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property.
- Treas. Reg. § 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property.

Change in Accounting Method

Except as otherwise stated in the final regulations, a change to comply with the regulations is a change in method of accounting to which the provisions of I.R.C. §§ 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change a method of accounting must secure the IRS's consent. In general, a taxpayer seeking a change in method of accounting to comply with the regulations must take into account a full adjustment under I.R.C. § 481(a).

The IRS will provide separate procedures under which taxpayers may obtain automatic consent for a tax year beginning on or after January 1, 2012, to change to a method of accounting provided in the final regulations. The IRS anticipates that a limited I.R.C. § 481(a) adjustment will apply if a taxpayer seeks to change to a method of accounting that is applicable only to tax years beginning on or after January 1, 2014. The limited adjustment will take into account only amounts paid or incurred in tax years beginning on or after January 1, 2014 (or, at a taxpayer's option, amounts paid or incurred in tax years beginning on or after January 1, 2012).

The use of the de minimis safe harbor is a tax year election that is **not** made by filing an application for a change in method of accounting. Thus a change in a taxpayer's financial accounting procedures (for example, increasing the dollar amount in its financial accounting capitalization policy) is not a change in method of accounting.

De Minimis Rules

All taxpayers may deduct the cost of an item properly classified as nonincidental materials and supplies regardless of the item's useful life if the item costs no more than $200. A safe harbor will allow taxpayers to deduct as an ordinary or necessary business expense the cost of depreciable property that does not exceed a ceiling amount that depends upon whether the taxpayer has an AFS.

Material and Supplies

Treas. Reg. § 1.162-3 permits taxpayers to deduct the cost of nonincidental materials and supplies in the tax year in which the materials and supplies are first used or consumed in the taxpayer's operations. Treas. Reg. § 1.162-3(c)(1) generally defines *material and supplies* as tangible property that is used or consumed in the taxpayer's operations, that is not inventory, and that has an economic useful life of 12 months or less.

Treas. Reg. § 1.162-3(c)(1)(iv) provides a de minimis rule that allows taxpayers to deduct certain low-cost items regardless of their useful lives. The 2011 regulations set a $100 ceiling, but the final regulations raise the ceiling to $200, and the IRS is authorized to change this amount in future published guidance. Commenters on the 2011 regulations noted that the $100 threshold did not capture common supplies such as calculators and coffee makers.

Treas. Reg. § 1.162-3(c)(1)(iv) clarifies that property treated as materials and supplies in published guidance is still treated as material and supplies under the new regulation. For example, Rev. Proc. 2002-12, 2002-1 C.B. 374, allows a taxpayer to treat smallwares as nonincidental materials and supplies. Similarly, Rev. Proc. 2002-28, 2002-1 C.B. 815, allows a qualifying small business taxpayer to treat certain inventoriable items in the same manner as nonincidental materials and supplies.

De Minimis Safe Harbor

Treas. Reg. § 1.263-1(f)(1) provides a de minimis safe harbor that allows taxpayers to elect to treat the cost of qualifying depreciable tangible property as a currently deductible expense rather than capitalizing the cost and taking depreciation deductions, unless the I.R.C. § 263A uniform capitalization rules apply to the property. The final regulations eliminate a complex ceiling on the overall deduction that was included in the 2011 regulations and generally allow a deduction determined at the invoice or item level for amounts that are properly expensed under a taxpayer's financial accounting policies. The dollar limit is $5,000 for taxpayers with an AFS and $500 for taxpayers who do not have an AFS.

Taxpayer with an AFS

If a taxpayer has an AFS and at the beginning of the tax year has written accounting procedures treating the cost of items that cost less than a specified dollar amount or have an economic useful life of 12 months or less as an expense for nontax purposes, and the taxpayer treats the amount as an expense on its applicable financial statement in accordance with its written accounting procedures, the cost is deductible for tax purposes if the amount paid does not exceed $5,000 per invoice (or per item as substantiated by the invoice). The IRS may change this ceiling in future published guidance.

An AFS (in descending priority) is

- a financial statement required to be filed with the Securities and Exchange Commission (SEC);
- a certified audited financial statement that is accompanied by the report of an independent CPA that is used for credit purposes; reporting to shareholders, partners, or similar persons; or any other substantial nontax purpose; or
- a financial statement (other than a tax return) required to be provided to a federal or state government or an agency other than the SEC or the IRS.

Taxpayer without an AFS

If a taxpayer does not have an AFS but at the beginning of the tax year the taxpayer has accounting procedures in place that treat the cost of items that cost less than a specified dollar amount or have an economic useful life of 12 months or less as an expense for nontax purposes, and the taxpayer treats the amount as an expense on its books and records in accordance with the accounting procedures, the cost is deductible for tax purposes if the amount paid does not exceed $500 per invoice (or per item as substantiated by the invoice). The IRS may change this ceiling in future published guidance.

A taxpayer who has an AFS cannot use the de minimis safe harbor for a taxpayer who does not have an AFS.

Exceptions

The de minimis safe harbor does not apply to amounts paid for property that is or is intended to be included in inventory property; amounts paid for land; and certain amounts paid for rotable, temporary, and standby emergency spare parts.

Additional Rules

A taxpayer electing the de minimis safe harbor is not required to include additional costs (for example, delivery fees, installation services, or similar costs) in the cost of acquiring or producing property **if** the costs are not included in the same invoice as the tangible property.

If a taxpayer deducts the cost of property using the de minimis safe harbor, the property is not treated as an I.R.C. § 1221 capital asset or as I.R.C. § 1231 property used in the trade or business when it is sold or otherwise disposed of.

A taxpayer who elects the de minimis safe harbor must also apply it to all amounts paid for eligible materials and supplies during the tax year. Taxpayers may not selectively choose items to be expensed under the safe harbor.

Practitioner Note Rotable and Spare Parts

The final regulations continue to treat rotable and temporary spare parts as materials and supplies that are used and consumed by the taxpayer in the year the taxpayer disposes of the parts unless the taxpayer chooses a different treatment under Treas. Reg. § 1.162-3(d) or (e).

Standby emergency spare parts (as defined in Rev. Rul. 81-185, 1981-2 C.B. 59) are now included in the definition of materials and supplies and are eligible for the Treas. Reg § 1.162-3(d) capitalization election.

A taxpayer who uses the Treas. Reg § 1.162-3(e) optional method (which allows the cost of a rotable or temporary spare part to be deducted in the first year the part is used but requires an income inclusion when the part is restored to the pool) must use the optional method for all pools of rotable and temporary spare parts that are used in the same trade or business for which the optional method is used for the taxpayer's books and records.

Practitioner Note I.R.C. § 179 Expense

By contrast, taxpayers may select specific assets to expense under I.R.C. § 179, and those items are treated as I.R.C. § 1231 property when they are sold or otherwise disposed of. However, the de minimis election to deduct the cost of qualifying property is not subject to a total annual dollar limit, an investment limit, or a business income limit. See the "New Legislation" chapter of this book for a summary of the I.R.C. § 179 limits for 2013.

If a consolidated group member's financial results are reported on a group AFS, the group's AFS may be treated as the taxpayer's AFS, and the group's written accounting procedures may be treated as the taxpayer's written accounting procedures.

Time and Manner of Election

The de minimis election applies to all amounts paid during the tax year for qualifying property. A taxpayer makes the irrevocable election for a tax year by attaching a statement to the taxpayer's timely filed (including extensions) original federal tax return for the tax year in which the amounts were paid. The statement must be titled "Section 1.263(a)-1(f) de minimis safe harbor election" and include the taxpayer's name, address, taxpayer identification number (TIN), and a statement that the taxpayer is making the de minimis safe harbor election under Treas. Reg. § 1.263(a)-1(f).

An S corporation or partnership election is made by the S corporation or the partnership and not by the shareholders or partners.

If a consolidated group is filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must include the names and TINs of each member for which the election is made.

An election may not be made through the filing of an application for change in accounting method. See Treas. Reg. §§ 301.9100-1 through 301.9100-3 for the provisions governing extensions of time to make regulatory elections.

Antiabuse Rule

The IRS may make appropriate adjustments if a taxpayer acts to manipulate transactions with the intent to achieve a tax benefit or to avoid the safe harbor's limitations, such as using invoices created to componentize property that is generally acquired or produced as a single unit of tangible property.

Practitioner Note Examiner Discretion

The preamble in T.D. 9636 states that the de minimis safe harbor does not require IRS examining agents to revise their materiality thresholds. If an examining agent and a taxpayer agree that certain amounts in excess of the de minimis safe harbor limitations are not material or otherwise should not be subject to review, that agreement will be respected. However, a taxpayer who seeks a deduction for amounts in excess of the safe harbor amount has the burden of showing that such treatment clearly reflects income.

Amounts Paid to Improve Property

Treas. Reg. § 1.263(a)-3 generally retains the 2011 rules for determining a unit of property and whether there is an improvement to a unit of property, as well as the routine maintenance safe harbor and the optional regulatory accounting method, but it modifies the 2011 temporary regulations in several areas.

Rehabilitation Doctrine Obsolete

The judicially created *plan of rehabilitation doctrine* provides that a taxpayer must capitalize otherwise deductible repair or maintenance costs if they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the property. The 2011 temporary regulations departed from this doctrine, providing that a taxpayer must capitalize under I.R.C. § 263(a) indirect costs that directly benefit an improvement, but indirect costs (such as repair and maintenance costs) that are not incurred by reason of an improvement and do not directly benefit the improvement are not required to be capitalized.

The final regulations retain the 2011 rules and supersede the plan of rehabilitation doctrine to the extent that the court-created doctrine provides different standards.

Personal Residence Exception

An exception for a personal residence permits an individual taxpayer to capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to property that is not used in the taxpayer's trade or business or for the production of income, such as a remodeling of the taxpayer's home.

Removal Costs

If a taxpayer disposes of a depreciable asset and takes the adjusted basis of the asset or component of the asset into account in realizing gain or loss, the costs of removing the asset or component are not required to be capitalized under I.R.C. § 263(a).

If a taxpayer disposes of a component of a unit of property and the disposal is not a disposition for federal tax purposes, the taxpayer could be required to capitalize the costs of removing the component, based on whether the removal costs relate to a repair to the unit of property or an improvement to the unit of property. The regulations provide several examples illustrating these principles.

Small Taxpayer Safe Harbor

A special rule permits a qualifying small taxpayer to elect to not apply the improvement rules to an eligible building property if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of $10,000 or 2% of the unadjusted basis of the building [Treas. Reg. § 1.263(a)-3(h)].

A *qualifying small taxpayer* is a taxpayer with 3-year average annual gross receipts of $10,000,000 or less. *Eligible building property* can be owned or leased by the qualifying taxpayer. The property's unadjusted basis cannot exceed $1,000,000.

The final regulations eliminate the need to separately analyze the building structure and the building systems, as required elsewhere in the final regulations' improvement rules.

The taxpayer must include amounts expensed under the Treas. Reg. § 1.263(a)-1(f) de minimis safe harbor and the routine maintenance safe harbor for buildings (discussed later) to determine the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the building.

The small taxpayer safe harbor is elected annually on a building-by-building basis by including a statement on the taxpayer's timely filed (including extensions) original federal tax return for the year the costs are incurred. A taxpayer making the irrevocable election may deduct amounts to which the safe harbor applies I.R.C. § 162 or 212, as applicable, provided the amounts otherwise qualify for deduction under those sections.

Routine Maintenance Safe Harbor

The 2011 temporary regulations provided that the costs of performing certain routine maintenance activities for property other than a building or the structural components of a building are not required to be capitalized as an improvement. The *routine maintenance safe harbor* provides that *maintenance* includes recurring activities that a taxpayer expects to perform to keep the unit of property in its ordinarily efficient operating condition. Activities are treated as *routine* if (at the time the unit of property is placed in service) the taxpayer reasonably expects to perform the activities more than once during the property's alternative depreciation system (ADS) class life, regardless of whether the property is depreciated under the ADS.

Buildings

The final regulations contain a safe harbor for routine maintenance of buildings, which is defined as activities the taxpayer reasonably expects to perform more than once in a 10-year period.

Other Changes

The final regulations make several additional changes and clarifications to the safe harbor for routine maintenance that are applicable to both buildings and other property.

- Routine maintenance can be performed any time during the life of the property provided that the activities qualify as routine.
- The taxpayer's treatment of the activity on its applicable financial statement is not considered because such treatment may not be indicative of whether the activities are routine.
- The list of exceptions from the routine maintenance safe harbor includes three additions and a modification:
    - Amounts paid for a betterment to a unit of property
    - Amounts paid to adapt a unit of property to a new or different use
    - Amounts paid for repairs, maintenance, or improvement of network assets (defined as railroad tracks, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in those respective industries)
    - Amounts paid for property for which a taxpayer has taken a basis adjustment resulting from a casualty loss (slightly modified to be consistent with the revised casualty loss restoration rule discussed later in this section)

Recurring Activities

A taxpayer's reasonable expectation at the time a unit of property is placed in service that qualifying maintenance activities will be performed more than once during the relevant period will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the relevant period, if the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service.

The taxpayer's actual experience may be used in assessing the reasonableness of the taxpayer's expectation of the frequency of restoration or replacement at the time a new unit of property is placed in service, but hindsight should not be used to invalidate an initial reasonable expectation when subsequent events do not conform to the taxpayer's reasonable expectation.

Betterments

The final regulations no longer phrase the betterment test in terms of amounts that *result* in a betterment. Instead, the regulations provide that a taxpayer must capitalize amounts that are reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of a unit of property; that are for a material addition to a unit of property; or that ameliorate a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property (whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production).

The 2011 temporary regulations provided that, when an expenditure is necessitated by a particular event, the determination of whether an expenditure is for the betterment of a unit of property is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the event necessitating the expenditure. The final regulations retain this general rule but clarify that the rule applies when the event necessitating the expenditure is either normal wear and tear or damage to the unit of property during the taxpayer's use of the property.

Restorations

An amount is paid to restore, and therefore improve, a unit of property if it meets one of six tests [Treas. Reg. § 1.263(a)-3(k)(1)]:

1. It is for the replacement of a component of a unit of property, and the taxpayer has properly deducted a noncasualty loss for that component (with a salvage value exception).
2. It is for the replacement of a component of a unit of property, and the taxpayer has properly taken the adjusted basis of the component into account in realizing gain or loss from the sale or exchange of the component (with a salvage value exception).
3. It is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty.
4. It returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.
5. It results in the rebuilding of the unit of property to a like-new condition after the end of its class life.
6. It is for the replacement of a major component or a substantial structural part of the unit of property.

Salvage Value Exception

Some property cannot be depreciated to an adjusted basis of zero due to the application of salvage value (for example, assets that do not qualify for ACRS or MACRS depreciation). The restoration rules do not apply when a noncasualty loss is properly deducted or adjusted basis is taken into account in realizing gain or loss from a sale or exchange, if the amount of loss or basis is attributable only to the remaining salvage value.

Casualty Loss Rule

The 2011 temporary regulations recognized a taxpayer's ability to deduct a casualty loss under I.R.C. § 165 or, to the extent eligible, to deduct the repair expense associated with the casualty damage, but the 2011 temporary regulations did not permit a taxpayer to deduct both amounts arising from the same event in the same tax year. However, the final regulations revise the casualty loss rule to permit a repair expense deduction for amounts spent in excess of the adjusted basis of the property damaged in a casualty event.

A casualty loss cannot exceed the taxpayer's basis in the property, and the taxpayer must reduce the property's basis by the allowable loss deduction. The revised casualty loss rule still requires a taxpayer to capitalize some amounts paid to restore damage to the property. However, the costs required to be capitalized are limited to the excess of the taxpayer's basis adjustments resulting from the casualty event over the amount paid for restoration that constitutes a restoration under one of the other five criteria of Treas. Reg. § 1.263(a)-3(k)(1).

Casualty-related expenditures in excess of the limitation may be properly deducted if they otherwise constitute ordinary and necessary business expenses (such as repair costs).

Example 13.13 Repairs after a Casualty

A flood damages a building that has a $50,000 adjusted basis. The building's owner deducts a $50,000 casualty loss and hires a contractor for $80,000 to remove debris and repair the damage, restoring the building to its operating condition. The owner must capitalize $50,000 of the $80,000 expense, but the remaining $30,000 is deductible as a repair cost.

Major Component Defined

The final regulations add a new definition for major components and substantial structural parts of buildings. A *major component* is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. A *substantial structural part* is a part or combination of parts that comprises a large portion of the physical structure of the unit of property.

The final regulations clarify that an *incidental component* of a unit of property that performs a discrete and critical function in the operation of the unit of property generally will not be treated as a major component. An example of an incidental component is a switch, which performs the discrete and critical function of turning property on and off.

Election to Capitalize Repair Costs

A taxpayer may elect to treat amounts paid during the tax year for repair and maintenance to tangible property used in a trade or business as amounts paid to improve that property and as an asset subject to the allowance for depreciation as long as the taxpayer treats the amounts as capital expenditures on its books and records used for regularly computing income.

A taxpayer that elects this treatment must apply the election to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that tax year, and must begin to depreciate the cost of the improvements when the improvements are placed in service. The irrevocable election is made by attaching a statement to the taxpayer's timely filed (including extensions) original federal tax return for the tax year in which the improvement is placed in service.

A taxpayer that capitalizes repair and maintenance costs under the election is still eligible to apply the de minimis safe harbor, the safe harbor for small taxpayers, and the routine maintenance safe harbor to repair and maintenance costs that are not treated as capital expenditures on its books and records.

Change in Accounting Method

Rev. Proc. 2011-14, 2011-4 I.R.B. 330, explains how a taxpayer can obtain the IRS's automatic approval of a change in method of accounting without payment of a user fee. Taxpayers must file Form 3115, Application for Change in Accounting Method, to request automatic consent to a change in accounting method, entering the applicable automatic change number on line 1 in Part I of the form.

About 3 months after publishing the temporary regulations that distinguish repairs and capital expenditures, the IRS issued two revenue procedures that provide guidance for accounting method changes requested to comply with the temporary regulations.

- Rev. Proc. 2012-19, 2012-14 I.R.B. 689, provides directions and automatic change numbers for changing accounting methods for deductions and capitalization.
- Rev. Proc. 2012-20, 2012-14 I.R.B. 700, provides directions and automatic change numbers for changes related to depreciation and dispositions.

These revenue procedures are effective for tax years beginning on or after January 1, 2012, for taxpayers who elect to apply the temporary regulations for tax years beginning on or after January 1, 2012, and before January 1, 2014.

Cross-Reference Temporary Regulations

See pages 460–471 in the *2012 National Income Tax Workbook* for a discussion of the temporary regulations and related examples.

A change in accounting method may require an I.R.C. § 481(a) adjustment (that is, a cumulative adjustment in the current year that prevents income or deductions from being duplicated because the accounting method changes).

Practitioner Note Temporary Rules Available for 2 Years

Taxpayers may choose to apply the provisions of the 2011 temporary regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014. The guidance in Rev. Procs. 2012-19 and 2012-20 applies to these accounting method changes.

T.D. 9636 says the IRS will publish new procedures for obtaining automatic consent to accounting method changes for taxpayers who choose to apply the provisions of the final regulations to tax years beginning on or after January 1, 2012.

In most cases a taxpayer applying for an automatic change must file a Form 3115 in duplicate, attaching the original form to the filer's timely filed (including extensions) federal income tax return for the year of change and filing a copy with the IRS National Office. For some changes the appendix of Rev. Proc. 2011-14 or other published guidance requires the taxpayer to file the copy with the IRS office in Ogden, Utah, instead of the IRS National Office. The taxpayer must file the copy no earlier than the first day of the year of change and no later than the date the original is filed with the federal income tax return for the year of change.

The following summaries provide the automatic change numbers needed to prepare Form 3115. The instructions to Form 3115 for each change number provide citations to the applicable revenue procedures for additional guidance on specific changes.

Deducting Repair and Maintenance Costs

Designated change number 162 applies to the following changes:

- Change from capitalizing amounts paid or incurred for tangible property under I.R.C. § 263(a) to deducting these amounts as repair and maintenance costs under I.R.C. § 162 and Temp. Treas. Reg. § 1.162-4T
- Change to units of property under Temp. Treas. Reg. § 1.263(a)-3T(e) solely for purposes of determining whether amounts paid or incurred improved a unit of property under Temp. Treas. Reg. § 1.263(a)-3T

Regulatory Accounting Method

Designated change number 163 applies if a taxpayer engaged in a regulated industry trade or business wants to change its tax method of accounting to follow its method of accounting for regulatory accounting purposes to determine whether an amount paid or incurred improves property, consistent with Temp. Treas. Reg. § 1.263(a)-3T(k).

A regulated industry is one that is subject to the regulatory accounting rules of the Federal Energy Regulatory Commission, the Federal Communications Commission, or the Surface Transportation Board.

Deducting Nonincidental Materials and Supplies When Used or Consumed

Designated change number 164 applies if a taxpayer wants to change its method of accounting for nonincidental materials and supplies to the method of deducting such amounts in the tax year in which they are actually used or consumed.

Deducting Incidental Materials and Supplies When Paid or Incurred

Designated change number 165 applies if a taxpayer wants to change its method of accounting for incidental materials and supplies to the method of deducting such amounts in the tax year in which they are paid or incurred.

Deducting Nonincidental Rotable and Temporary Spare Parts When Disposed Of

Designated change number 166 applies if a taxpayer wants to change its method of accounting for costs to acquire or produce nonincidental rotable and temporary spare parts to the method of deducting such costs in the tax year in which the taxpayer disposes of the parts.

Optional Method for Rotable and Temporary Spare Parts

Designated change number 167 applies if a taxpayer wants to change its method of accounting for rotable and temporary spare parts to the optional method of accounting for rotable and temporary spare parts described in Temp. Treas. Reg. § 1.162-3T(e).

Dealer Expenses That Facilitate the Sale of Property

Designated change number 168 applies if a dealer in property wants to change its method of accounting for commissions and other costs paid or incurred to facilitate the sale of tangible property to the method of treating such costs as ordinary and necessary business expenses.

Deducting De Minimis Amounts

Designated change number 169 applies if a taxpayer wants to change its method of accounting for amounts paid or incurred to acquire or produce a unit of property to the method of applying the de minimis rule under Temp. Treas. Reg. §§ 1.263(a)-2T(g) and 1.263A-1T(b)(14).

Deducting Certain Costs for Investigating or Pursuing the Acquisition of Property

Designated change number 170 applies if a taxpayer wants to change its method of accounting from capitalizing to deducting amounts paid or incurred in the process of investigating or otherwise pursuing the acquisition of real property if the amounts meet the requirements of Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(iii), or the acquisition of real or personal property if the amounts are for employee compensation or overhead costs under Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(iv).

Safe Harbor Routine Maintenance on Property Other Than Buildings

Designated change number 171 applies if a taxpayer wants to change its method of accounting for amounts paid or incurred for routine maintenance performed on a unit of property to the method of treating such amounts as amounts that do not improve the unit or property, consistent with Temp. Treas. Reg. § 1.263(a)-3T(g).

Nondealer Expense to Facilitate the Sale of Property

Designated change number 172 applies if a taxpayer that is not a dealer in property wants to change its method of accounting for commissions and other costs paid or incurred to facilitate the sale of property to the method of capitalizing such costs, consistent with Temp. Treas. Reg. § 1.263(a)-1T(d)(1).

Capitalizing Acquisition or Production Costs

Designated change number 173 applies if a taxpayer wants to change its method of accounting to capitalizing amounts paid or incurred to acquire or produce property under Temp. Treas. Reg. § 1.263(a)-2T and, if depreciable, to depreciating such property under I.R.C. § 168.

Capitalizing Improvements to Tangible Property

Designated change number 174 applies if a taxpayer wants to change its method of accounting to capitalizing amounts paid or incurred for improvements to units of property consistent with Temp. Treas. Reg. §§ 1.263(a)-1T and 1.263(a)-3T and, if depreciable, to depreciating such improvements under I.R.C. § 168.

Depreciation of Leasehold Improvements

Designated change number 175 applies if a taxpayer with a depreciable interest in leasehold improvements at the beginning of the year of change wants to change from improperly depreciating or amortizing these leasehold improvements over the term of the lease (including renewals, if applicable) to properly depreciating or amortizing these leasehold improvements under I.R.C. § 167(f)(1), 168, or 197, as applicable. The taxpayer should also complete Schedule E (Form 3115), Change in Depreciation or Amortization.

Depreciation of MACRS Property

Designated change number 176 applies if a taxpayer with MACRS property wants to change from a permissible depreciation method to another permissible depreciation method listed in section 6.28(3) in the appendix to Rev. Proc. 2011-14. The taxpayer should also complete Schedule E (Form 3115).

Dispositions of a Building or Structural Component

Designated change number 177 applies if a taxpayer wants to change to an identifiable asset that is permissible under Temp. Treas. Reg. § 1.168(i)-8T(c)(4) for determining which building, condominium unit, cooperative unit, or structural components held in a multiple asset account the taxpayer disposed of for depreciation purposes, or from a method not specified in Temp. Treas. Reg. § 1.168(i)-8T(f)(1), (f)(2)(i), (f)(2)(ii), or (f)(2)(iii) to one that is specified for identifying which buildings, condominium units, cooperative units, or structural components in multiple asset accounts the taxpayer disposed of for depreciation purposes.

This change will also affect the determination of gain or loss from the disposition of the building, condominium unit, cooperative unit, or the structural component, and may affect whether the applicant must capitalize amounts paid to restore a unit of property under Temp. Treas. Reg. § 1.263(a)-3T(i).

Dispositions of Other Tangible Assets

Designated change number 178 applies if a taxpayer wants to change to an identifiable asset that is permissible under Temp. Treas. Reg.

§ 1.168(i)-8T(c)(4) for determining what I.R.C. § 1245 property or depreciable land improvement held in a multiple asset account the taxpayer disposed of for depreciation purposes, or from a method not specified in Temp. Treas. Reg. § 1.168(i)-8T(f)(1), (f)(2)(i), (f)(2)(ii), or (f)(2)(iii) to one that is specified for identifying what I.R.C. § 1245 property or depreciable land improvements in multiple asset accounts the taxpayer disposed of for depreciation purposes.

This change will also affect the determination of gain or loss from the disposition of the I.R.C. § 1245 property or the depreciable land improvement and may affect whether the taxpayer must capitalize amounts paid to restore a unit of property under Temp. Treas. Reg. § 1.263(a)-3T(i).

Dispositions of Tangible Depreciable Assets in a General Account

Designated change number 179 applies if a taxpayer with a valid general asset account (GAA) election for MACRS property wants to change to an identifiable asset that is permissible under Temp. Treas. Reg. § 1.168(i)-1T(e)(2)(viii) for determining what asset the taxpayer disposed of for depreciation purposes, or from a method not specified in Temp. Treas. Reg. § 1.168(i)-1T(j)(2)(i), (ii), (iii), or (iv) to a method that is specified, as applicable, for identifying the assets the taxpayer disposed of for depreciation purposes.

This change also may affect the determination of gain or loss from the disposition of the asset and may affect whether the applicant must capitalize amounts paid to restore a unit of property under Temp. Treas. Reg. § 1.263(a)-3T(i).

General Asset Account Elections

Designated change number 180 applies if a taxpayer wants to make one of the following changes:

- A late GAA election under I.R.C. § 168(i)(4), Treas. Reg. § 1.168(i)-1, and Temp. Treas. Reg. § 1.168(i)-1T for MACRS property that the taxpayer placed in service in a tax year beginning before January 1, 2012
- A late election to recognize gain or loss upon the disposition of all the assets (or the last asset) in a GAA in accordance with Temp. Treas. Reg. § 1.168(i)-1T(3)(ii)
- A late election to recognize gain or loss upon the disposition of an item of MACRS property (for which the taxpayer made a valid GAA election) in a qualifying disposition in accordance with Temp. Treas. Reg. § 1.168(i)-1T(e)(3)(iii)

This change also may affect the determination of gain or loss from the disposition of the asset and whether the applicant must capitalize amounts paid to restore a unit of property under Temp. Treas. Reg. § 1.263(a)-3T(i). This change applies only to the applicant's first or second tax year beginning after December 31, 2011.

ISSUE 4: PREPARING AND CORRECTING FORM W-2

This issue reviews preparation of Form W-2, including special reporting situations, and the actions needed to correct an erroneous Form W-2.

In contrast to the $600 threshold for filing Form 1099-MISC, Miscellaneous Income, for payments of nonemployee compensation, business employers who pay any amount of wages subject to income, social security, or Medicare withholding are required to file a Form W-2, Wage and Tax Statement, for each employee [I.R.C. § 6051]. Form W-2 must be filed if any type of withholding is required or would be required if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4, Employee's Withholding Allowance Certificate.

However, if no type of withholding is applicable to the wages (such as certain noncash compensation) paid, the $600 I.R.C. § 6041 threshold for reporting compensation applies in determining whether a Form W-2 is required.

Practitioner Note Alternate Terms for Payroll Taxes

For consistency, this discussion uses the terms *social security and Medicare taxes*. These terms are often combined and referred to as FICA taxes. I.R.C. § 3101 calls them old-age, survivors, and disability insurance (OASDI) and hospital insurance (HI) taxes.

Employer Payroll Records

The following employer and employee information is needed to prepare Forms W-2 and W-3, Transmittal of Wage and Tax Statements:

- Employee names, social security numbers (SSNs), and current addresses
- Employer name, employer identification number (EIN), and current address
- Employer year-to-date payroll detail reports (taxable wages, federal income tax withholding, social security wages and withholding, Medicare wages and withholding, state and local wages, state and local income tax withholdings, pretax deductions, after-tax deductions, and taxable fringe benefits for each employee)

Planning Pointer Reconciling Form W-3 to Other Reports

The amounts reported on Form W-3, which totals the amounts from the employers' Forms W-2, should match the amounts reported on federal and state employment tax returns, such as the totals of the employer's four Forms 941, Employer's QUARTERLY Federal Tax Return, for the year. Preparing Forms W-2 and W-3 and reconciling the year-to-date amounts before filing the fourth-quarter payroll reports may avoid amended reports. See "Combined Annual Wage Reporting" later in this issue.

Form W-2 Information

13

The first entry on Form W-2 (box a) is the employee's SSN as shown on the employee's social security card. An individual taxpayer identification number (ITIN) cannot be entered on a Form W-2. (See the discussion "H-2A Workers" later in this section.) The IRS issues ITINs only to aliens who are not eligible for U.S. employment and need identification for other tax purposes.

Cross-Reference ITIN Requirements

See the "IRS Issues" chapter of this book for more information about ITINs.

The employer's EIN, name, and address are reported in boxes b and c of Form W-2. These entries should match the EIN, name, and address used on the employer's employment tax returns. The U.S. Postal Service recommends that no commas or periods be used in a return address.

The employee's name (as shown on the employee's social security card) and address are entered in boxes e and f. All parts of a compound surname are included in the second part of box e with either a hyphen or a space between the parts. Titles or academic degrees are not included.

Practitioner Note Name and SSN Verification

Employers may verify that an employee's name and SSN match Social Security Administration (SSA) records using an online service at `www.socialsecurity.gov/employer/ssnv.htm` or by calling 800.772.6270.

Many computerized payroll tax programs will prepare Forms W-2 for e-filing. Employers that prepare paper Forms W-2 should use black ink and 12 point Courier font. Script or italic fonts and other inks cannot be read by the SSA processing equipment. Dollar entries should omit dollar signs and commas but include decimal points and cents (for example, 2005.56). Boxes that do not apply are left blank.

The SSA's Business Services Online (BSO) website lets employers create, save, and submit Forms W-2 and Forms W-3 electronically. Employers using the site can also print copies of the forms to distribute to employees, file with state and local governments (if required), and retain for the employer's records.

Figure 13.9, part of Example 13.15 later in this issue, shows a completed Form W-2.

Wages, Tips, and Other Compensation

The preparer enters an employee's wages, tips, and other compensation in box 1 of Form W-2. The total compensation is generally the amount paid to the employee during the year before any payroll deductions are subtracted. Most elective deferrals [such as employee contributions to a 401(k) or a 403(b) plan] are excluded, except for contributions to an I.R.C. § 501(c)(18) plan. Amounts reported in box 1 include the following items:

1. Wages, bonuses (such as signing bonuses), prizes, and awards
2. Noncash payments, including certain fringe benefits (see "Fringe Benefits" later in this issue)
3. Tips the employee reported to the employer (but not allocated tips)
4. Employee business expense allowances paid under an accountable plan that exceed the amounts treated as substantiated under IRS rules, and business expense reimbursements paid under a nonaccountable plan (see "Business Expense Reimbursements" later in this section)
5. The cost of accident and health insurance premiums paid by an S corporation for a 2%-or-more shareholder-employee
6. Taxable benefits from an I.R.C. § 125 cafeteria plan (e.g., the employee chose cash)
7. Employee contributions to an Archer medical savings account (MSA)
8. Employer contributions to an Archer MSA if at the time of payment it is not reasonable to believe that the contribution will be excludable from the employee's income
9. Employer contributions for qualified long-term care services provided through a flexible spending arrangement (FSA) or similar plan
10. Taxable cost of group-term life insurance in excess of $50,000
11. Payments for education expenses that are not job related or are paid under a nonaccountable plan and are not excludable as I.R.C. § 127 educational assistance program benefits

Cross-Reference Employers' Tax-Free Assistance

See the "Education Provisions" chapter of this book for more information about employer educational assistance benefits.

12. The grossed-up amount treated as wages when an employer pays the employee's share of social security and Medicare taxes for the employee instead of withholding the taxes (see "Employee Taxes Paid by Employer" later in this section)
13. Designated Roth contributions made under a 401(k) plan, a 403(b) salary reduction agreement, or a governmental 457(b) plan
14. Distributions to an employee or former employee from a nonqualified deferred compensation (NQDC) plan (including a rabbi trust) or a nongovernmental 457(b) plan
15. Amounts contributed to a ineligible plan of a state or local government or a tax-exempt organization that are no longer subject to a substantial risk of forfeiture [I.R.C. § 457(f)]
16. Payments to statutory employees whose wages are subject to social security and Medicare tax withholding but are not subject to federal income tax withholding
17. Cost of current insurance protection under a compensatory split dollar life insurance arrangement
18. Employee contributions to a health savings account (HSA)
19. Employer contributions to an HSA if it is not reasonable to believe at the time of payment that the contribution will be excludable from the employee's income
20. Amounts included in income under an NQDC plan because of I.R.C. § 409A

21. Payments to former employees on active duty in the armed forces or other uniformed services
22. All other taxable compensation, including scholarship and fellowship grants that are payments for services (such as teaching or research) that are required as a condition of receiving the grant

Other Form W-2 Information

The preparer enters the following information in the remaining Form W-2 boxes:

- Box 2: Federal income tax withheld–total federal income tax withheld from the employee's wages, including the 20% excise tax withheld on excess parachute payments
- Box 3: Social security wages–total wages (before payroll deductions) that are subject to social security tax (up to the wage base limit) excluding tips but including elective deferrals to retirement plans, Roth contributions, and other deferred or nonqualified plan amounts when there is no substantial risk of forfeiture

Practitioner Note 2013 Wage Base Is $113,700

An annual limit applies to the amount of wages subject to social security tax. The total amount included in boxes 3 and 7 of an employee's Form W-2 should not exceed the limit, which is $113,700 for 2013.

- Box 4: Social security tax withheld–total employee social security tax withheld, including social security tax on tips, up to the 2013 maximum of $7,049.40 ($113,700 × 6.2%)
- Box 5: Medicare wages and tips–total wages and tips (before payroll deductions) that are subject to Medicare tax, with no wage base limit
- Box 6: Medicare tax withheld–total employee Medicare tax (1.45% of Medicare wages and tips plus the additional 0.9% Medicare tax on compensation in excess of $200,000 beginning January 1, 2013)

Example 13.14 Additional 0.9% Medicare Tax

In 2013 Carolyn Crowley earned $215,000 of wages and contributed $17,500 to her 401(k) plan. Her earnings reported in box 1 are $197,500 ($215,000 – $17,500). Her social security wages are limited to $113,700, and her Medicare wages are $215,000. Her employer must withhold the 0.9% additional Medicare tax on $15,000 of her wages. Figure 13.6 shows her social security and Medicare withholding.

Cross-Reference Additional Medicare Tax

See the "Affordable Care Act" chapter of this book for an explanation of the additional Medicare tax.

FIGURE 13.6 Carolyn Crowley's 2013 Social Security and Medicare Tax Withholding

	Wage Base		Rate		Withholding
Social security tax (box 4)	$113,700	×	6.20%	=	$7,049.40
Medicare tax	$215,000	×	1.45%	=	$3,117.50
Additional Medicare tax ($215,000 – $200,000)	$ 15,000	×	0.90%	=	135.00
Total Medicare tax (box 6)					$3,252.50

- Box 7: Social security tips—total amount of tips the employee reported to the employer, up to the total wage base limit
- Box 8: Allocated tips—tips allocated by a large food or beverage establishment to employees who reported actual tips that were less than 8% of the employee's sales (see "Tipped Employees" later in this section)
- Box 9: To be left blank
- Box 10: Dependent care benefits—total cost or fair market value (FMV) of dependent care assistance paid or incurred by the employer for the employee, including forfeitures of I.R.C. § 125 plan amounts
- Box 11: Nonqualified plans—nonqualified deferred compensation amounts that were earned in a prior year and paid in the current year, or that were earned in a prior year and became subject to social security and Medicare taxes in the current year because they were no longer subject to a substantial risk of forfeiture
- Box 12: Codes—descriptive codes A through EE (see Figure 13.7) and the corresponding dollar amounts

Practitioner Note Four-Item Limit on Copy A for SSA

Copy A of Form W-2 is submitted to the SSA, and it cannot include more than four items in box 12. Additional Forms W-2 must be prepared for the SSA if more than four items are reportable in box 12, but the information in boxes 1 through 11 of the first Form W-2 for an employee should not be repeated on any additional Form W-2 for the employee.

An approved substitute Form W-2 can include more spaces for box 12, so that only one Form W-2 that includes all of the box 12 items is distributed to the employee.

Practitioner Note Health Coverage Reporting on Form W-2

Large employers generally began reporting the cost of employer-provided health care coverage in box 12 of Form W-2 with code DD beginning with the 2012 Forms W-2 provided in 2013. All employers, including those who issue fewer than 250 Forms W-2 and those with self-insured plans that are not subject to continuation coverage requirements, must report the cost on their 2013 Forms W-2 issued in 2014. Notice 2012-9, 2012-4 I.R.B. 315, provides guidance on determining the reportable cost.

The reporting requirement is for information purposes only. It does not change the gross income exclusion for the health care coverage.

- Box 13: Checkboxes—check all that apply
  - Statutory employee—independent contractor under the common law rules for income tax purposes but treated by I.R.C. § 3121(d)(3) as an employee for social security and Medicare tax purposes
  - Retirement plan—active participant for any part of the year in a 401(k), 403(a), 403(b), 408(k), 501(c)(18), or 457(b) plan
  - Third-party sick pay—third-party sick pay payer filing Form W-2 for insured employer's employee, or employer reporting sick pay paid by third party
- Box 14: Other—additional information for employee

Practitioner Note Additional Information

Entering any amount is box 14 is optional, but an employer that included 100% of a vehicle's annual lease value in the employee's income must also report the value in box 14 or on a separate statement given to the employee. Employers may use box 14 to report items such as a minister's housing allowance, union dues, uniform payments, educational assistance payments, and pension plan contributions that are not reportable elsewhere on Form W-2.

- Boxes 15–20: State and local income tax information—the employer's two-letter state abbreviation, state identification number, state wages, and state income tax withheld; and the employer's locality abbreviation, local wages, and local income tax withheld

FIGURE 13.7 Form W-2 Guide for Box 12 Codes

Code	Description
A	Uncollected social security or railroad retirement (RRTA) tax on tips
B	Uncollected Medicare tax on tips (but not additional Medicare tax)
C	Taxable cost of group-term life insurance over $50,000
D	Elective deferrals to a 401(k) cash or deferred arrangement plan [including a SIMPLE 401(k) arrangement and excess deferrals]
E	Elective deferrals under a 403(b) salary reduction agreement
F	Elective deferrals under a 408(k)(6) salary reduction SEP (SARSEP)
G	Elective deferrals and employer contributions (including nonelective deferrals) to a 457(b) deferred compensation plan that are not subject to a substantial risk of forfeiture
H	Elective deferrals to an I.R.C. § 501(c)(18)(D) tax-exempt organization plan
J	Nontaxable sick pay
K	20% excise tax on excess golden parachute payments
L	Amounts treated as substantiated employee business expense reimbursements if excess amounts were paid under an accountable plan and the reimbursements are included in box 1
M	Uncollected social security or RRTA tax on taxable cost of group-term life insurance over $50,000 (former employees only)
N	Uncollected Medicare tax on taxable cost of group-term life insurance over $50,000 (but not additional Medicare tax) (former employees only)
P	Excludable moving expense reimbursements paid directly to employee that were not included in box 1
Q	Nontaxable combat pay
R	All employer contributions to an Archer MSA
S	Employee salary reduction contributions under a 408(p) SIMPLE plan that is not part of a 401(k) arrangement
T	All adoption benefits, including those paid from an I.R.C. § 125 plan
V	Income from exercise of nonstatutory stock options (spread between FMV and exercise price)
W	All employer contributions (including employee contributions through a cafeteria plan) to an employee's HSA
Y	Amounts deferred during the current year under an I.R.C. § 409A NQDC plan (optional; see Notice 2008-115, 2008-2 C.B. 1367)
Z	NQDC amounts not previously reported as income that became income under I.R.C. § 409A because of a plan failure and are subject to the additional 20% tax
AA	Designated Roth contributions under a 401(k) plan
BB	Designated Roth contributions under a 403(b) plan
CC	For 2010 only, HIRE wages and tips for which the employer claimed the social security tax exemption
DD	Cost of nontaxable employer-sponsored health coverage
EE	Designated Roth contributions under a governmental 457(b) plan

Practitioner Note Multiple State and Locality Taxes

Employers that report wages or taxes for more than two states and localities for an employee must complete more than one Form W-2 for the employee. The additional forms should include only information that was not reported in any numbered boxes on the first Form W-2. The preparer should contact the state or locality for specific reporting information for boxes 15–20.

Example 13.15 Form W-2

Wallace Way is an employee of West Willow Wings Flight Agency. His employer makes HSA contributions that are not included in his taxable income. Figure 13.8 shows Wallace's 2013 payroll information, and Figure 13.9 shows his completed Form W-2.

Special Reporting Situations

Some situations require special treatment when preparing Form W-2.

Deceased Employees

If an employee dies during the year, the employer reports only the wages paid before death in box 1 of the employee's Form W-2 but reports all of the employee's wages (including amounts paid in the same year as income in respect of the decedent) in boxes 3 and 5.

The employer must also file a Form 1099-MISC to report the wages, vacation pay, and other compensation that the employer pays to the decedent's estate or beneficiary after the employee's death. The employer enters the wages in box 3, "Other income," of the Form 1099-MISC and shows the recipient's name and taxpayer identification number (TIN) (not the decedent's) as the payee.

Practitioner Note Reissued Checks

If the employee received a paycheck before his or her death but had not cashed it, the employee had constructively received the income. The taxable wages are still included in box 1 of the employee's Form W-2, and not on Form 1099-MISC, even if the employer reissues the check to the decedent's estate or beneficiary.

If wages earned before the decedent's death are not paid until the year following death, they are not subject to social security and Medicare taxes [I.R.C. § 3121(a)(14)] and are reported only on Form 1099-MISC.

Example 13.16 Payment in the Year of Death

Before his death on June 15, 2013, Jason Johnson received $10,000 in wages, and his employer withheld $1,500 of federal income tax. The employer, Parts Company, owed Jason $3,000 at the time of his death ($2,000 for wages and $1,000 for accrued vacation pay). Parts Company sent Jason's estate a $2,770.50 check [$3,000 – $229.50 (7.65% × $3,000) social security and Medicare taxes] on July 5, 2013. Figure 13.10 shows Jason's properly completed Form W-2. Parts Company also reports $3,000 in box 3 of the Form 1099-MISC it issues to Jason's estate, even though the payment was reduced by Jason's share of social security and Medicare taxes, because the full $3,000 would be included in box 1 of Jason's Form W-2 if he had received the payment before death.

If Jason had died in December 2013 and the $3,000 was not paid to the estate until January 2014, boxes 3 and 5 of Jason's Form W-2 would show only the $10,000 of wages, and the employer would pay the estate the full $3,000 with no social security or Medicare tax withholding. The $3,000 would still be reported on Form 1099-MISC.

FIGURE 13.8 Wallace Way's 2013 Payroll Information

Description	Form W-2 Reporting	Amount
Gross pay	Boxes 3 and 5 (unless amount exceeds social security wage base)	$53,000.00
SIMPLE IRA contribution	Box 12, code S	(1,400.00)
Wages included in federal gross income	Box 1 (box 16 amount may be different in some states)	$51,600.00
Federal income tax withheld	Box 2	(8,800.00)
State income tax withheld	Box 17	(3,000.00)
Social security tax withheld ($53,000 box 3 wages × 6.2%)	Box 4	(3,286.00)
Medicare tax withheld ($53,000 box 5 wages × 1.45%)	Box 6	(768.50)
Net pay (equals total from pay stubs)		$35,745.50
Employer HSA contribution (fringe benefit not included in wages)	Box 12, code W	$1,800.00

FIGURE 13.9 Wallace Way's Form W-2

22222 Void ☐	a Employee's social security number 222-22-2222	For Official Use Only ▶ OMB No. 1545-0008	
b Employer identification number (EIN) 94-1941941		1 Wages, tips, other compensation 51600.00	2 Federal income tax withheld 8800.00
c Employer's name, address, and ZIP code West Willow Wings Flight Agency 34 Main St West Willow WI 10101		3 Social security wages 53000.00	4 Social security tax withheld 3286.00
		5 Medicare wages and tips 53000.00	6 Medicare tax withheld 768.50
		7 Social security tips	8 Allocated tips
d Control number		9	10 Dependent care benefits
e Employee's first name and initial Wallace A	Last name Way Suff.	11 Nonqualified plans	12a See instructions for box 12 Code S 1400.00
45 Fifth St West Willow WI 10101		13 Statutory employee ☐ Retirement plan ☒ Third-party sick pay ☐	12b Code W 1800.00
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
WI	40940940	51600.00	3000.00			

Form **W-2** **Wage and Tax Statement** **2013**

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.

Copy A For Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

Cat. No. 10134D