Fall 1991

Accountant's Business Manual: Fall Tax Supplement 1991

William H. Behrenfeld

Andrew R. Biebl

Accountant's Business Manual

FALL TAX SUPPLEMENT 1991

- Employment Regulations
- Workers' Compensation
- Unemployment Insurance
- Social Security
- Current-Year Cases and Rulings
- Important 1991–92 Tax Planning and Compliance Issues

NEW ...
1992 *Tax Planning Information Inside*

FALL TAX SUPPLEMENT 1991
Accountant's Business Manual
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Accountant's Business Manual

FALL TAX SUPPLEMENT 1991

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PREFACE TO THE FALL TAX SUPPLEMENT 1991

Each year we have reviewed the many subscriber response pages and crafted additions to or adjustments in the manual that readers have suggested. Overwhelmingly, readers have asked for more topical detail and more tax information. The one-volume format of the looseleaf clearly could not contain more pages to support these requests.

With this stand-alone paperback Supplement, we have addressed the looseleaf space difficulties and made a highly practical change in the *Accountant's Business Manual.* The paperback format allows us to provide over 200 pages of new tax information in two new chapters:

- Current-Year Cases and Rulings
- Important 1991–92 Tax Planning and Compliance Issues

The four payroll tax chapters have been removed from the looseleaf and now are completely updated in the paperback:

- Employment Regulations
- Workers' Compensation
- Unemployment Insurance
- Social Security

Remember to remove the guide-cards and text pages of these chapters from your *Accountant's Business Manual* looseleaf.

As tax practitioners ourselves, we are well aware of the challenges for the months ahead and the difficulties in keeping abreast of the flurry of IRS pronouncements throughout the year. We are hopeful that the reports and analyses in this Fall Supplement will be of value in your practice and will confirm your confidence in the *Accountant's Business Manual.*

We think the paperback Supplement has another important bonus: Each Fall, you'll receive a new volume, saving you the time required to file chapter updates.

Our thanks go to Robert J. Ranweiler, CPA, and Albert L. Grasso, LLM, for their assistance in compiling the tax information, which is adapted from the CPE Seminar "Mastering the 1992 Tax Season—An Annual Update," presented by the AICPA Continuing Professional Education Division.

W.H.B.
A.R.B.

December 1991

TABLE OF CONTENTS

SOCIAL SECURITY

CURRENT-YEAR CASES AND RULINGS

CUT ALONG DOTTED LINE

Dear Subscriber:

The *Accountant's Business Manual* is intended to be a practical, efficient, up-to-date desk reference for use by professional accountants and business advisors. Semi-annual supplements will be issued to keep the *Manual* abreast of current developments. However, we believe the *Manual* should also be responsive to user needs, with updates containing additional materials identified by readers. Thus, we would appreciate your taking a few minutes to tell us what you think of the *Manual* and how it can better serve your purposes. Please use the reverse of this form as necessary.

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EMPLOYMENT REGULATIONS

EMPLOYMENT REGULATIONS

1. INTRODUCTION

Employment is regulated by the federal government, by state and local governments, by collective bargaining agreements, and by written or oral employment contracts. This chapter covers wages and hours, labor relations, discrimination issues, and certain post-employment issues. Occupational health and safety is covered in the chapter on workers' compensation, and employee benefits and U.S. immigration laws are also covered in other chapters of the manual.

These employment regulations exist to protect employees with regard to such items as wages and hours, unlawful discrimination, and hiring policies.

2. SOURCES

Employment regulation stems from several sources. Federal statutes, state statutes, local ordinances, collective bargaining agreements, common law, and private employment contracts all interact to govern the employer/employee relationship.

Even though federal statutes may not exist in a given area, state and local statutes, along with collective bargaining agreements, should be closely reviewed for possible applicability.

2.1 Federal Statutes and Regulations

The federal government draws its authority to regulate employment from such laws as the Fair Labor Standards Act (FLSA), the Civil Rights Act of 1964 (specifically Title VII), the Age Discrimination in Employment Act of 1967, the 1974 Employee Retirement Income Security Act (ERISA), the 1986 Comprehensive Budget Reconciliation Act (COBRA), the Immigration and Naturalization Act of 1986, and the National Labor Relations Act.

The agencies authorized by Congress to regulate in this area are

— The Department of Labor (DOL).

— The Equal Employment Opportunity Commission (EEOC).

— The National Labor Relations Board (NLRB).

2.2 State and Local Statutes and Regulations

States and local governments may regulate in areas that have not been preempted by Congress. This means states and local governments may and do regulate in areas not regulated by Congress or where Congress does not expressly or by implication prevent it.

Sources of state regulation can be found in state statutes and administrative rules and regulations. This chapter summarizes *sources* of information on each state and describes general circumstances in states because it would not be practical to cover each state in detail. A listing of the state labor agencies is found at the end of this chapter; to obtain more specific statutory and regulatory information, apply to these sources.

2.3 Common Law

Because many areas of employment law have been heavily contested, both federal and state statutory laws have been interpreted and modified by the courts. Also, labor and payroll management guides such as those published by Commerce Clearing House and Prentice-Hall provide detailed state-by-state information as well (see references to the chapter). Under our common-law system, court-made law is another source of regulation.

2.4 Collective Bargaining Agreements

Collective bargaining agreements, when negotiated, provide a source of regulation for the specific employment relationship mandated by the agreement. Such agreements are valid and enforceable, assuming their provisions are legal and reasonable.

2.5 Written Employment Agreements

Where written employment agreements exist, they are a source of regulation for the specific employment relationships covered by the agreements. As long as the agreements are not illegal or unconscionable, they are valid and enforceable.

3. DEFINITIONS

The following definitions apply throughout this chapter. Different statutes tend to define the terms differently, so the terms must be considered in relation to specific statutes.

Employee. Any individual who performs services at the direction and control of an employer, both as to what shall be done and how it shall be done. An employer has the right to hire and fire an employee and also furnishes the tools and a place to work.

Independent contractor. Persons in business for themselves who are not under the direct supervision of another employee.

Workweek. A fixed and regular recurring period of 168 hours—seven consecutive 24-hour periods—that may start on any day of the week. Some collective bargaining agreements define a workweek to be less than seven days.

Holiday. A day customarily observed in the community in celebration of some historical or religious occasion.

Pay period. Period of service for which a payment of wages is ordinarily made to an employee. Each state governs the length of pay periods.

Vacation. A period of rest from work normally for a specific time frame, normally enjoyed with recreational activities.

Leave. A period for which permission to be absent from work has been granted.

3.1 Independent Contractor or Employee

An employer who erroneously categorizes an employee as an independent contractor may be liable for failure to pay unemployment insurance contributions, minimum wages, overtime, or social security, and for failure to withhold income tax. Additionally, employees who have been erroneously classified as independent contractors are covered by the National Labor Relations Act, and, if they are wrongfully discharged, the employer may be held liable for reinstatement of the discharged employee with back pay and restoration of lost benefits.

Statutes, such as the National Labor Relations Act and the Fair Labor Standards Act, do not provide a uniform definition of *independent contractor*. Various administrative agencies and the courts have not formulated one uniform definition, but instead look at the specific facts of each case and the purpose of each law in determining whether a worker is an independent contractor. Because of this, an individual who is considered an independent contractor, for purposes of unemployment insurance, may be determined to be an employee under the Fair Labor Standards Act.

Under common law, an employer-employee relationship generally is determined to exist when an employer has the right to control and direct the worker, not only in terms of what needs to be accomplished but also with respect to details and the means by which the result is accomplished. Stated differently, an employee is subject to the will and control of the employer not only in regard to what shall be done, but also *how* it shall be done. As long as the employer has the right to direct and control the manner in which the services are performed, an employer-employee relationship is deemed to exist.

Historically, the courts have also looked at other factors beyond the single determinative issue of control. The courts have found that other major factors that characterize an employer-employee relationship include the fact that the individual has the same wages, hours, or working conditions as other employees, and that the individual is subject to the same personnel policies as other employees, or that the employer furnishes the employee with tools or a place to work as he or she similarly furnishes to other employees.

Conversely, if a person exercises control or direction merely with respect to what is to be accomplished and not to the means and methods for accomplishing the result, an individual working with that person is normally deemed to be an independent contractor. Examples include construction contractors, lawyers and accountants engaged in the pursuit of an independent trade or business, and other similar professional trades or businesses.

An individual's status is determined on a case-by-case basis, and requires an examination of all the factors surrounding a particular working relationship. For the most part, the courts have looked at the "right to control," both in terms of the result to be accomplished and the manner and means by which the result is achieved.

The following is a list of factors bearing on the "right to control" that should be considered when determining the employment status of an individual:

— Generally, an individual is an employee if required to follow instructions, oral or written, regarding where, when and how the work is to be completed.

— If an individual is trained by an employee, that individual is ordinarily also considered an employee.

— If an individual's services to a business have a direct bearing to the success or continuation of that business, that individual normally is subject to a certain amount of control, indicating that the individual is an employee.

— If an employer is concerned with not only how well a job is completed but who completes the job, the services are considered personal, which thereby indicates that the individual performing the services is an employee.

— If an employer makes payments to, supervises and hires individuals, it is generally considered that the individuals are employees. However, if one individual pays, hires, and supervises other individuals under a contract to provide labor and materials, the supervisor normally would be considered an independent contractor, not an employee.

— An employer-employee relationship exists if a continuing relationship is established between the employer and the individual performing the services.

— If an employer sets hours of work, an employer-employee relationship normally exists.

— If an individual does not engage in other work, but devotes full time to the business, that individual would normally be considered an employee.

— If an individual performs work on the employer's premises that could be performed elsewhere, the individual is normally considered an employee. The fact that the individual is on the employer's premises implies that the employer controls the direction and supervision of the work.

— If an individual's work must be completed in a certain sequence, the employer is establishing control and therefore the individual is considered an employee.

— If an individual is required to submit reports to the employer, the individual is normally considered an employee.

— Independent contractors are normally paid by the job, whereas employees are normally paid by the hour, week or month.

— An independent contractor normally is not reimbursed for business and traveling expenses, whereas an employee is normally reimbursed by the employer for such expenses.

— Employees normally are furnished tools and materials by the employer, whereas an independent contractor normally must furnish these items himself or herself.

— An individual who must provide facilities for the performance of work is normally considered an independent contractor. For example, independent contractors often must provide their own premises for work, clothing, and other instruments.

— An employee normally is not in a position to realize a profit or loss, whereas an independent contractor may realize a profit or loss as a result of work.

— An individual who holds out services to the general public is generally considered an independent contractor.

— If an employer has the right to discharge an individual, that individual is normally considered an employee. An independent contractor normally cannot be discharged as long as the contract is fulfilled.

— If an individual has the right to terminate work efforts, that individual normally is considered an employee. An independent contractor must complete the contract before terminating the relationship.

4. FEDERAL WAGE AND HOUR REQUIREMENTS

4.1 Covered vs. Exempt Employees

All employees of certain enterprises having workers engaged in interstate commerce, producing goods for interstate commerce, or handling, selling, or otherwise working on goods or materials that have been moved in or produced for such commerce by any person are covered by the FLSA.

A covered enterprise is the group of related activities performed through unified operation or common control by any person or persons for a common business purpose and is

— Composed exclusively of one or more retail or service establishments (as defined in the FLSA) whose annual gross volume of sales or business is not less than $500,000.

— Any other type of enterprise having an annual gross volume of sales or business of not less than $250,000.

— Engaged in the operation of a hospital; an institution primarily engaged in the care of the sick, the aged, the mentally ill or defective who reside on the premises; a school for mentally or physcially handicapped or gifted children; a preschool, elementary or secondary school; or an institution of higher education (regardless of whether or not such hospital, institution, or school is public or private or operated for profit or not-for-profit).

— Engaged in the business of construction or reconstruction.

— Engaged in laundering or cleaning of clothing or fabrics.

Some employees are specifically exempted from the requirements of the Fair Labor Standards Act. As a basic rule, bona fide executive, administrative, and professional employees (including academic administrative personnel and teachers) and outside salespeople are exempt from the minimum wage and overtime requirements if they meet the tests set forth for each category.

Whether employees are exempt depends on

— Their duties and responsibilities.

— The salary paid (except in the case of doctors, lawyers, teachers, and outside salespeople).

The following partial lists represent employees who are fully or partially exempt from minimum wage, equal pay, and overtime pay requirements of the FLSA. A complete listing can be found in payroll management guides such as those published by Commerce Clearing House (CCH) and Prentice-Hall (see references to the chapter).

— Fully exempt from minimum wage, equal pay, and overtime pay:

Executive, administrative, or professional employees, including teachers, who meet minimum salary levels
Outside salespersons
Employees of amusement or recreational establishments that have seasonal peaks
Agricultural employees (see a payroll guide for details)

— Fully exempt from only the overtime requirements:

Employees of motor carriers subject to regulation by the secretary of transportation
Seamen
Agricultural employees
Taxicab drivers
Household domestic employees

— Partially exempt from overtime pay requirements:

Commissioned employees of retail or service establishments
Private hospital employees
Employees of hotels, motels, or restaurants

4.2 Minimum Wage Requirements

The minimum wage (federal) for agricultural and nonagricultural employees increased from $3.80 to $4.25 per hour on April 1, 1991. State law also covers minimum wage and overtime provisions. The FLSA prevails over less beneficial state laws where both cover the same employees. Where requirements fixed by state law are higher than those under the FLSA, state law prevails.

For individuals from the ages of sixteen through nineteen entering the labor market for the first time, a training wage of 85 percent of the minimum wage or $3.35 per hour (whichever is greater) is in effect until April 1, 1993. The training wage can be paid for ninety days. A second employer may hire the employee at the same wage for an additional ninety days if the employer receives a certificate of employment for that employee from the secretary of labor. In no event can the training wage be paid to one individual for more than 180 days total. A complete list of requirements and rules can be found in payroll management guides such as those published by Commerce Clearing House (CCH) or Prentice-Hall (see References section of this chapter).

Employees can be paid on an hourly, salary, monthly, piecework, or any other basis as long as the minimum hourly requirement is met. Calculations and requirements of the minimum hourly rate are as follows:

— A week in which the minimum rate is underpaid cannot be averaged with a week in which it is overpaid to satisfy the minimum requirement.

— Employees hired solely on the hourly rate *must* be paid at least the minimum rate.

— A fixed weekly salary divided by the number of hours worked must equal or exceed the minimum rate.

— Fixed monthly salaries can be converted into a weekly equivalent by multiplying the monthly salary by 12, then dividing by 52.

— Wages paid on a piece-rate basis meet the minimum requirements if the average hourly earnings for the workweek equal or exceed the minimum rate.

4.3 Overtime Pay

Generally, overtime pay must be paid on hours over forty worked in a workweek. The overtime pay must be one and one-half times the employee's regular hourly rate. The *regular hourly rate* is normally defined to be the average rate paid for hours worked during the week. It is the employee's total weekly compensation, less exclusions provided for in the FLSA, divided by total weekly hours worked. Calculations and requirements on overtime pay are these:

— The overtime pay is figured on a workweek basis whether the employee is paid on a daily, weekly, biweekly, monthly, or piecework basis.

— Each workweek stands alone. Overtime worked in one week may not be offset against nonovertime hours worked in another week.
— The FLSA contains no provision that requires the employer to pay an employee overtime for hours worked in excess of eight hours per day or for work on holidays, Saturdays, or Sundays, although some state and local statutes contain such provisions.
— An employer's order prohibiting overtime does not relieve the employer of the responsibility to pay overtime, if the employee is permitted to work.
— Overtime does not need to be paid weekly. It can be paid on the normal payday.

4.3.1 Overtime computations

Following are examples of computing overtime.

Hourly rate (regular pay rate for an employee paid by the hour). If more than forty hours are worked, at least one and one-half times the regular rate for each hour over forty is due, where regular rate is defined per paragraph one of section 4.3, above.

Example. An employee paid $4.25 an hour works 44 hours in a workweek. The employee is entitled to at least one and one-half times $4.25, or $6.38, for each hour over forty. Pay for the week would be $170 for the first forty hours, plus $25.52 for the four hours of overtime—a total of $195.52.

Piece rate. The regular rate of pay for an employee paid on a piecework basis is obtained by dividing the total weekly earnings by the total number of hours worked in the same week. The employee is entitled to an additional one-half times this regular rate for each hour over forty besides the full piecework earnings.

Example. An employee paid on a piecework basis works forty-five hours in a week and earns $191.25. The regular pay rate for this week is $191.25 divided by forty-five, or $4.25 an hour. In addition to the straight-time pay, the employee is entitled to $2.13 (one-half the regular rate) for each hour over forty.

Time and a half. Another way to compensate a pieceworker for overtime, if agreed to before the work is performed, is to pay one and one-half times the piece rate for each piece produced during overtime hours. The piece rate must then be the one actually paid during non-overtime hours and must be enough to yield at least the minimum wage per hour.

4.4 Amounts Treated as Wages for Agricultural Employees

Although most agricultural labor is considered covered employment under the Federal Insurance Contribution Act (FICA), only cash payments constitute wages for purposes of the FICA and only if the cash remuneration paid during the year is $150 or more per employee or the employer's total payroll is $2,500 or more (cash wages only) for the year and any cash wages were paid.

Cash includes checks and other monetary forms of exchange, but it does not include noncash items such as lodging, food, clothing, or payment of other goods or commodities. Noncash payments for agricultural employees are not subject to FICA, federal, or state tax withholding or unemployment taxes.

4.5 Tipped Employees

Effective April 1, 1991, wages paid to a tipped employee are deemed to be increased by up to 50 percent of the applicable statutory minimum wage rate and not more than the actual tips received by the employee. In paying the wages of a tipped employee, the employer is allowed to credit up to 50 percent of the employee's statutory minimum wage as coming from tips. Each state sets its own maximum tip credit.

> *Example.* Assume the statutory minimum wage is $4.25. The employer is allowed to pay a tipped employee $2.12 per hour (4.25 − (4.25 × .50)) provided that the employee actually received tips equal to or in excess of the tip credit.

To qualify as a tipped employee, the employee must be engaged in an occupation in which it is customary to receive more than $30 per month in tips.

4.6 Holiday Pay

Employers are not required by the FLSA to pay employees who do not work holidays or to pay at a premium rate for those who do work on holidays.

4.7 Vacation and Sick Pay

Employers are not required by the FLSA to give employees vacations, paid or otherwise, or to pay sick pay.

4.8 Rest Periods and Coffee Breaks

The FLSA does not require that employees be given rest or meal periods or coffee breaks. However, if rest periods and coffee breaks are given, governmental enforcement agents require them to be counted as hours worked if they last twenty minutes or less.

4.9 Child Labor Laws

The FLSA child labor provisions protect children who are employed. The provisions protect the educational opportunities of minors and prohibit their employment in jobs under conditions detrimental to their health or well-being. The Secretary of Labor provides lists of hazardous occupations for both farm and nonfarm jobs, in which minors below specified ages may not be employed.

Regulations governing youth employment in farm versus nonfarm jobs differ somewhat. A complete list of ages and acceptable work may be obtained by contacting

U.S. Department of Labor
Employment Standards Administration
Wage and Hour Division

Minors of any age may be employed by their parents at any time in any occupation on a farm owned and operated by their parents, although many state statutes exist to provide more restrictive regulations. Such state statutes should be referred to for specifics.

4.10 Employer's Records

Every employer subject to the provisions of the FLSA must maintain records on its employees and their wages, hours, and pay. This is true even with respect to exempt employees in determining whether the conditions for exemption are satisfied.

4.10.1 Employee information

The records for each covered employee must include the following:

— Full name

— Home address

— Date of birth if employee is younger than nineteen

— Sex and occupation

— Time and day on which the employee's workweek begins
— Regular hourly pay rate, the basis on which wages are paid, and regular rate exclusions
— Hours worked each workday and each workweek
— Total daily or weekly straight-time wages
— Total overtime excess compensation for the workweek
— Total additions to or deductions from wages paid each pay period
— Total wages paid each pay period
— Date of payment and the pay period covered
— Retroactive wage payment under government supervision
— The basis for payment of any wages differential to employees of the opposite sex in the same establishment

4.10.2 Form W-4

Employers are required to retain on file for each employee Form W-4, Employee's Withholding Allowance Certificate. The information on this form is used to determine the amount of income tax withholding per payroll for the employee. If an employee claims more than ten exemptions, the employer is required to send a copy of the form to the Internal Revenue Service along with the next Form 941, Employers Quarterly Federal Tax Return, filed.

4.10.3 Form I-9

Employers are required to retain on file a completed Form I-9, Employment Eligibility Verification, for all employees hired after November 7, 1986. Form I-9 was developed for verifying that persons are eligible to work in the United States. Form I-9 does not need to be filed with any authorities.

4.10.4 Statement of deductions

Some states require that employees be given a statement of deductions for each wage payment. Other states require that such information be given employees at stipulated intervals. A complete list of requirements by state can be found in a payroll managment guide such as those published by Commerce Clearing House (CCH) or Prentice-Hall (see references to this chapter).

4.10.5 Form of records and their retention

There are no specific guidelines as to the particular form that the employer's records must follow. However, the records will be considered inadequate if the specified information must be computed from scattered, unrelated, or illegible sources.

Most of the employer's records on an employee's wages and hours must be retained for three years, although it is recommended that retention be for a longer period, normally five years. There is significant disagreement about the length of time to retain records beyond that required by law.

4.10.6 Timing of wage payments

Each state governs the required frequency with which wage payments must be made. A payroll management guide such as those published by Commerce Clearing House or Prentice-Hall contains details (see references to this chapter).

4.11 Penalties

Any person found to willfully violate the Fair Labor Standards Act may be subject to a fine up to $10,000 or imprisonment up to six months.

Employers may be subject to civil liability to employees of unpaid minimum wages or overtime pay plus an equal amount as liquidated damages as well as attorneys' fees and costs, if a willful violation occurs.

If an employer is found to have discriminated against an employee for filing a complaint under this statute, the employer may also be subject to additional liability to that employee as a court may deem appropriate.

4.12 Payroll Deductions

Payroll deductions fall into seven categories:

1. Deductions to cover the cost of furnishing board, lodging, and other facilities to employees.
2. Deductions for other items such as tools and uniforms that are not regarded as facilities.
3. Social security tax and other deductions required by law.
4. Reductions in a fixed salary paid for a fixed workweek in weeks when the employee fails to work the full schedule.
5. Deductions for disciplinary reasons.
6. Garnishment. If an employer is required under court order to make payment to an employee's creditor, the payments are equivalent to payment to the employee. The amount withheld from a wage payment may not exceed restrictions imposed by the federal garnishment law. The wage garnishment law also prohibits the firing of an employee whose pay is garnished for the payment of a single debt.

7. Other deductions authorized by the employee in writing and permitted by law, such as union dues.

4.13 Handicapped Workers

Special reduced minimum wage rates are allowed under the FLSA for people whose earning capability is impaired due to age, physical or mental deficiency, or injury. A certificate authorizing employment at a lower rate must be obtained from the authorized regional representative of the federal wage and hour division. The following rules apply to these certificates:

— Applications must be made on an official form signed by the handicapped worker and the employer.

— Certificates remain in effect no longer than twelve months.

— Applications for renewal will be reviewed by the administrator's representative.

— Descriptions of alleged handicaps must be detailed.

— A medical certificate is required when the handicap is not clearly obvious.

— The disability must be a specific handicap to the proposed employment.

4.14 Termination

4.14.1 Termination pay

Dismissal payments and severance pay are any payments made by an employer on account of the involuntary separation of an employee from the service of the employer. These payments are subject to FICA, income tax withholding, and unemployment tax.

4.14.2 Final wage payment

Each state governs the time within which a final wage payment must be made to a terminated employee.

4.14.3 Form W-2

Upon termination, employees may request that their Form W-2 be issued to them. The employer is required to furnish the form within thirty days of the request or final payment of wages, whichever is later.

4.15 Leaves of Absence

4.15.1 Time off to vote

Many states have laws that allow employees to take time off to vote. Although state laws vary, a general pattern exists. Ordinarily, an employee who is entitled to vote may leave work for a specified time without penalty or deduction from wages. The employer designates the length of the absence, although minimum time periods may be imposed by state law.

4.15.2 Military leave

The FLSA does not provide specific guidelines with regard to payment of wages during military leave. If an employee is on temporary leave from the job to serve in a state National Guard unit and the employer pays the employee the difference between the regular salary and the amount received from the state, the difference is considered wages and is subject to withholding.

4.15.3 Disability leave

The FLSA does not specify guidelines regarding disability leave. Company policy governs the length of any disability leave and other specifications. Many companies address disability leaves through funding provided by short-term and long-term disability insurance programs.

Federal statute specifies that sex discrimination includes discrimination on the basis of pregnancy, and that pregnant workers must be treated similarly to employees affected by other medical conditions. Pregnant workers have a qualified right to reinstatement of employment, and equal employment opportunity assures that pregnant workers will not lose their jobs on account of pregnancy. Many states guarantee pregnant women a certain number of pregnancy disability leaves in a manner similar to other disability leaves.

4.15.4 Jury leave

Under the Jury System Improvement Act of 1978 employers are prohibited from discharging, threatening to discharge, intimidating, or coercing any permanent employee as a result of that employee's jury duty service.

Employers who violate this act

— Are liable for lost wages due to the employee.

— May be forced to provide other appropriate relief such as reinstatement of an employee discharged because of the employee's jury leave.

— Are subject to a civil penalty of up to $1,000 for each violation to each employee.

4.15.5 Parental leave

The FSLA does not specify guidelines regarding parental leave. Many companies now offer a parental leave, to either parent, after the birth of a child and subject to approval of the company.

4.16 Family Employment

The employment of family members is subject to special rules.

Income tax withholding. No statutory exclusion is granted from the withholding of income tax from wages paid between family members. Effective January 1, 1990, all agricultural wages subject to Social Security withholding are subject to federal income tax withholding whether paid to family or nonfamily members.

FICA tax. Certain types of family employment are excluded from the withholding of FICA tax:

— Work performed by a child under eighteen years of age employed by a parent. This exemption ceases on the child's eighteenth birthday. (See section 7.4 of the Social Security chapter.)

The family service exception does not apply to work performed for a corporation where services are being performed by a child. The same is generally true for partnerships.

Federal unemployment tax. Services performed by an individual for a child or spouse and services performed by a child under the age of twenty-one in the employ of a parent are not subject to federal unemployment tax. (See section 3.8 of the Unemployment Insurance chapter.)

Special reduced minimum wage. Services performed by a minor under special certification during the school year in the health care industry may qualify for a reduced minimum wage.

5. DISCRIMINATION

5.1 Definition

Employment discrimination is the failure to apply similar terms and conditions of employment to all persons equally where no reasonable distinction can be found between those favored and those not favored.

5.2 Federal Legislation

Federal statutes prohibit discrimination in employment against those individuals who belong to a protected class: race, color, religion, sex, national origin, or age. For government contractors, discrimination is also prohibited for physical and mental handicap and against veterans.

5.2.1 Prohibited actions

These statutes specifically prohibit discrimination against any member of a protected class in any aspect of employment, including hiring, promotion, compensation, employee benefits, and termination. They also cover limiting, segregating, or classifying employees or applicants for employment in any manner that would deprive or tend to deprive any member of a protected class of employment opportunities or otherwise adversely affect that individual's employment status.

Employees who feel they have been discriminated against can obtain relief under provisions of the federal Equal Employment Opportunity Act and various state and local statutes.

5.2.2 Sexual harassment

Title VII of the Civil Rights Act of 1964, as well as state and local antidiscrimination laws, prohibit sexual harassment on the job. Sexual advances, verbal and physical, are considered sexual harassment when

— Submission to the advance is made either explicitly or implicitly a term of employment.

— Submission to or rejection of the advance is used as a basis for employment decisions.

— The advances substantially interfere with the individual's work performance or make the working environment intimidating, hostile, or offensive.

Penalties include injunctive relief, reinstatement or rehiring (with or without back pay), or any other equitable relief a court deems appropriate (including attorneys' fees).

5.2.3 Employer's obligations

An employer should have a policy stating clearly and concisely that discrimination and sexual harassment in the workplace is prohibited. In conjunction with these policies, there should also be a mechanism in place that will promptly and effectively permit an employee to raise a complaint with responsible management and require management to investigate and respond to complaints about discrimination and sexual harassment.

Two primary reasons employers should have both a policy and a procedure are that

— Complaints may be resolved before expensive governmental investigation and litigation.

— Employers may not be subject to liability if an employee does establish discrimination in the workplace, but failed to report it.

5.3 Age Discrimination in Employment Act (ADEA)

Employers are prohibited from discriminating against any individual because of that individual's age. Since the coverage of this law is under the Commerce Clause of the U.S. Constitution, only employers who are engaged in an industry in interstate commerce are affected. The purpose of the age discrimination law is to encourage the hiring of individuals based on ability rather than age. Many states also have statutes prohibiting discrimination based on age.

Employer coverage. Employers covered by ADEA must

— Be engaged in industry affecting commerce.

— Employ twenty or more workers for each working day in each of twenty or more weeks in the current or preceding calendar year.

Employee coverage. Generally, the age discrimination law covers employees over forty years of age.

Enforcement. The Age Discrimination Employment Act is enforced under the Fair Labor Standards Act by the Equal Employment Opportunity Commission (EEOC). Enforcement is obtained through individual employee suits and collective actions by employees.

5.4 State Antidiscrimination Laws

Appendixes at the end of this chapter summarize the respective state agencies in the area of civil rights and equal employment opportunity.

5.5 Comparable Worth

The Equal Pay Act of 1963 requires that workers receive equal pay for similar jobs, regardless of the sex of the individual employed. The objective is to prevent wage discrimination in the workplace based on gender.

Comparable worth addresses the difference in compensation that cannot be accounted for except by the individual's sex. Wages should be based on the worth of the work, not on the sex of the person doing the work. To conform to comparable-worth guidelines, major studies are frequently required to determine the worth of work.

5.6 Affirmative Action

Affirmative action is the attempt to systematically dismantle discrimination against protected classes. Its proponents believe that affirmative action is one of the few effective methods to resolve discrimination.

A statement of affirmative action is provided by many companies, and, under provisions of the Equal Employment Opportunity Act, government contractors and others must issue and follow affirmative action programs.

6. NATIONAL LABOR RELATIONS BOARD

6.1 General Provisions

The purpose of the National Labor Relations Act (NLRA) is to ensure that labor strife does not impede interstate commerce in a major way and to encourage the collective bargaining process as a means to accomplish this purpose. It attempts to protect against abuses of the collective bargaining process on the part of employers, employees, and unions by prohibiting certain unfair labor practices.

This act gives employees the right to form, join, or assist labor organizations and to bargain collectively through representatives of their own choosing as well as engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection. This act also gives employees the right to refrain from these activities unless an agreement requiring membership in a labor organization exists. The act is administered by the National Labor Relations Board through regional offices.

6.2 Prohibited Practices

6.2.1 Employers

The following acts are considered unfair labor practices on the part of employers:

— To interfere with employees in the exercise of their rights to organize.

— To dominate or interfere with the formation or administration of any labor organization, including financial or other support.

— To discriminate against any employee with respect to hiring, discharge, or conditions of employment in order to discourage or encourage union membership or because the employee has filed charges or given testimony under this act.

— To refuse to bargain collectively with the representatives of their employees.

6.2.2 Labor organizations

Labor organizations and their agents (including employees) may not

— Restrain or coerce

Employees with respect to their rights under this act.

Employers in their selection of their representatives for collective bargaining or grievance adjustment purposes.

— Cause or attempt to cause an employer to discriminate against an employee when such discrimination would be an unfair labor practice.

— Refuse to bargain collectively with an employer.

— Engage in or induce or coerce others to engage in unlawful strikes.

— Require excessive membership fees from employees.

— Require payment from an employer for services that have not been or will not be rendered.

— Picket unlawfully.

— Enter into an agreement with an employer in which the employer agrees to cease doing business with any other employer. (There is an exception for the construction industry.)

6.3 Penalties

The National Labor Relations Board (NLRB) has the power to prevent unfair labor practices. If the NLRB finds that any person has engaged or is engaging in any unfair labor practices, it has the power to issue a cease-and-desist order and to take any affirmative action, including reinstatement of employees with or without back pay, consistent with the policies of the NLRA. If the order is not complied with, the NLRB has the right to seek enforcement in any of the Courts of Appeals of the United States.

Employers. Employers may be forced to cease or desist from engaging in unfair labor practices, reinstate employees with or without back pay, and perform other acts consistent with the policies of the NLRA.

Labor organizations, agents. Labor organizations may be ordered to cease and desist from engaging in unfair labor practices along with any other acts, consistent with the purposes of the NLRA.

Employees. Employees who participate in unlawful strikes may be terminated from employment.

Others. Any person who willfully interferes with the NLRB or any member or agent is subject to a fine of not more than $5,000 or imprisonment for up to one year.

7. PAYROLL REQUIREMENTS

Employers are required to withhold payroll taxes (FICA and federal and state income tax) from covered employees' wages and remit the withholding to the proper federal and state offices. Employers also must pay payroll taxes for their share of social security (FICA tax) and federal and state unemployment taxes. For a complete listing of types of employment and requirements for withholding employment taxes, see IRS Circular E: *Employer's Tax Guide,* which is available at any IRS office or by mail from the Internal Revenue Service.

7.1 Federal Insurance Contribution Act (FICA)

The FICA tax rate for 1991 is 7.65 percent for both employees and employers. The maximum wage base is $53,400. However, the 1.45 percent Medicare Hospital Insurance portion of the total 7.65 percent rate is calculated on a maximum wage base of $125,000.

Because of the part-time, irregular nature of farm work, farmers hiring seasonal help are subject to special rules governing how farm workers' wages are reported for social security purposes. Any time the wages of a farm worker exceed $150 in cash during a calendar year, Social Security tax must be paid on the wages. Similarly, wages may count if they are paid on a time basis, such as by the hour, day, week, or month, for any part of twenty or more days during a calendar year. Also, if the total payroll of the agricultural employer is $2,500 or more of cash wages for the year, any cash wages paid are subject to Social Security tax.

7.2 Federal and State Income Tax

Tables for withholding income tax from employees' wages can be found in IRS Circular E: *Employer's Tax Guide* and state withholding booklets.

7.3 Unemployment Tax

A separate chapter in this manual is devoted to Unemployment Insurance. The Federal Unemployment Tax Act and state unemployment insurance requirements are discussed in sections 3 through 6 of that chapter.

7.4 Deposit of Payroll Taxes

7.4.1 FICA and federal income tax

Employers must make deposits of the FICA and federal income tax withheld from employees' wages plus the employer's share of FICA when the liability reaches certain limits. The following calculation should be used to determine the federal payroll liability.

Total Social Security wages	XXX	
× combined employee/employer Social Security rate	XXX	
Social Security tax		XXX
Total Medicare wages	XXX	
× combined employee/employer Social Security rate	×.029	
Medicare tax		XXX
Total FICA tax		XXX
FWHT (federal income tax withheld)		+XXX
Liability		XXX

7.4.2 Rules for depositing federal liability

The following rules apply to periodic deposit of employer and employee shares of payroll tax.

Rule 1. Less than $500 at end of quarter. If at the end of the calendar quarter the total undeposited taxes for the quarter are less than $500, no deposit of the taxes is required. They may be paid to the IRS with Form 941 or deposited with a federal tax deposit coupon (Form 8109).

Rule 2. Less than $500 at the end of any month. If at the end of any month the total undeposited taxes are less than $500, no deposit is necessary. Amount may be carried over to the following month within the quarter.

Rule 3. $500 or more but less than $3,000 at the end of any month. If at the end of any month the total undeposited taxes are $500 or more but less than $3,000, they must be deposited within fifteen days after the end of the month.

Rule 4. $3,000 or more at the end of any eighth monthly period. Each month is divided into eight deposit periods that end on the third, seventh, eleventh, fifteenth, nineteenth, twenty-second, twenty-fifth, and last day of the month. If at the end of any eighth monthly period the total undeposited taxes are $3,000 or more, the funds should be deposited within three banking days after the end of the eighth monthly period. Local holidays observed by authorized financial institutions, Saturdays, Sundays, and legal holidays should not be counted as banking days. Rule 4 will be considered to be met if

— At least 95 percent of tax liability for the eighth monthly period is deposited within three banking days after the end of the period.

— Any underpayment is deposited as follows:

If the eighth monthly period is in the first or second month of the quarter, the underpayment is deposited with the first deposit required to be made after the fifteenth of the following month.

If the eighth monthly period is in the last month of the quarter, any underpayment of $500 or more is deposited by the due date of the return.

Exception. If this is the first time a deposit is required within three banking days after the end of an eighth monthly period, the deposit may be made by the fifteenth of the next month (instead of within three banking days after the eighth monthly period) if *all* of the following conditions are met:

— A deposit was not required under rule 4 during the four quarters preceding the current quarter.

— A deposit was not required under rule 4 during earlier months of this quarter.

— The total undeposited taxes at the end of any eighth monthly period during this month are less than $10,000.

Rule 5. $100,000 or more at the end of an eighth monthly period. If an employer is required to make deposits of taxes on the basis of eighth monthly periods, the employer must make deposits of the taxes on the next banking day after the day on which the employer has $100,000 or more of taxes for deposit, regardless of whether the day is the last day of an eighth monthly period.

This rule became effective for amounts required to be deposited after July 31, 1990.

7.4.3 State income tax

All state income tax withheld from employees' wages must be deposited with the proper state agency. Deposit rules vary by state.

7.5 Magnetic Media Reporting

Employers who file at least 250 wage or pension information items on Forms W-2 or W-2P are required to use magnetic media. For purposes of IRS regulations, "magnetic media" refers to magnetic tape and diskette. However, regulations indicate that the use of diskette may be limited for Forms W-2 and W-2P.

The IRS regulation provides for a waiver for employers who can show that they will be subject to hardship if required to file a return on magnetic media. A request for waiver (Form 8508) must be submitted at least ninety days before the filing of the first return for which the waiver is sought.

Employers required to file on magnetic media, but who fail to do so, are deemed under the regulation to have failed to file the necessary returns, and will be subject to applicable penalties.

8. POSTEMPLOYMENT ISSUES

8.1 Covenants Not to Compete

A covenant not to compete is a clause in an employment agreement under which an employee agrees not to compete with his or her employer while employed and after terminating employment. To be enforceable, these covenants must be reasonably necessary to protect the employer and they cannot be so restrictive as to prevent the former employee from self-support. Generally, they cannot exceed a geographic area larger than that covered by the employment agreement and are rarely valid if they exceed one year. Unreasonable covenants are not enforceable. Some states allow their courts to edit these covenants to make them reasonable; others simply refuse to enforce them.

8.2 Wrongful Discharge

Wrongful discharge is an action based on the claim that an employee was unlawfully discharged from employment. This claim can be based on some form of discrimination, retaliation for the attempt to exercise a right, or violation of an employment agreement. The employee may be seeking reinstatement, back wages, and/or punitive damages.

8.2.1 Constructive discharge

Constructive discharge is similar to wrongful discharge. The difference is that, under constructive discharge, the employee was not discharged but rather the employer made working conditions so unreasonable that the employee was forced to quit.

8.3 Insurance Continuation

The federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA), effective July 1, 1986, supersedes most state law relating to insurance coverage continuation following employment termination. State law will override federal law to the extent that the state law provides greater benefits to the employee.

8.3.1 Employers covered by COBRA

All employers of twenty or more employees, with health insurance plans (self-insured or through an insurance carrier), must offer continuation of insurance coverage on termination of employment or death.

8.3.2 Right to continue insurance coverage

Persons other than employees have the right to continue insurance coverage. Continued coverage must be offered to

— Voluntarily and and involuntarily terminated employees, except employees discharged for gross misconduct.

— Employees who may lose coverage because of change in employment status from full-time to part-time.

— Employees' spouses and spouses who are divorced, widowed, or separated, and their dependents.

— Dependent children who might become ineligible because of divorce, marriage, or age.

8.3.3 Period of coverage

Insurance coverage may continue for a maximum of eighteen months. Spouses and dependents are eligible for thirty-six months of continuation. Coverage may be terminated if a qualified person fails to pay a premium or if he or she becomes covered by another group plan.

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APPENDIX 1: State Labor Agencies

ALABAMA
Alabama Labor Dept.
500 Folsom Admn. Bldg.
Montgomery, AL 36130

ALASKA
All Labor Laws
Dept. of Labor
Commissioner's Office
P.O. Box 21149
Juneau, AK 99802-1149
(907)465-2700

ARIZONA
All Labor Laws
P.O. Box 19070
Phoenix, AZ 85005
(602)255-4515

ARKANSAS
Dept. of Labor
10421 W. Markham #100
Little Rock, AR 72205
(501)682-4500

CALIFORNIA
Dept. of Industrial Relations
Div. of Administration
395 Oyster Point
South San Francisco, CA 94080

COLORADO
Dept. of Labor and Employment
600 Grant St., Suite 900
Denver, CO 80203-3528
(303)837-3800

Industrial Claim Appeals Office
1525 Sherman St., Rm. 510
Denver, CO 80203

Div. of Labor
1313 Sherman St.
Denver, CO 80203

Div. of Labor
Labor Standards Unit
The Chancery
1120 Lincoln, Suite 1302
Denver, CO 80203-2140
(303)894-2900

CONNECTICUT
State Board of Labor Relations
200 Folly Brook Blvd.
Wethersfield, CT 06109

Dept. of Labor, Mediation & Arbitration
200 Folly Brook Blvd.
Wethersfield, CT 06109
(203)566-4394

All Other Labor Laws
Labor Dept.
200 Folly Brook Blvd.
Wethersfield, CT 06109

DELAWARE
Office of the Secretary
Delaware Dept. of Labor
Elbert N. Carvel Bldg., 6th Fl.
820 North French St.
Wilmington, DE 19801
(302)571-2710

DISTRICT OF COLUMBIA
Dept. of Employment Services
500 C St., N.W., Suite 600
Washington, D.C. 20001

FLORIDA
Div. of Labor, Employment and Training
Dept. of Labor and Employment Security
1320 Executive Center Dr.
300 Atkins Bldg.
Tallahassee, FL 32399-0667
(904) 488-7228

GEORGIA
Dept. of Labor
Sussex Pl.
148 International Blvd, N.E., Rm. #302
Atlanta, GA 30303-1751

HAWAII
All Labor Laws
Dept. of Labor and Industrial Relations
830 Punchbowl St., Rm. 321
Wage and Hour Laws Rm. 340
Disability Comp Rm. 210
Prepaid Health Care Rm. 209
Unemploy Insurance Rm. 437
Honolulu, HI 96813
(808)548-4533

IDAHO
Dept. of Labor and Industrial Services
277 N. 6th
Statehouse
Boise, ID 83720
(208)334-2327

ILLINOIS
Illinois Dept. of Labor
310 S. Michigan Ave., 10th Fl.
Chicago, IL 60604
(800) 654-4620
Illinois Dept. of Labor
1 W. Old State Capitol Plaza
Springfield, IL 62701
(217) 782-6206

Wage Claims Section
310 S. Michigan Ave.,
Chicago, IL 60604

Dept. of Employment Security
401 S. State St., 4th Fl.
Chicago, IL 60605

INDIANA
All Labor Laws
Dept. of Labor
1013 State Office Bldg.
100 N. Senate Ave.
Indianapolis, IN 46204-2287
(317)232-2663

Mediation and Conciliation
(317) 232-2673

Building and Factory Inspection
IOSHA Administrator
(317)232-2693

Bureau of Child Labor
(317)232-2675

Minimum Wage and Wage Claims
(317)232-2673

IOWA
Labor Laws of Iowa
Div. of Labor Services
1000 East Grand Ave.
Des Moines, IA 50319-0209
(515)281-3606

KANSAS
All Labor Laws
Div. of Employment Standards and Labor Relations
Kansas Dept. of Human Resources
1430 S.W. Topeka Blvd., 3rd Fl.
Topeka, KS 66612-1853
(913)296-4062

KENTUCKY
Labor Cabinet
1049 U.S. 127 South
Frankfort, KY 40601
(502)564-3070

LOUISIANA
All Labor Laws
Dept. of Employment & Training
P.O. Box 94094
Baton Rouge, LA 70804-9094
(504)342-3011 or,
P.O. Box 94186
Baton Rouge, LA 70804-9186
Attn: Employer Status
(504) 342-3011

MAINE
Labor Relations Board (MLRB)
State Office Bldg., Station 90
Augusta, ME 04333
(207)289-2015

All Other Labor Laws
Dept. of Labor
Bureau of Labor Standards
State House, Station #45
Augusta, ME 04333

MARYLAND
All Labor Laws
Div. of Labor and Industry
501 St. Paul Pl.
Baltimore, MD 21202-2272
(301)333-4179

MASSACHUSETTS
Labor Relations Act
Labor Relations Commission
100 Cambridge St.,
Room 1604
Boston, MA 02202
(617)727-3505

All Other Labor Laws
Dept. of Labor and
Industries
State Office Bldg.
100 Cambridge St.
Boston, MA 02202
(617)727-3455

MICHIGAN
All Labor Laws
Michigan Dept. of Labor
201 N. Washington Square
P.O. Box 30015
Lansing, MI 48909
(517)373-9600

MINNESOTA
Bureau of Mediation Services
1380 Energy Lane, Suite 2
St. Paul, MN 55108
(612)649-5421

Dept. of Labor and
Industry
443 Lafayette Rd.
St. Paul, MN 55155
(612)296-6107

MISSISSIPPI
All Labor Laws
Occupational Safety and Health
Branch
Mississippi State Dept. of
Health
305 West Lorenz Blvd
P.O. Box 1700
Jackson, MS 39215-1700
(601)987-3981

MISSOURI
Dept. of Labor and
Industrial Relations
33115 W. Truman Blvd
Jefferson City, MO 65109
(314)751-4091

Div. of Employment
Security
P.O. Box 59
421 E. Dunklin St.
Jefferson City, MO 65104
(314)751-3215

All Other Labor Laws
Div. of Labor Standards
P.O. Box 449
Jefferson City, MO 65102

MONTANA
Standards Bureau
Investigations Bureau
Employment Relations Div
Dept. of Labor &
Industry
P.O. Box 8011
Helena, MT 59624-8011
(406)444-3555

NEBRASKA
Dept. of Labor
Box 94600
State House Station
Lincoln, NE 68509
(402)475-8451

NEVADA
All Labor Laws
Nevada State Labor Commission
505 E. King St., Rm. 602
Carson City, NV 89710
(702)885-4850

NEW HAMPSHIRE
Dept. of Labor
19 Pillsbury St.
Concord, NH 03301
(603)271-3176

NEW JERSEY
Dept. of Labor
John Fitch Plaza
CN-110
Trenton, NJ 08625
(609)292-2323

NEW MEXICO
Labor & Industrial Div
New Mexico Dept. of
Labor
1596 Pacheco St.
Santa Fe, NM 87501

Wage and Hour Bureau
501 Mountain Rd. N.E.
Albuquerque, NM 87102

NEW YORK
State Labor Relations Act
New York State Labor Relations
Board
2nd Fl.
400 Broome St.
New York, NY 10013

NORTH CAROLINA
North Carolina Dept. of
Labor
Wage and Hour Div.
4 West Edenton St., Rm. 103
Raleigh, NC 27601
(919)733-2152

All Other Labor Laws
4 West Edenton St., Rm. 103
Raleigh, NC 27601
(919)733-7166

NORTH DAKOTA
North Dakota Dept. of
Labor
6th Fl., State Capitol
600 E. Boulevard Ave.
Bismarck, ND 58505
(701)224-2660

OHIO
Dept. of Industrial
Relations
Div. of Prevailing
Wage, Minimum
Wage & Minors
2323 W. 5th Ave.
Post Office Box #825
Columbus, OH 43216
(614)644-2239

OKLAHOMA
State Dept. of Labor
4001 N Lincoln Blvd.
Oklahoma City, OK 73105
(405)528-1500

OREGON
Employment Relations Board
528 Cottage St., N.E.
Suite 400
Salem, OR 97310
(503)378-3807

All Other Labor Laws
Bureau of Labor and Industries
State Office Bldg.
1400 S.W. Fifth Ave.
Portland, OR 97201
(503)229-5737

PENNSYLVANIA
State Public & Private Sector
Labor Relations Act
Pennsylvania Labor Relations
Board
1601 Labor and Industry
Bldg.
Seventh and Forster Sts.
Harrisburg, PA 17120
(717)787-1091

All Other Labor Laws
Dept. of Labor and Industry
1700 Labor and Industry
Bldg.
Seventh and Forster Sts.
Harrisburg, PA 17120

PUERTO RICO
Commonwealth Labor Relations
Act
Puerto Rico Labor Relations
Board
San Juan, PR

All Other Labor Laws
Dept. of Labor and Human
Resources
P.O. Box 14427
Bo. Obrero Station
Santurce, Puerto Rico 00916-
4427

RHODE ISLAND
State Labor Relations Act
Rhode Island Labor Relations
Board
311 Doric Ave.
Cranston, RI 02910
(401)277-6099

All Other Labor Laws
Rhode Island Dept. of Labor
220 Elmwood Ave.
Providence, RI 02907
(401)457-1800

SOUTH CAROLINA
All Labor Laws
Dept. of Labor
3600 Forest Dr.
P.O. Box 11329
Columbia, SC 29211

SOUTH DAKOTA
Dept. of Labor
Div. of Labor and
Management
Kreip Bldg.
700 Governor's Dr.
Pierre, SD 57501-2277
(605)773-3681

TENNESSEE
All Labor Laws
Dept. of Labor
501 Union Bldg., Second Fl.
Nashville, TN 37243-0655
(615)741-2582

TEXAS
All Labor Laws
Texas Dept. of Licensing &
Regulation
P.O. Box 12157, Capitol Station
Austin, TX 78711
(512)463-2906

UTAH
State Labor Relations Act
Industrial Commission of Utah
160 East 300 South, 3d Fl.
P.O. Box 510910
Salt Lake City, UT 84151-0910
(801)530-6811

State of Utah
Industrial Commission
Labor/Anti-Discrimination Div.
160 East 300 South
P.O. Box 510910
Salt Lake City, UT 84151-0910
(801)530-6801

VERMONT
All Labor Laws
Dept. of Labor and
Industry
7 Court St.
Montpelier, VT 05602
(802)828-2286

VIRGINIA
All Labor Laws
Dept. of Labor and
Industry
205 North 4th St.
P.O. Box 12064
Richmond, VA 23241
(804)786-2376

WASHINGTON
All Labor Laws
Dept. of Labor and
Industries
334 General Administration
Bldg.
(HC 101)
Olympia, WA 98504
(206)753-6307

WEST VIRGINIA
All Labor Laws
Dept. of Labor
Rm. 319
1800 Washington St., East
Charleston, WV 25305
(304)348-7890

WISCONSIN
Dept. of Industry, Labor
and Human Relations
P.O. Box 7946
Madison, WI 53707

WYOMING
All Labor Laws
Dept. of Labor and
Statistics
Herschler Bldg.
122 W. 25th
Cheyenne, WY 82002

APPENDIX 2: State Civil Rights Agencies

These agencies have overall responsibility for preventing and redressing discrimination due to race, color, sex, age, national origin, religion, or handicap in employment, education, housing, public accommodations, and credit.

ALASKA
State Commission for Human Rights
800 A St.
Suite 202
Anchorage, AK 99501
(907)276-7474

ARIZONA
Civil Rights Div.
Off. of Attorney Gen.
1275 W. Washington
Phoenix, AZ 85007
(602)255-5263

CALIFORNIA
Dept. of Fair Employment & Housing
2014 T St., Suite 210
Sacramento, CA 95814
(916)739-4616

COLORADO
Civil Rights Div.
Dept. of Regulatory Agencies
1515 Sherman St.
Rm. 600C
Denver, CO 80203
(303)866-2624

CONNECTICUT
Comm. on Human Rights & Opportunities
90 Washington St.
Hartford, CT 06106
(203)566-3350

FLORIDA
State Dept. of Labor & Employment Security
Off. of Civil Rights
2012 Capitol Circle SE
203 Hartman Bldg.
Tallahassee, FL 32399-2157
(904)488-5905

IDAHO
Human Rights Comm.
450 W. State St.
Boise, ID 83720
(208)334-2873

ILLINOIS
Dept. of Human Rights
100 W. Randolph
State of Illinois Center
Suite 10-100
Chicago, IL 60601
(312)917-6200

INDIANA
Civil Rights Comm.
311 W. Washington St.
Rm. 319
Indianapolis, IN 46204-2773
(317)232-2612

IOWA
Civil Rights Comm.
211 E. Maple-2d Fl.
c/o Grimes State Office Bldg.
Des Moines, IA 50319
1-800-457-4416

KANSAS
Comm. on Civil Rights
900 S.W. Jackson, Suite 851 S.
Topeka, KS 66612-1258
(913)296-3206

KENTUCKY
Comm. on Human Rights
832 Capital Plaza Tower
Frankfort, KY 40601
(502)564-3550

LOUISIANA
Dept. of Justice
P.O. Box 94005
Baton Rouge, LA 70804-9005
(504)342-7013

MAINE
Human Rights Comm.
State House Station 51
Augusta, ME 04333-0051
(207)289-2326

MARYLAND
Comm. on Human Relations
20 E. Franklin St.
Baltimore, MD 21202
(301)333-1700

MASSACHUSETTS
Comm. Against Discrimination
One Ashburton Pl.
Rm. 601
Boston, MA 02108
(617)727-7319

MICHIGAN
Dept. of Civil Rights
303 W Kalamazoo
Lansing, MI 48913
(517)334-6079

MINNESOTA
Dept. of Human Rights
500 Bremer Tower
7th Place at Minnesota St.
St. Paul, MN 55101
(612)296-5663

MISSOURI
Comm. on Human Rights
Labor & Industrial Relations Dept.
3315 West Truman Blvd.
P.O. Box 1129
Jefferson City, MO 65102-1129
(314)751-3325

MONTANA
Human Rights Commission
Dept. of Labor & Industry
P.O. Box 1728
Helena, MT 59624-1728
(406)444-2884

NEBRASKA
Equal Opportunity Comm.
301 Centennial Mall
P.O. Box 94934
Lincoln, NE 68509-4934
(402)471-2024

NEVADA
Equal Rights Comm.
1515 E. Tropicana, 590
Las Vegas, NV 89158
(702)486-7161

NEW HAMPSHIRE
Comm. For Human Rights
61 S. Spring St.
Concord, NH 03301
(603)271-2767

NEW JERSEY
Div. on Civil Rights
Dept. of Law & Public Safety
CN 090
Trenton, NJ 08625
(201)648-2700

NEW MEXICO
Department of Labor
Human Rights Div
Aspen Bldg.
1596 Pacheco St.
Santa Fe, NM 87502
(505)827-6420

NEW YORK
Div. of Human Rights
Executive Dept.
55 W. 125th St.
New York, NY 10027
(212)488-5750

NORTH CAROLINA
Human Relations Comm.
Dept. of Administration
121 W. Jones St.
Raleigh, NC 27603
(919)733-7996

NORTH DAKOTA
Dept. of Labor
6th Fl., State Capitol
Bismarck, ND 58505
(707)224-2660

OHIO
Civil Rights Comm.
220 Parsons Ave.
Columbus, OH 43266-0543
(614)466-6715

OKLAHOMA
Human Rights Comm.
Jim Thorpe Bldg., Rm. 480
Oklahoma City, OK 73105
(405)521-3441

OREGON
Civil Rights Div.
Bur. of Labor & Industries
1400 SW Fifth Ave.
Portland, OR 97201
(503)229-5900

PENNSYLVANIA
Human Relations Comm.
101 S. Second St.
Suite 300
P.O. Box 3145
Harrisburg, PA 17105-3145
(717)787-4410

RHODE ISLAND
Commission for Human Rights
10 Abbott Park Place
Providence, RI 02903-3768
(401)277-2661

SOUTH CAROLINA
Human Affairs Commission
Post Office Box 4490
Columbia, SC 29240
(803)253-6336

SOUTH DAKOTA
Div. of Human Rights
222 E. Capitol, Suite 11
c/o State Capitol Bldg.
Pierre, SD 57501-5070
(605)773-3177

TENNESSEE
Human Rights Comm.
Capitol Blvd. Bldg., Suite 602
226 Capitol Blvd.
Nashville, TN 37219
(615)741-5825

TEXAS
Comm. on Human Rights
8100 Cameron Road
Bldg. B, Suite 525
P.O. Box 13493
Austin, TX 78753
(512)837-8534

UTAH
Labor and Anti-Discrimination Div.
Industrial Comm. of Utah
160 E. 300 St.
P.O. Box 510910
Salt Lake City, UT 84151-0910
(801)530-6801
(801)426-0667

VERMONT
Civil Rights Unit
Public Protection Div.
Off. of Attorney Gen.
109 State St.
Montpelier, VT 05602
(802)828-3171

WASHINGTON
Human Rights Comm.
402 Evergreen Plaza Bldg., FJ-41
711 S. Capitol Way
Olympia, WA 98504-3341
(206)753-6770

WEST VIRGINIA
Human Rights Comm.
Room 106
1321 Plaza East
Charleston, WV 25301-1400
(304)348-2616

WISCONSIN
Div. of Equal Rights
Industry, Labor & Human Relations
P.O. Box 8288
Madison, WI 53708
(608)266-0946

WYOMING
Dept. of Administration & Fiscal Control
Emerson Bldg.
Cheyenne, WY 82002
(307)777-6730

DISTRICT OF COLUMBIA
Dept. of Human Rights
2000 14th St., N.W., 3d Fl.
Washington, DC 20009
(202)939-8740

GUAM
Dept. of Law
Office of Attorney General
238 Archbishop F.C. Flores St.
Suite 701, Pacific News Bldg.
Agana, GU 96910
(671)472-6841

PUERTO RICO
Civil Rights Comm.
P.O. Box 2338
Hato Rey, PR 00919
(809)764-8686

VIRGIN ISLANDS
Civil Rights Comm.
P.O. Box 6645
St. Thomas, VI 00801
(809)776-2485

APPENDIX 3: State Equal Employment Opportunity Agencies

These agencies enforce laws promoting equal employment opportunity.

ALABAMA
Equal Opportunity Employment Off.
Dept. of Industrial Relations
649 Monroe St.
Montgomery, AL 36130
(205)261-5355

ALASKA
Equal Employment Opportunity Div.
Office of the Governor
P.O. Box AE
Juneau, AK 99811
(970)465-3570

ARIZONA
Governor's Office of Affirmative Action
1700 W. Washington, Suite 104
Phoenix, AZ 85007
(602)542-3711

ARKANSAS
Office of Personnel Management
Dept. of Finance & Administration
201 DFA Bldg.
1509 West 7th St.
P.O. Box 3278
Little Rock, AR

CALIFORNIA
Dept. of Fair Employment and Housing
2014 T St., Suite 210
Sacramento, CA 95814
(916)323-5256

COLORADO
Civil Rights Div.
Dept. of Regulatory Agencies
1525 Sherman St.
Rm. 600C
Denver, CO 80203
(303)866-2621

CONNECTICUT
Comm. on Human Rights & Opportunities
90 Washington St.
Hartford, CT 06106
(203)566-3350

DELAWARE
Dept. of Labor
820 N. French St.
Wilmington, DE 19801
(302)571-2710

FLORIDA
Human Relations Comm.
325 John Knox Rd.
Suite 240, Bldg. F
Tallahassee, FL 32399-1570
(904)488-7082

GEORGIA
Ga. Off. of Fair Employment Practice
156 Trinity Ave., S.W.
Suite 208
Atlanta, GA 30303
(404)656-1736

HAWAII
Off. of Affirmative Action
Off. of the Governor
Rm. 442, State Capitol
Honolulu, HI 96813
(808)548-3432

IDAHO
Human Rights Comm.
450 W. State St.
Boise, ID 83720
(208)334-2873

ILLINOIS
Dept. of Human Rights
100 W. Randolph
Illinois Center
Suite 10-100
Chicago, IL 60601
(312)917-6245

INDIANA
Civil Rights Comm.
311 W. Washington St.
Rm. 319
Indianapolis, IN 46204-2773
(317)232-2612

IOWA
Civil Rights Comm.
211 E. Maple St.
Grimes State Office Bldg.
Des Moines, IA 50319
(515)281-4121

KANSAS
State Equal Employment Opportunity Off.
Kansas Dept. of Admin.
900 SW Jackson
Rm. 902N.
Landon State Office Bldg.
Topeka, KS 66612-1251
(913)296-4288

KENTUCKY
Comm. on Human Rights
P.O. Box 69
Louisville, KY 40201-0069
(502)564-3550

LOUISIANA
Off. of Labor
Dept. of Labor
P.O. Box 94094
Baton Rouge, LA 70804-9094
(504)925-4221

MAINE
Human Rights Comm.
State House Station 51
Augusta, ME 04333-0051
(207)289-2326

MARYLAND
Comm. on Human Relations
20 E. Franklin St.
Baltimore, MD 21202
(301)333-1700

MASSACHUSETTS
State Off. of Affirmative Action
One Ashburton Pl.
Rm. 303
Boston, MA 02108
(617)727-7441

MICHIGAN
Dept. of Civil Rights
303 W. Kalamazoo
Lansing, MI 48913
(517)334-6079

MINNESOTA
Office of Job Service & UI Operations
Dept. of Jobs & Training
390 N. Robert St.
St. Paul, MN 55101
(612)296-3625

MISSISSIPPI
Equal Employment Opportunity Dept.
Employment Security Comm.
P.O. Box 1699
Jackson, MS 39215-1699
(601)961-7420

MISSOURI
Comm. on Human Rights
Labor & Industrial Relations Dept.
3315 West Truman Blvd.
P.O. Box 1129
Jefferson City, MO 65102-1129
(314)751-3325

MONTANA
Human Rights Comm.
Dept. of Labor & Industry
P.O. Box 1728
Helena, MT 59624-1728
(406)444-2884

NEBRASKA
Equal Opportunity Comm.
301 Centennial Mall, South
P.O. Box 94934
Lincoln, NE 68509-4934
(402)471-2024

NEVADA
Equal Rights Comm.
1515 E. Tropicana, 590
Las Vegas, NV 89158
(702)486-7161

NEW HAMPSHIRE
Comm. for Human Rights
16 S. Spring St.
Concord, NH 03301
(603)271-2767

NEW JERSEY
Div. of Equal Employment Opportunity & Affirmative Action
44 South Clinton Ave.
Trenton, NJ 08625-0315
(609)520-0299

NEW MEXICO
New Mexico Dept. of Labor
Human Rights Comm.
Aspen Plaza, 1596 Pacheco St.
Santa Fe, NM 87502
(505)827-6420

NEW YORK
Dept. of Civil Service
W. Averell Harriman State Office
Building Campus Bldg. #1
Albany, NY 12239
(518)457-2487

NORTH CAROLINA
Equal Opportunity Services Div.
Off. of State Personnel
116 W. Jones St.
Raleigh, NC 27603-8004
(919)733-0205

NORTH DAKOTA
Dept. of Labor
6th Fl., State Capitol
Bismarck, ND 58505
(701)224-2660

OHIO
Civil Rights Comm.
220 Parsons Ave.
Columbus, OH 43266-0543
(614)466-6715

OKLAHOMA
Employment Security Comm.
Oklahoma State Employment Service
Will Rogers Memorial Office Bldg.
2401 North Lincoln Blvd.
Oklahoma City, OK 73105-4495
(405)521-3769

OREGON
Employment Div.
Dept. of Human Resources
875 Union St., NE
Salem, OR 97311
(503)378-3211

PENNSYLVANIA
PA Human Relations Comm.
101 S. Second St.
Suite 300
Harrisburg, PA 17101
(717)787-4410

RHODE ISLAND
Dept. of Admin., Div. of Human Services
Equal Opportunity Off.
1 Capitol Hill
Providence, RI 02908-5865
(401)227-3090

SOUTH CAROLINA
Human Affairs Comm.
2611 Forest Dr., Suite 200
Post Office Drawer 11009
Columbia, SC 29211
(803)253-6336

SOUTH DAKOTA
Bur. of Personnel
500 East Capital
Pierre, SD 57501-5070
(605)773-3148

TENNESSEE
Equal Employment Opportunity
Dept. of Employment Security
500 James Robertson Pkwy
12th Fl., Volunteer Plaza
Nashville, TN 3724-0200
(615)741-0921

TEXAS
Governor's Office of Personnel/ EEO
P.O. Box 12428
Capitol Station
Austin, TX 78711
(512)475-6507

UTAH
Labor/Anti-Discrimination Div.
160 E. 300 St.
P.O. Box 510870
Salt Lake City, UT 84110-5800
(801)530-6801

VERMONT
Office of the Attorney General Civil Rights
Pavilion Office Bldg.
109 State St.
Montpelier, VT 05602
(802)828-3171

VIRGINIA
Office of Equal Employment Services
Dept. of Personnel & Training
101 N. 14th St.
Richmond, VA 23219
(804)225-2237

WASHINGTON
Affirmative Action Program
Dept. of Personnel
600 S. Franklin
Box 1789
Olympia, WA 98504
(206)753-3758

WEST VIRGINIA
Personnel Div.
Bldg. 6, Rm B-456
1900 Washington St. E.
Charleston, WV 25305
(304)348-3950

WISCONSIN
Div. of Equal Rights
Industry, Labor & Human Relations
P.O. Box 8928
Madison, WI 53708
(608)266-6860

WYOMING
Dept. of Employment, Labor Standards/Fair Employment Program
Herschler Bldg., 2d Fl. East
Cheyenne, WY 82002
(307)777-7261

DISTRICT OF COLUMBIA
Off. of Human Rights
420 Seventh St., N.W.
Rm. 200
Washington, DC 20004
(202)727-3100

AMERICAN SAMOA
Dept. of Human Resources
American Samoa Government
Pago Pago, AS 96799
(684)633-4489

GUAM
Dept. of Labor
P.O. Box 9970
Tamuning, GU 96931-9970
(671)646-9241

NORTHERN MARIANA ISLANDS
Dept. of Commerce & Labor
Commonwealth of the Northern Mariana Islands
Capitol Hill
Saipan, MP 96950
(011)322-8711/4
322-4361

PUERTO RICO
Fair Employment
Labor & Human Resources Dept.
505 Munoz Rivera Ave.
Hato Rey, PR 00918
(809)754-2105

VIRGIN ISLANDS
Div. of Labor Relations
Dept. of Labor
P.O. Box 148
St. Thomas, VI 00804

WORKERS' COMPENSATION

WORKERS' COMPENSATION

1. INTRODUCTION

1.1 Background

Before workers' compensation benefits became statutory, injured employees who sought compensation for a loss were obliged to sue their employers under the civil negligence laws. Such action normally was very lengthy and costly, and often the employee did not receive any compensation at all. As the inequity of this system became widely realized, states developed plans whereby employees gave up their right to sue the employer for negligence. In return, the employer was required to guarantee certain benefits. A system of insurance was designed to implement this plan, and workers' compensation was formed. In the course of time, workers' compensation has shifted the burden of industrial injury to the cost of production and established a system compensating employees for injuries, under state law.

1.2 Purpose

The purpose of workers' compensation laws is to provide a uniform and fair system of compensating employees for work-related injuries, diseases, and deaths.

Workers' compensation laws make the employer strictly liable to an employee for injuries sustained by the employee that arise out of and in the course of employment. This liability is paid for by workers' compensation insurance policies, self-insured employer plans, or state funds. In awarding compensation for injuries, negligence on the part of the employer or employee is disregarded, with compensation uniformly held to be a no-fault exclusive remedy. All states have workers' compensation laws that provide medical, compensation, and other benefits for injuries. Although these laws vary from state to state, they are broadly similar in their provisions.

2. DEFINITIONS

Employer. An entity engaged in a business effecting commerce that has employees (29 U.S.C. Section 652(5)).

Employee. One employed in a business of an employer that effects commerce (29 U.S.C. Section 652(6)).

Commerce. "Trade, traffic, commerce, transportation, or communication among the several states, or between a state and any place outside thereof, or within the District of Columbia, or a possession of the United States . . . , or between points in the same state but through a point outside thereof" (29 U.S.C. Section 652(3)).

3. FEDERAL REGULATIONS

3.1 Coverage

A determination of the exact jurisdiction and benefits applicable to a particular workers' compensation claim depends on the jurisdiction and benefit provisions of each state's workers' compensation statute. Each state has its own law establishing benefits and jurisdictional considerations. In addition to state laws, there are several federal workers' compensation statutes that provide workers' compensation coverage for certain specified groups of employees. These federal statutes include the District of Columbia Workers' Compensation Act (for injuries occurring before July 30, 1982), the Federal Employees Workers' Compensation Act, and the Longshore and Harbor Workers' Compensation Act.

Exemptions from workers' compensation coverage are discussed in section 3.3 of this chapter.

3.2 Compulsory Coverage

Workers' compensation laws are classified as either compulsory or elective. Under a compulsory law, every employer must accept the act and must provide the specified compensation benefits. Under an elective act, employers have the option of either accepting or rejecting the benefits under the act. However, if the act is rejected, the employer loses the customary common law defenses, such as assumption of the risk by an employee, negligence of fellow employees, and contributory negligence of an employee.

Today, most states have compulsory workers' compensation laws. Accordingly, some form of insurance is mandatory for covered employers. Specific requirements for coverage, as well as penalties for failure to insure, vary considerably from state to state and can be learned only by examining the appropriate state regulations. Section 5 of this chapter discusses specific state requirements for coverage. New employers should contact their state workers' compensation authority to determine the exact requirements for workers' compensation insurance.

3.3 Employees

Compensation for work-related injuries will only be paid to employees, a definition that generally includes both part-time and temporary employees. Professional and managerial employees are also considered employees. Certain types of employees may nevertheless be excluded from coverage under workers' compensation laws (for example, partners, some corporate officers, family members, volunteers, farm and domestic labor, and students). State regulations must be examined to determine exemption.

Sole proprietors are not considered "employers" or "employees" and are generally not covered under workers' compensation laws. Again, it is necessary to examine state laws to make a final determination.

The employer is responsible for compensating the injured employee. In general, workers are compensated for their loss of wages while out of work because of an injury, for their permanent disabilities and loss of wage-earning capacity, and for their medical needs. The amount of compensation varies from state to state, and benefits are paid directly by an employer's workers' compensation insurer or from a self-insured fund. Specific categories of benefits are discussed in section 3.13 of this chapter.

3.4 Employers

All employers covered under workers' compensation regulations are classified into specific groups by the nature of their business and activities, classifications based on the degree of risk of injury and accidents involved in the business.

All employers must be aware of their primary legal responsibilities and duties to injured employees. Under workers' compensation laws, the exact definition of *employer* varies from state to state. For example, some states base their definition on the number of employees a particular person employs. Again, individual state statutes must be reviewed. Whenever an employer is required to provide workers' compensation coverage, most laws require that he or she file certain reports and keep certain records.

3.5 Financing and Recordkeeping

Covered employers are liable for the cost of workers' compensation insurance, and the cost may not be passed along to employees.

Accurate wage records must be kept for all covered workers and be available for review, inspection, or audit at all times. Failure to comply may result in penalties and fines.

Management is responsible for understanding and meeting the requirements of the various workers' compensation statutes in states where its employees are situated. Management must establish a system to ensure that covered employees and their salary bases are properly accounted for and reported. Employees should be properly classified and these classifications periodically reviewed in connection with rate changes. The claims-handling process should also be re-evaluated periodically.

3.6 Rates

Accident experience throughout American business is compiled by the National Council on Compensation Insurance. The council is recognized by all insurance carriers and state fund administrators. Rates are determined in accord with a standard nationwide rate-making procedure approved by the National Association of Insurance Commissioners. The National Council on Compensation Insurance has issued an experience-rating-plan manual that is standard with all insurance companies.

Workers' compensation rates are assigned to employers based on the employer's classification. The rate is usually expressed as a percentage of payroll paid by an employer and is adjusted according to the employer's accident record. Employers in the same classification may have different rates based on the number of accidents their workers experience. In this way, the cost of workers' compensation is spread out more justly.

3.7 Wage Base

The rate assigned an employer is applied to the employer's wage base to determine the employer's workers' compensation liability. The wage base is the estimated wages an employer will pay in a year and should be adjusted periodically according to state regulations.

Wage-base audits are periodically completed to determine whether an employer has overpaid or underpaid. A wage-base audit compares the estimated wage base to the actual wages paid for a specified period.

3.8 Accidental Injury

Most state and federal workers' compensation laws require that an injury be "accidental" in nature. The majority of states accept an injury as accidental if its cause was of a chance nature or if its effect was the unexpected result of the routine performance of an employee's normal job duties. A few states require proof that an employee's injury was in some way unusual and not merely the result of performing normal job duties.

3.9 Arising Out of Employment

All state and federal workers' compensation laws require that an injury "arise out of" employment in order to be compensable. An injury generally is said to arise out of employment when conditions of employment cause the injury.

3.10 In the Course of Employment

All state and federal workers' compensation laws also require that an injury occur "in the course of" employment. The time, place, and activity of the employee are demonstrative of whether the injury occurred in the course of employment. For example, in most states, many injuries that occur while employees are on their way to and from work are generally held not to occur in the scope of the employment and are not covered under workers' compensation laws.

3.11 Occupational Diseases

In addition to coverage for accidental injuries, most workers' compensation laws provide compensation for employees who sustain occupational diseases that arise out of and in the course of employment. In general, while an accidental injury arises from a specific event, occupational diseases result from repeated exposure over a long period of time to some condition that is characteristic of the employment. The exact definition of an occupational disease and the benefits payable for such a disease vary from state to state. Some states provide workers' compensation coverage not only for physical diseases, but also for mental diseases arising from employment, such as work-related mental and emotional stress and psychiatric disorders.

3.12 Accident Reports

Employees are legally required to report accidents to their employers as soon as possible. In turn, employers are required to submit reports of accidents and injuries to the proper authorities in their state. In many states the report should be made to the state workers' compensation board, but this varies from state to state. Failure by an employer to report an accident may result in penalties and fines. These limitation periods vary from state to state and may require that a claim be filed as soon as one year following an injury, or as long as three years.

3.13 Benefits

An employee can recover the costs of hospitalization, medical care, and other expenses resulting from a work-related injury. In addition, an employee is generally entitled to receive disability benefits as a replacement for temporary wage loss while out of work following an injury or as compensation for a permanent disability.

3.13.1 Categories of benefits

There are four basic categories of workers' compensation benefits:

1. *Temporary Total Benefits.* These benefits are for a disability that is temporary in quality and total in character. They are wage loss benefits and are generally payable to employees out of work following an injury and before maximum medical improvement is reached.
2. *Temporary Partial Benefits.* These benefits are for a disability that is temporary in quality and partial in character. They are wage loss benefits and are payable when an employee returns to work at a lighter-duty and lower-paying job, but before the employee reaches maximum medical improvement.
3. *Permanent Partial Benefits.* These benefits are for a disability that is permanent in quality and partial in character. They are monetary benefits in addition to medical treatment and care for a permanent disability and may be based on a percentage of anatomical disability or on a permanent loss of wage-earning capacity, depending on the provisions of a state's statute. The amount of permanent partial benefits may be based upon the part of the body that is injured, such as the arm, the leg or the back.
4. *Permanent Total Benefits.* These benefits are for a disability that is permanent in quality and total in character. They are payable when an employee is permanently unable to return to work at his or her regular job or to any form of gainful employment.

3.13.2 Vocational rehabilitation

When an employee is physically unable to return to work at his or her regular job following a work-related injury, but is able to work at alternative jobs, most workers' compensation laws require employers to provide vocational rehabilitation services. Vocational rehabilitation may include vocational guidance, counseling, testing, retraining, and relocation. Job placement, education, and assistance in modification of an employee's home to accommodate a disability may also be included in vocational rehabilitation.

The extent of required vocational rehabilitation varies considerably from state to state. Some states provide for a fund from which an employer may seek payment to cover the cost of rehabilitation. Other states do not provide for such a fund, and the cost of rehabilitation is usually directly paid by the employer's workers' compensation insurer.

3.13.3 Death benefits

When an employee dies as the result of a work-related injury, his or her surviving spouse, children, or other dependents may be entitled to death benefits. The amount of such benefits varies depending on whether a dependent was totally dependent on the deceased employee's income for support, or only partially dependent. Death benefits may also include some reimbursement for funeral expenses and some education costs for minor children through college. The specific requirements and amounts of death benefits vary substantially from state to state.

3.13.4 Benefits for pre-existing disabilities

In some cases, an employee's work-related permanent disability may be superimposed over a pre-existing disability or injury. In such situations, some states have special funds established under the workers' compensation statute that may be responsible for payment of permanent disability benefits to an employee for a pre-existing disability. The policy behind such special funds is to ensure that an employer is responsible for only the disability caused by a work-related injury and to encourage employers to hire employees with pre-existing disabilities or handicaps.

3.14 Tax Consequences

Workers' compensation premiums are deductible as a business expense by employers. Benefits are not taxable to an employee upon receipt.

4. OCCUPATIONAL SAFETY AND HEALTH

Occupational safety and health standards help create a safe and healthful work environment, which in theory reduces the number of workers' compensation claims filed against employers.

4.1 Background

The Occupational Safety and Health Act (OSHA) was enacted by Congress in 1970 because states were perceived as not providing adequate protection for workers. It is an attempt to provide uniform standards and a method of enforcement.

In general, OSHA covers all employers and employees in all fifty states, the District of Columbia, Puerto Rico, and all other federal territories. The act does not cover self-employed persons, farms where only immediate members of the farmer's family work, and workplaces already protected by other federal laws. Although federal agencies are covered, OSHA does not cover employees of state and local governments. However, many states have laws with requirements similar to those of OSHA.

4.2 Scope and Purpose

The purpose of the act is to "assure so far as possible every working man and woman in the Nation safe and healthful working conditions. . . ." The statute looks to a number of methods to carry out this purpose. These methods include voluntary efforts by employees and employers as well as joint labor/management to reduce hazards, standards promulgated by the federal Secretary of Labor, effective means to enforce the standards, research into causes and prevention of occupational injuries and disease, and encouragement of state efforts.

4.3 Compliance With OSHA

Employers have an obligation to provide places and working conditions free from recognized hazards, and both employers and employees have an obligation to comply with OSHA standards. Employers and employees who do not comply with OSHA standards may be subject to civil fines and/or imprisonment. The nature of the fine and the length of imprisonment depend on the nature of noncompliance.

Enacted safety standards are published in the Code of Federal Regulations. Proposed safety standards are published in the Federal Register. Employers may obtain temporary or permanent variances from standards by showing that noncompliance is due to circumstances beyond their control or that existing working conditions are as safe as the proposed OSHA standards. Employees have the right to a hearing on employers' requested variances.

4.4 Relation to State Laws

This act is not meant to affect any workers' compensation act or any existing common law or statutory duties, rights, or liabilities of employers and employees with respect to occupational safety and health. States may regulate any occupational safety or health issue with respect to which there are no standards in effect under OSHA. They may also regulate issues already covered by OSHA standards upon submission to and approval of a plan for development of standards and enforcement that are at least as effective as OSHA standards and enforcement. See the Appendix at the end of this chapter for a complete list of occupational safety state agencies and addresses.

5. STATE INFORMATION AND OFFICES

A compulsory statute applies to all employers who are not specifically excluded, and excluded employers are often covered voluntarily. An elective statute either applies to all employers who elect to be covered by the statute or does not apply to those employers who reject the statute. Employers who opt out of elective statutes may be sued without being able to use common-law defenses that were available before the statutes were enacted.

The penalty for the failure to insure varies widely from state to state. It can include a fine, imprisonment, or an injunction from doing business or engaging in employment activities. Many states also allow injured workers to sue their employers with the common-law defenses either as an alternate remedy to the compensation provided by the statute or in addition to that compensation. If the employer is a corporation, officers are frequently held personally liable for penalties, damages, and compensation.

The following is a brief state-by-state analysis of workers' compensation laws as they relate to private employment.

Alabama The statute is compulsory. Insurance is required of all employers with three or more employees. Failure to insure is subject to a fine from $25 to $1,000. An injured employee may sue the employer and receive double compensation under the statute if the employer is uninsured.

Code of Alabama. Section 23-5-1 et seq

Workmen's Compensation Division
Department of Industrial Relations
649 Monroe St.
Montgomery, AL 36130
(205)261-5420

Alaska The statute is compulsory. Insurance is required of all employers. The failure to insure is a class B or C felony subject to a fine up to $50,000, imprisonment up to ten years, or both. Section 23.30.075(b) of the *Alaska Statutes* provides for a fine up to $10,000 or imprisonment up to one year, or both. The employer may be enjoined from doing business if the uninsured employer is sued and negligence is presumed. Corporate officers and managers are personally liable.

Alaska Statutes. Section 23.30.005 et seq

Department of Labor
Division of Workers' Compensation
P.O. Box 25512
Juneau, AK 99802-5512
(907)465-2790

Arizona The statute is compulsory. Insurance is required of all employers. An injured employee may elect to receive compensation under the statute or to pursue legal remedies in tort. The employer may be enjoined from doing business if the employer fails to insure. An injured worker will be awarded compensation and a 10 percent penalty plus expenses, and attorneys' fees or $500 (whichever is greater) will be imposed on the employer. This award is paid from a special fund and must be reimbursed with 10 percent interest.

Arizona Revised Statutes. Section 23-901 et seq

Industrial Commission of Arizona
800 W. Washington
P.O. Box 19070
Phoenix, AZ 85005-9070
(602)542-4661

Arkansas The statute is compulsory. Coverage is required for all employers with three or more employees. Failure to insure is subject to a fine of $500, imprisonment of one year, or both if the employer has no workers' compensation coverage. An employee may also elect to receive compensation under the statute or to sue the employer.

Arkansas Statutes. Section 81-1301 et seq; Ark. Code Ann. 1988 11-9-101 et seq

Workers' Compensation Commission
2nd Floor, Justice Bldg.
625 Marshall St.
Little Rock, AR 72201-1073
(501)682-3930

California The statute is compulsory. Insurance is required of all employers. If an employer is enjoined from doing business there is a penalty of $1,000 per employee, with $5,000 for compensable cases (up to $50,000). Intentional failure to insure and failure to obey an injunction are both misdemeanors, subject to a fine up to $1,000, imprisonment up to sixty days, or both. The injured worker may receive compensation and sue the employer.

California Labor Code. Section 3201 et seq

Department of Industrial Relations
Division of Workers' Compensation
395 Oyster Point Blvd., 5th Floor, Wing C
So. San Francisco, CA 94080
(415)737-2900

Colorado The statute is compulsory. Insurance is required of all employers. An employer who fails to insure may be enjoined from doing business. An injured worker may elect to receive compensation plus 50 percent under the statute or to pursue legal remedies if the employer was uninsured at the time of the injury.

Colorado Revised Statutes. Section 8-40-101 et seq

Division of Labor
Department of Labor & Employment
The Chancery
1120 Lincoln, Suite 1406
Denver, CO 80203
(303)866-2782

Connecticut The statute is compulsory. Insurance is required of all employers. Willful failure to insure is subject to a fine up to $1,000.

Connecticut General Statutes. Section 31-275 et seq

Workers' Compensation Commission
1890 Dixwell Ave.
Hamden, CT 06514
(203)789-7783

Delaware The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine of $.10 per day per employee (not less than $1 nor more than $50). The employer may be enjoined from doing business if failure to insure continues for thirty days.

An injured worker may elect to receive compensation or to sue the employer who fails to insure.

Delaware Code. Section 2301 et seq

Industrial Accident Board
Attn: Accounting
820 N. French St.
Wilmington, DE 19801
(302)571-2877

Florida The statute is compulsory. Coverage is required of all employers with four or more employees or any employee in contracting or subcontracting. Failure to insure is subject to a fine up to $500, imprisonment up to one year, or both. An employer may be enjoined from doing business. The injured worker will receive workers' compensation and cannot sue the employer.

Florida Statutes. Section 44.01 et seq

Division of Workers' Compensation
Labor & Employment Security Dept.
2728 Centerview Dr.
Forrest Bldg.
Tallahassee, FL 32399-0680
(904)488-2514

Georgia The statute is compulsory for all employers with three or more employees. Employers are required to obtain insurance or be approved as self-insurers. Failure of an employer to insure or be self-insured is a misdemeanor and if an injured worker seeks compensation, the Board may award compensation in the amount 10 percent greater than that provided by law and shall also fix reasonable attorneys' fees to be paid by the employer.

Official Code of Georgia. Section 34-9-1 et seq

State Board of Workers' Compensation
Suite 1000, South Tower
One CNN Center
Atlanta, GA 30303-2788
(404)656-3875

Hawaii Insurance is required of all employers. Failure to insure is subject to a penalty of $250 or $10 per day per employee, whichever is greater. If the failure lasts for thirty days, the employer may be enjoined from doing business.

Hawaii Revised Statutes. Section 386-123 et seq

Disability Compensation Division
Labor & Industrial Relations
830 Punchbowl St.
Honolulu, HI 96813
(808)548-5414

Idaho The statute is compulsory. Insurance is required of all employers. Failure to insure is a misdemeanor. Any officer or employee of a corporation who has authority to procure insurance and fails to do so is also guilty of a misdemeanor and personally liable for compensation and penalties assessed against the corporation. The willful failure to insure is subject to a penalty of $2 per day per employee. After thirty days an employer may be enjoined from doing business (there is also a penalty of $1 per day per employee as well as a penalty for defaulting on premiums to the state fund). In addition, an injured worker may receive compensation under the statute plus a 10 percent penalty and costs and attorneys' fees.

Idaho Code. Section 72-101 et seq

State Insurance Fund
317 Main St.
Boise, ID 83720
(208)334-2370

Illinois The statute is compulsory. Insurance is required of all employers engaged in the "extra hazardous" activities listed in the statute. Failure to insure is a petty offense. The fine is from $100 to $500 per day.

Illinois Statutes. Section 138-1 et seq

Department of Labor
1 West Old State Capitol
Room 300
Springfield, IL 62701
(217)782-6206

Indiana The statute is compulsory. Insurance is required of all employers. Failure to insure is a class A infraction with a fine up to $10,000. The employer may be enjoined from doing business. An injured employee may be awarded an amount up to double the compensation provided by the statute plus medical expenses and attorneys' fees.

Indiana Code. Section 22-3-1 et seq

Worker's Compensation Board of Indiana
601 State Office Bldg.
Indianapolis, IN 46204
(317)232-3808

Iowa The statute is compulsory. Insurance is required of all employers, and may be through private insurers or by self-insurance. An employer who fails to insure may be sued by an injured worker. There is a presumption of negligence.

Iowa Code. Chapters 85, 85A, 85B, 86 and 87.

Division of Industrial Services
1000 E. Grand Ave.
Des Moines, IA 50319
(525)281-3934

Kansas The statute is compulsory. Insurance is required of all employers who have or can reasonably anticipate having a gross annual payroll of $10,000 or more in a calendar year. The intentional failure to insure is a class C misdemeanor. An injured worker may pursue legal remedies against the employer.

Kansas Statutes. Section 44-501 et seq

Department of Human Resources
Division of Workers' Compensation
Landon State Office Bldg.
900 S.W. Jackson, Room 651-S
Topeka, KS 66612-1276
(913)296-3441

Kentucky The statute is compulsory. Insurance is required of all employers with a few exceptions (mainly those who employ agricultural workers). Workers may reject this statute as long as they do so before they are injured. The employer may be enjoined from doing business. If an employer fails to insure, the injured worker may file a claim under the statute and pursue legal remedies.

Kentucky Revised Statutes. Section 342.001 et seq

Kentucky Department of Worker's Claims
Perimeter Park West, Bldg. C
1270 Louisville Rd.
Frankfort, KY 40601
(502)564-3070

Louisiana The statute is compulsory. Insurance is required of all employers. An employer who fails to insure is liable for the compensation award plus a 12 percent penalty and attorneys' fees.

Louisiana Revised Statutes. Section 23.1021 et seq

Office of Workers' Compensation
Department of Labor
P.O. Box 94040
Baton Rouge, LA 70804-9040
(504)925-4563

Maine The statute is compulsory. Failure to insure is a class D crime. The president or treasurer or both of a corporation that fails to insure are liable for the punishment imposed for a class D crime, and may be liable to pay a civil penalty up to $10,000. An injured worker may elect to sue the employer or to claim compensation under the statute.

Maine Revised Statutes. 39 Section 1 et seq

Workers' Compensation Commission
State House Station 27
Augusta, ME 04333
(207)289-3731

Maryland The statute is compulsory. Insurance is required of all employers. Failure to insure is a misdemeanor subject to a fine from $500 to $5,000, imprisonment up to one year, or both. The employer may be assessed a penalty equal to six months' premiums due to the state fund if the employer fails to become insured within ten days after being ordered to do so. An employee may elect compensation under the statute or file suit against the employer.

Annotated Code of Maryland. Section 101-1 et seq

Workers' Compensation Commission
6 N. Liberty St., Room 940
Baltimore, MD 21201
(301)333-4775

Massachusetts The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to $1,500, imprisonment up to one year, or both. Failure to insure after conviction is a separate offense. For the corporate employer, the president and treasurer are subject to the same penalty. The injured worker may elect to forgo coverage under the act in favor of retaining common law rights to sue. However, an injured worker of an uninsured employer may both petition for compensation and sue an uninsured employer.

Massachusetts General Laws. C. 152 Sec. 1 et seq; Regs. 452 CMR 1.00 et seq

Department of Industrial Accidents
600 Washington St.
Boston, MA 02111
(617)727-3400

Michigan The system is compulsory for all private employers, except agricultural, who regularly employ three or more persons; all private employers, except agricultural, who regularly employ one person for thirty-five or more hours per week for thirteen weeks or longer during a fifty-two week period; all public employers; and all agricultural employers with three or more employees who were employed for thirteen consecutive weeks during the previous fifty-two weeks. Real estate salespersons are not considered employees under the statute. Certain stockholders of closely held corporations can choose to be excluded from the act if they are the only employees. Failure to insure is subject to a penalty of $1,000, imprisonment from thirty days to six months, or both.

Michigan Compiled Laws. Section 418.161 et seq

Bureau of Workers' Disability Compensation
Department of Labor
P.O. Box 30016
Lansing, MI 48909
(517)373-3480

Minnesota The statute is compulsory for all employers. Failure to insure is subject to a fine of $750 for employers with fewer than five employees and $1,500 for employers with five or more employees ($2,500 or $5,000 for willful or intentional failure to insure). If failure to insure continues, there is an additional penalty equal to five times the lawful premium for that employer. The intentional failure to insure is a gross misdemeanor. If the employee elects to receive compensation under the special fund, the commissioner may pursue the employer for compensation paid plus a 50 percent penalty.

Minnesota Statutes. Section 176.181 et seq

Special Compensation Fund
Workers' Compensation Division
Department of Labor & Industry
443 Lafayette Rd.
St. Paul, MN 55155-4317
(612)296-6490

Mississippi The statute is compulsory. Insurance is required of all employers with five or more employees. Failure to insure is subject to a fine up to $1,000, imprisonment up to one year, or both.

Mississippi Code. Section 71-3-1 et seq

Workers' Compensation Commission
1428 Lakeland Dr.
Jackson, MS 39216
(601)987-4200

Missouri The statute is compulsory. Insurance is required of all employers with more than five employees. An employee may receive benefits from the second injury fund. The employer will have to reimburse the fund for compensation plus $100 per day the employer remains uninsured after the worker is injured up to a maximum of $5,000.

Missouri Statutes. Section 287.010 et seq

Division of Workers' Compensation
Labor & Industrial Relations Department
3315 West Truman Blvd., Box 58
Jefferson City, MO 65102
(314)751-4231

Montana The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a penalty equal to twice the unpaid premium (not less than $200). The employer may also be subject to an injunction. There is a presumption of negligence. The employee may file a claim under the uninsured employers fund (for which the employer is liable for reimbursement up to $50,000), may sue the employer for damages, and has a separate course of action because the employer was uninsured. The uninsured fund has the right to set off against any funds recovered from the uninsured employer or any third party.

Montana Code Annotated. Section 39-71-501 et seq

Department of Labor & Industry
Employment Relations Division
P.O. Box 8011
Helena, MT 59604-8011
(406)444-6500

Nebraska The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to $1,000, imprisonment up to one year, or both. The employer may be enjoined from doing business. The employer may be sued by any injured worker.

Revised Statutes of Nebraska. Section 48-101 et seq

Workers' Compensation Court
13th Floor, State Capitol
P.O. Box 98908
Lincoln, NE 68509-8908
(402)471-2568

Nevada The statute is compulsory. Insurance is required of all employers. Failure to insure is a misdemeanor subject to a fine up to $500 per offense. The employer may be enjoined from doing business. The injured worker may elect to receive compensation or to sue the uninsured employer. Negligence will be presumed.

Nevada Revised Statutes. Section 616.010 et seq

Department of Industrial Relations
Capitol Complex
1380 South Curry St.
Carson City, NV 89710
(702)687-3033

New Hampshire The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a penalty of $500 plus $100 per day per employee. The employer may be subject to an injunction. The employee may sue.

New Hampshire Revised Statutes. Section 281-A et seq

Workmen's Compensation Division
Department of Labor
19 Pillsbury St.
Concord, NH 03301
(603)271-3173

New Jersey The statute is elective; unless the employee and employer, in writing, reject the statute, insurance is required for all employers with the exception of approved self-insured employers. Failure to insure may result in a fine not to exceed $7,500, imprisonment not to exceed a term of 18 months, forfeiture of corporate charter, or revocation of certification authorizing conduct of business in New Jersey.

In addition, an assessment of $1,000 may be imposed for each consecutive ten-day period the employer remains uninsured.

New Jersey Statutes. Section 34:15-1 et seq

Division of Workers' Compensation
Department of Labor
John Fitch Plaza, CN 381
Trenton, NJ 08625
(609)292-2414

New Mexico The statute is compulsory. Insurance is required of all employers with three or more employees. The employer may be enjoined from doing business for failure to insure. The employee may not sue.

New Mexico Statutes Annotated. Section 52-1-1 et seq

New Mexico Department of Labor
Workers' Compensation Division
P.O. Box 27198
Albuquerque, NM 87125-7198
(505)841-8787

New York The statute is compulsory. Insurance is required of all employers. The first-time offense for failure to insure is subject to a fine from $500 to $2,500, imprisonment, or both. Repeated offenses can go up to $7,500. There is an additional penalty of $250 for each ten-day period without coverage or 2 percent of the payroll for that period. The employer may be sued by the employee or the employee may apply for workers' compensation benefits. If the employee receives benefits, the employer is liable for the benefits and for an assessment of $250 plus 15 percent of the award, such assessment not being less than $1,500 and not exceeding $5,000 on each claim.

Consolidated Laws of New York. Workers' compensation law.

Workers' Compensation Board
180 Livingston St.
Room 600
Brooklyn, NY 11248
(718)802-6666

North Carolina The statute is compulsory. Insurance is required of all employers with three or more employees or whose employees are exposed to radiation where conditions exist that cause said exposure. Failure to insure is subject to a fine of $1.00 per day per employee (from $50 to $100). It is also a misdemeanor for which an employer may be fined or imprisoned, or both, at the discretion of the court. The employer is liable to injured workers either for compensation under the statute or in suit in a civil action if the employer has not provided workers' compensation insurance.

General Statutes of North Carolina. Section 97-1 et seq

Industrial Commission
Department of Commerce
430 N. Salisbury St.
Raleigh, NC 27611
(919)733-4820

North Dakota The statute is compulsory. Insurance is required of employers with hazardous working conditions, as defined in the statute. Failure to insure is a misdemeanor subject to a fine of $500, imprisonment for one year, or both. The employer is subject to an injunction and may be sued.

North Dakota Century Code. Section 65-1 et seq

Workers' Compensation Bureau
4007 N. State St.
Bismarck, ND 58501
(701)224-2700

Ohio The statute is compulsory, and Ohio is an exclusive jurisdiction state. Coverage is required for all employers. Failure to obtain coverage or to have coverage in effect on the date of injury makes a "non-complying" employer directly liable for all compensation and medical expenses paid out in a claim, and a lien may be filed against the employer's property to secure payment. The employer may be enjoined from doing business. The employer may also be sued to recollect amounts paid to a claimant from the State Surplus Fund or to collect past due premium obligations.

Page's Ohio Revised Code Annotated. Section 4123.01 et seq

Industrial Commission
246 N. High St.
Columbus, OH 43215
(614)466-3567

Workers' Compensation Bureau
246 N. High St.
Columbus, OH 43215
(614)466-1935

Oklahoma The statute is compulsory. Coverage is required by all employers on all employees, whether full-time or part-time. The civil penalty for failure to insure is $250 per employee for a first offense and $500 for a second offense up to a maximum of $10,000. The criminal penalty for willful failure to insure is a maximum fine of not more than $1,000 and six months in the county jail. This is in addition to the civil penalty. A second violation constitutes a prima facie case of willful violation. The uninsured employer may be sued civilly for damages and cannot assert certain common-law defenses.

Oklahoma Statutes Annotated. Title 85 O.S. Section 63.1 et seq

Workers' Compensation Court
1915 North Stiles
Oklahoma City, OK 73105-4904
Oklahoma City (405)557-7600
Tulsa (918)581-2714
or
Oklahoma Department of Labor
1315 Broadway Place
Oklahoma City, OK 73103
Oklahoma City (405)235-0530
Tulsa (918)581-2400

Oregon The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to an initial penalty up to $1,000. If an employer fails to become insured after being ordered to do so, the employer may also be fined up to $25 per day. If an employee is injured while the employer is uninsured, there is an additional penalty not less than $100 nor more than $5,000 (depending on the type of injury). The injured worker must file a claim for compensation under the statute. This claim is paid out of the Industrial Accident Fund. The employer is liable for the cost of compensation, reasonable administrative fees, and attorneys' fees awarded the employee.

Oregon Revised Statutes. Section 656.001 et seq

Department of Insurance and Finance
Workers' Compensation Division
Room 21 Labor and Industries Bldg.
Salem, OR 97310
(503)378-5713

Pennsylvania The statute is compulsory. Coverage is required for all employers. Failure to insure is subject to a fine from $500 to $2,000, imprisonment up to one year, or both. Each day is considered a separate offense. Where the employer does have workers' compensation insurance coverage or has been approved as a self-insured employer by the Bureau of Workers' Compensation, the employee's exclusive remedy for a work-related injury is under the statute. If the employer was not insured or not approved by the Bureau as a self-insurer as of the date of injury, the employee may sue the employer.

Purdon's Pennsylvania Statutes Annotated. Title 77.

Bureau of Workers' Compensation
Department of Labor & Industry
1171 South Cameron St., Room 103
Harrisburg, PA 17104-2501
(717)783-5421

Rhode Island The statute is compulsory. Insurance is required of all employers engaged in hazardous occupations as defined under the statute, or with four or more employees. Failure to insure is subject to a fine up to $1,000, imprisonment up to one year, or both. Corporate officers are personally liable for compensation while the corporation is uninsured. The employer may be sued.

General Laws of Rhode Island. Section 28-29-1 et seq

Department of Workers' Compensation
610 Manton Ave.
P.O. Box 3500
Providence, RI 02909
(401)272-0700

South Carolina Unless the statute is rejected by filing the proper form with the Workers' Compensation Commission, all employers employing four or more persons must provide insurance. Failure to insure is subject to a fine of $.10 per day per employee (minimum $1, maximum $50 per day). Failure to insure may be subject to an injunction. The willful failure to insure is a misdemeanor subject to a fine up to $1,000, imprisonment from thirty days to six months, or both. An uninsured employer may be sued in tort, and his defenses of assumption of the risk, contributory negligence, and fellow servant are denied.

Code of South Carolina. Title 42.

Workers' Compensation Commission
P.O. Box 1715
Columbia, SC 29202-1715
(803)737-5770

Workmen's Compensation Fund*
800 Dutch Sq. Blvd.
Building C, No. 160
Columbia, SC 29210
(803)737-9450

South Dakota The statute appears to be elective. Any employer who fails to insure is deemed to have elected not to operate under the statute. The employer may be sued. There is no civil fine or criminal penalty for the failure to insure, but there can be a greater civil liability.

South Dakota Codified Laws. Title 62.

Division of Labor and Management
Department of Labor
Kneip Bldg., 700 Governor's Dr.
Pierre, SD 57501-2277
(605)773-3681

Tennessee The statute is compulsory. Insurance is required of employers with five or more employees. Failure to insure is subject to a fine from $10 to $100. If the failure continues, the fine is from $1 to $10 per day for each day of continued noncompliance. The employee may elect compensation under the statute or file suit against the employer. The Workers' Compensation Division has been given the power to assess a fine of $5,000 for continued and willful refusal to provide workers' compensation coverage. This is in addition to previously listed fines.

Tennessee Code Annotated. Section 50-6-1 et seq

Department of Labor
501 Union Bldg.
Nashville, TN 37219
(615)741-2395

Texas The statute is elective. Insurance is required of employers who accept the statute. There is no penalty for the failure to insure. However, the injured worker may sue the employer.

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*Provides workers' compensation insurance to all state agencies; any county or municipality in the state may elect to purchase workers' compensation coverage from the state fund; no sales to private companies.

Vernon's Annotated Civil Statutes. Articles 8306 to 8309.

Workers' Compensation Comm.
Southfield Bldg.
4000 S. IH 35
Austin, TX 78704
(512)448-7900

Utah The statute is compulsory. Insurance is required of all employers. Any employer, including officers, that fails to insure is guilty of a class B misdemeanor. Each day is a separate offense. The employer is subject to a fine up to $1,000 if an individual, up to $5,000 if some sort of business entity. The employer is also subject to imprisonment from thirty days to six months. The injured worker may elect compensation under the statute or file suit against the employer, when the employer is uninsured. Workers' compensation in the state of Utah is a no-fault insurance. A 15 percent penalty can be added on to an award for employer willful neglect in the cause of an injury.

Utah Code Annotated. Section 35-1-1 et seq

Workmen's Compensation Division
160 E. 300 St.
P.O. Box 5800
Salt Lake City, UT 84110-5800
(801)530-6811

Vermont The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to $100 per day if insurance is not provided within thirty days after notice to the employer.

Vermont Statutes Annotated. Title 21, Sections 601 to 710.

Department of Labor and Industry
State Office Bldg.
Montpelier, VT 05602
(802)828-2186

Virginia The statute is compulsory. Insurance is required of all employers with three or more employees regularly in service in the same business in the state of Virginia (if the employer is a farm, more than two full-time employees). Failure to insure is subject to a fine from $50 to $1,000. The intentional failure is a class 2 misdemeanor. The employer may be subject to an injunction. The injured worker may sue the employer instead of seeking compensation under the statute. If the employer has failed to insure, the traditional common-law defenses are not available.

Code of Virginia. Section 65.1-1 et seq

Department of Workmen's Compensation
P.O. Box 1794
Richmond, VA 23214
(804)367-8600

Washington The statute is mandatory. Insurance is required through the Washington State Fund or if the employer qualifies through self-insurance. Failure to insure is subject to a penalty not less than 50 percent nor more than 100 percent of the cost of any injury or occupational disease along with an additional penalty of $500 or double the amount of unpaid premiums, whichever is greater. If the failure to insure is intentional, the employer is subject to a fine from $25 to $100 for each day there is no insurance.

Revised Code of Washington Annotated. Title 51.

Department of Labor and Industries
General Administration Bldg.
M/S HC-216
Olympia, WA 98504
(206)753-6307

West Virginia The statute is compulsory. Insurance is required of all employers unless exempt under the Workers' Compensation Act. There is no criminal penalty for failure to insure unless the employer knowingly failed to insure; then the employer is subject to a fine up to $5,000. Failure to subscribe causes an immediate default that subjects the employer to interest and penalties on the unpaid premiums. If an employee of a defaulting employer collects compensation under the statute, the employer is liable to the state fund for past premiums plus interest and reimbursement of all claims paid by the fund on the employer's behalf.

West Virginia Code. Chapter 23.

Workers' Compensation Fund
Employer Relations Division
P.O. Box 153
Charleston, WV 25321
(304)348-0380

Wisconsin The statute is compulsory. Insurance is required of all employers who have paid $500 or more in wages in any calendar quarter (or for farmers with six or more employees on twenty or more days). Failure to insure is subject to a fine of double the amount of premium evaded while uninsured. (The minimum fine is $750.) Each day is a separate offense. The employer may be subject to an injunction. The employer is personally liable for all benefits, if uninsured.

Wisconsin Statutes Annotated. Section 102.01 et seq

Division of Workers' Compensation
Industry, Labor and Human Relations Department
P.O. Box 7901
Madison, WI 53707
(608)266-1340

Wyoming An exclusive state fund since 1915. Mandatory coverage is required for employments enumerated as extrahazardous by the Wyoming Legislature. Employees not enumerated as extrahazardous may be covered, if the employer elects to obtain coverage through written request. Coverage shall go into effect after receipt of the written request and approval by the Division. An employer electing coverage cannot withdraw for a period of three years.

Wyoming Statutes Annotated. Section 27-14-101 et seq

Wyoming Workers' Compensation Division
Office of State Treasurer
122 West 25th St.
Herschler Bldg., 2nd Floor, East Wing
Cheyenne, WY 82002-0700
(307)777-7441

District of Columbia The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to $1,000 or imprisonment up to one year, or both.

District of Columbia Code. Section 36-301 et seq

Office of Workers' Compensation
P.O. Box 56098
Washington, DC 20011
(202)576-6265

American Samoa The statute is compulsory. Insurance is required of all hazardous employment and for all employers with three or more employees. Failure to insure is subject to a fine up to $1,000, or imprisonment up to one year, or both. The employer may also be sued.

Workmen's Compensation Commission
Department of Human Resources
Pago Pago, AS 96799
(684)633-4485

Guam The statute is compulsory. Insurance is required of all employers engaged in a trade, occupation, or profession for profit. Failure to insure is subject to a fine up to $1,000, imprisonment up to one year, or both. The employer may be sued and must reimburse the state for compensation paid to the injured worker.

Department of Labor
P.O. Box 23548
GFM, GU 96921
(671)646-9241

Puerto Rico The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine from $25 to $1,000, imprisonment up to six months, or both. There is an additional penalty equal to 30 percent of the compensation paid out (not less than $10). The employer may also be sued.

Laws of Puerto Rico Annotated. Title 11.

Puerto Rico State Insurance Fund
G.P.O. Box 365028
San Juan, PR 00936
(809)781-0615
(809)783-3808

Virgin Islands The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to $500, imprisonment up to six months, or both, as well as interest on past-due premiums. The employer is liable for compensation, expenses, and a 30 percent penalty of the total and may be sued by the injured employee.

Workmen's Compensation Division
Department of Labor
P.O. Box 148
St. Thomas, VI 00801
(809)775-5747

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APPENDIX: Occupational Safety— State Agencies and Addresses

(Enforce safety standards for the protection of employees in places of employment.)

ALABAMA
Dept. of Labor
64 N Union St., Rm 500
Montgomery, Al 36130
(205)261-3460

ALASKA
Occupational Safety & Health
Dept. of Labor
P O Box 21149
Juneau, AK 99802-1149
(907)465-4855

ARIZONA
Industrial Comm of Arizona
Occupational Safety & Health
P O. Box 19070
Phoenix, AZ 85005-9070
(602)542-5795

ARKANSAS
Dept of Labor
10421 W Markham #100
Little Rock, AR 72202
(501)375-8442

CALIFORNIA
Occupational Safety & Health
Dept. of Industrial Relations
395 Oyster Point Blvd
3rd Floor, Wing C
San Francisco, CA 94080
(415)557-1946

CONNECTICUT
Occupational Safety & Health
Dept of Labor
200 Folly Brook Blvd
Wethersfield, CT 06109-1114
(203)566-4550

DELAWARE
Dept. of Labor
Div. of Industrial Affairs
OSHA Consultation Services
820 North French St., 6th Fl
Wilmington, DE 19801
(302)571-2877

FLORIDA
Dept. of Labor & Employment Security
Div. of Workers' Compensation
Directors Office
2728 Centerview Dr, Suite 301
Tallahassee, FL 32399-0680
(904)488-5201

GEORGIA
Dept of Labor
Safety Engineering
148 International Blvd N E.
Atlanta, GA 30303
(404)656-3014

HAWAII
Division of Occupational Safety & Health
830 Punchbowl St., Room 423
Honolulu, HI 96813
(808)548-4155

IDAHO
Dept. of Labor & Industrial Services
277 No. 6th St.
Statehouse Mall
Boise, ID 83720
(208)334-3950

ILLINOIS
Ill. Public Employees Health & Safety Program
Dept. of Labor
100 N. First St.
Springfield, IL 62706
(217)782-6206

INDIANA
Dept. of Labor
1013 State Off Bldg
100 N. Senate Ave.
Indianapolis, IN 46204-2287
(317)232-2663

IOWA
Division of Labor
1000 East Grand
Des Moines, IA 50319
(515)281-3606

KANSAS
Dept of Human Resources
Division of Industrial Safety & Health
512 SW Sixth St., 1st Fl.
Topeka, KS 66603-3150
(913)296-4386

KENTUCKY
Occupational Safety & Health
Labor Cabinet
The 127 Bldg.
U.S. 127 S.
Frankfort, KY 40601
(502)564-2300

LOUISIANA
Dept. of Employment & Training
Office of Worker's Compensation
P.O. Box 94040
Baton Rouge, LA 70804-9040
(504)925-4221

MAINE
Dept. of Labor
Bur. of Labor Standards
State House Station 45
Augusta, ME 04333
(207)289-3331

MARYLAND
Occupational Safety & Health
Div of Labor & Industry
Department of Licensing & Regulation
501 St. Paul Pl., 3rd Fl.
Baltimore, MD 21202-2272
(301)333-4195

MASSACHUSETTS
Dept. of Labor & Industries
Div. of Industrial Safety
100 Cambridge St.
Boston, MA 02202
(617)727-3567

MICHIGAN
Bureau of Safety & Regulation
Dept of Labor
P O Box 30015
Lansing, MI 48909
(517)322-1814

MINNESOTA
Dept. of Labor & Industry
Occupational Safety & Health Admn.
443 Lafayette Rd
St. Paul, MN 55155
(612)296-2116

MISSISSIPPI
Occupational Safety & Health Branch
State Dept. of Health
305 West Lorenz Blvd
P O. Box 1700
Jackson, MS 39215-1700
(601)987-3981

MISSOURI
Div. of Labor Standards
Labor & Industrial Relations Dept.
P.O. Box 449
Jefferson City, MO 65102
(314)751-3403

MONTANA
Montana Dept. of Labor & Industry
Employment Policy Div/Bureau of Safety
1327 Lockey
P.O. Box 1728
Helena, MT 59624
(406)444-3022

NEBRASKA
Div. of Safety
Dept. of Labor, Division & Safety
P.O. Box 95024
Lincoln, NE 68509-5024
(402)471-2239

NEVADA
Occupational Safety & Health
Dept. of Industrial Relations
1370 S. Curry St.
Carson City, NV 89710
(702)885-5240

NEW HAMPSHIRE
Dept. of Labor
19 Pillsbury St.
Concord, NH 03301
(603)271-3171

NEW JERSEY
Division of Workplace Standards
Dept. of Labor
CN054
Trenton, NJ 08625
(609)292-2313

NEW MEXICO
Environmental Improvement Division
Occupational Health & Safety Bureau
1190 St. Francis Dr
Santa Fe, NM 87503
(505)827-2877

NEW YORK
Dept. of Labor
Division of Safety & Health
Campus, State Off. Bldg. 12, Rm 457
Albany, NY 12240
(518)457-2741

NORTH CAROLINA
Dept. of Labor
Division of Occ. Safety & Health
413 N. Salisbury St.
Raleigh, NC 27603
(919)733-2360

NORTH DAKOTA
Workers' Compensation Bureau
4007 N. State St.
Bismarck, ND 58501
(701)224-2700

Safety Dept.
North Dakota Workers' Compensation Bureau
4007 N. State St.
Bismarck, ND 58501
(701)224-3800

OHIO
Div. of Safety & Hygiene
Bureau of Workers' Compensation
246 N. High St.
Columbus, OH 43215
(614)466-3564

OKLAHOMA
Safety Standards Div.
Dept. of Labor
4001 N. Lincoln Blvd.
Oklahoma City, OK 73105-5212
(405)521-2461

OREGON
Occupational Safety & Health Div. (OSHA)
Department of Insurance & Finance
160 Labor & Industries Bldg.
Salem, OR 97310
(503)378-3272

PENNSYLVANIA
Occupational & Industrial Safety
Dept. of Labor & Industry
1529 Labor & Industry Bldg.
Harrisburg, PA 17120
(717)787-3323

RHODE ISLAND
Occupational Safety & Health
Dept. of Labor
220 Elmwood Ave.
Providence, RI 02907
(401)277-2756

SOUTH CAROLINA
Occupational Safety & Health
Dept. of Labor
P.O. Box 11329
Columbia, SC 29211
(803)758-3080

TENNESSEE
Dept. of Labor
501 Union Bldg.
Nashville, TN 37243-0659
(615)741-2793

TEXAS
Div. of Occupational Hygiene
Dept. of Health
1100 W. 49th St.
Austin, TX 78756
(512)458-7111

UTAH
Occupational Safety & Health Div.
Industrial Comm.
P.O. Box 510870
160 E. 300 So.
Salt Lake City, UT 84151-0870
(801)530-6901

VERMONT
Occupational & Safety Health Admin. Div.
Dept. of Labor & Industry
5 Court St.
Montpelier, VT 05602
(802)828-2765

VIRGINIA
Dept. of Labor & Industry
205 N. Fourth St.
Richmond, VA 23219
(804)786-2376

WASHINGTON
Industrial Safety & Health
Dept. of Labor & Industries
P.O. Box 207
Olympia, WA 98507
(206)753-6308

WEST VIRGINIA
Dept. of Labor
State Capitol Complex
Bldg. 3, Rm. 319
Charleston, WV 25305
(304)348-7890

WISCONSIN
Dept. of Industry, Labor & Human Relations
Div. of Safety & Buildings
P.O. Box 7969
Madison, WI 53707
(607)266-1816

WYOMING
Occupational Health & Safety Comm.
Herschler Building, 2nd Fl. East
Cheyenne, WY 82002
(307)777-7787

DISTRICT OF COLUMBIA
Occupational Safety & Health
Dept. of Employment Services
950 Upshur St., NW
Washington, DC 20011
(202)576-6339

AMERICAN SAMOA
Occupational Safety & Loss Prevention
Administrative Services Dept.
Pago Pago, AS 96799
(684)633-2237

GUAM
Dept. of Labor
Occupational Safety & Health Admin.
P O. Box 9970
Tamuning, GU 96911-9970
(671)646-9241/2/3

NORTH MARIANA ISLANDS
Dept. of Commerce & Labor
Off of the Governor
Saipan, MP 96950
(011)322-8711/4
322-4361

PUERTO RICO
Occupational Safety & Health Office
505 Munoz Rivera Ave
Hato Rey, PR 00918
(809)754-5353

VIRGIN ISLANDS
Occupational Safety and Health
Dept. of Labor
Lagoon Complex, Frederiksted
St. Croix, VI 00840
(809)772-1315

UNEMPLOYMENT INSURANCE

UNEMPLOYMENT INSURANCE

1. INTRODUCTION

1.1 Background

Unemployment insurance provides income to people who have lost their jobs through no fault of their own and who are actively seeking suitable employment—a concept many states apply quite liberally. In theory, unemployment insurance spreads the cost of unemployment equitably among many employers.

Unemployment insurance is designed to provide a means of support to people who have involuntarily left the labor force and are actively attempting to return.

1.2 Federal-State Interaction

The Federal Unemployment Tax Act (FUTA) levies a tax against wages paid to employees and allows a credit to the employer of up to 90 percent of the tax owed. The tax is 6.2 percent of wages up to $7,000. Employer credit for tax paid to state unemployment funds is as much as 5.4 percent of taxable wages. Amounts paid to unemployment insurance funds are used to fund claims and pay administrative expenses. The federal portion is used to make advances to states that run short of funds in their own unemployment insurance system, advances that states must repay.

2. DEFINITIONS

Employer

— Any person or organization that during the current or preceding year either (a) paid wages of $1,500 or more in any calendar quarter, or (b) had one or more employees at any time in each of any twenty calendar weeks.

— Any agricultural employer who during the current or preceding year either (a) paid cash wages of $20,000 or more for farm labor in any calendar quarter, or (b) employed ten or more farm workers at any time for at least one day during any twenty different weeks.

— Any household employer who during the current or preceding year paid cash wages of at least $1,000 during any calendar quarter for household services in a private home, local college club, or fraternity/sorority.

Employee. An individual who performs services under the direction and control of an employer.
Successor employer. One who acquires substantially all the property used in a trade or business of another employer and who employs in the trade or business a substantial majority of the same individuals employed by the preceding employer.
Common paymaster. Any member of a group of related corporations that disburses remuneration to employees of two or more of those corporations and is responsible for keeping books and records for those employees.
Normal or 90 percent credit. Credit that allows an employer to use the state unemployment insurance contribution as an offset against the greater portion (90 percent) of the federal unemployment tax liability.
Additional credit. Credit against an employer's federal unemployment tax liability equal to the difference between the amount of contributions actually paid to the state and the amount that would have been required to be paid if a reduced experience rating had not been obtained.
Experience rating. The method by which employer contributions under the state unemployment compensation laws may be varied on the basis of each individual employer's experience with unemployment. Also called *merit rating.*
Voluntary contribution. Contribution to the state unemployment fund by an employer to achieve a better experience rating. The contribution is allowed as an offset against benefits charged to the employer's account.

3. FEDERAL UNEMPLOYMENT TAX ACT (FUTA)

3.1 Purpose

The Federal Unemployment Tax Act (FUTA) is designed to provide unemployment compensation to workers who have lost their jobs through layoff, reduction in labor force, or other reasons beyond their control.

3.2 Covered Employment

All employment is considered to be covered employment except as described in section 3.8.

3.3 Successor Employer

A successor employer acquires substantially all the property used in another employer's trade or business and continues to employ the same individuals. The successor employer

— May count the wages paid by the first employer during the current year in figuring the $7,000 wage limit.
— Is not subject to pass the twenty-weeks or $1,500-wages-in-a-calendar-quarter test. Since the first employer has already met these tests, the successor employer is automatically liable.

The manner of acquisition is immaterial. All the following situations result in successor employers:

— Purchase of trade or business
— Incorporation of previously unincorporated trade or business
— Continuation of an existing partnership by a new partnership

3.4 Statutory Merger

A statutory merger or consolidation does not result in successor employers. No adverse tax effect results either, since the new entity following the merger or consolidation is considered the same employer and taxpayer as the previous employer. The new employer may thus consider wages paid by the absorbed entity as having been paid by it (the new employer) when computing FUTA tax.

3.5 Credit for Successor Employers

A successor employer may not count wages paid by a predecessor who did not qualify as an employer under the Federal Unemployment Tax Act. However, a credit is allowed against the successor's FUTA tax based on the percentage of employees retained by the successor employer.

> *Example*: Jones Partnership sells to Smith, Inc. all its property before Jones has met employer qualifications under the Federal Unemployment Tax Act. Smith retains 20 percent of Jones' employees, representing 20 percent of total wages paid. Smith cannot count the wages paid by Jones when figuring the $7,000 wage limit. Instead, Smith is entitled to a credit against its FUTA tax based on the amount of credit Jones could have claimed for the employees retained by Smith if Jones had qualified as an employer. If Jones could have claimed a $1,000 credit against its FUTA tax liability, Smith is entitled to claim a $200 credit since it retained 20 percent of Jones' employees.

3.6 Common Paymaster

Related corporations with a common paymaster who have employees working for all the corporations do not have to pay FUTA tax on the first $7,000 of wages paid to each employee by each of the related corporations.

Example: Bill Doe works for two related corporations—Red, Inc. and Blue, Inc. Doe earns $25,000 annually from Red, Inc. and $25,000 from Blue, Inc. He devotes his time equally between the two corporations. Red, Inc. is the common paymaster, so the corporations are treated as one employer. Therefore FUTA tax is calculated on only $7,000 of Doe's wages, not on $14,000.

3.7 Corporations Entitled to Use Common Paymaster

Three criteria must be met to qualify for this special treatment:

— *Related corporations*. Corporations that meet any one of the following tests are considered related:

The corporations are members of a "controlled group of corporations" as defined in Internal Revenue Code Section 1563.

Fifty percent of the board of directors of a corporation that does not issue stock are members of the other corporation's board of directors.

Fifty percent or more of one corporation's officers are concurrently officers of the other corporation.

Thirty percent or more of one corporation's employees are concurrently employees of the other corporation.

— *Common paymaster*. The common paymaster is not required to pay every one of the employees of the related corporations. But, for the special provision described in the example to apply, the particular employees' wages must be disbursed through a common paymaster. The remuneration may be paid by one combined paycheck drawn on one account or by separate paychecks drawn on different accounts.

— *Concurrent employment*. Employees must perform services for the benefit of the employing corporation in exchange for remuneration contemporaneously from two or more corporations.

3.8 Exemptions

Employers described in section 2 are subject to FUTA tax except for:

— Agricultural employment when total wages paid by the employer are less than $20,000 in a quarter or the employer does not employ ten or more employees on twenty days in different weeks.

— Domestic service when the employer pays wages less than $1,000 in any calendar quarter in the current or preceding year.

— Service not in the course of the employer's trade or business unless wages equal or exceed $50 and work is performed by an individual regularly employed to perform such services.

— Employment of child or spouse, or child under twenty-one in employ of parent.

— Employment by U.S. government or instrumentality of the United States owned in whole or in part by the United States, or exempt under FUTA Section 3301.

— Employment by a state political subdivision or instrumentality owned in whole or in part by the state.

— Service in employ of religious, charitable, educational, or other institution exempt from tax under 501(a) unless that institution employs four or more employees.

— Employment under the Railroad Unemployment Insurance Act.

— Students enrolled in a college or university employed at same.

— Work study.

— Service performed in hospital by a patient.

— Service performed in the employ of a foreign government or in the employ of an instrumentality wholly owned by a foreign government.

— Student nurses or interns in the employ of a hospital or training school.

— Insurance agents paid wholly by commission.

— Individuals under eighteen with paper routes.

— Employment by an international institution.

— Employment for commercial fishing.

— Nonimmigrants under worker's visas.

— Full-time students employed by a camp.

3.9 Tax Rate

The gross FUTA tax rate is 6.2 percent of the taxable wages paid during a calendar year. Employers receive a credit against their FUTA tax liability for contributions made to their state fund. The maximum credit is limited to 90 percent of a deemed 6 percent federal tax rate, or 5.4 percent. The net FUTA tax rate for many employers is 0.8 percent.

A reduction in the net federal unemployment rate from 0.8 percent to 0.6 percent was to occur January 1, 1988. However, the 0.8 percent rate has been extended through December 31, 1995, when the rate is scheduled to decrease to 0.6 percent.

3.10 Covered Earnings

Employers are liable for FUTA tax on the first $7,000 paid to each employee during a calendar year.

3.11 Compliance

Penalties, fines, interest, and levies are imposed upon employers who do not comply with FUTA tax rules.

3.11.1 Penalties and interest

— A four-tier penalty for failure to make timely deposits is imposed as follows:

2% if the failure is for five days or less,
5% if the failure is for six days but not more than fifteen days,
10% if the failure is sixteen days or more, and
15% if the tax is not deposited on or before the earlier of

— The day ten days after the date of the first delinquency notice to the taxpayer under IRC Section 6303, or

— The day on which notice and demand for immediate payment is given under IRC Section 6861 or Section 6862, or the last sentence of IRC Section 6331(a). The penalty will not be imposed if it can be shown that failure is due to reasonable cause and not to willful neglect.

— Bad checks result in a penalty of the greater of 1 percent of the amount of the check or a flat $5 if the check is for $500 or less.

— A 5 percent penalty of the net tax to be reported is imposed per month up to a maximum penalty of 25 percent for each month or part of a month that employment tax returns are late.

— A penalty of half of 1 percent up to 25 percent of the tax due is imposed for each month during which the failure to pay continues.

— Criminal penalties, in addition to the penalties previously listed, of imprisonment and fines of up to $10,000 will be imposed when a willful attempt to evade payment of employment taxes by failing to file the federal unemployment tax form (Form 940) or by filing a false return is made.

Taxes due and unpaid will bear interest at the current federal rate, compounded daily.

3.11.2 Levies

The IRS may authorize a levy on and seize property and property rights of an employer if the employer fails to pay any tax liability within ten days after notice and demand for payment.

3.12 Deposit Requirements

Employers must compute their FUTA tax liability quarterly as follows: FUTA Taxable Wages × Net FUTA Tax Rate = FUTA Tax Liability

3.12.1 Deposit rules

- If the aggregate quarterly undeposited FUTA tax liability is more than $100, a deposit of the tax must be made by the due date.
- If in any of the first three quarters the FUTA tax liability is under $100, the liability is carried over to the next quarter and added to that quarter's liability.
- If fourth-quarter FUTA tax liability is over $100, the liability must be deposited by January 31 of the following year.
- If the FUTA tax liability for the fourth quarter is under $100, it may be remitted directly to the IRS with Form 940.
- If the employer wishes to receive a ten-day extension of the due date for Form 940, all FUTA tax must be deposited by January 31 of the following year, even if the liability is less than $100.

3.12.2 Where and how to deposit

Form 8109, Federal Tax Deposit Coupon, is used to make deposits of FUTA tax. Deposits are to be made at a Federal Reserve bank or an authorized depository. Deposits made by mail should be by check or money order payable to the depository bank. The date of receipt will determine the timeliness of the deposit. A deposit received after the due date will still be considered timely if the employer can establish that it was mailed on or before the second day before the due date.

3.12.3 Deposit due dates

When an FUTA tax deposit is required, it is due the last day of the month following the end of the quarter (April 30, July 31, October 31, and January 31). If the due date falls on a Saturday, Sunday, or legal holiday, the due date becomes the next business day.

4. REPORTING REQUIREMENTS UNDER FUTA

All employers subject to FUTA tax during a calendar year must file an annual return on Form 940 or 940-EZ, Employer's Annual Federal Unemployment Tax Return. Employers can use Form 940-EZ if

— Unemployment taxes were paid to only one state,

— These taxes were paid by the due date of the Form 940-EZ, and

— All wages that were taxable for FUTA were also taxable for state unemployment tax.

Hereafter, all references to Form 940 include Form 940-EZ.

4.1 Who Must File

— If there is a change of ownership or transfer of business during the year, each employer who qualifies as an employer under FUTA requirements must file Form 940 reporting the wages paid during the year.

— If there is a statutory merger or consolidation, the resulting corporation is considered the same employer and only one Form 940 must be filed.

— If a successor-predecessor relationship exists and the predecessor was not an employer under FUTA requirements, the successor, if considered an employer under FUTA requirements, must file Form 940 for the portion of the year following acquisition of the business.

4.2 Filing Due Date

Form 940 is due on or before January 31 of the following year. If the employer has made timely deposits and the FUTA liability is paid in full, Form 940 will receive an automatic ten-day extension until February 10 of the following year. If the due date falls on a Saturday, Sunday, or legal holiday, Form 940 is due the next business day.

A mailed return bearing a postmark indicating that it was mailed on or before the due date will be considered timely filed. The registration date of a return sent by registered mail will be considered the postmark. If a return is sent by certified mail, the postmark date on the employer's receipt is considered the postmark date.

4.3 Signing Form 940

The return should be signed by:

Type of Entity	Signer
Sole proprietorship	Individual
Corporation	Principal officer
Partnership or unincorporated organization	Partner or officer
Trust or estate	Fiduciary of trust or estate

An unsigned Form 940 will not be considered a return.

4.4 Where to File Form 940

The completed Form 940 should be sent to the IRS center of the region in which the employer's principal place of business or office or agency is located. Below is a list of regions, states included within them, and addresses.

If your principal business, office, or agency is located in	*File with the Internal Revenue Service Center at*
Florida, Georgia, South Carolina	Atlanta, GA 39901
New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)	Holtsville, NY 00501
New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont	Andover, MA 05501
Illinois, Iowa, Minnesota, Missouri, Wisconsin	Kansas City, MO 64999
Delaware, District of Columbia, Maryland, Pennsylvania, Puerto Rico, Virginia, Virgin Islands	Philadelphia, PA 19255
Indiana, Kentucky, Michigan, Ohio, West Virginia	Cincinnati, OH 45999

If your principal business, office, or agency is located in	*File with the Internal Revenue Service Center at*
Kansas, New Mexico, Oklahoma, Texas	Austin, TX 73301
Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Ogden, UT 84201
California (all other counties), Hawaii	Fresno, CA 93888
Alabama, Arkansas, Louisiana, Mississippi, North Carolina, Tennessee	Memphis, TN 37501

If you have no legal residence or principal place of business in any IRS district, file with the Internal Revenue Service Center, Philadelphia, PA 19255.

5. FUTA AND STATE UNEMPLOYMENT INSURANCE

Two types of credit are applicable against the FUTA tax for contributions made to state unemployment agencies—normal (or 90 percent) credit and additional credit.

5.1 The "Normal" or "90 Percent" Credit

The Federal Unemployment Tax Act permits an employer to offset against the FUTA tax liability 90 percent of the FUTA tax. This credit is only allowed to employers whose state laws require state unemployment contributions and only if the contributions are actually paid by the employer in the year in which the credit was claimed.

Although the FUTA gross tax rate is 6.2 percent, only 90 percent of a deemed 6 percent federal tax rate is allowed. The 0.2 percent difference will continue in effect until January 1, 1996, when the rate is scheduled to decrease to 6 percent.

Example: An employer is subject to both federal and state unemployment tax. The taxable payroll for both laws is $50,000. The state contribution rate is 2.9 percent, so the state tax liability is $1,450 ($50,000 × 2.9%). The federal tax liability before deducting the 90 percent credit is $3,100 ($50,000 × 6.2%). The employer may take a credit of $2,700 ($50,000 × 6% × 90%) against the federal tax. The net federal tax is $400 ($3,100 − $2,700).

5.2 Requirements to Qualify for 90 Percent Credit

The total credit against federal tax for a calendar year may not exceed 90 percent of 6 percent, including the 90 percent credit and the additional credit described in section 5.3. The lowest net federal tax rate therefore cannot be lower than .8 percent (6.2 percent less 5.4 percent).

The full 90 percent credit applies only if all state contributions are paid on or before the due date of the federal return. A partial credit is allowed for the amount of state contributions paid after the due date. This partial credit is limited to 90 percent of the amount that would have been allowed if the state contributions had been timely made. The partial credit would be 81 percent (90 percent of 90 percent) of the federal tax.

5.3 Additional Credit

For an employer who had obtained a good experience rating the amount paid for state contributions would be considerably less than 90 percent of the deemed federal rate (5.4 percent). In this case there would not be any benefit in a favorable rating, since the employer would be paying considerably more in FUTA tax.

For this reason an additional credit is allowed. The federal government allows the employer to take an additional credit against the federal tax equal to the difference between the contributions actually paid to the state and the amount that would have been paid if the reduced rate had not been in effect.

5.4 State Loans and Shortages

Title XII of the Social Security Act allows a state to borrow funds from the federal unemployment account to enable the state to pay unemployment benefits. This allows a state to continue to pay benefits when its funds run low because of poor economic conditions. Repayment of this loan, without interest, can occur in three ways:

— A reduction of the state's share of the amount of any excess in the employment security administration account that would have been transferred to the state's account in the unemployment trust fund.

— A transfer of funds from the state's account in the unemployment trust fund to the federal unemployment account.

— A reduction in the total credit otherwise allowed an employer.

This reduction of the credit against federal tax is computed on Part 1 of Form 940. Each quarter the employer should compute the federal tax liability, using the net FUTA rate. The credit reduction is not computed and paid until Form 940 is filed.

Example: Blake, Inc. has a net FUTA rate of .8 percent. Taxable wages for the calendar year were $100,000, or $25,000 per quarter. For the first three quarters, Blake should deposit $200 ($25,000 × .8%) each quarter. The state Blake resides in has borrowed funds from the federal government because its unemployment funds have run low. The IRS has enforced a credit reduction of .9 percent on this state in order to collect the loan repayment. Blake's fourth-quarter FUTA deposit is calculated as follows:

Fourth-Quarter Taxable Wages $25,000
Net FUTA Rate × .8%
Fourth-Quarter FUTA Tax $200 ($25,000 × .8%)
Credit Reduction
Total Taxable Wages for the Year $100,000
Credit Reduction Rate × .9%
Additional FUTA Tax $900 ($100,000 × .9%)
Deposit Due January 31 $1,100 ($200 + $900)

6. STATE UNEMPLOYMENT INSURANCE

All states have unemployment compensation laws that require contributions from employers. Some states require contributions from employees. Each state is responsible for the content and development of its unemployment insurance laws.

Each state governs

— Amount and duration of benefits, with minor limitations.

— Coverage and contribution rates.

— Eligibility requirements and disqualification provisions.

— Direct administration of the laws, including collecting contributions, maintaining wage records, taking claims, determining eligibility, and paying benefits.

6.1 Experience Rating

Experience ratings allow employer state contribution rates to vary based on the employer's experience with unemployment. Experience ratings permit the cost of unemployment compensation to vary depending on an employer's rate of involuntary unemployment. As a result of experience ratings, state contribution rates range from the lowest rate allowed of 0 to rates that exceed 5.4 percent. All states are required to provide for experience ratings up to at least 5.4 percent because of the federal credit of 5.4 percent (6% × 90%).

6.2 Determination of Experience Rating

All formulas for calculating an experience rating are devised to determine the experience of each employer with unemployment or benefit costs. This list indicates the type of plan used to determine experience ratings as of January 1, 1991:

Experience Rating

Alabama	Benefit ratio
Alaska	Payroll decline
Arizona	Reserve ratio
Arkansas	Reserve ratio
California	Reserve ratio
Colorado	Reserve ratio
Connecticut	Benefit ratio
Delaware	Benefit-wage ratio
District of Columbia	Reserve ratio
Florida	Benefit ratio
Georgia	Reserve ratio
Guam	None
Hawaii	Reserve ratio
Idaho	Reserve ratio
Illinois	Benefit-wage ratio
Indiana	Reserve ratio
Iowa	Benefit ratio
Kansas	Reserve ratio
Kentucky	Reserve ratio
Louisiana	Reserve ratio
Maine	Reserve ratio
Maryland	Benefit ratio

Experience Rating *(Continued)*

Massachusetts	Reserve ratio
Michigan	Benefit ratio
Minnesota	Benefit ratio
Mississippi	Benefit ratio
Missouri	Reserve ratio
Montana	Reserve ratio
Nebraska	Reserve ratio
Nevada	Reserve ratio
New Hampshire	Reserve ratio
New Jersey	Reserve ratio
New Mexico	Reserve ratio
New York	Reserve ratio
North Carolina	Reserve ratio
North Dakota	Reserve ratio
Ohio	Reserve ratio
Oklahoma	Benefit-wage ratio
Oregon	Benefit ratio
Pennsylvania	Modified Benefit ratio
Puerto Rico	None
Rhode Island	Reserve ratio
South Carolina	Reserve ratio
South Dakota	Reserve ratio
Tennessee	Reserve ratio
Texas	Benefit ratio
Utah	Benefit ratio
Vermont	Benefit ratio
Virgin Islands	Benefit ratio
Virginia	Benefit ratio
Washington	Benefit ratio
West Virginia	Reserve ratio
Wisconsin	Reserve ratio
Wyoming	Benefit ratio

6.3 Reserve-Ratio Formula

An account for each employer shows total payroll, employer contributions, and benefits paid to workers. Benefits are subtracted from contributions. The net amount is then divided by total payroll to determine the size of the balance in terms of potential liability. While a balance of $5,000 may be adequate for a total payroll of $50,000, it would be low for a total payroll of $200,000.

The size of an employer's reserve ratio determines the experience rating. The larger the reserve ratio, the lower the experience rating. The formula is designed to give a better experience rating to those employers who have contributed more than benefits paid out.

6.4 Benefit-Ratio Formula

This formula compares benefits to payrolls. The basis for this formula is the fact that if each employer pays a rate that meets the benefit ratio the program will be adequately funded.

6.5 Benefit-Wage-Ratio Formula

This experience rating is measured by separations of workers that result in the payment of benefits; the duration of their benefits is not considered. The separations are weighted with the workers' wages earned from each base-period employer and are recorded on each employers' experience record. These wages are termed *benefit wages.* For any one employer, only one separation per beneficiary per benefit year is recorded on the record.

The experience of each employer is determined by dividing the total benefit wages into the total taxable wages. This experience factor is then multiplied by the state's experience factor. A table is then used to determine the experience rate.

6.6 Payroll-Decline Formula

This experience rating formula is measured by the decline in an employer's payrolls from year to year or quarter to quarter. No benefit or contribution amounts are considered. This formula operates on the assumption that if an employer's payroll declines, the employer is not offering as much employment and is therefore considered a source of potential unemployment.

7. FACTORS AFFECTING EMPLOYER'S EXPERIENCE RATING

Certain factors affect an employer's experience rating. Among these are benefit charges, seasonal workers, voluntary contributions and successor employer situations.

7.1 Benefit Charges

When an employee receives unemployment benefits, those benefits either have to be charged to the state's fund or to the employer or employers who had paid wages to the employee for which the benefits were received. In reserve-ratio and benefit-ratio states, a claimant's benefits need to be charged. In benefit-wage states the benefit wages need to be charged. There is no charging of benefits in payroll-decline states.

There are three methods of charging benefits to employers.

7.1.1 Charging most-recent employers

A few states charge the most-recent employer on the theory that this particular employer is primarily responsible for the unemployment. In most of these states the charges are limited to the most-recent employer who employed the employee for a certain number of weeks. Other states do not charge an employer unless a specified amount of wages was paid.

7.1.2 Charging base-period employers in inverse chronological order

Some states charge base-period employers but limit the amount for each employer. The charge first is applied to the most-recent employer, then in inverse chronological order to previous employers. This method is based on the assumption that responsibility lessens for unemployment as time goes by.

A limit is place on the amount any one employer may be charged. When the limit is reached, the next-previous employer is charged with the remainder. The limit is determined as either a fraction of the wages paid by the employer or as a specified amount in the base period or quarter, or both.

If the last employer in a base period employed a claimant for a considerable part of the base period or the claimant's unemployment is short, this method of charging base-period employers in inverse chronological order has the same effect as charging the most recent employer. If the claimant's unemployment is long, this method results in charging all base-period employers proportionately.

7.1.3 Charging proportionate base-period wages

Most states charge benefits to all base-period employers based on the wages earned from each employer by the claimant. This method is based on the assumption that unemployment is a result of the general conditions of the labor market rather than separation from a given employer.

7.2 Seasonal Workers

Several states have specific guidelines for identifying the employers of seasonal workers and charging them with benefits paid to these seasonal employees. Seasonal employers are generally charged only for benefits paid for unemployment during the seasonal period. Nonseasonal employers are charged for benefits for all periods.

7.3 Noncharging of Benefits

Depending on the particular state, some benefits are not charged to employers

— If the duration of unemployment is very short.

— If benefits are paid on the basis of a determination in a case that is appealed and later reversed.

— If benefits are paid following a period of disqualification for voluntary quitting, misconduct, or refusal of suitable employment.

— If the employer who employs a claimant part time in the base period continues to provide that claimant with equal part-time employment.

— If the benefits are being paid to a claimant who is taking approved training.

7.4 Voluntary Contributions

About half of the states allow employers to make voluntary contributions (these states all use the reserve-ratio formula). The voluntary contribution increases the balance in the employer's reserve so the employer is assigned a lower rate. An employer who will be increasing the number of employees in the coming year, for example, may benefit from making a voluntary contribution. This may result in a lower experience rating being applied to the larger wage base.

State agencies usually do not supply employers the amount of the voluntary contribution necessary to lower the experience rating, but worksheets are available to compute it. It is important to make the payment large enough to result in a lower rate since the voluntary contribution is often not refunded if it does not result in a reduced rate.

Voluntary contributions cannot be credited against the federal unemployment tax.

7.5 Successor Employers

Although laws vary from state to state, most states provide that the predecessor's experience rating be transferred to a successor employer.

In order to receive this transfer of rating, certain conditions must be met, depending on the particular state:

— Successor assumes responsibility for contributions of predecessor.

— No substantial reduction of personnel takes place after the transfer.

— There is continuity of ownership or management.

— Successor continues same type of trade or business.

— Predecessor has ceased to do business.

If the successor employer was not subject to unemployment laws before the transfer, the successor will normally be required to use the predecessor's rate for the remainder of the year. If the successor was subject to unemployment laws prior to the transfer, the successor usually must continue to use that same rate for the remainder of the year, although some states recompute the successor's rate at the time of transfer.

When a business transfer occurs, both the predecessor and the successor should notify the appropriate state agencies. Most states provide special forms for this purpose and require filing within a limited time period.

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APPENDIX: State Unemployment Insurance Agencies

The following list contains addresses and telephone numbers of state unemployment insurance agencies as of January 1, 1990:

ALABAMA
Department of Ind Relations
Unemployment Compensation Agency
649 Monroe St.
Montgomery, AL 36130
(205)261-5386

ALASKA
Unemployment Insurance
Div of Employment Security
Dept. of Labor
P.O. Box 3-7000
Juneau, AK 99802
(907)465-2712

ARIZONA
Dept. of Economic Security
P.O. Box 6123
Phoenix, AZ 85005
(602)255-5678

ARKANSAS
Employment Security Div
Capitol Mall, P.O. Box 8007
Little Rock, AR 72203
(501)682-2121

CALIFORNIA
Employment Development Dept.
P.O. Box 826880, MIC40
Sacramento, CA 94280-0001
(916)445-8008

COLORADO
Div of Employment & Training
Dept. of Labor & Employment
251 E. 12th Ave
Denver, CO 80203
(303)866-6561

CONNECTICUT
State of Connecticut
Dept. of Labor
Employment Security Div
200 Folly Brook Blvd.
Wethersfield, CT 06109
(203)566-4288

DELAWARE
Dept. of Labor
Unemployment Insurance Div
Rte 273 & Chapman Rd
University Plaza
P.O. Box 9149
Newark, DE 19714-9029
(302)368-6730

FLORIDA
Tax Rates & Adjustments Section
Bureau of Tax
Caldwell Bldg., Rm 326
Tallahassee, FL 32399-0236

GEORGIA
Unemployment Insurance Div
Sussex Place, Rm 718
148 International Blvd. N.E.
Atlanta, GA 30303-1751
(404)656-3050

HAWAII
Unemployment Insurance Div
Labor and Industrial Relations Dept.
830 Punchbowl St., Room 325
Honolulu, HI 96813
(808)548-6951

IDAHO
Dept. of Employment
317 Main St.
Boise, ID 83735
(208)334-6100

ILLINOIS
Dept. of Employment Security
P.O. Box 802551
Chicago, IL 60680-2551
1-800-247-4984

INDIANA
Dept. of Training & Employment Services
10 N Senate Ave., Rm. 109
Indianapolis, IN 46204
(317)232-7428

IOWA
Dept. of Employment Services
Bureau of Job Insurance
1000 E. Grand Ave
Des Moines, IA 50319
(515)281-5526

KANSAS
Dept. of Human Resources
Division of Admin
Contributions Branch
401 SW Topeka Blvd.
Topeka, KS 66603-3182
(913)296-5075

KENTUCKY
Div of Unemployment Insurance
Cabinet for Human Resources
275 E. Main St.
Frankfort, KY 40621
(502)564-2900

LOUISIANA
Off. of Employment Security
Dept. of Employment & Training
P.O. Box 94094
Baton Rouge, LA 70804-9094
(504)342-3113

MAINE
Dept. of Labor
Bur of Employment Security
P.O. Box 309
Augusta, ME 04332-0309

MARYLAND
Unemployment Insurance Admin.
Dept. of Economic & Employment Dev
1100 N Eutaw St.
Rm 614
Baltimore, MD 21201
(301)333-5502

MASSACHUSETTS
Dept. of Employment & Training
Charles F Hurley Bldg.
19 Staniford St.
Boston, MA 02114
(617)727-6600

MICHIGAN
Employment Security Comm.
Dept. of Labor
7310 Woodward Ave
Detroit, MI 48202
(313)876-5500

MINNESOTA
Jobs Opportunities & Insurance
Dept. of Jobs & Training
390 N. Robert St.
St. Paul, MN 55101
(612)296-3567

MISSISSIPPI
Unemployment Insurance Div
Employment Security Comm.
1520 W Capitol St.
Jackson, MS 39203
(601)961-7700

MISSOURI
Div of Employment Security
421 E. Dunklin, Box 59
Jefferson City, MO 65104
(314)751-3215

MONTANA
Unemployment Insurance Div
Dept. of Labor & Industry
Box 1728
Helena, MT 59624-1728
(406)444-2723

NEBRASKA
Unemployment Insurance
Dept. of Labor
P.O. Box 94600
State House Station
Lincoln, NE 68509-4600
(402)475-8451

NEVADA
Employment Security Dept.
500 E. Third St.
Carson City, NV 89713
(702)885-4635

NEW HAMPSHIRE
State of New Hampshire
Dept. of Employment Security
32 S. Main St.
Concord, NH 03301
(603)224-3311

NEW JERSEY
New Jersey Dept. of Labor
Div of Unemployment & Disability Insurance
Labor Building, Room 601
CN 058
Trenton, NJ 08625-0058
(609)292-2460

NEW MEXICO
Unemployment Insurance Bur
Dept. of Labor
P.O. Box 1928
Albuquerque, NM 87103
(505)841-8431

NEW YORK
Office of Director
N Y State Dept. of Labor
Governor W Averell Harriman State Office Building Campus
Albany, NY 12240
(518)457-2741

NORTH CAROLINA
Employment Security Comm.
P.O. Box 25903
Raleigh, NC 27611

NORTH DAKOTA
Job Insurance Div
Job Service
P.O. Box 1537
Bismarck, ND 58502
(701)224-2833

OHIO
Bur of Employment Services
145 S. Front St., P.O. Box 923
Columbus, OH 43216
(614)466-2319

OKLAHOMA
Unemployment Insurance Div.
Employment Security Comm.
206 Will Rogers Bldg.
Oklahoma City, OK 73105
(405)557-7131

OREGON
Employment Div
Dept. of Human Resources
875 Union St., NE
Salem, OR 97311
(503)378-3211

PENNSYLVANIA
Bureau of Employer Tax Operations
Dept. of Labor & Industry
Labor & Industry Bldg., Room 915
Harrisburg, PA 17121
(717)787-6223

RHODE ISLAND
Tax Division
Dept. of Employment Security
P.O. Box 1029
Providence, RI 02901
(401)277-3612

SOUTH CAROLINA
Employment Security Comm.
1550 Gadsden St.
P.O. Box 995
Columbia, SC 29202
(803)758-2686

SOUTH DAKOTA
Div of Unemployment Insurance
Dept. of Labor
420 S. Roosevelt
P.O. Box 4730
Aberdeen, SD 57401
(605)622-2302

TENNESSEE
Experience Rating
Dept. of Employment Security
Nashville, TN 37245-3550

TEXAS
Employment Comm.
101 E. 15th St.
Austin, TX 78778-0001
(512)463-2652

UTAH
Job Service
Dept. of Employment Security
174 Social Hall Ave.
Salt Lake City, UT 84147
(801)533-2400

VERMONT
Unemployment Compensation Div.
Dept. of Employment & Training
Green Mountain Dr.
P.O. Box 488
Montpelier, VT 05602
(802)229-0311

VIRGINIA
Employment Comm.
P.O. Box 1358
Richmond, VA 23211
(804)786-3001

WASHINGTON
Employment Security Dept.
Experience Rating Unit
MS-KG-11
Olympia, WA 98504-5311
(206)753-5114

WEST VIRGINIA
Div of Employment Security
112 California Ave , Rm 610
Charleston, WV 25305
(304)348-2630

WISCONSIN
Unemployment Compensation Div
Dept. of Industry, Labor & Human Relations
P.O. Box 7942
Madison, WI 53707
(608)266-7074

WYOMING
Unemployment Insurance Div
Employment Security Comm., Dept of Employment
P.O. Box 2760
Casper, WY 82602
(307)235-3215

DISTRICT OF COLUMBIA
Off of Unemployment Compensation
Dept. of Employment Services
500 C St., NW, Rm 515
Washington, DC 20001
(202)639-1163

GUAM
Dept. of Labor
P.O. Box 9970
Tamuning, GU 96911-2970
(671)646-9241

PUERTO RICO
Bur of Employment Security
Labor & Human Resources Dept.
50 Munoz Rivera Ave.
Hato Rey, PR 00918
(809)754-5375

VIRGIN ISLANDS
Employment Security Agcy
Dept. of Labor
P.O. Box 1092
St. Thomas, VI 00801
(809)776-3700

SOCIAL SECURITY

SOCIAL SECURITY

1. BACKGROUND

1.1 History

With the enactment of the Old Age and Survivors Insurance program in 1935, the United States established the concept of a government-sponsored pension plan in this country. The revenue collected by this program was placed in a trust fund designed to insure workers in the areas of commerce and industry—with the exception of railroad employees, who were guaranteed benefits under the Railroad Retirement Act. In the 1950s coverage was expanded to include almost all workers in the United States, Puerto Rico, and the Virgin Islands. Americans working for U.S. employers outside the United States were also given coverage. By the end of the 1950s the program, renamed Old-Age, Survivors, and Disability Insurance (OASDI) and commonly referred to as Social Security, covered almost 90 percent of the American working population. During this period the self-employed and professionals gained coverage.

The Medicare program (a health insurance program for covered workers over age sixty-five and their spouses over sixty-five, and later for disabled workers covered by Social Security) was added to the Social Security structure in 1965. In 1972 the Supplemental Security Income (SSI) program was created to ensure a minimum level of income for the eligible elderly or disabled. SSI is funded out of general revenue.

Today, nine out of every ten workers in the United States are earning protection under the Social Security system and one of every six Americans receives monthly checks. By withholding FICA (Federal Insurance Contributions Act) taxes, employers and self-employed persons ensure that the system has sufficient funds to provide retirement benefits for those who qualify. In addition, Medicare currently covers almost the entire U.S. population over age sixty-five and three million disabled under that age.

1.2 Purpose and Goals

The Social Security program is designed to assure that Americans receive a continuing source of income when their income is reduced by the retirement, disablement, or death of an insured worker. Social Security is not intended to replace all lost earnings but rather to supplement savings, pensions, investments, or other insurance plans.

1.3 When to Contact Social Security

In order to receive Social Security benefits, it is necessary to apply for them. Recommended times to contact Social Security include

- When a person is unable to work because of an illness or injury that is expected to last a year or longer.
- When a person sixty-two or older plans to retire.
- When a person is within three months of age sixty-five even if he or she doesn't plan to retire.
- If a family member who has worked and contributed to Social Security dies.
- If a worker, spouse, or dependent child suffers permanent kidney failure.

In most instances, dealings with the Social Security Administration can be conducted by telephone. The telephone number for the nearest Social Security office can be found in the telephone directory under "Social Security Administration" or "U.S. Government." Because of the heavy volume of telephone calls received at the Social Security offices during the first week of each month, it is strongly recommended that non-urgent calls be made after the middle of the month. Persons calling Social Security should have available their Social Security and Medicare cards. Callers having questions regarding their Social Security or SSI checks should have the claim number appearing on their check readily accessible. (See section 6, herein.)

2. RETIREMENT BENEFITS

2.1 Qualification

For a worker, or a spouse or child of a worker (and in some select cases a dependent parent of a worker) to be eligible for benefits certain minimum requirements must be met.

2.1.1 Work credits needed

To receive retirement benefits, a worker must have accumulated a required amount of work credits. Work credit is measured by "quarters of coverage," with four quarters of coverage equaling one year of coverage. Presently an employee or self-employed person receives one quarter of coverage for each $570 earned annually doing work covered by Social

Security or in net earnings from self-employment. The maximum number of credits that can be earned per year is four. The dollar amount required to earn a quarter of coverage increases periodically to keep pace with average wages. The exact amount of credits required for retirement benefits depends on the age of the covered person. Under Social Security, a person who stops working and accumulating enough credits to be eligible for benefits cannot receive individual or family benefits (coverage is either all or nothing). Work credits are, however, recorded on a person's Social Security record and if a person returns to work, under Social Security, his or her previous credits will be counted toward determining eligibility for benefits.

The following table shows work credits needed for retirement benefits.

If you reach age sixty-two in	Work credits you need	Years you need
1983	32	8
1984	33	8¼
1985	34	8½
1986	35	8¾
1987	36	9
1988	37	9¼
1989	38	9½
1990	39	9¾
1991 or later	40	10

Work credits required for employees of nonprofit organizations or for disabled persons may vary from the preceding standards (see sections 3.1 and 4.2, below).

2.1.2 Work performed outside the United States

The 1983 Social Security Amendments allow any American employer to provide coverage for U.S. citizens and residents working for a foreign affiliate, provided that the U.S. employer has at least a 10 percent direct or indirect interest in the foreign-affiliate employer.

In addition, the President of the United States may enter into bilateral agreements with foreign countries stating that employees of either country are taxed only by their country of residence. Bilateral agreements (or totalization agreements) thus eliminate dual taxation for work performed in countries bound by the agreement. The United States has entered into bilateral agreements with Sweden, Switzerland, Italy, West Germany, Norway, Belgium, Canada, Great Britain, France, and Spain.

2.1.3 Spouse and child requirements

If a worker covered by Social Security is receiving retirement or disability benefits, the following are also entitled to monthly benefits:

— All unmarried children under age eighteen (nineteen if full-time high school students)

— Any unmarried children eighteen or older who were severely disabled before the age of twenty-two and continue to be disabled

— A spouse age sixty-two or older

— A spouse under age sixty-two if the spouse is caring for a child under the age of sixteen who is getting a benefit based on the retired or disabled worker's earnings or is caring for the worker's disabled child

— Any divorced spouses age sixty-two or older, provided the marriage lasted ten years or longer and the divorced spouse has not remarried

Facts to consider:

— If an eligible divorced spouse has been divorced for two years or longer, he or she may receive benefits regardless of whether the former spouse is receiving benefits or not. The former spouse must, however, be eligible for benefits.

— A marriage must have lasted for at least one year before dependents of a retired worker can receive monthly benefits.

2.2 Rules Governing When to Apply for Benefits

Persons planning to retire before age sixty-five should apply for Social Security benefits no later than the last day of the month for which benefits are desired to begin. Generally, benefits for months of retirement before the age of sixty-five cannot begin before the person applies for the benefits (starting in 2000, the age at which full benefits are payable will be gradually raised to sixty-seven). Furthermore, benefits can only be paid for months during which the person has been eligible for the entire month.

Until January 1991, those applying for benefits after reaching age sixty-five could receive up to six months of back payments prior to the month of application. The Omnibus Budget Reconciliation Act of 1990 that was passed in October 1990, effective January 1, 1991, eliminated the ability of those over age sixty-five to receive payments retroactive up to six months prior to the month of application. Two groups are affected. One is composed of those employees who plan to retire from full-time work at age sixty-five and continue working part-time. The other group comprises those individuals who plan to retire at age sixty-five but who have an older dependent spouse who cannot collect benefits until the working spouse applies for benefits.

The ability of these two groups to file retroactively under the former rules safeguarded thousands of dollars in future benefits for the first group, which had been threatened by complicated rules under which benefit levels are cut when earnings exceed a certain amount. The advantage for the second group was that an older dependent spouse received an extra six months of benefits that would not otherwise be available.

However, the two groups can circumvent the elimination of their right to file retroactively simply by filing for benefits for an effective date six months before the sixty-fifth birthday of the filer even though he or she continues to work full-time and would not be eligible to receive Social Security checks during the period.

For those persons not belonging to the two groups described, it is advisable to file promptly to ensure that benefits start on time. It is permissible to apply up to three months before benefits are to start. For Medicare coverage to begin at age sixty-five, a person must enroll for coverage during this three-month period. When applying for benefits, make sure to have the following:

- Social Security card or a record of number
- Proof of age
- Proof of spouse's age
- Marriage certificate, if spouse is entitled to receive benefits
- Children's birth certificates, if children are entitled to benefits
- Form W-2 for the latest year of employment or a copy of your latest federal income tax return, plus copies of canceled checks for taxes paid if self-employed

2.3 Responsibility for Reporting

When a person receives the benefits of Social Security he or she assumes responsibility for reporting certain changes in facts to the Social Security Administration. If changes are not timely filed or if a false statement is made, the penalty can be a deduction from benefits, a fine, or imprisonment. Benefits can also be held back for future entitlements of family members.

2.3.1 What must be reported

The Social Security Administration requires that individuals who are receiving Social Security report

— Change of mailing address.
— Earnings of more than the annual limit.
— Travel outside the United States.
— Work outside the United States.
— Imprisonment for a felony.
— Spouse's receipt of a government pension.
— Marriage, divorce, or annulment.
— Adoption of a child.
— Child leaving the care of a parent.
— Child nearing eighteen who is disabled or a full-time student.
— Change in school attendance for a student eighteen to nineteen.
— Eligibility for or receipt of a pension from work not covered by Social Security.
— Inability to manage funds.
— Death of person receiving benefits.

2.3.2 How to file a report

Reports can be made to the Social Security Administration by telephone, by mail, or in person. The following information must be included:

— Name of person or persons about whom the report is being made
— Facts of report
— Date of facts
— Signature (if not filing by telephone)
— Address
— Claim number (the nine-digit Social Security number [000-00-0000] followed by a letter)

2.4 Work After Retirement and Social Security

To receive retirement benefits, a worker need not retire completely; however, wages and self-employment income earned after benefits begin may affect the amount paid in benefit checks. The SSA uses an earnings test to determine if benefits are to be reduced or stopped because earnings are above the annual limit. There is no limit to earnings for people seventy and older, and full benefits will be paid in 1992 if annual earnings do not exceed

— $7,440 for people under sixty-five.

— $10,200 for people sixty-five through sixty-nine.

For people age sixty-five through age sixty-nine, $1 of benefits will be withheld for every $3 of earnings above the annual limit. For people under age 65, $1 of benefits will be withheld for every $2 of earnings above the annual limit. These reductions will also affect family members' benefits. But, if a person receiving benefits based on a worker's earnings has personal earnings from work exceeding the allowable limit, only that person's benefits will be reduced. Earnings must be counted for the entire year; for most people, this means January through December. Annual reports of earnings must be filed by April 15 of the following year, and reports of expected changes in earnings must be made to the SSA as soon as they are known.

Self-employed individuals collecting Social Security at age sixty-nine should consider postponing receipt of other income (in excess of $10,200) from work to the following year, since earnings are not subject to any Social Security limits at age seventy. With the exception of serving on boards of directors, self-employment earnings are only counted when received, and not when earned.

2.4.1 The special monthly rule

The special monthly rule applies for people who wish to retire during a year and would like to receive benefits for the remainder of the year. This rule states that a person can receive full benefits for any month in that year in which the monthly exempt amount is not exceeded and substantial services are not performed in self-employment. Current exempt amounts are

— $620 for persons under sixty-five.

— $850 for persons sixty-five or older.

Substantial services are judged based on amount of time devoted to business, type of services rendered, and how services rendered compare to those performed in the past. Work totaling more than forty-five hours each month will generally be considered substantial. Work of fewer than fifteen hours in a month will not be considered substantial.

2.4.2 What counts as earnings

It is important to use the SSA definition of earnings when figuring earnings. For an employee, gross wages are counted, not just take-home pay. For the self-employed, net losses can be deducted. People who are both employees and self-employed must combine earnings. If wages earned during the year were paid after year-end they must still be counted as earnings for the year in which the work was done. In addition, the following are also counted as earnings:

— Bonuses, commissions, fees, vacation pay, and pay in lieu of vacation

— Cash tips amounting to $20 or more from work for one employer

— Severance pay

— Noncash payments such as meals or living quarters

— Fees collected as director of a corporation

— Deferred compensation

— Personal use of employer-provided vehicles

2.4.3 What does not count as earnings

Not all types of income are considered earnings by the SSA. The following is a list of income items not required to be counted as earnings:

— Investment income in the form of dividends from stocks (must be counted as income by securities dealers)

— Interest on savings accounts

— Income from Social Security benefits, pensions, other retirement pay, or Veterans Administration benefits

— Income from annuities

— Gain or loss from the sale of capital assets

— Gifts or inheritances

— Rental income from owned real estate (must be counted as income by real estate dealers and certain farm owners)

— Royalties received at or after age sixty-five from patents obtained before turning sixty-five

— Retirement income of a retired partner if

The retirement payments are to continue for life under a written agreement that provides for payments to all the partners (or to a class or classes of them)

An individual's share of the partnership capital was paid in full before the end of the partnership's taxable year and there is no obligation from the partnership to the individual except to make retirement payments

— Income from a limited partnership

— Income from self-employment that is not attributable to services performed after the month of entitlement

Special rules apply to payments from certain trust funds, payments from certain annuity plans, sick pay received after the sixth full calendar month after the employee last worked or paid after employment was terminated, loans from employers unless repaid by work, moving expenses, travel expenses, and pay for jury duty. (Additional information on these subjects can be obtained from local Social Security offices.)

Example. Computing reduction in SSA benefits: Joe Elder, sixty-four, is single and receives monthly SSA benefit checks. During 1992, Joe received total SSA benefits of $8,000. Joe worked at his son's hardware store and received a W-2 for $7,362. He is also a director of City Bank, and received $1,500 in director fees for 1992. Joe's other income included $1,000 interest income and $500 rental income. The following is a computation of Joe's reduction in SSA benefits for 1992.

SSA earnings	
W-2 wages	$7,362
Director fees	1,500
Total	$8,862
SSA allowed earnings	(7,440)
	$1,422
	÷2
Reduction in benefits	$ 711

2.5 Calculations of Future Retirement Benefits

The Social Security Administration has always encouraged individuals to check their Social Security earnings records for accuracy. However, the information provided was limited to a breakout of annual earnings for the last four years and a summary of all earnings from 1937 to the present. They also provided, if requested, an indication of insured status and limited estimates of retirement benefits.

To overcome these limitations, the SSA has redesigned the system to provide workers a more complete statement of their earnings and benefit estimates. The new, enhanced statement, known as the Personal

Earnings and Benefit Estimate Statement (PEBES), serves as a viable tool for workers to verify their posted earnings and to learn the estimated amount of FICA taxes paid on the earnings. It also explains what they may expect in the way of Social Security protection so as to aid in their planning for their own future financial security.

The revised statement is now available to the general public and can be requested by using the new request form SSA-7004. These forms can be obtained by writing: Consumer Information Center, Dept. 55, Social Security Administration, Pueblo, CO 81009.

Persons who complete the new request form are asked to provide information about their most recent earnings (which are not yet on record), their expected future earnings, and the age at which they plan to retire. This information is used in calculating the benefit estimates.

The new statement of earnings will provide workers with the following information:

— A summary of their earnings from 1937–1950.

— An annual breakout of earnings from 1951–present, with the corresponding estimated FICA taxes.

— Benefit estimates for retirement at a reduced age, full retirement age, and age seventy, and for survivors and disability benefits.

— More realistic estimates using the worker's anticipated future earnings and recent unposted earnings, as well as including projected real wage growth.

— The number of credits the worker needs to be insured for each type of benefit and the credits currently on record.

Note that the new statement will not be available to the following categories of individuals. Those who

— Have no Social-Security-covered earnings on record.

— Have only Medicare-qualified government earnings (MQGE) on record.

— Have 120 or more months of railroad service.

— Already receive Social Security benefits, who have a benefit claim pending, or who are age sixty-five or older.

Persons in any of the above categories will receive a modified statement that will not include all of the information described earlier.

Benefit amounts vary for people with differing average incomes, but a retired worker reaching age sixty-five in 1992 can receive as much as $1,088 per month without dependents.

2.6 Early Retirement

Although a person cannot receive full retirement benefits before reaching age sixty-five, it is possible to receive reduced benefits starting at age sixty-two. A covered worker retiring at age sixty-two can receive 80 percent of the full benefit amount. Spouse's benefits starting at age sixty-two will be reduced to 75 percent of the full benefit amount. (These benefit reductions are permanent, to compensate for the extra time the checks will be received.) Each month a person waits to retire after turning sixty-two will increase the amount of benefit received until it is at 100 percent when he or she turns sixty-five.

2.6.1 Advantages of retiring before age sixty-five

Retirement before age sixty-five means reduced monthly payments, but not necessarily less money in the long run. During the thirty-six-month period between age sixty-two and age sixty-five a person will be receiving payments he or she would not ordinarily receive. Despite the fact that monthly payments are permanently reduced, it can take an average of twelve years beyond age sixty-five to offset the total amount of the additional thirty-six checks received. If a portion of the money received from Social Security is invested, the time required to offset the difference would be increased even further.

> *Example.* If Mr. Williamson begins collecting a reduced benefit payment of $480 a month at sixty-two and Mr. Harrison (who is entitled to the same benefits) waits until age sixty-five to receive a benefit payment of $600 a month, Williamson will be receiving checks for three years before Harrison receives his first check. Thus, even if Williamson does not invest the money he received during the three additional years, it will take Harrison twelve years to receive benefit payments equal to the payments received by Williamson.

2.6.2 Advantages of working beyond age sixty-five

Starting in 1990, benefits will be increased by 3.5 percent per year for each year a person continues to work beyond age sixty-five, through age sixty-nine. Beginning in 1990 this credit will be gradually increased until it reaches 8 percent by 2008.

These percentage increases, known as "delayed retirement credits," are applied to a person's full age-sixty-five benefit rate. A person delaying retirement until age seventy, for example, will find a 17.5 percentage increase in the benefit he or she would have received if retirement had occurred at age sixty-five.

2.7 Payment of Retirement Benefits to Recipients Outside the United States

Citizens of the United States or any of the countries listed here can receive their Social Security checks no matter how long they stay outside the United States, as long as they are eligible for the checks.

Antigua and Barbuda
Argentina
Austria
Bahamas
Barbados
Belgium
Belize
Bolivia
Bourkina Faso
Brazil
Canada
Chile
Colombia
Costa Rica
Cyprus
Czechoslovakia
Denmark
Dominica
Dominican Republic
Ecuador
El Salvador
Federated States of Micronesia
Finland
France
Gabon
Greece
Grenada
Guyana
Iceland
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Liechtenstein
Luxembourg
Malta
Marshall Islands
Mexico
Monaco
The Netherlands
Nicaragua
Norway
Panama
Peru
Philippines
Poland
Portugal
San Marino
Spain
St. Lucia
Sweden
Switzerland
Trinidad-Tobago
Trust Territories of the Pacific (Palau)
Turkey
United Kingdom
West Germany
Western Samoa
Yugoslavia
Zaire

(This list of countries is subject to change from time to time.)

If the recipient is not a citizen of the United States or one of the other countries listed above, the checks will normally stop six months after leaving the United States. For exceptions to this policy, contact a local Social Security office.

U.S. Treasury Department and Social Security regulations prohibit sending checks if the recipient is in Albania, Cuba, Democratic Kampuchea (formerly Cambodia), East Berlin, East Germany, North Korea, Vietnam, or the countries formerly part of the U.S.S.R. U.S. citizens can receive all the withheld checks once they leave these countries for a country where Social Security is able to send checks.

3. SURVIVORS' BENEFITS

3.1 Qualification

Social Security coverage does not necessarily stop with the death of an insured worker. Social Security survivors' insurance can provide cash benefits on the earnings record of a deceased worker to

— A widow or widower—full benefits at 65 or any age if caring for an entitled child (under 16 or disabled) of the deceased worker. Reduced benefits can be received at 60 (or 50 and disabled) if not caring for a child. Remarriage after 60 (50 if disabled) will not prevent the payment of benefits provided the worker died before the remarriage.

— Unmarried children up to 18 (or 19 if they are attending an elementary or secondary school full time). Children who were disabled before 22 can receive benefits at any age as long as they remain disabled.

— Divorced widow or widower after 10 years of marriage—full benefits at 65 or any age if caring for an entitled child (under 16 or disabled) of the deceased worker. Reduced benefits can be received at 60 (or 50 if disabled). Remarriage after 60 (or 50 if disabled) will not prevent the payment of benefits.

— Divorced widow or widower married less than 10 years—at any age if caring for an entitled child (under 16 or disabled) of the deceased worker.

— Lump-sum death payment—is a one-time payment of $255. This is in addition to any monthly survivor insurance benefits. It is paid to the surviving widow(er) who was either living in the same household as the deceased at the time of death or was eligible for or entitled to survivor's benefits on the deceased worker's record for the month of death. If there was no surviving widow(er), it is payable to a child or children eligible for or entitled to survivors' benefits on the deceased worker's record for the month the worker died.

In addition, grandchildren, great-grandchildren, and dependent parents 62 or older may qualify for survivors' benefits on the deceased worker's record under certain circumstances.

In order for eligible surviving relatives to receive monthly checks following a covered worker's death, the worker must have met certain minimum work credit requirements during his or her lifetime (see section 2.1, above). Under a special provision, payments can be made to a worker's children and the worker's mother or father provided that the worker worked under Social Security for a period of a year and a half during the three years preceding his or her death. The following table represents the number of work credits required for persons born before 1930.

Born before 1930, die in	Credits needed	Years you need
1985	34	8½
1986	35	8¾
1987	36	9
1988	37	9¼
1989	38	9½
1990	39	9¾
1991 or later	40	10

For persons born after 1929, the following table applies.

Born after 1929, die at age	Credits needed	Years you need
28 or younger	6	1½
30	8	2
32	10	2½
34	12	3
36	14	3½
38	16	4
40	18	4½
42	20	5
44	22	5½
46	24	6
48	26	6½
50	28	7
52	30	7½
54	32	8
56	34	8½
58	36	9
60	38	9½
62 or older	40	10

3.2 Benefits

The amount of monthly benefit checks varies depending on the worker's average earnings, but a widowed mother with two children can receive an average of $1,252 per month; an aged widow alone, $584; an aged couple (both receiving benefits), $1,067; and the average for all retired workers is $629 per month.

4. DISABILITY BENEFITS

4.1 Definitions

4.1.1 Social Security definition of disability

In determining a person's eligibility for disability benefits, it is important to be aware of what Social Security considers disabling. To be considered disabled under Social Security law a person must have a physical or mental condition that

— Prevents the person from doing any "substantial gainful work" (see section 4.1.2).

— Is expected to last (or has lasted) for at least twelve months or is expected to result in death.

To prove disability, the SSA must be supplied with medical evidence from physicians or other sources showing the extent of the person's condition and the degree to which it prevents that person from working. Social Security Regulations contain a complete list of conditions that are considered disabling. Circumstances the SSA usually considers disabling include

— Diseases of the heart, lung, or blood vessels that have resulted in serious loss of heart or lung reserves as shown by x-ray, electrocardiogram, or other tests and, in spite of medical treatment, there is breathlessness, pain, or fatigue.

— Severe arthritis that causes recurrent inflammation, pain, swelling, and deformity in major joints so that the ability to get about or use the hands is severely limited.

— Mental illness resulting in marked constriction of activities and interests, deterioration in personal habits or work-related situations, and seriously impaired ability to get along with other people.

— Damage to the brain or brain abnormality that has resulted in severe loss of judgment, intellect, orientation, or memory.

— Cancer that is progressive and has not been controlled or cured.

— Diseases of the digestive system that result in severe malnutrition, weakness, and anemia.

— Acquired Immune Deficiency Syndrome (AIDS).
— Progressive diseases that have resulted in the loss of a leg or have caused it to become useless.
— Loss of major function of both arms, both legs, or a leg and an arm.
— Serious loss of function of the kidneys.
— Total inability to speak.

A similar definition of disability applies to disabled surviving spouses and disabled children.

4.1.2 Social Security definition of substantial gainful work

In determining eligibility for disability benefits, substantial gainful work or substantial gainful activity is defined differently for employees and for the self-employed. For employees, the amount of earnings is the primary factor. The general rule is that average earnings of $500 a month (after allowable deductions) imply substantial gainful work. Average earnings of between $190 and $500 per month can be considered gainful if other workers in the same area are receiving comparable earnings. This decision is also based on the time, energy, skill, and responsibility involved in the work. The work need not be in the worker's previous field, but people who can do other substantial work may not be considered disabled. Earnings of less than $190 a month are not considered gainful. For self-employed persons, "substantial work" is based on the type and value of the work performed (including management).

Certain impairment-related expenses for items or services needed to work can be deducted from earnings when deciding if work is substantial and gainful. These expenses can be deducted only if the worker keeps records of them and provides proof of payment for all expenses.

For workers disabled by blindness, these rules apply:

— Average monthly earnings of $780 or less in 1990 are not considered substantial and gainful.
— If the worker is fifty-five to sixty-five, monthly benefits will continue if the worker cannot resume doing the same or similar work he or she did before becoming blind or turning fifty-five, whichever is later.

4.2 Qualification

In addition to being considered disabled by the SSA, a worker must have accumulated enough work credits to be entitled to receive benefits. A person disabled before age twenty-four needs one and one-half years of covered work in the three-year period ending when the disability began. For a worker aged twenty-four through thirty-one, credit is required for working half of the time between turning twenty-one and becoming disabled. For disabled workers thirty-one or older, the general rule is that they must have earned at least five years of work credit in the ten years immediately before they became disabled. An exception to this rule is people disabled by blindness who may have earned credit at any time after 1936; for them no recent work is required.

For workers age thirty-one or older, this table applies.

Born after 1929, became disabled at	Born before 1930, became disabled before sixty-two in	Years of work credit you need
31–42		5
44		5½
46		6
48		6½
50		7
52	1981	7½
53	1982	7¾
54	1983	8
55	1984	8¼
56	1985	8½
57	1986	8¾
58	1987	9
60	1989	9½
62 or older	1991 or later	10

4.3 Who Can Receive Disability Benefits

In many cases Social Security benefits can be received by family members of disabled workers as well as by the workers themselves (the following list of eligible family recipients applies only with respect to disabled workers who have been approved for disability benefits):

— Unmarried children (including stepchildren, adopted children, and in some cases, grandchildren or great-grandchildren) who are under eighteen (nineteen if in high school full-time) or if over eighteen, disabled before age twenty-two

— A spouse caring for a worker's child who is under sixteen or disabled and also receiving checks

— A spouse age sixty-two or older

— Disabled widows and widowers (and in some cases disabled surviving divorced spouses) of workers who were insured at death (these checks are payable as early as age fifty)

4.4 Applying for Disability Benefits

4.4.1 How to apply

It is necessary to apply for disability benefits to receive them. An application for disability benefits should be filed as soon as a condition appears likely to prevent all substantial gainful work for at least a year. If an applicant is unable to go to a Social Security office to apply in person, other arrangements can be made by phone. A spouse, parent, other relative, friend, or legal guardian may also complete the application. When applying be sure to have the following data available:

— The Social Security number and proof of age for each person eligible for payments

— Names, addresses, and phone numbers of doctors, hospitals, clinics, and institutions where treatment has been received, with dates of treatment and hospital or clinic numbers if known

— An employment history covering the past fifteen years

— A copy of W-2 forms (wage and tax statements), or federal tax returns for self-employed people, for the past year

— Dates of any military service

— Dates of any prior marriages if a spouse is applying for benefits

— The claim number of any other benefit check received or expected to be received because of the disability

— The worker's death certificate and proof of marriage if the person applying for checks is a disabled widow or widower

— Information about any worker's compensation claims

To ensure that applications are processed as quickly as possible, information must be complete and accurate. Additional evidence or information requested by the SSA should be furnished promptly.

4.4.2 Additional facts to consider

Social Security checks paid to a child will stop at age eighteen. If disability occurs, Social Security should be contacted several months before the person's eighteenth birthday to ensure that benefit checks will continue, based on the disability. Checks are available to a disabled widow or widower between ages fifty and sixty if the disability started before the spouse's death or within seven years afterward. If checks were received by a widow or widower with children, eligibility begins at age fifty or older if the person becomes disabled before the payments end or within seven years after they end. The marriage must have lasted ten years or longer in the case of a surviving divorced wife or husband; proof of this will be necessary when applying.

4.5 The Disability Decision

When a person meets all the basic requirements, the Social Security office sends the claim to the Disability Determination Services (DDS) office in the applicant's state of residence. The DDS employs physicians and disability-evaluation specialists to determine if people are disabled under Social Security law. The DDS will obtain all medical records needed to make a determination and may request that the person in question have a special examination paid for by Social Security. The process usually takes two or three months, after which time a written decision will be mailed.

4.5.1 If the claim is approved

If the claim is approved, the applicant will receive a certificate of award and will be told when the checks will begin and the amount of the benefit. Typically, monthly checks begin in the sixth full month of an SSA-recognized disability. The amount of the benefit check is dependent on the worker's average earnings covered by Social Security. Current payments average $610 monthly to an individual worker and $1,056 to a worker with a family.

4.5.2 Right to appeal if claim is denied

If the SSA denies a disability claim, the person filing the claim will receive written notification explaining the denial. The complainant then has sixty days to file a written appeal with any Social Security office. Appeals are initially reconsidered by the DDS. If again denied, the complainant can request a hearing before an administrative law judge, then a review by the appeals council, and then civil action in a federal court (in that order).

4.6 Items That Can Affect Disability Benefits

The following occurrences can lead to changes in benefit amounts and must be reported to the Social Security Administration:

— Death

— Change of address

— Any changes in disabling condition
— Return to work (see section 4.7, below)
— Travel outside the United States
— Other disability checks received
— Pension from work not covered by Social Security
— Government pension received by spouse or surviving spouse
— Marriage
— Inability to manage own funds
— Conviction of a felony

The reporting procedure is the same described in section 2.3.2.

4.7 If a Disabled Person Works

Social Security is not designed to discourage disabled persons from returning to work and, therefore, benefits do not stop as soon as one returns to work. Most people receiving checks are entitled to a trial work period during which they can continue receiving benefits for up to nine months while testing their ability to work (the worker must still be disabled). Usually only months in which a person earns more than $200 in gross wages count as trial months. Trial months for self-employed people are based on $200 net earnings and more than forty hours devoted to the business. The nine months do not have to be consecutive. At the end of the trial period, a decision is made as to whether the person can do substantial gainful work (see section 4.8 below). If it is determined that the worker can do the work, benefits continue for an additional three months (the month in which disability ends plus the two following months) and then stop. If the worker is still judged disabled, the benefits continue until the condition changes. If the worker's disability ceases during the trial period, the benefits will continue for three months and then stop.

There is an extended period of eligibility of 36 months after the trial work period during which a person may receive benefits for any month during which he or she does not perform substantial gainful activity. If disability payments stop because of work activity and a person is still disabled, Medicare can continue for up to thirty-nine months after the extended period of eligibility. Just about everybody who receives Social Security disability benefits is referred to a State Vocational Rehabilitation Agency for possible vocational rehabilitation services. If a person unexpectedly recovers while under an approved vocational rehabilitation program likely to enable him or her to work, payments may continue until the plan is completed. In addition, certain impairment-related work expenses that a disabled person needs in order to work may be deducted when counting earnings to determine if the person is performing substantial gainful activity for SSI purposes. Examples include medical devices such as a wheelchair or braces, attendant care services, transportation costs, and work-related equipment such as a special typewriter or braille device.

4.8 Disability Review Process

To ensure that all persons receiving disability benefits are actually still disabled, the SSA requires periodic reviews of all cases. Notice letters are mailed to any person whose case is up for review and that person is requested to visit the closest Social Security office (unless the impairment prevents the person from going to the office). An SSA agent reviews all information, including any new information relevant to the case, then sends the updated folder to DDS. A team composed of a doctor and a disability examiner will then review the case and make a determination. If more medical evidence is needed, an additional examination paid for by the SSA may be required. All decisions are based on a uniform national policy.

Reviews are scheduled based on the following conditions:

— Improvement expected: First review six to eighteen months after disability decision is made

— Improvement possible: Once every three years

— Improvement not expected: Once every five to seven years

If the worker's condition is determined to be no longer disabling, benefit payments will be stopped after three months. A worker who disagrees with a decision can file an appeal within sixty days. If an appeal is filed during the first ten days of the sixty-day period, benefits can continue through the appeal process. If the appeal is denied, payments will stop after three months (and payments received during the appeal process must be returned, unless a waiver of overpayment is requested and granted).

4.9 If a Worker Becomes Disabled Again

If a worker who has received disability checks becomes disabled for a second time within five years after payments have stopped (for any reason), the new checks can start with the first full month of the new disability; the five-month waiting period is not required. This provision also applies to disabled widows or widowers and persons disabled before age twenty-two who become disabled again within seven years after the earlier benefits end.

5. MEDICARE

5.1 Description

Medicare is a federal health insurance program for people sixty-five or older, people of any age with permanent kidney failure, or people with certain other disabilities. Medicare is administered by the Health Care Financing Administration (HCFA) and covers people receiving medical or hospital care anywhere in the United States (including the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and American Samoa). Medicare is divided into two parts: hospital insurance and medical insurance. Hospital insurance helps pay for in-patient hospital care and certain outpatient follow-up care and is financed by part of the Social Security tax. Medical insurance helps pay for doctors' services and other medical services and is financed by the monthly premiums paid by people enrolled in the program (see section 5.4.1, below) and by general federal revenues.

5.2 Eligibility

To be eligible for Medicare hospital coverage, people age sixty-five or older must meet at least one of the following criteria:

- They are entitled to monthly Social Security or railroad retirement benefits.
- They have worked long enough to be insured under Social Security or the railroad retirement system.
- They have worked long enough in federal employment (see the table at the end of this section) to be insured for Medicare purposes.

People are entitled to coverage before sixty-five if they meet one of the following conditions:

- They have been entitled to Social Security disability benefits for twenty-four months.
- They have worked long enough in federal employment and meet the requirements of the Social Security disability program.

People are eligible at any age if they need maintenance dialysis or a kidney transplant for permanent kidney failure and

— Are insured or getting monthly benefits under Social Security or the railroad retirement system.

— Have worked long enough in federal employment.

Spouses and children of workers may also be eligible for maintenance dialysis or kidney transplant. Under certain conditions spouses, divorced spouses, widows, widowers, or dependent parents may be eligible at age sixty-five. This may also apply to disabled widows or widowers under sixty-five, disabled surviving divorced spouses under sixty-five, and disabled children eighteen or older.

Work credits needed for federal employees

If you reach age 65	Years you need
1983	7¼
1984	7½
1986	8
1990	9
1994 or later	10

5.3 Medicare Hospital Insurance (Part A)

5.3.1 How to get hospital insurance coverage

People receiving Social Security or railroad retirement checks do not have to apply for hospital insurance; it will begin automatically at age sixty-five (except for federal employees, who should apply three months before their sixty-fifth birthday). People who plan to keep working after age sixty-five should also file an application three months prior to turning sixty-five. Those not eligible for coverage at sixty-five because they do not have enough work credits or are not receiving benefits can purchase it for $192 a month in 1992 (to buy hospital insurance one must also buy medical insurance). People with permanent kidney failure should apply for Medicare as soon as the condition appears. There is a twenty-four-month waiting period for disabled workers under sixty-five and a two-month waiting period for people receiving maintenance dialysis treatment.

5.3.2 Hospital coverage

Hospital coverage provides benefits for inpatient care, skilled-nursing-facility care, home health care, and hospice care. If a person needs inpatient hospital care, Medicare Hospital Insurance covers the first ninety days of a hospital stay and includes sixty additional lifetime reserve days that can be used at the discretion of the patient. Coverage includes

— Semiprivate room and board.

— General nursing service.

— Lab tests, x-rays, other radiology services, and radiation therapy.

— Drugs furnished by the hospital.

— Medical supplies.

— Rehabilitation services.

— Cost of special-care units.

For patients requiring home health services, Medicare coverage includes

— Part-time skilled nursing care.

— Physical and speech therapy.

— Medical supplies and services provided by an agency.

— Occupational therapy.

Skilled-nursing-facility care and hospice care are also available to patients whose conditions require these services.

5.3.3 Patients' financial obligations

Medicare hospital insurance fully pays for the first twenty days of skilled-nursing-facility care and then pays all but $81.50 per day for continuous confinement through the hundredth day. The patient must have had a minimum three-day hospital stay, and the Medicare patient's doctor has to certify the medical necessity for skilled-nursing-facility care.

Medicare pays all costs for home health care and all costs for hospice care except for a 5 percent co-payment for drugs, biologicals (serum, vaccines, etc.), and respite care.

Hospital expenses

Length of stay	Patients' obligation
0–60 days	First $652
61–90 days	$163 per day
91–150 days (includes reserves)	$326 per day
150+ days	All costs
90+ days (reserves exhausted)	All costs

5.4 Medical Insurance (Part B)

5.4.1 How to get medical insurance coverage

People eligible for hospital insurance will automatically be enrolled for medical insurance unless they specifically refuse it at the time they become eligible for hospital insurance. The monthly premium for 1992 is $31.80. People who must apply for medical insurance include

— People planning to work past age sixty-five.

— People age sixty-five who are not eligible for hospital insurance.

— People with permanent kidney failure.

— People eligible for Medicare on the basis of federal employment.

5.4.2 Medical coverage

Medical insurance coverage provides for doctors' services and outpatient care and includes

— Medical and surgical treatment.

— Services of a doctor's nurse.

— Drugs and biologicals that cannot be self-administered.

— Medical supplies and equipment (does not include basic first-aid equipment).

— Medically required ambulance services.

— Blood transfusions provided on an outpatient basis.

5.4.3 Patients' financial obligations

Medicare's Part B coverage is designed to cover 75 percent of reasonable charges less the annual deductible ($100 in 1992). It should be noted, however, that if there is a difference between what the doctor charges and what Medicare considers reasonable, the patient must pay the difference.

5.5 What Medicare Does Not Cover

Services and supplies not covered by either hospital insurance or medical insurance include

— Custodial care such as help with bathing, eating, and taking medicine.

— Dentures and routine dental care.

— Eyeglasses, hearing aids, and examinations to prescribe or fit them.
— Personal-comfort items such as a phone or TV in a hospital room.
— Prescription drugs and patent medicines.
— Routine physical checkups and related tests.

5.6 Filing a Medicare Appeal

Decisions on the amount Medicare will pay on a claim, or on whether services received are covered by Medicare, may be appealed.

The notices sent from Medicare telling of the decision made on a claim will also tell exactly what appeal steps can be taken. Claimants have at least 60 days from the date they receive the notice in which to file their appeals. For more information about appeal rights claimants should call any Social Security office, the Medicare intermediary or carrier, or the peer review organization (PRO) in their states. Following is a brief summary of the different Medicare appeals processes.

5.6.1 Appealing decisions by peer review organizations

Peer review organizations are groups of doctors in each state who are paid by the federal government to help Medicare decide when hospital care is necessary and meets standards of quality accepted by the medical profession. Medicare-participating hospitals can provide a brochure, "An Important Message From Medicare," which describes a hospital patient's appeal rights and supplies the name, address, and phone number of the PRO in that state.

If claimants disagree with the decision of a PRO, they can appeal by requesting a reconsideration. Then, if they disagree with the PRO's reconsideration decision and the amount in question is $200 or more, claimants can request a hearing by an Administrative Law Judge.

Cases involving $2,000 or more can eventually be appealed to a Federal Court.

5.6.2 Appealing all other hospital insurance (Part A) decisions

Appeals of decisions on all other services covered under Medicare hospital insurance (skilled-nursing-facility care, home health care, and hospice services) are handled by Medicare intermediaries. If claimants disagree with the intermediary's initial decision, they may request a reconsideration. The request can be submitted directly to the intermediary or through the claimant's Social Security office. If there is further disagreement with the intermediary's reconsideration decision and the amount in question is $100 or more, the claimant can request a hearing by an Administrative Law Judge. Cases involving $1,000 or more can eventually be appealed to a Federal Court.

5.6.3 Appealing decisions on medical insurance (Part B) claims

Under Medicare medical insurance, either the claimants, their doctors or their suppliers submit the claim for payment. Medicare will send the claimant an explanation of the decision of the claim on a form called "An Explanation of Medicare Benefits" (EOMB). The EOMB also explains how the claimant can appeal denials or payment decisions with which he or she disagrees, and gives the name, address, and statewide toll-free number of the carrier (the names and addresses of the carriers and areas they serve are also listed in the back of *Your Medicare Handbook*).

If a claimant disagrees with the decision on the claim, he or she can ask the carrier to review it. Claimants have up to six months from the date on the EOMB to request the review and the request must be sent to the carrier in writing.

If there is further disagreement with the carrier's written explanation of its review decision and the amount in question is $100 or more, the claimant can request a hearing by the carrier. (Other claims that have been reviewed within the previous six months can be counted towards the $100 amount.)

If there is disagreement with the carrier hearing decision and the amount in question is $500 or more, claimants are entitled to a hearing before an Administrative Law Judge. Cases involving $1,000 or more can eventually be appealed to a Federal Court.

5.6.4 Appealing decisions by health maintenance organizations and competitive medical plans

If the claimant is a member of a Medicare-certified health maintenance organization (HMO) or competitive medical plan (CMP), the same appeal rights that all other Medicare beneficiaries have apply. However, the initial steps of the grievance or appeals procedure may vary from plan to plan. Federal law requires Medicare-certified HMOs and CMPs to provide a full, written explanation of appeal rights to all members at the time of enrollment. If claimants are members of such a plan and have not received a written explanation of appeal rights, they should request one from their plan's membership office or write to: Health Care Financing Administration, Office of Prepaid Health Care, Humphrey Bldg., 200 Independence Ave., S.W., Washington, D.C. 20201.

5.7 Supplemental Health Insurance

Medicare does not discourage people from buying additional health insurance, but they should avoid plans that simply duplicate Medicare's coverage. For protection, people wishing to cancel existing policies in favor of Medicare should not cancel any health insurance they have until the month Medicare begins. For people working past age sixty-five who have employer health plans, Medicare will be the secondary insurance payer (Medicare will pay for coverage not offered by employer health plans).

6. SUPPLEMENTAL SECURITY INCOME

6.1 Overview

In addition to retirement, disability, survivors', and medical benefits, Social Security also offers Supplemental Security Income (SSI) to assure a minimum monthly income to people with limited income and resources who are sixty-five or older, blind, or disabled. SSI is financed from general funds of the federal Treasury, not from Social Security taxes. Eligibility for the program is based on income and assets. A single person can own as much as $2,000 in resources and still receive checks (see section 6.2.3 for the SSI definition of resources); for a couple this figure is $3,000. Not all assets count. A home does not count, and a car and personal belongings generally do not count. Federal payments of up to $422 a month for individuals and $633 a month for couples are possible. Amounts of monthly checks vary because the amount is based on where a person lives (some states may add to the federal SSI payments), income, and living arrangements. Thus, first and second checks are based on a person's first month's income and living arrangements. The checks for the months that follow are based on income and living arrangements that existed for the two previous months (therefore, if no changes are reported, the amount of the check will not change). SSI cases are reviewed periodically to ensure that those receiving benefits are still eligible for them.

6.2 Responsibility for Reporting

Those who receive SSI are responsible for reporting changes in their conditions that could affect the amount of their checks within ten days after the end of the month in which the change occurred. Fines of up to $100 are imposed for failing to report changes or making false statements. Reports can be made by phone, by mail, or in person.

6.2.1 What must be reported

The SSA requires that a report be filed if a person meets any of these criteria:

— Moves or changes address

— Has a change in his or her household

— Has a change in income

— Has a change in resources

— Receives help with living expenses

— Enters or leaves an institution

— Leaves the United States

— Marries or ends a marriage

— Becomes a sponsored immigrant

— Improves in condition while receiving benefits based on disability or blindness

— Starts or stops attending school

— Is a drug addict or alcoholic and stops treatment

The fact that a person receiving benefits cannot manage money or dies must also be reported. Some states also have additional reporting responsibilities.

6.2.2 State requirements

The following states have additional SSI reporting requirements:

California. Residents must report if they were eating meals away from home regularly and are now eating at home, and vice versa.

Hawaii, Michigan, Vermont. Residents must report if they are living in a facility that provides different levels of care and their level of care changes.

Massachusetts. Residents must report if they (or they and their spouses) were paying more than two thirds of the living expenses for the household and are now paying less, and vice versa.

New York. Residents have the same reporting requirements as do residents of California and must, in addition, report if they are living with other people and they formerly prepared their meals alone but are now preparing them with other people, and vice versa.

6.2.3 Social Security definition of resources

In order to determine if a person meets the SSI resource requirement to receive benefits one must know what SSI considers resources. A person's home and the land it is built on do not count. Household goods, personal property, and cars may not count, depending on their worth. In addition, up to $1,500 in burial funds for each worker and a spouse may not count. The following items *do* count as resources:

— Checking and savings accounts

— Certificates of deposit

— Stocks and bonds

— Money set aside for any purpose

6.2.4 What is not considered income by SSI

Items not counted as income by SSI include these:

— Medical care and services

— Social services

— Gain from sale, exchange, or replacement of personal property*

— Income tax refunds*

— Proceeds of a loan*

6.2.5 Applying for SSI

Applications for supplemental security income (SSI) payments can be expedited when applicants know what to bring with them when they visit the Social Security office.

Before applying for SSI, a person should have

— A Social Security card or a record of his or her Social Security number.

— Proof of age in the form of a birth certificate or the oldest other proof of age available.

— Information about any income and resources such as payroll slips, copies of tax returns, bank books, insurance policies, car registration, and burial-fund records. (If applying for benefits for a child, information about the parents' income and resources will be needed.)

— Information about the place he or she lives, including the amount of the mortgage and property taxes on his or her home, the lease

*May become resources.

and landlord's name (if renting), and the monthly cost of food and utilities.

— If the person is disabled or blind, medical records, or the names, addresses, and telephone numbers of doctors, hospitals, and clinics that have treated the person.

It is advisable to call the Social Security office before applying; SSA representatives can help in identifying just what records will be needed to support an application.

6.3 Right to Appeal

As with any decision made by Social Security, everyone has the right to appeal a decision made concerning an SSI judgment. There are three ways to present a case for reconsideration.

Case review. Evidence in a file is reviewed by someone in the Social Security office who did not have a part in the decision being appealed. The person filing the appeal is not present during the review but may examine the evidence in the file before the review. To view medical records, a person must first appoint a representative. The person appealing can add any evidence that he or she feels will help the case.

Informal conference. An informal conference is similar to a case review except that the person filing the appeal may personally present reasons for disagreeing with a decision to the person who is making the reconsideration decision. Witnesses may also be produced.

Formal conference. A formal conference differs from an informal conference only in that unwilling witnesses will be requested to appear for cross-examination with any evidence about the case.

A case review can be requested if an applicant was turned down for SSI or if a recipient feels that the amount of his or her check is too small. Any of the three methods can be requested if SSI checks are terminated or reduced. The DDS uses the case-review method to deal with medical issues.

7. CONTRIBUTION RESPONSIBILITIES

7.1 Employers and Employees

Employers and employees pay an equal share of Social Security taxes. Employee taxes are deducted from wages on each payday, matched by the employer, and sent to the Internal Revenue Service. The table shows the tax rate that must be paid by both employers and employees.

Employer and employee tax rates

Years	For cash benefits (%)	For hospital insurance (%)	Total (%)
1985	5.70	1.35	7.05
1986–1987	5.70	1.45	7.15
1988–1989	6.06	1.45	7.51
1990 and after	6.20	1.45	7.65

In 1985, the maximum FICA tax was $2,792 and the maximum self-employment tax was $4,673. In 1992 the maximum taxable earnings level is $55,500 for employees and self-employed individuals for cash benefits only; the maximum taxable earnings level is $130,200 for hospital insurance benefits.

For 1992 the maximum taxes are as follows:

Employees	
$ 55,500 × 6.20%	$3,441.00
$130,200 × 1.45%	1,887.90
	$5,328.90*
Self-Employed	
$ 55,500 × 12.40%	$6,882.00
$130,200 × 2.90%	3,775.80
	$10,657.80

*Note employers also pay $5,328.90 in taxes for each employee.

7.2 Self-Employed People

Self-employed individuals who have $400 or more in net earnings for a year must report their earnings and pay self-employment tax. Prior to 1990 self-employed people received a credit of 2 percent of self-employment income against the self-employment tax. The following table represents rates for self-employed persons before the tax credit.

Self-employed tax rates (before credit)

Years	For cash benefits (%)	For hospital insurance (%)	Total (%)
1985	11.40	2.70	14.10
1986–1987	11.40	2.90	14.30
1988–1989	12.12	2.90	15.02
1990 and after	12.40	2.90	15.30

Starting in 1990, the credit is eliminated; however, self-employed taxpayers can deduct half the self-employment (Social Security) tax they pay. On $55,500 income, the deduction saves a taxpayer in the 28 percent bracket a total of $1,189 in federal taxes. This deduction is from gross income in determining adjusted gross income. It is not an itemized deduction.

Self-employed individuals whose self-employment earnings are less than $55,550 can save on self-employment tax. In computing the self-employment income subject to the tax, the income is reduced by .0765 percent; the self-employment tax is 15.3 percent of the lower of that amount or the $55,500 base.

Example. During the year, attorney Smith had self-employment income of $53,000. The self-employment tax is computed as follows:

Self-Employment Income	$53,000.00	
	× .0765	
	$4,054.50	(A)
Self-Employment Income	$53,000.00	
Less: (A)	4,054.50	
New Base	48,945.50	
	× .153	
Self-Employment Tax	$ 7,488.66	

This tax is less than the $8,109 self-employment tax that would have been calculated on the base amount (53,000 × .153).

A self-employed person who has net earnings of $400 or more in any year should file the following forms:

— Form 1040 (U.S. Individual Income Tax Return)

— Schedule C (Profit or Loss from Business or Profession) or Schedule F (Farm Income and Expense)

— Schedule SE (Computation of Social Security Self-Employment Tax)

7.3 Religious Exemptions

The following are exempt from self-employment tax.

— Members of religious orders who have taken a vow of poverty

— Clergy (may elect coverage)

— Members of religious sects opposed to insurance

7.4 Elimination of Certain Employee Exemptions

Beginning in 1988, wages paid to a child over seventeen years of age employed by a parent in the parent's unincorporated trade or business are subject to Social Security taxes. In addition, wages of a spouse employed in the spouse's unincorporated trade or business are subject to Social Security taxation.

Prior to 1988, casual agricultural wages under $150 per person per year were not subject to Social Security taxes. Beginning in 1988, this exemption applies only if the agricultural employer's total payroll is under $2,500 per year.

7.5 Nonfarm Optional Method

Self-employed individuals who are not engaged in farming may continue coverage through the nonfarm optional method even when their self-employment activity generates a loss or small net profit for the year. The following tests must be met:

1. Actual nonfarm self-employment net earnings are less than $1,600.
2. Nonfarm self-employment net earnings are less than two-thirds of total gross income from nonfarm self-employment.
3. The individual must be self-employed on a regular basis. To qualify for this test, actual net earnings from self-employment must be $400 or more in at least two of the three preceding tax years.
4. The individual cannot use this method more than five years in a lifetime.

If the above tests are met and gross income from all nonfarm business is $2,400 or less, two-thirds of the gross income from the nonfarm business may be used as net earnings from self-employment.

Example 1. Gene Brown meets all four tests listed above. Gene's gross self-employment income was $2,000 with net earnings of $500. Gene's net earnings are less than $1,600 and less than two-thirds of his gross earnings. Gene may report actual earnings of $500, or use the optional method and report earnings of $1,333 (two-thirds of $2,000).

Example 2. Assume the same facts, except Gene has a net loss of $300. Gene may use the optional method to report earnings of $1,333 (two-thirds of $2,000).

Example 3. Assume Gene has gross earnings of $500 and net earnings of $100. Gene cannot use the optional method since two-thirds of his gross income ($333) is less than the minimum income requirement of $400.

7.6 Farm Optional Method

The farm optional method allows continuation of self-employment tax coverage when net profit is small or a loss is incurred. There are fewer restrictions on the farm optional method than on the nonfarm method. There is no test of regular self-employment, actual net earnings may be less than two-thirds of gross income, and there is no limitation on the number of times this method may be used.

Example 1. Jay Steer has a gross income of $25,000 and net earnings of $1,000. Jay may use the optional method to report self-employment income of $1,600.

Example 2. Assume the same facts as Example 1, but substitute that Jay has a net loss of $5,000. Jay may still use the optional method to report self-employment income of $1,600.

8. INCOME TAX LIABILITIES ON BENEFIT PAYMENTS

People having substantial income in addition to their Social Security benefits may have to pay income tax on as much as half of their benefits. To determine if a person must pay tax, compute his or her adjusted gross income, plus tax-exempt interest, plus one-half of Social Security benefits, and subtract

$25,000 for a single taxpayer.
$32,000 for a married couple filing a joint return.
$0 for a married person living with a spouse at any time during the year and filing separate returns.

If the figure reached is positive, the taxpayer pays tax on the lesser of half of this figure or half of the Social Security benefits.

Example. Charles and Diana receive annual Social Security benefits totaling $7,200. In addition, the couple has adjusted gross income of $28,000 annually and $3,000 annually in tax-exempt interest. To compute their income tax liability as a married couple filing jointly, Charles and Diana must:

Add adjusted gross income	$28,000
to tax-exempt interest	3,000
and one-half of SS benefits	3,600
	34,600
And subtract the exempt amount for a married couple filing a joint return	(32,000)
	$ 2,600

Charles and Diana now pay income tax on half the $2,600 figure calculated above or on half their Social Security benefits, whichever is the lesser amount (in this case they would pay tax on half of $2,600).

Social Security benefits include

- Any Medicare medical insurance premiums that have been deducted from a person's check.
- Any overpayments not repaid in the year received.
- Any lump-sum payment of monthly benefits received.
- Any worker's compensation checks that cause a reduction in Social Security disability checks.

9. MISCELLANEOUS SOCIAL SECURITY ITEMS

9.1 Verification of Records

The SSA keeps earnings records throughout a worker's lifetime. To verify that earnings have been recorded accurately and plan the financial future a worker can request his or her own "Personal Earnings and Benefit Estimate Statement" by completing Form SSA 7004 PC entitled "Request For Earnings and Benefit Estimate Statement." The form may be requested by calling the toll-free number (1)(800)772-1213 (In N.Y. call (1)(800)234-5772) or by contacting the local Social Security office or writing to the Consumer Information Center, Department 55, Pueblo, CO 81009.

The Omnibus Budget Reconciliation Act of 1990 requires the Social Security Administration to establish, no later than September 30, 1995, a program to send to covered workers periodic Social Security account statements (earnings and benefit statements) concerning their earnings and the potential benefits payable on the basis of these earnings. Starting October 1, 1999, these reports will be provided on an annual basis. This will eventually eliminate the requirement for a covered worker to request this information.

9.2 Direct Deposit

To protect checks from being lost or stolen and to ensure that checks are deposited as soon as possible, Social Security offers direct deposit. Workers can arrange for direct deposit of checks into the financial institution of their choice by requesting a direct deposit form, SF-1199. Some financial institutions charge a fee for this service.

9.3 Sources of Information

Information publications on Social Security can be obtained by writing to local Social Security offices, the addresses of which appear in local telephone directories, or from the American Association of Retired Persons:

AARP
1909 K Street, N.W.
Washington, D.C. 20049

9.4 Unique Social Security Problems for Farmers

Retired farmers age sixty-five or older, still in possession of crops or livestock, will have the subsequent sale of such items excluded from the annual earnings test. To protect from an adverse earnings-test determination when old carryover items are being marketed, at the time drawing of benefits begins the retiring farmer should advise the SSA of how much crops and livestock remain in his or her possession.

9.5 The "Notch Effect"

The "notch effect" refers to the fact that some persons born between 1917 and 1921 receive benefit amounts that differ slightly from those paid to persons born in other years.

The notch effect results from an attempt by Congress to correct an error made in computing the cost-of-living increase in 1972. This error resulted in a benefit formula that overadjusted for inflation. To ease the transition from the old to the new formula, special computation provisions apply to workers born between 1917 and 1921. Their benefits are figured two ways—under the new indexing method and under a modified version of the method in effect before the 1977 Social Security Amendments. Workers in these age groups are paid a benefit rate based on the higher of the two calculations. Workers born after 1921 have their benefits figured only under the indexing method.

9.6 Preretirement Tax Planning Software

The preretirement tax planning software—a program that computes Social Security benefits—can be obtained from National Technical Information Service, 5285 Port Royal Road, Springfield, VA 22161; tel. (703) 487-4650. The cost is $50.00 for the program.

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CURRENT-YEAR CASES AND RULINGS

CURRENT-YEAR CASES AND RULINGS

1. INTRODUCTION

Each year, the IRS issues numerous rulings and informational announcements on various tax matters. Additionally, hundreds of court cases affecting tax issues are decided annually.

This section contains a summary of some of the more important developments of the past year. We present a brief synopsis of each development and draw conclusions about many of the matters. Readers are urged to take care not to base decisions on synopses alone. Rather, the synopses should be used to locate a full copy of the particular case or ruling, by which the details of the issue can be analyzed and compared to possibly similar client circumstances.

Although practitioners normally refer to cases and rulings intermittently as support for reasoning in particular client circumstances, we suggest that this chapter be reviewed for tax-planning and compliance ideas for the coming season.

Each section is categorized by certain tax elements, with a breakdown of issues within each broad category. To look up an issue, review the broad category and the breakdown to find particular cases or rulings that may be helpful to you. Once the case or ruling of interest is located, be sure to review the detail by referring to the citation given.

A number of major Treasury regulation projects were released during the past year which are not discussed in this section. These matters should be separately referred to and reviewed, as appropriate. Some of the more important regulations projects released by the Treasury during the past year are these:

1. Single Class of Stock: S Corporations (Prop. Reg. 1.1361-1)
2. ACRS Depreciation: Half-Year and Mid-Quarter Conventions (Prop. Reg. 1.168(d)-1)
3. Section 179: Expensing Rules (Prop. Regs. 1.179-1 through 1.179-6)
4. Self-Charged Interest—Passive Activity Rules (Prop. Reg. 1.469-7)
5. Like-Kind Exchanges (Regs. 1.1031(a), 1.1031(b), 1.1031(j), 1.1031(k))
6. Information Reporting on Real Estate Transactions (Reg. 1.6045-4)
7. Accuracy-Related Penalties (Prop. Regs. 1.6662 and 1.6664)
8. Preparer Penalties (Prop. Regs. 1.6694-1 and 1.6694-4)
9. Information Return Reporting Penalties (Temp. Regs. 301.6721-1T through 301.6724-1T)
10. Capitalization of Interest on Production of Property (Prop. Regs. 1.263A(f)-0 through 1.263A(f)-9)
11. Estate and Gift: Freezes—Valuation Rules (Prop. Regs. 25.2701 through 25.2703)
12. Partner and Partnership Transactions (Prop. Regs. 1.707-2 through 1.707-9)
13. Partnership Liabilities (Prop. Regs. 1.752-1 through 1.752-5)

2. TAXABILITY OF INCOME

2.1 Minister's Housing Allowance Exclusion

An ordained minister who was employed by the state as a prison chaplain was not permitted to exclude a portion of his wages as a housing allowance, despite a parsonage allowance designation by his church. Employment by the state was not the barrier (this had been approved for a police chaplain in *Boyd*, TC 1981-528). Rather, the church was not actively involved in the day-to-day conduct of the chaplain's work, and this insufficient involvement rendered its parsonage allowance designation invalid. (TAM 9052001)

2.2 Civil Service Pension

Retiring federal government employees have several options for drawing their civil service pensions, including receipt of a large initial lump-sum payment followed by a smaller monthly annuity paid out over a number of years. An employee selecting this alternative drew an initial lump sum equal to his own contributions, arguing that the first payment was a return of capital. However, the court ruled that IRC Sec. 72 annuity distribution rules apply, with basis spread over all expected annuity payments and distributions. Further, the court imposed the 10% premature distribution penalty. (*J.E. Shimota*, 90-2 USTC ¶ 50,489, Cl. Ct., 1990)

2.3 State Legislator's Housing Allowance

The fair market value of an apartment in a state-owned building provided to a state legislator was includible in the legislator's wages for income tax and withholding purposes when the legislative district residence was 50 or fewer miles from the state capitol building. However, for those legislators whose district residence was more than 50 miles from the state capitol and who were entitled to travel deductions under IRC Sec. 162(h), the lodging portion of a per diem amount was excludible from wages under IRC Sec. 119. (TAM 9127009)

2.4 Income vs. Loan

An attorney engaged to handle an estate received a $100,000 loan from the spouse of the decedent. The court determined that the "loan" was in substance a currently taxable advance of legal fees for estate services.

There was no fixed date for repayment, no amortization schedule, a low interest rate, and no unconditional obligation to repay. (*Michael v. Frierdich,* 91-1 USTC ¶ 50,074, CA-7, 1991, affirming TC Memo 1989-103)

2.5 Capital Gain vs. Ordinary Income

2.5.1 Non-compete covenant

A minority stockholder sold his interest in a corporation and also received payments under a non-compete agreement. The stockholder argued that the payments were in substance for goodwill and should qualify for capital gain. However, the court refused to disregard the specific language of the agreement, which designated the amounts as paid for a covenant not to compete. (*Kent L. Brown,* TC Memo 1991-260, 6/10/91)

2.5.2 Stock redemption from ex-spouse

A 90% stockholder transferred a portion of his stock to his ex-wife; this was followed by an immediate redemption of her stock by the corporation. Both steps occurred under the terms of the couple's divorce decree. Under the actual form of the transaction, the ex-wife qualified for capital gain treatment. However, if the husband was considered the substantive owner of the stock who caused the corporation to satisfy the obligation to his ex-wife, the distribution from the corporation would be a partial redemption subject to ordinary income dividend treatment.

The IRS National Office noted that divorce statutes allow taxpayers the flexibility to structure the form of their transactions to achieve a desired tax outcome, and did not apply the "substance over form" doctrine. The form of the transaction governed, and capital gain treatment was achieved. (TAM 9046004)

2.6 Fringe Benefits: Employer-Provided Transportation

Effective July 1, 1991, two regulations were amended regarding employer-provided transportation. If an employer provides transportation (such as a late-night cab fare home) solely because of unsafe conditions to employees who would otherwise walk or use public transportation, and does so under a written policy, the taxable value that is reportable as income to the employee is $1.50 per one-way commute. Employees qualifying for this fringe must be hourly rate workers who are not in a "highly compensated" class.

De minimis fringe benefits are excludible from employee income, and include small items administratively impractical to account for. This includes public transit passes, tokens, and fare cards and vouchers provided to employees who use a public transit system. The former exclusion of up to $15 per month is increased to $21 per month. However, if the employer provides a monthly public transit pass in excess of $21, the entire amount, not just the excess value over $21, is included in income. (Amended Regs. 1.61-21 and 1.132-6, 5/20/91)

2.7 Personal Injury Exclusion

2.7.1 Age discrimination damages

A taxpayer received a $58,000 payment from his former employer in settlement of an age discrimination suit (under the federal Age Discrimination in Employment Act, or ADEA). The Sixth Circuit, reversing the Tax Court, held that the amount was fully excludible as compensation for the personal injury resulting from employer discrimination. The fact that a portion of the settlement could be considered payment for loss of wages did not transform the discrimination into a nonpersonal injury. (*Carmen Pistillo*, 90-2 USTC ¶ 50,469, CA-6, 1990, reversing TC Memo 1989-329)

Similarly, the Ninth Circuit held that an ADEA judgment against a former employer, although partially designated as $189,500 in "economic damages," was a tort-type recovery from a personal injury and was fully excluded from income and FICA taxation. (*Fremont G. Redfield v. Insurance Co. of North America*, 91-2 USTC ¶ 50,385, CA-9, 1991, reversing unrept. D.C.)

The Tax Court, changing its position as a result of opinions in the Third, Sixth, and Ninth Circuits, has now also ruled that ADEA payments were entirely excludible under IRC Sec. 104. In two separate cases involving airline pilots, the court noted that all portions of the ADEA settlements were tax-free, consisting of both liquidated damages from age discrimination and financial losses arising from the discrimination in the form of nonliquidated damages. (*Burns P. Downey*, 97 TC No. 10, 7/13/91; *Howard H. Keller*, TC Memo 1991-373, 8/8/91)

Observation. The above cases involve amounts received by taxpayers in pre-1989 years. Effective for amounts received after July 10, 1989, IRC Sec. 104 has been amended to tax punitive damages received in connection with a case not involving physical injury or physical sickness. It should be noted, however, that the Tax Court, in the *Downey* opinion, appeared to conclude that ADEA-liquidated damages were not punitive.

2.7.2 Defamation suit and punitive damages

An individual brought a suit for defamation and emotional distress, resulting in a trial award consisting partially of compensatory damages and partially of punitive damages. The Fourth Circuit, reversing the Tax Court, held that the punitive damage portion was taxable. (*Commisioner v. Bonnie A. Miller*, 90-2 USTC ¶ 50,511, CA-4, 1990, reversing 93 TC 330)

2.7.3 Sex discrimination damages

Damages received from a sex discrimination action under the Civil Rights Act of 1964 were excludible from income. The IRS argued that damages represented back pay that would have been taxable had discrimination not occurred, but the court determined that the origin and character of the claim arose from a tax-free personal injury matter. (*Therese A. Burke*, 91-1 USTC ¶ 50,175, CA-6, 1991, reversing D.C., 90-1 USTC ¶ 50,203)

2.8 Debt Relief Income

2.8.1 Debt acquired by related corporation

IRC Sec. 108 allows relief to bankrupt or insolvent debtors from current taxability when they realize income from discharge of indebtedness. This privilege is not available, however, when the debt acquisition involves a related party. The IRS has ruled that this related-party prohibition may not be circumvented when a party unrelated to the debtor forms a corporation to acquire the debt and subsequently sells the corporate stock to the debtor. (Rev. Rul. 91-47, IRB 1991-35)

2.8.2 Proposed regulations

IRC Sec. 108(e)(10) allows an insolvent or bankrupt corporation to issue its own stock in satisfaction of its indebtedness without income recognition other than for the issuance of nominal or token shares. Proposed regulations have been issued, providing a series of test ratios, to assist in determining whether a stock issuance is nominal or token. (Prop. Reg. 1.108-1, CO-76-90, 12/7/90)

2.8.3 Financial institution early-withdrawal penalties

When a customer prematurely withdraws a certificate of deposit, the early-withdrawal penalty is taxable income to a savings institution, not excludible discharge of indebtedness. The certificate holders did not forgive or release a portion of the institution's debt to them, but rather accepted a contractual penalty previously agreed to at acquisition of the certificate of deposit. (*Centennial Savings Bank FSB*, 91-2 USTC ¶ 50,344, CA-5, 1991 on remand from S. Ct.)

2.8.4 Gambling debt discharge

A gambler did not realize debt discharge income when he reached a settlement with a casino on a disputed debt. His debt was not enforceable under state law, and the settlement only served to fix the amount of disputed debt. (*David Zarin*, 90-2 USTC ¶ 50,530, CA-3, 1990, reversing 92 TC 1084)

2.8.5 Purchase price adjustment vs. debt discharge

IRC Sec. 108(e)(5) holds that a solvent debtor does not realize debt discharge income when a seller of property reduces a debt obligation (i.e., purchase price adjustment). The IRS has ruled that the reduction of the principal of an undersecured nonrecourse debt by a holder who was not the seller of the property securing the debt results in taxable debt discharge income to the obligor. (Rev. Rul. 91-31, IRB No. 1991-20)

2.8.6 Definition of insolvency

In measuring insolvency for the debt relief provisions of IRC Sec. 108, the IRS has ruled that assets that are exempt from the claims of creditors under state law are to be excluded from the taxpayer's net worth. (LR 9125013 and LR 9130005; see also *Hunt*, TC Memo 1989-335)

3. BUSINESS EXPENSES AND LOSSES

3.1 Insurance Expense: Captive Company

A parent corporation may deduct insurance premiums paid to a wholly owned insurance subsidiary that writes a majority of its business in outside insurance. (*AMERCO and Subsidiaries*, 96 TC No. 3, 1991. See also *Harper Group and Subsidiaries*, 93 TC No. 4, 1991 and *Sears, Roebuck & Co. Affiliated Corporations*, 96 TC No. 5, 1991)

Observation. The court distinguished *Carnation Co.*, 81-2 USTC ¶ 9263, CA-9, affirming 71 TC 400, and other similar cases, in which payments made to captive insurance companies were held to be non-deductible.

3.2 Bank Overdraft Charges

A dry-cleaning proprietorship could not deduct bank overdraft charges as ordinary and necessary business expenses. The bank allowed overdrafts if covered by deposits on the same day, but also imposed fees. The court noted that the taxpayers could have made deposits earlier to avoid the charges and had not sought financing from other lenders. (*Asa M. Bailey, Jr.*, TC Memo 1991-385, 8/12/91)

3.3 Passive Activities: Rental by Developer

When property constructed or developed by the taxpayer is placed in rental status for less than 12 months, any net income or gain (but not a deduction or loss) is converted from passive income to active business income. Retroactive amendments to existing regulations are provided to define when the 12-month rental period commences. The new rules clarify that a taxpayer who purchases an interest in property for which construction is complete will not be subject to the recharacterization of passive rental income if the property is more than 50% leased at acquisition. (Reg. 1.469-2T(f)(5), T.D. 8318, 11/16/90)

3.4 Home Office Deduction

3.4.1 Focal point test

The Fourth Circuit has affirmed the Tax Court elimination of the focal point test for home office deductions. Formerly, the Tax Court only allowed home office expenses when the residence was the principal place where goods or services were provided to customers. The court will now approve deductions when essential management and administrative activities are conducted in the residence, as in the case of an anesthesiologist who generated his revenue and spent most of his time working in hospitals. He conducted essential record-keeping, study, and billing work on a regular basis in his home office because of lack of suitable office space in the hospitals. (*Nader E. Soliman*, 91-1 USTC ¶ 50,291, CA-4, 1991, affirming 94 TC 20)

3.4.2 Convenience of employer

A college professor was not entitled to home office deductions when his employer/university provided adequate office space. The court distinguished these facts from the *Soliman* decision, in which the taxpayer had no office space available at his outside work location. (*Thomas C. Cadwallader*, 90-2 USTC ¶ 50,597, CA-7, affirming TC Memo 1989-356)

Deductions for a home computer were disallowed to an engineer because the computer was not required as a condition of employment and was not purchased for the employer's convenience. (*Frank Tavano*, TC Memo 1991-237, 5/29/91)

3.4.3 Day-care provider

The portion of a residence used for a day-care business must be calculated using both a ratio of square footage and a ratio of the hours used in the business. The IRS has ruled that the time allocation is to be computed by determining the hours that each room within the residence is used for day care. (TAM 9126003, 3/15/91)

Observation. The preliminary draft of new Form 8829, used to report deductible home expenses of proprietorships and employees, requires calculation of an hourly ratio on lines 4–6, but it is unclear whether the instructions will require this on a room-by-room basis.

3.4.4 Exclusive and regular use

An attorney whose principal office was in Anchorage maintained a pool-side office in her residence located about 50 miles away. Although the pool-side area was frequently used for client meetings and entertainment, it failed to meet the "exclusive and regular use" tests, and a depreciation deduction for the pool and its enclosure was denied. (*M. Ashley Dickerson*, TC Memo 1990-577, 11/8/90)

3.5 Vacation Home

Deductions for a beach cottage were disallowed because it was only rented for several weeks during the year. The property was originally purchased as a vacation home, and the taxpayer failed to introduce records of occupancy to support that it was not used personally for more than the greater of 14 days or 10% of the rental days. (*Larry v. Nicholson*, TC Memo 1991-135, 3/26/91)

3.6 Hobby Losses

3.6.1 Vintage auto racing

A dentist who competed in a vintage auto cross-country race was denied deductions under the hobby-loss rule of IRC Sec. 183. Even though first prize in the event was $100,000, the taxpayer could not have received over $10,000, because of financial obligations and sharing arrangements with sponsors, partners, etc. Because his personal costs were $27,000, there was no opportunity for profit. (*James C. Dunkel*, TC Memo 1991-336, 7/22/91)

3.6.2 Horse breeding

Despite sustaining losses in each year since inception, taxpayers were allowed deductions for an Arabian horse-breeding activity. Taxpayers spent many hours researching and publicizing the venture and performing the daily tasks of the operation. (*Flois D. Burrow*, TC Memo 1990-621, 12/11/90)

Taxpayers failed to establish a profit objective for the Arabian horse-breeding venture. Evidence of this included lack of consistent breeding and the sizeable losses incurred. However, negligence and substantial understatement penalties were not applicable. (*Alfred L. Harston*, TC Memo 1990-538, 10/17/90)

3.6.3 Dog kennel

Losses incurred in operating a dog kennel were deductible. The taxpayer operated in a business-like manner under rules of the American Kennel Club, incurred advertising and maintained adequate records. The financial commitment of the kennel was too large compared to outside income for the activity to be considered a hobby, despite the lack of a separate checking account for the business. (*Ronald D. Larson, Sr.*, TC Memo 1991-99, 3/6/91)

3.6.4 Book writing

Expenses incurred by a computer programmer in travel and writing activities lacked a profit objective. No income was generated from writing, and activities were not conducted in a business-like manner. (*Sarah Lesher*, TC Memo 1991-161, 4/9/91)

3.7 Ordinary Loss vs. Capital Loss

3.7.1 Commodity futures

Losses realized by a taxpayer from trading commodity futures were capital losses. The taxpayer bought and sold futures for his own account as a trader, and was not a dealer selling commodity futures contracts to customers in a business activity. (*Robert A. MacAdam*, TC Memo 1991-410, 8/20/91)

3.7.2 Residence of relocated employee

A corporation incurred a capital loss when it purchased an employee's home and later sold it at a loss. Even though there was a business purpose to this transaction because of requirements in an employment contract, the asset was not actually used directly in the company's own trade or business and therefore defaulted into capital asset status. (*Azar Nut Co.*, 91-1 USTC ¶ 50,257, CA-5, 1991, affirming 94 TC No. 26)

A corporation that paid a fee to relocation companies for the purchase and subsequent sale of homes of relocated employees was considered to be the actual owner of the residences. The fee arrangement required the company to incur the loss, or receive credit for the gain, from the sale of employee homes, placing the employer in the same capital loss position as if it had directly accomplished the sale of the residence. (TAM 9036003)

3.7.3 Stock as inventory hedge

A convenience-store chain was successful in claiming an ordinary loss from the sale of its 10% ownership of an oil company's stock. The company acquired the oil stock to ensure an adequate supply of gasoline for its stores. This was based on contractual agreements that effectively allowed the taxpayer a hedge position by converting its share of the oil company's production into gasoline for its stores. The stock purchase fit within the inventory exception to the statutory definition of a capital asset. (*The Circle K Corp.*, 91-1 USTC ¶ 50,260, Cl. Ct. 5/16/91)

Observation. In 1988, the Supreme Court, in its *Arkansas Best* decision (485 U.S. 212) greatly narrowed the ability to qualify a business hedging transaction as an ordinary loss. The Claims Court determined, however, that a hedging transaction that secures a source of supply for an integral part of a taxpayer's inventory will still produce an ordinary loss.

3.8 Business Expense vs. Capital Asset

3.8.1 Defending against a hostile takeover

IRS National Office has ruled that expenses incurred by a corporation to resist an unfriendly takeover are deductible. Conversely, expenses incurred to facilitate a friendly merger or sale of stock of a target company are not deductible, because they create a long-term benefit to the corporation. (TAM 9043003)

3.8.2 Fees in a friendly takeover

Consulting and legal fees incurred in assessing and accepting a friendly takeover bid are not currently deductible, but must be capitalized. Even though a separate asset was not created by the expenditures, the friendly change in ownership would produce long-term benefits of a capital nature for the corporation. (*National Starch & Chemical Corp.*, 90-2 USTC ¶ 50,571, CA-3, 1990)

3.9 Corporate Expenses Paid by Others

3.9.1 Paid by shareholder-employee

Corporate business expenses paid by shareholders (including a noncontrolling 25% shareholder) could not be deducted against personal income, because they were not the business expenses of the shareholders. The disbursements constituted either corporate capital contributions or loans. (*Robert G. Verbica,* TC Memo 1990-584, 11/14/90 and *John Van Hassent,* TC Memo 1990-585, 11/14/90)

3.9.2 Paid by Director

Legal expenses paid on behalf of a corporation by a director were deductible in the year paid. The corporation had been dissolved several years earlier, and the payments were reasonably related to the individual's activity as the director. (LR 9039023)

3.10 Alimony

An individual entered into an oral alimony agreement in which he consented to pay amounts in excess of the divorce court decree. The additional deduction was denied because this agreement was not reduced to an enforceable written amendment. (*Boyd J. O'Donnell,* TC Memo 1991-74, 2/27/91)

3.11 Financial Institutions: Mortgage Exchange Losses

The Supreme Court has resolved a split between Appeals Courts by allowing financial institutions to recognize losses on the exchange of participation interests in residential mortgages. Savings and loan institutions had formed mortgage pools for participation interests and then exchanged participation interests with other financial institutions, recognizing a loss for tax purposes that they were not required to report for accounting purposes. The Supreme Court, in allowing the tax losses, looked to the fact that the underlying residences and obligors on the mortgages were different. (*Cottage Savings Association*, 91-1 USTC ¶ 50,187, S. Ct. 89-1965, 4/17/91, reversing CA-6, 89-2 USTC ¶ 9,662)

3.12 Continuing Education Expenses

3.12.1 Attorney: master's degree in taxation

An attorney who temporarily resigned his law firm position to enter a graduate tax law program as a master's degree candidate in taxation was allowed full deductibility for the graduate courses. The study constituted a temporary suspension from the legal business, and in fact the taxpayer continued to do occasional legal work while in graduate study. The additional courses improved existing skills rather than qualifying him for a new business. (PLR 9112003)

3.12.2 Teacher: law degree

A high-school teacher was not allowed to deduct expenses of law school. The taxpayer advanced the novel argument that the costs were amortizable under Sec. 195 as business start-up expenses. Negligence penalties were imposed! (*Robert Duecaster*, TC Memo 1990-518, 9/27/90)

3.13 Travel Expenses: Temporary vs. Indefinite Employment

3.13.1 Temporary construction work

An electrician was allowed daily deductible transportation between his home in Ohio and a power-plant construction site in Pennsylvania, where it was shown that the employment was realistically expected to be temporary at its inception. (*Philip D. Williams*, TC Memo 1990-467, 8/29/90)

An electrician's employment was temporary and expenses were deductible, even though employment lasted three years. He returned home each weekend at a distance of 250 miles, and continued to sign in at his union each weekend for local work. The distant job was always represented as temporary, and in fact resulted in one six-month layoff. (*Obie E. Kemp*, 91-1 USTC ¶ 50,166, N.D. Ga., 1991)

3.13.2 Itinerant worker

Workers were not allowed deductions for travel expenses because they lacked a permanent tax home and accordingly did not incur duplicate living expenses while residing in the area of their temporary employment. Cases include taxpayers employed as a construction worker (*Neil D. Staley*, TC Memo 1991-409, 8/20/91), a business consultant (*John T. Griffiths*, TC Memo 1991-55, 2/12/91), a piping draftsman (*Barry Hamby*, TC Memo 1990-516, 9/26/90), and a minor-league baseball player (*Jeffrey J. Pries*, TC Memo 1991-177, 4/17/91).

3.14 Travel Expenses: Identifying Tax Home

A taxpayer was involved in multiple business activities, including a swimming-pool construction business in Massachusetts and swimming-pool and horse-breeding businesses in Florida. The taxpayer owned a residence in Massachusetts occupied for six months from May to October, and a Florida home occupied for the other six months of the year. Expenses of the Florida residence were deducted by the taxpayer as incurred away from his primary tax home while he conducted his secondary business activities.

The Tax Court originally disallowed the Florida expenses, holding that the taxpayer had two tax homes. However, the First Circuit has reversed and remanded the case to the Tax Court for a determination of the location that was the primary place of business in order to identify the deductible secondary location. (*Edward W. Andrews*, 91-1 USTC ¶ 50,211, CA-1, 1991, reversing TC Memo 1990-391)

3.15 Employee Business Expenses

Within the past year, the IRS has issued various Revenue Procedures and Regulations regarding employee business expenses, including updated per diem meal and lodging amounts and clarifications regarding accountable versus nonaccountable plans. See section 4.1 in "Important 1991-92 Tax Planning and Compliance Issues."

3.16 Bad Debts: Business vs. Nonbusiness

3.16.1 Business determination

The principal founder of a corporation invested over $300,000 in capital stock and later, after a public offering, loaned $150,000 to the corporation. Upon later failure of the company, losses were allowed as ordinary business bad debts, because the dominant motive for the loans was to retain the founder's employment and further his extensive personal business activities. (*Harry Litwin*, 91-1 USTC ¶ 50,229, D.C. Ks., 1991)

Loans that an individual made to a car dealership in which he was a shareholder resulted in ordinary business bad debt treatment. The court found that the individual was in the business of promoting, organizing, and financing businesses for resale, identifying 12 separate businesses owned by the taxpayer. This activity of buying and selling businesses constituted a trade or business at the individual level, and accordingly allowed ordinary bad debt treatment on the loans. (*Ronald L. Farrington*, 91-1 USTC ¶ 50,115, N.D., Okla. 1991)

3.16.2 Nonbusiness determination

The sole shareholder of a corporation was required to make payment on a loan that he had guaranteed for his corporation. The court found that the guarantee was not given primarily to protect his corporate salary since no salary was drawn from the corporation. Business bad debt treatment was denied. (*John Pierce*, 90-2 USTC ¶ 50,580, E.D., Ark. 1990)

A taxpayer who had guaranteed a line of credit for his son's business was not allowed business bad debt treatment when the guarantee was called. The guarantee was given by the father without the receipt of any consideration. In the case of related-party transactions, this lack of consideration eliminates any deduction, whether business or nonbusiness bad debt status. (*Webster Lair*, 95 TC No. 35, 11/6/90)

3.17 Compensation to Spouse of Owner

Compensation to the spouse of a corporation's president and sole shareholder was disallowed because the corporation failed to establish that any services were rendered. The payments were in fact intended as support during a period of marital separation. (*JBS Enterprises, Inc*, TC Memo 1991-254, 6/5/91)

4. DEPRECIATION, AMORTIZATION, AND CREDITS

4.1 Lease Income Inclusion Amounts

For automobiles first leased in 1991 and after with a fair market value over $13,400, new tables are provided for the annual lease income inclusion. These tables also appear in IRS Publication 917, "Business Use of a Car." (Rev. Proc. 91-30, IRB No. 1991-20)

4.2 "Placed in Service" Definition: Depreciable Residence

A proprietor converted a portion of his residence to qualifying business use in 1983. However, the ACRS method could not be used, because the home was first placed in service in 1974 when purchased as a residence. IRC Sec. 167 estimated life depreciation was allowable because the depreciation system is based on the date of original acquisition, not on the date of the asset's first use in business. (*Thomas Jumper*, TC Memo 1991-86, 1991)

4.3 Initial Short Year

A subsidiary corporation was in existence for less than one month of the tax year, although it filed as a member of an existing consolidated group. Depreciation for the initial short year was limited to one-twelfth of the annual amount of depreciation. (*Hamilton Industries, Inc. and Sub.*, 97 TC No. 9, 1991)

4.4 Allocation to Depreciable vs. Nondepreciable Basis

4.4.1 Property converted from personal

An individual who converted his personal residence to rental use failed to support his allocation between land and building. Accordingly, the court used a ratio established from a property tax assessment. The court also required the individual to compute depreciation based on original cost rather than fair market value at conversion, since Reg. 1.167(g)-1 requires the lesser of the two amounts to be used. (*Leonard Proctor, Jr.*, TC Memo 1991-202, 1991)

4.4.2 Land vs. building

The IRS National Office ruled that a taxpayer could not allocate cost basis solely according to the assessed values of land and buildings for real estate tax purposes when the IRS examining agent had established better evidence to determine the fair market values of the properties. (TAM 9110001)

To the contrary, a partnership was required to allocate the basis of an office building between the building and land based on the allocation used by local taxing authorities. (*Conroe Office Bldg., Ltd.*, TC Memo 1991-224, 5/22/91)

4.5 Depreciation of Artwork

Taxpayers were not entitled to depreciation for an oil painting purchased in 1984, because they failed to establish a useful life. Even though post-1980 assets are under a class life depreciation system, it is still necessary that assets have a determinable useful life in order to be depreciable. (*W. Cordell Clinger*, TC Memo 1990-459, 8/27/90)

4.6 Section 179: Substitution of Assets

Taxpayers were not allowed to substitute the assets for which the Sec. 179 election had originally been made. Substitution of items would constitute a revocation of the original election, and this is only allowed with the consent of the IRS. (*Boyd B. King*, TC Memo 1990-548, 10/22/90)

Observation. The proposed regulations for IRC Sec. 179 include rules for identifying IRC Sec. 179 property and allocating disallowed IRC Sec. 179 to specific property.

4.7 Oil and Gas Percentage Depletion: Regulations Issued

Final regulations, which closely follow earlier 1977 proposed regulations, cover the 15 percent depletion for up to 1,000 barrels per day of oil and gas production by smaller independent producers and royalty owners. Clarification is provided regarding the allocation of a single 1,000-barrel-a-day limit among businesses under common control. Amended regulations affecting partners and S corporation shareholders remain in proposed status. (Reg. 1.613A, T.D. 8348, 5/10/91)

4.8 Amortization of Start-Up Costs

Costs incurred prior to actively beginning the conduct of business must be capitalized under IRC Sec. 195 as start-up costs, subject to 60-month amortization. The IRS has ruled that active business began on the date that the manufacturing process met required standards, and that production resulted in items ready for sale for which the corporation was ready to receive revenue. (LR 9047032)

4.9 Amortization of Intangibles

4.9.1 Peanut acreage allotment

A taxpayer purchased a 3,000-acre plantation and allocated $300,000 of the cost to a 300-acre peanut acreage allotment (representing the right to produce the crop and participate in a government price-support program). Amortization was denied because of the indefinite useful life of the asset, despite political controversy as to the duration of the peanut allotment program. (*Fred Wenzel*, TC Memo 1991-166, 4/10/91)

4.9.2 Bank core deposits

A bank holding company was entitled to depreciate core deposits as a separately identified intangible asset. The core deposits were valued by computing the present value of the future stream of net income, and represented an amortizable asset separate from goodwill. (*Colorado National Bankshares, Inc.*, TC Memo 1990-495; see also *Citizens and Southern Corp.*, 91-1 USTC ¶ 50,043, CA-11, 1990 affirming 91 TC 463)

4.9.3 Cable TV franchise

IRC Sec. 1253(d) allows amortization for principal sums over $100,000 paid for franchises when the transferor retains continuing substantial rights. The court allowed amortization to the purchaser of cable TV franchises because of the continuing rights retained by local government units. Also, because of the monopolistic rights granted by the governmental entities, there was no goodwill separate from the franchise right. (*Tele-Communications, Inc.*, 95 TC No. 36, 11/7/90)

4.9.4 Manufacturer's work force

Based on an appraisal, the purchaser of a clothing manufacturer allocated $7.7 million to "work force in place." An average per capita amount was allocated to each production worker and a deduction claimed when employment terminated. The IRS and Tax Court determined, however, that the assembled work force was not an amortizable asset, but rather represented nondeductible going-concern value. (*Ithaca Industries, Inc.*, 97 TC No. 16, 8/12/91)

Note: See section 4.6, "Alternatives to Goodwill," in the chapter entitled "Important 1991-92 Tax Planning and Compliance Issues" for a further discussion related to amortization of intangibles.

4.10 R & D Credit: Dungeons and Dragons

A manufacturer of games and game-related products was denied the IRC Sec. 44F (now IRC Sec. 41) research and development credit for expenses incurred in creation and development of games. The R & D tax credit applies only to expenditures that are scientific and technical in nature. The court's opinion contains an extensive discussion of the definition of "qualified research." (*TSR, Inc.*, 96 TC No. 44, 6/25/91)

4.11 Low-Income Housing Credit

4.11.1 Correction to Form 8609

Instructions to Low-Income Housing Credit Allocation Certification (Form 8609) incorrectly state that the increased credit is not available for federally subsidized buildings in high-cost areas. Taxpayers are to disregard this instruction in Part I, Line 3b. (IRS Ann. 91-112, IRB No. 1991-13)

4.11.2 IRS guidance

The IRS has issued a lengthy ruling providing guidance with respect to the IRC Sec. 42 low-income housing credit. The ruling discusses the two-tier percentage system and the definitions of eligible expenditures and qualified low-income housing, and presents answers to twelve frequently asked questions. (Rev. Rul. 91-38, IRB No. 1991-26)

5. INTEREST EXPENSE

5.1 Home Mortgage Interest

5.1.1 Delinquency charges

Delinquency charges imposed by a bank on late mortgage payments were disallowed as not constituting interest expense. The court noted that the calculations had no correlation with the passage of time or prevailing interest rates, but rather were fees levied because of additional costs incurred by the bank. (*Robert G. West*, TC Memo 1991-18, 1/17/91)

Observation. This case contrasts with Rev. Rul. 74-187 (1974-1 CB 48), which allows late charges paid to a public utility to be deducted as interest.

5.1.2 Home mortgage points

IRC Sec. 461(g)(2) allows immediate deductibility of points paid on debt in connection with the purchase or improvement of the principal residence of the taxpayer. In 1988, the Tax Court disallowed points on a 30-year residential mortgage deemed to be refinancing, as it had replaced a temporary three-year note that arose at acquisition of the residence (*Huntsman*, 91 TC 917).

The Eighth Circuit reversed in 1990. The Appeals Court viewed the three-year note as simply a step in obtaining the long-term mortgage, and thus the points were in connection with the original purchase of the residence three years earlier (905 F2d 1181, CA-8). The IRS Chief Counsel has announced that *Huntsman* will not be appealed, but also that the IRS will not follow the decision outside of the Eighth Circuit. (AOD* 1991-02)

*An *Action on Decision* is an internal IRS document accompanying an IRS acquiescence.

5.2 Investment Interest Expense Carryover

Investment interest expense that is disallowed because of the net investment income limitation may be carried over and deducted in a subsequent year. Prior to a law change effective in 1987, the IRS held that investment interest expense that exceeded total taxable income for the year (such that normal NOL rules would have prohibited any utilization) was not available for carryover (Rev. Rul. 87-70, 1986-1 CB 83). However, the Fourth Circuit has now set aside the IRS position; excess investment interest from pre-1987 years is fully available as a carryover, even if in excess of taxable income in the year of origin. (*Arthur Beyer*, 90-2 USTC ¶ 50,536, CA-4, 1990, reversing 92 TC 1304)

Observation. Taxpayers who in current open years have excess investment interest carryover from pre-1987 years should review the calculation of these carryovers to determine if the former taxable income limit may have unduly restricted the carryover. Note, however, that the IRS Chief Counsel has recommended nonacquiescence in the *Beyer* decision (AOD 1991-010).

5.3 Debt Transactions Between Owners and Pass-Through Entities

An S corporation redeemed the stock of several of its shareholders, using promissory installment notes. The IRS ruled that the S corporation may characterize the interest expense based on an allocation of its assets using any reasonable method (such as allocation according to fair market value of assets or adjusted basis of assets). (PLR 9116008)

Observation. This private ruling is consistent with IRS Notice 89-35 (IRB No. 1989-13), which allows elective characterization of interest expense associated with distributions to S shareholders or partners using reasonable methods such as allocation according to the types of assets within the pass-through entity. This Notice allows the opportunity of avoiding the tracing rules, and should be reviewed for characterization of any interest expense on debt involving transactions between owners and pass-through entities.

5.4 Debt vs. Equity

Debentures issued by a holding company to acquire stock in a bank were held to be true debt rather than equity instruments. (*First M&F Corp.*, 91-2 USTC ¶ 50,357, N.D., Ms., 1991)

5.5 Accrual of Interest on Tax Deficiencies

A corporation could not accrue and deduct interest expense on tax deficiencies in the years in which the tax adjustments arose. The taxpayer argued that all events had occurred to determine the liability because of its acceptance of the IRS corrections to its returns. However, the court allowed accrual of the interest only from the point of the acceptance of the IRS adjustments. (*Phillips Petroleum Co. & Subs.*, TC Memo 1991-257, 6/6/91)

5.6 Intrafamily Loans

A father made gifts of money to his adult children. Shortly afterwards, each child would loan an equal amount back to the parent. Multiple gifts and loans were made, with the parent deducting about $14,000 of interest per year. All interest expense was disallowed because the "gift" lacked donative intent and valid debts had not been created. (*Peter Muserlian,* 91-1 USTC section 50,204, CA-2, 1991, affirming TC Memo 1989-493)

Interest expense was disallowed when an individual established trusts for his niece and nephew, transferred cash to the trusts, but then received the cash back in exchange for notes bearing 20% interest. (*Paul D. Martyr,* TC Memo 1990-558, 10/25/90)

5.7 Corporate Interest Paid to Related Exempt Entity

The "earnings stripping" rules of IRC Sec. 163(j) disallow excessive interest expense paid by a corporation to a related tax-exempt entity. Proposed regulations have been issued defining excess interest expense (i.e., excess net interest expense exceeds 50% of adjusted taxable income, and tax-exempt related-party interest expense is involved), and a safe harbor is provided if the corporate debt-equity ratio is less than or equal to 1.5-to-1 at year end. (Prop. Reg. 1.163(j), 6/13/91)

5.8 Accrued Interest on Deferred Compensation

A taxpayer established several nonqualified deferred compensation plans for key employees, requiring the company to increase each deferred compensation account for interest. The company accrued the interest on a monthly basis, but the IRS denied the deduction. The tax court concurred, treating the interest as compensation and making it deductible only when paid per IRC Sec. 404(a)(5). (*Albertson's, Inc.*, 95 TC No. 30, 1990)

5.9 Blended Annual AFR Interest Rate for 1991

The blended annual AFR rate for purposes of computing forgone interest on demand loans for 1991 is 7.11%. (Rev. Rul. 91-39, IRB No. 1991-27)

6. ACCOUNTING METHODS AND PERIODS

6.1 New Form 8752 for Fiscal Year Required Payments

New IRS Form 8752, Required Payment or Refund under Section 7519, is to be used by partnerships and S corporations that have elected fiscal-year retention under IRC Sec. 444. The form is used to calculate and report the payment required under IRC Sec. 7519, and replaces reporting previously done on Form 720, Quarterly Federal Excise Tax Return. The new form is applicable for tax years beginning in 1990. (IRS Ann. 90-112, IRB 1990-40)

6.2 Accrual Taxpayers: Economic Performance Requirement

6.2.1 Election of recurring item exception

Proposed regulations issued June 1990 (Prop. Regs. 1.461) specify that accrual-method taxpayers may only claim deduction for certain categories of expenses when "economic performance" occurs. Economic performance is defined as payment. Effectively, these regulations place accrual taxpayers on the cash method for the following items: rebates and refunds; awards, prizes and jackpots; and amounts paid for insurance, warranties, service contracts, and taxes.

As a relief measure, the regulations permit a taxpayer to elect deductibility under the "recurring item exception." Under this method, an accrued deduction is allowed if payment occurs within 8½ months following the year of accrual, or, if earlier, by the date of a timely filed return (but with an amended return privilege). The regulations originally required election of the recurring item exception for the tax year beginning in 1990.

The IRS has announced that the election to adopt the recurring item exception is postponed until the tax return beginning in 1991 for a taxpayer who has previously incurred the applicable types of liabilities. However, for new taxpayers or those who have never incurred items eligible for the election, the election remained applicable for tax years beginning in 1990. A sample election for 1991 follows. (IRS Notice 91-10, IRB 1991-11)

SAMPLE ELECTION
Adoption of Recurring Item Exception

Pursuant to Prop. Reg. 1.461-5(d), taxpayer hereby adopts the recurring item exception, and submits the following information per Reg. 1.461-7T from Q&A-7(b) (formerly 1.461-3T).

The recurring item exception is adopted with respect to the following businesses:

____

____

The recurring item exception is adopted with respect to *all* items as defined in Prop. Reg. 1.461-4(g)(3)-(6) incurred in all businesses above.

Observation. Because IRS Notice 91-10 was published in March 1991 after many 1990 returns were filed, many accrual-method taxpayers apparently again need to submit the above election form. Also, for taxpayers previously deducting the specified liabilities on the cash method, a three-year forward spread is required for the change in method.

6.2.2 Election to accrue property taxes ratably

The IRS has announced that future final regulations under IRC Sec. 461(h) concerning the economic performance requirement will contain a procedure allowing taxpayers to automatically make or revoke an election under IRC Sec. 461(c). IRC Sec. 461(c) provides that an accrual-basis taxpayer may accrue real property taxes over the specific period to which the taxes relate. The adoption of the IRC Sec. 461(c) method precludes application of the IRC Sec. 461(h) economic performance/payment restriction. (IRS Ann. 91-89, IRB No. 1991-25)

Observation. The ability to automatically revoke an IRC Sec. 461(c) election may be the more advantageous aspect of the future regulations. In most states, adoption of the recurring item exception (allowing deduction of real property taxes paid within 8½ months following the close of the year) will provide an earlier deduction than accrual over the period to which the taxes relate.

6.2.3 Subdivided real estate

Rev. Proc. 75-25 (1975-1 CB 720) allows subdividers of real estate to request permission from the IRS to increase the basis of property sold by the estimated cost of future improvements. The June 1990 Prop. Regs. under IRC Sec. 461(h) suggested that the economic performance criteria would eliminate this privilege.

The IRS has now granted temporary relief until further regulations are issued, although submission of a request under Rev. Proc. 75-25 may be required for costs and sales after January 1, 1991. (IRS Notice 91-4, IRB 1991-4)

Observation. Subdividers should carefully review the dates and request deadlines of Notice 91-4 to determine their particular status.

6.3 Banks: Bad Debt Chargeoffs

Banks are permitted to make an election under which debts are conclusively presumed to be worthless when they are charged off for regulatory purposes. This presumption applies to debt chargeoffs that (1) result from a specific order of the bank's regulatory authority or (2) correspond to the bank's classification of the debt, in whole or in part, as a loss asset (consistent with standards set forth by the Comptroller of the Currency, FDIC, Federal Reserve, or similar regulatory authority). If elected, the bad debt deduction for tax purposes must be claimed in the same year that the debt is charged off for regulatory purposes. Moreover, no bad debt deduction will be allowed for any debt that has not been charged off for regulatory purposes.

The election is made by attaching a written statement to the timely filed return for the first taxable year ending after May 29, 1991. No adjustment under IRC Sec. 481 is required and, once made, the election is revocable only with IRS consent. (Prop. Reg. 1.166-2, FI-34-91, 5/29/91)

6.4 Corporations: Sec. 448 Accrual Requirement

6.4.1 Veterinary services

IRC Sec. 448 requires C corporations to use the accrual method of accounting, with specific exceptions for farming entities, smaller corporations with gross receipts under $5 million, and eight specific personal service corporations, one of which is in the field of health. The IRS has now ruled that veterinary services are included in the field of health, thus allowing corporations whose employees perform veterinary services to potentially use the cash method of accounting. (Rev. Rul. 91-30, IRB 1991-19)

Observations. As a personal service corporation, a vet practice will also be subject to the flat 34% corporate rate per IRC Sec. 11(b)(2), and may potentially be forced to the calendar year under IRC Sec. 441(i). Also, the IRS National Office has informally indicated that this ruling applies only to veterinary practices performing services; those selling material amounts of supplies, feed, medicines, etc. would be subject to the accrual method under the normal principles of IRC Secs. 471 and 446. Amended returns may be appropriate in some cases. The IRS is likely to monitor by reference to the Form 1120 business code.

6.4.2 Conversion to accrual method

Corporations subject to IRC Sec. 448 that had not changed to the accrual method were provided amended return relief rules until July 8, 1991 (assuming the statute was still open). For corporations not complying after that date, normal accounting method change requirements apply per Reg. 1.446-1(e)(3). (Reg. 1.448-1T, TD 8329, 1/4/91)

6.5 Cash vs. Accrual Method

6.5.1 Conformity with books

The IRS has ruled that use of the cash method does not violate the IRC Sec. 446(a) conformity rule when the books are on the accrual method and workpapers are maintained reconciling accrual-method book income to cash-method taxable income. The IRS noted that earlier rulings (Rev. Rul. 68-35 and Rev. Rul. 68-83) had allowed the use of reconciling entries to meet the conformity rule. (TAM 9103001)

6.5.2 Clear reflection of income

A manufacturer of water-treatment control systems was forced to use the accrual method. The court noted that Reg. 1.471-1 requires the use of inventories whenever the production, purchase, or sale of merchandise is an income-producing factor, and that Reg. 1.446-1 holds that when inventories must be used, the accrual method of accounting must be used for purchases and sales. Because the accrual method increased corporate income by an average of $600,000 over the three years audited, the cash method did not achieve a substantially identical result and did not clearly reflect income. (*Ralston Development Corp.*, 91-2 USTC ¶ 50,333, CA-10, 1991, reversing unreported DC)

6.6 Valuation of Inventory

A winery was permitted to use appropriate market values of bulk wine in valuing its goods-in-process and finished goods under the lower-of-cost-or-market method, even though it was not engaged in the sale of bulk wine. (TAM 9121003)

6.7 Security Deposits

6.7.1 TV subscriber deposits

A television subscription operation collected a $25 security deposit in connection with installation of an electronic decoder box that allowed the subscriber to receive an unscrambled TV signal. In determining whether security deposits were taxable income, the courts originally used a "primary purpose" test, categorizing deposits either as prepayments for goods and services (taxable) or as security for performance of non-income-producing covenants, including security against damage to property (nontaxable) (see *City Gas Co. of Florida*, CA-11, 1982). However, in *Indianapolis Power & Light Co.* (498 U.S. 110, 1990), the Supreme Court rejected the primary purpose test, and instead held that taxability hinges on whether there is an express obligation to repay the security deposit. Withdrawing an earlier memorandum decision, the Tax Court held that the deposits were not taxable; the fact that the taxpayer did not segregate the funds, did not pay interest to the subscriber, and offset some security deposits against delinquent rents was not determinative. (*Oak Industries, Inc.*, 96 TC No. 20, 4/1/91, withdrawing TC Memo 1987-65)

6.7.2 Utilities: change in method

Procedures are provided allowing utility companies to change their method of accounting with respect to customer deposits as a result of the Supreme Court's decision in *Indianapolis Power & Light Co.* In general, the change is to be made in either the first or second tax year ending after June 30, 1990, with a Form 3115 accompanying the tax return for the year of change. (Rev. Proc. 91-31, IRB 1991-21)

6.8 Long-Term Contracts: Completed Contract Method

A taxpayer constructing a runway for the government was allowed to keep the contract open, even though the government had taken possession in the prior tax year. Meaningful work remained to be completed after the close of the year, including correcting defects in a road, removing and replacing a curb, and constructing additional pavement areas. Also, this work was subject to buyer acceptance. (*Ball, Ball and Brosamer, Inc.*, TC Memo 1990-454, 8/22/90)

6.9 Change in Accounting Method: Package Design Costs

The IRS has revoked earlier procedures regarding capitalization and amortization of package design costs, providing new detailed procedures allowing taxpayers a choice of three methods of accounting for package design costs: (1) capitalization, with deduction only upon disposition or abandonment of the design; (2) capitalization by each design, with 60-month amortization, and (3) pool-of-cost capitalization, with amortization over 48 months, but with no early deductions for abandonment, disposition, or failure to place in service. A Form 3115 must be filed with the tax return and the IRS National Office, and an IRC Sec. 481 adjustment must be computed. Generally, the year of change is to be the first tax year ending after December 17, 1990, with an amended return permitted up to 180 days after the beginning of the third tax year ending on or after December 18, 1990. (Rev. Proc. 91-31, IRB 1991-21)

6.10 Timing of Income

6.10.1 Receipt by mail

Checks mailed and dated the day before the end of the fiscal year of a cash-basis taxpayer were includible in that taxpayer's income in the following year. The court determined that the checks were received after the close of the year by review of the date on the checks and the date of the bank deposit. (*William Bingo*, TC Memo 1991-248, 6/5/91). See section 7.3, "Constructive Receipt and Form 1099 Reporting," in the chapter entitled "Important 1991-92 Tax Planning and Compliance Issues" for a further discussion of this issue.

6.10.2 Constructive receipt

An employee of the taxpayer received a check for over $3 million on December 27 for sale of stock. Because of the size of the check, the first bank of deposit would not release the funds until the check had cleared, which occurred on January 3. Nevertheless, the taxpayer was held to be in constructive receipt of the income in the year in which the check was received. (*Bright*, 91-1 USTC ¶ 50,142, CA-5, 1991)

6.11 Installment Sale Method

6.11.1 Abusive transactions with partnerships

The IRS has indicated that installment sale regulations will be amended to prevent abusive transactions with partnerships under which artificial gain is created in one year followed by an artificial deferred loss in a later year. The transaction targeted by the IRS involves creation of a large installment gain in an early year followed by a redemption of a majority partner, such that an artificial loss results in later years. (IRS Notice 90-56, IRB 1990-38)

6.11.2 Cancellation by will

Under the terms of a decedent's will, an installment note receivable from a related party was canceled as a result of the death. Per IRC Sec. 691, the unreported installment gain was recognized in the Form 1041 income of the estate; the debtor was not required to include any amount in income. (LR 9108027)

7. FARM AND RANCH TAXATION

7.1 Prepaid Feed Expense Denied Under Farm Syndicate Rules

In the case of a farming syndicate, prepaid feed and supplies are only deductible when consumed (IRC Sec. 464). A farming syndicate is an enterprise sold under a registered offering *or* is an activity that allocates more than 35% of the losses to persons not actively participating in management.

Under these rules, a medical doctor was denied substantial prepaid feed expenses in connection with a cattle-feeding operation (e.g., feed purchases of $1,600,000 in 1983, but only $81,000 consumed during year). The Tax Court determined that the doctor did not actively participate, primarily because a feedlot manager, whom the doctor did not supervise and could not dismiss, exercised operating and management control. (*Estate of Gerald L. Wallace*, 95 TC No. 37, 11/14/90)

7.2 Early Livestock Sale From Drought

A rancher may elect to defer gain for one year under IRC Sec. 451(e) when livestock sales are accelerated due to drought conditions. Having made this election in his 1988 return, a rancher applied to the IRS for permission to revoke and to use instead the IRC Sec. 1033 involuntary conversion election. This statute allows rollover of the gain from breeding or selling dairy animals because of drought if the animals are replaced within two years. The IRS approved revocation of the IRC Sec. 451(e) election, effectively allowing the rancher to roll the gain against the depreciable basis of replacement livestock rather than the mere one-year deferral of IRC Sec. 451. (LR 9127012)

7.3 Accrual Method for Large Farming Corporations: S Election

Family farms organized as C corporations with over $25 million in gross receipts are forced to use the accrual method. However, in the year of change from cash to accrual, the corporation is allowed to establish a suspense account representing the net amount of the accounting change in lieu of currently taking the change into income. This suspense account may be recaptured into income if gross receipts decrease, the corporation ceases to be a family-controlled entity, or other such corporate changes occur. Two private rulings have held that election of S status is not a disqualifying event causing recapture of the accrual adjustment; the suspense account continues with the S corporation. Similarly, the merger of two related family corporations prior to the S election does not cause recapture. (LR 9117055 and LR 9129028)

7.4 Exchange of Grazing Rights

A limited partnership engaged in ranching held 10-year renewable lease rights to state grazing lands. The IRS ruled that the partnership could exchange its leasehold interest in one ranch for similar state leasehold rights to another ranch, even though the leases only had a six-year remaining term at time of exchange. Normally, IRC Sec. 1031 regulations require a lease to be of 30-year duration before exchange treatment is allowed. However, the IRS noted that the 30-year interpretation involves exchanges of fee title for leasehold interests, whereas this case involved exchange of similar leasehold interests. Further, the state grazing rights were readily renewable, effectively making them of indefinite duration. (LR 9126007)

7.5 Corporate-Provided Meals and Lodging

Three individuals transferred crops, hogs, farm equipment, and dwellings to a newly formed corporation. An employment agreement with the corporation required that the individuals reside on the corporate premises and that the corporation bear all meals and lodging costs (deductible by the corporation under IRC Sec. 162 but not taxable to the employees under IRC Sec. 119).

An examining IRS agent attempted to deny the corporate deduction using IRC Sec. 269 (this authorizes IRS prohibition of deductions, credits, etc. when use of a controlled corporation has as its principal purpose the evasion or avoidance of taxation by securing tax benefits not otherwise available). However, the IRS National Office held that IRC Sec. 269 did not apply; the individuals were merely obtaining tax benefits authorized by statute, and this does not rise to the level of "tax avoidance or evasion." (TAM 9134003)

Observation. The use of corporate-provided meals and lodging in farming and ranching has consistently been approved by the courts (e.g., *J. Grant Farms*, TC Memo 1985-174 and *John M. Harrison*, TC Memo 1981-211). Also, the IRS National Office noted that the benefits of IRC Sec. 119 would have been available had the individuals simply formed a partnership (see *Armstrong v. Phinney*, 68-1 USTC ¶ 9,355, CA-5, 1968).

8. CORPORATIONS

8.1 IRC Sec. 1244 Loss and Business Bad Debts

Loans made by a shareholder to an auto dealership corporation qualified as business bad debts when the taxpayer was able to show that he was in the business of promoting businesses. Contrary to the IRS position, the claim of an ordinary loss on his stock under IRC Sec. 1244 had no effect on the business bad debt deduction. (*Farrington*, 91-1 USTC ¶ 50,115, N.D. Okla., 2/19/91)

8.2 IRC Sec. 1244 Loss: Computation of Basis

Payments that a shareholder made for corporate expenses prior to the date the stock was issued constituted part of his basis in the stock. An ordinary loss under IRC Sec. 1244 was allowed to the extent of his basis. (*Miller*, TC Memo 1991-126, 3/20/91)

8.3 Deductions Incident to a Liquidation

A taxable nonprofit corporation organized to provide credit reporting and collection services to commercial businesses sold its credit files for

$10.4 million, goodwill for $3.25 million, and its collection files and records for $1.5 million. The balance of the $18.5 million sales price covered fixed assets, working capital, assembled work force, and a noncompetition covenant. The corporation had no shareholders or persons with a proprietary interest. The sales proceeds were distributed to its customers based upon prior usage of its services. The corporation unsuccessfully attempted to reduce its income by excluding or deducting the proceeds from the sale of the credit files and was not allowed a basis adjustment even though it was contractually obligated to distribute most of the proceeds to its customers. (*Credit Bureau Services of Northwestern Ohio, Inc.*, 91-2 USTC ¶ 50,341, N.D. Ohio, 6/24/91)

8.4 Reasonable Compensation

Amounts paid by a corporation to its majority shareholder based upon a commission agreement (which was never produced) entitling him to 50% of the gross receipts from the Chicago Bulls lease was not deductible, because it exceeded reasonable compensation. (*Chicago Stadium Corp.*, 91-2 USTC ¶ 50,352, N.D. Ill., 6/21/91)

8.5 Independent Contractor

An accountant was the sole shareholder, director, and president of an accounting corporation. He performed services solely for the corporation. He worked full-time, exercised exclusive authority, and made all management decisions. He was not an independent contractor. Because he was an employee, the corporation was obligated for all payroll taxes. (*Harris, Inc.*, 91-1 USTC ¶ 50,271, W.D. Okla., 5/7/91)

Note: See Section 19.1, herein, for a survey of cases on the issue of employee versus independent contractor.

8.6 Liquidation: Valuation

The taxpayer acquired the stock of 7-Up Co. in a hostile takeover. The target was then liquidated pursuant to IRC Secs. 332 and 334. As a result, it was necessary to allocate the basis of the stock among the assets acquired. There was no dispute over the fair market value of the tangible assets. The dispute centered on the valuation of the intangibles. The court discussed the bargain, residual, and capitalization of earnings methods. The court concluded that the bargain method was inappropriate because the parties did not bargain over the value of the intangibles. Similarly, the residual value method was inappropriate because in a hostile takeover, the purchase price is not negotiated. The capitalization method used by the taxpayer was reasonable. It compares the annual earnings of the business for a period of years with a fair return on the tangible assets and allocates the excess to the intangibles. (*Philip Morris, Inc.*, 96 TC No. 23, 4/11/91)

8.7 Liquidation: Step Transaction

A sale of a 99.97%-owned subsidiary to another company, followed by a repurchase of all the subsidiary's assets except a grocery store, was recharacterized as a tax-free liquidation of a subsidiary under IRC Sec. 332 and a sale of the grocery store. An attempt to break the 80% ownership requirement was disregarded pursuant to the step transaction doctrine despite a stated business purpose for the steps. A claimed loss was disallowed. (*Associated Wholesale Grocers, Inc.*, 91-1 USTC ¶ 50,165, CA-10, 1991)

8.8 Assignment of Income

A professional hockey player for the Minnesota North Stars was not subject to tax on amounts paid to his wholly owned personal service corporation by the team except to the extent of salary paid to him. Monies contributed to a pension plan or retained by the corporation are not taxable to the player. The court rejected the application of both IRC Sec. 482 and the assignment of income doctrine. (*Sargent*, 91-1 USTC ¶ 50,168, CA-8, 1991, reversing 93 TC No. 48)

An accountant assigned his partnership interest in an accounting partnership to a wholly owned corporation. Monies received by the corporation in liquidation of his interest in the accounting partnership as a result of his retirement are taxable to the accountant. (*Findley*, TC Memo 1991-339, 7/25/91)

8.9 Self-Incrimination

No Fifth Amendment defense against self-incrimination is available to custodians of corporate records. (*Merkendorff*, 91-1 USTC ¶ 50,087, D. S.C., 1991)

8.10 Loans vs. Dividends

An attorney borrowed $1,220,000 from his wholly owned corporation to pay his personal living expenses. During the same period, he also borrowed $237,000 from his pension plan. Three years later, the borrowings from the corporation exceeded $3,000,000. No notes evidenced the corporate loans. Only nominal repayments were made. The IRS successfully argued that the loans were really dividends. (*Jacques v. Comm.*, 91-1 USTC ¶ 50,292, CA-6, 1991)

8.11 IRC Sec. 338 Elections

To prevent multiple levels of gain or loss recognition by virtue of IRC Sec. 338, new temporary regulations have been adopted to ensure that no gain or loss is recognized by a target corporation acquired by another corporation on the deemed sale of stock of an affiliated corporation if an election under IRC Sec. 338(g) is made. (Temp. Reg. 1.338-6T, T.D. 8339, 3/14/91)

8.12 Tax Attributes Preceding Ownership Change

Final regulations relating to the use of capital losses and excess credits under IRC Secs. 382 and 383 that are attributable to the period preceding an ownership change have been adopted without significant modification. (T.D. 8352, 6/26/91)

8.13 Professional Association

A professional association was classified as a corporation because it possessed the corporate characteristics of continuity of life, centralized management, and limited liability. A portion of the compensation paid in proportion to ownership was disallowed as unreasonable. (*Richlands Medical Association v. Comm.*, TC Memo 1990-660, 12/31/90)

8.14 Liquidation of Subsidiary Checklist

The checklist of information to be submitted with private letter ruling requests relating to complete liquidations of controlled subsidiary corporations under IRC Sec. 332 has been updated. (Rev. Proc. 90-52, IRB No. 1990-41)

8.15 Waiver of Five-Year Restriction on Consolidated Group

Procedures are provided to enable a corporation that ceased to be a member of a consolidated group to again file consolidated returns with that group or another affiliated group with the same parent within five years. (Rev. Proc. 90-53, IRB No. 1990-42)

8.16 Embezzlement Loss of PHC

A personal holding company can deduct an embezzlement loss in the year it occurs rather than in the year of discovery. IRC Sec. 165 mandates reporting of theft losses in the year of discovery. However, the court concluded that this would lead to an "absurd and unintentional result" when PHC income of which the corporation was unaware was embezzled. (*Rod Warren, Ink, A Corporation,* 90-2 USTC ¶ 50,465, CA-9, 8/20/90, reversing 92 TC 995)

Observation. In its opinion, the Ninth Circuit discussed the authority and precedent for judicial interpretation to override Internal Revenue Code language. Although these situations are infrequent, the court mentioned five earlier cases in which judicial interpretation has stepped outside of statutory language when followng the Code had unintended and inequitable results.

9. PARTNERSHIPS

9.1 Statute of Limitations

The statute of limitations for assessing tax against the partners attributable to adjustments of partnership items is based on the filing dates of the partners' returns and not the partnership return. Consents to extend the statute signed by a partner permitted partnership adjustments even though the statute had run on the Form 1065. The court declined to follow the rationale adopted by the Ninth Circuit in *Kelley* with respect to S corporations and by the Eighth Circuit in *Fendell* with respect to trusts. (*Siben,* 91-1 USTC ¶ 50,215, CA-2, 1991. See also *Stahl,* 96 TC No. 37, 6/10/91)

Observation. No court has accepted this defense with respect to partnership audits to date. Pending legislation may preclude this defense in the future.

Taxpayers may not raise the statute of limitations defense for the first time after a decision on the merits is rendered. Even if the defense is properly raised, the statute does not run from the date the partnership return is filed. (*Charlton,* TC Memo 1991-285, 6/27/91)

9.2 Fringe Benefits

Premiums paid by a partnership on behalf of a partner for accident and health insurance are guaranteed payments under IRC Sec. 707(c) if the premiums are paid for services rendered and to the extent that the premiums are determined without regard to partnership income. As guaranteed payments, the premiums are deductible by the partnership and includible in the recipient's income.

Alternatively, the partnership may account for premiums paid on behalf of a partner as nondeductible distributions to the partner. In either case, the partner may deduct 25% of the premiums in accordance with IRC Sec. 162(l). (Rev. Rul. 91-26, IRB 1991-15)

Observation. The ruling also revokes Rev. Rul. 72-596, which held that payments for workers' compensation insurance on behalf of partners were nondeductible by the partnership and now treats such payments as guaranteed payments as well. Presumably, the ruling is equally applicable to other fringe benefits.

9.3 Partnership Administrative Proceedings: Timeliness

On May 11, 1990, the IRS mailed to the tax matters partner (TMP) and to all other partners a commencement notice of the beginning of administrative proceedings at the partnership level for the year ended September 30, 1986. On May 14, 1990, the IRS mailed the TMP a notice of Final Partnership Administrative Adjustment (FPAA)—the equivalent of a 90-day letter. On July 11, 1990, the IRS mailed copies of the FPAA to all other partners. Because the commencement notice was not mailed to all partners at least 120 days prior to the mailing of the FPAA to the TMP, the partners elected out of the administrative proceedings. In an attempt to avoid the proposed adjustments by virtue of the running of the statute of limitations on the individual returns, the partners unsuccessfully argued that the FPAA was invalid because of its issuance by IRS only three days after the commencement notice. (*White & Case*, 91-1 USTC ¶ 50,173, U.S. Cl. Ct., 4/5/91)

9.4 Partnership Administrative Proceedings: Refund Action

A partnership through its tax matters partner challenged the adjustments in the FPAA. Under the partnership agreement, the TMP was allocated none of the partnership income and 90% of the deductions. The IRS concluded that the partnership was a sham, allocated all of the income to the TMP, and disallowed all expenses for lack of substantiation. The FPAA was poorly drafted and the amount of the deficiency was not apparent. In a refund suit, the court concluded that it must dismiss the suit because of failure to pay the entire deficiency but allowed the TMP 90 days to pay the shortfall before dismissal. The court also concluded that it did not have jurisdiction to consider the enhanced interest on substantial underpayment of tax attributable to tax-motivated transactions under IRC Sec. 6221(c) because this is a personal tax item rather than a partnership item. (*Span Hansa Management Co.*, 91-1 USTC ¶ 50,123, W.D. Wash. 4/11/91)

9.5 Partnership Administrative Proceedings: TMP

Mailing the FPAA to a limited partner who was selected as the tax matters partner by the IRS was proper even though the limited partner's interest was smaller than that of other partners. The sole general partner was deceased and the partnership had not designated a successor. The partnership was given the opportunity to designate a new TMP to ratify the petition filed by the son of the deceased TMP, who was not himself a partner. (*Starlight Mine*, TC Memo 1991-59, 2/13/91)

9.6 Partnership Administrative Proceedings: Closing Agreement

The taxpayer entered into an agreement with the IRS in which he agreed to the settlement of the partnership items included in the notice of FPAA. He declined to settle the overvaluation penalty and enhanced interest issues. The IRS issued a 90-day letter for both items and also assessed the tax and the increased interest. The taxpayer's petition for injunction and redetermination of the tax could not be heard because of the settlement. (*Powell*, 96 TC No. 30, 5/20/91)

A closing agreement relating to partnership adjustments did not refer to additions to tax and increased interest. The IRS is not barred from issuing a subsequent notice of deficiency covering such items. (*Estate of Magarian*, 97 TC No. 1, 7/2/91)

9.7 Partnership Administrative Proceedings: Zip Code

The use of the wrong zip code of the Tax Court on the notice of FPAA does not render the notice invalid. (*Gemini Twin Fund II*, TC Memo 1991-315, 7/9/91)

9.8 Substantial Economic Effect

Allocations of income, gain, loss, deductions, or credits in accordance with a partnership agreement are recognized unless the allocation lacks substantial economic effect. An allocation of 75% of losses lacked economic substance even though the capital accounts reflected the loss allocation. Liquidation proceeds were not distributed in proportion to capital account balances, and partners were not required to restore deficit capital account balances upon dissolution. (*Young,* 91-1 USTC ¶ 50,045, CA-9, 1991. See also *Estate of Carberry,* 91-1 USTC ¶ 50,280, CA-2, 1991)

Observation. Practitioners should review written partnership agreements to ensure compliance with IRC Sec. 704(b).

9.9 Substantial Economic Effect: Penalty Interest

The allocations under a partnership agreement were determined to be without substantial economic effect. Under IRC Sec. 6221(c), penalty interest at 120% of the regular rate can be assessed on tax-motivated transactions. The determination was equivalent to a finding that the transaction was a sham. As a result, penalty interest was properly assessed. (*Estate of Carberry,* 91-1 USTC ¶ 50,290, CA-2, 1991)

9.10 Allocation of Losses

A partnership agreement provided for the allocation of profits but was silent as to the allocation of losses. In the absence of any evidence that losses were allocable in a different manner, a partner entitled to 10% of the profits was allocated only 10% of the losses. Also, a limited partner could not reduce his self-employment income by his share of the partnership loss. (*Mammoth Lakes Project,* TC Memo 1991-4, 1/10/91)

An allocation of losses claimed on Form K-1 attached to the partnership return was not a modification of the partnership agreement approved by the partnership. (*Conroe Office Building, Ltd.,* TC Memo 1991-224, 5/22/91)

9.11 Step-Up in Basis Election

In 1981, a taxpayer sold a 24% interest in a general partnership, in which he originally owned a 50% interest, to another partnership. The other partnership consisted of his wife and five adult children. The wife owned a 79% interest in the family partnership. To acquire the 24% interest, the family partnership paid $2.4 million in the form of a note due in twelve years. The general partnership elected under IRC Sec. 754 to step up the basis of that portion of the assets allocated to the

24% interest. The resulting increased depreciation deductions were allocated to the family partnership, and 79% of such deductions were used to offset the taxpayer's income on a joint return with his wife. The IRS successfully argued that IRC Sec. 755 requires that the increase in adjusted basis must be allocated to specific partnership property. Relying upon an appraisal, the court allocated the increase first to tangible property and the balance of $1,117,000 to non-amortizable intangibles, thereby reducing the depreciation deductions. (*Muserlian*, 91-1 USTC ¶ 50,204, CA-2, 1991)

Observation. The taxpayer unsuccessfully argued that the intangible asset was the premium value due to favorable financing that should be amortized over the term of the note.

9.12 Disguised Sale

A transfer of property by a partnership to a newly formed joint venture for a 25% interest, followed by a contribution of cash by the 75% joint venturer and the payment of the cash to the partnership, is a disguised sale (rather than a nontaxable capital contribution and nontaxable distribution to the extent of basis). ITC recapture was also required to the extent that the property was deemed sold. (*Jacobson*, 96 TC No. 21, 4/2/91)

Observation. IRC Sec. 707(a)(2)(B), added by TRA '86, is intended to prevent disguised sales in the future.

9.13 Taxation of Distributions

Distributions from a cash-basis partnership to a retiring partner are ordinary income pursuant to IRC Sec. 736 rather than capital gain, to the extent that they represented unrealized receivables of the partnership at the time of withdrawal. At the time of withdrawal, 90% of the partnership's assets were accounts receivable. (*Estate of Quirk*, 91-1 USTC ¶ 50,148, CA-6, 1991)

9.14 Debt Cancellation: Insolvent Partnership

Certain partnership debts were discharged when the partnership was insolvent but its limited partners were not. The court concluded that the insolvency exception to the realization of income upon cancellation of indebtedness was to be applied at the partnership rather than the partner level. As a result, the insolvent partnership realized no income, but also was not entitled to an increase in basis. (*Estate of Newman*, 91-1 USTC ¶ 50,281, CA-2, 1991, reversing TC Memo 1990-230)

Observation. The result has changed since the enactment of IRC Sec. 108(d)(6), which provides that the tests are to be applied at the partner level.

9.15 Ordinary or Capital Loss Upon Partnership Bankruptcy

A general partner of a bankrupt partnership is entitled to an ordinary rather than a capital loss arising from the worthlessness of the partnership interest. Although a partnership interest is a capital asset, capital loss treatment is inappropriate absent a sale or exchange. The partner received nothing for his interest and there was no deemed distribution under IRC Sec. 752, because there was no discharge of his liabilities as a general partner in the partnership bankruptcy proceedings. (*In re Kriedle*, 91-2 USTC ¶ 50,371, Bankr. D. Colo. 7/8/91)

9.16 Abandonment of Partnership Interest

Partners in a real estate partnership refused to make further contributions to the partnership and offered their partnership interests to any other partner at no cost. The value of the real estate was less than the outstanding nonrecourse debt. The partners claimed an abandonment loss under IRC Sec. 165 in 1976. The property was sold in a foreclosure sale in 1977. The Court concluded that the loss was properly claimed in 1976 when the partnership interest was either abandoned or became worthless. The subsequent foreclosure sale was not indicative of the date of loss from the partnership interest. (*Echols*, 91-2 USTC ¶ 50,360, CA-5, 1991)

9.17 Suit for Rescission: Disallowed Loss

A partner unsuccessfully sought a return of his capital contribution two months after making it. A year later, he filed a suit for rescission and dissolution of the partnership and return of the contribution. In the interim, he received a K-1 on which he was allocated 25% of the partnership loss for the year, and he claimed the loss on his return. Based upon IRC Sec. 165, the IRS sought to disallow the loss because of his pending suit. The court allowed the loss and distinguished between the loss from operations and the loss of the partner's capital investment. (*Garcia*, 96 TC No. 36, 6/5/91)

9.18 Classification as a Limited Partnership

A checklist is provided to assist taxpayers seeking a ruling regarding the classification of an entity as a limited partnership. (Rev. Proc. 91-13, IRB No. 1991-6)

9.19 Receipt of Profits Interest

A taxpayer who received a profit interest in real estate partnerships that he helped form and syndicate did not realize income on receipt of the interest. The value of the interest received was speculative. The Tax Court previously valued the income by discounting the future stream of distributions and tax benefits in the offering memorandum. (*Campbell*, 91-2 USTC ¶ 50,420, CA-8, 1991, reversing TC Memo 1990-162)

10. S CORPORATIONS

10.1 Unified Audit Procedures: Exemption

Unified audit procedures for S corporations were authorized as part of TEFRA. For partnerships, an exemption exists for entities with ten or fewer partners. In 1987, regulations exempted S corporations with five or fewer shareholders from the unified audit requirement. Whether an exemption from the unified audit requirements for years between 1983 and 1987 exists is unclear. The courts have been inconsistent in determining whether an exemption exists.

1. An S corporation with three shareholders was not exempt from the unified audit rules. (*2319 Creekside, Inc.*, TC Memo 1990-649, 12/1/90, reaffirmed, TC Memo 1991-271, 6/12/91)
2. An S corporation with four shareholders was not exempt from the unified audit rules. Moreover, the Tax Court indicated that it would no longer follow its prior decision in *Blanco Investments and Land, Ltd.* (89 TC 1169), in which it exempted S corporations with one shareholder. (*Eastern States Casualty Agency, Inc.*, 96 TC No. 35, 6/4/91. See also *Cichy*, TC Memo 1991-270, 6/12/91 involving 8 shareholders)
3. Unified audit procedures did not apply to S corporations with ten or fewer shareholders in a year prior to 1987. The statutory exemption for partnerships with ten or fewer partners is applicable to S corporations. (*Arenjay Corp.*, 91-1 USTC ¶ 50,015, CA-5, 1991)

10.2 Unified Audit Procedures: Tax Matters Partner

No shareholder had been designated as the TMP. The shareholder with the largest ownership interest executed the consent to extend the statute of limitations. In an earlier case, the court ruled that the secretary-treasurer was the TMP. (*Modern Computer Games, Inc.*, TC Memo 1989-483). As a result, the corporation argued that the consent was invalid. The court disagreed, concluding that at the time of execution, the largest shareholder was the TMP. (*Modern Computer Games, Inc.*, 96 TC No. 40, 6/20/91)

10.3 Unified Audit Procedures: Basis

A notice of final S corporation administrative adjustments (FSAA) did not adjust the deductions and losses claimed by the S corporation or the allocation among shareholders. All adjustments were made to capital stock, loans payable, loans receivable, and similar items affecting basis. An effort to dismiss the FSAA notice on the grounds that the items affected were basis adjustments and not Subchapter S items was denied. (*University Heights at Hamilton Corp.*, 97 TC No. 17, 8/20/91)

10.4 Statute of Limitations

The Guam Department of Revenue sought to assess taxes against Guam taxpayers based on their shares in an S corporation chartered in the Commonwealth of the Northern Mariana Islands. Guam and the Marianas have mirror-image tax codes. Since the assessment was made more than three years after the filing of the corporate return, the assessments were barred. The court relied on its earlier ruling to the same effect involving U.S. taxpayers in *Kelley*, 89-1 USTC ¶ 9360, CA-9, 1989. (*Holmes v. Director of Dept. of Rev. & Tax*, 91-2 USTC ¶ 50,350, CA-9, 1991)

Taxpayers have not yet been able to convince the Tax Court of the validity of this defense. (See e.g., *Fehlhaber*, 94 TC No. 54, 6/13/90; *Euramco Associates, Inc.*, TC Memo 1991-39, 2/4/91; *Aries*, TC Memo 1991-41, 2/5/91; *Brody*, TC Memo 1991-78, 2/27/91 and *Bufferd*, TC Memo 1991-170, 4/15/91)

10.5 Fringe Benefits

Premiums paid by an S corporation on behalf of a 2% or greater shareholder for accident and health insurance are deductible by the S corporation under IRC Sec. 162 and reportable by the shareholder as Form W-2 wages. Payments may qualify for deduction by the shareholder on Form 1040 under IRC Sec. 162(l). The IRS will not challenge the treatment of premiums paid for tax years beginning before 1991. (Rev. Rul. 91-26, IRB 1991-15)

Observation. The IRS resolution will cause affected shareholders to be subject to payroll taxes. It also ensures that affected shareholders qualify for the IRC Sec. 162(l) deduction for 25% of health insurance premiums.

Presumably the rationale of the ruling applies equally to other fringe benefits disallowed to more-than-2% shareholders by IRC Sec. 1372.

10.6 Payroll Taxes

Dividends paid by an accounting corporation that elected S status to its accountant-president, who was its only accountant, in lieu of wages are subject to payroll and withholding taxes. 1978 Act Sec. 530 relief was also unavailable because there was no reasonable basis for not treating him as an employee. (*Spicer Accounting, Inc.*, 91-1 USTC ¶ 50,103, CA-9, 1991)

Observation. This is but the latest in a series of successful IRS suits involving attempts by S corporation shareholder-employees to avoid payroll taxes. (See *Joseph Radtke, S.C.*, 90-1 USTC ¶ 50,113, CA-7, 1990 and *Fred R. Esser, P.C.*, Civ. No. 89-973, DC, Az. 1990)

10.7 NOL Carryover: Tax Benefit Rule

An NOL carryover from a C year cannot offset income during an S year. The deductions taken gave no tax benefit to the extent of the carryovers. The tax benefit rule does not permit recharacterization of deductions taken in C years as income exclusions. (*Rosenberg*, 96 TC No. 15, 3/17/91. See also *Hudspeth*, 90-2 USTC ¶ 50,501, CA-9, 1990)

10.8 NOL Carryover: Years

For purposes of counting the number of years that an NOL may be carried over or carried back, the two short years resulting from a midyear termination of an S election are treated as one year. Effectively, the short S year is disregarded. (TAM 9114003, 12/18/90)

10.9 Penalties Imposed on TMP

Penalties for delaying court proceedings are properly assessed against the TMP rather than the S corporation or its other shareholders. The

TMP filed a petition alleging that he could substantiate the contested deductions. He failed to do so, did not attend scheduled conferences, failed to file a trial memorandum, and did not appear at trial. (*Rollercade, Inc.*, 97 TC No. 8, 7/29/91)

10.10 Taxable Income

A shareholder in an S corporation must report his distributive share of taxable income. It is immaterial that the corporation did not make distributions to him or that the failure to make distributions was a breach of an agreement requiring payment. (*Knott*, TC Memo 1991-352, 7/31/91)

10.11 Short Tax Years—Election to Close Year

A corporation terminated its S year and had two short periods. The corporation failed to include the election and signed consents to close the books with the tax return for the C corporate year. An extension of time to file the election was granted. (TAM 9115002, 11/27/90)

11. QUALIFIED RETIREMENT PLANS

11.1 Dual-Purpose Plans

Disability benefits can be exempt from tax pursuant to IRC Sec. 105. A permanently disabled osteopathic doctor unsuccessfully attempted to exclude benefits received from a defined-benefit pension plan and a money-purchase pension plan as a result of his disability. Neither plan contained any indication that it was intended to qualify as an accident and health plan under IRC Sec. 105. Also, the plans did not vary the benefits based on the nature of the injury. (*Berman*, 91-1 USTC ¶ 50,081, CA-6, 1991)

Observation. Taxpayers have sometimes successfully argued that disability benefits payable from profit-sharing plans are tax-exempt pursuant to IRC Sec. 105. (See *Wood v. U.S.* (79-1 USTC ¶ 9244, CA-9, 1979.) To qualify, the plan should specifically state that it is intended as a dual-purpose plan for both IRC Secs. 105 and 401 and should vary the benefits based upon the nature of the injury.

11.2 Federal Tax Liens

The prohibition against assignment or alienation in a qualified pension plan creates a federal exemption under IRC Sec. 522(b)(2)(A) of the Bankruptcy Act. The IRS cannot enforce a tax levy against the plan assets. (*In re Lewis,* 91-1 USTC ¶ 50,296, Bankr. Ct. D. Colo., 9/20/90)

Another court came to the opposite conclusion that a participant's interest in a qualified retirement plan is subject to a federal tax lien. The bar against assignment or alienation of IRC Sec. 401(a)(13) does not preclude a tax levy or judgment resulting from unpaid taxes. (*In re Taylor,* 91-2 USTC ¶ 50,354, Bankr. Ct. D. Md. 5/14/91)

11.3 Priority of IRS Claims to Excise Taxes in Bankruptcy

The 10% excise tax under IRC Sec. 72(t) for early withdrawals from a pension plan is a punitive penalty rather than a tax or compensatory penalty and is ineligible for priority status in a bankruptcy proceeding. (*In re Cassidy,* 91-1 USTC ¶ 50,120, Bankr. Ct. D. Colo., 1991). Another court reached the same conclusion with respect to the 10% (now 50%) excise tax on asset reversions upon termination of a defined-benefit pension plan under IRC Sec. 4980 (*In re C-T of Virginia, Inc.,* 91-1 USTC ¶ 50,240, Bankr. Ct. W.D. Va., 5/3/91)

11.4 Prohibited Transaction: Payment of Legal Fees

Payment by a pension plan of the legal fees of a trustee of the Central States Teamsters Pension Fund who was indicted and convicted of conspiring to bribe a U.S. senator is a prohibited transaction. (*O'Malley,* 96 TC No. 24, 4/15/91)

Observation. In an earlier case, the court concluded that the payments were taxable income to the trustee. (*O'Malley,* 91 TC 352)

11.5 Prohibited Transaction: Contribution of Property

The transfer of unencumbered property by an employer to its pension plan in satisfaction of its funding obligations is not a prohibited transaction. Unencumbered property transfers are prohibited. (*Keystone Consolidated Industries, Inc.*, TC Memo 1990-628, 1990)

A contribution of three third-party promissory notes by the employer sponsoring a defined-benefit pension plan to satisfy the minimum funding obligation is not a prohibited transaction subject to excise taxes. The contribution of the notes was not a sale or exchange between the plan and a disqualified person. (*Wood,* 95 TC No. 26, 1990)

11.6 Prohibited Transactions: Participant Loans

Loans from a qualified plan to participants that are properly classified as prohibited transactions are subject to excise taxes based upon the market rate of interest rather than the amount of the loan. An agreement with the Department of Labor relating to the repayment terms does not preclude the IRS from assessing the excise taxes. Failure to disclose the loans on Form 5500 subjects the transaction to the six-year rather than the three-year statute of limitations. (*Thoburn,* 95 TC No. 11, 1990)

11.7 Prohibited Transactions: Loans to Clients

A law firm may not cause its qualified retirement plans to make unsecured loans to firm clients. The loans benefit the law firm, which is a disqualified person. As a result, the loans are prohibited transactions. (TAM 9118001, 12/5/90)

11.8 Taxation of Distributions

A taxpayer received a lump-sum distribution and made a partial rollover to an IRA. He claimed ten-year averaging on the balance. Between the date he prepared his return and the date he filed it, temporary regulations were issued that precluded such treatment. The regulation permitted revocation within 44 days of its publication. The court denied his attempted revocation more than three years after the normal time for filing amended returns. (*Hall,* TC Memo 1991-133, 3/25/91)

Observation. Essentially the same result as the one desired by the taxpayer can be achieved by combining an annuity with a partial lump sum.

11.9 Erroneous Advice: Taxation of Distributions

Erroneous advice regarding the taxation of a distribution from a qualified profit-sharing plan given by the plan administrator is not a basis for the Tax Court to modify the proper treatment. The taxpayer received a distribution that he reported as capital gain but at trial conceded was properly taxable as ordinary income. (*Johnston*, TC Memo 1991-5, 1/14/91)

11.10 Erroneous Advice: Funding Deficiencies

Based on erroneous advice from a pension consultant, a doctor timely set aside the contributions to his pension plans in a segregated bank account but failed to actually contribute the monies to the plans. The doctor unsuccessfully sought to avoid the imposition of the penalty under IRC Sec. 4971 for funding deficiencies on the basis that his failure was not willful. (*D.J. Lee, M.D., Inc.*, 91-1 USTC ¶ 50,218, CA-6, 1991)

11.11 Disqualification

IRS issued a retroactive favorable determination letter conditioned on limiting the corporate deduction for contributions and requiring the inclusion of the disallowed amounts in the income of the plan participant. Because the participant refused to include the amounts in income and the plan was not qualified, the earnings of the trust were taxable. (*TCS Manufacturing, Inc. Employees' Pension Trust*, TC Memo 1990-691, 1990)

11.12 Disqualification: Failure to Amend

IRS may retroactively revoke a determination that a profit-sharing plan is qualified if the plan was not timely amended to comply with the tax law changes. No changes actually affected the operation of the plan and the failure to amend was not cured by the cessation of contributions and termination of the plan. (*Basch Engineering, Inc.*, TC Memo 1990-212)

An ESOP was not timely amended to comply with TEFRA, DEFRA, and REA. Once the amendments were made, they could not be retroactively applied, because the employer did not timely seek a favorable determination letter. (*Stark Truss Co., Inc.*, TC Memo 1991-329, 7/17/91; see also *Attardo*, TC Memo 1991-357, 8/1/91)

11.13 Remedial Amendment Period

The remedial amendment period for qualified plans to satisfy the requirements of TRA '86 has been extended until the end of the first plan year beginning after December 31, 1991. (IRS Notice 90-73, IRB 1990-51)

11.14 User Fees

The user fee program has been extended by OBRA 1990 by five years. Form 8717 and the applicable fee should be submitted with determination letter requests. (IRS Ann. 90-125, IRB 1990-48)

11.15 Deductibility of Keogh Contributions

A self-employed individual contributed $7,031 to his Keogh plan and sought to claim the contribution as a deduction on his Schedule C rather than on Form 1040. The consequence of this treatment would be to reduce net earnings from self-employment and the attendant self-employment tax. The Court ruled that such treatment was improper. (*Gale*, 91-2 USTC ¶ 50,356, N.D. Ill. 6/27/91)

11.16 Partial Termination

In the event of a termination or partial termination of a qualified retirement plan, the interests of affected participants become fully vested. Whether a partial termination has occurred depends on all the facts and circumstances. In determining whether a partial termination of a pension plan occurred, the Court initially held that only the number of nonvested participants discharged is relevant. Although 33.4% of participants terminated, only 16.4% of nonvested participants were discharged. No partial termination occurred. (*Weil v. Retirement Plan Administrative Committee*, 91-1 USTC ¶ 50,025, CA-2, 1991) On rehearing, however, the Court was persuaded by the IRS, which filed an amicus curia brief, that both vested and nonvested employees who were discharged should be taken into account. As a result, it reversed its earlier ruling and concluded that a partial termination had occurred. (*Weil*, 91-1 USTC ¶ 50,248, CA-2, 1991)

11.17 Permissible Reversions

Guidance is provided regarding the circumstances under which employer contributions to a qualified plan may revert to the employer. Reversions based on failure to qualify the plan are permitted only if—

1. The return is conditioned on initial qualification of the plan.
2. The plan received an adverse determination with respect to its initial qualification.
3. The application for determination is timely filed.

(Rev. Rul. 91-4, IRB 7, 1991-3)

11.18 Highly Compensated Employees

The temporary regulations relating to the scope and meaning of the term "highly compensated employee" in IRC Sec. 414(q) have been amended to reflect their use in connection with the separate-line-of-business rules under IRC Sec. 414(r). (Temp. Reg. 1.414(q)-1T, TC 8334, 1/31/91)

11.19 Simplified Employee Pensions (SEP)

A mass submitter or sponsoring organization may obtain an opinion letter for an SEP that provides for elective deferrals by an employee. Model amendments for adding elective deferral provisions are included. (Rev. Proc. 91-44, IRB No. 1991-31)

11.20 COLA Adjustments

The COLA adjustments to various employee plan limitations for 1991 are as follows:

Maximum pension benefit	$108,693
Elective deferrals	8,475
Excess distributions	136,204
Highly compensated	90,803
Top 20% group	60,535
Compensation limit	222,220

(IRS News Release IR-91-12, 1/17/91)

11.21 Restoration of Terminated Plans

Temporary regulations have been issued relating to the minimum funding requirements for terminated plans that are restored by order of PBGC. (Temp. Reg. 1.412(c)(1)-3T)

11.22 Partnership Plans With CODA Features

Partnership plans containing cash or deferred features that failed to make the one-time irrevocable election permitted by Notice 88-127 will still be treated as satisfying the requirements of IRC Sec. 401(k) provided the following conditions are met by December 31, 1992:

1. The plan must distribute any contributions and earnings in excess of the amounts allowed under IRC Sec. 402(g).
2. The plan must satisfy the IRC Sec. 401(k)(3) actual-deferral percentage test, assuming that all contributions the partner could have elected not to contribute are elective deferrals and any qualified nonelective contributions (QNEC) that met the requirements—but for distribution restrictions—are treated as QNECs.
3. Form 1099-R is issued for any distribution.
4. Any steps necessary to satisfy qualification requirements for future years are taken.

(Rev. Proc. 91-47, IRB 1991-34)

Observation. Only new partners or partners who have just become eligible to participate may elect not to participate.

11.23 Fiscal Year Contributions to CODA Plan Years

Contributions to an IRC Sec. 401(k) plan or to a defined-contribution plan as matching contributions are not deductible if attributable to compensation earned by participants after the end of the taxable year. (Rev. Rul. 90-105, IRB 1990-52)

Taxpayers required to change their method of accounting by reason of Rev. Rul. 90-105 are not subject to penalties for underestimating taxes, provided the requirements of Rev. Rul. 90-105 are satisfied. (IRS Ann. 90-144, IRB 1990-52)

Taxpayers will not be assessed a late payment by reason of compliance with Rev. Rul. 90-105, provided the applicable tax is paid by March 15, 1991. (IRS Ann. 90-144A, IRB 1990-53)

11.24 Form 5310—Notice of Termination

Revised Form 5310 and Form 6088, Distributable Benefits from Employee Pension Plans, are now available. Form 5310-A will be available on October 1, 1991. (IRS Ann. 91-124, IRB 1991-34)

11.25 Miscellaneous IRS Pension Procedures

Procedures are issued to request a ruling that employer contributions to a defined-benefit pension plan be nondeductible in order to permit a reversion to the employer. A ruling is not required for nondeductible contributions under $25,000. (Rev. Proc. 90-49, IRB 1990-39)

Procedures for issuing ruling letters, information letters, and determination letters on matters relating to employee plans and exempt organizations are revised. (Rev. Proc. 91-4, IRB 1991-4)

Procedures for issuing technical advice on issues involving employee plans and exempt organizations are revised. (Rev. Proc. 91-5, IRB 1991-4)

Procedures for issuing determination letters for qualified plans are revised. Sample Notices to Interested Parties are included. (Rev. Proc. 91-10, IRB No. 1991-5). Supplemental procedures have been adopted. (Rev. Proc. 91-41, IRB 1991-28)

Rev. Proc. 85-29, relating to approval for changes to acceptable funding methods, which was scheduled to expire Dec. 31, 1989, has been extended to plan years beginning before Jan. 1, 1992. (IRS Notice 90-63, IRB 1990-43)

12. INDIVIDUAL RETIREMENT ACCOUNTS

12.1 Innocent-Spouse Relief

A widower did not qualify for innocent-spouse relief for unpaid tax on omitted income from a taxable IRA distribution of his spouse. No penalties were imposed, because he had no reason to know that the amount deposited in a joint bank account was from the IRA rather than other separate investments. (*Varney*, TC Memo 1991-14, 1991)

12.2 Active Participant

Employees who are active participants in a qualified plan are generally ineligible to contribute to an IRA unless their adjusted gross income is below certain thresholds (e.g., $50,000 for married individuals). An employee in a qualified plan whose benefit accruals have been suspended pursuant to Model Amendments 2 or 3 pending amendment of the plan to comply with TRA '86 continues to be an active participant for purposes of completing Form W-2 and contributing to an IRA. (IRS Ann. 91-11, IRB 1991-4)

12.3 Compensation: Safe Harbor

Questions frequently arise about the inclusion of vacation pay, severance pay, deferred compensation, and other amounts in the compensation base for the purpose of contributing to an IRA. Amounts shown in Box 10 on Form W-2 less amounts properly shown on Box 14 (nonqualified plans) can be used as a safe harbor for the purpose of contributing to an IRA. (Rev. Proc. 91-18, IRB 1991-9)

12.4 Compensation Paid by Family-Owned Corporation

Amounts paid to a taxpayer by a family-owned corporation did not constitute compensation for personal services and could not be used to support an IRA contribution. (*Bingo*, TC Memo 1991-248, 6/5/91)

12.5 Participants in Operation Desert Storm

Military and support personnel who were in the designated Desert Storm area at any time from August 2, 1990, through January 1, 1991, have 285 days after they leave the combat zone to file their 1990 federal income tax returns and make their IRA contributions. (IRS News Release IR-91-46, 3/26/91)

12.6 Reporting Desert Storm Contributions

Contributions made after April 15, 1991, to an IRA by personnel in the Desert Storm area should be reported on Form 5498 by including the designation DS in any of the empty boxes. Amended Forms 5498 may be appropriate. (IRS Notice 91-17, 5/24/91)

12.7 Rhode Island Banks and Credit Unions

Banks and credit unions were closed by the governor of Rhode Island. IRA owners who were unable, by reason of the closing, to withdraw the minimum distributions from their IRAs after attaining age 70½ as required by IRC Sec. 4974 are exempted from the 50% excise tax. (IRS Notice 91-22, IRB 1991-29)

12.8 Consequences of Divorce

A taxpayer attained age 70½ in 1988 and was required to commence distributions from his IRA by April 1, 1989. He was divorced in 1989 and transferred half of his IRA to his former spouse pursuant to his divorce. The IRS ruled that for purposes of determining the minimum distribution for 1988, the total IRA assets in 1988 must be used. (LR 9011031)

Observation. The minimum distribution for 1990 will be reduced to reflect the IRA value after the divorce.

12.9 More Divorce Consequences

An individual withdrew monies from three IRAs to pay his ex-wife's tax liabilities. The divorce decree directly allocated the IRAs to the taxpayer and made him liable for his wife's taxes. The amounts withdrawn were includible in his taxable income and subject to penalties for early withdrawal, negligence, and substantial understatement of tax. (*Harris*, TC Memo 1991-375, 8/9/91)

Observation. The taxpayer should have used non-IRA funds or should have caused the IRAs to be allocated to his wife and made her responsible for payment of her own taxes.

13. OTHER EMPLOYEE BENEFIT PLANS

13.1 Deduction for Nonqualified Plan Interest

Amounts designated as interest but constituting part of a nonqualified plan of deferred compensation are deductible only as permitted by IRC Sec. 404 rather than as accrued interest. (*Albertson's, Inc.*, 95 TC No. 30, 1990)

13.2 Taxation of Distributions From Nonqualified Plan

Payments received by an air force officer who was involuntarily separated from active duty for readjustment/separation are ineligible for lump-sum distribution treatment because they were not received from a qualified plan. (*Sampson*, TC Memo 1990-485. See also *Acquisto*, TC Memo 1991-293, 7/2/91)

13.3 Educational Benefit Fund

A trust fund organized primarily to award scholarships to employees and their families is not entitled to tax-exempt status as an educational organization. Although it did further education, it was not operated exclusively for exempt purposes. Its primary purpose was to provide additional compensation to employees in the form of fringe benefits. (*Copperweld Steel Company's Warren Employee's Trust*, TC Memo 1991-7, 1/14/91)

13.4 COBRA Continuation Coverage for Military Reservists

Guidance is provided on COBRA continuation coverage for military reservists called to active duty in the Middle East. If an employer does not voluntarily maintain coverage for an employee called to active duty, IRC Sec. 4980B requires that the employer's group health plan offer the reservist, spouse, and dependents the option to continue health care coverage at their own expense. (IRS Notice 90-58, IRB 1990-40)

Observation. The COBRA continuation coverage rules do not apply to smaller employers (fewer than 20 employees), governmental plans, and church plans. However, for those employers to whom it is applicable, the penalty for failing to offer continuation coverage is equal to $100 per day for each beneficiary (maximum of $200 per day per family).

14. EXEMPT ORGANIZATIONS

14.1 Unrelated Business Taxable Income: Insurance Income

A postal workers' union permitted non-union federal employees to participate in its health insurance plan if they paid the regular insurance premiums and an annual fee of $35. The provision of health benefits to nonmembers constitutes income from a trade or business entered into with the hope of realizing a profit and does not contribute importantly to the exempt purposes of the organization. The income is subject to tax as unrelated business taxable income. (*American Postal Workers Union, AFL-CIO*, 91-1 USTC ¶ 50,096, CA-DC, 1991)

14.2 Unrelated Business Taxable Income: Rental of Donor Lists

A tax-exempt organization rented its donor lists to for-profit organizations. It did not report the income received as UBTI on the basis that the monies represented royalties exempt pursuant to IRC Sec. 512(b)(2). In reversing the Tax Court (which had earlier found that the income constituted exempt royalties), the Court concluded that the doctrine of collateral estoppel prevented the organization from relitigating the taxability of the income, because the same issue had been decided in favor of the IRS in an earlier year. (*Disabled American Veterans*, 91-2 USTC ¶ 50,336, CA-6, 1991, *reversing* 94 TC 60)

Observation. Although the Tax Court case was reversed, the basis for reversal was a procedural matter, and the conclusion that rentals of donor lists are not UBTI continues to be valid. Income from rentals of donor lists to another exempt organization is exempt from tax pursuant to IRC Sec. 513(h)(1)(B).

14.3 Unrelated Business Taxable Income: Worker Compensation

A farm bureau realized income from providing worker compensation insurance to members. The bureau successfully maintained that—

1. The activity was not a trade or business, because it was not entered into with the dominant hope and intent of realizing a profit.
2. The activity was conducted during no more than two weeks and was not, therefore, regularly carried on.
3. The activity was substantially related to the exempt purposes of the organization.

The income realized was not UBTI. (*California Farm Bureau Fed.*, 91-1 USTC ¶ 50,300, E.D. Cal. 5/22/91)

14.4 Unrelated Business Taxable Income: Parking Lot Rentals

Generally, rents from real property are exempt from UBTI pursuant to IRC Sec. 512(b)(3). Several Technical Advice Memoranda differ as to whether parking lot rents constitute a business subject to tax or are exempt real estate rents. According to IRS Chief Counsel, an exempt organization that operates a parking lot is conducting a service business subject to UBTI. However, a net lease of the entire parking lot to a third party is exempt. (GCM 39825, 8/17/90)

14.5 Unrelated Business Taxable Income: Advertising Income

The IRS will continue to litigate whether advertising income is UBTI. The IRS maintains that the decision in *National Collegiate Athletic Ass'n*, in which the Tenth Circuit concluded that the advertising income from the annual NCAA basketball tournament was not an activity regularly carried on, is erroneous because the court failed to consider the time involved in soliciting and selling the advertising. (AOD, 7/3/91)

14.6 Unrelated Business Taxable Income: Golf Clubs

The IRS has released from suspense all pending UBTI cases involving social clubs following its Supreme Court victory in *Portland Golf Club*. In the case, the Court held that investment income may not be offset by losses from nonmember sales unless a profit motive can be shown. The IRS will monitor the filing patterns of social clubs to verify that amended Form 990-T returns are being filed. (IRS Ann. 90-138, IRB 1990-48)

Observation. In light of the IRS announcement, practitioners representing country clubs and other exempt social organizations should review the treatment of nonmember sales for all open years to ascertain whether amended returns should be filed.

14.7 Unrelated Business Taxable Income: Athletic Clubs

Losses from nonmember undertakings that included professional golf tournaments, nonmember golf activities, and food and beverage sales are to be aggregated in determining profit motive. The undertakings have a common business purpose of improving nonmember interest in the club. Direct and indirect costs, when subtracted from gross receipts, resulted in losses for five of six years. Such losses could not be offset against investment income. (*Atlanta Athletic Club*, TC Memo 1991-83, 2/29/91)

14.8 Unrelated Business Taxable Income: Debt-Financed Property

A pension fund owned three certificates of deposit that contained penalties for early withdrawal. Interest rates increased greatly. To avoid the penalties, the S & L that issued the CDs proposed that the plan borrow money using the old CDs as collateral and invest the borrowed funds in higher-yielding CDs. The court concluded that the new CDs were debt-financed property and the interest income was UBTI. (*Kern County Electrical Pension Fund*, 96 TC No. 41, 6/20/91)

14.9 Qualification as a Church

A religious organization maintained a chapel and sponsored religious retreats and gospel music events but did not have an established congregation. Guest ministers conducted religious activities on the premises. At issue was whether the organization qualified for exemption as a church. For an organization to qualify as a church, it must meet the following IRS criteria:

1. Have a distinct legal existence
2. Have a recognized creed and form of worship
3. Have a definite and distinct ecclesiastical government
4. Have a formal code of doctrine and discipline
5. Have a distinct religious history
6. Have a membership not associated with any other church or denomination
7. Have an organization of ordained ministers
8. Have ordained ministers selected after completing prescribed studies
9. Have a literature of its own
10. Have an established place of worship
11. Have a regular congregation
12. Conduct regular religious services
13. Maintain Sunday schools for religious instruction of the young
14. Maintain schools for the preparation of its ministers

The court concluded that the criteria are a useful guide although each criterion need not be met. Under the circumstances, the organization was not qualified. (*Spiritual Outreach Society*, 91-1 USTC ¶ 50,111, CA-8, 1991)

14.10 Payroll Taxes of Religious Orders

Guidelines are provided to help in determining whether an organization is a religious order for federal employment tax purposes. The IRS uses the following criteria:

1. The organization is described in IRC Sec. 501(c)(3).
2. Members vow to live under a strict set of rules requiring moral and spiritual self-sacrifice.
3. After a probationary period, members make a long-term commitment.
4. The organization is under the control of or is significantly funded by a church.
5. Members live in a community and are held to a stricter standard than are lay members.
6. Members pursue religious goals full-time.
7. Members participate regularly in religious activities.

(Rev. Proc. 91-20, IRB No. 1991-10)

14.11 Standing to Challenge Tax Exemption

Lenora Fulani, a presidential candidate of the New Alliance Party in 1988, was denied the opportunity to participate in the public debates sponsored by the Commission on Presidential Debates, a tax-exempt organization. Her suit to require the IRS to revoke the exempt status of the organization was dismissed on the grounds that she lacked standing to sue. Ms. Fulani was on the ballot in all states and qualified for federal matching funds. She ultimately received .24% of the popular vote. The court concluded that her injury was not attributable to the exempt status of the organization. (*Fulani v. Brady*, 91-2 USTC ¶ 50,305, CA-DC, 1991)

Observation. The Second Circuit reached the opposite conclusion in a companion debate case. (*Fulani v. League of Women Voters Educ. Fund*, 89-2 USTC ¶ 9520, CA-2, 1989)

14.12 Liquidation of Subsidiary

A wholly owned taxable subsidiary of a tax-exempt organization adopted a plan of liquidation and sold its sole asset, an apartment complex, for $1,100,000 in cash and a note for $500,000 in 1979. The parent is not subject to tax on the liquidation by virtue of IRC Sec. 332. However, the parent has transferee liability attributable to the gain realized by the subsidiary pursuant to IRC Sec. 337(c)(2)(A). The parent unsuccessfully argued that IRC Sec. 337(c)(2)(A) was inapplicable because its basis in the property received was not carryover basis pursuant to IRC Sec. 334(b)(1) but was instead determined under IRC Sec. 514(d). The latter section sets forth the rule for determining basis of debt-financed property acquired in a corporate liquidation. IRC Sec. 514(d) is inapplicable because the parent did not acquire the apartment complex but instead acquired the proceeds of the sale. (*Centre for International Understanding*, TC Memo 1991-424, 8/27/91)

14.13 Resale of Prison-Made Goods

An organization formed to purchase goods made by prisoners for resale to the public was not an exempt organization. State agencies did not recognize the organization as acting on behalf of government. Accordingly, it did not "lessen the burdens of government" or otherwise operate exclusively for an exempt purpose. (*Public Industries, Inc.*, TC Memo 1991-3, 1/8/91)

15. ITEMIZED DEDUCTIONS

15.1 Medical Expenses: Relocation of Residence

Taxpayers were not allowed to deduct expenses associated with selling a residence and searching for a new home at a location recommended as beneficial to their health by their physician. Deductible medical expenses must be associated with a diagnosis or treatment of a specific illness; expenditures that merely benefit general health are nondeductible. (LR 9030049)

15.2 Charitable Contributions

15.2.1 Life insurance policy to a charity

In a surprising departure from prior rulings, the IRS determined that a contribution of a life insurance policy to a charity was nondeductible because the charity did not have an insurable interest under state law. The taxpayer purchased the life insurance contract, named the charity as sole beneficiary, and assigned ownership to the charity with an intent to continue payment of the premiums as an annual charitable deduction. However, the executor of the taxpayer's eventual estate could assert a claim on the death benefit because of the violation of state law. The IRS therefore ruled that there was a non-remote possibility that the insurance proceeds could revert to the donor, and accordingly disallowed the charitable deduction because it was an incomplete transfer. (LR 9110016)

Observation. This private ruling represents a reversal of the long-standing position established in Rev. Rul. 58-372 (1958-2 CB 99). Tax advisers should review state law as to the ability of a charity to acquire a policy on the life of an individual in which it may not have an insurable interest. In states with this restriction, consider the strategy of having the charity acquire a policy on an employee, director, or other individual in which it may have an insurable interest, rather than on the life of the donor.

15.2.2 Valuation methods: closely held stock

An individual donated 40% of the stock of his computer software corporation to a university, claiming a $260,000 deduction. This was followed by a contribution of the remaining 60% of the stock in the next year and a deduction of $390,000. The valuation of the stock was based on the taxpayer's estimate of the software's reproduction or replacement cost. The court, however, determined that the primary measure of value of the stock must be the income potential of the software. Because the facts indicated that the software lacked marketability, was not unique, and in fact was neither used nor marketed by the university, the court supported the IRS determination of zero value. (*Provitola*, TC Memo 1990-523, 10/2/90)

15.2.3 Substantial benefit to donor

To qualify for a charitable contribution, the donor may not receive a direct or indirect substantial economic benefit from the donation. The IRS has ruled that fraternity alumni had such a disqualifying interest when they made a donation to a historical preservation society, which in turn used the contributions to fund a grant for renovation of their fraternity house. The fact that the historic preservation society would use the funds in its exempt purpose is only one test for deductibility; the expectation of benefit to fraternity alumni from restoration of their fraternity chapter property constituted a "significant personal interest" preventing deductibility. (LR 9118012)

15.2.4 Loan-contribution scheme

In a novel money-circle "scheme," a corporation loaned funds to individuals (at a 3% rate with principal due in twenty years), who in turn made charitable contributions of a slightly larger amount to a charity controlled by the same individuals who controlled the lending entity. With the low interest rate and long-term repayment arrangement, the tax savings of the charitable contribution exceeded the present value of the debt. Both the Tax Court and Court of Appeals denied the charitable contribution as a sham because of the interdependence of the steps (the charitable contribution found its way back to the lending entity) and also imposed negligence penalties. (*Kenneth and Barbara Allen*, 91-1 USTC ¶ 50,080, CA-9, 1991, affirming 92 TC 1)

15.2.5 Valuation of artwork: Murphy's Law

A taxpayer who donated a sandstone sculpture of John Wayne to a university was allowed a $30,000 charitable contribution by the Tax Court, rather than the amount claimed in his tax return of $500,000. (*Murphy*, TC Memo 1991-276, 6/18/91)

15.3 Condo Owners: Property Taxes

A municipality entered into an agreement with a condo developer under which the city acquired blighted land and made substantial project site improvements for the condo project. Under the agreement with the city and based on a special statute, the condo owners were relieved of real property taxes, but instead were required to make "service payments" in lieu of taxes to the city until the debt for the site improvements had been recovered. Because the service payments were equal to the amount of real property taxes otherwise payable and were collected at the same time as real property taxes, the IRS ruled that each condo owner could deduct his or her share of service payments as long as the amounts continued to be computed on the basis of the existing net real property tax rate. (LR 9109030)

15.4 Crystal Ball: A Tax Deduction in Your Future

A taxpayer suffering from psychological disorders and a recent divorce consulted two fortune-tellers in New York City, turning over $19,000 in cash and property for their services. After learning that fortune-telling was a crime under local law, he filed a report with the city police and claimed a theft-loss deduction in his tax return. Noting that a theft must have occurred within the definition of local law, the Tax Court confirmed that fortune-telling was in violation of New York statute. In allowing the deduction, the court focused on the fact that the taxpayer had been defrauded or swindled, even though he had entered into the transactions voluntarily in good faith. (*George Kreimer*, TC Memo 1990-587, 11/15/90)

15.5 Tax Return Preparation Fees

A taxpayer owned a consulting practice operated as a proprietorship, served as a general partner in an equipment lease partnership, owned and actively managed four rental real estate properties, and owned all of the stock of an S corporation selling computer software. The taxpayer sought ruling advice from the IRS as to the treatment of fees paid to his CPA for tax advice on the treatment of personal income and expenses, as well as income and deductions associated with each activity. The CPA's advice included instructions as to recordkeeping and deductibility of expenses associated with each activity and subsequent preparation of related tax returns.

IRS National Office ruled that the CPA's advice regarding deductions for rental properties arose in connection with preparation of the Form 1040 and was not allowed as a deduction against rental income, but only as a miscellaneous itemized deduction subject to the 2% floor. Similarly, CPA tax advice on deductions associated with the consulting proprietorship was held to be only remotely connected with the business, and was more directly a tax return preparation expense allowable as a miscellaneous itemized deduction. The only CPA fees allowed full deductibility were return preparation expenses of the partnership and S corporation. (LR 9126014)

15.6 Gambling Losses: Cohan Rule

In cases when the taxpayer is unable to substantiate or document deductions, the courts may accept testimony and estimates from the taxpayer to determine the proper deduction. This is known as the Cohan rule and is permitted for areas other than those in which the statute requires specific documentation (such as travel and entertainment, listed property, business gifts, etc.).

A North Dakota taxpayer who participated heavily in pulltab gambling benefitted from the Cohan rule in establishing offsetting gambling losses. Based on state gambling reports, the IRS determined that the taxpayer had winnings of approximately $78,000 over a two-year period. Because he had no losing tickets or documentation of his gambling losses, the IRS only allowed $500 in losses for each year. Based on testimony that the taxpayer engaged in pulltab gambling five to six hours a day for six days a week, and on evidence of the taxpayer's net worth position, the Tax Court applied the Cohan rule to allow gambling losses of about $65,000. (*Randy G. Doffin*, TC Memo 1991-114, 3/18/91)

16. ESTATE AND GIFT TAX

16.1 Distribution Deductions

Distributions of income to the beneficiaries of an estate were made without approval of the probate court. As a result, the deduction under IRC Sec. 661 for amounts properly paid by the estate was disallowed. Subsequent court approval of the final accounting did not cure the problem because under Oklahoma law the executor is without authority to distribute any of the estate without a court order. The distributions were income of the estate rather than of the beneficiaries. (*Murphy*, 91-1 USTC ¶ 50,167, W.D. Okla., 3/18/91)

16.2 Basis of Property Held in a Marital Trust

The decedent died possessing a general power of appointment over property held in a marital trust created by her husband's will. Although the assets of the trust were included in the decedent's estate for estate tax purposes, the IRS argued that the assets were not entitled to a step up in basis under IRC Sec. 1014. The court rejected the IRS assertion. (*Connecticut Nat'l Bank*, 91-2 USTC ¶ 50,348, CA-2, 1991)

16.3 Ineffective Disclaimer

A trustee acting solely in a fiduciary capacity disclaimed a power to invade trust corpus for the benefit of a specific beneficiary. Such a disclaimer is ineffective under state law. As a result, the disclaimer is not a qualified disclaimer for purposes of IRC Sec. 2518. If the disclaimer is effective, the transfer taxes are applied as if the disclaimed interest had never been transferred. (Rev. Rul. 90-110, IRB 1990-52)

16.4 Subjects for Which Advance Rulings Not Issued

The IRS has updated its procedure for subjects on which it will not rule. These include the actuarial factors for valuing interests in the prospective estate of a living person or for valuing prospective gifts and determining whether transfers to pooled-income funds or charitable remainder trusts qualify as a gift or estate tax charitable deduction. (Rev. Proc. 91-3, IRB 1991-1)

16.5 Mandatory Checklist for Ruling Requests

The IRS has published a mandatory checklist that must be included with every request for a ruling related to estate, gift, and generation-skipping transfer tax issues. (Rev. Proc. 91-14, IRB 1991-6)

16.6 Parent's Loan Guarantee

A parent's enforceable guarantee of a loan to a child is a transfer of an economic benefit to the primary obligor that is subject to gift tax on the date executed. (LR 9113009, 12/21/90)

Observation. The ruling does not indicate how to value the gift.

16.7 Income Tax Deduction for GST Tax

Guidance is provided for beneficiaries of generation-skipping trusts who are entitled to an income tax deduction for payment of the GST tax in the year paid. (IRS Ann. 91-43, IRB 1991-11)

16.8 Gifts From Trust

An individual established a revocable living trust naming himself as trustee and sole beneficiary. He made various annual gifts directly from the trust. In 1985, he was declared incompetent. The successor bank trustee made additional gifts during his lifetime. At his death, the IRS sought to include in his estate all gifts made from the trust within the preceding three years. The court concluded that the gifts that the individual made were excludible but that those made by the bank were includible. (*Estate of Jalkut*, 96 TC No. 27, 4/29/91)

17. SELF-EMPLOYMENT TAX

17.1 Single Business With Dual Status

Taxpayer was a full-time life insurance agent who was not an employee of the insurance company under common-law rules. However, under the "statutory employee" requirements of IRC Sec. 3121(d)(3)(B), the life insurance company is required to impose FICA taxes on the agent's commissions. The agent also received various commissions from other companies that were not subject to statutory FICA. The insurance agent sought to combine all commission income on Schedule C, apply all business deductions, and compare the net to the FICA-covered commissions to determine any remaining self-employed taxable income.

However, the IRS National Office has ruled that the insurance agent must separate expenses attributable to the full-time life insurance income and those allocable to the other self-employment commissions. Expenses attributable to the full-time life insurance income may not be used to reduce other self-employed income. (TAM 9123001 and TAM 9125003)

Observation. Full-time life insurance statutory employees are entitled to report income and expenses on self-employed Schedule C (see Rev. Rul. 90-93, IRB No. 1990-45). Effectively, those with other self-employed commissions will need to prepare a second Schedule C to allocate expenses attributable to the other self-employed income. The consequences of these expense allocations will be more significant starting in 1991, with the increased Medicare tax base reaching $125,000.

17.2 Payments to Retired Insurance Agents

Retired self-employed insurance salespersons often receive continuing payments from insurance companies based on their activity in years prior to retirement. Such payments include renewal commissions, deferred commissions paid after retirement for sales prior to retirement, and amounts calculated as a percentage of commissions received in years prior to retirement. The IRS has indicated that all such payments are subject to tax under SECA. The names or characterizations given these payments do not affect their taxability. However, if attributable to sales activities occurring prior to retirement, they generally will not cause a reduction in social security benefits under the social security earnings test. (IRS Notice 90-72, IRB 1990-50)

Observation. Revenue Ruling 59-162 held that renewal commissions received by a widow after the death of the spouse who earned them were not self-employment earnings.

17.3 Payments to Fishing-Boat Operators and Crew

The alleged negligence of Corporation X reduced or eliminated commercial fishing in an area for the year. To avoid litigation, X compensated fishing-boat owners, operators, and crew, with settlements based on their income from fishing in prior years. Noting that these payments were measured by historical profits and represented income that would have been derived from current fishing, the IRS ruled that the payments are subject to the SECA tax. The IRS compared these payments to drought and other government-subsidy payments to farmers that are subject to the self-employment tax. However, if payments were made by X to an individual based on prior employee status, the payments are includible in gross income but are not earnings from self-employment or wages for employment tax purposes. (Rev. Rul. 91-19, IRB 1991-10)

Observation. The IRS noted that there must be a nexus between the income received and the self-employed business of the taxpayer. It specifically noted its disagreement with a prior Tax Court decision (*Newberry*, 76 TC 441, 1981), wherein the Tax Court did not impose SE tax on insurance payments received for lost earnings during a period when a grocery store was temporarily out of business because of a fire.

17.4 Fiduciary Fees

17.4.1 Attorney as professional trustee

An attorney in private practice who received income as trustee of twelve trusts was liable for SE tax on the trustee fees. Even though he did not solicit trustee work and was not engaged full-time as a fiduciary, the IRS ruled that his trustee work was not an isolated situation, and that as an attorney he had special knowledge and expertise characteristic of professional fee income. (LR 9107009)

17.4.2 Estate administration fee

An individual acted as administrator of his brother's estate, receiving a fee for managing and liquidating realty and personal property. To make a proper determination of the self-employed status of the income, the court noted that it must judge both the profit motive of the taxpayer and the extent and substance of his activities in managing the estate. Accordingly, a motion for dismissal was denied, based on the need for a trial to examine the underlying facts. (*R. A. Bozeman*, 91-1 USTC ¶ 50,251, N.D., Tex., 1991)

17.5 Spouse as Partner vs. Employee

Husband (H) and wife (W) filed a pre-1988 joint Form 1040 containing a Schedule C for H's proprietorship, a full-time Amway distributorship. The Schedule C included a deduction for wages paid by H to W as his employee. The Tax Court agreed with the IRS determination that W was a partner of H rather than an employee, and imposed self-employed social security tax on her share of earnings. Both participated substantially and equally in the business, all paperwork and documents with Amway dealt with them as co-owners, and the Forms 1099 sent to their distributors bore both names as payors. (*Henry and Carol Zampa*, TC Memo 1990-561, 10/29/90)

17.6 Business Trusts

An individual was actively involved as a 50% partner in two partnerships. He transferred these businesses to business trusts (unincorporated common law trusts often referred to as "Massachusetts Trusts"). The court found that the actual management authority and business operations continued in the same manner, with control exercised by the beneficiaries. Accordingly, the trusts were merely a sham lacking substance, and self-employment tax was imposed on distributions to the beneficiaries. See "Important 1991-92 Tax Planning and Compliance Issues," Section 6.2, herein for a further discussion of this case and related issues regarding use of entities to minimize SE tax. (*Robert C. Chase*, 91-1 USTC ¶ 50,090, CA-8, 1991, affirming TC Memo 1990-164)

17.7 Gas Well Royalties From Partnership

A taxpayer received income from various oil and gas properties reported through a partnership. The income was subject to self-employment tax as attributable to an active business; the taxpayer was unable to establish limited-partner status because certificates of limited partnership had not been filed with any of the states in which the partnership operated. (TAM 9110003)

18. ALTERNATIVE MINIMUM TAX

18.1 AMT and Tax Benefit Rule

Four individuals sought to eliminate AMT by use of the tax benefit rule. Their tax preference deductions, such as the capital-gain exclusion and depreciation preferences, were so large that negative taxable income occurred for regular tax purposes. They argued that their AMT increases should not include the portion of the deductions and preferences that produced no regular tax benefit. However, the court found that the tax benefit rule does not apply to the AMT, based both on specific language in the legislative history of the 1986 Tax Reform Act and on the fact that the AMT system contains built-in tax benefit provisions via the minimum tax credit carry forward. (*Howard M. Weiser et al*, 90-2 USTC ¶ 50,480, N.D. Cal., 1990)

18.2 Percentage Depletion and Basis

Cumulative percentage depletion in excess of the adjusted tax basis of the property is an AMT preference. Accordingly, excess depletion cannot reduce the AMT basis of mineral property below zero. (LR 9126009)

18.3 E&P vs. Corporate Book Income

Prior to commencement of the ACE corporate adjustment in 1990, a corporation was required to compare its AMT income to its "applicable financial statement" income to calculate the 50% book income preference. The IRS has clarified that a corporation that lacked a financial statement was required to use current earnings and profits (E&P) to compute its adjusted net book income. The corporation was not required to request an extension to use current E&P. (LR 9109001)

18.4 Corporate AMT: Proposed and Final ACE Regulations

See "Important 1991-92 Tax Planning and Compliance Issues," Section 6.3, herein for a summary of 1991 proposed and final regulations (Reg. 1.56(g)-1) on the corporate ACE adjustments, including an option available for LIFO-method taxpayers allowing simplified AMT calculations.

19. COMPLIANCE: IRS PROCEDURES AND PENALTIES

19.1 Employee vs. Independent Contractor

Determination of whether a worker is an employee or independent contractor is a "facts and circumstances" matter, dependent on the employer's control as evidenced by a lengthy set of criteria (see Rev. Rul. 87-41, 1987-1 CB 296 for twenty factors used by the IRS). Although particular cases and rulings tend to be confined to their unique facts, the following list of determinations may be helpful for similar categories of workers or as indications of trends on this topic.

19.1.1 Determination of employee status

- Crab-meat pickers, despite providing their own tools (*Breaux and Daigle, Inc. v. U.S.*, 90-2 USTC ¶ 50,491, CA-5, 1990, affirming D.C., 89-2 USTC ¶ 9536)

- Workers for a bicycle-assembly company whose contract contained a noncompetition clause (*In re Associated Bicycle Service, Inc. v. U.S.*, 91-1 USTC ¶ 50,134, B.C. 88-61426, 9/26/90)
- A securities salesperson (*In re Saleem Black*, 91-1 USTC ¶ 50,282, B.C. 89-50188, 5/21/91)
- A CPA who was the sole shareholder, director, and president of an accounting corporation and its sole worker (*Darrell Harris, Inc.*, 91-1 USTC ¶ 50,271, W.D., Okla. 1991)
- Photographers for a service firm who controlled their assignments (TAM 9126006, 3/27/91)
- Persons who demonstrated products for a firm in various grocery stores (TAM 9124005, 3/13/91)
- A licensed practical nurse working in the home of a quadriplegic, considered to be performing domestic services in a private home (TAM 9123005, 3/5/91)
- Dog groomers performing services for a pet shop (TAM 9122002, 2/14/91)
- College instructors for a statewide community college (TAM 9105007, 10/29/90)

19.1.2 Determination of independent contractor status

- Welders who provided services to a general contractor (TAM 9121006, 2/13/91)
- Taxicab drivers who leased their cabs from the dispatching firm (TAM 9216004, 1/9/91)
- Referral attorneys engaged by a professional corporation (TAM 9047004, 8/21/90)
- Drivers for a firm providing one-way transportation of newly manufactured vehicles from the factory to dealerships (TAM 9041001, 7/5/90)

19.2 $10,000 Cash Transaction Reporting

19.2.1 Attorney-client privilege

The attorney-client privilege, as well as various constitutional defenses, does not exempt a law firm from the requirement to file Form 8300 (as required by IRC Sec. 6050I) when receiving more than $10,000 in cash from criminal defendant clients. (*U.S. v. Goldberger & Dubin, P.C.*, 91-2 USTC ¶ 50,315, CA-2, 1991, affirming unreported D.C.)

19.2.2 Reporting by nontaxable entities

The IRS has ruled that exempt organizations and qualified employee plans are subject to reporting over-$10,000 cash transactions. Exempt organizations are subject for any business activity, regardless of whether that activity incurs the unrelated business income tax. However, charitable cash contributions in excess of $10,000 are not subject to reporting. (IRS Notice 90-61, IRB 1990-40)

19.3 Information Returns

19.3.1 Home mortgage points

Effective January 1, 1991, IRS Form 1098, issued by mortgage-interest recipients, must separately disclose points paid by borrowers on the purchase of their principal residence. Reportable points are only those that meet all five of the following criteria as amounts: (1) charged for the use of money and not for services, (2) conforming to established business practice in the area and not exceeding the amount generally charged, (3) for closings occurring after 1990, (4) paid directly by the mortgagor, and (5) for the purchase of the mortgagor's principal residence with the mortgage secured by such residence. (IRS Notice 90-70, IRB 1990-48)

19.3.2 Timber royalties

Owners of standing timber often sell under contracts calling for payment per unit of harvested timber, known as "pay-as-cut" contracts. These proceeds are reportable on Form 4797 and may receive capital-gain treatment. Accordingly, for 1991 and later, payers are to report timber royalties issued under a "pay-as-cut" contract on Form 1099-S, Proceeds From Real Estate Transactions. (IRS Ann. 90-129, IRB 1990-48)

19.4 1991 Form W-2

1991 Form W-2, Wage and Tax Statement, has been revised to reflect the split in the Social Security wage base (to $53,400) and Medicare wage base (to $125,000). Form W-2 and a portion of the Employee Copy instructions are reproduced below. (IRS Ann. 91-12, IRB 1991-5)

Box 16.—Any amount in Box 16 is a distribution made to you from a nonqualified deferred compensation plan. This amount is also included in Box 10 and is taxable for Federal income tax purposes.

Box 17.—If there is an amount in Box 17, there should be a code (letter) next to it. You can find out what the code means from the list below. You may need this information to complete your tax return. The codes are:

A—Uncollected social security tax on tips (See your Form 1040 instructions for how to pay this tax.)

B—Uncollected Medicare tax on tips (See your Form 1040 instructions for how to pay this tax.)

C—Cost of group-term life insurance coverage over $50,000
D—Section 401(k) contributions
E—Section 403(b) contributions
F—Section 408(k)(6) contributions
G—Section 457 contributions
H—Section 501(c)(18)(D) contributions
J—Sick pay not includible as income
K—Tax on excess golden parachute payments
L—Nontaxable part of employee business expense reimbursements
M—Uncollected social security tax on cost of group-term life insurance coverage over $50,000 (former employees only) (See your Form 1040 instructions for how to pay this tax.)
N—Uncollected Medicare tax on cost of group-term life insurance coverage over $50,000 (former employees only) (See your Form 1040 instructions for how to pay this tax.)

Box 22.—The amount in this box is the total amount of dependent care benefits your employer paid to you (or incurred on your behalf). Any amount over $5,000 has been included in Box 10. Also, if you are claiming the credit for child and dependent care expenses, you must use this amount to determine the amount of credit you are able to claim. See the instructions for Form 1040 and 1040A.

Box 23.—This amount has already been included as wages in Box 10. Do not add this amount to Box 10. If there is an amount in Box 23, you may be able to deduct expenses that are related to fringe benefits; see the instructions for your income tax return.

(*Continued*)

1 Control number		OMB No. 1545-0008	
2 Employer's name, address, and ZIP code		6 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ 942 emp. ☐ Subtotal ☐ Deferred compensation ☐ Void ☐	
		7 Allocated tips	8 Advance EIC payment
		9 Federal income tax withheld	10 Wages, tips, other compensation 60,000.00
3 Employer's identification number	4 Employer's state I.D. number	11 Social security tax withheld (6.2%) 3,310.80	12 Social security wages 53,400
5 Employee's social security number		13 Social security tips	14 Medicare wages and tips * 60,000.00
19 Employee's name, address, and ZIP code		15 Medicare tax withheld *(1.45%) 870.00	16 Nonqualified plans
		17 See Instrs. for Box 17 * Code B M N	18 Other
20	21	22 Dependent care benefits *	23 Benefits included in Box 10 *

24 State income tax	25 State wages, tips, etc.	26 Name of state	27 Local income tax	28 Local wages, tips, etc.	29 Name of locality

Copy B To Be Filed With Employee's FEDERAL Tax Return Department of the Treasury—Internal Revenue Service

Form W-2 Wage and Tax Statement 1991

* NEW

This information is being furnished to the Internal Revenue Service.

19.5 Power of Attorney Requirements

19.5.1 New forms

IRS Form 2848, Power of Attorney and Declaration of Representative, has been revised effective March 1991. Form 2848-D is obsolete, replaced by Form 8821, Tax Information Authorization, to be used only to authorize disclosure of certain confidential tax information. (IRS Ann. 91-80, IRB 1991-22)

19.5.2 Procedural rules

Procedural rules for powers of attorney required for representation of taxpayers before the IRS are amended. An attorney-in-fact named on a non-IRS power of attorney will be permitted to execute a Form 2848 on behalf of a taxpayer under prescribed rules. The Centralized Authorization File (CAF) will only accept powers of attorney relating to tax periods ending not more than three years after receipt of the power. The amended rules also clarify that a power is required for the purpose of representing a taxpayer before the IRS, irrespective of the specific action of representation. Finally, the IRS is authorized to accept facsimile (FAX) transmission of a copy of a power of attorney. (Amendment of Procedural Rules, Reg. 601.501-509, Fed. Reg. 5/24/91)

19.6 Tax Shelter Registration Rules for Organizers

The IRS has issued three rulings applicable to tax shelter organizers. Organizers are not required to furnish the registration number upon mere receipt of subscriptions, but only when unconditionally obligated to transfer a partnership interest to a subscriber. In testing for the 2-to-1 tax shelter ratio, all deductions and credits potentially allowable must be considered, without any reduction for possible IRC Sec. 469 passive limitations. The numerator of the tax shelter ratio must be calculated using gross rather than net deductions of the partnership, and must also include pass-through deductions from lower-tier partnerships. (Rev. Ruls. 90-84, 90-85 and 90-86, IRB 1991-42)

19.7 Timely Returns

19.7.1 Incorrect IRS service center

Taxpayer filed her personal return with the Ogden service center, even though the instructions were to return the form to Philadelphia because of foreign earned income. The return was filed in a timely manner, under extension with Ogden on August 1, and was transferred by the IRS to Philadelphia on October 20. Accordingly, the three-year statute of limitations was measured from October 20. (*Kathryn Winnett*, 96 TC No. 38, 6/13/91)

Observation. The Tax Court expressed concern that taxpayers could shorten the running of the statute of limitations merely by sending a return to the wrong center. The court suggested that meticulous compliance with filing requirements is required by taxpayers.

19.7.2 Invalid extensions

A corporation that filed IRS Form 7004 in a timely manner was not granted a valid extension, because it failed to make a corresponding deposit of its remaining tax liability. Despite the extension request, the corporation filed its Form 1120 in a timely manner. The Form 7004 was filed solely to provide a delay in payment of the profit-sharing plan contribution. The invalidation of the corporate extension resulted in disallowance of the profit-sharing plan deduction. (TAM 9033005, 5/11/90)

The IRS invalidated a Form 1040 extension and imposed a late filing penalty because the tax shown as due on the application for extension was understated. However, in eliminating the penalty, the court found that the taxpayer's return preparer had made a reasonable attempt to estimate the liability for purposes of the extension, even though a Form 1099-MISC for $200,000 of income was inadvertently overlooked. (*Steven J. Cannata*, TC Memo 1990-502, 9/24/90)

For a further discussion, see section 7.1, "Invalid 1040 Extension and Its Consequences," in the chapter "Important 1991-92 Tax Planning and Compliance Issues."

19.8 Statute of Limitations

19.8.1 Correction of carryover from closed years

Although the statute of limitations prevented the assessment of a deficiency in a closed year, the IRS was not barred from recalculating the tax liability to reduce the amount of ITC carryover. The credit carryover was used in an open year, and the IRS was permitted to recompute the proper ITC available for carryover to the open year. (*Kenneth C. Hill*, 95 TC No. 31, 10/18/90)

19.8.2 No statute on abusive shelter penalty

No period of limitations applies to the assessment of the IRC Sec. 6700 penalty on abusive tax shelters. Therefore, a penalty of over $490,000 for involvement in the organization and sale of 186 trusts was timely. (*Noske*, 91-1 USTC ¶ 50,018, D.C. Mn. 1990)

19.8.3 Termination of statute extension

Taxpayers and the IRS had entered into a Form 872-A waiver of the statute of limitations, which was to terminate upon the IRS' mailing of a notice of deficiency or upon a final assessment. The Tax Court, contrary to its earlier decisions, followed Appeals decisions in the Third, Sixth, and Ninth Circuits and now holds that a misaddressed notice of deficiency does not terminate the Form 872-A waiver of the statute. (*Donald R. Coffey*, 96 TC No. 7, 1991)

19.8.4 Denial of refunds on late returns

Joint taxpayers had overpaid income tax for 1984 through withholding, but the Form 1040 was filed late in April 1988. Citing IRC Sec. 6511, the IRS denied the refund because the Form 1040, representing a claim for refund, was not filed within two years from the time the tax was paid (withheld tax deemed paid on April 15 following the close of the tax year per IRC Sec. 6513). If a return is not filed in a timely manner, the taxpayer has only two years from the date of payment of the tax to file a claim for refund. Further, this claim must be *received* by the IRS within the two-year period, not merely postmarked. (*Donald M. Arnzen*, 91-1 USTC ¶ 50,020, W.D., Wash. 12/3/90)

19.9 Reconstruction of Income: Net Worth Method

The IRS was not prohibited from using the net worth method to reconstruct the income of taxpayers from their construction company and grocery business. The net worth method was permitted even though the accounting system of the taxpayers was capable of accurately reflecting income and the books appeared adequate on their face. (*L. Winston Waller*, TC Memo 1991-183, 4/25/91)

19.10 Property Exempt From IRS Levy

Husband was liable for unpaid federal employment taxes from his construction company, resulting in a lien on his residence, which was jointly owned with his nonliable spouse. The Eighth Circuit reversed a lower court and supported the IRS authority to enforce tax liens when property is jointly held by a delinquent taxpayer and a nonliable third party, even to the extent of overriding the spouse's homestead exemption from creditors. The supremacy clause of the U.S. constitution allows federal tax collection statutes such as IRC Sec. 7403 to override state homestead exemptions. (*Cecil and Judy Bierbrauer*, 91-2 USTC ¶ 50,331, CA-8, 1991, reversing unreported D.C.)

19.11 Tax Evasion: Good Faith Belief as a Defense

Consistent with a long line of tax protestor cases, an airline pilot who had claimed exemption from tax on his salary was charged and convicted of IRC Sec. 7201 tax evasion and IRC Sec. 7203 willful failure to file, with the decision affirmed by the Seventh Circuit. However, the Supreme Court vacated the convictions and remanded the case back to trial because of erroneous jury instruction. In determining "willfulness," the jury had originally been instructed that an honest but unreasonable belief would not serve as a defense. Instead, the Supreme Court determined that a standard of subjective, as opposed to objective, reasonableness must apply to a defendant's belief in the lawfulness of his actions. (*Cheeks*, No. 89-658, S. Ct., 1/8/91; see also *Powell*, CA-9, 6/13/91)

19.12 Tax Return Preparers

19.12.1 Definition of tax return preparer

An individual prepared a large number of returns without directly charging the taxpayers for his services. However, he also engaged in the practice of purchasing the tax refunds of his clients at a discount (the years involved preceded the law change making this practice illegal). The court viewed a portion of the profits realized through the discounting activities as compensation for the preparation of tax returns, and determined that the individual was a paid tax return preparer potentially subject to return preparer penalties. (*Junius A. Tiddy*, 91-1 USTC ¶ 50,180, W.D., N.C. 3/28/91)

19.12.2 Preparer negligence penalty

The IRS proposed a preparer negligence penalty against a CPA based on the examination of a Form 1040 proprietorship in which a salary from the proprietor to spouse had been disallowed. The court, upon finding that legitimate services were rendered by the employee-spouse to the proprietorship and that the salary was only disallowed for technical reasons regarding lack of proper payment, eliminated the preparer penalty. (*Kenneth R. Chandler*, 90-2 USTC ¶ 50,525, W.D., Ky. 10/1/90)

19.12.3 Aiding-and-abetting penalty

An individual who sold insurance, investments, and tax shelters was involved in the preparation of a false S corporation tax return that passed erroneous tax credits through to 34 shareholders. The court determined that a single $10,000 IRC Sec. 6701 aiding-and-abetting penalty applied to involvement with the erroneous corporate return rather than a separate $1,000 penalty for each of the 34 shareholders. There was insufficient direct involvement with the returns of the individual shareholders to support the IRS assertion of a $34,000 penalty. (*In re James E. Mitchell*, 90-2 USTC ¶ 50,040, W.D. Wash. 1990, affirming Bankr. Ct.)

19.12.4 Disclosure of information

IRC Sec. 7216 provides penalties for any tax return preparer who wrongfully discloses or uses any client confidential information. Regulations have been adopted that expand authorized disclosures to include the use of information for quality or peer review conducted by others authorized to practice before the IRS. A record of the review must be retained by the preparer being reviewed. (Reg. 301.7216-2T, T.D. 8326, 12/27/90)

19.12.5 Action to enjoin

Based on evidence that a tax accountant had prepared numerous returns containing inflated deductions and erroneous tax calculations and that he had repeatedly prepared fraudulent returns, the court granted the IRS a preliminary injunction to enjoin the individual from any tax preparation activities. The court deferred for six months, pending a hearing, on the issue of whether the preliminary injunction should be made into a permanent enjoinder from practice. (*Thomas C. Franchi*, 91-1 USTC ¶ 50,086, W.D. Pa. 1991)

19.13 100% Penalty: Withheld Payroll Tax

19.13.1 Company owners/officers/employees held responsible

Individuals were subject to the IRC Sec. 6672 100% penalty for unpaid withholding taxes because they met the tests of responsibility and willfulness. Responsibility is determined by degree of influence and control over financial affairs of the employer, and willfulness is evidenced by failure to make payment of taxes when there were available funds (such as for payment of other creditors). (*A. Harold Tomblin*, 91-2 USTC ¶ 50,366, S.D. W.Va., 6/26/91; *James M. O'Connor*, 91-1 USTC ¶ 50,155, Dist. Md. 3/14/91; *Leon R. Miller*, 91-1 USTC ¶ 50,141 S.D., Ia. 3/7/91; *Elmer E. McDermitt*, 91-1 USTC ¶ 50,094, S.D., Oh., 1/31/91; *Natalie Novick*, 91-1 USTC ¶ 50,250, E.D., Wa. 12/26/90; *In re James Grant*, 91-2 USTC ¶ 50,324, W.D., Pa. 6/17/91, affirming Bankr. Ct. 90-2 USTC ¶ 50,504; *In re Ira P. Mason*, 90-2 USTC ¶ 50,516, Dist., Mass., 9/6/90; *Craig Seachrist*, 91-1 USTC ¶ 50,019, N.D., W.Va. 12/28/90; *Charles L. Honey*, 91-1 USTC ¶ 50,073, W.D. Ark. 1/31/91; *Duncan C. Peek*, 91-1 USTC ¶ 50,208, Dist. Md. 4/18/91)

19.13.2 Officer or owner not responsible

Individuals who were either officers, employees, or minority shareholders were not found to be responsible persons for the IRC Sec. 6672 100% penalty, generally due to lack of authority over disbursement of company funds. (*Stan Wolfley*, 91-1 USTC ¶ 50,118, Dist. Ut., 12/3/90; *Ernest W. Carlson*, 91-1 USTC ¶ 50,262, Dist., Ut., 5/10/91; *In re William P. Costarides*, 91-1 USTC ¶ 50,199, Bk. Ct., Ala. 4/9/91)

19.13.3 Bankruptcy vs. Sec. 6672 penalty

A determination of bankruptcy did not discharge the individual's liability for unpaid corporate withheld payroll taxes. Per the U.S. Supreme Court's decision in *Sotelo* (436 U.S. 268-1978), the IRC Sec. 6672 penalty is nondischargeable in bankruptcy. (*In re Robert Garrett*, 91-1 USTC ¶ 50,226, E.D., Va. 5/2/91)

19.13.4 Nonemployee held partially responsible

An individual who was not an officer or employee, but rather a consultant who had authority to sign checks, review financial data, and negotiate with creditors, was determined to be a responsible person for approximately $23,000 out of $39,000 of assessed withholding taxes. A portion of the penalty was relieved because he had reasonably relied on assurances of the company's owner. However, at the point the assurances became unreasonable, the penalty was imposed. (*William J. Doonan*, 91-1 USTC ¶ 50,091, C.D., Ca. 1/24/91)

19.13.5 Interest on Sec. 6672 penalty

Individuals were assessed an IRC Sec. 6672 penalty for unpaid payroll taxes of their corporation. The corporation later emerged from bankruptcy and paid the back trust-fund taxes. However, the court determined that the individuals remained responsible for interest that had accrued on the IRC Sec. 6672 penalty. (*Bradley and Agnew*, 91-2 USTC ¶ 50,332, CA-2, 1991, affirming Dist., 90-1 USTC ¶ 50,227)

19.13.6 Recovery of attorney fees

A bankruptcy debtor who prevailed against the IRS in its attempt to collect unpaid employee withholding taxes was entitled to recover attorney fees and costs. The IRS had improperly pursued its claim for the payroll tax penalty, failing to investigate documents at the initial audit level and failing to present evidence of a proper assessment at the trial level. (*In re Dennis Chambers*, 91-2 USTC ¶ 50,355, Bankr. Ct. N.D., Ill. 6/28/91)

19.13.7 Allocation of payments in bankruptcy

A company in a Chapter 11 bankruptcy liquidation plan could not allocate payments between unpaid employment taxes and accrued interest and penalties. The court distinguished this Chapter 11 liquidation from a Chapter 11 reorganization wherein the Supreme Court (*Energy Resources*, 90-1 USTC ¶ 50,281) had approved such an allocation. (*In re Kare Kemical, Inc.*, 91-2 USTC ¶ 50,389, CA-11, 1991, reversing D.C., 90-1 USTC ¶ 50,044).

19.14 Claim for Refund of Employee FICA

An IRS audit had determined that on-site lunches provided by a bank to its employees were subject to payroll tax, with the bank ultimately paying both halves of the FICA tax. Subsequently, the Supreme Court in *Rowan* (452 U.S. 247, 1981) determined that such meals were tax-free under IRC Sec. 119. The bank then sued directly for refund of the FICA taxes, on the premise that it had remitted the taxes and was therefore entitled to full recovery. However, the Claims Court supported the IRS position, which deems the employee share of FICA to have been paid by each employee and requires the bank under Reg. 31.6402 to secure the written consent of each employee to obtain the refunds. (*The First National Bank of Chicago*, 90-2 USTC ¶ 50,519, Cl. Ct. 248-89T, 9/28/90)

19.15 Sick Pay Withholding: Third-Party Payors

Procedures are laid out detailing third-party liability for withholding and payment of social security tax when the third party is treated as an employer under Temp. Reg. 32.1(e)(3) for sick-pay payments. (IRS Notice 91-26, IRB 1991-31)

19.16 Valuation Overstatement Penalty

Deductions and tax credits associated with an investment in a refrigerated food container were disallowed because of failure to place the asset in service. Accordingly, even though the container was grossly overvalued, the substantial overstatement penalty was not applicable, because the overvaluation itself had produced no penalty. Earlier Fifth and Ninth Circuit cases were followed. (*Carl Bogardus, Jr.*, 91-1 USTC ¶ 50,034, W.D., Okla., 12/28/90, following *Todd*, CA-5, 1988 and *Gainer*, CA-9, 1990)

19.17 Innocent Spouse

19.17.1 Knowledge of error

The Eighth Circuit determined that the Tax Court had applied an unduly harsh standard of testing for innocent-spouse relief. The Tax Court had denied relief merely on the basis of spouse's knowledge that an investment in a limited partnership had been reported in their joint return. The Eighth Circuit remanded the case to the Tax Court for further proceedings, to determine if the facts, in totality, would have led a reasonably prudent taxpayer to inquire further as to the legitimacy of the investment and deductions. (*Gwen Erdahl*, 91-1 USTC ¶ 50,184, CA-8, 1991, reversing TC Memo 1990-101)

19.17.2 Percentage of income test

Before innocent-spouse relief can be requested, IRC Sec. 6013 requires that the understatements exceed 25% of AGI (10% if AGI is under $20,000). The Court denied innocent-spouse relief for one of two years under this percentage-of-income test, rejecting the taxpayer's argument that the two years involved in the audit should be treated as one because the deficiencies arose from a single issue. (*Paula K. Childers*, TC Memo 1991-232, 5/28/91)

19.18 Special Procedures: Operation Desert Storm

Various legislative, regulative, and procedural changes have been enacted for participants in the Desert Storm combat zone area:

- The IRS issued guidance in the form of answers to frequently asked questions on tax issues of concern to military reservists and others affected by Operation Desert Shield. (IR-90-142 of 11/21/90)

- A Presidential Executive Order designated areas in the Persian Gulf region as a combat zone, entitling enlisted personnel to tax-exempt income and commissioned officers an income exclusion up to $500 per month per IRC Sec. 112, effective for pay beginning January 17, 1991. Also, armed service members are allowed to file their income tax returns up to 180 days after departing the combat-zone region. Interest and penalties are waived, and prior collection actions are suspended. (Executive Order 12744 of 1/21/91, reissued 2/14/91)
- Federal legislation was enacted to provide a deferral period for tax obligations, retroactive to August 2, 1990. Also, interest on income tax refunds due military personnel begins accruing April 15, 1991, even if the return is filed later. (P.L. 102-2 of 1/31/91)
- Power of attorney rules are eased for Persian Gulf troops. (IR-91-20, 1/31/91)
- Procedures are issued for designating tax returns affected by Operation Desert Storm. (T.D. Notice 951, 2/19/91; IRS Publication 945, 3/91)
- Guidance is provided to military service members regarding qualification for the combat-zone income exclusion, retroactively effective to January 16, 1991. (Prop. Reg. 1.112-1, 3/11/91)
- The IRS clarified that the 180-day postponement period for personnel in Operation Desert Storm is intended to run consecutively with the 105-day normal filing season (January 1 to April 15). Accordingly, personnel who were in the designated Desert Storm area as of January 1, 1991, have until 285 days after they leave the combat zone to file their 1990 tax return. For those who entered the combat zone after January 1, the 285-day period is reduced by the number of days between January 1 and the day they entered the combat zone. For example, a taxpayer who served in the combat zone from January 20 forward has 266 days following departure from the combat zone to file (285 days less nineteen days from January 1 to January 19). (IR-91-46, 3/26/91)
- Because of the amendment to IRC Sec. 7508 allowing extended time for compliance by Desert Storm personnel, affected individuals may also defer their 1990 IRA investment until the extended tax return due date. Procedures are specified for IRA trustee reporting on Form 5498. (IRS Notice 91-17, IRB 1991-23)
- Procedures are specified for taxpayers residing in Kuwait, granting an automatic extension until December 15, 1991, to file 1990 returns. (IR-91-69, 6/13/91)

19.19 IRS Procedures

The IRS has issued its annual updated procedures in the following areas:

1. Issuance of rulings, determination letters, information letters, and closing agreements (Rev. Proc. 91-1, IRB 1991-1)
2. Updated list of areas in which IRS will not issue advance rulings or determination letters (Rev. Proc. 91-3, IRB 1991-1)
3. Procedures for ruling letters, information letters, and determination letters regarding employee plans and exempt organizations (Rev. Proc. 91-4, IRB 1991-4)
4. Procedures for issuing technical advice on issues involving employee plans and exempt organizations (Rev. Proc. 91-5, IRB 1991-4)
5. Issuance of determination letters for qualified plans and sample notices to interested parties (Rev. Proc. 91-10, IRB 1991-5)

IMPORTANT 1991–92 TAX PLANNING AND COMPLIANCE ISSUES

IMPORTANT 1991–92 TAX PLANNING AND COMPLIANCE ISSUES

1. INTRODUCTION

A great number of issues of special importance to tax practitioners always exists. Some issues are important because of current economic and regulatory developments, whereas others are critical because they continue to develop in complexity or breadth of applicability over a period of time.

This section contains twenty-five topics of current importance to practitioners. The matters are presented in terms of an initial brief synopsis, an analysis of the issues (often accompanied by illustrative examples), and, in many cases, a concluding summary.

The discussions are not intended to be complete treatments of each topic. The issues raised in this section only *survey* some of the more important matters affecting practitioners. Further analysis and research may be required in certain instances.

Readers should briefly review the matters discussed, ascertain which issues may be important to their clients' situations, and then conduct further research as needed. Some issues are quite technical and may apply to just a handful of practices, whereas other matters are global in nature and affect every tax practitioner.

Readers are encouraged to use the comment form at the front of the book to introduce additional "hot topics" that can be addressed in future Supplements.

2. FILING STATUS

2.1 Head-of-Household Status Arising From Adult Child at Home

Under IRC Sec. 2(b), a taxpayer who provides more than half of the cost of maintaining the household of an unmarried, adult child living at home may qualify for head-of-household filing status, even though the adult child does not qualify as a dependent of the taxpayer.

2.1.1 Head-of-household status

Normally, head-of-household status is achieved with a dependent. Additionally, eligibility occurs if

1. The taxpayer is not married at the end of the taxable year and is not a surviving spouse, and
2. The taxpayer provides over half the cost of maintaining his or her household during the year, and the home is for more than half of the year the principal residence of an unmarried child, stepchild, or grandchild. (IRC Sec. 2).

The child or grandchild need not be a dependent of the taxpayer to obtain head-of-household status for the taxpayer, but must live in the same household with the taxpayer for more than half the year (Reg. 1.2-2(e)).

If the child or grandchild is married at the close of the tax year, then he or she must qualify as a dependent (IRC Sec. 2(b)(1)(A)(i)).

2.1.2 Advantages of head-of-household status over single status

The taxpayer maintains a lower income-tax rate on taxable income up to certain limits, and is also entitled to a higher standard deduction. In addition, because prior to the changes made by the 1990 Revenue Reconciliation Act the earned income credit was not available for single taxpayers, amended returns to claim head-of-household status for 1990 and prior years may also result in eligibility for the earned income credit.

2.1.3 Examples

Example 1. Mary Melody is a widow whose husband passed away five years ago. Mary's son, Marvin, who is thirty years old and unmarried, lives with her on a full-time basis. Mary does not charge Marvin rent and provides over half the cost of maintaining the household. Marvin's gross income for 1991 is $25,000 and he does not qualify as Mary's dependent. Mary can, however, claim head-of-household status on her 1991 tax return. Mary's adjusted gross income for 1991 is $30,000 and she uses the standard deduction. Below is a summary of the tax benefit received by Mary if she files as head of a household rather than single:

	Head of Household		*Single*
Adjusted gross income	$30,000		$30,000
Standard deduction	(5,000)		(3,400)
Personal exemption	(2,150)		(2,150)
Taxable income	$22,850		$24,450
Tax	$ 3,428		$ 4,201
Tax benefit		$773	

Example 2. Assume the same facts as in Example 1, except that Mary's adjusted gross income for 1990 was $10,000. If Mary overlooked head-of-household status in her original 1990 return, an amended return would also allow qualification for the earned income credit.

	Head of Household (Amended)		Single (as filed)
Adjusted gross income	$10,000		$10,000
Standard deduction	(4,750)		(3,250)
Personal exemption	(2,050)		(2,050)
Taxable income	$ 3,200		$ 4,700
Tax	$ 484		$ 709
Earned income credit (assuming $10,000 is all earned income)	(953)		—
Net Tax (Refund)	$ (469)		$ 709
Tax benefit		$1,178	

2.1.4 Conclusion

Head-of-household status arising from nondependent children and grandchildren is an easily overlooked benefit, particularly when the tax preparer is not assisting with both tax returns. In these cases, a few detailed questions asked by the tax preparer may result in a more advantageous tax-filing status for the taxpayer.

2.2 Limited Liability Companies

Business owners frequently seek to protect their nonbusiness assets from the claims of business creditors. Shareholders of corporations are entitled to the protection afforded by corporate limited liability. A few states (Colorado, Florida, Kansas, Virginia, Texas, Utah, and Wyoming) have authorized the formation of limited liability companies, or LLCs. LLCs are neither a traditional partnership nor a traditional corporation. In 1988, the Internal Revenue Service confirmed that Wyoming LLCs would be treated as partnerships for tax purposes.

2.2.1 Taxed as partnership or corporation?

The characteristics of the entity will determine whether it is taxed as a partnership or as a corporation.

There are six characteristics the regulations use to determine whether an entity is an association taxable as a corporation. Because all partnerships and corporations have the first two characteristics (associates, and an objective to carry on business) in common, the last four criteria are determinative. If no more than two of these last four characteristics are present, the organization may be classified as a partnership (Reg. 301.7701-2(a)).

An LLC generally contains four of the six required characteristics:

	Corp.	*LLC*
1. Associates	X	X
2. An objective to carry on business and divide gains therefrom	X	X
3. Continuity of life	X	
4. Centralization of management	X	X
5. Liability for company debts limited to company assets	X	X
6. Free transferability of interests	X	

2.2.2 Description of LLCs

1. Ownership interests are not freely transferable.
2. The LLC has a stated limit on its duration, such as a thirty-year term, or termination upon the death of a member unless all remaining members consent to continue.
3. Ownership is held by two or more "members."
4. Individual members have limited liability.
5. Management may be centralized in the hands of designated members.

2.2.3 LLCs generally taxed as partnerships

Because LLCs do not contain two of the last four corporate characteristics, they may be taxed as partnerships.

1. An early private letter ruling classified a Wyoming LLC as a partnership because it lacked two of the four corporate attributes. (PLR 8106082)
2. In 1988, the IRS ruled that a Wyoming LLC was taxable as a partnership, despite having centralized management in the form of designated managers (Rev. Rul. 88-76, 1988-2 CB 360). It nevertheless lacked the corporate characteristics of continuity of life and free transferability of interests.
3. A 1990 private letter ruling approved partnership tax status to an LLC whose members shared management in proportion to their interests and thus lack centralized management (LR 9010027).
4. For additional letter rulings approving LLCs, see LRs 8937010 and 9030013 (both Florida) and LR 9052039 (unidentified state).
5. A conversion from limited partnership status into an LLC has been approved as a nontaxable event (PLR 9119029).

2.2.4 S corporations and LLCs compared

LLCs may include an unlimited number of corporations, partnerships, nonresident aliens, trusts, pension plans, and charitable organizations as members. S corporations may have no more than thirty-five individuals or estates as shareholders.

An S corporation may not own 80% or more of another corporation, whereas LLCs have no similar restrictions.

Members of an LLC may contribute property to an LLC without recognition of gain. Shareholders of an S corporation may recognize a gain because they cannot meet the nonrecognition provisions of IRC Sec. 351.

LLCs are not restricted to one class of stock as are S corporations.

An LLC may pass through losses and tax-free distributions to the extent of a member's capital contribution plus the member's share of the LLC's debt. S corporation shareholders cannot use their share of the S corporation's debt to increase their basis.

2.2.5 Similarities between LLCs and partnerships

LLCs, like partnerships, have the ability to make special allocations of tax attributes.

LLC liabilities are nonrecourse (unless personally guaranteed), placing members of the LLC in a position similar to limited partners.

LLCs and partnerships must continue to meet minimum ownership percentage and capital account balance requirements of Rev. Proc. 89-12, 1989-1 CB 798.

- General partners (or managing members in the case of an LLC) must have a 1% share of income, deductions, and credits.
- Also, they must maintain a minimum capital account balance of the lesser of at least 1% of total capital or $500,000.

2.2.6 Recent developments

In May 1991, the AICPA Council proposed a change to Rule 505, "Form of Organization and Name." The board of directors recommended that rule 505 (governing form of practice by AICPA members) not make reference to specific types of organizations such as partnerships, proprietorships, or professional or general corporations, but simply allow any form of organization permitted by state law or regulation.

1. A mail ballot of AICPA members in November 1991 determines whether rule 505 is changed to allow AICPA members to adopt the LLC entity.
2. Despite possible liberalization of AICPA membership rules, many states have statutory restrictions on forms of practice for licensed CPAs conducting public accounting practice.

A *Wall Street Journal* article (May 14, 1991, p. B-2) stated that several states (Arizona, Illinois, Maryland, Michigan, Nevada, Ohio, and Oklahoma) have moved toward introducing LLC statutes.

2.2.7 Conclusion

Recent IRS rulings suggest that LLCs, if properly structured, will qualify as partnerships for federal taxation. Caution is necessary since uncertainty remains as to how the states will handle the LLCs. If, for example, a Wyoming LLC does business in both Wyoming and Nebraska (a non-LLC state), how will the state of Nebraska tax this income? If pending changes to both AICPA membership rules and state CPA licensing statutes occur, it may soon be possible for CPA firms to organize as LLCs.

3. TAXABLE INCOME

3.1 Tax Consequences of Abandonment of Bankruptcy Assets

Income taxes generated on sales and dispositions of property by a bankruptcy estate are a liability of the bankruptcy estate and are paid as an administrative expense of that estate (IRC Sec. 6012(a)(9)). If the estate has insufficient funds to pay the income tax, the unpaid tax liability is not transferred to the debtor.

A tax trap related to this scenario is the right of the trustee to abandon any property that is burdensome or has inconsequential value to the estate. Often, secured property with a value less than the secured debt against that property will be abandoned by the bankruptcy estate back out to the debtor. Any subsequent disposition of this property by the debtor may create a tax liability for the debtor instead of the bankruptcy estate.

3.1.1 Two significant objectives under the Bankruptcy Code

The debtor is given a "fresh" start regarding finances.

— Part of the objective of filing bankruptcy is to transfer income-tax liability to the bankruptcy estate. Professional consultants often suggest a bankruptcy filing instead of a workout arrangement outside of bankruptcy, so that the tax liability on the disposition of appreciated property would fall outside the debtor's income tax return.

— Separate taxable entities are created under individual Chapter 7 and Chapter 11 proceedings. Chapter 12 and Chapter 13 proceedings do not create separate taxable entities.

The debtor's creditors are given equitable treatment.

3.1.2 Abandonment of property

Abandonment of property may result in a tax liability for the debtor.

The transfer of the debtor's property into the bankruptcy estate does not trigger any tax consequences. The estate takes over the tax bases that are possessed by the debtor. When the bankruptcy estate sells or disposes of the debtor's assets, it is obligated to report the income/losses on its fiduciary income tax returns. If, at the termination of the bankruptcy, any assets remain, these can pass out to the debtor without a taxable event occurring (IRC Sec. 1398(f)(2)).

The Bankruptcy Code allows bankruptcy trustees to abandon property that has no value to the estate (11 USC Sec. 554). This will often happen where certain assets are worth less than the secured debt against them.

Example: A cash-method taxpayer files a Chapter 7 bankruptcy with the following assets:

	Basis	*Value*	*Secured Debt*
A/R	$ —	$ 50,000	$ 60,000
Equipment	10,000	20,000	30,000
Land	100,000	150,000	120,000

Presumably, the bankruptcy trustee would abandon the A/R and the equipment back to the debtor. The land would be sold by the trustee because it would generate $30,000 cash for the unsecured creditors. The estate would need to report the $50,000 land gain on its fiduciary income tax return.

3.1.3 Deflection vs. entrapment

Tax cases on abandonment are split over deflection or entrapment.

The IRS has taken the position that abandonment by the trustee is not a taxable event (i.e., the deflection theory). The *McGowan* case involved the abandonment of low basis machinery back to the debtor. The court held that the abandonment was not a sale or exchange by the trustee. The court interpreted that abandonments are covered under the "termination of the estate" rules of IRC Sec. 1398(f)(2). (In re *McGowan*, Bankr. No. 00813C (Bankr. N.D. Iowa, 1988))

In the *Olson* case, the trustee abandoned land to the debtor. Although the court did cite the *McGowan* case as being overbroad in defining abandonment as a "termination of the estate," it also held that the tax liability when the land was disposed of was the debtor's responsibility. (In re *Olson*, Bankr. No. 85-02333S (Bankr. N.D. Iowa, 1989))

One court has embraced the entrapment theory. In the *Laymon* case, the U.S. District Court for Minnesota determined that the bankruptcy court had incorrectly permitted a trustee's abandonment request. The case was somewhat distinctive in that the trustee had already collected about $22,000 of rental payments related to the real estate that was abandoned. The court noted that the income-tax impact of abandonment on debtors is one aspect the trustee needs to consider. The trustee has a duty to the debtor as well as to the unsecured creditors, and the court noted that the trustee cannot unduly burden the debtor's opportunities for a fresh start by placing upon him a large potential income tax liability. (In re *Laymon*, Civ. 6-89-235, D. Minn. 1989)

3.1.4 Summary

The IRS position continues to be based on IRC Sec. 1398(f)(2), which states that property passing out of an estate is not a taxable event. Although the IRS recognizes this theory could inhibit the debtor from obtaining a "fresh start," it also relies on the fact that giving debtors a fresh start is only one of the goals of bankruptcy legislation. The bankruptcy court recognizes that the goals of rehabilitating debtors and giving equal treatment to creditors must be balanced with the interests of governmental tax authorities.

The cases at the bankruptcy court level seem to follow the above theory. The Minnesota District Court case has confused the issue somewhat and seems to provide some ammunition for aggressive taxpayers. The *Olson* case is now under appeal and its findings may shed some light on the future of the abandonment issue.

3.2 State Taxation of Interest on U.S. Obligations Held by Mutual Funds and Money Market Accounts

Interest income earned on certain qualified federal obligations (more commonly labeled "U.S. Bond Interest") is taxable on the federal return, but is not taxable on State returns. Litigation is now occurring in some states concerning whether the taxpayer must have a direct investment in the federal obligation or whether investments purchased by mutual funds, money market funds, or even retirement trusts might also qualify for the exclusion.

3.2.1 The federal law

States are not allowed to tax income from federal obligations in which taxpayers have invested (31 U.S.C. Sec. 3124(a), 1982). These obligations normally include U.S. bonds, U.S. Treasury bills and notes, and several obligations issued by various U.S. agencies such as the Federal Farm Credit Board Administration and the Federal Home Loan Banks. States may vary in their interpretation of what types of federal agency obligations qualify for the exclusion.

3.2.2 New developments

Courts in a number of states have recently held that interest income earned on U.S. obligations that is passed through from a mutual fund or money market account also may qualify for the exclusion.

For example, on August 31, 1990, the Minnesota Supreme Court held that a Minnesota individual was allowed to subtract from taxable income the tax-exempt federal obligation portion of the total dividend income from a mutual fund (*Yurista*, No. C2-89-2201).

For similar cases allowing exemption for dividends received from mutual funds that are directly attributable to U.S. obligation interest, see *Brown v. Franchise Tax Bd.*, 197 Cal. App. 3d 300, 305-06 (California - 1988); *Andras v. Ill. Dept. of Rev.*, 154 Ill. App. 3d, 37 (Illinois - 1987); *In re Thomas C. Sawyer Estate*, 149 Vt. 541 (Vermont - 1987); and *Capital Preservation Fund v. Wisc. Dept. of Rev.*, 145 Wis. 2d 841 (Wisc. - 1988).

Example. A mutual fund paid $4,500 in dividends to Clarence in 1991. A statement attached to Form 1099 indicated that 25% of the dividends came from direct U.S. government guaranteed obligations and an additional 20% came from U.S. government guaranteed agencies. The remaining 55% came from nongovernment securities. In Clarence's home state, only direct U.S. obligations are exempt, and Clarence claims a $1,125 ($4,500 x 25%) subtraction on his state return.

3.2.3 Planning opportunities

Amended return opportunities may exist for returns associated with open years. Taxpayers should be encouraged to retain explanatory attachments to Forms 1099 and to provide this information to tax preparers to allow the exempt portion to be calculated.

4. DEDUCTIONS

4.1 Employee Business Expenses

The treatment of employee business expenses and reimbursements has been the subject of numerous changes over the past few years. In December 1990 the IRS issued final regulations and a Revenue Procedure concerning these expenses. This section presents a general review and additional clarification of accounting for employee business expenses.

The Family Support Act of 1988 added IRC Sec. 62(c), restricting employee deductions for business expenses unless under a reimbursement or other expense allowance arrangement, and leading to enactment of what is called an *accountable plan.* Effective 1/1/89, "above-the-line" deductions have been virtually eliminated. Above-the-line deduction is now achieved only by not reporting the reimbursement on the employee's W-2 (with an exception for certain performing artists). To avoid including advances and reimbursements for business expenses in the employee's W-2, the employee must now substantiate expenses under an accountable plan.

4.1.1 Accountable plans (Reg. 1.62-2(c)(2))

Amounts paid under an accountable plan are

— Excludable from the employee's gross income,

— Not reported on the employee's W-2, and

— Exempt from withholding and payment of employment taxes.

To qualify as an accountable plan, the arrangement must meet three requirements.

1. *Business connection* — The expense must be a deductible business expense connected with the performance of services by an employee. If the advance is paid with wage payments, the advance must be specifically identified (Reg. 1.162-2(d)).
2. *Substantiation* — An employee must specifically identify the nature of each business expense as required in Reg. 1.274-5T and Reg. 1.162-17 (broad terms are not allowed).
   — The employer must be able to conclude that the expense is for the employee's business activities.
   — Adequate accounting for lodging and/or meals can be met by using per diem allowances in many cases.
3. *Return of amounts exceeding expenses* — Employees are required to return advances received in excess of the amount substantiated. To satisfy this requirement, three factors must be met (Reg. 1.62-2(f)):
   — Advances must be calculated not to exceed anticipated expenditures. (See per diem below.)
   — Advances must be made within a reasonable time of the payment of the anticipated expenditures or their occurrence. (See "fixed date method" and "periodic statement method" below.)
   — Any excess advances must be returned within a reasonable time after the advance is made. (See "fixed date method" and "periodic statement method" below.)

4.1.2 Measuring "reasonable time"

Advances, substantiation and return of excess must all occur within a reasonable period of time. There are two safe harbor methods to meet this requirement per Reg. 1.62-2(g)(2):

— Fixed Date Method
  1. The advance must be made within thirty days before expense is paid or incurred,
  2. Substantiation occurs within sixty days after expense was paid or incurred, and
  3. Excess amounts are returned within 120 days after expenses are paid or incurred.

— Periodic Statement Method
  1. The employer statement is issued at least quarterly, setting forth the amounts advanced in excess of the substantiated expenses, and
  2. The employee substantiates and/or returns the excess within 120 days after the employer-provided statement is issued.

The IRS regulations contain an anti-abuse provision whereby these safe harbors won't apply where there is a pattern of overreimbursement.

Excess unsubstantiated amounts not returned within a reasonable time by the employee must be

1. Treated as paid under a nonaccountable plan,
2. Included in the employee's gross income and reported on Form W-2, and
3. Subjected to withholding and employment taxes.

4.1.3 Nonaccountable plans

A nonaccountable plan is any plan that fails to satisfy either the business connection rule, substantiation requirements, or return-of-excess requirement of an accountable plan. However, if the arrangement meets the three criteria but the employee fails, within a reasonable time, to return any amounts in excess of the amount substantiated, then only the excess attributable to the substantiated days will be treated as paid under a nonaccountable plan.

Reporting under nonaccountable plans. Reimbursements under a nonaccountable plan are included in the employee's W-2 as gross wages and are subject to withholding.

In the employee's Form 1040, offsetting employee business expense deductions may only be claimed as miscellaneous itemized deductions, subject to the 2-percent-of-AGI limit and to nondeductibility for AMT.

Observation. The original temporary regulations appeared to imply that a small amount in nonaccountable payments might "taint" the other accountable payments if separate plans were not formally adopted. The final regulations clarify that an employer is deemed to have both an accountable and a nonaccountable plan in such circumstances (Reg. 1.62-2(d)(2)).

4.1.4 Withholding rules (Temp. Reg. 31.3401(a)-4)

Accountable plan. Payments under a reimbursement or other expense-allowance arrangement that do not exceed the amount of substantiated expenses are not wages subject to FICA, FWHT, or FUTA. If wages and reimbursements are combined into a single payment, the reimbursement must be specifically identified.

The employee is not required to reflect the reimbursement or expense amount in his or her return. However, Reg. 1.162-17(b)(1) states that the employee should include a statement with the return indicating that reimbursements do not exceed the expenses paid or incurred.

Reg. 1.162-17(b)(1) is not a new regulation. It dates back to taxable years beginning after December 31, 1957. Also, note that the 1991 Form W-2 now requires the employer to report as a memo item (Box 17, Code L) employee business expense advances or reimbursements equal to the federal per diem rate.

Nonaccountable plan. Amounts are subject to FICA, FWHT, and FUTA no later than first payroll after the end of a reasonable period if the arrangement otherwise satisfies the requirements but the expenses are not substantiated or excess amounts returned (Temp. Reg. 1.62-2T(h)).

- "Reasonable period" refers to safe harbors for establishing an accountable plan (discussed previously). If the fixed date method is used for reference, withholding presumably would be required 120 days after payment.
- If the periodic statement method applies, the employer must withhold 120 days after issuing the quarterly statement.
- If the plan does not require substantiation or return of excess amounts, *all* amounts paid under the plan are included in wages and subject to payroll taxes as of the date paid.
- No penalties will be imposed for failure to withhold before July 1, 1991, in cases in which there has been a good faith effort to comply (IRS Notice 90-74).

4.1.5 Per diems and mileage allowances

When employer-established per diems or mileage allowances are used, no return of the excess advance is required if—

1. The allowance is reasonably calculated not to exceed the actual or anticipated expenses, and
2. The employee is required to return the portion of the allowance related to days or mileage not substantiated as being for business.

Generally, an advance of either the IRS "high-low" method or CONUS per diems discussed below would be adequate. If the advance is in excess of the federal per diems, the excess amount is treated as paid under a nonaccountable plan, to be reported on the employee's W-2 subject to income and employment taxes. (See IRS Announcement 90-127, IRB No. 1990-48.)

The plan is still an accountable plan even if the employee does not return the excess *as required by the arrangement, for the days or miles substantiated.* The portion substantiated would still qualify as paid under an accountable plan.

However, amounts advanced for *days* or *miles* not substantiated must be returned as required by the arrangement. (e.g., An employee receives an advance for two days of meals and incidental expenses (M&IE) at a per diem rate of $40. The employee substantiates one day at the federal per diem rate of $26. The excess of $14 for the one day may be kept by the employee and reported as additional wages. However, the $40 for the second day must be returned to avoid treatment as a nonaccountable plan for the entire advance of $80.)

Rev. Proc. 90-60 sets forth new per diem rates for meals and incidental expenses paid or incurred on or after January 1, 1991. Per diem rates for lodging plus M&IE are also applicable for payments made after 1990 (See high-low and CONUS discussion below).

Per diem status is also achieved if the payor pays actual expense for lodging with per diem for meal and incidental expenses (Rev. Proc. 90-38).

4.1.6 Lodging plus M&IE per diems

The IRS provides two options for determining lodging plus M&IE per diems (Reg. 5e.274-8(h)). Under an accountable plan, the amount considered substantiated is equal to the lesser of the amount provided to the employee or the amount deemed substantiated using rate tables or the high-low method, set forth in Rev. Proc. 90-60.

The federal maximum per diem rate uses the continental United States (CONUS) table or outside continental United States (OCONUS) tables (tables of separate lodging and M&IE rates under Federal Travel Regulations, 41 C.F.R. Part 301-7). Per diem rates for high-cost and low-cost areas are

	Lodging Rate	*M&IE Rate*	*Combined Per Diem*
High-cost areas	$96	$34	$130
All other areas	$62	$26	$ 88

Lodging *plus* M&IE per diems can be used only for employees or other payees under a reimbursement plan (but see prohibition for related parties at 4.1.7, below). Lodging *plus* M&IE per diems cannot be used for those who are self-employed or employees paying own expenses.

4.1.7 Meal and incidental expenses per diems

Rev. Procs. 90-60 and 89-67 allow the use of per diem amounts in lieu of actual expenses for M&IE. In addition to employer-employee reimbursement and advances, the M&IE per diem may be used by a self-employed individual, by nonreimbursed employees (on Form 2106), or between certain payor-payee relationships such as independent contractors and customers.

Per diem rates may not be used in any case in which a payor and an employee are related parties as defined in IRC Sec. 267(b), with a 10% common ownership standard applied instead of the 50% stated in IRC Sec. 267(b)(2). The entire M&IE per diem rate is subject to the 80 percent limitation on meals and entertainment expenses.

Per diem M&IE amounts for travel within the continental United States under the high-low method are

— $26/day in low-cost areas, and

— $34/day in high-cost areas.

(If travel occurs outside the continental United States, the M&IE rate is 40% of the OCONUS per diem rate for that locality. OCONUS per diems are reflected as one amount to include lodging and M&IE.)

High-cost areas are established by IRS Rev. Proc. 90-60 and IRS Notice 90-14. Where you stop for sleep and rest determines the "cost area." The most recent high-cost localities can be found in IRS Publ. 1542. For 1991, San Diego, Key West, and Detroit have been added to the list. Palm Springs, Conway, NH, and Dallas/Ft. Worth have been deleted.

It should be noted that the CONUS tables do not have the same high-cost areas as set out in the high-low table. While the CONUS tables also use $26 and $34 for the M&IE rate, more localities are given $34 status. The CONUS tables contain lodging per diem rates, which vary for each location.

If a payor uses the high-low method for an employee, the CONUS per diem is not available for the same calendar year (except the employer may use the OCONUS rates for travel outside the United States, the CONUS meal-only rate, or actual expense reimbursement).

A special meal rate for payors in the travel industry is set forth in Rev. Proc. 90-60:

1. $30/day — travel within the United States
2. $34/day — travel outside the United States

Travel industry employment means moving people or goods by airplane, bus, ship, train, or truck, and regularly requiring travel away from home which, during any single trip, involves localities with differing federal M&IE rates.

Per diem amounts must be pro-rated based on a twenty-four day divided into four equal parts:

Midnight – 6 a.m.
6 a.m. – noon
Noon – 6 p.m.
6 p.m. – midnight

One fourth of the M&IE rate may be taken for each six-hour period. Other methods can be used if consistently applied and used within reasonable business practice.

4.1.8 Meals provided in kind

The payor is not required to reduce the per diem rate for a meal provided in kind. For example, an airline employee per diem need not be reduced for meals received from airline.

Exhibit 1 Availability of Per Diems and Mileage Allowances to Various Taxpayers

Per Diems and Allowances	*Employee—Reimbursed*	*Employee—Not Reimbursed*	*Self-Employed*	*Independent Contractor/Payee**	*Related Party†*
M&IE	Yes	Yes	Yes	Yes	No; must use actual
M&IE plus Lodging	Yes	No; must use actual	No; must use actual	Yes	No; must use actual
Mileage allowances	Yes	Yes	Yes	Yes	Yes

*Certain payor-payee relationships under a reimbursement (accountable) plan.
†As defined in IRC Sec. 267(b), 10% common ownership instead of standard 50% stated in IRC Sec. 267(b)(2).

4.1.9 Unreimbursed expenses

To claim deductions for unreimbursed expenses incurred, employees and self-employed individuals may deduct the M&IE per diems without substantiation but must still prove time, place, and business purpose of travel. "Lodging plus M&IE" per diems may only be used by reimbursed employees or other payees to substantiate amount. Unreimbursed employees, self-employed individuals, or other payees must use the actual cost for lodging.

Example 1: Reimbursed Lodging Plus M&IE Per Diem. Fritz, an employee with an employer reimbursement plan, travels away from home to New York for two days on business. Because this is a high-cost locality, he may be reimbursed $260 ($130 x two days) without substantiating meal and lodging amounts. This reimbursement is not included in Fritz's W-2 income.

Example 2: Unreimbursed Expenses. Assume the same facts as Example 1, except that Fritz's employer provides no reimbursement. Fritz may claim a below-the-line deduction of $54 ($34 x two days x 80%) without substantiating the amount using the M&IE per diem. However, he may not claim a lodging per diem deduction, but rather must use his actual, substantiated lodging expenses.

4.1.10 Accountable plan examples

Example 1: Excess Allowance. Harry Smith receives an advance of $40 per day for meals and incidental expenses. During one week, Harry spent 5 full days in San Francisco, four of which were substantiated as being for business. The M&IE per diem for San Francisco is $34. If Harry uses the M&IE rate and returns to his employer the allowance attributable to the day that was unsubstantiated, the accountable plan requirements will be met. The excess allowance over the federal per diem ($6) does not need to be returned for the days that were for business. However, the $6 per day will be treated as wages subject to withholding. If Harry did not return the one day that was unsubstantiated and the plan did not provide for the return of excess payments, then the entire amount (or $200) would be treated as wages subject to withholding.

Example 2: Related Party. John is president and a 30% shareholder of corporation X that provides for reimbursement of employee travel expense under the high-low method. John travels to Washington, DC for a three-day business trip and receives an advance allowance of $390 ($130 x 3). John's actual expenses came to $316. Under the related party rule, John is required to use actual expenses. The company plan should provide for the return of any excess. If it does and John does not return the excess, only the excess would be wages. If the plan does not provide for the return of excess and John does not return the excess, the entire $390 would be wages.

Example 3: Self-Employed. Bill is a self-employed insurance salesman. During 1991, Bill is away from home overnight for twenty days. In computing his deduction, Bill may use the per diem M&IE rate of $26 (assuming he is not in a high-cost area) and must use his actual lodging costs. Because Bill is self-employed, he cannot use the lodging plus M&IE per diem rate in computing his deduction.

Example 4: Independent Contractor-Payee. Tom, a construction consultant, enters into an agreement with a general contractor in which Tom is to be paid the $88 lodging and M&IE per diem in low-cost areas and $130 in high-cost areas for travel. Even though Tom is self-employed, he may use the per diem rate because of the reimbursement arrangement, assuming all requirements are met for an accountable plan. It would appear that for any unsubstantiated travel under an accountable plan, the general contractor would simply add that portion of the day's unsubstantiated payment to Tom's 1099.

Example 5: Interplay With Federal Alternative Minimum Tax. Alan is an outside salesman who is not under an accountable plan. In 1991, he incurred $25,000 of employee business expenses, as reported on Schedule A, subject to the 2% AGI floor. Alan also has an adjusted gross income of $120,000, files a joint return claiming four exemptions, has Schedule A taxes of $12,000, and mortgage interest of $6,000.

Because miscellaneous itemized deductions are an adjustment for alternative minimum tax (AMT) purposes and the 1991 rate increased from 21% to 24%, Alan would incur approximately $2,400 of AMT in 1991. Alan should attempt to convert his arrangement with his employer to an accountable plan.

4.2 Ministers and Clergy: Accountable Plans and Housing Allowances

Because members of the clergy increasingly receive their compensation on Form W-2, planning for this special class of taxpayers has become more critical than ever. Consideration must be given to Social Security and the manner under which it is computed for members of the clergy and to planning their total compensation package, including the possibility of adopting an accountable plan to help minimize their tax burden.

4.2.1 Treatment of clergy business expenses

Clergy may deduct business expenses under one of two alternatives:

1. If Form 1099 is issued to report the compensation, any related expense may be deducted on Schedule C.

2. More likely, under common law rules, a Form W-2 is required for clergy categorized as employees, forcing the deduction for employee business expenses to Schedule A subject to the 2% limitation. This means the expense must not only exceed the 2% limitation, it must also exceed the standard deduction.

Ministers or members of religious orders who are common law employees are exempt from federal income tax withholding per IRC Sec. 3401(a)(9) and from FICA per IRC Sec. 3121(b)(8), but are subject to the self-employed Social Security tax per IRC Sec. 1402(c)(2)(D) unless they filed a timely application for exemption from the Social Security system in their first year of earnings as a minister.

As an employee statutorily exempt from FICA and federal withholding, a minister will receive a Form W-2 reporting gross wage income, but zero FICA wages, zero FICA tax, and zero federal withholding.

Members of the clergy are not provided the same benefits as statutory "employees" under IRC Sec. 3121(d) (e.g., full-time life insurance salespeople, who are subject to W-2 FICA but otherwise are independent contractors entitled to Schedule C reporting).

Example. Reverend John Brown's only source of income for 1991 is $30,000 from wages paid to him as an employee of the church, reported on Form W-2. Reverend Brown has no housing allowance plan or provision for reimbursement of job-related expenses. Reverend Brown incurred various expenses in connection with his job in the amount of $3,500, including mileage, professional dues, and publications. Because Reverend Brown has no other itemized deductions, he will not receive any tax benefit from the $3,500 of job-related expenses. Reverend Brown is married and has one child. His 1991 federal income tax and self-employment tax are computed as follows:

Federal income tax:		
W-2	$30,000	
Less: Standard deduction	(5,700)	
Exemptions (3)	(6,450)	
Taxable income	$17,850	
		$2,678
Self-employment tax:		
W-2	$30,000	
Less: Adjustment for job-related expenses (per Rev. Rul. 80-110)	(3,500)	
Net SE income	$26,500	
Self-employment tax		3,744
Combined federal income tax and SE tax		$6,422

4.2.2 Rental allowance provisions (IRC Sec. 107)

The rental value of a home furnished to a minister as part of compensation or allowance paid to him or her for renting or providing a home is exempt from income tax (Reg. 1.107-1). The exclusion of the rental allowance does not limit the minister's ability to deduct mortgage interest and real estate property taxes paid on the personal residence (IRC Sec. 265(a)(6)). The housing allowance must be designated as such by the employer to distinguish from salary or other remuneration (Reg. 1.107-1(b)).

The exclusion is limited to the lesser of the amount of the allowance or the actual costs of maintaining the home (Reg. 1.107-1(c)). Eligible costs include items such as utilities and telephone, furnishings, real estate taxes, mortgage payments (P & I), repairs and maintenance, and insurance. The rental allowance provision does not provide exemption from income subject to self-employment tax (IRC Sec. 1402(a)(8)).

4.2.3 Employee business expenses/reimbursements

Under the provisions of IRC Sec. 62(c), an employer may establish an accountable plan (see section on employee business expenses for more details) that would enable the employee to receive reimbursements for job-related expenses.

Allowances and reimbursements under an accountable plan are not included in the employee's gross income for income-tax purposes.

Example. The facts are the same as in the previous example, except that Reverend Brown has entered into the following arrangements with his church:

1. A rental allowance, as provided in IRC Sec. 107, will be provided in the amount of $7,000 per year. This amount is equal to Reverend Brown's cost of maintaining his home and includes such expenses as rent, utilities, telephone, furnishings, insurance, and repairs for the year. *Planning point*: Although the allowance must be reasonable, it is to the taxpayer's advantage to provide an allowance which approximates the total annual housing disbursements.
2. An accountable plan, as provided under IRC Sec. 62(c), was established whereby Reverend Brown would be reimbursed for his $3,500 of job-related expenses.
3. As a result of the above, Reverend Brown agrees to reduce his salary by the amounts of the housing allowance and accountable expense reimbursement plan.
4. Assuming the above plan was in place for 1991, Reverend Brown's tax liability would be computed as follows:

Federal income tax:		
W-2 ($30,000 – $7,000 – $3,500)	$19,500	
Housing allowance (excluded $7,000 per IRC Sec. 107)	—	
Reimbursement for job-related expenses (excluded $3,500 per IRC Sec. 62(c))	—	
Total	$19,500	
Less: Standard deduction	(5,700)	
Exemptions (3)	(6,450)	
Taxable income	$ 7,350	
Federal income tax		$1,103
Self-employment tax:		
W-2	$19,500	
Plus housing allowance	7,000	
Less: Job-related expenses (already excluded)	—	
Net SE income	$26,500	
Self-employment tax		3,744
Combined federal income tax and SE tax		$4,847

Result: Although the self-employment tax remains unchanged, the federal income tax is reduced by $1,575.

4.2.4 Conclusion

For members of the clergy classified as employees for Form W-2 reporting, the need to carefully implement plans under IRC Secs. 107 and 62(c) is becoming of greater value. As the previous example demonstrates, the tax savings may be significant.

4.3 Travel as a Form of Education

Before 1987, Reg. 1.162-5(d) allowed a deduction for travel costs directly related to duties of the individual's employment or business. The Tax Reform Act of 1986 enacted IRC Sec. 274(m)(2), which overrules Reg. 1.162-5(d) by disallowing all deductions "for travel as a form of education." This disallowance does not apply to travel that is a necessary adjunct to an educational activity. Questions remain as to the definition of educational travel when conducted in connection with a trade or business. Although any individual in any profession may be subject to IRC Sec. 274(m)(2), it appears that certain professions, such as teachers, may encounter the most difficulty with the new rules.

4.3.1 Travel alone nondeductible

After enactment of IRC Sec. 274(m)(2), no deduction is allowed for travel that itself constitutes a form of deduction. Travel remains deductible, however, to the extent necessary to attend otherwise deductible events such as seminars, lectures, and conventions. For example, a professor of French touring France in order to sustain or enhance her familiarity with the French language and culture is not allowed a business expense for her travel. On the other hand, if the professor travels to Paris primarily for library research or to attend classes not available elsewhere, she would be permitted to deduct her expenses.

4.3.2 Travel incident to business

Travel incident to deductible business education may be deducted if properly accounted for. If it can be determined that direct expenses (fees, tuition, books) related to educational seminars, lectures, etc. are qualified business deductions, indirect costs such as travel, meals, and lodging are also deductible if the taxpayer is "away from home." However, deductibility of any travel expense ultimately depends on the determination of whether the travel is primarily business or primarily personal. Reg. 1.162-5(d) holds that the fact that an employer approved of and treated travel as meeting required professional educational minimums is not determinative of the deductibility of the travel by the employee as a business expense.

The major factors in determining whether travel is primarily business or personal relates to the amount of time spent on business and personal activities during the outing.

Example. Henry Hollinsdale is an engineer. Henry traveled from Ohio to the Virgin Islands to attend a seminar on new techniques in bridge construction. The seminar ran two days from 8 a.m. to 4 p.m. Henry spent two full weeks on the islands, and in his words, "viewed many bridges during his free days." Since only one seventh of Henry's time was devoted to the seminar and the time spent "viewing bridges" does not qualify as deductible educational travel, the majority of the trip was personal. As a result, only the meals and lodging for the business portion are deductible. The travel to and from the Virgin Islands is non-deductible (Reg. 1.162-5(e)(2), Examples (2) and (3)).

4.4 Passive Activities: Caution on Entering Pass-Through Items on Schedule K-1

Because of the restrictions and special rules regarding passive activity income, losses, and credits, it is critical for the tax preparer to clearly identify these items in the proper locations when preparing partnership and S corporation tax returns. Misclassifications or nonidentified items can dramatically affect how partners/shareholders prepare their individual income tax returns.

4.4.1 Passive activities in partnerships/S corporations

In general, IRC Sec. 469 provides rules that limit the deduction of passive losses and credits. These rules also apply to partners and shareholders who are individuals, estates, or trusts, and who have a passive activity loss or credit for the year.

Passive activities include the following when conducted inside a partnership or S corporation:

1. Trade or business activity in which the partner or shareholder does not materially participate, and
2. Activities that meet the definition of rental activities under Temporary Regs. 1.469-1T(e)(3).

Passive activities *do not* include the following when conducted inside a partnership or S corporation:

1. Business activities in which the partner or shareholder materially participates
2. Qualified transitional low-income housing projects per 1986 TRA Sec. 502
3. Rental activities that do not meet the definition under Temporary Regs. 1.469-1T(e)(3) (including activities in which there is "incidental rental use" or "extraordinary personal services" provided)

4.4.2 Classification by circumstances

Certain activities can be classified as passive or nonpassive in nature depending on circumstances. Trade or business activities will always be reported on line 1 of Schedule K of the partnership or S corporation return. These trade or business activities will then be classified at the individual level as passive or nonpassive depending on whether the partner/shareholder materially participated in the trade or business.

Capital gains or losses must be categorized at the partnership/corporate level as either portfolio income or nonportfolio income. Portfolio capital gains (losses) are reported on lines 4(d) and 4(e) of Schedule K. These items are always nonpassive at the individual level. Nonportfolio capital gains (losses) are reported as "Other Income" on line 7 of Schedule K of a partnership return and line 6 of Schedule K of an S corporation return. This includes gains or losses from the disposition of nondepreciable personal property used in the trade or business of the partnership or corporation.

The determination of whether these gains or losses are passive is then made at the individual level depending upon whether the partner/shareholder materially participates.

If multiple activities are conducted by the entity, these capital gains (losses) must be identified to indicate which activity they pertain to.

Rental activities must be differentiated into "real estate" and "other" on lines 2 and 3 of the Schedule K's. Rental real estate activities are separated from other rental activities because realty activities may be eligible for the annual $25,000 loss privilege at the partner/shareholder level. Rental real estate may also be subject to the rules preventing conversion of portfolio income into passive income (i.e., the less than 30% depreciable basis rule of Reg. 1.469-2T(f)(3)). This item would need to be shown on line 4(f), "Other Portfolio Income," on Schedule K.

4.4.3 Schedule K classification consequences

Joe Wealthy is an executive with $60,000 of passive loss carryovers from several tax-shelter limited partnerships. In addition, Joe has accumulated excess capital loss carryovers of $18,000 from prior securities transactions. He is also a partner in a company that manufactures clothing but does not materially participate in that operation. The clothing partnership specializes in manufacturing Minnesota North Star hockey team clothing. Because of the team's surprise showing in the 1991 playoffs, a sale of the business produced a $75,000 capital gain within the partnership. The tax preparer must be sure to categorize this as a nonportfolio passive capital gain or Joe will not be able to carry the income to his Form 8582. Proper classification will, in this case, cause a double benefit:

1. The classification of the capital gain as passive will allow Joe to use his ordinary tax shelter losses, and
2. The capital gain will also permit Joe to use his capital loss carryover.

1991 TAX RETURN DATA

	Portfolio Capital Gain (Incorrect)	*Non Portfolio Capital Gain (Correct)*
Capital gain	$75,000	$75,000
Passive loss carryover allowed	—	(60,000)
Long-term capital loss carryover allowed	(18,000)	(18,000)
Other nonpassive income	35,000	35,000
AGI	$92,000	$32,000

4.5 Using Year-End Loans to Increase S Corporation Basis

Pass-through losses from an S corporation that are nondeductible because of lack of basis carry forward indefinitely. However, taxpayers often want to utilize losses as soon as possible to take advantage of tax savings. A common technique involves loaning money to the S corporation before year-end, to add basis so as to deduct either current or prior-year losses. The discussion below reveals that in certain circumstances this strategy can have a detrimental effect.

4.5.1 Determination of basis under current law

Aggregate losses and deductions of an S corporation can be deducted by the shareholder only to the extent of the shareholder's basis in stock and direct loans to the S corporation (IRC Sec. 1366(d)(1)).

Basis is determined at the end of the S corporation's taxable year.

1. A shareholder's direct loans to a corporation before that date increase basis for determining deductibility of current or prior-year losses.
2. The shareholder's personal guarantee of the corporation's obligations to third parties does not create basis (Rev. Rul. 70-50, 1970-1 CB 178).

4.5.2 Reduction of basis below zero

Losses or deductions passed through to the shareholder first reduce stock basis. After stock basis is reduced to zero, remaining loss amounts are applied against debt basis (IRC Sec. 1367(b)(2)(A)). If debt basis is reduced to an amount lower than the face value of the loan, a repayment to the shareholder on that loan will create gain to the shareholder (Rev. Ruls. 64-162, 1964-1 CB 304 and 68-537, 1968-2 CB 372). If debt basis has been reduced to zero, the total note repayments to the shareholder will be taxable gain.

Example 1. Fred loaned $20,000 to an S corporation of which he is the sole shareholder. Because of prior years' losses, the basis of this loan has been reduced to zero. If the corporation repays Fred $10,000 of principal on this loan, Fred will have a taxable gain of $10,000.

If debt basis is reduced to less than face value but greater than zero, the note repayment to the shareholder will be partially taxable.

Example 2. Frank loaned $40,000 to an S corporation of which he is the sole shareholder. Because of prior years' losses, the basis in Frank's stock is zero and his basis in the $40,000 note is $25,000. In 1991, the corporation repays Frank $10,000 of principal on the note. $3,750 must be reported as taxable gain in 1991.

$$\frac{\$40{,}000\text{ (face amount)} - \$25{,}000\text{ (basis)}}{\$40{,}000\text{ (face amount)}}$$

$$\times\ \$10{,}000\text{ Repayment} = \$3{,}750\text{ gain}$$

The character of the gain on the loan repayment depends on whether the debt is evidenced by a note. If there is no note, the gain is ordinary income, as would be the case with open accounts receivable. If there is a debt instrument, the gain generated by the retirement of the debt is deemed to be a sale or exchange of a capital asset (IRC Sec. 1271(a)(1)).

4.5.3 Impact of shareholder loans

Timing on the making of loans, and in particular their repayment, can be critical.

Example. George is the sole shareholder of an S corporation that incurred a $5,000 loss in its first year, entirely eliminating the basis in his stock. As the end of the second year approaches and George realizes that the corporation will incur a $20,000 loss that would otherwise be deferred because of insufficient basis, he makes a last-minute loan to the corporation to provide basis. This $20,000 year-end loan allows full use of the second-year loss of $20,000. Shortly after the close of the second year, George has the corporation repay the $20,000 loan, thus incurring a gain of $20,000.

In the third year, the corporation incurs a loss of $10,000, which becomes a carryforward at the shareholder level because of insufficient basis. In the fourth year, the S corporation passes through income of $30,000, which provides basis to George to allow utilization of his $10,000 carryover loss. At the end of the fourth year, George has reported overall net pass-through income from his S corporation of $15,000, and has $20,000 of basis in his stock. The following summarizes these calculations:

CASE A

		Stock Basis	Debt Basis	Shareholder Income (Loss)	Shareholder Carryover Loss
Year 1	Stock investment	$ 5,000			
	Loss of $5,000	(5,000)		$(5,000)	
		—			
Year 2	Loan before year-end		$20,000		
	Loss of $20,000		(20,000)	(20,000)	
			—		
Year 3	Loan repaid: Gain			20,000	
	Loss of $10,000				$(10,000)
Year 4	Income of $30,000	20,000		20,000	10,000
	Summary	$20,000		$15,000	$ —

How would George's position compare if he had made no loan to the corporation during this four-year period? Was the loan near the end of the second year for the purpose of securing the $20,000 loss advantageous or detrimental to George's overall position?

CASE B

		Stock Basis	Debt Basis	Shareholder Income (Loss)	Shareholder Carryover Loss
Year 1	Stock investment	$ 5,000			
	Loss of $5,000	(5,000)		$(5,000)	
		—			
Year 2	Loss of $20,000				$(20,000)
Year 3	Loss of $10,000				(10,000)
Year 4	Profit of $30,000				30,000
	Summary	$ —		$(5,000)	$ —

As can be seen from Case B, the losses in the second and third year simply become carryforwards, awaiting the profit in the fourth year. At the end of the four years, George has reported an overall tax loss of $5,000 in his personal return, as contrasted with the overall $15,000 income in Case A where the loan was made to the corporation and repaid in the subsequent year. In recognition of the fact that George reported additional income with the loan technique, he has a corresponding increased basis in his stock ($20,000 basis vs. zero basis where no loan was made). In many cases, increased stock basis may be of little significance. This could be of benefit to George if he is able to distribute $20,000 of tax-free cash from the corporation, or if he disposes of his stock in a taxable transaction.

4.5.4 Conclusion

The loan technique can be advantageous to securing earlier use of a loss, but it eliminates the availability of the loss for future offset of profits or income from the S corporation. If the shareholder anticipates that income will be realized from the S corporation in the near term, it may be advisable to refrain from use of a year-end loan.

4.6 Alternatives to Goodwill

Purchased goodwill is nondeductible for federal income tax purposes. In contrast, the amounts paid for a covenant-not-to-compete are amortized and deducted over the period of the covenant, typically three to five years. In the context of business acquisitions, in order to limit the amount of the purchase price allocable to goodwill, some taxpayers have asserted that they have acquired other intangibles that are also deductible over specific taxable periods. This section sets forth some of the intangible assets claimed by creative taxpayers that have been identified by the General Accounting Office (GAO) from IRS files and a general discussion of possible legislative changes.

The GAO report "Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets" (GAO/GGD-91-88), released August 12, 1991, identifies current taxpayer practices in the handling of goodwill and other intangible assets. The report indicates that the disallowance of any income tax deduction for goodwill encourages taxpayers to seek alternatives and recommends a legislative change to the current tax treatment of intangibles.

In general, the report recommends that Congress should permit taxpayers to deduct the costs of intangibles, including goodwill, over statutorily imposed recovery periods. In addition, the report suggests that the costs of creating such intangibles should be capitalized and therefore nondeductible. Although the report does not identify those expenses that would be capitalized, it might serve as the basis for disallowing part of the costs of advertising. Entertainment costs might also be included in the category of capital expenditures.

Pending the enactment of statutory standards in response to the report, the report is also instructive insofar as it contains a comprehensive listing of intangible assets that taxpayers have claimed as deductible alternatives to purchased goodwill. The following list is taken from the GAO report.

Exhibit 2 Taxpayer-Claimed Intangible Assets

Accelerated market growth
Access programming
Accounts receivable
Accounts/vendors
Acquisition costs
Advertising lists
Advertising contracts
Agreements
Assembled workforce
Backlog
Bargain leases
Broadcasting rights
Brochures/catalogs
Cable franchises
Capital grants expensed
Competitive advantage
Computer programs
Computer software
Computer software licenses
Computer software manuals
Concessions and scoreboards
Construction contracts
Construction permits
Consulting agreements
Consumer franchises
Contracts (general)
Contracts with related companies
Copyrights
Core deposits
Course material
Covenant not to compete
Credit files
Customer base
Customer contracts
Customer lists
Customer relations
Customer routes
Customer structure
Data base
Dealer network
Deferred financing costs
Deferred organization expense
Delivery systems
Deposit base
Development rights
Diminishing network compensation
Disadvantage competition
Distributions
Drawings
Employment agreement contracts
Equipment leases
Equity in unearned premium
Equity on government owned property
Favorable financing
Favorable savings
Favorable leases
Favorable wage rates
Federal Communications Commission license
Field staff
Film contracts
Formulas
Franchises (general)
Gas allocation rights
Gas purchase contracts
Income agreements
Information systems
Insurance client lists
Insurance contracts
Insurance expirations (lists)
Insurance-in-force
Key employees
Lease rights
Leasehold improvements
Leasehold interests/equity
Leases (general)
Legal and auditing
Library
Licensing agreement (television, cable, radio)
Lists (dealers and others not listed)
Loan portfolio premium
Local media contracts
Location value
Long-term leases

Mailing list
Maintenance contracts
Make-ready costs
Management contracts
Manufacturing agreements
Manufacturing process and procedures
Manufacturing representations
Market service (product support)
Marketing contracts
Medical records
Miscellaneous expenses
Morgue
Mortgage servicing (lists)
Mortgage servicing rights
Negative asset base
Newspaper masters
Nonunion status
Novelty rights
Nurse files
Nurse procedures/manuals
On-air talent contracts
Other advertising relations
Patent applications
Patents
Patient files/records
Physician/dental referral
Player contracts
Premium on loan
Premium market population asset
Premium on early delivery of plant
Premium on investment securities
Prepaid leases
Presold contracts
Product lines
Profit and loss revenue
Program format
Proposal contracts
Purchase order contracts
Radio franchises
Rate files/photo files
Real estate option leases
Recipes
Recruitment and financial assets
Research and development
Right to solicit customers
Rights (general)
Safe deposit box contracts
Savings value of escrow fund
Service contracts
Servicing rights
Specialty program contracts
Standstill agreements
Stock of first bank
Student files
Studio space and site leases
Subscription lists
Supply contracts
Technical expertise
Technical manuals
Technician files
Technology
Television franchises
Timber cutting rights
Timber leasehold
Trademarks
Trade names
Trained staff
Training programs
Television network affiliation
Television spots
Underdeveloped market (competition)
Unfilled purchase orders
Unpatented know-how
Value of loans receivable
Vehicles in service
Water rights

5. RETIREMENT PLANS

5.1 Self-Employed Retirement Plan Contribution Calculations

Prior to 1990, the calculation of employer/employee self-employed retirement plans was relatively simple. For 1990 and later years, the calculation takes on a new factor — the deduction of one half of self-employment tax in arriving at net self-employment income. To complicate matters further, in 1991 and future years the self-employment wage base is split into two parts: 15.3% tax on earnings up to $53,400, and 2.9% Medicare tax on earnings between $53,400 and $125,000.

5.1.1 Pre-1990 calculations

The following formula can be used to calculate pre-1990 self-employed retirement plan contributions:

X = Employer self-employed retirement plan contribution
Y = Qualified employee wages
Z = Business income prior to employee self-employed retirement plan contribution
A = Self-employed retirement plan contribution rate

NOTE: Per IRS Publication 560, the stated employee percentage is adjusted to a lower effective rate for the owner, such as a 15% employee rate reduced to a 13.0435% owner rate. The self-employed owner's rate (A2) can be calculated by reference to the employee rate (A1) as follows:

$$\text{Owner \% (A2)} = \frac{\text{Employee \% (A1)}}{1 + \text{Employee \% (A1)}}$$

$$\text{Formula: } X = [Z - (Y \times A1)] \times A2$$

Example 1. I.M. Lost operates a sole proprietorship engaged in airplane pilot training. Mr. Lost has one employee whose gross wages for 1990 were $25,000. Net business income was $62,000. Mr. Lost would like to contribute 10% to his profit-sharing self-employed retirement plan (9.0909% effective rate for owner).

X = [62,000 − (25,000 × 10%)] × 9.0909%
X = $5,409 employer contribution
$2,500 employee contribution

5.1.2 1990 calculations

The following formula can be used to calculate 1990 self-employed retirement plan contributions:

Factors are the same as Example 1, plus B = one half self-employment tax deduction, based on net earnings after the employee contribution. Also, Z = Business income prior to employee self-employed retirement plan contribution and one-half of self-employment tax.

$$\text{Formula: } X = ([Z - \{Y \times A\}] - B) \times A$$

Example 2. Assume the same facts as Example 1, except the year is 1990.

B = 3,924 (maximum ½ SE tax deduction for 1990)
X = ([62,000 − {25,000 × 10%}] − 3,924) × 9.0909%
X = $5,052 employer contribution
$2,500 employee contribution

5.1.3 1991 calculations

The same formula as for 1990 can be used to calculate 1991 self-employed retirement plan contributions. However, the calculation of one-half of self-employment tax is more difficult because of two separate self-employment earnings bases for Social Security and Medicare tax. (See section on 1991 Self-Employment Tax Calculation).

Example 3. Assume the same facts as Example 1, except the year is 1991.

B = $4,108 = ½(53,400 × 12.4%) + ½(59,500 × 92.35% × 2.9%)
X = ([62,000 − {25,000 × 10%}] − 4,108) × 9.0909%
X = $5,036 employer contribution
$2,500 employee contribution

Example 4. Assume the same facts as Example 3, except Mr. Lost wants to contribute $1,000 to his employee's self-employed retirement plan.

The employee contribution must be converted into a percentage of the employee's wages:

$1,000 ÷ 25,000 = 4% (Therefore owner rate of 3.8462% per IRS Pub. 560)

From this point, the same formula as Example 3 is used:

B = $4,128 = ½(53,400 × 12.4%) + ½(61,000 × 92.35% × 2.9%)
X = (62,000 − 1,000 − 4,128) × 3.8462%
X = $2,187 employer contribution

5.1.4 Integrated self-employed retirement plan

Retirement plans that are integrated with Social Security add even more complexity to contribution calculations. To calculate a self-employed's contribution under an integrated plan, the following steps should be followed:

1. Determine employee contribution.
2. Determine net business income after deducting employee contribution.

3. Calculate self-employment tax.
4. Subtract half the amount in item 3 from the amount in item 2 (B in formula below).
5. Calculate the self-employed's retirement plan contribution using the following formula:

$$\text{Formula: } A = \frac{B + iD}{1 + D + C}$$

A = Self-employed earnings of owner for retirement plan contribution *after* owner deduction
B = Income after employee contribution and half self-employed tax deduction (item 4 above)
C = Base contribution rate
D = Contribution rate above integration level
i = Integration level

6. After A is computed, use rates for C and D to calculate the self-employed's contribution.

Example 5. Mary Ann Dorsey's 1991 net business income before employee contribution is $80,000. Mary Ann has one employee whose wages qualified for the retirement plan. The employee's wages for 1991 were $25,000. The retirement plan provides for a 5% contribution rate on all income plus 3% above the Social Security wage base ($53,400 for 1991). Calculate the employee and Mary Ann's retirement plan contributions following steps 1-6 above:

1. $25,000 × 5% = $1,250 employee contribution
2. $80,000 − 1,250 = $78,750 net business income to Sched. SE
3. Self-employment tax = $8,731
4. $78,750 − (8,731 ÷ 2) = $74,384 net after employee contribution and ½ SE tax deduction
5. A = [$74,384 + (53,400 × .03)] ÷ [1 + .03 + .05] = $70,357 owner's earnings after plan contribution
6. Owner plan contribution
   $70,357 × .05 = $3,518
   (70,357 − 53,400) × .03 = $509
   $3,518 + 509 = $4,027
   (Proof: $4,027 + 70,357 = $74,384)

5.1.5 Conclusion

The creation of a two-tier self-employed/FICA rate in 1991, combined with the 50% self-employed tax deduction, makes the proper calculation of a Keogh or SEP plan deduction enormously complicated, especially where the plan rate involves integration with the Social Security earnings base. Because the owner's rate may only be applied to net earnings after reduction for the owner retirement plan contribution, a formula approach is required.

5.2 Avoiding the Early Withdrawal Penalty on Retirement Plan Distributions

Early distributions from a qualified retirement plan are subject to income tax and possibly a 10% penalty. The penalty can be avoided if the taxpayer uses one of the statutory exceptions. Besides the more common exceptions for payment after reaching age fifty-nine and a half or under a qualified domestic relations order (QDRO), there are several less-publicized exceptions.

5.2.1 Exempt distributions

Distributions are exempt to the extent of deductible medical expenses. A taxpayer may avoid the early withdrawal penalty on a distribution to the extent of medical expenses that exceed 7.5% of adjusted gross income. The taxpayer is not required to itemize deductions to take advantage of this exception (IRC Sec. 72(t)(2)(B)). IRA distributions do not qualify for this exception (IRC Sec. 72(t)(3)(A)).

If a taxpayer has considerable medical expenses, he or she may want to withdraw funds from a qualified retirement plan and avoid the early withdrawal penalty. In addition, the distributed funds may be used to pay the medical expenses.

Example 1. Corrine Davis, age forty-five, was involved in a car accident. Corrine incurred substantial medical bills and was unable to sustain her business, reflected by a Schedule C loss on her tax return. She withdrew $7,000 from her retirement plan and incurred $6,900 in qualified medical expenses. Corrine's adjusted gross income (including the retirement plan distribution) was $5,200, thus resulting in zero taxable income. Corrine is eligible to reduce the early distribution by $6,510 ($5,200 × 7.5% = $390; $6,900 medical expenses less $390). The early withdrawal penalty is $49 ($7,000 distribution less $6,510 = $490 × 10%). Corrine saved $651 in penalties ($6,510 × 10%).

Example 2. Kelly Cole, age forty-eight, incurred $5,500 of qualified medical expenses. To help fund the medical expenses, Kelly withdrew $3,500 from her qualified retirement plan. Kelly's adjusted gross income for the year was $40,000. The amount eligible to reduce the distribution subject to the 10% penalty is $2,500. ($40,000 AGI × 7.5% = $3,000; $5,500 medical expenses less $3,000 = $2,500). The $3,500 distribution is reduced by $2,500, resulting in a $100 penalty ($1,000 × 10%).

5.2.2 Equal annual distributions

A series of substantially equal lifetime payments also provides an exception. The early withdrawal penalty does not apply to equal periodic distributions paid at least annually over the individual's life expectancy (IRC Sec. 72(t)(2)(A)(iv)). This exception does not apply to distributions from non-IRA qualified plans unless the periodic payments begin after the employee separates from service.

The periodic payments may be spread over the joint life expectancies of an employee and a designated beneficiary. See IRS Notice 89-25 and Prop. Reg. 1.401(a)(9) for calculation of the periodic payment amount. In PLR 8946045, the IRS ruled that a series of equal periodic payments from one IRA avoided the penalty, without any requirement of taking distributions from two other IRA accounts.

There is an early distribution recapture tax that will apply if the periodic payment plan is changed within its first five years or before the employee reaches fifty-nine and a half (except upon the employee's death or disability) to a method that would not have qualified for an exception to the additional tax (IRC Sec. 72(t)(4)(A)(ii)(II)).

Example. Tim Smith, age fifty-one, is planning to retire this year. Tim has accumulated a pension with a current value of $150,000. If he were to receive his entire pension at retirement and chose not to roll over these funds, he would be assessed a $15,000 early withdrawal penalty on the distribution. If Tim elected to receive substantially equal payments over his expected life, he could avoid the penalty. When Tim reaches the age of fifty-nine and a half, he may decide to withdraw the remaining pension. Therefore, Tim would not be subject to the early withdrawal penalty. By electing to receive annuity payments, Tim saved $15,000 in penalties and was able to maintain cash flow during his retirement years.

5.2.3 Early retirement exception

Early retirement may provide an exception even if the taxpayer goes to work for another employer. An employee who separates from service after reaching age of fifty-five is not liable for the 10% early withdrawal penalty (IRC Sec. 72(t)(2)(A)(v)). Even if the employee returns to work for another employer, this exception remains in effect, provided the employee separated from service before the distribution. This exception is not applicable to an IRA distribution (IRC Sec. 72(t)(3)(A)).

Example. Shirley Smith, age fifty-four, is considering retirement. She will turn fifty-five in six months. If Shirley retires in one month, she will receive a distribution from a qualified plan of $102,000. Consequently, she would be subject to a penalty of $10,200. If Shirley waits six months, she will forgo the penalty and save $10,200.

Other exceptions to the early withdrawal penalty are these:

1. Distributions are made on or after the date on which the employee attains age fifty-nine and a half (IRC Sec. 72(t)(2)(A)(i)).
2. After the death of a participant, the distribution is disbursed to a beneficiary or estate (IRC Sec. 72(t)(2)(A)(ii)).
3. The participant is totally and permanently disabled (IRC Sec. 72(t)(2)(A)(iii)).
4. The distribution is paid to an alternate payee under a qualified domestic relations order (IRC Sec. 72(t)(2)(A)). This exception does not apply to IRAs.
5. Distributions are made to alternate payees pursuant to a QDRO (IRC Sec. 72(t)(2)(C)).
6. Distributions are dividends from certain employee stock ownership plans (IRC Sec. 72(t)(2)(C)).
7. Distributions are from annuity contracts that are allocable to investment in the contract before August 14, 1982.

5.2.4 Conclusion

Being cognizant of the seldom-used medical exemption and the other more common exemptions to the 10% early withdrawal penalty may provide significant tax savings. Many tax preparation software packages may not automatically calculate the medical exclusion, particularly where the standard deduction is used.

5.3 Loans to an Adult Child to Make IRA Contributions

IRA contributions at an early age increase the long-term financial value of an IRA account. Loans to an adult child to make IRA contributions when the child begins employment result in a higher IRA value at retirement and a reasonable return on the parent's loan.

Most working individuals would prefer to fund IRA contributions in preparation for retirement. Often, an individual's earning capacity and other financial obligations inhibit contribution to an IRA at a younger age.

If an individual made an annual $2,000 IRA contribution from ages forty-one through fifty, the balance in the IRA account at age sixty-five, assuming an 8% interest rate, would be approximately $76,000. If the same individual had made the annual $2,000 IRA contribution from ages twenty-one through thirty, the balance in the account at age sixty-five, assuming an 8% interest rate, would be approximately $490,000. This is over six times more, for the same amount of cash invested.

5.3.1 Effect of loan from parent

Example. Harry Smith, Jr. graduated from college and began his first job in 1991. Harry Jr. is age twenty-one. Harry will be in a 34% combined federal and state tax bracket but feels he could not afford contributions to an IRA account for another five years until age twenty-six.

Harry Smith, Sr. is age fifty and has sufficient resources to loan Junior the cash to make the annual $2,000 IRA contribution for five years for a total loan of $10,000. Senior will charge a 9% interest rate on the loan.

On April 15, 1992, Junior makes a $2,000 IRA contribution on his 1991 individual income tax return with money loaned to him from Senior. This contribution will save Junior $680 in taxes ($2,000 × 34%). Junior pays Senior $680 on December 31, 1992, a portion of which is interest (which is taxable to Senior) and a portion of which is principal. This process continues for the next four years.

After Junior's December 31, 1996 payment of $680 to Senior, Junior owes Senior $8,651. The value of Junior's IRA account as of December 31, 1996 is $11,733.20. On January 1, 1997, Junior withdraws enough out of his IRA account ($1,561) to pay down the loan from Senior by $873 so that it can be paid off at a rate of $2,000 per year for the next five years. The remainder of the $1,561, or $688, will pay the tax and penalty on the $1,561 withdrawal ($1,561 × 44%*).

On December 31, 1997, Junior makes his first $2,000 annual loan repayment to Senior. This continues for four more payments, using the funds Junior would have placed in an IRA on his own starting at age twenty-six.

By the time Junior is thirty years old, the loan from Senior has been paid in full. Senior has been able to earn 9% on this money, and Junior has an established IRA account that will be worth approximately $241,000 at age sixty-five. If Junior had waited until age twenty-six to start the IRA contributions, five years later, his IRA account would have been worth approximately $187,000 at age sixty-five.

Junior has invested a total of $10,000 into an IRA account that will be worth $54,000 more at age sixty-five than if he had waited five years. Senior has earned 9% on his loan to Junior, plus has helped Junior get started on his retirement security.

If Junior is a minor and is claimed as a dependent on his parents' return, an IRA contribution can be used to reduce or eliminate unearned income, while the standard deduction reduces the earned income.

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*The 44% rate consists of a 28% federal rate, 6% state rate, and 10% IRC Sec. 72(t) premature withdrawal penalty.

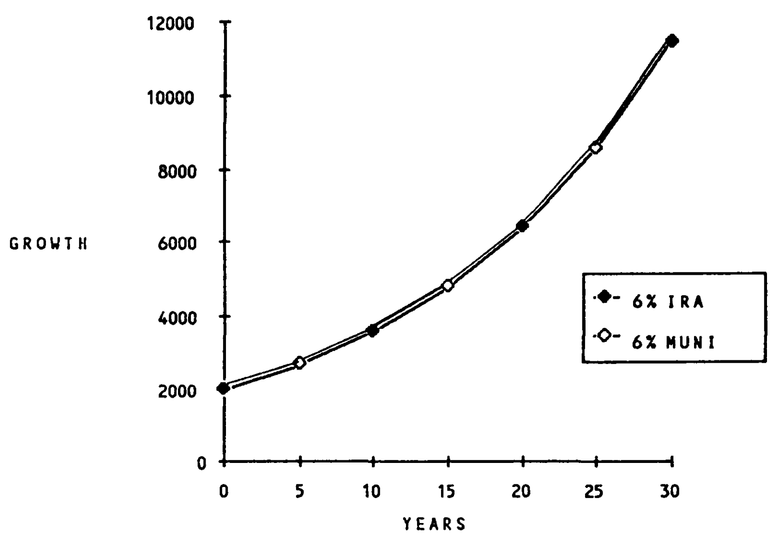
5.4 Deductible IRAs or Nontaxable Municipals

Several conflicting articles have been published comparing the advantages and disadvantages of investing in a deductible IRA vs. nontaxable municipal bonds. Calculations and graphs are presented to illustrate the total after-tax return of IRAs vs. tax-free vs. fully taxable investments at selected interest rates.

5.4.1 Comparing IRAs and Munis at identical rates

An IRA investment generally is deductible by the taxpayer for the lesser of $2,000 or earned income. A $2,000 IRA deduction will save a taxpayer in the 28% tax bracket $560. The $560 tax savings can then be reinvested in a nontaxable municipal bond. Below is a graph that shows the growth of a single $2,000 IRA contribution at 6% plus $560 of tax savings invested in nontaxable municipal bonds at 6%. The results reflect the 28% tax incurred on distribution of the IRA at each point on the graph. This investment has exactly the same outcome as a single $2,000 investment in nontaxable municipal bonds at 6%. This occurs because the $560 invested tax savings in the IRA alternative compounds at the same rate as the IRA fund, such that it is always equal to the tax cost on termination of the IRA.

Exhibit 3 28 Percent Tax Bracket



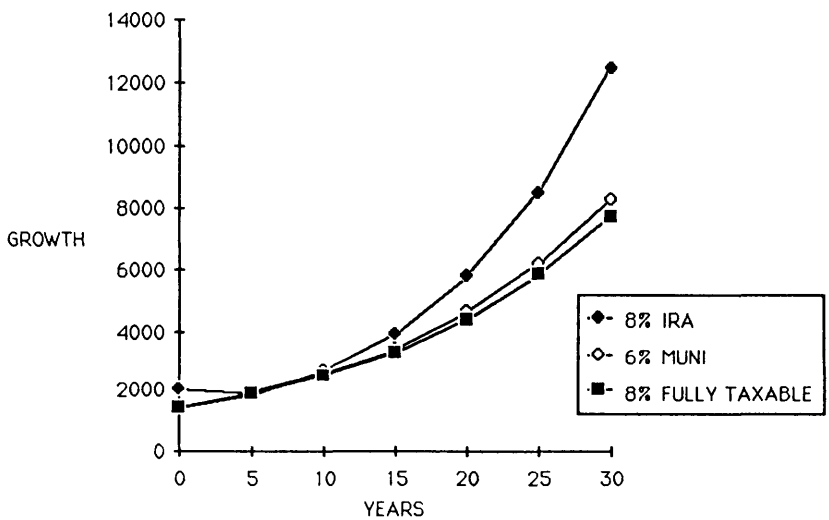
As can be seen from Exhibit 13, there is no difference for either investment if both yield the same rate (6% in this case).

Note that if the IRA distribution is premature, a 10% penalty would be imposed upon distribution, making the nontaxable municipal bonds a more profitable investment at identical rates.

5.4.2 High-yield IRA vs. low-yield Muni

It is more realistic to compare a higher-yielding IRA to a 6% municipal bond. The graph in Exhibit 4 shows the growth of a single $2,000 IRA invested at 8%, with a subtraction for the 28% tax and a 10% penalty upon premature distribution. This is compared to a single $1,440 investment in nontaxable municipal bonds at 6% and also to a fully taxable investment of $1,440 at 8% (5.76% after tax yield). The $1,440 figure represents the after-tax portion of $2,000 of income reduced by a 28% tax cost.

Exhibit 4 28 Percent Tax Bracket

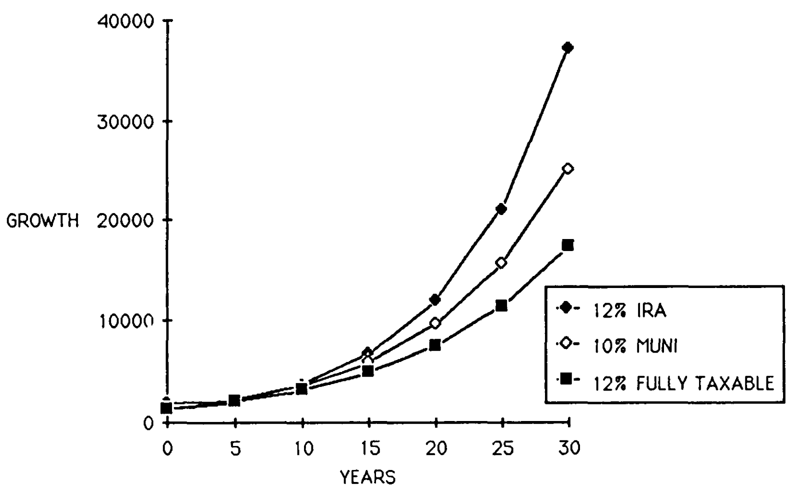


Note the crossover point between five and ten years of growth, when all three investments would yield about the same. After fifteen years, the 8% IRA investment rises above the 6% Muni and the 8% fully taxable investment. In these circumstances, a taxpayer in the 28% tax bracket would be ahead investing in an IRA even when considering the 10% premature distribution penalty. Given the choice between a 6% Muni and an 8% fully taxable investment, a taxpayer in the 28% tax bracket would derive slightly more benefit from the 6% Muni investment if the expected term of growth is at least fifteen years.

5.4.3 Comparing IRA, Muni, and fully taxable investments

Do these conclusions still follow in a high-interest-rate environment? The graph in Exhibit 5 shows the growth of a single $2,000 IRA contribution at 12%, minus 28% tax and a 10% penalty upon premature distribution. This is compared to a single $1,440 investment in nontaxable municipal bonds at 10% and also to a fully taxable investment of $1,440 at 12% (8.64% after tax).

Exhibit 5 28 Percent Tax Bracket



Although the curves are steeper, the basic relationship remains the same. After five and ten years of growth the 12% IRA and the 10% Muni are about the same, while the 12% fully taxable investment is slightly lower. After fifteen years of growth, the IRA rises above the 10% Muni and the 12% fully taxable investment. Again, the taxpayer in the 28% tax bracket is ahead by investing in the 12% IRA instead of the other two investment possibilities.

5.4.4 Conclusion

IRAs produce the superior results (other than in the first years when the premature distribution penalty eliminates an IRA's yield advantage). If the threat of the 10% premature distribution penalty is removed, the

IRA is always superior. Of course, this is largely the result of the two-point rate spread between taxable and tax-free investments used in the previous examples. A larger spread favors IRAs whereas a lesser spread narrows the differences.

5.5 Age-Weighted Profit Sharing Plans

Traditional profit sharing plans allocate the employer contribution solely on the basis of each eligible participant's compensation. An age-weighted profit sharing plan also takes into account the age of the participants. Defined benefit and target benefit pension plans consider both the age and compensation levels of participants in determining the benefits or contributions provided on behalf of participants. Pension plans are subject, however, to the minimum funding standards imposed by IRC Sec. 412. Defined benefit pension plans may also be subject to Title IV of ERISA, including both the requirement to pay annual premiums and liability for underfunding on plan termination. In contrast, a profit sharing plan is not subject to either annual or termination funding obligations. Contributions can be completely discretionary from year to year.

5.5.1 Plan design contribution comparisons

Set forth below is a comparative analysis of the allocation of contributions under various common profit sharing plan designs. In each instance, an assumption is made that a maximum contribution of $30,000 is made on behalf of the most highly paid employee. The plans illustrated incorporate the following design features:

1. 15% nonintegrated allocation
2. 13.5% nonintegrated allocation
3. Integrated allocation using 9.17% of total compensation and 5.7% of compensation in excess of the Social Security wage base of $53,400
4. Integrated allocation using 5.7% of total compensation and 5.7% of excess compensation plus an IRC Sec. 401(k) plan with a 1.75% employer contribution and 1.75% employee salary reduction contribution
5. An age-weighted allocation

The allocation results are relatively constant at the upper compensation levels but the amounts contributed on behalf of lower-paid employees vary greatly depending on the plan design. Below is a comparative analysis.

Employee	Compensation	A 15%	B 13.5%	C 9.17% × 5.7% Excess
A	222,220	30,000	30,000	20,378 + 9,622 = 30,000
B	200,000	30,000	27,000	18,340 + 8,356 = 26,696
C	100,000	15,000	13,500	9,170 + 2,656 = 11,826
D	50,000	7,500	6,750	4,585 + 0 = 4,585
E	20,000	3,000	2,700	1,834 + 0 = 1,834
		85,000	79,950	74,941

	D 5.7% + 5.7% Excess + 1.75% + 1.75% K
A	12,666 + 9,622 = 22,288 + 3,888 + 3,824 = 30,000
B	11,400 + 8,356 = 19,756 + 3,500 + 3,500 = 26,756
C	5,700 + 2,656 = 8,356 + 1,750 + 1,750 = 11,856
D	2,850 + 0 = 2,850 + 875 + 0 = 3,725
E	1,140 + 0 = 1,140 + 350 + 0 = 1,490
	73,827

E

	Age	1%	Factor		Age-Weighted*		
A	50	2222	28.05591	=	62,340	=	30,000
B	50	2000	28.05591	=	56,111	=	27,002
C	40	1000	12.40872	=	12,408	=	5,971
D	35	500	8.252364	=	4,126	=	1,986
E	25	200	3.649900	=	730	=	351
					135,715		65,310*

*To calculate the age-weighted allocation it is necessary to multiply 1% of compensation by the age factor from an actuarial table (such as shown in Exhibit 6). Each participant's allocation is determined by dividing his or her own age-weighted factor by the total factors and multiplying the result by the total employer contribution. In this case, the total employer contribution of $65,310 is forced by reference to the $30,000 statutory maximum for employee A.

$$62{,}340 \div 135{,}715 = .4593449X = 30{,}000$$
$$X = 65{,}310$$

Exhibit 6 Age Factors for Age-Weighted Allocation

Age	*Age Factor*	*Age*	*Age Factor*	*Age*	*Age Factor*
15	1.614297	46	20.24442	77	59.34581
16	1.751512	47	21.96520	78	57.08672
17	1.900391	48	23.83224	79	54.84224
18	2.061924	49	25.85798	80	52.62250
19	2.237188	50	28.05591	81	50.43987
20	2.427349	51	30.44066	82	48.29247
21	2.633674	52	33.02812	83	46.17331
22	2.857536	53	35.83551	84	44.07292
23	3.100427	54	38.88153	85	41.99562
24	3.363963	55	42.18646	86	39.94595
25	3.649900	56	45.77231	87	37.92859
26	3.960141	57	49.66296	88	35.94694
27	4.296753	58	53.88431	89	34.00605
28	4.661977	59	58.46448	90	32.11146
29	5.058246	60	63.43396	91	30.27001
30	5.488196	61	68.82584	92	28.49030
31	5.954693	62	74.67604	93	26.75803
32	6.460842	63	81.02350	94	25.07647
33	7.010014	64	87.91050	95	23.44946
34	7.605865	65	85.86543	96	21.88216
35	8.252364	66	83.80303	97	20.38254
36	8.953814	67	81.72069	98	18.93576
37	9.714889	68	79.60708	99	17.54320
38	10.54065	69	77.45125	100	16.20714
39	11.43661	70	75.25621	101	14.93106
40	12.40872	71	73.02548	102	13.72354
41	13.46346	72	70.76282	103	12.56819
42	14.60785	73	68.48186	104	11.46448
43	15.84952	74	66.19006	105	10.41234
44	17.19673	75	63.89627	106	9.411216
45	18.65845	76	61.61073	107	8.462682

Preretirement interest: 8.50%; postretirement interest: 8.50%; mortality: UP1984; NRA: age 65 or 1 year.

5.6 IRS Alternatives to Plan Disqualification

Any operational defect in a qualified retirement plan technically can result in disqualification of the plan. Certain operational defects may be so minor that it is not productive for the IRS to pursue the sanction of disqualification. New IRS policies indicate the circumstances in which the IRS will accept alternatives to plan disqualification.

5.6.1 IRS policy revision

The IRS has indicated that certain operational violations of IRC Sec. 401(a) should not be pursued to the level of plan disqualification.* The guidelines indicate that an operational violation is a nondisqualifying event if *all* of the following criteria are satisfied:

1. The operational violation is an isolated insignificant instance.
2. The plan must have either a history of compliance both in form and operation, or, if the plan does not have a history of compliance, the violation was corrected before examination and there is no evidence of noncompliance in other areas.
3. The plan sponsor must have established practices and procedures to ensure compliance, including procedures involving the area in which the violation occurred.
4. Established procedures must have been followed, but through an oversight or mistake in applying the procedures, an operational violation occurred.
5. The dollar amounts involved are insubstantial in view of the total facts of the case.
6. The taxpayer must make an immediate and complete correction to cure the violation after discovery so that no participant or beneficiary suffers substantial detriment.

Failure to amend the plan timely for any change in the law (e.g., TEFRA, DEFRA, or REA) cannot be considered a nondisqualifying event. Similarly, violations of the exclusive benefit requirements are not considered administrative errors which can be corrected.

In the event of receiving notice of an IRS audit of the plan, a practitioner should promptly review the plan's operations prior to the audit in an effort to ascertain and correct any operational defects.

5.6.2 Employee plans closing agreements pilot program

The IRS has indicated that closing agreements may be considered as a possible alternative to revocation of a plan's qualified status in cases involving

1. Failure to timely amend a plan for TEFRA, DEFRA, and REA,
2. Improper allocation of an integration formula,

*Policy Regarding Sanctions—Revision of IRM 7(10)54—Employee Plans Examination Guidelines Handbook.

3. Partial termination, or
4. Operational-top-heavy violations.

Guidance to IRS agents indicates that closing agreements should not be considered in cases involving

1. Significant discrimination in favor of highly compensated employees,
2. Exclusive benefit violations resulting in diversion of trust assets, or
3. Repeated, deliberate, or flagrant violations.

If a closing agreement is appropriate, the IRS agent is directed to obtain retroactive and prospective correction of all plan defects, not just for prior years where the statute of limitations is open, and obtain agreement for a nondeductible payment to the Treasury in return for the plan not having its qualified status revoked.

The maximum payment amount is equal to the total tax resulting from the disallowance of the sponsor's deduction for contributions to the plan, the inclusion of trust income as taxable income, and the inclusion in participants' income of the appropriate shares of plan contributions. The stated objective in the guidelines is to obtain agreement for 100% of the maximum payment, but the agent is authorized to accept less based on the particular facts and circumstances.

Observation. If the maximum payment amount is assessed, there seems to be little advantage in consenting to the closing agreement.

5.7 Defined Benefit Pension Plans Actuarial Resolutions Program

Following its victory in *Jerome Mirza & Associates, Ltd.*, the IRS commenced a controversial nationwide audit of defined benefit pension plans with five or fewer participants who had normal retirement ages lower than sixty-five and interest assumptions of less than 8%. Approximately 12,000 audits are now pending. In an effort to resolve the audits without litigation, the IRS has proposed a program to concede the various penalties in exchange for a concession of the assessed taxes and interest.

In IRS Announcement 91-92, the IRS announced that it would enter into closing agreements with taxpayers whose defined benefit pension plans are under examination. Under the Actuarial Resolutions Program, the IRS will consider all pertinent information provided by the taxpayer and will propose an adjustment to the pension contribution. The taxpayer must agree to the adjustment.

Under the program, the IRS will not assess the following:

1. The 10% excise tax under IRC Sec. 4972 for nondeductible contributions

2. The 10%–30% addition to tax under IRC Sec. 6659A for significant underpayment of tax
3. The additions to tax under IRC Sec. 6641 for failure to file tax return and failure to pay
4. The addition to tax under IRC Sec. 6661 for substantial understatement of tax liability
5. The addition to tax under IRC Sec. 6662 involving the accuracy-related penalties
6. The asset reversion tax under IRC Sec. 4980

The program is most likely to be accepted by taxpayers who

— Have only modest amounts of tax in controversy,
— Can avoid or substantially reduce the asset reversion tax on plan termination by accepting disallowance of contribution deductions,
— Prefer to avoid examination of their entire return in exchange for disallowance of the pension deduction, or
— Are concerned about the uncertain consequences and costs of continuing to contest the matter.

Pending before the Tax Court for trial in early 1992 are eleven selected cases involving a cross-section of fact patterns. The IRS reportedly has postponed the trials because of an inability to obtain credible expert actuarial testimony that the practices employed are improper. Two cases involve nationally known major law firms with more than $13,000,000 at issue.

6. OTHER TAXES AND CREDITS

6.1 1991 Self-Employment Tax Calculation

Beginning January 1, 1991, there are two wage base levels for determining total Social Security tax. The base for Social Security retirement benefits (OASDI) is $53,400 and for Medicare (HI) $125,000. The 1991 tax rate of 15.3 percent consists of 12.4 percent for Social Security and 2.9 percent for Medicare. For self-employed individuals, the earned income subject to self-employment tax is reduced by half of the self-employment tax rates prior to computing the tax (IRC Sec. 1402(a)(12)).

6.1.1 Self-employment tax calculation in 1991

The following worksheet can be used to calculate the 1991 self-employment tax:

1. Income (loss) from self-employment:		
a. Schedule C	$____	
b. Schedule F	____	
c. Partnership earned income	____	
d. Other earned income	____	
2. Total self-employment income		$____
3. Multiply line 2 by .9235 (if result less than $400, not subject to self-employment tax—see Summary below)		$____

Step 1 (OASDI)

4. Maximum amount of earnings subject to OASDI tax is $53,400	$ 53,400
5. Total Social Security wages from box 12 of 1991 Form W-2	(____)
6. Subtract line 5 from line 4	____
7. Earnings subject to OASDI tax (lesser of line 6 or line 3)	$____
8. Tax Rate	× 12.4%
9. 1991 OASDI tax (line 7 × line 8)	$____

Step 2 (HI)

10. Maximum amount of earnings subject to HI tax is $125,000	$125,000
11. Total Medicare wages from box 14 of 1991 Form W-2	(____)
12. Subtract line 11 from line 10	____
13. Earnings subject to HI tax (lesser of line 12 or 3)	$____
14. Tax Rate	× 2.9%
15. 1991 HI tax (line 13 × line 14)	$____
16. Total 1991 self-employment tax (line 9 + line 15)	$____

6.1.2 Self-employment tax deduction for AGI

As in 1990, a deduction is allowed as an "adjustment to income" in the amount equal to half of the 1991 self-employment tax (IRC Sec. 164(f)).

6.1.3 Examples of self-employment tax calculations in 1991

1. Assuming self-employment income of $50,000 and no W-2 income:

Step 1

Self-employment income	$50,000	
Reduction rate	× .9235	
Earnings subject to OASDI tax	46,175	
OASDI rate	× 12.4%	
OASDI tax		$5,726

Step 2

Earnings subject to HI tax	46,175	
HI rate	× 2.9%	
HI tax		1,339
Total 1991 Self-employment tax		$7,065

(Memo: The income tax deduction in arriving at AGI would be half this amount, or $3,533).

2. Assuming self-employment income of $110,000 and no W-2 income:

Step 1

Self-employment income	$110,000	
Reduction rate	× .9235	
Earnings subject to SE tax calculation	$101,585	
Earnings subject to OASDI tax (maximum)	$ 53,400	
OASDI rate	× 12.4%	
OASDI tax		$6,622

Step 2

Earnings subject to HI tax	101,585	
HI rate	× 2.9%	
HI tax		2,946
Total 1991 Self-employment tax		$9,568

6.1.4 Observation

The 1991 proof of Form 1040 Schedule SE allows the 7.65% subtraction (accomplished via multiplying by the 92.35% reduction rate) to be applied to *all* earned income, not merely the lower $53,400 base exposed to the full rate. This appears to be consistent with the framework of IRC Sec. 1402(a)(12), which states that the deduction in computing self-employment tax is simply the self-employment net earnings multiplied by half the sum of the 12.4% OASDI and 2.9 HI rates. However, a more logical approach would be to limit the subtraction to 1.45% on the self-employment net earnings in excess of $53,400. If this occurred in Example 2 above, the total self-employment tax on $110,000 would be $9,766, an increase of $198 over the amount required per the 1991 proof of Schedule SE.

The pending Technical Corrections Bill of 1991 (H.R. 1555) does not address this issue.

6.1.5 Summary

The maximum self-employment tax for self-employed individuals in 1991 is $10,247, which consists of $6,622 for OASDI and $3,625 for HI.

Maximum 1991 self-employment income before any self-employment tax applies:

1. A self-employed individual can have up to $433 of self-employment income in 1991 without incurring any self-employment tax ($400 ÷ .9235 = $433).
2. Refer to Section F for the proof of the 1991 Schedule SE.

For planning and quick calculation purposes, the following effective tax rates can be used.

1. **OASDI (Social Security tax)**
   11.45% (12.4 × .9235) on maximum earnings of $57,825 ($53,400 ÷ .9235)
2. **HI (Medicare tax)**
   2.68% (2.9 × .9235) on maximum earnings of $135,350 ($125,000 ÷ .9235)

6.2 Techniques to Minimize Self-Employment Tax: Creation of a New Entity

As the self-employment tax rates and base continue to rise, an increasing percentage of a tax planner's time and creativity is spent on minimizing self-employment taxes as opposed to income taxes. The Tax Reform

Act of 1986 has curtailed many income tax planning moves but does little to prevent the knowledgeable tax planner from devising strategies to minimize self-employment taxes. The creation of a new entity (such as a partnership, S corporation, or trust) is becoming an increasingly common technique to minimize self-employment taxes.

However, while separate entities such as corporations, trusts, and partnerships might result in Social Security tax savings, care must be exercised in establishing supportable arms-length arrangements between owners and the entity.

6.2.1 Partnerships

Normally a partnership is ineffective in saving self-employment taxes. The activity or lack thereof of the individual partner does not affect the determination of whether the partnership produces self-employment income. If the partnership operates a trade or business, any net income is self-employment income and each partner reports his or her share of the income as self-employment income. IRC Sec. 1402(a) provides exceptions for rental activity, ministers, etc. A commonly applied practical test is this: If an individual operated the same trade or business as the partnership and the income was self-employment income, then the partnership income is self-employment income and each partner is allocated his or her share. Self-employment taxes apply to all income whether distributed or not (IRC Sec. 1402(a)).

When a partner performs services for, or advances capital to, a partnership within his or her capacity as a partner and the payment for such is determined without regard to partnership income, the payment is a guaranteed payment. Guaranteed payments are subject to self-employment tax if the partnership is conducting a trade or business (IRC Sec. 707(c)). Trade or business is basically defined per IRC Sec. 162 (note that this *includes a rental activity* since the exceptions of IRC Sec. 1402(a) do not apply to guaranteed payments).

Tax Trap. A guaranteed payment is includible for self-employment tax purposes if the partnership engages in a trade or business. Since a real estate investment partnership is technically engaged in a trade or business, the payment of a guaranteed payment to a general partner may create self-employment tax even though the receipt of a distributive share of the partnership profits would not under IRC Sec. 1402(a).

The only ability to save self-employment taxes with a partnership appears to be related to IRC Sec. 707(a). If a partner engages in a transaction with a partnership other than in the capacity as a member of such partnership, the transaction is considered as occurring between the partnership and one who is not a partner (IRC Sec. 707(a)). Guaranteed payments apply only to payments for services or for the "use of capital." Rental payments for the use of property do not fall under the phrase "use of capital," but instead would be subject to IRC Sec. 707(a), where the partner is dealing in a transaction with a partnership other than in his or her capacity as a partner.

For example, where two construction companies formed a partnership and the partnership agreement called for differing amounts of rentals due to each partner for the lease of specific equipment, the court determined that payments by the partnership were deductible rents rather than distributions of profits (*Shirley v. O'Malley*, 50-1 USTC 9336, DC-Ne. CV No. 108-49 6/5/50). Further, Reg. 1.707-1(a) states that "where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes, the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner."

Thus, when a partner acts as a landlord, it appears that the partner may receive payments of rent from the partnership without having those payments subjected to self-employment tax.

Example. Joe Farmer operates a farming operation with his son. He has retained his 200 acres of farmland outside of the partnership. The partnership rents the real estate from Joe at $100 per acre plus real estate taxes. Joe Farmer has no debt associated with the real estate. If Joe transfers the real estate into the partnership, his capital interest and share of profits will be greater. All partnership net profits will be subjected to self-employment tax. By retaining the land outside the partnership, Joe Farmer can take advantage of IRC Sec. 707(a) and convert $20,000 of income from self-employment income to rental income. (CAUTION: Joe will likely not be able to treat this rental income as passive income for purposes of IRC Sec. 469. Reg. 1.469-2T(f)(6) treats net rental income as business income if it is leased to a partnership or an S corporation in which the lessor materially participates.)

6.2.2 Subchapter S corporations

The FICA tax on an S corporation employee/shareholder is levied only on the amount of actual wages and salaries drawn from the corporation. IRC Sec. 1402 does not extend to undistributed (or distributed) income as it would in the partnership format. S corporation income and loss items flow through to the shareholder for purposes of determining tax under Chapter 1 of the Code (IRC Sec. 1366(a)(1)). The character of these items is retained at the shareholder level under IRC Sec. 1366(b), but only for purposes of Chapter 1. The self-employment tax of IRC Sec. 1402 is categorized under Chapter 2 of the Code.

However, the IRS has shown increased scrutiny of unreasonably low salaries to S shareholders, imposing payroll taxes and corresponding penalties and interest (Rev. Rul. 74-44, 1974-1 CB 287; *Radtke S.C.*, 89-2 USTC 9466 CA-7, 1990; *Spicer Accounting Inc.*, No. 89-35071, CA-9, 1990; *Fred R. Esser, P.C.*, No. 89-973, DC Az. 1990). Further, by creating corporate salaries to owners, federal and state unemployment taxes are incurred. Finally, possible detrimental impact on Social Security disability and retirement benefits must be considered.

6.2.3 Trusts

Income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust. (Reg. 1.1402(a)-2). Currently, trusts are not commonly used as vehicles to save self-employment taxes, but seemingly could have most of the same advantages/disadvantages of the S corporation while minimizing legal and accounting costs (e.g., no balance sheet required on tax return).

The Eighth Circuit has ruled that business trusts lacked the economic substance necessary for recognition as separate entities under IRC Sec. 1401. Since there had been no real change in the taxpayer's economic relationship to his former partnership and proprietorship businesses as a result of the creation of the trusts, it was considered that the trusts were merely a sham to avoid payment of the self-employment tax (*Chase*, No. 90-2097, CA-8, 2/22/91). Trustees appointed were "dummy" corporations whose officers and directors did not perform any duties for the trusts but merely signed blank pieces of paper that were later filled in by the business managers (grantors of the trusts). The business managers did not receive any compensation from the trusts. The only remuneration the managers received from the trusts was in the form of distributions for their beneficial interests reported on Schedule E of their returns.

Future litigation may be necessary to clarify whether the trust "veil" for self-employment tax purpose is now in jeopardy or whether a more formal and substantive relationship between business managers and their established trusts will create a legitimate separate entity (e.g., reasonable salaries trustee with authority).

6.3 Corporate AMT and the Minimum Tax Credit Carryover

In 1991, final regulations were issued to provide guidance on the adjusted current earnings (ACE) adjustment for corporate AMT, and regulations were proposed to allow a special election to simplify computation of the LIFO inventory adjustment for ACE. The IRS has also revised corporate AMT tax forms for 1991. Illustrations covering multiyear AMT from corporate installment sales and depreciation are provided.

6.3.1 Final regulations

The final guidance on corporate AMT adjusted current earnings (ACE) is contained in Reg. 1.56(g)-1 (T.D. 8340 of 3/14/91). The ACE proposed regulations at 1.56(g)-1 were originally issued on May 30, 1990, and contained a detailed analysis of the increases and decreases required in making the corporate ACE calculation. The final regulations are generally the same as the proposed regulations, with only minor modifications. These clarifications include the following:

— Refunds of federal income taxes are not included in ACE (Reg. 1.56(g)-1(c)(4)(ii)).

— Lessee improvements to leasehold property that are excluded from the lessor's gross income under IRC Sec. 109 do not increase ACE; similarly, nonshareholder capital contributions to a corporation excluded from income under IRC Sec. 118 do not increase ACE (Reg. 1.56(g)-1(c)(7)).

— If the ACE basis in a life insurance contract exceeds the death benefits received or the proceeds upon surrender of the contract, the resulting loss is allowed as a deduction in computing ACE (Reg. 1.56(g)-1(c)(5)(i)).

— The preamble to the regulations suggests that the IRS will consider making the treatment of new ACE items effective prospectively, and that published guidance regarding additional items subject to ACE may appear other than in regulations.

For 1991, the IRS has expanded Form 4626 to add an ACE Adjustment Worksheet. This form closely follows the ACE increases and decreases specified in Reg. 1.56(g)-1, and, in fact, on several lines refers to the regulations for lists of potential ACE increase items. Because of the extensive list of potential ACE adjustments, as well as the traditional AMT preferences and adjustments, the preparation of every regular corporate income tax return should include a detailed test of the application of AMT. Further, because ACE represents a separate tax system, it is necessary to maintain ACE depreciation schedules, ACE carryforward basis schedules for corporate-owned whole-life insurance contracts, and other such carryforward items that might apply to the particular transactions of the corporation.

6.3.2 Proposed regulations: LIFO inventory adjustment

ACE is increased or decreased by the increase or decrease in the LIFO recapture amount (defined as the excess of the inventory amount under the FIFO method over the inventory amount under the LIFO method) (IRC Sec. 56(g)(4)(D) and Prop. Reg. 1.56(g)-1(f)(3)). However, there is no decrease in ACE to the extent the ACE LIFO reserve recapture amount decreases below the amount on the last day of the last tax year beginning before January 1, 1990, and similarly ACE is increased by increases in the ACE LIFO reserve recapture amount only to the extent of increases above the ACE LIFO reserve recapture amount on the last day of the last tax year beginning before January 1, 1990.

To complicate matters further, Reg. 1.56(g)-1(a)(5) requires taxpayers to compute their inventories for ACE purposes by taking into account ACE adjustments (for example, ACE depreciation must be used to capitalize for IRC Sec. 263A purposes, thus leading to a separate ACE LIFO reserve distinct from the regular tax LIFO reserve).

Example. The LIFO baseline freeze is illustrated by a calendar year corporation using the LIFO method, which makes the proper ACE adjustments in determining the following year-end inventory amounts:

Year-End Inventory	*1989*	*1990*	*1991*
FIFO	$500	$360	$560
LIFO	300	180	320
LIFO recapture amount	$200	$180	$240
ACE increase		$-0-	$ 40

The corporation has no ACE decrease for 1990 because its LIFO recapture amount decreased below the $200 baseline amount. In 1991, the ACE increase is $40, limited to the amount of the LIFO recapture amount in excess of the $200 baseline.

Election to use regular inventories for AMT (Prop. Reg. 1.56(g)-1(r)). Taxpayers may elect to use their regular tax inventory amounts in computing AMTI and ACE, including the LIFO inventory adjustment. This election eliminates the need to compute a separate inventory amount for purposes of ACE, and to maintain a separate ACE LIFO reserve. As a consequence of the election, however, all ACE and AMT adjustments for the year are directly recorded in calculating AMT; adjustments or preferences that would have been capitalized in ending ACE inventory are ignored, potentially leading to an accelerated AMT income in a year in which ending inventory amounts increase.

Manner of making election. A *prospective* election is allowed where the taxpayer has never separately calculated AMT or ACE adjustments into its ACE LIFO reserve, or when the taxpayer has never filed a federal income tax return on which the election could apply. A statement electing the simplified method must be attached to the original return, filed in a timely manner, for the first tax year ending after the date on which this regulation becomes final. A *retroactive* election via an amended return (due within 180 days after the regulation becomes final) must be made by taxpayers who have not historically used the simplified method. The amended return is to be filed for the earliest post-1986 open year, and the entire IRC Sec. 481 adjustment is included in amended AMT income.

For most corporate taxpayers using LIFO, the simplified method election represents an attractive choice. However, for those with substantial AMT and ACE depreciation adjustments that are capitalized to inventory, the election may serve to accelerate AMT.

6.3.3 Other changes

Where a taxpayer claims an alternative energy preference deduction, it must reduce the basis for ACE purposes where appropriate to prevent a double deduction or benefit (e.g., where a portion of the alternative tax energy preference deduction is attributable to depletion, the taxpayer must reduce basis for purposes of computing ACE depletion in subsequent tax years) (Prop. Reg. 1.56(g)-1(s)).

Foreign corporations are subject to ACE only with respect to items that are treated as connected with the conduct of a U.S. business (Prop. Reg. 1.56(g)-1(m)).

6.3.4 New forms and illustrated calculations

Form 4626 now contains an Adjusted Current Earnings Adjustment Worksheet, to allow calculation of the 75% ACE adjustment.

Form 8827 replaces Form 8801 for corporate taxpayers, and is used to determine the credit for prior-year minimum tax. Note that per amendment to IRC Sec. 53(d)(1)(B)(iv), corporations are allowed full carryover of AMT as a minimum tax credit, effective for tax years beginning after 1989. Corporate AMT arising in 1990 tax years and after no longer requires recomputation to remove exclusion preferences in calculating the minimum tax credit carryover.

Prior-year minimum tax credits. In its 1990 Form 1120, Ace Supply Co. incurred alternative minimum tax of $8,000 (tentative minimum tax of $48,000 less regular tax after credits of $40,000).

In calculating its 1991 tax liability, Ace Supply determines that its regular tax after credits is $56,000. Fortunately, the corporation finds that its 1991 tentative minimum tax (per line 14 of 1991 Form 4626) is only $50,000, meaning that the AMT will not apply for 1991.

Form 8827 (Exhibit 7) is used to calculate Ace Supply's 1991 minimum tax credit for prior AMT. Per IRC Sec. 53(c), the use of a minimum tax credit carryover is limited to the extent that current regular tax exceeds current tentative minimum tax. Ace Supply will use $6,000 of credit in 1991; the remaining $2,000 carries forward.

Exhibit 7 Form 8827

Form **8827**

Department of the Treasury
Internal Revenue Service

Credit For Prior Year Minimum Tax—Corporations

▶ Attach to corporation's tax return.

OMB No 1545-XXXX

1991

Name: ACE SUPPLY CO.

Employer identification number: 42-1234567

Minimum Tax Credit for 1991

1	**Alternative minimum tax for 1990.** Enter the amount from line 15 of 1990 Form 4626 . . .	1	8,000
2	**Carryforward of minimum tax credit from 1990.** Enter the amount from line 26 of 1990 Form 8801 . . .	2	—
3	Enter any 1990 unallowed credit for fuel produced from a nonconventional source. Also include any 1990 unallowed orphan drug credit. See instructions . . .	3	—
4	Add lines 1, 2, and 3 . . .	4	8,000
5	Enter the corporation's 1991 regular income tax liability minus allowable tax credits. See instructions . . .	5	56,000
6	Enter the amount from line 14 of 1991 Form 4626 . . .	6	50,000
7	Subtract line 6 from line 5. If zero or less, enter -0- . . .	7	6,000
8	**Minimum tax credit.** Enter the **smaller** of line 4 or line 7. Also enter this amount on the appropriate line of the corporation's 1991 tax return. See instructions . . .	8	6,000

Carryforward to 1992

9	**Minimum tax carryforward to 1992.** Subtract line 8 from line 4. See instructions . . .	9	2,000

Installment sale illustration. In general, ACE is computed without regard to the installment method (Reg. 1.56(g)-1(f)(4)), except as provided below:

1. For any sale originating in a tax year beginning before January 1, 1990, the installment method applies in computing ACE to the same extent that it applies in determining AMTI.
2. The installment method is available for ACE if the installment receivable is one on which interest is payable on the deferred tax under IRC Sec. 453A(a)(1). However, the installment method is not available for ACE with respect to income allocable to the first $5 million of realty installment receivables arising in a post-1989 year which are not subject to the payment of interest. To the extent that a contract subject to the payment of interest is partially ineligible for the installment method under ACE, the regulations provide guidance on the allocation of the gain for these adjustments.

Example. Corporation XYZ has regular federal taxable income of $100,000, without considering an IRC Sec. 1231 gain on a 1991 installment sale. The sale has a total gain of $150,000 and a gross profit ratio of 75%. $25,000 of cash will be collected in 1991, $50,000 is to be collected in 1992 and 1993, and $75,000 is to be collected in 1994. There are no other AMT adjustments or tax preferences. The 1991 regular taxable income is $118,750 ($100,000 + [$25,000 × 75% gross profit ratio]).

1991 AMT Calculation:

Taxable income		$118,750
Adjustments and preferences		—
Preadjustment AMTI		118,750
1991 ACE ($100,000 + $150,000 sale gain)	$250,000	
Less preadjustment AMTI	(118,750)	
Difference	131,250	
ACE adjustment rate	× 75%	98,438
AMTI		217,188
Exclusion (subject to phase-out)		(23,203)
AMTI less exclusion		193,985
AMT rate		× 20%
Tentative minimum tax		38,797
Regular tax		(29,563)
Alternative minimum tax		$ 9,234

The 1991 AMT is a result of the ACE adjustment on the deferred gain of the installment sale of $131,250 ($150,000 total gain − $18,750 reported in 1991 for regular tax).

1991 AMT Calculation (assuming $100,000 of taxable income before the gain on the $50,000 installment sale collection):

Regular taxable income ($100,000 + [$50,000 × 75%] or $37,500)		$137,500
Adjustments & preferences		—
Preadjustment AMTI		137,500
1991 ACE	$100,000	
Less preadjustment AMTI	(137,500)	
Difference	(37,500)	
ACE adjustment rate	× 75%	(28,125)
AMTI		109,375
Exclusion		(40,000)
AMTI less exclusion		69,375
AMT rate		× 20%
Tentative minimum tax		13,875
Regular tax		(36,875)
1992 alternative minimum tax		$ —

1992 Credit for Prior-Year Minimum Tax:

1991 AMT	9,234
Limitation:	
1992 regular tax liability	36,875
Tentative minimum tax	(13,875)
1992 regular tax less tentative minimum tax	23,000
Minimum tax credit for 1991	$ 9,234

Summary. In this example, the corporation experienced an acceleration of tax as a result of the 1991 installment sale for a period of one year. The corporation could have eliminated the AMT by electing out of the installment method for regular tax purposes in 1991. However, the 1991 regular tax would have been $80,750, rather than its tax of $38,797 under the installment sale method. If taxable income remained steady at $100,000 before the installment sale, the total tax for years 1991 through 1994 would be the same under both methods. However, with an election out of the installment method, a larger regular tax is accelerated into 1991. Given the income and tax brackets involved in this example, it is still more advantageous to use the installment sale method even though AMT and ACE will apply.

Depreciation illustration. A corporate taxpayer must calculate depreciation for regular tax, AMT and ACE. If AMT occurs, the minimum tax credit can provide relief, or alternate depreciation choices can be considered.

Corporation A has a consistent net taxable income before depreciation of $110,000. The only depreciation is on $400,000 of seven-year-class assets purchased on June 1, 1991. No additional assets are purchased in future years. The corporation has no other AMT preferences or adjustments.

Depreciation calculations on $400,000 of seven-year-class assets purchased June 1, 1991, with an ADR midpoint of 10 years:

Depr. Method	*1991*	*1992*	*1993*	*1994*	*1995*
MACRS (DDB, 7 yr.)	$57,160	$97,960	$69,960	$49,960	$35,720
AMT (1.5DB, 10 yr.)	30,000	55,520	47,160	40,080	34,960
ACE (SL, 10 yr.)	20,000	40,000	40,000	40,000	40,000

Calculation of alternative minimum tax.

(1) 1991 Form 4626		
Line 1. Taxable income ($110,000 − $57,160)		$52,840
Line 2a. Depreciation adjustment ($57,160 − $30,000)		27,160
Line 4. Pre-adjustment AMTI		80,000
Line 5. ACE adjustment:		
AMT depreciation	$30,000	
Less ACE depreciation	(20,000)	
Excess ACE	10,000	
Excess × 75%		7,500
Line 9. AMT income		87,500
Line 10c. Exemption		(40,000)
Line 11.		47,500
Line 12. Line 11 × 20%		9,500
Line 15. Regular tax liability		(8,210)
Line 16. Alternative minimum tax		$ 1,290

(2) 1992 Form 4626

Line 4. Pre-adjustment AMTI ($110,000 – $55,520)		$54,480
Line 5. ACE adjustment:		
AMT depreciation	$55,520	
Less ACE depreciation	(40,000)	
Excess ACE	15,520	
Excess × 75%		11,640
Line 9. AMT income		66,120
Line 10c. Exemption		(40,000)
Line 11.		26,120
Line 12. Line 11 × 20%		5,224
Line 15. Regular tax liability		(1,806)
Line 16. Alternative minimum tax		$ 3,418

(3) 1993 Form 4626

Line 9. Alternative minimum taxable income	$68,210
Line 10c. Exemption	(40,000)
Line 11.	28,210
Line 12. Line 11 × 20%	5,642
Line 15. Regular tax liability	6,006
Line 16. Alternative minimum tax	$ –0–

Calculation of the credit for prior-year minimum tax:

(1) 1992 Form 8827

Line 4. 1991 AMT	$ 1,290
Line 5. 1992 Regular tax liability	1,806
Line 6. From Line 12, 1992 Form 4626 AMT	5,224
Line 7. Line 5 – Line 6	—
Line 8. Minimum tax credit (lesser of Lines 4 or 7)	—
Line 9. Credit carryover (Line 4 – Line 8)	1,290

(2) 1993 Form 8827

Line 4. 1991 & 1992 AMT	$ 4,708
Line 5. 1993 Regular tax liability	6,006
Line 6. From Line 12, 1993 Form 4626 AMT	5,642
Line 7. Line 5 − Line 6	364
Line 8. Minimum tax credit (lesser of Lines 4 or 7)	364
Line 9. Credit carryover (Line 4 − Line 8)	4,344

(3) 1994 Form 8827

Line 4. 1991 & 1992 AMT carryover	$ 4,344
Line 5. 1994 Regular tax liability	10,010
Line 6. Line 12, 1994 Form 4626 AMT	5,996
Line 7. Line 5 − Line 6	4,014
Line 8. Minimum tax credit (lesser of Line 4 or Line 7)	4,014
Line 9. Credit carryover (Line 4 − Line 8)	330

Summary. Continuing these same facts, the $4,708 of alternative minimum tax incurred in 1991 and 1992 should be recovered by 1995. The total federal tax liability, including AMT, for Corporation A for years 1991 through 1995 is as follows:

1991	$ 9,500
1992	5,224
1993	5,642
1994	5,996
1995	13,240
Total	$39,602

If Corporation A had elected to use the alternative 1.5 DB depreciation method, AMT would not have applied. The total federal tax liability for the years 1991 through 1995 would have been the following:

1991	$15,450
1992	8,620
1993	10,710
1994	12,480
1995	13,764
Total	$61,024

If the facts remain the same ($110,000 of income before depreciation), the total federal tax for years 1991 through 2001, using the regular tax method and incurring AMT, is about $165,000. Total federal tax for the same period using the alternative depreciation method, which avoids AMT, is about $150,000. However, the accelerated depreciation method tax cost, even with AMT, is significantly lower in the early years, and only becomes higher in the last three years when seven-year MACRS depreciation has ended for regular tax. Applying an 8% net present value, the discounted ten-year tax cost is only about $2,000 higher when AMT is incurred with accelerated depreciation. Because of the significant deferral of income to later years under this MACRS/AMT approach, the taxpayer may prefer this choice if there are prospects for new deductions (i.e., replacement depreciation) in those later years.

6.4 Low-Income Housing Credit: Carryover of Excess Credit

Generally, excess tax credits can be carried back three years and forward fifteen years. Low-income housing credits flowing to a taxpayer from a passive activity are subject to special treatment in determining if they can be carried back or must be carried forward.

6.4.1 Eligibility for carryforward

Determination must first be made as to whether any of the credit from the passive activity may be used in the current year (IRC Sec. 469). In general, credits from passive activities are limited to the tax attributable to the passive activity (IRC Sec. 469(d)(2)). The following exceptions exist:

1. A "closely held" C corporation is not subject to this limitation (IRC Sec. 469(e)(2)(A) and (B)).
2. A natural person who actively participates in a rental real estate activity may use credits up to a deduction equivalent of $25,000 (IRC Sec. 469(i)(1)).
   — The deduction equivalent of credits is determined by calculating the reduction in tax if the $25,000 would have been allowed as a deduction (e.g., $25,000 × 31% = $7,750) (IRC Sec. 469(j)(5)).
   — In the case of rental real estate, the $25,000 deduction equivalent is phased out by 50% of the amount of the taxpayer's adjusted gross income that exceeds $100,000.

Other, special exceptions to these general rules apply for low-income housing credits. The $25,000 deduction equivalent credit is allowed regardless of whether the taxpayer actively participates in the activity (IRC Sec. 469(i)(6)(B)). Special rules apply for phase-out of the $25,000 deduction equivalent. The $25,000 deduction equivalent is phased out by 50% of AGI in excess of $200,000, rather than the

$100,000 level which applies for passive rental real estate activities (IRC Sec. 469(i)(3)(B)).

Example:

Facts:

— Credit: $7,750 from pre-January 1, 1990, project passed through in 1991

— AGI: $230,000

Computation:

Deduction equivalent amount		$ 25,000
AGI	$230,000	
Phase-out begins at	(200,000)	
Excess	$ 30,000	
Phase-out rate	× 50%	
Phase-out amount		$(15,000)
Balance of deduction equivalent remaining for 1991		$ 10,000
Tax rate		× 31%
Credit available for use in 1991		$ 3,100

Carryover: The balance of $4,650 ($7,750 − $3,100) would be available for carryover.

Post-December 31, 1989, property: The AGI phase-out is eliminated for property placed in service in taxable years ending after December 31, 1989. In the case of a taxpayer who holds an interest in a pass-through entity, the interest in the pass-through entity must be acquired after December 31, 1989, to avoid the phase-out (1989 Act. Sec. 7109, amending IRC Sec. 469(i)). CAUTION: Although the use of low-income housing *credits* up to the $25,000 deduction equivalent no longer phases out at higher AGI levels, any *loss* pass-throughs from low-income rental housing properties are subject to phase-out as AGI exceeds $100,000.

Ordering rules. The $25,000 deduction equivalent amount is applied in the following order:

1. The passive activity loss
2. The portion of the passive activity credit not attributable to either the low-income housing credit or the rehabilitation investment credit
3. The portion of the credit attributable to the rehabilitation investment credit
4. The portion of the credit attributable to the low-income housing credit.

Example:

Facts:

—Credit (pre-January 1, 1990, property)	$ 7,750
—Rental loss	10,000
—AGI (1991)	230,000

Computation:

Deduction equivalent	$ 25,000
Less: amount used for rental loss (fully phased out)	-0-
Balance	$ 25,000
Less $200,000 AGI phase-out	(15,000)
Balance	$ 10,000
Credit equivalent rate	× 31%
Low-income housing credit allowed	$ 3,100

6.4.2 Credit carryforward limits summary

Low-income housing credits can become a carryforward under the passive limits in the following instances:

1. The current-year low-income housing credit exceeds the $25,000 deduction equivalent.
2. The current $25,000 allowance has been consumed by passive rental losses, thus deferring all current low-income housing credits.
3. The property is a pre-1990 acquisition and AGI exceeds $200,000, causing phase-out of the $25,000 deduction equivalent.
4. *Note*: All of the above illustrations assume that the taxpayer does not have tax attributable to other positive passive income that could offset passive low-income housing credits.

6.4.3 Credit carryforward under passive activity limits

Low-income housing credits in excess of the passive activity limitations discussed above can be carried forward indefinitely but cannot be carried back (IRC Sec. 469(b)).

For example, Marilyn invested in a low-income housing limited partnership in 1989, receiving a credit allocation in 1991 of $2,000. Marilyn's 1991 AGI is $300,000. Since the credit is from a pre-January 1, 1990, activity, the AGI phase-out will disallow the use of any credit on Marilyn's 1991 tax return. Marilyn uses IRS Form 8582-CR, Passive Activity Credit Limitations, to calculate this limit. The credit cannot be carried back but rather must be carried forward because the credit was disallowed because of passive activity limitations.

IRC Sec. 469(g) allows the deduction of suspended *losses* upon a fully taxable disposition, but does not allow the claiming of credits. Instead, IRC Sec. 469(j)(9) allows an election to increase the basis of a passive property upon disposition (for purposes of computing gain or loss from disposition) by the amount of unused credits that reduced the basis of the property for the year in which the credit arose. Because low-income housing credits do not reduce the basis of the property, it would appear that this election is not available.

6.4.4 General business credit limitations

If the passive activity limitations are overcome, the low-income housing credit is treated as a credit arising within the year. It is aggregated with other credits from nonpassive activities (e.g., general business credits), which are then subject to limitations based on the amount of tax.

IRC Sec. 38(c)(1) limits the amount of credits that may be used to the taxpayer's net income tax minus the greater of

— The tentative minimum tax for the year, or

— 25% of net regular tax liability in excess of $25,000.

If the credit is in excess of the current tax limitation discussed above, the excess is then treated as a credit arising in the current year and can be

— Carried back three years and carried forward fifteen years (IRC Sec. 38(c)(1)).

— Taxpayers may not carry back the credit to taxable years ending before 1987 (IRC Sec. 39(d)(4)). Note: IRC Sec. 39(d)(4) was repealed effective November 5, 1990, as current excess credits are no longer capable of reaching a pre-1987 tax year.

7. PROCEDURES AND PENALTIES

7.1 Invalid 1040 Extension and Its Consequences

The Internal Revenue Service will grant an automatic four-month extension for filing an individual income tax return. To obtain a valid extension, a reasonable and bona fide estimate of tax must be made. If a proper estimate is not made, late filing penalties will be assessed and a number of elections will be lost. The impact of these rules and the upcoming implementation of the new APEX (automated processing of extensions) system requires a careful review of the process of obtaining an extension to file.

7.1.1 Basic rules

An automatic four-month extension is allowed under Reg. 1.6081-4(a)(4) if three requirements are met:

1. A correctly completed Form 4868 is signed by taxpayer or authorized individual,
2. An extension is filed on or before the original due date of the return, and
3. Payment of *properly estimated* tax accompanies the application. (CAUTION: Application does not extend time for payment, only time for filing. The 90% safe harbor provision applies to the failure to pay penalty).

A general but careful estimate of tax due must be used. The taxpayer must make a bona fide, reasonable estimate based on information available at the time the request is filed. For cases on this issue (generally supportive of IRS denial of extension), see *Ottis B. Crocker*, 92 TC 899; *Joann Pflug*, 58 TCM 685; *Stewart Perry*, 59 TCM 533. The IRS reserves the right to terminate an extension if there is a failure to make a bona fide and reasonable estimate of tax liability (Reg. 1.6081-4(a)(4)).

7.1.2 Consequences of invalid extension

A failure-to-file penalty may be assessed that is an additional 5% of tax due for each month the return is late, not to exceed 25% (IRC Sec. 6651(a)(1)). The penalty may be waived if failure to file is due to a reasonable cause and not willful neglect. According to Reg. 301.6651-1(c)(3), reasonable cause is presumed to exist if the excess of the actual tax on the Form 1040 over the amount paid by the regular due date is no more than 10% of the actual tax (i.e., the amount paid with the Form 4868 brings the tax payments made by April 15 to 90% or more of the final tax liability).

Negligence or intentional disregard may also be imposed.

Loss of Keogh or SEP contribution deduction (must be contributed by the due date of the return, including *valid* extension date), and a 6%

overfunding excise penalty could be imposed for contributions to a plan after the filing due date. Normally, an extension for filing an income tax return also extends the post-year-end contribution deadline for qualified retirement plans, even if the extension is filed solely to defer the funding and the return is filed by the original due date (Rev. Rul. 66-144).

Numerous IRC elections may be lost if a timely return is not filed:

— Long-term contracts, using a simplified method to determine the degree of contract completion (IRC Sec. 460)

— Several uniform capitalization rule elections (IRC Sec. 263A)

— Recordation of commodity credit loans under income method (Reg. 1.77-1)

— Reduced basis in depreciable property from discharge of indebtedness (IRC Sec. 108(b)(5))

— Other basis adjustment elections from discharge of indebtedness (IRC Sec. 1017)

— Inclusion of unearned income of a child on parents' return (IRC Sec. 1(i))

— Use of 150% MACRS as well as other depreciation methods (IRC Sec. 168)

— Standard mileage rate (Rev. Proc. 89-66)

— Amortization of research expenditures (IRC Sec. 174)

— Amortization of start-up expenditures (IRC Sec. 195)

7.1.3 Sample calculation of consequences

Joe, a single sole proprietor, requested his accountant to file Form 4868 to extend his return. Joe was going on a cruise and would not have time to gather his tax information before leaving. Joe used a manual bookkeeping system and was usually several months behind in his recordkeeping. Joe advised his accountant that his net Schedule C was about the same as 1990 and that he would make his Keogh contribution when he returned.

Joe returned from his cruise in June and sent his accountant the tax data. Joe's accountant prepared the return and filed by June 15. Joe's accountant advised Joe that his actual net Schedule C in 1991 was about $30,000 higher than in 1990 and that the IRS might disallow his extension. Joe's accountant prepared an analysis if that scenario occurs:

	Valid	*Invalid*
Net Schedule C	$60,000	$60,000
Keogh contribution	(7,800)	—
1/2 SE tax	(4,100)	(4,100)
AGI	48,100	55,900
Itemized deductions	(10,000)	(10,000)
Personal exemptions	(2,150)	(2,150)
Taxable income	35,950	43,750
Tax	7,420	9,605
SE tax	8,200	8,200
Total tax	15,620	17,805
Estimates paid	(5,620)	(5,620)
Tax due	10,000	12,185
Failure to pay penalty	100	122
Interest	185	226
Failure to file penalty	—	1,219
Total due 6/15	$10,285	$13,752

Application of reasonable care in estimating the tax liability at the time of preparing an extension is extremely important. In fact, it may be advantageous to overestimate rather than underestimate. (*Tax pointer*: It can be advantageous to add the first quarter estimated tax payment to the payment accompanying the extension, to provide a cushion in the event the actual liability is higher. The Form 2210 penalties are not as severe as the late-filing and late-payment penalties.)

7.1.4 APEX system

The purpose of APEX is to eliminate Forms 4868 and 2688. Although APEX was to be implemented for the taxable year 1991, the IRS announced on August 16, 1991, that the system would *not* be implemented for 1991. A number of proposals and recommendations remain under review, for possible action in 1992.

7.2 Individual Estimated Tax for S Shareholders

Taxpayers who do not receive income evenly throughout the year may use the annualized income installment method to compute their estimated tax payments. When computing their quarterly estimates, how do shareholders take into account their distributive share of an S corporation's income or loss?

7.2.1 Former law

Shareholders took S corporation income and loss items into account in determining their estimated tax payments in the calendar quarter in which the S corporation's year ended. Rev. Rul. 81-144 held that a taxpayer's proportionate share of an S corporation's loss was to be determined only at the end of the corporation's year for purposes of applying the estimated tax penalty. Reasoning centered on the principle that former IRC Sec. 1374 provided for a taxpayer's deduction for S corporation losses only on the last day of the corporation's year.

Similarly, Rev. Rul. 62-202 concluded that a shareholder's proportionate share of undistributed taxable income was to be determined only once a year, at the end of the corporation's taxable year, for purposes of determining a shareholder's estimated tax penalty under IRC Sec. 6654. The IRS reached this conclusion because former IRC Sec. 1373 forced inclusion of a dividend in a shareholder's gross income, equal to undistributed taxable income, on the last day of the corporation's taxable year.

7.2.2 Current law

IRC Sec. 1366, as enacted by 1982 SSRA, provides that an S corporation is a pass-through entity. The committee report on PL 97-354 specifically noted that treatment similar to partnerships is to apply. In determining a partner's taxable income under the annualized income method for the months in the taxable year preceding the installment due date, a partner must include the distributive share of partnership items (Reg. 1.6654-2(d)(2)(i)). Only partnership income that will be included in the partner's current year return must be considered.

For example, assume that the taxable year of the partnership, in which calendar-year taxpayer B is a member, ends on June 30. B must take into account in determining his taxable income for purposes of the installment due on April 15, 19X2, the distributive share of partnership items for the period July 1, 19X1, through March 31, 19X2; for the installment due on June 15, 19X2, he must take into account such amounts for the period July 1, 19X1, through May 31, 19X2; and for the installments due on September 15, 19X2, and January 15, 19X3, he must take into account such amounts for the entire partnership taxable year of July 1, 19X1, through June 30, 19X2 (Reg. 1.6654-2(d)(2)(iii), Example (2)).

The Internal Revenue Code, regulations, and IRS rulings provide no direct guidance on this issue. However, it would appear that the principles of IRC Sec. 1366 would require an S corporation shareholder to prepare annualized estimated tax payments taking into account any distributive income from the S corporation on a quarter-by-quarter basis as is now required for partnerships.

Two 1985 private letter rulings indicate that a current pass-through approach is to apply, but do not address the specifics of whether the entire year's income is to be pro-rated back to each quarter, or whether actual income or loss of the S corporation is to be calculated for each pertinent quarterly period (LR 8542034 and LR 8544011).

IRS instructions within Publication 505, *Tax Withholding and Estimated Tax,* state that the annualized income method requires inclusion of the share of "S corporation income or loss items since the beginning of the tax year through the end of the payment period."

A 1986 private letter ruling indicates that a shareholder must take into account his pro rata share of an S corporation's actual taxable income for any S corporation year ending with or within his tax year to the extent that taxable income or loss was attributable to the months in the S corporation's tax year that ended on or before the due date of the payment period. The shareholder computes the amount of the S corporation's income or loss for a given period as if the S corporation's taxable year ended on the last day of the payment period (LR 8639008, 6/23/86).

Only S corporation income that will be included in the shareholder's current-year return must be considered.

An S corporation with a taxable year ending on August 31 has the following cumulative net income:

Sept. 1–March 31	$20,000
Sept. 1–May 31	$33,000
Sept. 1–August 31	$50,000

The above amounts must be considered in a shareholder's estimate payments due April 15, June 15, and September 15, respectively. Income from the corporation's year beginning September 1 of the current year does not have to be considered because it will not be included in the shareholder's taxable income until the following calendar tax year.

7.2.3 Conclusion

It is likely that a revenue ruling or procedure that will formally resolve the issue will be issued by the IRS. Until that time, taxpayers must recognize that the position indicated in Revenue Rulings 81-144 and 62-202 seems to contradict the current IRS opinion.

7.3 Constructive Receipt and Form 1099 Reporting

Generally, under the cash basis of accounting, an item is included in income in the year cash or its equivalent is received (Reg. 1.446-1(c)(1)(i)). The doctrine of constructive receipt takes exception to this rule, requiring income to be reported in the year it is constructively received, rather than in the year of actual possession. Situations where constructive receipt applies may cause Form 1099 matching discrepancies with the IRS.

7.3.1 Doctrine of constructive receipt (Reg. 1.451-2)

Income must be reported in the taxable year that the income is—

1. Credited to the recipient's account,
2. Set apart for the recipient,
3. Made available to the recipient so that it can be drawn upon at any time, or
4. Made available so that the recipient could have drawn upon it if notice had been given to the recipient (Reg. 1.451-2(a)).

Courts have ruled on constructive receipt cases on a "facts and circumstances" basis and have indicated that the doctrine of constructive receipt should be applied sparingly.

The constructive receipt doctrine may require income reporting prior to the time that payments are received. Normally, a cash basis recipient reports income in the year the cash is received. However, a recipient must report income prior to the year the payment is received if—

1. The payment is due to the recipient before the end of the year, and
2. The recipient could have received the payment before year-end (by physically picking up a payment or requesting that the payment be hand-delivered, not mailed).

Payment made by check may be conditional (Reg. 1.461-1(a)(1)):

1. Payment is considered made when a check is mailed or delivered, even though not honored by a bank until a later time.
2. The payor (and the recipient) should keep proof of the date mailed (or received).
3. The check must be dated in the current year in order to take a deduction. Post-dated checks to the following year require the deduction to be taken in the year the check is dated.
4. Although case law does not directly address the issue, it can be inferred that an overdrawn account does not prohibit the deduction

in the current year if sufficient funds are available when the check is presented at the bank (*Field*, 15 TCM 631, 1956).

7.3.2 Examples of constructive receipt

Joel Ryan leases his building to Brian Lee, requiring rental payments due the first of each month to Joel. Brian, the lessee, has been advised during year-end tax planning to lower his taxable income. On December 31, 1991, he issues a check to Joel for the January 1992 rent. Both individuals use the cash method of accounting.

— Brian is allowed to deduct the January 1992 rent payment in 1991 if the check is mailed or delivered to Joel by December 31, 1991.

— If the check is mailed and Joel does not receive it until 1992, the rent income is deferred until 1992.

— If Brian delivers the check to Joel by December 31, 1991, Joel must report the rent income in 1991, even if the check was delivered after the close of banking hours.

— Constructive receipt in 1991 may be implied if Brian offers to deliver the rent check to Joel but Joel suggests the check be mailed so that it is not received until 1992.

7.3.3 Wages and constructive receipt

Wages are also subject to the constructive receipt rules.

1. Cash-basis taxpayers report compensation in the tax year it is actually received.
2. However, compensation must be reported in the year it is constructively received, even though the actual receipt may not be until the following year.
3. Compensation is constructively received for the year it is credited to the taxpayer's account, set apart for the recipient, or otherwise made available to the recipient to draw upon (Reg. 1.451-2(a)). This rule has been held to cause taxation to a controlling stockholder-employee, where the corporation has authorized or accrued a bonus and has sufficient funds with which to make payment prior to year end (Rev. Rul. 72-317, 1972-1 CB 128; *Elmer Benes*, 42 TC 358, 1964).
4. Tips received by an employee are reportable in the year in which a written report of tips is furnished to the employer (IRC Sec. 451(c)). Presumably this is a rule of convenience, allowing a tipped employee to report amounts reflected on the employer's W-2 wage statement.
5. Payroll checks drawn in late December and delivered by mail in early January are income to the recipients in the earlier year if the checks could have been received in the earlier year by appearing in person to claim the checks (Rev. Rul. 68-126).

7.3.4 Substantial restriction

A "substantial restriction" placed on a check may prevent constructive receipt. If a recipient agrees to hold a check received and not cash it until after the first of the year, income is not realized by the recipient until the funds are under his or her control, free from any restrictions. In addition, the payor will not be allowed a deduction until any restrictions are lifted (*Fischer*, 14 TC No. 792, 802, 1950).

7.3.5 Form 1099 reporting requirements

Form 1099 reporting requirements can cause matching problems under the constructive receipt doctrine:

1. *Payor requirements*—Forms 1099-MISC, INT, & DIV must be issued to recipients in the year the payor makes payment.
2. *Recipient requirements*—Based on the recipient's method of accounting and the doctrine of constructive receipt, recipients should claim as income payments received. If the correct reportable income varies from the amount reported on a Form 1099, the recipient should report gross income per Form 1099 to avoid IRS matching problems. An adjustment should be made on the same tax schedule as the income was reported, to net to the correct amount of reportable income.

Example. Mary Smith owes interest to her mother, Laura Smith, which is due January 1 of each year. In 1991, Mary made an interest payment of $1,000 on January 1 and, for the following year, $800 on December 31. Mary mailed the check on December 31 to Laura, who lives 1,200 miles away. Mary issued a 1991 Form 1099-INT to Laura for $1,800.

Per Form 1099-INT, Laura should report on Schedule B the full amount of interest ($1,800). To net to the actual interest Laura received in 1991 of $1,000, a deduction should be claimed on Schedule B for $800, captioned "received and reported in 1992."

7.3.6 Conclusion

When payor and recipient intentionally act so as to accelerate deductions and defer income, careful attention needs to be given to the facts so that it can clearly be shown the recipient could not obtain the payment until after year-end. Further, any Form 1099 reporting discrepancies need to be reconciled to prevent IRS matching inquiries.

7.4 Unrelated Related Parties

The tax laws generally attempt to restrict tax planning opportunities with family members. Affected family members vary, depending on the particular statutory definition involved. Opportunities abound if a transaction can be structured with a family member who is not related for the particular definition.

The federal tax laws impose a variety of limitations on tax planning opportunities involving family members. For example, IRC Sec. 267 limits the ability to claim losses on sales to related family members; IRC Sec. 318 limits the ability to claim capital gains treatment on corporate redemptions when stock is held by related persons; and IRC Sec. 1563 limits the use of tax benefits of multiple corporations owned by related persons.

An understanding of who is or is not related for each of the relevant statutory provisions permits various planning opportunities. For example, a transaction with an adult child which has adverse tax consequences can invariably be structured successfully with the child's spouse. Set forth below is a summary of the affected relationships for the principal statutory definitions.

Sec. 267 — Related	*Sec. 318 — Related*	*Sec. 1563 — Related*
Spouse	Spouse (unless legally separated)	Spouse (under some circumstances)
Descendants	Children	Children under 21
Ancestors	Grandchildren	Parents of child under 21
Siblings	Parents	Parents, grandparents, grandchildren and children over 21 if taxpayer owns more than 50% of stock

Sec. 267 — Unrelated	*Sec. 318 — Unrelated*	*Sec. 1563 — Unrelated*
Significant other	Significant other	Spouse (under some circumstances)
Aunts	Grandparents	Significant other
Uncles	Siblings	Siblings
Cousins	Aunts	Aunts
In-laws	Uncles	Uncles
	Cousins	Cousins
	In-laws	In-laws
		Parents, grandparents, grandchildren over 21 unless taxpayer owns more than 50% of stock

INDEX

All references in this index are to the chapter title and chapter section numbers. The following is a key to abbreviated references used in the index.

Chapter	Index Abbreviation
Current-Year Cases and Rulings	C&R
Employment Regulations	EMP
Important 1991-92 Tax Planning and Compliance Issues	TPC
Social Security	SS
Unemployment Insurance	UI
Workers' Compensation	WORK

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