

INDIVIDUAL ISSUES

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Learning Objectives

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

- ✓ Calculate and report the value of employer-provided autos and airplanes included in an employee's income
- ✓ Explain the employment and income tax treatment of household caregivers
- ✓ Apply the proposed changes in the laws that relieve spouses from joint liability
- ✓ Calculate the charitable contribution deduction for donations of food inventory
- ✓ Determine the best use of a qualified charitable distribution from an IRA
- ✓ Prepare a tax return for a minister
- ✓ Apply the special tax rules for members of the Amish and Mennonite communities
- ✓ Explain how to avoid recharacterization of a lease option as an installment sale
- ✓ Report income and expenses for lessors and lessees when an option to purchase is exercised, sold, or allowed to expire
- ✓ Explain how to report crowdfunding on the contributors' and recipients' income tax returns
- ✓ Explain how to report fantasy football income and expenses

Introduction

This chapter discusses the taxation of employer-provided autos and airplanes, and household caregivers. It explains proposed regulations for spousal relief from joint liability and two new laws that enhance the deduction for charitable

donations of food inventory, and make the exclusion for IRA charitable distributions permanent. This chapter also discusses special tax rules that apply to ministers and members of the Amish and Mennonite communities, and it explains the tax rules that apply to a lease with an option to purchase, crowdfunding income, and income from fantasy football.

ISSUE 1: EMPLOYER-PROVIDED AUTOS AND AIRPLANES This section explains how to calculate the value of employer-provided autos and airplanes, and how the employer reports that value on Form W-2.

If an employer provides an employee with a vehicle or use of an airplane, the employer must determine the value of the employee's personal use of the vehicle or airplane. The employer must report the value of the personal use to the employee on Form W-2, Wage and Tax Statement, and the employee must pay income and FICA taxes on the value of the personal use of the vehicle or airplane.

van [Treas. Reg. § 1.61-21(e) and Notice 2016-12, 2016-12 I.R.B. 312].

The employer can use the cents-per-mile rule if

- the employer reasonably expects the vehicle to be used regularly in the employer's trade or business throughout the year, or
- the vehicle meets the mileage test (discussed later).

Automobiles

An automobile is defined as any four-wheeled vehicle, such as a car, pickup truck, or van. There are three ways to calculate the taxable value of an employee's personal use of an automobile: the cents-per-mile rule, the commuting rule, and the lease value rule.

Cents-per-Mile Rule

Under the cents-per-mile rule, the employer multiplies the personal miles driven by the employee in the employer-provided vehicle by the business standard mileage rate, which, for 2016, is 54¢ per mile [Notice 2016-1, 2016-2 I.R.B. 265]. Personal use is any use other than for the employer's trade or business. If the employee does not reimburse the company, the employer must include the value of the personal use of the vehicle in the employee's wages. To use the cents-per-mile rule, the value of an employer-provided vehicle first made available for personal use in calendar year 2016 cannot exceed more than \$15,900 for a passenger vehicle and \$17,700 for a truck or

Regular Use in Trade or Business

The vehicle must be regularly used in the employer's trade or business. At least one of the following conditions must be met:

- At least 50% of the vehicle's total annual mileage is for the trade or business.
- The employer sponsors a commuting pool that generally uses the vehicle each workday to drive at least three employees to and from work.
- The vehicle is regularly used in the employer's trade or business based on all of the facts and circumstances.

Mileage Test

The vehicle must meet both of the following requirements:

- The vehicle is actually driven at least 10,000 miles per year (or a proportionate amount if the vehicle is not owned for the full year).
- The vehicle is used during the year primarily by employees, even if that use is personal use.

The employer must use the cents-per-mile rule on the first day the vehicle is made available to any employee for personal use. The employer must continue to use the rule in subsequent years unless the commuting rule applies (discussed next). If the employer provides a replacement vehicle, the employer must continue to use the cents-per-mile method if the primary reason for the replacement vehicle is to reduce federal taxes. The cents-per-mile rate includes the value of maintenance and insurance for the vehicle. Within the United States and its territories and possessions, Canada, and Mexico, the cents-per-mile rate includes the value of fuel provided by the employer. If the employer does not provide fuel, the rate is reduced by no more than 5.5¢.

Example 6.1 Cents-per-Mile Calculation

XYZ Corporation provides a company car to their salesman Casey Carson. XYZ requires Casey to keep track of his miles and turn them in to XYZ once a month. In 2016, Casey drove the car 18,500 miles, of which 4,200 were personal-use miles. The value of the car was less than \$15,900. XYZ can use the cents-per-mile rule to value Casey's personal use of the car because it met the mileage test (the car was driven over 10,000 miles during the year and used primarily by an employee) and the regular-use test (because more than half of the annual mileage was business-related). If Casey did not reimburse XYZ for his personal use of the car, \$2,268 is taxable to him (4,200 personal-use miles × 54¢). XYZ must include this amount on Casey's Form W-2. If XYZ did not pay for the fuel Casey put in the car, the rate is reduced by 5.5¢ per mile.

Commuting Rule

The commuting rule calculates the taxable portion of the use of a company car for transportation to and from home. Each trip is considered one-way and is valued at \$1.50 per trip. If the employee does not reimburse the employer, the employer must include the total commuting charges in the employee's wages. The employer must meet the following requirements to use the commuting rule:

- The vehicle is provided to an employee for use in the employer's trade or business, and for bona fide noncompensatory business reasons, the employee is required to commute in the vehicle. This condition is considered to be met if the employer provides the vehicle to carry at least three employees to and from work, as in an employer-sponsored commuting pool.
- There is a written policy prohibiting the employee from using the vehicle for personal reasons, other than commuting or de minimis personal use.
- The employee follows the written policy.
- The employee is not a *control employee*, which is defined as any of the following:
 - ▲ A board- or shareholder-appointed, confirmed, or elected officer whose pay is \$105,000 or more
 - ▲ A director
 - ▲ An employee whose pay is \$215,000 or more
 - ▲ An employee who owns a 1%-or-more equity, capital, or profits interest in the business
 - ▲ An employee who was a 5% owner at any time during the year or the preceding year
 - ▲ An employee who received more than \$120,000 in pay for the preceding year (unless not in the top 20% of all employees ranked by pay for the preceding year)

Example 6.2 Commuting Rule

Casey from Example 6.1 made 500 trips (250 round-trips) to and from his home to work in 2016. XYZ required Casey to commute in the car for bona fide noncompensatory business reasons. Casey used the vehicle provided by XYZ Corporation primarily for business and followed XYZ's written policy limiting personal use to commuting and de minimis travel. He documented business use of the vehicle and can verify that he did not exceed the allowable personal use. XYZ paid him an \$83,000 salary, and he has no ownership in the company. Casey must either reimburse XYZ or include the \$750 (500 trips × \$1.50 per trip) value of the personal use of the vehicle in his income. The amount that Casey has to include in

income is less than the amount calculated under the cents-per-mile rule. Casey can ask XYZ to use the commuting rule, but ultimately XYZ decides which method to use.

Lease Value Rule

The employer can determine the value of the company-provided vehicle using the annual lease value. The employee must keep track of mileage for business and personal use, and document where he or she went and the purpose of the travel so that the employer can reduce the annual lease value by the amount that is excluded from the employee's wages as a working condition benefit. However, the employer can elect to include the entire lease value in the employee's wages.

As with the cents-per-mile method, the employer must use the lease value rule on the first

day the vehicle is made available to any employee for personal use, and the employer must continue to use the rule in subsequent years unless the employer changes to the commuting rule.

Calculation

Under the lease value rule, the value of a company-provided vehicle is determined as follows:

1. Determine the fair market value (FMV) of the automobile on the first date it is available to any employee for personal use.
2. Using Table 3-1, Annual Lease Value Table [IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits (For use in 2016)*] shown in **Figure 6.1**, find the dollar range for the automobile's FMV in column (1). Read across to column (2) to find the annual lease value.

FIGURE 6.1 Table 3-1, 2016 Annual Lease Value Table

(1) Automobile FMV	(2) Annual Lease	(1) Automobile FMV	(2) Annual Lease
\$ 0 to 999	\$ 600	22,000 to 22,999	6,100
1,000 to 1,999	850	23,000 to 23,999	6,350
2,000 to 2,999	1,100	24,000 to 24,999	6,600
3,000 to 3,999	1,350	25,000 to 25,999	6,850
4,000 to 4,999	1,600	26,000 to 27,999	7,250
5,000 to 5,999	1,850	28,000 to 29,999	7,750
6,000 to 6,999	2,100	30,000 to 31,999	8,250
7,000 to 7,999	2,350	32,000 to 33,999	8,750
8,000 to 8,999	2,600	34,000 to 35,999	9,250
9,000 to 9,999	2,850	36,000 to 37,999	9,750
10,000 to 10,999	3,100	38,000 to 39,999	10,250
11,000 to 11,999	3,350	40,000 to 41,999	10,750
12,000 to 12,999	3,600	42,000 to 43,999	11,250
13,000 to 13,999	3,850	44,000 to 45,999	11,750
14,000 to 14,999	4,100	46,000 to 47,999	12,250
15,000 to 15,999	4,350	48,000 to 49,999	12,750
16,000 to 16,999	4,600	50,000 to 51,999	13,250
17,000 to 17,999	4,850	52,000 to 53,999	13,750
18,000 to 18,999	5,100	54,000 to 55,999	14,250
19,000 to 19,999	5,350	56,000 to 57,999	14,750
20,000 to 20,999	5,600	58,000 to 59,999	15,250
21,000 to 21,999	5,850		

For automobiles with an FMV of more than \$59,999, the annual lease value equals 0.25 multiplied by the FMV of the automobile, plus \$500.

3. Multiply the annual lease value by the percentage of personal miles out of the total miles driven by the employee.

Determining Fair Market Value

The FMV of an automobile is the amount a person would pay to buy it from a third party in an arm's-length transaction in the area in which the automobile is bought or leased. If the employer purchases an automobile in an arm's-length transaction, the safe harbor FMV is the cost, including sales tax, title, and other purchase expenses.

For a leased automobile, any of the following meets the safe harbor rules:

- The manufacturer's invoice price (including options) plus 4%
- The manufacturer's suggested retail price minus 8%, including sales tax, title, and other expenses of purchase
- The retail value of the automobile reported by a nationally recognized pricing source, if reasonable

Example 6.3 Annual Lease Value

Casey from Examples 6.1 and 6.2 uses a car that XYZ Corporation purchased for \$38,900 in 2016. The price included taxes and title fees. The corresponding annual lease amount from Figure 6.1 is \$10,250. If Casey drove 4,200 personal miles and 18,500 total miles, the amount taxable to Casey is \$2,327 [$\$10,250 \times (4,200 \text{ personal miles} \div 18,500 \text{ total miles})$].

Form W-2

An employer includes personal use of an employer-owned vehicle in boxes 1, 3, and 5 of Form W-2. The employer should describe the included amount in box 14. If the employer includes the full annual lease payment, the employee can deduct the included business use as an itemized deduction subject to the 2%-of-AGI floor.

Income Taxes and FICA Taxes

An employer must generally withhold applicable income taxes on the value of the personal use of the vehicle. However, if the employer elects to not withhold income taxes, the employer must inform the employee in writing by January 31 of the election year, or within 30 days after the employer provides a vehicle.

The employer is, however, required to withhold social security and Medicare taxes. Because there is no cash involved in the fringe benefit, many employers choose to pay the employee's share of the FICA taxes. The employer must include the payment in the employee's wages.



Practitioner Note

Agricultural Labor

Farmers do not have to withhold FICA taxes for wages paid to agricultural workers in the form of the personal use of a company vehicle because noncash wages paid for agricultural labor are excluded from FICA tax [I.R.C. § 3121(a)(8)(A)]. The value of the personal use of the vehicle is subject to income tax and must be included in the wages reported in box 1 of Form W-2 but not in boxes 3 and 5.

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Special Accounting Rules

The employer can include the value of taxable noncash fringe benefits, such as an employer-provided vehicle, paid in the last 2 months of the year in the employee's income for the subsequent year. The employer does not have to notify the IRS to use the special rule. The employer can include the value of the taxable noncash benefits in the employee's income as often as each pay period or as infrequently as annually.

Airplanes

Many companies own airplanes for business purposes and allow employees or their family members to fly for personal reasons. The personal use of the plane is a fringe benefit that is taxable to the employee. The employer can use two methods used to determine the taxable personal use of an airplane: the charter value or the Standard Industry Fare Level (SIFL).

- The charter value method, also known as the FMV method, often produces a higher taxable amount. It values the personal use by comparing it to the value of a similar flight chartered on a similar plane.
- The SIFL is the more commonly used valuation method. The SIFL uses a formula that includes the distance traveled, aircraft size, number of people connected to the employee, and a multiple that takes into account whether or not the employee is classified as a control employee. Instead of comparing the flight to a similar chartered flight,

it compares the flight to a first-class flight on a commercial plane.



Practitioner Note

Employer's Deduction

The employer's allowable deduction is not based on either the charter value method or the SIFL method. Instead, it is based on the costs connected to the flight. If top executives use the plane for personal purposes, the IRS may disallow a deduction for many of the costs because they are not ordinary and necessary business expenses.

ISSUE 2: HOUSEHOLD CAREGIVERS

This section focuses on the taxation of compensation paid to household employees who provide care for children and seniors.

Nannies and senior caregivers who provide care in the taxpayer's home are typically household employees because the taxpayer controls what work is done and how it is done. However, if an agency provides the caregiver and controls his or her work, the caregiver is an employee of the agency.

Example 6.4 Household Caregiver

Elena Emerson's husband, Elmer, suffers from Alzheimer's disease and cannot be left alone. Elena hired a caregiver to come to her home and care for Elmer. Elena provides household equipment and supplies for the caregiver. Every day Elena leaves the caregiver specific instructions. Because Elena controls the work done, the caregiver is likely an employee.

Employers must file Schedule H (Form 1040), Household Employment Taxes, to report

- federal income tax withheld for a household employee during the calendar year,
- employment taxes withheld on household employee cash wages of \$2,000 or more during the calendar year, and
- federal unemployment taxes owed on household employee cash wages of \$1,000 or more in any calendar quarter of the year or previous year to all household employees.

Income Tax Withholding

The employer of a household employee does not have to withhold federal income tax from the household employee's wages. The employer can (but is not required to) withhold income tax if the household employee requests withholding. If the employer withholds income tax, the employer must issue a Form W-2 to the employee, even if the form is not otherwise necessary.

Employment Tax Withholding

The employer must withhold and pay social security and Medicare taxes if the employer paid a household employee \$2,000 or more of cash wages in 2016. Instead of withholding, the employer can pay the employee's share of the taxes. Any amounts paid by the employer on behalf of the employee are included in the employee's taxable wages (box 1 of Form W-2, but not boxes 3 and 5). Noncash wages such as food, lodging, and clothing are not included in social security and Medicare wages. If the cash wages paid to a household employee are under \$2,000 in 2016, they are not subject to social security or Medicare tax. If cash wages paid to a household employee are \$2,000 or more in 2016, the entire amount is subject to social security or Medicare tax.



Observation Wage Base

The 2016 social security wage base is \$118,500. No social security tax is owed on wages in excess of that amount, but the Medicare tax applies to all of the cash wages, and the additional Medicare tax may apply.



Cross-Reference Employee FICA Paid by Employer

Example 5.17 on pages 143–144 in the 2011 *National Income Tax Workbook* provides an explanation of the gross-up of the employee's salary for the employee portion of FICA paid by the employer and a completed Form W-2.

Federal Unemployment Tax (FUTA)

The employer may have to pay federal unemployment tax (FUTA) if the employer paid a household employee total cash wages of \$1,000 or more in any calendar quarter of 2015 or 2016. The tax is 6% of cash wages and applies only to the first \$7,000 earned in the year. If the employer is also required to pay a state unemployment tax (SUTA) and pays that tax timely, a 5.4% credit usually reduces the net FUTA tax to 0.6%. Depending on the state of residence, the employer may also have to obtain workers' compensation insurance.

Exceptions

Wages paid to the taxpayer's spouse, child under the age of 21, or parent (see the exception discussed in the following section "Grandparent Wages Subject to FICA Tax") are not subject to either FICA or FUTA taxes. There is also an exception from FICA requirements for any employee under the age of 18 at any time in 2016 (see the exception discussed in the next section).

Example 6.5 Exempt Employees

Brian Brown is divorced. He hires his niece Bonnie, a student, to stay with his 8-year-old daughter when he travels. Bonnie celebrated her eighteenth birthday in June. In 2016, Brian paid Bonnie a total of \$2,100. Bonnie's wages are not subject to FICA taxes because Bonnie was under the age of 18 at some time in 2016. That exception does not apply to FUTA taxes.



Observation Taxable Income to Caregiver

If the caregiver's compensation is exempt from FICA and/or FUTA tax; the amount the employer pays is still taxable income. The employer, however, is required to issue a Form W-2 only for cash wages that are subject to social security and Medicare taxes and/or when federal income tax is withheld.

Employee under Age 18

The exemption from FICA taxes for an employee under the age of 18 does not apply if providing household services is the employee's principal occupation. If the employee is a student, providing household services is not considered to be the employee's principal occupation.

Grandparent Wages Subject to FICA Tax

Although domestic services performed in a private home by an individual in the employ of his or her spouse, son, or daughter are usually exempt from FICA tax, there is an exception when an employee cares for his or her grandchild living in the employer's home who is either

- under the age of 18, or
- has a physical or mental condition that requires the personal care of an adult for at least 4 continuous weeks in the calendar quarter services were performed.

The exception applies (and wages are subject to FICA tax) only if the household employer is one of the following:

- Divorced and not remarried

- A widow or widower
- Living with a spouse whose mental or physical condition prevents him or her from caring for the child for at least 4 continuous weeks in the calendar quarter services were performed

Example 6.6 Grandparent as Nanny

Brian from Example 6.5 hired his mother, Ruth, to care for his daughter Angela. He paid Ruth \$2,100 in wages. Angela is under 18 years old, and Brian is divorced. The grandparent exception applies, so Ruth's wages are subject to FICA taxes, but they are not subject to FUTA tax.

Fringe Benefits

The following fringe benefits provided to employees (including household employees) are typically not included in wages:

- Meals provided to the employee at the employer's home for the employer's convenience
- Lodging provided to the employee at the employer's home for the employer's convenience and as a condition of employment
- Up to \$255 per month in 2016 for transit passes (or cash reimbursement for transit passes) used to commute to the employer's home
- Up to \$255 per month for 2016 for the value of parking (or cash reimbursement for parking) at or near the employer's home or at or near a location from which the employee commutes to the employer's home

Other fringe benefits such as car expenses and health insurance paid to a household employee may also be excluded from wages.

Car Expenses

The employer can provide a tax-free mileage reimbursement if the employee uses his or her own vehicle to transport the children or seniors to appointments or activities, or run errands for the employer. The maximum reimbursement amount for 2016 is 54¢ per mile; any excess

reimbursement is taxable to the recipient. Reimbursement for commuting mileage is included in the employee's wages.

If the employer provides a vehicle, personal miles are taxable to the employee (see Issue 1 in this chapter for a discussion of the value of autos provided by employers).

Health Insurance

The employer can provide a medical or health insurance plan for the household employee. The premium payments made by the employer are not taxable, and they are not subject to social security, Medicare, or FUTA taxes if

1. there is only one household employee and the employee purchases the policy on the individual Marketplace, or
2. there are two or more household employees, and the employer purchases the insurance in the Small Business Health Options Program (SHOP) Marketplace.

Child and Dependent Care Credit

If a household employee cares for a dependent who is under age 13 or a spouse or dependent of the taxpayer who cannot care for himself or herself, the taxpayer may qualify for the child and dependent care credit. The amount of the credit depends on the earned income of the taxpayer (and spouse, if applicable). The maximum credit percentage of 35% of the maximum allowable expenses is available only to taxpayers with an adjusted gross income (AGI) of \$15,000 or less. The maximum allowable expenses are \$3,000 of qualifying expenses for one dependent and \$6,000 for two. With limited exceptions, the taxpayer (and spouse if the taxpayers file jointly) must be working in order to claim the credit.

Flexible Spending Account

Taxpayers who work for companies that offer a flexible spending account (FSA) can participate in a dependent care flex account. Employees set money aside on a pretax basis (both income tax and FICA tax) to pay for dependent care expenses that enable the employee and/or his

or her spouse to work. For 2016, the maximum allowable contribution is \$5,000. For a taxpayer filing MFS, the maximum contribution is \$2,500.

Example 6.7 Dependent Care Flex Account

Jason Johnson works for a large company that offers an FSA. He is in the 25% federal income tax bracket. Jason's wife, Janna, is disabled and requires someone to be with her while Jason is working. Jason pays a caregiver, Anna, \$20,000 per year to take care of Janna. If Jason elects to set aside the maximum \$5,000 per year for Janna's care, Jason's individual federal income tax is reduced by \$1,250 ($\$5,000 \times 25\%$). His portion of FICA taxes is reduced by \$382.50 ($\$5,000 \times 7.65\%$). (The FICA savings would be less than \$382.50 if his wages exceeded the social security maximum taxable earnings for the year.)

Deduction for Medical Expenses

A taxpayer may be able to claim an itemized deduction for medical expense paid to a household employee providing nursing-type services and providing certain qualified long-term maintenance or personal care services. Qualified long-term care services are diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services; and maintenance and personal care services that are required by a chronically ill individual, and provided under a plan of care prescribed by a licensed health care practitioner.



Cross-Reference

Household
Employment Taxes

See pages 141–152 of the *2011 National Income Tax Workbook* for more discussion and examples of household employment taxes.

ISSUE 3: RELIEF FROM JOINT LIABILITY Proposed regulations make changes to the laws that relieve spouses from joint liability.

When spouses file a joint return, they are not only reporting combined income and deductions, they are also declaring that they are jointly and severally liable for the original tax, any additional tax, penalties, and interest. As a result, the IRS can collect the entire liability from either spouse, even if the tax arose from income, deductions, credits, or basis belonging to only one spouse. There are situations, however, when “it’s not fair” to hold both spouses liable. In those cases the spouse who believes that he or she is being unfairly treated can request relief from some or all of the liabilities. I.R.C. § 6015 provides three different methods for a spouse to request relief: innocent spouse relief, separation of liability, and equitable relief.



Cross-Reference

Types of Relief from
Joint Liability

See pages 232–238 of the *2015 National Income Tax Workbook* for a discussion of the types of innocent spouse relief, and how to request that relief.



Cross-Reference

Injured Spouse

An innocent spouse is not the same as an injured spouse. An injured spouse's portion of the refund on a joint return is applied, or expected to be applied, to the other spouse's legally enforceable past-due financial obligation. See pages 30–31 of the *2013 National Income Tax Workbook* for an explanation of the injured spouse rules.



Practitioner Note

State Income Tax
Relief

Filing for relief from joint liability for federal income tax may not provide relief from state income tax liability.

New proposed regulations set forth a number of significant changes to the existing I.R.C. § 6015 regulations. The proposed regulations provide

additional guidance on the judicial doctrine of res judicata and the I.R.C. § 6015(g)(2) exception to res judicata when a requesting spouse did not meaningfully participate in a prior court proceeding, and add a list of acts to consider in determining whether the requesting spouse meaningfully participated in a prior proceeding. The regulations also

1. propose a definition of underpayment or unpaid tax for purposes of I.R.C. § 6015(f),
2. provide detailed rules regarding credits and refunds in innocent spouse cases,
3. expand the rule that penalties and interest are not separate items from which relief can be obtained to cases involving underpayments,
4. incorporate a rule that attribution of an erroneous item follows the attribution of the underlying item that caused the increase to adjusted gross income (AGI),
5. update the discussion of the allocation rules under I.R.C. § 6015(c) and (d), and
6. revise the rules regarding prohibition on collection and suspension of the collection limitations statute.

Res Judicata

Under the doctrine of res judicata, the same parties cannot relitigate a matter that has been adjudicated on the merits. A spouse cannot request innocent spouse relief if such relief was at issue in a prior proceeding, or the spouse meaningfully participated in a proceeding in which the spouse could have requested such relief. I.R.C. § 6015(g)(2) provides an exception if the prior proceeding did not consider the issue of relief and the individual requesting relief did not participate meaningfully in the proceeding.

Prop. Treas. Reg. § 1.6015-1(e)(2) clarifies that res judicata will not apply if the requesting spouse raised the issue of relief under I.R.C. § 6015 only in general and did not specify under which subsection relief was being requested, and was not eligible to elect relief because he or she did not meet the requirement to be divorced, widowed, legally separated, or living apart for 12 months at any time during the prior proceedings.

Prop. Treas. Reg. § 1.6015-1(e)(3) provides guidance on the meaningful participation

exception to res judicata. It includes a list of acts that show that a spouse *meaningfully participated* in a prior proceeding and is barred from requesting relief based on res judicata. The IRS and courts must look at the facts and circumstances and consider a number of acts in making the determination regarding meaningful participation. These acts include whether the requesting spouse

1. participated in the IRS appeals process while the prior case was docketed;
2. participated in discovery;
3. participated in pretrial meetings, settlement negotiations, or the trial;
4. signed court documents; and
5. was represented by counsel in the prior proceedings.

Pursuant to Prop. Treas. Reg. § 1.6015-1(e)(3)(i), the requesting spouse is not considered to have meaningfully participated in the prior proceeding if any of the acts in the previous list were performed because of spousal abuse, control, or fear of retaliation.

Prop. Treas. Reg. § 1.6015-1(e)(3)(ii) restates the rule from the current regulations that a requesting spouse did not meaningfully participate in a prior proceeding if, due to the effective date of I.R.C. § 6015, relief was not available in that proceeding. Prop. Treas. Reg. § 1.6015-1(e)(3)(iii) provides that in a case arising from a statutory notice of deficiency under I.R.C. § 6213, the fact that the requesting spouse did not have the ability to effectively contest the underlying deficiency is irrelevant for purposes of determining whether the requesting spouse meaningfully participated in the prior proceeding.

Example 6.8 Res Judicata

Craig and Connie Chavez were audited, received a statutory notice of deficiency, and filed a petition in the US Tax Court. In the petition, they argued that Connie was entitled to relief under I.R.C. § 6015, although they did not indicate how she qualified. Craig met with the IRS chief counsel attorney, and the two of them came to an agreement. Connie was not present for the meeting, and Craig and the IRS chief counsel did not discuss Connie's request for relief. Connie signed the agreement that Craig reached with the IRS. One year later, Connie filed Form 8857, Request

for Innocent Spouse Relief, requesting innocent spouse relief.

If Connie's only participation in the process was to sign the agreement that Craig reached with the IRS, she did not meaningfully participate in the process, and she is not barred from filing for relief.

Unpaid Tax

Under Prop. Treas. Reg. § 1.6015-4, a spouse requesting equitable relief under I.R.C. § 6015(f) can get relief only if he or she

1. filed a joint return
 - a. for which an understatement or deficiency was determined, or
 - b. for which there was unpaid tax; and
2. does not qualify for full relief under the innocent spouse rules or the separation-of-liability rules.

Prop. Treas. Reg. § 1.6015-1(h)(6) defines unpaid tax for purposes of Treas. Reg. § 1.6015-4 equitable relief. The regulations propose that the terms *unpaid tax* and *underpayment* have the same meaning. The unpaid tax or underpayment on a joint return is the balance shown as due on the return reduced by the tax paid with the return or paid on or before the due date for payment (without considering any extension of time to pay). The balance due is determined after applying withholding credits, estimated tax payments, payments with an extension, and other credits applied against the total tax reported on the return. Payments made with the return include payments made by check, direct debit, credit card, or other commercially acceptable means on or before the due date for payment.

The determination of the existence and amount of unpaid tax is made as of the date the joint return is filed, or as of the due date for payment if payments are made after the return is filed but on or before the due date. If there is no balance due after all timely payments have been made, there is no unpaid tax for purposes of equitable relief.



Observation

Understatement or Deficiency

If there is no unpaid tax, the spouse may be eligible for equitable relief if the joint return understated tax liability or the IRS finds a deficiency on the return.

Example 6.9 Fully Paid Returns

Don and Dianne Donaldson filed a joint return for 2014. They paid the \$1,400 balance due before the due date of the return in 2015. Neither spouse qualifies for equitable relief based on unpaid tax on the 2014 joint return.

Credits or Refunds

I.R.C. § 6015(g)(1) allows a requesting spouse who is eligible for relief to receive a credit or refund of payments made to satisfy the joint income tax liability. It does not matter whether the liability resulted from an understatement or an underpayment. I.R.C. § 6015(g) limits the availability of a credit or refund. Prop. Treas. Reg. § 1.6015-1(k)(2) through (5) discusses the limits on a credit or refund when a requesting spouse is eligible for relief. The proposed regulations state the following:

1. A requesting spouse is not entitled to a credit or refund of any payments made on the joint income tax liability as a result of allocating the deficiency using the separation-of-liability method.
2. Equitable relief cannot be used to circumvent the fact that no credit or refund is available for allocated deficiencies using the separation-of-liability method.
3. Filing Form 8857 is treated as the filing of a claim for a credit or refund even if not specifically requested. If the requesting spouse is eligible, the allowable amount includes payments made after the filing of the form plus payments made within the applicable look-back period (within 3 years of the due date of the return or 2 years after the last payment).
4. A requesting spouse who is entitled to relief is generally not eligible for a credit or refund

of joint payments made with the nonrequesting spouse. However, he or she may be eligible for a credit or refund of the requesting spouse's portion of the requesting and nonrequesting spouse's joint overpayment from another tax year that was applied to the joint income tax liability to the extent the requesting spouse can establish his or her contribution to the overpayment.

Example 6.10 Separation of Liability

Frank and Fiona Foreman were married in 2013, and they filed a joint return. They were divorced in 2014, and Fiona filed Form 8857 in 2014, claiming that Frank understated his 2013 income and she was entitled to separation-of-liability relief. The IRS found that Fiona was not responsible for the understated tax and allocated the deficiency to Frank. Fiona will not receive a refund of amounts paid because she was granted relief based on the separation-of-liability method and no refund is allowed. If instead Fiona had filed for relief based on the innocent spouse method, she may be entitled to a refund of any prior-year overpayments that were applied to the joint liability.

Penalties and Interest

Treas. Reg. § 1.6015-1(h)(4) provides, in part, that penalties and interest are not separate erroneous items from which a requesting spouse can be relieved separate from the tax. Relief from penalties and interest related to an understatement or deficiency is generally determined based on the proportion of the total erroneous items from which the requesting spouse is relieved.

Prop. Treas. Reg. § 1.6015-1(m) clarifies that penalties and interest on an underpayment also are not separate items from which a requesting spouse may obtain relief under Treas. Reg. § 1.6015-4. Relief from penalties and interest on the underpayment is determined based on the amount of relief from the underpayment to which the requesting spouse is entitled, not a separate consideration of the penalties.

In a situation where an assessed deficiency has been paid in full or the unpaid tax on the return is later paid in full, it is possible that penalties and interest may remain unpaid. The requesting

spouse can request relief from the penalties and interest under I.R.C. § 6015. The determination of relief from the penalties and interest is made by considering whether the requesting spouse would be entitled to relief from the underlying tax and not considering the penalties and interest as if they were separate items. A requesting spouse may be relieved from the penalties and interest even if relief in the form of a refund of the payments made on the underlying tax is barred.

Example 6.11 Penalty and Interest Relief

Gary and Georgia Garrett divorced in 2016. The IRS audited their 2015 joint return and assessed an accuracy-related penalty on the deficiency because Gary failed to report his gambling income. The Garretts paid all of the taxes due on the unreported gambling income, but they did not pay the penalty and interest. If Georgia requests relief under I.R.C. § 6015, she cannot get a refund of amounts paid, but she can request relief from the penalty and interest.

Attribution Rules

If an understatement or deficiency results from either a disallowance of an item or an increase to an amount of tax, other items on the return may be affected because of the change to AGI or to modified adjusted gross income (MAGI). Prop. Treas. Reg. § 1.6015-1(n) provides attribution rules for a portion of an understatement or deficiency relating to the disallowance of certain items. Specifically, Treas. Reg. § 1.6015-1(n) addresses items that are otherwise not erroneous items, but are disallowed solely because of an increase of AGI (or MAGI) over a phaseout threshold as a result of an erroneous item attributable to the nonrequesting spouse.

Under Prop. Treas. Reg. § 1.6015-1(n), the understatement or deficiency related to the item disallowed due to the increase to AGI is attributed to the spouse whose erroneous item caused the increase to AGI, unless the evidence shows that a different result is appropriate. If the increase to AGI is the result of erroneous items of both spouses, the resulting income changes are apportioned proportionately.

Example 6.12 Attribution Rules

Harley and Harriett Howard filed a joint 2016 income tax return reporting \$50,000 of itemized deductions on Schedule A (Form 1040), Itemized Deductions. Later the IRS disallowed \$10,000 of Harriet's expenses reported on her Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), which increased Harley and Harriett's AGI. As a result, their itemized deductions were reduced to \$45,000 because their AGI exceeded the phaseout amount. The IRS determined a \$6,000 deficiency.

If Harley requests relief under I.R.C. § 6015, the entire \$6,000 deficiency is attributable to Harriett because the itemized deductions were reduced solely due to the increase in AGI resulting from Harriett's erroneous Schedule C (Form 1040) expenses. Harley satisfies the attribution factor of Treas. Reg. § 1.6015-2(a)(2) and the threshold condition in section 4.01(7) of Rev. Proc. 2013-34, 2013-43 I.R.B. 397, with respect to the entire deficiency. Under Treas. Reg. § 1.6015-3(d)(2)(iv), the portion of the deficiency related to the disallowance of the Schedule A (Form 1040) deductions is initially allocated to Harriett.

Question.

What if the \$10,000 increase in Harley and Harriett's AGI was caused by \$4,000 of Harry's unreported income and \$6,000 of Harriett's unreported income, and the IRS determined that \$1,500 of the deficiency relates to Harry's erroneous item, \$2,500 of the deficiency relates to Harriett's erroneous item, and \$2,000 of the deficiency relates to the reduced itemized deductions?

Answer.

Assuming the conditions for relief under I.R.C. § 6015 are otherwise satisfied, the \$2,500 deficiency from Harriett's omitted income is attributable to her, and the \$1,500 deficiency from Harry's omitted income is attributable to him.

Both Harry's and Harriett's erroneous items increased AGI and reduced the itemized deductions, and the portion of the deficiency related to the disallowed itemized deductions is partially attributable to each of them. Of the \$2,000 deficiency from the disallowed itemized deductions, \$800 is attributable to Harry because 40% ($\$4,000 \div \$10,000$) of the items that resulted in the increase to AGI are attributable to him, and \$1,200 is attributable to Harriett because 60%

($\$6,000 \div \$10,000$) of the items that resulted in the increase to AGI are attributable to her.

If both Harry and Harriett requested relief, the most Harry could be relieved from is the \$3,700 ($\$2,500 + \$1,200$) attributable to Harriett, and the most Harriett could be relieved from is the \$2,300 ($\$1,500 + \800) attributable to Harry.

Allocation Rules

I.R.C. § 6015(g)(3) provides that no credit or refund is allowed as a result of an allocation of a deficiency under I.R.C. § 6015(c). Prop. Treas. Reg. § 1.6015-3(c)(1) states that whether relief is available to a requesting spouse under I.R.C. § 6015(c) is not dependent on the availability of a credit or refund. If a requesting spouse is eligible to allocate the entire deficiency to the nonrequesting spouse, the requesting spouse has received full relief (even if the requesting spouse made payments on the deficiency and is not entitled to a refund of those payments) and is not eligible for relief under I.R.C. § 6015(f).

However, if a requesting spouse receives only partial relief (part of the deficiency is still allocated to the requesting spouse), then the requesting spouse may be considered for relief under I.R.C. § 6015(f) for the portion of the deficiency allocable to the requesting spouse.

Knowledge of the Deficiency

Under the proposed regulations, a requesting spouse who had no knowledge or reason to know of a portion of an erroneous item may be relieved of the liability attributable to that portion of that item. Prop. Treas. Reg. § 1.6015-3(c)(2)(iv) clarifies that the requesting spouse's joint ownership of the erroneous item is one of the factors that may be relied upon in demonstrating that the requesting spouse had actual knowledge of the item. Prop. Treas. Reg. § 1.6015-3(c)(vi) adds that abuse or financial control by the nonrequesting spouse will result in the requesting spouse being treated as not having actual knowledge of the items giving rise to the understatement.

Example 6.13 Partial Liability Relief

Joseph and Jill Johnson timely filed their 2014 return in March 2015. In 2015, Joseph was

convicted of embezzling \$2,000,000 from his employer. Joseph kept all of his embezzlement income in a separate bank account and used most of the money to support his gambling habit. The Johnsons also had a joint bank account. Joseph paid the household expenses using the joint account and transferred \$10,000 a month from his separate account to the joint account. Jill received the bank statements for the joint account each month, so she was aware of the \$120,000 ($\$10,000 \times 12$ months) deposited into that account. Jill cannot request relief of the tax liability resulting from the \$120,000 because she knew about the income, but she can request relief of the tax liability resulting from the remaining \$1,880,000 ($\$2,000,000 - \$120,000$) that she did not know about.

Tax Benefit Rule

Pursuant to Prop. Treas. Reg. § 1.6015-3(d)(2)(i), under the tax benefit rule of I.R.C. § 6015(d)(3)(B), the amount of an erroneous item allocated to a requesting spouse may increase or decrease depending on the tax benefit to the requesting and nonrequesting spouses. Generally, an item that produced a deficiency on a joint return is

allocated to the individuals in the same way it would have been allocated if they had filed separate returns. There is, however, an exception when one spouse benefits from the item on the joint return. An erroneous item that would be allocated to one spouse is allocated to the second spouse to the extent the second spouse received a tax benefit on the joint return and the first spouse did not receive a tax benefit.

Example 6.14 Tax Benefit Based on Taxable Income

Karl and Keyana King filed a joint return for 2015. Karl reported \$60,000 in wages, and Keyana reported \$25,000 in wages. They also had \$2,000 of joint interest income and \$6,000 of joint investment income. The total of their personal exemptions and itemized deductions was \$30,000. Keyana also reported a \$20,000 loss from her separate investment in a partnership. Following an audit, Keyana's partnership loss was disallowed, and the IRS assessed an additional \$5,000. Keyana died in December of 2016, and Karl filed a timely request for innocent spouse relief. The deficiency has not been paid. The initial allocation is depicted in **Figure 6.2**.

FIGURE 6.2 Initial Allocation

	Karl	Keyana	Total
Wages	\$60,000	\$25,000	\$ 85,000
Interest income	1,000	1,000	2,000
Investment income	3,000	3,000	6,000
AGI	\$64,000	\$29,000	\$93,000
Exemptions and itemized deductions	(15,000)	(15,000)	(30,000)
Taxable income before partnership loss	\$ 49,000	\$14,000	\$63,000
Partnership loss		(20,000)	(20,000)
Taxable income	\$49,000	\$ (6,000)	\$43,000
Unused tax benefit		\$ (6,000)	
Tax benefit to Keyana		\$(14,000)	
Tax benefit to Karl	\$(6,000)		

Because Keyana's taxable income could be eliminated by using \$14,000 of the partnership loss, the additional \$6,000 loss benefited Karl. Therefore, \$14,000 of the disallowed \$20,000 loss is allocable to Keyana ($\$14,000 \div \$20,000 = 70\%$),

and \$6,000 of the disallowed loss is allocable to Karl ($\$6,000 \div \$20,000 = 30\%$). Karl's liability is limited to \$1,500 ($30\% \times \$5,000$ deficiency) [Prop. Treas. Reg. § 1.6015-3(d)(5), Example 7].

Example 6.15 Nonrequesting Spouse Receives Benefit from Requesting Spouse's Error

Larry and Leona Lane filed a joint 2014 return. Leona reported \$40,000 of wages, and Larry reported \$12,000 of wages. They also deducted \$20,000 for their personal exemptions and itemized deductions. They both made errors on the return. Larry erroneously claimed a \$5,000 casualty loss on his separately owned property, and Leona erroneously claimed a \$7,000 loss on her separate investment in a tax shelter. They legally separated in 2015, and the IRS assessed a \$2,400 deficiency on their 2014 return. The deficiency was due to the disallowance of the \$12,000 (\$5,000 + \$7,000) in errors on the return.

If Larry requests innocent spouse relief, the IRS will initially allocate the \$5,000 erroneous casualty loss to him. However, he used only \$2,000 of the casualty loss to offset his \$2,000 of taxable income (\$12,000 of wages – \$10,000 of personal exemption and itemized deductions). Therefore, \$3,000 of the disallowed casualty loss is allocable to Leona even though it is Larry's item, and \$2,000 of the loss is allocable to Larry.

The \$7,000 tax shelter loss is also allocable to Leona because Larry did not have knowledge of the facts that made the tax shelter item unallowable as a loss. Larry's allocation percentage is 16.67% (\$2,000 ÷ \$12,000), and Larry's liability is limited to \$400 (16.67% of the \$2,400 deficiency). The IRS may collect up to \$400 from Larry and up to \$2,400 from Leona (but the total amount collected may not exceed \$2,400).

Question 1.

What is the limit on Larry's liability if the IRS proved that Larry had knowledge of the facts that made the deduction for his casualty loss unallowable?

Answer 1.

The entire \$5,000 casualty loss would be allocable to Larry. Larry's allocation percentage would be 41.67% (\$5,000 ÷ \$12,000) and Larry's liability would be limited to \$1,000 (41.67% of the \$2,400 deficiency).

Question 2.

What is the limit on Leona's liability if Leona also requested innocent spouse relief (and Larry did not have knowledge of the facts that made his \$5,000 loss unallowable)?

Answer 2.

The IRS could collect \$2,000 [$(\$10,000 \div \$12,000 = 83.33\%)$ of the \$2,400 deficiency] from Leona, and \$400 [$(\$2,000 \div \$12,000 = 16.67\%)$ of the \$2,400 deficiency] from Larry. There would be no remaining joint and several liability.

Question 3.

What is the limit on Leona's and Larry's liability if they both requested innocent spouse relief and the IRS proved that Leona had knowledge of the facts that made the deduction for the \$7,000 loss on her investment unallowable?

Answer 3.

Leona would be liable for the entire \$2,400 deficiency, while Larry would remain liable for up to \$400 (but the total amount collected may not exceed \$2,400) [Prop. Treas. Reg. § 1.6015-3(d)(5), Example 8].

Restriction on Collections and Suspension of the Limitations Period

6

Under Prop. Treas. Reg. § 1.6015-7, if a spouse requests innocent spouse relief, separation of liability, or most types of equitable relief, the IRS cannot initiate a levy or initiate or prosecute a court proceeding against the requesting spouse to collect the taxes that are the subject of the request for relief until 90 days after the IRS mails a notice of determination, or, if a petition is filed with the Tax Court, until the decision of the Tax Court becomes final under I.R.C. § 7481.

The I.R.C. § 6502 statute of limitations on collection against the spouse requesting relief is suspended during the time that the IRS is prohibited from collecting by levy or a proceeding in court and for 60 days thereafter. If the requesting spouse signs a waiver of the restrictions on collection, the suspension of the period of limitations on collection against the requesting spouse terminates 60 days after the date the spouse files the waiver.

ISSUE 4: CHARITABLE CONTRIBUTIONS OF FOOD INVENTORY

The Protecting Americans from Tax Hikes (PATH) Act, Pub. L. No. 114-94, made the enhanced charitable deduction for contributions of food inventory permanent.

Taxpayers may qualify for an enhanced charitable contribution deduction if they donate food inventory. Partnerships and S corporations pass the deduction through to their partners or shareholders, and the partners or shareholders calculate the limits on the deduction at the individual level.



Cross-Reference

Deduction for Conservation Easement

The PATH Act also made the enhanced charitable deduction for land conservation permanent. That provision is discussed in the “New Legislation” chapter of this book.

Contributions of Food Inventory

In general, the deduction for charitable contributions for inventory property under I.R.C. § 170 is limited to the lesser of fair market value (FMV) of the inventory or the taxpayer's basis in the contributed property. Under I.R.C. § 170(e)(3)(C), a taxpayer who makes a charitable contribution of food inventory is allowed to take a larger deduction if the FMV of the contributed food inventory exceeds its basis.

Qualified Contribution

A qualified contribution must be made to a qualified organization, which is defined as a nonprofit group that is religious, charitable, educational, scientific, or literary in purpose. An organization that works to prevent cruelty to children (or animals) is also a qualified organization. A qualified contribution must meet the following conditions:

1. The contribution must meet the requirements of “apparently wholesome food” from the donor's trade or business.
2. The food must be intended for human consumption.

3. The food must meet all the quality and labeling standards imposed by federal, state, and local laws, but the food does not have to be readily marketable due to appearance, age, freshness, grade, size, surplus, and other conditions.
4. The receiving organization must use the food only for the care of the ill, the needy, or infants.
5. The use of the food must be related to the receiving organization's exempt purpose or function.
6. The organization must agree not to transfer the donated food for money, other property, or services.
7. The receiving organization must provide a written statement agreeing to comply with the requirements for the use of the food.
8. The receiving organization cannot be a private non-operating foundation (an organization that grants money to other charitable organizations).
9. The donated food must satisfy any applicable requirements of the Federal Food, Drug, and Cosmetic Act and regulations on the date of the transfer and for the previous 180 days.

Calculating the Deduction

For qualified contributions of food inventory, the taxpayer can generally deduct an amount equal to its basis in the inventory plus half of the profit that would have been recognized if the inventory had been sold at its FMV on the date of contribution. The deduction is limited to two times the taxpayer's basis in the contributed property. IRS Publication 526, *Charitable Contributions*, provides a worksheet to determine the amount of the donation. The taxpayer must complete a separate worksheet for each donation.

Basis

Basis is defined as any cost incurred for the inventory in an earlier year that would otherwise have

been included in opening inventory for the year of the contribution. The taxpayer must remove the amount of the charitable contribution deduction from the opening inventory because the taxpayer cannot include that amount in cost of goods sold.

If the taxpayer does not otherwise include the cost of the donated inventory in opening inventory, there is no basis and there is no charitable contribution deduction. A taxpayer who purchases and donates food inventory in the same year must treat the inventory cost the same as the taxpayer would treat the cost under the taxpayer's ordinary method of accounting. For example, the taxpayer could include the cost of food inventory purchased and donated in the same year as part of the cost of goods sold for that year.

Pursuant to the PATH Act, if a taxpayer is not required to maintain an inventory and is not required to capitalize indirect costs under I.R.C. § 263A, the taxpayer can elect to treat the basis of any apparently wholesome food as equal to 25% of its FMV.

Determining FMV

The taxpayer must value the food inventory considering the price at which the taxpayer sells the same food items (or substantially the same) at the time of the contribution. Under the PATH Act, FMV is calculated without regard for the following factors:

- The food was not sold solely because of internal standards of the taxpayer.
- There was no market for the food.
- The taxpayer produced the food exclusively for the purpose of making a qualified contribution.

Limit on Deduction

Unlike other inventory donations, there is no requirement that donors of food inventory be C corporations. However, the deduction for taxpayers other than C corporations is limited to 15% of total net income from all trades or businesses that donated food inventory. The limit for C corporations is 15% of all of its taxable income. The limit is applied to taxable income without regard for current-year net operating loss carrybacks, any capital loss carrybacks, and the domestic production activities deduction.

Deductions in excess of the 15% net income or taxable income limit can be carried forward and treated as qualifying food inventory contributions in each of the 5 succeeding taxable years in order of time.

C corporations are subject to a general 10% of taxable income limit on all charitable contributions. The 10% limit does not apply to donations of food inventory, but C corporation contributions of food inventory apply toward the 10% limit for purposes of calculating other charitable deductions.

Example 6.16 C Corporation Donation of Food Inventory

In 2016, Family Restaurant, Inc. (a C corporation) donated food inventory to a local children's home that met the definition of a qualified charity. The basis of Family Restaurant's contributed inventory food items was \$10,000, and its FMV was \$10,000. Family Restaurant's taxable income was \$500,000. Family Restaurant's charitable deduction is \$10,000 [$\$10,000 \text{ basis} + (50\% \times \$0 \text{ profit})$].

Question 1.

What is Family Restaurant's charitable deduction if the basis of the food inventory was \$10,000 and its FMV was \$35,000?

Answer 1.

Family Restaurant's charitable deduction is \$20,000 because that is the lesser of the following two amounts:

1. Basis plus 50% of profit: $\$10,000 + (50\% \times \$25,000 \text{ profit}) = \$22,500$
2. Two times basis: $\$10,000 \times 2 = \$20,000$

Question 2.

How does Family Restaurant's donation of food inventory affect its limit on deducting other charitable contributions?

Answer 2.

Family Restaurant's general charitable deduction limit is \$50,000 ($10\% \times \$500,000$). If Family Restaurant deducts \$20,000 of food inventory, it is limited to deducting \$30,000 ($\$50,000 - \$20,000$) of other charitable contributions. Any excess amount can be carried over for 5 years subject to the 10%-of-taxable-income limit.

Question 3.

How much can Family Restaurant deduct if its taxable income was \$100,000?

Answer 3.

Family Restaurant can deduct only \$15,000 (15% $\times$ \$100,000) of its \$20,000 charitable contribution deduction. It can carry the remaining \$5,000 over for 5 years and deduct it subject to the 15%-of-taxable-income limit.

Family Restaurant cannot deduct any other charitable contributions for 2016 because the \$15,000 deduction for food inventory reduces its \$10,000 (10% $\times$ \$100,000) general limit to zero. Other charitable contributions for 2016 can be carried over for 5 years subject to the 10%-of-taxable-income limit.

Partnerships and S corporations cannot deduct charitable contribution deductions [I.R.C. §§ 703(a)(2)(C) and 1363(b)(2)]. Instead, they pass the deduction through to their partners and shareholders. Partners and shareholders are subject to the 15%-of-net-income (from trades or businesses that donate food inventory) limit for deducting donations of food inventory. For purposes of that limit, partners and shareholders aggregate their net income from all businesses that donated food inventory during the year.

Example 6.17 S Corporation Donation of Food Inventory

The facts are the same as in Example 6.16 except that Family Restaurant, Inc. is an S corporation. All of its \$500,000 net income passes through to Patty Cakes, its sole shareholder. If Family Restaurant donated food inventory with a \$10,000 basis and a \$10,000 FMV, Family Restaurant passes a \$10,000 charitable contribution deduction through to Patty. If instead Family Restaurant donated food inventory with a \$10,000 basis and a \$35,000 FMV it passes a \$20,000 charitable deduction through to Patty. That is the lesser of the \$10,000 basis plus 50% of the \$25,000 profit and two times the \$10,000 basis as calculated in Example 6.16.

I.R.C. § 170(e)(3)(C)(ii) says, “The amount of such contributions for any taxable year which may be taken into account under this section shall not exceed . . . 15% of taxable income.” *Such contributions* could mean all charitable contributions of food inventory, or it could mean only contributions of food inventory that qualify for the enhanced deduction.

The IRS Publication 526 worksheet for calculating the charitable deduction for donating food inventory applies the 15%-of-net-income limit only if the basis of the food exceeds its FMV. In other words, if the donation of food inventory does not qualify for the enhanced deduction for food inventory, the charitable deduction is not subject to the 15%-of-net-income limit.

Example 6.18 Limit on Shareholder’s Contribution Deduction

The facts are same as in Example 6.17 except that Family Restaurant’s net income is \$50,000 and Patty has no income from other trades or businesses that donated food inventory. Her MAGI is \$60,000, and she made no other charitable contributions in 2016.

If Family Restaurant donated food inventory with a \$10,000 basis and a \$10,000 FMV, Family Restaurant passes a \$10,000 charitable contribution deduction through to Patty as in Example 6.17. According to the worksheet in IRS Publication 526, Patty’s charitable contribution deduction is not limited to 15% of her \$50,000 of net income from Family Restaurant. The \$10,000 is less than 50% of her \$60,000 MAGI, so she can deduct the full \$10,000 on her 2016 income tax return.

If instead Family Restaurant donated food inventory with a \$10,000 basis and a \$35,000 FMV and passed a \$20,000 charitable deduction through to Patty as in Example 6.17, Patty’s charitable contribution deduction is limited to \$7,500 (15% $\times$ \$50,000). She can carry the \$12,500 (\$20,000 – \$7,500) excess forward for 5 years subject to the 15%-of-net-income limit.

ISSUE 5: IRA CHARITABLE DISTRIBUTIONS

The Protecting Americans from Tax Hikes (PATH) Act, Pub. L. No. 114-94, made the exclusion of qualified charitable distributions from an IRA permanent.

Two rules apply to an IRA owner when he or she turns age 70½. One is that the IRA owner must begin taking required minimum distributions (RMDs), which the owner includes in taxable income. The second is that the IRA owner can make qualified charitable distributions (QCDs) directly from the IRA to charities, which the owner does not include in income. Even though the distribution is not included in income, it is treated as a distribution for the IRA owner's RMD. The PATH Act made the QCD provisions permanent.



Cross-Reference

Required Minimum Distributions

See the "Retirement Issues" chapter in this book for further discussion of RMDs.

QCD Requirements

A QCD allows an IRA owner who is at least age 70½ to contribute up to \$100,000 from the IRA to a charity without having to claim the distribution in taxable income. Although the owner does not receive a charitable contribution deduction, the owner does not have a taxable distribution. The exclusion is available only to the extent the owner would have otherwise had to include the distribution in taxable income.

Qualified Charitable Organization

In general, qualified charitable organizations for the purposes of a QCD must be organized in the United States or any of its possessions. Qualified organizations include the following:

- A community chest, corporation, trust, fund, or foundation organized and operated only for charitable, religious, scientific, literary, or educational purposes; or to prevent cruelty to children or animals; or to foster national or international amateur sports competition

- War veterans' organizations, including posts, auxiliaries, trusts, or foundations
- Domestic fraternal societies, orders, and associations operating under the lodge system (if the organization is organized and operated for charitable, religious, scientific, literary, or educational purposes)
- Certain nonprofit cemetery companies or corporations (but not for care of a specific lot or mausoleum crypt)
- The United States or any state, the District of Columbia, a US possession, a political subdivision of a state or US possession, or an Indian tribal government or any of its subdivisions (must be used solely for public purposes)

A donor-advised fund and a supporting organization likely are not qualified charitable organizations. A donor-advised fund is a separately identified fund or account that is maintained and operated by an I.R.C. § 501(c)(3) organization. Individual donors make contributions to the fund. The organization has legal control over the fund, but the donor or the donor's representative retains advisory privileges with respect to the distribution of funds. Supporting organizations are charities that support other public charities. Although they can be qualified as public charities themselves, the relationship must ensure that the organization being supported effectively supervises the operations of the supporting organization.

Procedure

The IRA owner requests that the IRA trustee make the QCD. The trustee must write the check to the charitable organization. The owner will later receive Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., for the distribution, which the owner reports on Form 1040, U.S. Individual Income Tax Return, line 15a; or on Form 1040A, U.S. Individual Income Tax Return, line 11a. The owner writes "QCD" next to the entry and reports the taxable amount as

zero. Married couples filing jointly may exclude up to \$100,000 each. The charity must provide documentation of the contribution before the taxpayer can claim the QCD.

Example 6.19 Claiming the QCD

In 2016 Myron Miller, age 72, had a \$25,000 RMD. He arranged with his IRA trustee to write a check for \$50,000 to a qualified charitable organization. Myron delivered the check to the charity. The \$50,000 distribution was reported to Myron on Form 1099-R. The IRA distribution qualifies as a QCD because the trustee wrote the check to the charity. If instead Myron made the donation directly to the charity and then had the IRA trustee reimburse him, the distribution would not be a QCD, and the entire amount would be reported to Myron as a taxable ordinary distribution.

Eligible IRAs

An IRA owner can make a QCD from a traditional IRA for which the owner has taken contribution deductions, and from an IRA in which the owner has a basis because he or she was unable to take a contribution deduction (nondeductible IRA). Roth IRAs are also eligible up to the amount of the earnings. An IRA owner cannot make a QCD from a SEP or a SIMPLE IRA, and cannot make a QCD from an inherited IRA unless the beneficiary is at least age 70½.

Example 6.20 Nondeductible IRAs

In 2016, Nancy Norton, age 75, requested a \$25,000 QCD from her IRA. The value of the IRA at the time of the distribution was \$30,000, of which \$10,000 was basis. Nancy's QCD is limited to \$20,000 (the taxable portion of the IRA). Because Nancy made a distribution of

nondeductible contributions from her IRA, she includes the total distribution (\$25,000) on line 15a of Form 1040 and completes Form 8606, Nondeductible IRAs, to determine the amount to enter on line 15b of Form 1040. Nancy took no other distributions in 2016, so she enters \$0 on line 15b of Form 1040 and writes "QCD" next to that line to indicate a qualified charitable distribution. Nancy may be able to take a \$5,000 charitable contribution deduction. Nancy's basis in the IRA after the distribution is \$5,000.



Planning Pointer

Benefit of a QCD

Because the QCD is not included in AGI or taxable income and it does not use any of the 50%- or 30%-of-MAGI limit for deducting charitable contributions, it may be especially useful for taxpayers that

- would exceed the 50%- or 30%-of-MAGI limit for deducting charitable contributions if they donated a taxable distribution from an IRA to a charity;
- have very few or no itemized deductions other than charitable contributions and can claim the standard deduction if they make all of their charitable contributions by QCDs;
- have itemized deductions that are subject to the 2%-of-AGI floor;
- are subject to the Pease limitation on itemized deductions; and
- are subject to the personal and dependent exemptions deduction phaseout.

ISSUE 6: MINISTERS Several special tax rules apply to ministers' income and deductions.

A minister is a duly ordained, commissioned, or licensed minister of a church; or a member of a religious order who carries on a trade or business performing services in the exercise of his or her ministry. Such ministerial services include the ministration of sacerdotal functions and the conduct of religious worship; and the control, conduct, and maintenance of religious organizations. Whether services performed by a minister constitute the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting the church or church denomination [Treas. Reg. § 1.1402(c)-5]. A minister could be a priest; a rabbi; or any other ordained, commissioned, or licensed member of a religious order who provides ministerial services. The term minister and the term church are not specific to any particular religion. The courts and the IRS use these terms broadly to describe the leader of worship and the place of worship in any religion.

Income Tax

A minister is subject to income tax on all earnings. Earnings include wages; offerings; and fees for performing marriages, baptisms, funerals, and other services. A minister is not subject to income tax on a housing allowance, which is discussed later. The minister's earnings are subject to income tax regardless of whether the minister is an employee or is self-employed. However, the treatment of expenses related to the earnings differs. If the minister is an employee, the minister can deduct certain unreimbursed business expenses related to the ministerial services on Schedule A (Form 1040) as miscellaneous itemized deductions subject to the 2%-of-AGI floor. The minister may need to complete Form 2106, Employee Business Expenses. If the minister is self-employed, the minister must deduct expenses related to the self-employment (SE) income on Schedule C (Form 1040).



Practitioner Note

Accountable Plan

The 2%-of-AGI floor on deductibility of employee business expenses does not apply if the church adopts an accountable plan under Treas. Reg. § 1.62-2.

Tax Withholding

A minister's salary is not subject to federal income tax withholding if

- the minister is a duly ordained, commissioned, or licensed minister; a member of a religious order (who hasn't taken a vow of poverty); or a Christian Science practitioner or reader; and
- the salary is for ministerial services.

If the salary is not subject to withholding, the minister may need to make estimated payments of federal income tax and SE tax. Alternatively, the minister can enter into a voluntary withholding agreement with the church to withhold income and SE tax.

Self-Employment Tax

For social security and Medicare tax purposes, regardless of a minister's status as an employee or independent contractor, the services performed in the exercise of the ministry are considered SE earnings and are generally subject to SE tax.



Practitioner Note

Employment Status for Other Tax Purposes

Even though all income from performing ministerial services is subject to SE tax for social security tax purposes, if the minister is an employee, income earned is treated as wages for income tax and retirement plan purposes.

Ministers are covered by social security and Medicare provisions under the Self-Employment Contributions Act (SECA), not the Federal Insurance Contributions Act (FICA). If the minister is an employee, there are no FICA deductions on Form W-2, and the minister must file Schedule SE (Form 1040), Self-Employment Tax, and pay SE tax.

Example 6.21 Employee Minister

Reverend Mike Mason is an employee of a large denomination, serving at First Church in Indianapolis, Indiana. In 2016, First Church paid Reverend Mason a \$48,500 salary. Reverend Mason chose to make estimated tax payments. First Church must issue a Form W-2 to Reverend Mason showing \$48,500 in box 1. Box 2 is blank because Reverend Mason did not request federal withholding, and boxes 3–6 are blank because Reverend Mason is considered to be self-employed for purposes of social security and Medicare withholding. First Church must complete the state portion of the Form W-2 and include state and local withholding, if applicable.

Exemption from SE Tax

If a minister is opposed to public insurance because of religious beliefs, the minister can request an exemption from SE tax. The exemption applies only to earnings from ministerial services. To apply for the exemption, the minister must file Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners, by the due date of Form 1040, including extensions, for the second tax year in which the minister received at least \$400 in net SE earnings from ministerial services. The 2 years do not have to be consecutive. To claim the exemption, the minister must also certify to the IRS that the request is for other than economic purposes; notify the church or order about his or her opposition to public insurance; and establish that the organization that ordained, licensed, or commissioned the minister is a tax-exempt religious organization.

If the IRS approves the exemption, the IRS will add a code to the minister's IRS account, which will appear on transcripts issued from that

account. The minister must still make the IRS aware of the exemption by writing "Exempt—Form 4361" on Form 1040, line 57; or Form 1040NR, U.S. Nonresident Alien Income Tax Return, line 55. Unless the IRS specifically offers an opportunity to reenter the social security system, the exemption is permanent.

Example 6.22 SE Tax Exemption

Barbara Bailey had \$2,800 in ministerial earnings in 2012, her first year in the ministry. She returned to school full-time in 2013, and had no ministerial income in 2013, 2014, or 2015. In 2016, she earned \$12,500 from her ministry duties. She must file her request for the exemption from SE tax by the due date, including extensions, for her 2016 return. If she does not receive IRS approval for the exemption by April 18, 2017, she must pay her 2016 SE tax by that date.

Housing Exclusion

Under I.R.C. § 107, ordained, commissioned, or licensed ministers may be able to exclude from income tax a housing allowance or the rental fair market value (FMV) of a parsonage that is provided to them in exchange for their ministerial services. Ministers can exclude the housing allowance (sometimes referred to as the rental or parsonage allowance) from income for income tax purposes, but they must include the allowance in income for SE tax purposes.

Housing Allowance

If the church or other employer organization provides the minister with a housing allowance, the church or other organization must officially designate the payment amount as a housing allowance before it makes the payment. The minister can exclude the housing allowance from income if he or she uses the allowance to provide or rent a home, and the allowance is not more than reasonable pay for the minister's services. The amount that the minister can exclude cannot exceed the lowest of

1. the amount actually used to provide the home (mortgage payments, utilities, repairs, property taxes);

2. the amount officially designated as a housing allowance; or
3. the fair rental value of the home, including furnishings and utilities.



Practitioner Note Fair Rental Value

Neither the IRS nor case law provides guidance on how ministers determine the fair rental value of the home. A realtor or appraiser may be able to document rent paid for comparable homes. Alternatively, ministers could estimate the annual cost of owning and maintaining a comparable home.

Housing Provided

If the church or other employer organization provides the minister with a home, the minister can exclude from gross income the fair rental value of the home, including furnishings and utilities. The exclusion cannot be more than the reasonable pay for the minister's services. If the minister pays for the utilities, the minister can exclude any allowance designated for utility costs, up to the actual cost.

The church can either report the amount of the housing allowance in box 14 on Form W-2 or provide written documentation to the minister. The minister can exclude the allowance from gross income, but must report the allowance on Schedule SE (Form 1040). Most, but not all, states follow the federal treatment and exclude the allowance from gross income.

Excess housing allowance is an allowance in excess of reasonable salary, the fair rental value of the home (including utilities), or the amount actually used to provide a home. The minister must include excess rental allowance in gross income, and report that income as wages on Form 1040, line 7.

Example 6.23 Housing Allowance

Temple Beth Israel pays Rabbi Abe Feldman a \$1,000-per-month housing allowance, for a total of \$12,000 per year. Rabbi Feldman is buying his house. The monthly mortgage payments and the utilities total \$13,200 per year. Real estate taxes and insurance are included in his mortgage

payments. The fair rental value of his home is \$11,000 per year, including the furnishings and utilities.

Rabbi Feldman can exclude \$11,000 from his gross income, which is the lowest of the \$12,000 allowance, the \$13,200 actual costs, and the \$11,000 fair rental value. Rabbi Feldman must include the \$1,000 (\$12,000 – \$11,000) excess housing allowance in his gross income. The full \$12,000 allowance is included in Rabbi Feldman's income for SE tax purposes.



Observation Itemized Deductions

Even though a minister is allowed to exclude some or all of the housing allowance from income, the minister can still claim the full deductions for mortgage interest and real estate taxes as itemized deductions on Schedule A (Form 1040).

Example 6.24 Use of Parsonage

Temple Beth Israel gave Rabbi Amy Allen the use of a home owned by the temple. Amy does not have to include in gross income the fair rental value of the home and the utilities paid by the temple. However, if Amy's salary, including the fair rental value of the parsonage, is not a reasonable salary, Amy must include amounts in excess of a reasonable salary in her gross income. Amy must include the entire fair rental value of the parsonage in her income for purposes of calculating her SE tax.



Practitioner Note Retired Ministers

A retired minister can still qualify for a housing allowance if his or her pension designates the allowance. The retired minister can exclude from gross income the rental value of the home furnished to the retired minister as compensation for past services, or the housing allowance paid to the minister as compensation for past services.

Expenses and Tax-Exempt Income

Because of the housing exclusion, I.R.C. § 265 requires a minister to allocate business expenses between taxable and nontaxable income. The minister computes the nondeductible portion of expenses using the following formula:

1. Divide the excluded housing allowance or fair rental value of the parsonage by the total ministry income to get the nontaxable income percentage.
2. Multiply the total business expenses by the nontaxable income percentage from step 1 to determine the expenses allocable to nontaxable income, which are not deductible.

Example 6.25 Tax-Exempt Income Limitations on Deductions

Reverend Matthew Morrison is a common-law employee. He receives a \$52,000 salary per year. He also receives a \$500-per-month travel allowance (\$6,000 per year). His business expenses this year were \$6,200 for auto expenses, \$150 for dues, and \$400 for vestments, for a total of \$6,750. His excluded housing allowance was \$14,000.

Reverend Morrison's housing allowance is 19.4% [$\$14,000 \div (\$52,000 + \$6,000 + \$14,000)$] of his total salary. Reverend Morrison has \$6,750 in business expenses, of which \$1,310 ($\$6,750 \times 19.4\%$) is disallowed and the remaining \$5,440 is allowed.



Planning Pointer

Earned Income Tax Credit

When the exempt housing allowance is added back into income, it is counted as earned income for the purpose of figuring the earned income tax credit.

The housing allowance is included in the calculation of SE income, so a minister can deduct the full amount of business expenses to determine SE income.

Example 6.26 Calculating SE Tax

Reverend Morrison from Example 6.25 has \$58,000 of gross income (including his \$52,000 salary and the \$6,000 travel allowance, and

excluding the \$14,000 housing allowance). He can deduct \$5,440 allowable employee business expenses as a miscellaneous itemized deduction subject to the 2%-of-AGI floor. For SE tax purposes, his income is \$72,000 (his salary plus the allowances for travel and housing). The full amount of the housing allowance is included, so there is no tax-exempt income, and his total \$6,750 business expenses are allowed. His income for SE tax purposes is \$65,250 ($\$72,000 - \$6,750$).

Questions and Answers

Question 1.

Can a church designate 100% of the minister's salary as a housing allowance?

Answer 1.

Yes, but the amount designated must be a reasonable salary. The fact that the entire amount is called a housing allowance does not mean that the minister will be able to exclude it all on his or her personal return. The exclusion is limited to the lesser of the actual cost for housing or the fair rental value of the residence.

Question 2.

What is a love gift, and how is it treated?

Answer 2.

A church may ask its members to contribute a special offering to recognize the minister's anniversary at the church, a holiday, or the minister's birthday. The contribution is typically made directly to the minister. Whether it should be considered a gift or a part of the minister's compensation depends on the involvement of the church leaders and the intent of the "gift."

If the primary reason for the contribution is the members' generosity, it is likely a gift. If the church members want to reward the minister for his or her services and want to secure ongoing services, the contribution is likely compensation for services. Amounts paid to retain a minister's services at a low salary are typically compensation. On the other hand, amounts paid to a retired minister at or around the time he or she retires are usually characterized as gifts from a grateful congregation.

Question 3.

Some ministers, such as evangelists, travel from church to church. Often the church members make a “love offering” to the visiting minister. Is this a gift?

Answer 3.

No, it is compensation for the services of the visiting minister. In fact, if the church counts the offering before giving it to the guest, the church must issue a Form 1099-MISC, Miscellaneous Income, to the guest (if one is required).

Question 4.

If a minister owns a home near the church that employs him or her, and also travels extensively in a recreational vehicle for half the year to provide ministerial services at other churches, how many housing allowances can the minister receive?

Answer 4.

A minister is entitled to only one housing allowance. The allowance could be applied to the costs of the RV or the costs of the home.

Question 5.

If a church failed to authorize a housing allowance last year, can the church authorize the allowance retroactively?

Answer 5.

No, the church cannot retroactively authorize the allowance. If the church discovered the failure to authorize the allowance for 2016 on May 1, 2016, the church can provide the allowance only from May 1 to the end of the year.

Question 6.

What are the consequences of the church paying the minister the FICA taxes it would have paid if the housing allowance was subject to FICA taxes?

Answer 6.

The amount paid by the church is additional wage income to the minister. The church must include it on Form W-2, and the minister must report it as part of his or her gross wages.

Question 7.

Are the housing allowance rules different for missionaries?

Answer 7.

It depends on where they are serving. A missionary serving in the United States can qualify for a housing allowance. If the missionary is serving overseas, the foreign income exclusion and the foreign housing exclusion may apply.

ISSUE 7: AMISH AND MENNONITE TAXPAYERS Because of their religious beliefs, several special tax rules apply to members of the Amish and Mennonite communities.

Amish and Mennonite members pay income tax, sales tax, and property tax. However, they do not believe in public insurance. Instead, they choose to raise funds to pay for medical expenses of their members. Therefore, their income is exempt from the social security and Medicare taxes if they meet certain requirements.

Social Security and Medicare Tax Exemption

I.R.C. § 1402(g) grants an exemption from social security and Medicare taxes to members of recognized religious sects or divisions who are opposed to private or public insurance. Amish and

Mennonite members meet this requirement, and can request an exemption by filing Form 4029, Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits.

To request an exemption, a member of a recognized religious group must show the following:

- The sect or division is conscientiously opposed to accepting benefits of any private or public insurance that makes payments in the event of death, disability, old age, or retirement; makes payments for the cost of medical care; or provides services for medical care (including social security and Medicare benefits).

- Members of the sect or division provided in the past, and currently make reasonable provisions, for their dependent members.
- The sect or division has existed continuously since December 31, 1950.

The exemption from social security and Medicare tax applies only to SE income and income earned working for another exempt person. It does not apply to employment income generated outside the exempt community.

Example 6.27 Social Security and Medicare Tax

Amos and Naomi are members of the Amish community. Amos is a self-employed contractor. He has one employee, Andrew, who is also a member of the Amish community. Naomi works at the local bakery, which sells Amish baked goods, but which is owned by a private corporation. Amos, Andrew, and Naomi filed Forms 4029.

Amos is exempt from social security and Medicare tax because he is self-employed. He should write “Form 4029” on the SE tax line in the “Other Taxes” section on page 2 of Form 1040. Andrew is exempt because both he and his employer are in the exempt community. Amos will issue a Form W-2 to Andrew noting Form 4029 in the box marked “Other,” and there will be no entries in boxes 3, 4, 5, or 6. Naomi will have to pay the tax because she is the employee of a nonexempt corporation.



Practitioner Note

Nonexempt Employee

An exempt employer who employs a nonexempt employee must pay the employer’s share of FICA tax and withhold the employee’s share of FICA tax from the employee’s wages.

Social Security Numbers

The Form 4029 application for exemption requires a social security number (SSN). According to the Program Operations Manual System (POMS) for social security, the IRS will return a form that does not have an SSN and will advise the applicant to

contact a social security field office to apply for the SSN. Members of the Amish, Mennonite, and other recognized religious sects or divisions may object to applying for a social security card. If the applicant provides a statement that states that the applicant does not want a social security card, the Social Security Administration will issue a number, but they will not issue a card. The statement should specify that the individual will contact the social security field office to provide written consent for the disclosure of the SSN to a third party (the IRS) in order to complete the Form 4029.



Observation

Social Security Numbers

Not all Amish and Mennonite members object to receiving a social security number. Even if they do not intend to collect the benefits, there are advantages to having the number, such as being able to open a bank account and get a hunting license.

Exemptions and Credits

Generally, the taxpayer must have an SSN for a child to claim a dependent exemption for the child. If the taxpayer objects to obtaining an SSN for a child, the IRS recommends that the taxpayer file the return, showing the “exempt Form 4029” instead of the SSN. The IRS will deny the exemption for the child and send a math error notice (Letter 3050C). The taxpayer can deliver or mail a copy of the birth certificate and the approved Form 4029 to the IRS, and in most circumstances, the IRS will allow the deduction [I.R.M. § 21.6.1.5.1]. The taxpayer may have to repeat this process in subsequent years.

Members of exempt religious groups may not be able to claim the earned income tax credit (EITC) or the additional child tax credit. All wages, salaries, tips, and other employee compensation are earned income, even if FICA tax is not withheld, but if taxpayers are exempt and self-employed, their income is not earned income. Taxpayers cannot claim the EITC or the additional child tax credit if they have no earned income.

To claim the EITC, the child tax credit, or the additional child tax credit, the child must have a valid SSN by the due date of the return, including extensions. The taxpayer cannot claim the credits on an amended return if the taxpayer obtains an SSN for the child after the due date of the return.

Example 6.28 Tax Credits

Jonah and Esther, an exempt Amish couple, have six children, all under age 17. Jonah's net SE income in 2016 was \$42,000; they had no other

income. All of the children have SSNs. Jonah and Esther are entitled to eight exemptions and the standard deduction for joint filers, which eliminates all of their taxable income. They do not have to pay any SE tax, because they are exempt. However, they do not qualify for either the EITC or the additional child tax credit. If Jonah and Esther were not exempt, they would qualify for a refundable additional child tax credit and the EITC.

ISSUE 8: LEASE WITH AN OPTION TO PURCHASE Lessors and lessees face tax consequences when an option to purchase is exercised, sold, or allowed to expire. The IRS may also treat the option to purchase as an installment sale.

A *lease with an option to purchase*—commonly referred to as a “lease option”—is one way to buy and sell residential and commercial real estate. In general, a lease option is a contract in which a property owner (also referred to as a lessor or optionor) and tenant/buyer (also referred to as a lessee or optionee) agree that the lessee has the option, but not the obligation, to purchase the property at a specified price on a future date. This arrangement contractually binds the lessor to a possible future sale, but not the lessee.

To secure the option, the lessee must provide consideration in the form of an option fee at the inception of the lease option. The option fee is usually calculated as a percentage of the negotiated future purchase price.

Typically, the lessee lives in the property (or uses it in a business) during the rental period, makes monthly rent payments, and has an otherwise standard lessor-lessee relationship with the lessor. The lessee's monthly payments are usually a fair rental rate but could be set above the fair rental rate with the excess credited toward the purchase price of the property. Those credits are treated as an option payment like the upfront option fee. The credit percentage, if any, is negotiated in the contract, as is the rental period, which is typically 1–3 years.

If the lessee decides to not exercise the option, the lessor keeps the option fees and all rent payments.

Tax Effects of Lease Options

A number of factors determine the tax effects of a lease option for the lessors and lessees. Arguably, the most important factor is whether the IRS will recharacterize the contract as an installment sale or a conditional sales contract based on the facts and circumstances of the individual contract. That issue is discussed in greater detail in the next section. This section discusses the tax treatment of the lessee's payments to the lessor under a standard lease option contract.

Option Fee

The tax character of the option fee for the lessor and lessee cannot be determined until the option is exercised, sold, or allowed to expire. Until one of those events occurs, it is a nontaxable *open transaction* [*Federal Home Loan Mortgage Corporation v. Commissioner*, 125 T.C. 248 (2005)].

Example 6.29 Lease Option Fee

On October 1, 2015, Jessica Miracle leased a personal residence from Lanny Lincoln. The lease term is 24 months, and Jessica has the option to purchase the home at the end of the lease for its current \$300,000 fair market value (FMV). Jessica paid a nonrefundable \$15,000 option fee, which will be applied to the purchase price if she exercises the option. She also pays \$1,500-per-month

rent, which is a fair rental rate. None of the monthly rent payments is credited toward the purchase price if she exercises the option.

Because the tax character of the option fee cannot be determined until Jessica exercises or sells the option or allows it to expire, the option fee has no immediate income tax consequences for either Jessica or Lanny.

Option Exercised

If the option is exercised, the option fee is added to the option price to determine the lessee's basis in the property acquired through exercise of the option [Rev. Rul. 58-234, 1958-1 C.B. 279]. It is also included in the amount realized by the lessor from the sale of the property.

Example 6.30 Purchase Option Exercised

Assume the same facts as in Example 6.29. Jessica exercises the option at the end of the lease (October 1, 2017). She receives a credit for the \$15,000 option fee and pays Lanny an additional \$285,000 (\$300,000 option price – \$15,000 option fee) to purchase the home. She also pays \$5,000 in closing costs. Her basis in the home is \$305,000 (\$15,000 + \$285,000 + \$5,000).

Lanny includes the \$15,000 option fee and the \$285,000 Jessica paid when she exercised the option in the amount he realized from the sale of the property.

Option Sold

Instead of exercising the option, the lessee may sell the option to a third party. According to I.R.C. § 1234(a), the nature of the gain or loss from the sale of an option to buy or sell property is the same as the nature of the gain or loss that would arise from the sale of the property. For example, if the property is a capital asset such as a personal residence, the gain or loss from the sale of the option held for a year or less would be treated as a short-term capital gain or (nondeductible) loss. Similarly, the gain or loss stemming from the sale of an option for an I.R.C. § 1231 asset would be an I.R.C. § 1231 gain or loss. The gain or loss from the sale of an option for any other type of property is treated as ordinary income or loss.

The sale of the option is a nontaxable event for the lessor.

Example 6.31 Sale of a Lease Option

Assume the same facts in Example 6.29. On November 1, 2016, Jessica sold her option for \$10,000. Although Jessica realized a \$5,000 (\$10,000 – \$15,000) loss, she cannot deduct the loss because the underlying property was a personal residence.

If Jessica leased the property for investment purposes, she could claim a long-term capital loss on her 2016 return because the option was held for more than a year. If Jessica used the property in a trade or business, she reports the sale of the option in Part I of Form 4797, Sales of Business Property, as shown in **Figure 6.3**.

There are no income taxes consequences for Lanny from Jessica's sale of the option.

FIGURE 6.3 Form 4797 for Sale of Option

Form 4797 Department of the Treasury Internal Revenue Service		Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ Information about Form 4797 and its separate instructions is at www.irs.gov/form4797 .				OMB No. 1545-0184 2016 Attachment Sequence No. 27	
Name(s) shown on return JESSICA MIRACLE						Identifying number 111-22-3333	
1 Enter the gross proceeds from sales or exchanges reported to you for 2016 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions.						1	
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	OPTION TO PURCHASE	10-1-2015	11-1-2016	10,000		15,000	(5,000)

Option Expired

If the lessee lets the option expire without exercising it, the option is considered sold or transferred on the date of expiration, and the nature of the loss is determined under I.R.C. § 1234(a) as discussed previously.

If the lessee used the property in a business and lets the option expire, the option fee is a deductible business loss. If any portion of the rent is credited against the purchase price (an option payment), that portion is not a deductible rental expense but is a deductible business loss at the time the option expires.

If the lessee used the property as a personal residence and lets the option expire, the loss is a nondeductible personal loss.

If the lessee lets the option expire, the lessor must report the amount the lessee paid for the option as ordinary income in the year the option expires [Treas. Reg. § 1.1234-1(b)].

Example 6.32 Option Expired

Assume the same facts as in Example 6.29. On November 1, 2016, Jessica allowed the option to expire. She realized a \$15,000 nondeductible personal loss.

If Jessica used the property in a trade or business, she reports the transaction in Part I of Form 4797, Sales of Business Property, as if she sold the option for a zero sale price, as shown in **Figure 6.4**.

When Jessica let the option expire, Lanny realized \$15,000 of ordinary income.

FIGURE 6.4 Form 4797 for Expired Option

Form 4797 Department of the Treasury Internal Revenue Service		Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ Information about Form 4797 and its separate instructions is at www.irs.gov/form4797 .				OMB No. 1545-0184 2016 Attachment Sequence No. 27	
Name(s) shown on return JESSICA MIRACLE						Identifying number 111-22-3333	
1 Enter the gross proceeds from sales or exchanges reported to you for 2016 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions						1	
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	OPTION TO PURCHASE	10-1-2015	11-1-2016	0		15,000	(15,000)



Practitioner Note

Reporting Expired-Option Ordinary Income

The authors found no guidance on where the lessor reports the ordinary income from an expired option. It could be reported on line 21 of Form 1040, U.S. Individual Income Tax Return, which is the default place to report ordinary income.

Rental Payments

To the extent the rental payments in a lease option do not exceed a fair rental rate and are not an option fee, they are treated the same as rent paid under a lease that does not have an option

to purchase. The lessee deducts the rental payment as a business expense if he or she uses the property in a business. If the property is the lessee's personal residence, the lessee cannot deduct the rental payments except for any portion of the rent attributable to a qualified business use of the residence.

Regardless of the lessee's use of the property, the lessor must include the rental payments in ordinary income to the extent they do not exceed a fair rental rate and are not an option fee. That income is offset by the lessor's rental expenses, including mortgage interest, real estate taxes, depreciation, insurance, and maintenance costs. The lessor reports the income and expenses on Schedule E (Form 1040), Supplemental Income and Loss.

Recharacterization as a Sale

Perhaps the most important tax issue for parties entering into a lease option contract is whether the IRS will characterize the transaction as an installment sale rather than as a lease with an option to purchase. A recharacterization as a sale triggers a different set of income tax consequences for the contracting parties. Under the *substance over form* doctrine, the IRS can recharacterize the transaction as a sale for federal income tax purposes even if the transaction is not a sale under state and local law.

Criteria for Recharacterization

The fundamental question regarding lease option recharacterization is whether the lessee has gained title to or an equity interest in the underlying property. If so, the transaction will most likely be recharacterized as a conditional sale, and the lessee is deemed to have received ownership in the property at the time of the option payment and commencement of the lease period.

The courts have ruled that this determination is based on the facts and circumstances surrounding the inception of the lease, including the terms of the lease itself [*Benton v. Commissioner of Internal Revenue*, 197 F.2d 745 (5th Cir. 1952)]. Although no single factor definitively characterizes a transaction as a lease with an option to purchase or a conditional sale, the intent of the contracting parties is particularly significant. The following other factors also indicate that the contract is a sale rather than a lease:

1. The sum of the option fee and total rent payments are greater than or approximately equal to the FMV of the property at time of the purchase.
2. The rent is set at an above-market rate, and the option payment is below the market rate.
3. Regardless of whether rent is set at the fair rental rate, the option payment(s) and rent payments are credited toward the purchase price of the property.
4. The tenant-buyer is required by the terms of the lease to make capital improvements to the property during the rental period.
5. The tenant-buyer is guaranteed title after making a certain number of required payments.

6. The contract stipulates that part of each rent payment is interest or a substitute for interest.

If the contract is structured such that the lessee will recoup his or her investment only by acquiring the property, it is likely that the intention of the contracting parties is to eventually transfer ownership of the property, and the contract is recharacterized as an installment sale.



Planning Pointer

Lease Terms

It is highly advisable for the lessor and the lessee to memorialize their specific intention to structure and interpret the contract as a lease option. They should also avoid including any of the listed attributes of an installment sale in their contract. Including just one of the listed attributes can trigger a recharacterization as an installment sale.

Upon recharacterization, the transaction is construed as an installment sale with ownership of the underlying property deemed to transfer on the date the parties entered into the contract. The initial option fee is considered a down payment, and the lease payments are allocated between principal and interest payments according to the imputed interest rules in I.R.C. § 7872. The principal payments become part of the tax basis of the property.

If the lessee uses the property in a business, a significant income tax consequence of recharacterizing the transaction as a sale is that the lessee cannot deduct the rental payments as business expenses. I.R.C. § 162(a)(3) specifically disallows the deduction of rent payments if the taxpayer has taken or is taking title or an equity interest in the underlying property.

The loss of the rental deduction is partially offset by the deductions for mortgage interest (computed using the imputed-interest method), depreciation, and other costs of ownership.

The lessor, now deemed the seller, cannot deduct depreciation and ownership costs during the term of the “lease.” If the deemed sale results in a gain, the lessor reports the gain using the installment method unless he or she elects to report all of the gain in the year of the deemed sale. If the deemed sale results in a loss, the seller cannot use the installment method and must deduct the entire loss in the tax year of the sale.

Taxation of Installment Sales

If the lease option is recharacterized as an installment sale, the lessee's payments to the lessor are allocated between imputed interest and principal. The principal payments are further allocated between taxable gain or loss and nontaxable return of the adjusted basis in the property.



Cross-Reference

Installment Sale of Real Estate

See pages 398–409 of the *2011 National Income Tax Workbook* for a discussion and illustration of reporting an installment sale of real estate.

Reporting Lessor's Installment Sale

To use the default installment method for reporting gain from the deemed installment sale, the lessor files Form 6252, Installment Sale Income, and associated forms. Any unrecaptured I.R.C. § 1250 gain (maximum 25% rate) reported on the installment method is taken into account before the adjusted net capital gain [Treas. Reg. § 1.453-12(a)]. Alternatively, the lessor can elect out of the installment method by reporting the entire gain on the appropriate form (discussed next). The lessor cannot use the installment method to report a loss from the deemed installment sale.



Practitioner Note

Depreciation Recapture

The lessor cannot use the installment method to report any depreciation recapture from the sale. However, it is unlikely that there would be any depreciation recapture from the sale of real property.

In most cases the lessor in a lease option qualifies for I.R.C. § 1231 treatment of gain or loss realized from the sale of the leased property because it is rental property. In that case the lessee carries the installment gain calculated on Form 6252 to line 4 of Form 4797. If the lessor elects out of installment reporting of gain or realizes a loss on the deemed installment sale, the lessor reports the sale on line 2 of Form 4797.

If the lessor is a dealer in real estate and the leased property was held for sale in the ordinary course of his or her business, the gain or loss is ordinary gain or loss, and the lessor must report all of the gain or loss on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), in the year the lease option was executed.



Practitioner Note

Capital Gain or Loss

It is possible that the lessor held the property as an investment and the lease did not convert it to rental property because it was just a means of covering the carrying costs while trying to sell it after the investment use. In that case the gain or loss on the deemed installment sale is a capital gain or loss reported on Schedule D (Form 1040), Capital Gains and Losses.

Similarly, it is possible that the lessor used the property as a personal residence and the lease did not convert it to rental property. In that case the gain or loss on the deemed installment sale is a capital gain or loss. However, the lessor's gain may qualify for the exclusion of gain from sale of a personal residence under I.R.C. § 121, and a loss is a nondeductible personal loss.

The lessor reports the imputed-interest portion of the lease payments as ordinary income.

Reporting Lessee's Installment Purchase

If the lease option is recharacterized as an installment sale, the lessee has all of the tax consequences of an installment purchase of property. The installment purchase price is the lessee's basis in the property, which can be depreciated if the lessee uses the property in a business or as rental property. The lessee can deduct the imputed interest as a business expense on Schedule C (Form 1040), Schedule E (Form 1040), or Schedule A (Form 1040) if he or she uses the property in a business, as rental property, or as a primary or secondary residence, respectively.

ISSUE 9: CROWDFUNDING

The income tax consequences for contributors and recipients of crowdfunding depends on the purpose for the fundraising.

Crowdfunding websites provide a platform for people to raise money for personal expenses, business expenses, and charitable endeavors. Websites such as GoFundMe, Indiegogo, and Kickstarter help raise money to pay large medical bills, attend school, or start a business. They also help raise funds for unique projects, such as translating Moby Dick into emoji characters and making soap that smells like bacon. Family members, friends, and total strangers provide the funding.

There are over 600 websites that offer crowdfunding. An individual, business, or charity sets up an online fundraising campaign based around a fundraising page and accepts money directly from that page using the website's payment processor. The website takes a share of the receipts and may charge a setup fee, a monthly fee, and fees for accepting credit card payments. Tax consequences to the contributor and the recipient vary depending on the type of crowdfunding and the use of the funds.

In a contribution to the Forbes website on June 9, 2015 ("Trends Show Crowdfunding to Surpass VC in 2016"), Chance Barnett reported that in 2010, crowdfunding raised \$880 million. In 2014, it raised \$16 billion, and it was expected to raise \$34 billion in 2015.

Types of Crowdfunding

The following are the four most common types of crowdfunding:

- Donation-based funding is typically used for personal or charitable purposes. People make contributions because the cause appeals to them, and they do not expect anything in return.
- Rewards-based funding can be used for personal, charitable, or business purposes. The rewards may have little or no intrinsic value, such as a thank-you note from the recipient or a sample of a product resulting from the funding, or the reward may be close in value to the amount of the contribution.

The reward may be in the form of goods or services.

- Equity funding allows investors to provide start-up funding for businesses in exchange for an equity interest in the business. On October 30, 2015, the Securities and Exchange Commission (SEC) adopted final rules under the Jumpstart Our Business Startups Act of 2012 (the Jobs Act), Pub. L. No. 112-106. The rules allow businesses to offer and sell securities via crowdfunding. Potential investors are no longer required to meet the accredited-investor standards (\$1,000,000 in assets, not including a principal residence; or an annual income greater than \$200,000 in the 2 prior years).
- Loan-based funding allows investors to receive interest on their contribution as well as the return of the amount they contributed.

Tax Consequences

In IRS Information Letter 2016-0036 (March 30, 2016), the IRS provides very basic guidance on the treatment of amounts recipients of crowdfunding receive from contributors. It notes that I.R.C. § 61(a) includes all income (from whatever source derived) in gross income. However, Congress provides specific exclusions for certain benefits that it chooses not to tax. Information Letter 2016-0036 summarizes the application of the basic rules to crowdfunding as follows:

Crowdfunding revenues generally are includible in income if they are not 1) loans that must be repaid, 2) capital contributed to an entity in exchange for an equity interest in the entity, or 3) gifts made out of detached generosity and without any "quid pro quo." However, a voluntary transfer without a "quid pro quo" is not necessarily a gift for federal income tax purposes. In addition, crowdfunding revenues must generally

be included in income to the extent they are received for services rendered or are gains from the sale of property.

This section discusses the potential income and gift tax consequences of crowdfunding based on the basic guidance from the IRS. Information Letter 2016-0036 concludes that the income tax consequences of crowdfunding depends on all the facts and circumstance surrounding it and reminds taxpayers that they can request a private letter ruling that applies the law to the taxpayer's particular facts and circumstances.



Practitioner Note

Apply Existing Tax Principles

Because there are no cases or rulings on crowdfunding, practitioners should analyze the facts and circumstances in light of existing tax principles to determine how to report crowdfunding revenue and expenses on a client's tax return.

Donation-Based Funding

If the contributor does not receive anything in return for the contribution, the contribution is likely a gift. There are no tax consequences for the contributor if the gift does not exceed the annual gift tax exclusion (\$14,000 in 2016). The contributor may be entitled to a charitable contribution deduction if the contribution is to a qualified charitable organization, but will not be entitled to a charitable deduction if the contribution is to an individual. There are no tax consequences for the recipient.



Practitioner Note

Lack of Quid Pro Quo

Information Letter 2016-0036 states that "a voluntary transfer without a 'quid pro quo' is not necessarily a gift for federal income tax purposes." It does not indicate how to report a voluntary transfer if it is not a gift.

Example 6.33 Donation-Based Contribution

Bill Baker's 17-year-old son was in a car accident. Bill was out of work and couldn't afford the cost of the medical bills, so Bill set up a GoFundMe

account. Bill posted the information about the account on Facebook, and 350 people contributed. No person contributed more than \$14,000. Bill raised a total of \$20,500. He used \$18,500 to pay the medical expenses, and he used the remaining funds to buy his son a new computer.

The contributors did not receive anything in exchange for their contribution, and the contributions will likely be treated as gifts that qualify for the annual exclusion. The contributors cannot deduct their contributions because the funds went to an individual. If instead the contributors contributed the funds to a qualified public charity that provides services for accident victims and were not specifically earmarked for Bill's son, the contributors could claim a charitable deduction.

The funds were a gift to Bill. He does not owe any tax on the receipt of the funds even though the amount raised exceeded the cost of the medical bills (but see the discussion later regarding information returns). If the crowdfunding is properly characterized as a gift to Bill, then he should be treated as paying the medical expenses and can claim the medical expenses as an itemized deduction.

Reward-Based Funding

If the contributor contributes funds and receives a reward with de minimis value, there are likely no tax consequences to the contributor or the recipient. However, if the value of the reward is more than de minimis, the transaction may be characterized as a sale or a payment for services. The contributor is treated as the buyer, and the recipient is treated as the seller and may have to pay income tax, SE tax, and sales tax on the deemed sale or payment for services.

Example 6.34 Reward-Based Contribution

Mandy Martinez needed help to pay for her college tuition. She is an excellent seamstress and decided to offer a homemade purse to everyone who contributed \$150 or more to her Indiegogo fund. Mandy raised a total of \$16,500, and 50 donors received a purse.

If the value of each purse was \$100, Mandy could argue that she has \$5,000 ($\100×50) of gross income and the remaining \$11,500 ($\$16,500 - \$5,000$) in contributions is a gift. But, arguably, Mandy sold each purse for \$150 because that is

what the contributors paid to receive the reward. In that case, she has \$7,500 ($\150×50) of gross income, and the remaining \$9,000 ($\$16,500 - \$7,500$) in contributions is a gift.

Mandy must report and pay income tax on the gross income (reduced by her expenses to make the purses), and she may have to pay state sales tax. If Mandy's sewing is a hobby, she reports the income on Form 1040, line 21, as miscellaneous income and deducts the expenses (up to the amount of the income) on Schedule A (Form 1040), Itemized Deductions. If Mandy is in the business of making and selling purses for profit, she reports the income and expenses on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), and her profit on Schedule SE (Form 1040), Self-Employment Tax.



Cross-Reference

Trade
or Business

See the discussion of what activities constitute a trade or business on pages 110–118 in the *2015 National Income Tax Workbook*.

Start-Up Costs

If the crowdfunding is to start a new business, the business may have start-up costs or organizational expenses, which must be capitalized [I.R.C. § 195]. The taxpayer can elect to deduct up to \$5,000 in start-up costs. Corporations and partnerships can also deduct up to \$5,000 of organizational costs. The \$5,000 of deductions is reduced by the amount that total start-up or organizational costs exceed \$50,000. Any remaining costs must be amortized over 180 months. Taxpayers deduct start-up expenses in the year the trade or business becomes active, and organizational expenses in the year the partnership or corporation begins business.

Timing of Income

Most crowdfunding campaigns have a funding goal. In a flexible funding campaign, the campaign creator is entitled to funds upon receipt and does not return funds if the campaign does not meet the goal. In a fixed funding campaign, the campaign creator may return contributions to the contributors if the campaign does not meet the

goal. The funds do not vest with the campaign creator, and the creator has not completed any sales until the goal is met. Arguably, in a flexible funding campaign, income should be reported upon receipt, and in a fixed funding campaign, income should be reported when the project is fully funded. However, in a fixed funding campaign, contributions could be characterized as a sale at the time of contribution, and as a refund if the goal is not met and the funds are returned.



Practitioner Note

Sales and
Use Tax

Washington state has issued guidance regarding sales tax on reward-based crowdfunding. In Washington, the minimum contribution amount at each level is considered to be the value of the item or service, and any amounts above the minimum are donations not subject to tax.

Equity Funding

With equity crowdfunding, the funds are contributed in exchange for capital in the company. Usually, there are no immediate tax consequences to the contributor or the recipient. However, the contributor should understand the tax and non-tax consequences of owning an interest in the company.

1. Is the company a corporation, partnership, LLC, or other entity under state law?
2. Is the entity taxed as a C corporation, S corporation, or partnership?
3. Does the contributor have taxable income or deductible losses from the company each year?
4. Will the contributor receive a Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., from the company?
5. Does the contributor have capital gain or loss on the sale of the equity in the company?

Loan Funding

If the recipient promises to repay the contributor with interest, the recipient is a borrower and

the contributor is a lender. The contributor must include interest income in his or her gross income, and the recipient may have an interest deduction if the recipient uses the “loan” for a business or investment purpose.

Information Returns

Third-party service organizations (TPSO) such as PayPal and Amazon collect the contributions from the contributors and transfer the funds to the recipients minus a handling fee. If the TPSO collects more than \$20,000 in a single year for the recipient and there are more than 200 transactions in a single year for a recipient, the TPSO must send Form 1099-K, Payment Card and Third Party Network Transactions, to the recipient and the IRS to report the gross amount the TPSO collected for the recipient (not reduced by the handling fee).

The TPSO in Example 6.33 (gifts) must issue a Form 1099-K, but the TPSO in Example 6.34 (sales) does not have to issue a Form 1099-K because the total transactions did not exceed \$20,000. Issuance of a Form 1099-K does not necessarily indicate taxable income, and nonissuance of a Form 1099-K cannot be relied on to show that there was no taxable income. Because the TPSO in Example 6.33 must issue a Form 1099-K, Bill should file a statement with his income tax return explaining that the amounts reported on the Form 1099-K were gifts and not income.

Example 6.35 Form 1099-K Business Income

Yvonne Yeager has come up with an idea to make people feel better about themselves: a talking mirror that offers encouragement (like the queen uses in the Snow White story). She set up a Kickstarter site, offering a miniature version of the mirror to anyone contributing \$75 and a larger mirror to anyone contributing \$250. She publicized her mirror on Facebook and Twitter and had \$15,000 in gross receipts. She did not receive Form 1099-K, but Yvonne is a sole proprietor in the business of selling mirrors with the intent to make a profit. She must report the \$15,000 and any other sales income on Schedule C (Form 1040).

Example 6.36 Form 1099-K Nonbusiness Income

Ellen Randolph lost her job and was having trouble supporting her five young children. Ellen set up an Indiegogo account to raise funds to support her family. She made a touching video, which went viral. Ellen received a Form 1099-K showing over 4,000 transactions and \$84,350 of receipts.

The contributions were nondeductible gifts to an individual. Each was within the annual exclusion amount, and there are no tax consequences for the contributor or the recipient. However, Ellen received Form 1099-K. Ellen should file a statement with her tax return to explain that the donations were actually gifts, because if she fails to address the income reported to her, she may owe substantial taxes and penalties.

6

ISSUE 10: FANTASY SPORTS Is playing a fantasy sport a hobby, gambling, or a business?

A study conducted by the Fantasy Sports Trade Association (FSTA) in 2016 showed 57,400,000 people in the United States played fantasy sports. Participation has grown over 60% during the past 4 years.

In fantasy football, a fantasy football general manager selects players from a variety of NFL teams. Fantasy league teams receive points based on what happens in the real game. For example, a

touchdown by an NFL player who is listed on the roster of a fantasy team may count as six points for the fantasy team. Participants earn cash and prizes based on their team’s success.

Depending on how those prizes are characterized, taxpayers may have to report prizes as income on their tax return, and may also be able to deduct certain expenses or losses.

Gambling

The Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA) states that participation in any fantasy or simulation sports game is not gambling if it meets the following conditions:

1. The fantasy team is not based on current membership in an actual team.
2. All prizes and awards offered to winning participants are established and made known to the participants in advance of the game or contest.
3. The value of prizes and awards cannot be determined by the number of participants or the amount of any fees paid by those participants.
4. All winning outcomes reflect the relative knowledge and skill of the participants and are determined predominantly by accumulated statistical results of the performance of individuals (athletes, in the case of sports events) in multiple real-world sporting or other events.
5. No winning outcome is based on the score, point spread, or any performance or performances of any single real-world team or any combination of such teams; or solely on any single performance of an individual athlete in any single real-world sporting or other event.

If a fantasy game fails to meet the exception, the prizes or awards are gambling income, and the site sponsor must issue Form W-2G, Certain Gambling Winnings. The recipient reports the income as "Other income" on line 21 of Form 1040, and reports the expenses (to the extent they do not exceed income) on Schedule A (Form 1040), Itemized Deductions, as other miscellaneous itemized deductions not subject to the 2%-of-AGI floor. Under the sessions rule, the recipient can subtract losses from winnings for each session.



Cross-Reference

Sessions

See pages 227–229 of the *2015 National Income Tax Workbook* for a discussion of calculating gambling income using the sessions method.

Example 6.37 Gambling Income

Johnny Jacobs and his friends played fantasy baseball. The amount of the prize was increased by \$100 for each person who paid a \$300 fee to enter the league. Johnny paid a \$300 entry fee and won \$1,000. Johnny has gambling income because the prize was tied to the number of participants in the league. He reports the \$1,000 on line 21 of Form 1040 as gambling income, and he reports the \$300 entry fee on Schedule A (Form 1040) as an other miscellaneous itemized deduction not subject to the 2%-of-AGI floor.



Practitioner Note

Daily Fantasy Sports

A growing list of websites offer the opportunity to play daily fantasy sports (DFS), which are a subset of fantasy sports games. The games take place over short-term periods, instead of a whole season. Many states have laws against online gambling, and state law may specifically include DFS or other fantasy sports games in the definition of gambling.

Hobby or Business

For federal purposes, fantasy sports games are not gambling if they meet the UIGEA exception requirements. Winnings that are not gambling must be characterized as either hobby or business income based on the nine factors in Treas. Reg. § 1.183-2(b). The IRS will consider the following:

1. The manner in which the taxpayer carried on the activity
2. The expertise of the taxpayer and his or her advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that the assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or loss with respect to the activity

7. The amount of occasional profits, if any, that are earned
8. The financial status of the taxpayer
9. Elements of personal pleasure or recreation

For most fantasy players, fantasy sports are a hobby conducted for personal pleasure or recreation. The players make no effort to maintain books and records, have no assets to appreciate, and do not attempt to make a profit. The taxpayer reports hobby income on line 21 of Form 1040, and reports associated expenses as miscellaneous itemized deductions subject to the 2%-of-AGI floor. Hobby expenses are limited to the amount of hobby income.

Some participants in fantasy sports have a profit motive and devote significant amounts of time and expertise to their fantasy sports games. If the fantasy sports player is engaged in the business of playing fantasy sports, the player can deduct expenses in excess of income, and losses offset other income. Unless the player forms a separate entity, the business income or loss is reported on Schedule C (Form 1040), Profit or Loss From a Business (Sole Proprietorship), and the player must pay self-employment (SE) tax on any profit.

Example 6.38 Profit Motive

Johnny Jacobs decided to get serious about his passion for fantasy sports. In 2015, he quit his regular job and spent a great deal of time creating an algorithm to predict players' performances. He withdrew \$10,000 from his IRA to use as entry fees for tournaments. His CPA gave him free advice on bookkeeping and business planning. Johnny made a \$3,000 profit in 2015, and in 2016, he had an \$8,000 profit from tournament play. Johnny likely has a profit motive and is participating in fantasy sports as a business.

Information Reporting

Companies that operate fantasy sports sites have an obligation to report earnings of \$600 or more to the IRS and to the individual player. Ltr. Rul. 2005-32-025 (May 3, 2005) addresses how to report amounts paid to online tournament participants playing mah-jongg, checkers, and other such games. The site sponsor must report the winnings on Form 1099-MISC, Miscellaneous Income. The Form 1099-MISC instructions tell taxpayers to report prizes and awards in box 3.

The private letter ruling reviews three methods to report the winnings and directs the taxpayer to use the *net method*. The net method requires the site sponsor to add the gross amounts credited to a player's account during a year. The site sponsor subtracts the entry fee for each tournament in which the player received a prize because the prize is a return of capital to the extent of the entry fee for that tournament. The site sponsor does not subtract the entry fee for tournaments in which the player did not win a prize because there are no winnings associated with the fee. Although it is possible that players can deduct fees for tournaments that resulted in no prize on their individual returns, there is no authority that allows the site sponsor to take a deduction on behalf of a player by reporting the net amount to the IRS.

The letter ruling directs the site sponsor to report the net amount on Form 1099-MISC if the net method results in \$600 or more for a player.



Practitioner Note Recordkeeping

Many of the fantasy sports sites use the cumulative net method, under which the sponsor adds the gross amounts credited to a player's account during a year and subtracts all entry fees paid during the year, whether or not the player received a prize from the tournament. And, players may not be able to ascertain the method of calculation used by a particular site. Therefore, fantasy sports players must maintain independent records, and tax practitioners should inquire about all fantasy sports income and expenses, even if the taxpayer did not receive a Form 1099-MISC.

**Example 6.39 Form 1099-MISC
Information—Net Method**

Johnny Jacobs plays fantasy football through one website. In 2016, he entered five tournaments with the following results:

1. Entry fee \$100, no wins
2. Entry fee \$250, won \$3,000
3. Entry fee \$100, won \$50
4. Entry fee \$150, won \$500
5. Entry fee \$1,000, no wins

Using the net method, the site sponsor reports \$3,050 $[(\$3,000 - \$250) + (\$50 - \$100) + (\$500 - \$150)]$ to Johnny on Form 1099-MISC (the net of tournaments 2, 3, and 4). Johnny may be able to deduct the \$1,100 $(\$100 + \$1,000)$ entry fees for tournaments 1 and 5 on Schedule A (Form 1040) as an other miscellaneous itemized deduction.
