

Qualified Empire Zone Enterprise (QEZE) Exemptions (Articles 28 and 29)

On May 29, 2002, Governor George E. Pataki signed Chapter 85 of the Laws of 2002. This legislation, in part, amended the Tax Law to make clarifications to the Empire Zones Program Act. The information in this TSB-M contains information from prior legislation (Ch. 63, L. 2000) and from Chapter 85 of the Laws of 2002. As a result, this TSB-M supersedes TSB-M-01(1)S.

The following is a summary of changes to the Empire Zones Program based on the new legislation:

- The effective date for Empire Zone designations has been extended for tax purposes;
- the *sales and use tax benefit period* is defined;
- definitions of *employment test*, *employment number*, *taxable year*, *test date*, and *test year* have been amended; and
- property related to a motor vehicle is exempt if the motor vehicle is used predominantly in an Empire Zone.

Business enterprises whose eligibility may be affected by the changes regarding the employment test, employment number, and test year are those that:

- have employees who were employed by a related person (see page 3);
- relocated to an Empire Zone from a business incubator facility (see page 4);
- have employees in Empire Zones in which they are not certified (see page 4); or
- were certified under Article 18-B of the General Municipal Law on the last day of the taxable year. (Such businesses will have a different *base period* based on the amended definition of *test year*. See page 3.)

Unless otherwise noted, these changes are deemed to have been in effect since January 1, 2001.

A business enterprise that has already applied for and received a *Qualified Empire Zone Enterprise (QEZE) Sales Tax Certification* (Form DTF-81) from the Commissioner of Taxation and Finance is **not** required to reapply for sales tax certification. However, beginning with its next annual determination of whether the employment test is met, the enterprise must consider the changes regarding the employment test, employment number, and test year as explained in this memorandum. These changes will be incorporated into Form TP-812, *Annual Employment Test Reminder for Qualified Empire Zone Enterprises (QEZE)s*, which the Tax Department sends to businesses for purposes of the annual determination.

A business enterprise that received a *Qualified Empire Zone Enterprise (QEZE) Sales Tax Certification* from the Commissioner of Taxation and Finance, but failed the employment test for a subsequent taxable year, should recompute the test for such year in accordance with the amended definitions and rules. If the employment test is met for such year as a result of the changes, the enterprise may apply for a refund or credit of sales tax paid during the year on purchases that would have been exempt if not for the previously failed employment test.

General information

Effective March 1, 2001, certain purchases and uses of tangible personal property and services by a “Qualified Empire Zone Enterprise” (QEZE) became exempt from the New York State 4% sales and use taxes and from the ¼ % taxes imposed within the Metropolitan Commuter Transportation District (MCTD) (i.e., the city of New York and the counties of Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk, and Westchester). The exemptions do not apply to any locally imposed sales and use taxes unless the county, city, or school district imposing those taxes elects to provide the exemptions.

The sales and use tax exemptions are available for the 120 months that make up the *sales and use tax benefit period* as defined below.

The Empire Zones Program Act (Ch. 63, L. 2000) changed the term *economic development zone* to *Empire Zone* wherever it appeared in the Consolidated or Unconsolidated Laws of New York.

Section 969(a) of Article 18-B of the General Municipal Law provides that a designation of an area as an Empire Zone will remain in effect during the period beginning on the date of designation and ending July 31, 2004. The Tax Law was amended by Chapter 85 to provide that if the designation of an area as an Empire Zone is no longer in effect because section 969 of the General Municipal Law was not amended to extend the effective date of such designation beyond July 31, 2004, a business enterprise that was certified pursuant to Article 18-B of the General Municipal Law on July 31, 2004, will be deemed to continue to be certified for purposes of the QEZE tax benefits. In addition, all references to *Empire Zones* in the provisions of the Tax Law concerning QEZEs shall be read as meaning areas designated as *Empire Zones* on July 31, 2004.

Definitions

For sales and use tax purposes, a QEZE is a business enterprise that has been certified as eligible to receive benefits under Article 18-B of the General Municipal Law prior to July 1, 2005, during the *sales and use tax benefit period*.

The *sales and use tax benefit period* consists of 120 consecutive months beginning on the later of March 1, 2001, or the first day of the month following the date of certification by the Commissioner of Taxation and Finance. However, it does not include any month falling within a taxable year immediately following a taxable year for which the business enterprise did not meet the employment test.

The *employment test* will be met for a *taxable year* if: (i) the business enterprise’s *employment number* in all Empire Zones for the taxable year equals or exceeds its employment number in Empire Zones for the *base period*, and (ii) the business enterprise’s employment number in New York State outside of the Empire Zones for the taxable year equals or exceeds its employment number in the state outside of the Empire Zones for the *base period*.

Taxable year means the taxable year of the business enterprise under sections 183, 184, 185 or former section 186 of Article 9 (Corporation Tax), or under Article 9-A (franchise tax on business corporations), Article 22 (personal income tax), Article 32 (franchise tax on banking corporations), or

Article 33 (franchise tax on insurance corporations) of the Tax Law. If a business enterprise does not have a taxable year because it is exempt from taxation or otherwise not required to file a return under any of the above-referenced sections or articles, then *taxable year* means the business enterprise's taxable year for federal income tax purposes or if the enterprise does not have a taxable year for federal income tax purposes, the calendar year.

Employment number means the average number of individuals (excluding general executive officers, in the case of a corporation) *employed full-time* by the business enterprise for at least one-half of the taxable year. The number of these individuals who are employed full-time by the business enterprise for at least one-half of the taxable year is computed by: (i) determining the number of individuals so employed on March 31, June 30, September 30, and December 31 during the applicable taxable year; (ii) adding together the number of such individuals determined on each of those dates; and (iii) dividing the sum by the number of such dates occurring within the applicable taxable year. *Employed full-time* means a job consisting of at least 35 hours per week and includes two or more jobs that together constitute the equivalent of a job of at least 35 hours per week.

Note: For purposes of the *employment test* for taxable years beginning on or after January 1, 2002, *employment numbers* for the taxable year and base period will not include individuals employed within the immediately preceding 60 months by a related person as defined in Internal Revenue Code, section 465(b)(3)(C). (See the addendum on page 12 for additional information.)

Test date means the later of July 1, 2000, or the date prior to July 1, 2005, on which the business enterprise was first certified under Article 18-B of the General Municipal Law. Accordingly, a business enterprise that has been certified under the General Municipal Law prior to July 1, 2000, is deemed to have a test date of July 1, 2000. That business enterprise does not need to be recertified under Article 18-B to qualify for the QEZE exemption benefits.

Test year means the last taxable year of the business enterprise ending **before** the test date. If a business enterprise does not have a taxable year that ends before the test date, then the enterprise will be deemed to have a test year that is either the last calendar year ending before its test date or, if the enterprise has as its taxable year a fiscal year, the last such fiscal year ending before its test date. (Previously, test year was defined as the last taxable year ending **on or** before the test date.)

Base period means the five taxable years immediately before the test year. If a business enterprise has fewer than five taxable years before the test year, then the term *base period* will mean the smaller set of taxable years. In the case of a new business enterprise that is first doing business and creating jobs in New York State, the employment numbers in the base period are zero. (See *Employment test for businesses with a base period of zero years* on page 4.)

Newly designated zones or changes in zone boundaries

In the case of a newly designated zone, or if the boundaries of an existing zone have been revised, the employment numbers in the base period are determined as if the new zone or the boundaries of the revised zone existed during the base period and as if the business enterprise had been located in the new or revised zone during the base period.

Relocation from a business incubator facility

If a business enterprise relocates to an Empire Zone from a business incubator facility operated by a municipality or by a public or private not-for-profit entity which provides space or business support services, or both, to newly established enterprises, the employment numbers in the base period are determined as if such business enterprise had been located in the Empire Zone during the base period.

Employment test for businesses with employees in Empire Zones in which they are not certified

Prior to the enactment of Chapter 85 of the Laws of 2002, the employment test was met for a taxable year if: (i) the business enterprise's employment number in Empire Zones **in which the business enterprise is certified under Article 18-B of the General Municipal Law** for the taxable year equaled or exceeded its employment number in the zones for the base period, and (ii) the business enterprise's employment number in New York State outside of the zones for the taxable year equaled or exceeded its employment number in the state outside of the zones for the base period.

In applying the two-part employment test as originally enacted, a business enterprise that had employees in an Empire Zone in which it was **not** certified under Article 18-B of the General Municipal Law would have included those employees in the employment numbers for part (ii) of the test. However, under the amended definition of employment test (see page 2), all the enterprise's qualifying employees in Empire Zones are included in the employment numbers for part (i).

Employment test for businesses with a base period of zero years

The employment test described below for business enterprises with a base period of zero years is effective August 1, 2002, and does **not** apply to any taxpayer that was certified under Article 18-B of the General Municipal Law prior to August 1, 2002, or to any taxpayer that has received a written letter of commitment regarding Empire Zone benefits from the Department of Economic Development prior to August 1, 2002. Generally, a business enterprise will be considered to be certified prior to August 1, 2002, if the effective date on its *Empire Zones Program Certificate of Eligibility* is prior to August 1, 2002.

If the base period is zero years and the enterprise has an employment number in such zone(s) of greater than zero for a taxable year, then the employment test will be met only if the enterprise qualifies as a new business as defined below.

For purposes of the preceding paragraph, a *new business* is any business entity, except one which is substantially similar in operation and in ownership to a business entity taxable, or previously taxable, under sections 183, 184, 185, or 186 of Article 9 of the Tax Law; or under Articles 9-A, 32, or 33 of the Tax Law; or under Article 23, or which would have been subject to Article 23 (as such article was in effect on January 1, 1980), or the income (or losses) of which is (or was) includable under Article 22 of the Tax Law.

(Tax Law, sections 14(a) through (g) and 1101(b)(23))

QEZE sales tax certifications issued by the Commissioner of Taxation and Finance

After obtaining certification under Article 18-B of the General Municipal Law and in addition to meeting the employment test, every QEZE that seeks sales and use tax exemption benefits is also required to apply to the Commissioner of Taxation and Finance for a *Qualified Empire Zone Enterprise (QEZE) Sales Tax Certification* (Form DTF-81). The application for a QEZE sales tax certification must be approved and the certification issued before any exemption benefits may be claimed. The application must be made on Form DTF-80, *Application for a Qualified Empire Zone Enterprise (QEZE) Sales Tax Certification*, and must be filed with the Department of Taxation and Finance at the address indicated in the application. Along with any other information that may be required, the application must contain sufficient information in order for the department to verify that the employment test has been met for the first taxable year. Since a QEZE must annually determine whether or not it has met the employment test, the department will issue annual reminders that the employment test must be met in the prior taxable year in order to claim any sales and use tax benefits during the current year. The QEZE will not be required to submit information regarding the employment test to the department after it has received its QEZE sales tax certification, but must make this information available to the department upon request. The business enterprise's status as a QEZE may be subject to verification on audit.

Lists of the names of QEZEs and other identifying information, along with those QEZEs whose QEZE certifications have been revoked or have expired, may be made public. For sales and use tax purposes, a business enterprise will cease to be a QEZE on the day that its certification is revoked under Article 18-B of the General Municipal Law.

During the period that a business enterprise is eligible to apply, or is qualified, for exemptions from the sales and use taxes, the Commissioner of Economic Development will, at the time that he or she certifies or decertifies the business enterprise under Article 18-B of the General Municipal Law, notify the Commissioner of Taxation and Finance of the certification or decertification. The notification will include the full legal name, address, and federal employer identification number of the enterprise. The Commissioner of Economic Development will, at the time of certification under Article 18-B, also advise the business enterprise of the need to apply for the QEZE sales tax certification described in this section.

(Tax Law, sections 14(h) and (i))

Exempt purchase certificates

A QEZE that has received a QEZE sales tax certification from the Commissioner of Taxation and Finance is then authorized to furnish a person required to collect the tax (i.e., a vendor) with a properly completed *Qualified Empire Zone Enterprise (QEZE) Exempt Purchase Certificate* (Form ST-121.6) in order to purchase qualifying tangible personal property and services exempt from tax. This exempt purchase certificate may be used as a *single purchase certificate* or as a *blanket certificate* covering future purchases. A QEZE exempt purchase certificate is considered to be properly completed when it contains **all** of the information that is required to be completed on the document (see 20 NYCRR 532.4).

The QEZE exempt purchase certificate is an exemption certificate under section 1132 (c) of the Tax Law. Accordingly, a vendor that in good faith accepts a properly completed QEZE exempt purchase

certificate not later than 90 days after the delivery of the property, or rendition of a service is relieved of the liability for failure to collect the tax with respect to the applicable transaction, and the burden of proving that the transaction is not taxable rests solely with the QEZE. A vendor may not accept a QEZE exempt purchase certificate in good faith if the vendor has actual knowledge (i.e., more than a mere suspicion or belief) that the certificate is false or fraudulent. If a vendor accepts the exempt purchase certificate in good faith, it is under no duty to investigate the QEZE or to debate the taxability of the sale with the QEZE.

(Tax Law, section 14(h))

Exemptions from tax

For purchases and uses of property and services to be exempt from tax, the property or services (other than the section 1105(b) consumer utility services discussed below) must be directly and predominantly used or consumed by the QEZE in an Empire Zone in which the QEZE has qualified for benefits. As used in these exemptions, *predominantly* means 50% or more (or at least 50%).

A QEZE's use of a motor vehicle or property related to a motor vehicle will be found to occur predominantly in an Empire Zone where the QEZE has qualified for benefits if: (i) the QEZE uses the vehicle at least 50% exclusively in such a zone, or (ii) at least 50% of the vehicle's use is in activities originating or terminating in such a zone, or (iii) at least 50% of its use is a combination of use exclusively in such a zone and in activities originating or terminating in such a zone. The QEZE may choose to compute the usage of the vehicle based on either hours of use or miles traveled. Property related to a motor vehicle includes a battery, diesel motor fuel, an engine, engine components, motor fuel, a muffler, tires, and similar tangible personal property used in or on a motor vehicle. (Note: The Tax Law requires payment of sales taxes on the purchase of diesel motor fuel and motor fuel at the time of purchase, and provides for a refund of sales taxes paid on qualifying purchases. To apply for a refund of sales taxes paid on qualifying purchases of diesel motor fuel or motor fuel, complete Form FT-500, *Application for Refunds of Sales Taxes Paid on Automotive Fuels*.) The QEZE exemptions pertaining to motor vehicles are also applicable to the special taxes imposed under Article 28-A of the Tax Law on passenger car rentals.

Consumer utility services (other than telephony and telegraphy, telephone and telegraph services, and telephone answering services) must be directly and exclusively (i.e., 100%) used or consumed by a QEZE in an Empire Zone in which the QEZE has qualified for benefits. These services include sales of gas, electricity, refrigeration, and steam, as well as gas, electric, refrigeration, and steam services of whatever nature. Telephony and telegraphy, telephone and telegraph services, and telephone answering services must be delivered and billed to the QEZE at an address in the zone in which the QEZE has qualified for these tax benefits in order for the exemptions to apply.

The QEZE exemptions do not apply to the taxes imposed under section 1105(d) of the Tax Law on sales of food or drink at restaurants, taverns, or other establishments, or to sales by caterers; nor do the exemptions apply to rent for hotel occupancy or amusement charges subject to tax under sections 1105(e) and (f), respectively.

The exemptions are also not applicable to local sales and compensating use taxes unless the individual locality elects the QEZE exemptions. (See *County, city, and school district taxes* on page 10.)

If the QEZE determines that the employment test has not been met and that the exemption benefits have been erroneously claimed, the QEZE must report the transactions to the department and pay any sales and use taxes that are due. If the QEZE is a registered vendor, it must report and pay the tax when it files its next sales tax return. If the QEZE is not a registered vendor, it must immediately file Form ST-130, *Purchaser's Report of Sales and Use Tax*, and pay the taxes due.

(Tax Law, sections 1115(z)(1) and (3))

Example

Company A began business in New York State in January 1990 and became zone certified under Article 18-B of the General Municipal Law on June 5, 2002 (the test date). The company has activities both within and outside of the zone. For New York State franchise tax purposes, Company A files on a calendar-year basis. Company A's test year is January through December 2001 (the last taxable year ending before the test date of 6/5/2002) and its base period is January 1996 through December 2000 (the five taxable years immediately before the test year). On June 26, 2002, Company A submits Form DTF-80, *Application for a Qualified Empire Zone Enterprise (QEZE) Sales Tax Certification*, to the Tax Department and reports the following:

Employees within Empire Zones: Computation of average number of employees (excluding general executive officers) employed full-time for at least one-half of the taxable year within Empire Zones.

	Year	Qtr 3/31	Qtr 6/30	Qtr 9/30	Qtr 12/31	Total	Average number of employees (employment number)
Number of full-time employees within Empire Zones for the taxable year immediately prior to 2002:	2001	450	450	450	450	1,800	450
Number of full-time employees within Empire Zones for the base period:							
Base period year 1:	1996	350	350	350	350	1,400	
Base period year 2:	1997	350	350	350	350	1,400	
Base period year 3:	1998	350	350	350	350	1,400	
Base period year 4:	1999	350	350	350	350	1,400	
Base period year 5:	2000	350	350	350	350	1,400	
Total full-time employees within Empire Zones for the base period:						7,000	
Average number of full-time employees within Empire Zones for the base period (total divided by 20 or number of dates in base period [employment number]):							350

The average number of full-time employees within Empire Zones (employment number) for 2001, the taxable year immediately prior to 2002, exceeds the average number of full-time employees within Empire Zones (employment number) for the base period.

Employees in New York State but outside Empire Zones: Computation of average number of employees (excluding general executive officers) employed full-time for at least one-half of the taxable year in New York State outside of Empire Zones.

	Year	Qtr 3/31	Qtr 6/30	Qtr 9/30	Qtr 12/31	Total	Average number of employees (employment number)
Number of full-time employees in NYS outside Empire Zones for the taxable year immediately prior to 2002:	2001	300	300	300	300	1,200	300
Number of full-time employees in NYS outside Empire Zones for the base period:							
Base period year 1:	1996	200	200	200	200	800	
Base period year 2:	1997	200	200	200	200	800	
Base period year 3:	1998	200	200	200	200	800	
Base period year 4:	1999	200	200	200	200	800	
Base period year 5:	2000	200	200	200	200	800	
Total full-time employees in NYS outside Empire Zones for the base period:						4,000	
Average number of full-time employees in New York State outside Empire Zones for the base period (total divided by 20 or number of dates in base period [employment number]):							200

The average number of full-time employees in New York State outside Empire Zones (employment number) for 2001, the taxable year immediately prior to 2002, exceeds the average number of full-time employees in New York State outside Empire Zones (employment number) for the base period.

The employment test has been satisfied, and the Tax Department will issue a *Qualified Empire Zone Enterprise (QEZE) Sales Tax Certification* (Form DTF-81), indicating that Company A is eligible for sales and use tax benefits beginning on July 1, 2002. Company A's sales and use tax benefit period will continue through June 30, 2012. Toward the end of Company A's 2002 taxable year, the Tax Department will remind Company A to compare its employment numbers for 2002 (upon completion of its 2002 taxable year) to those for the base period to determine if it is eligible for sales and use tax benefits in 2003.

County, city, and school district taxes

The QEZE exemptions are not applicable to the local sales and use taxes imposed in New York City or imposed by a county, city, or school district, unless the locality adopts a local law, ordinance, or resolution to elect the QEZE exemptions using an appropriate model resolution prepared by the Tax Department. Since an Empire Zone in which a QEZE has qualified for tax benefits may be located in both a county and a city imposing local taxes, QEZE transactions would not be fully exempt from tax unless both the county and the city elect the QEZE exemptions. For example, if an Empire Zone is located in City A, which is located in County B, and both City A and County B impose sales and use taxes, a QEZE's use of property and services in the Empire Zone in which the QEZE has qualified for tax benefits would not be fully exempt from these local taxes unless both City A and County B each separately elect the QEZE exemptions. If a zone is also located in a school district that imposes sales and use taxes on utility services, the QEZE's purchases of utility services would not be fully exempt from tax unless the school district also elects the QEZE exemptions.

Like state sales tax, the location where tangible personal property or services (or the location where tangible personal property upon which services have been performed) are delivered generally determines the incidence of the local sales taxes. Accordingly, in addition to any other requirement described in this memorandum, in order for a QEZE to be able to purchase tangible personal property or services exempt from local sales taxes, it must pick up or take delivery of the property or services in a locality (or localities) that has elected the QEZE exemptions. Additionally, similar to the state compensating use tax, the local use taxes are imposed on, among other things, the use in a locality of tangible personal property or services that were purchased outside of the locality without payment of the local sales taxes due at the time of purchase. Therefore, in order for a QEZE to use tangible personal property or services exempt from local use taxes, it must also use the property or services in a locality (or localities) that has elected the QEZE exemptions. For example, if County D elects the QEZE exemptions, and a QEZE from County E goes into County D to make purchases of tangible personal property or services, the QEZE's purchases would be exempt from County D's sales tax. But the QEZE's use of the property or services would nevertheless be subject to the local use tax in County E where the QEZE uses the property or services, unless County E has elected the QEZE exemptions.

Counties, cities, and school districts may elect to provide the exemptions (or repeal them) effective on March 1 of each year. The Tax Department publishes a list of those counties, cities, and school districts that have elected to provide the QEZE exemptions from tax; see Publication 718-Q, *Local Sales and Use Tax Rates on Sales to a Qualified Empire Zone Enterprise (QEZE)*. Publication 718-Q also lists those counties, cities, and school districts that have not elected the QEZE exemptions and the rates of tax in those localities.

(Tax Law, sections 1115(z), 1210(a)(1), 1210(b)(1), 1210(d), 1210(l), and 1212)

Contractors, subcontractors, and repairmen

In addition to the exemptions that are applicable to a QEZE's direct purchases and uses, the Tax Law also provides exemptions from tax for tangible personal property that is sold to a contractor, subcontractor, or repairman for use in erecting a structure or a building of a QEZE; or for use in adding to, altering,

improving, maintaining, servicing, or repairing real property, property, or land of a QEZE. These exemptions apply only if: (i) the tangible personal property becomes an integral component part of the QEZE's structure, building, real property, property, or land; (ii) the structure, building, real property, property, or land is located in an Empire Zone in which the QEZE has qualified for tax benefits; and (iii) the QEZE has issued to the contractor, subcontractor, or repairman a properly completed QEZE exempt purchase certificate, as discussed on page 5, which indicates that the QEZE is entitled to these benefits.

Tangible personal property that becomes an integral component part of the QEZE's structure, building, real property, property, or land includes items such as building and landscaping materials, but does not include items such as tools, equipment, and supplies that are used or consumed by the contractor, subcontractor, or repairman.

A contractor, subcontractor, or repairman must use Form ST-120.1, *Contractor Exempt Purchase Certificate*, when purchasing the tangible personal property that is exempt from tax.

(Tax Law, section 1115(z)(2))

Reporting requirements for vendors making exempt sales

Vendors that make sales of tangible personal property and services to QEZEs (or to qualifying contractors, subcontractors, or repairmen) must report these sales to the department and pay any local taxes that may be due on the receipts from these sales. The local taxes are not taken into consideration in determining any vendor collection credits that may be claimed pursuant to section 1137(f) of the Tax Law. The department will supply a schedule to all part-quarterly, quarterly, and annual filers of Forms ST-100 (*New York State and Local Quarterly Sales and Use Tax Return*), ST-101 (*New York State and Local Annual Sales and Use Tax Return*), ST-102 (*New York State and Local Sales and Use Tax Return for a Single Jurisdiction*), and ST-810 (*New York State and Local Sales and Use Tax Return Quarterly for Part-Quarterly Filers*), so they can report these sales.

Empire Zone refunds and credits

The QEZE sales and use tax exemptions described in this memorandum are alternatives to the Empire Zone refund and credit provisions that were originally enacted in 1986 and that are found in section 1119(a)(6) of the Tax Law. However, the QEZE exemptions from tax occur at the time of purchase, whereas the refund and credit provisions require the purchaser to pay the tax and to then file a claim for refund or credit of the tax paid. In addition, the QEZE exemptions apply to a broad class of tangible personal property and to utility and other services, provided that the property and services are used by the QEZE in the Empire Zone as previously described in this memorandum. The Empire Zone refund and credit provisions apply only to tangible personal property that is incorporated into industrial or commercial real property that is being constructed, expanded, or rehabilitated within an Empire Zone and that becomes an integral component part of that real property. See Publication 30, *A Guide to Sales and Use Tax Incentives Within Empire Zones*, for additional information on Empire Zone refunds and credits.

Addendum

The information below represents the Internal Revenue Service's interpretation of the definition of "related person" in section 465(b)(3)(C) of the Internal Revenue Code. Section 465 concerns the limitations on deductions to the amounts at-risk and the information below is contained in IRS Publication 925, *Passive Activity and At-Risk Rules – For use in preparing 2001 Returns*. In future years, you should check section 465(b)(3)(C) to see if the definition of "related person" has been amended.

Related persons include:

- Members of a family, but only brothers and sisters, half-brothers and half-sisters, a spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.),
- Two corporations that are members of the same controlled group of corporations determined by applying a 10% ownership test,
- The fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
- A tax-exempt educational or charitable organization and a person who directly or indirectly controls it (or a member of whose family controls it),
- A corporation and an individual who owns directly or indirectly more than 10% of the value of the outstanding stock of the corporation,
- A trust fiduciary and a corporation of which more than 10% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust,
- The grantor and fiduciary, or the fiduciary and beneficiary, of any trust,
- A corporation and a partnership if the same persons own over 10% in value of the outstanding stock of the corporation and more than 10% of the capital interest or the profits interest in the partnership,
- Two S corporations if the same persons own more than 10% in value of the outstanding stock of each corporation,
- An S corporation and a regular corporation if the same persons own more than 10% in value of the outstanding stock of each corporation,
- A partnership and a person who owns directly or indirectly more than 10% of the capital or profits of the partnership,
- Two partnerships if the same persons directly or indirectly own more than 10% of the capital or profits of each,
- Two persons who are engaged in business under common control, and
- An executor of an estate and a beneficiary of that estate.

To determine the direct or indirect ownership of the outstanding stock of a corporation, apply the following rules.

- 1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.
- 2) Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. The family of an individual includes only brothers and sisters, half-brothers and half-sisters, a spouse, ancestors, and lineal descendants.
- 3) Any stock in a corporation owned by an individual (other than by applying rule (2)) is considered owned directly or indirectly by the individual's partner.
- 4) When applying rule (1), (2), or (3), stock considered owned by a person under rule (1) is treated as actually owned by that person. But, if a person constructively owns stock because of rule (2) or (3), he or she does not own the stock for purposes of applying either rule (2) or (3) to make another person the constructive owner of the same stock.