

2 Individual and Small Business Problems

Problem 1: Depreciation of Equipment Used for Both Farm and Nonfarm Purposes

Facts. Troy West has two businesses—farming and an aerial spraying business. He bought a four-wheel drive pickup truck on June 4, 1997, that he uses in both businesses. From mileage records kept, the truck was used 73% for the farming business and 27% for the spraying business in 1997. Troy bought the truck outright (no trade-in) for \$26,000. The truck has an unloaded gross vehicle weight (GVW) rating of 6,500 pounds.

Question. *What is the maximum amount of depreciation and §179 deduction allowable on the truck for 1997?*

Answer. Since the truck is used for both a farming and a nonfarming business, different depreciation **method** rules apply. The easiest, though technically not correct, way to handle this situation would be to place the truck on the farm depreciation schedule and ignore the fact that it is a dual-purpose vehicle.

But since the question asks for the **maximum** amount of depreciation (MACRS) and the §179 deductions allowable, the proper allocation of the \$26,000 cost to the two businesses should be made.

Schedule F (Farming Business) Computations

\$26,000 cost × 73% farm use percentage =	\$18,980
Less: Maximum §179 deduction for 1997	(18,000)
Balance left for MACRS deduction	\$ 980
1997 MACRS deduction (\$980 × 15% first-year MACRS rate)	147

Notes:

1997 Workbook

1. The maximum §179 deduction of \$18,000 is allowable since the vehicle's **loaded GVW rating exceeds 6,000 pounds**.
2. The MACRS deduction of \$147 for 1997 is calculated using a five-year recovery period, 150% declining balance method, and the half-year convention (Table A-14 in the 1996 IRS Pub. #946, "How To Depreciate Property"). The 150% declining balance method over the normal GDS recovery period produces the **maximum allowable MACRS** deduction for property placed in service **after 1988 in a farming business**.

Schedule C (Aerial Spraying Business) Computations

\$26,000 cost × 27% spraying business use =	\$7,020
1997 MACRS deduction (\$7,020 × 20% first-year MACRS rate)	1,404

Note: The MACRS deduction of \$1,404 for 1997 is calculated using a five-year recovery period, 200% declining balance method, and the half-year convention (Table A-1 in the 1996 IRS Pub. #946, "How To Depreciate Property").

Summary. The answer to the question is \$19,551 consisting of

1. The maximum §179 deduction elected for Schedule F	\$18,000
2. The MACRS deduction for Schedule F	147
3. The MACRS deduction for Schedule C	1,404
Maximum MACRS and §179 deductions for 1997:	\$19,551

Problem 2: Vacation Home Tax Rules

I.R.C. §280A limits the otherwise deductible expenses incurred in connection with the rental of a vacation home. This disallowance section is complicated. The rationale of §280A is based on a strict "number of days of **personal use**" (the Code language is "**used by the taxpayer as a residence**") theory. The greater the "personal use" of the vacation home, the better the chance is that expenses will be limited.

Note: The disallowance rules apply to individuals, trusts, estates, partnerships, and S corporations. **They do not apply to C corporations.**

One of the keys in properly applying these complicated rules is to determine

1. The number of days the dwelling unit is rented during the year at a **fair rental price**, and
2. The number of days the dwelling unit is used during the year for **personal use (used as a**

1997 Workbook

Personal use days include the following:

1. Days that the taxpayer uses the dwelling unit for personal use. However, do **not** count any day that is spent **substantially full-time repairing or maintaining** the dwelling unit.
2. Days that the dwelling unit is used by a **spouse, child, grandchild, mother, father, grandparents, brother, sister, half-brother, or half-sister**.

Note: The rules for (2) above are further complicated by an exception best explained by examples [I.R.C. §280A(d)(3)]:

Example 1. Your grandfather uses your condo in Arizona for 10 days in January. You charge him no rent for the use of the condo you own. Count the 10 days as **your personal use days**.

Example 2. Same facts as in Example 1 except that grandfather pays you a fair rental price for the 10 days. His main home is in Des Moines, IA. Count the 10 days as **your personal use days**.

Example 3. You rent your condo in Arizona for the last seven months of your tax year to your grandfather. He **formerly** lived in Des Moines, IA. He sold his main home there and began to rent your condo on May 1. He pays you a fair rental price. Do **not** count the last seven months as **your personal use days**.

3. Days that the dwelling unit is used by someone else under a **reciprocal arrangement that lets you use some other dwelling unit**. For example, you own a condo in Arizona and your co-worker owns a beach house in Michigan. The co-worker uses your condo for 12 days in December 1997 for no charge, and you use his beach house for eight days in August 1997 for no charge (reciprocal arrangement). Count the 12 days as **your personal use days**.
4. Days that the dwelling unit is rented at **less than a fair rental price**.
5. Days that the dwelling unit is used by a person who has an ownership interest in it. However, there is an **exception for a co-owner who uses the unit as his or her main home under a shared equity financing agreement**.

If the dwelling unit is both used for **personal use** and **rented** during the year, the expenses must be divided between **personal use** and **rental use**.

Used As a Home

The dwelling unit is **considered to be used as a home during the year if it is used for personal use more than the greater of**

1. 14 days, or
2. 10% of the **total days it is rented to others at a fair rental price**.

Example 4. You converted the basement of your home into an apartment with a bedroom,

1997 Workbook

bathroom, and small kitchen. You rent the apartment at a fair rental price to a college student during the regular school year. You rent to the student on a nine-month (273-day) lease.

During the summer, your brother stays with you for a month (30 days) and lives in the apartment rent free.

Your basement apartment is **used as a home** because you use it for **personal use for 30 days**. 30 days is **more** than the **greater** of 14 days **or** 10% of the total days it is rented.

Note: Since it was rented for 273 days, 10% of 273 is 27.3 days. The **personal use** of 30 days exceeds 27.3 days (the **greater** of 14 days **or** 10% of the 273 total rental days).

Example 5. You rent out the guest bedroom in your home at a fair rental price during the summer tourist season for a total of 27 days. Your sister stays in the room rent free for 21 days during the year.

The room is **used as a home** because the **personal use** is 21 days, which is **more** than the **greater** of 14 days **or** 10% of the days rented (10% of the 27 rental days is 2.7 days).

Rules When Dwelling Unit Has *Not* Been Used as a Home

The determination of whether the dwelling unit has or has not been **used as a home** is vital. If it has **not** been **used as a home** during the year, expenses are divided between **personal use** and **rental use based on the number of days it was used for each purpose**. Rental losses are allowable on Schedule E subject to the passive loss rules for rental real estate activities.

The **personal use** portion of taxes and casualty losses are deductible on Schedule A if applicable.

Practitioner Caution. The personal use portion of interest is deductible as home mortgage interest **only** if the dwelling **has been used as a home during the year** (the greater of the 14-day or 10% test). If the dwelling has been used as a home, the personal use portion of the interest **could be deducted as mortgage interest for a qualifying second residence**.

If the dwelling has **not been used as a home**, the personal use portion of the interest is **not deductible as home mortgage interest on Schedule A** [Temp. Treas. Reg. §1.163-10T(p)(3)(c)(iii)]. Instead, the residence is considered to be **rental property rather than a second home**. Thus, the passive activity rules would apply.

Rules when Dwelling Unit Has Been Used as a Home

Once the total number of days **rented at a fair rental price** and the number of days of **personal use** are ascertained, the following **general rules** can be used if the property has been **used as a home**.

General Rule #1

Applies when the **number of days rented at a fair rental price** is **less than 15 days in the tax year**.

1997 Workbook

If the is the case, the dwelling unit is **treated as a residence (home) and not as rental property**. Any rental income received is excludable. Similarly, any expenses incurred during the period of the temporary rental are not deductible. However, interest, real estate taxes, and casualty losses for the dwelling unit may be deducted on Schedule A if applicable.

Note: See Question 20 in the Non–Agriculture-Related section of Chapter 5 for more information about this **loophole**, which was not closed by either the 1996 or the more recent 1997 tax legislation.

General Rule #2

Applies when the **number of days rented at a fair rental price is 15 days or more in the tax year**.

If a dwelling unit is used both **as a home** and as rental property during the tax year and it is rented at a fair rental price for 15 days or more, the expense limitations of I.R.C. §280A will apply if there is **net rental loss**.

Divide **expenses** for the dwelling unit between the **personal use** and **rental use** based on the number of days used for each purpose.

If there is a **net profit** from the rental activity for the year (rental income exceeds total prorated rental expenses, including depreciation), **all prorated rental expenses are deductible**. Use Schedule E to report the rental income and expenses.

If, however, there is a **net loss** from the rental activity for the year (rental income is less than prorated rental expenses, including depreciation), there is a **limit** on the amounts that can be deducted for certain rental expenses [**Treas. Reg. §1.280A-2(i)(5)**].

This limitation ensures that the prorated rental expenses are used to offset **only rental income**. If the total of the expenses exceeds rental income, the excess **cannot be used to offset income from other sources**. However, the excess and disallowed rental expenses of the current tax year can be **carried forward to the next tax year**, where they will be treated as rental expenses for the next year. The excess expenses that are carried forward can be deducted only up to the amount of rental income for the next year, **even if** the dwelling unit is **not used as a home** in the next year.

Example Explaining the Limitation Rules of General Rule #2. Jed North owns a vacation cabin in Michigan. It is his qualifying second residence for purposes of deducting home mortgage interest. He used it for eight days in August 1997 for his annual fishing vacation. His parents used it rent free for seven days in July 1997 for the same purpose. He rented it at a **fair rental price** to two friends in June and July 1997. The rental income facts are as follows:

Tenant	Number of Days Rented	Rent Received
#1	14	\$250
#2	10	200
Totals	24	450

1997 Workbook

Question 1. *Is Jed's cabin **used as a home** in 1997?*

Answer 1. Yes, the number of personal use days is 15 as it includes the seven days used rent free by Jed's parents. Fifteen is **more** than the **greater** of 14 days **or** 10% of the total days it was rented (10% of 24 is 2.4 days).

Following are the 1997 expenses for the cabin:

Item	Total	Personal Use Amount (14/38--IRS Method)	Rental Amount (24/38--IRS Method)
Mortgage interest	\$700	\$269 (IRS method)	\$431 (IRS method)
Real estate taxes	370	142 (IRS method)	228 (IRS method)
Repairs	100	38 (no dispute)	62 (no dispute)
Utilities	120	46 (no dispute)	74 (no dispute)
Insurance	100	38 (no dispute)	62 (no dispute)
Depreciation	545	None (N/A)	335 (no dispute)
Totals	\$1,935	\$533	\$1,192

Note: The IRS uses the following formula to allocate expenses between **personal use** and **rental use** amounts:

(Number of days rented at a fair rental price)/(Total of number of days rented **plus** personal use days)

The IRS applies this formula to all expenses, **including interest and taxes**, but the Tax Court and two Appeals Courts (the 9th and 10th Circuits) apply a **daily formula for interest and taxes only**. See **D.D. Bolton** (CA-9, 82-2 USTC ¶9699) and **E.G. McKinney** (CA-10, 83-2 USTC ¶9655) for authority.

Using the Tax Court formula results in the following allocation of Jed's interest and taxes:

Item	Total	Personal Use Amount (341/365—Daily Method Used by Tax Court)	Rental Amount (24/365— Daily Method Used by Tax Court)
Interest	\$700	\$654	\$46
Taxes	370	346	24
Totals	\$1,070	\$1,000	\$70

Using the Tax Court method of allocating interest and taxes, the worksheet (Table 1-2, which follows) from IRS Pub. #527, "Residential Rental Property," is completed as shown.

Note: Jed will be able to deduct the following on his 1997 Schedule A for cabin expenses **if** he itemizes:

Schedule A Line Number	Item	Amount
6	Real estate taxes	\$346
10	Home mortgage interest	654

1997 Workbook

The Tax Court formula is **generally** more favorable to taxpayers as it results in

1. More depreciation to be used to offset rental income, and
2. Larger deductions for the personal portion of interest and taxes on Schedule A **if the taxpayer itemizes**

Table 1-2. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer "yes" to all of the following questions.	
• Did you use the dwelling unit as a home this year? (See <i>Dwelling Unit Used as Home</i> .)	✓ YES
• Did you rent the dwelling unit 15 days or more this year?	✓ YES
• Are the total of your rental expenses and depreciation more than your rental income?	✓ YES
1. Enter rents received	450
2. a. Enter the rental portion of deductible home mortgage interest (see instructions) <i>*(Tax Ct. Formula.)</i>	46
b. Enter the rental portion of real estate taxes <i>*(Tax Ct. Formula.)</i>	24
c. Enter the rental portion of deductible casualty and theft losses (see instructions)	
d. Enter direct rental expenses (see instructions)	
e. Fully deductible rental expenses. Add lines 2a-2d	70
*Tax Court formula used rather than IRS formula.	
3. Subtract line 2e from line 1. If zero or less, enter zero	380
4. a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) <i>(\$62 repairs + \$74 utilities + \$62 insurance)</i>	198
b. Enter the rental portion of excess mortgage interest (see instructions)	198
c. Add lines 4a and 4b	198
d. Allowable operating expenses. Enter the smaller of line 3 or line 4c	182
5. Subtract line 4d from line 3. If zero or less, enter zero	182
6. a. Enter the rental portion of excess casualty and theft losses (see instructions)	335
b. Enter the rental portion of depreciation of the dwelling unit	335
c. Add lines 6a and 6b	182
d. Allowable excess casualty and theft losses and depreciation. Enter the smaller of line 5 or line 6c	0
7. a. Operating expenses to be carried over to next year. Subtract line 4d from line 4c	0
b. Excess casualty and theft losses and depreciation to be carried over to next year. Subtract line 6d from line 6c	153
Enter the amounts on lines 2e, 4d, and 6d on the appropriate lines of Schedule E (Form 1040), Part I.	
Worksheet Instructions	
Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, including operating expenses, casualty and theft losses, and depreciation, because of the rental income limit, add these unused amounts to your expenses for this year.	
Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. Do not include interest on a loan that did not benefit the dwelling unit. For example, do not include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.	Form 4684. enter 10% of your adjusted gross income figured without your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet. Note: Do not file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.
Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of	Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.
	Line 4b. On line 2a, you entered the mortgage interest you could deduct on Schedule A if you had not rented out the dwelling unit. Enter on line 4b of this worksheet the mortgage interest you could not deduct on Schedule A because it is more than the limit on home mortgage interest. Do not include interest on a loan
	that did not benefit the dwelling unit (as explained in the line 2a instructions).
	Line 6a. To find the rental portion of excess casualty and theft losses you can deduct, follow these steps. Use the Form 4684 you prepared for line 2c of this worksheet.
	A. Enter the amount from line 10 of Form 4684
	B. Enter the rental portion of (A)
	C. Enter the amount from line 2c of the worksheet
	D. Subtract (C) from (B). Enter the result here and on line 6a of the worksheet
	Allocating the limited deduction. If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

1997 Workbook

Table 1-2. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer "yes" to all of the following questions.	
• Did you use the dwelling unit as a home this year? (See <i>Dwelling Unit Used as Home</i> .)	✓ YES
• Did you rent the dwelling unit 15 days or more this year?	✓ YES
• Are the total of your rental expenses and depreciation more than your rental income?	✓ YES
1. Enter rents received	450
2. a. Enter the rental portion of deductible home mortgage interest (see instructions) <i>*(tax ct. Formula)</i>	46
b. Enter the rental portion of real estate taxes <i>*(tax ct. Formula)</i>	24
c. Enter the rental portion of deductible casualty and theft losses (see instructions)	—
d. Enter direct rental expenses (see instructions)	—
e. Fully deductible rental expenses. Add lines 2a–2d	70

*Tax Court formula used rather than IRS formula.

3. Subtract line 2e from line 1. If zero or less, enter zero	380
4. a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) <i>(\$62 repairs + \$14 utilities + \$62 insurance)</i>	198
b. Enter the rental portion of excess mortgage interest (see instructions)	198
c. Add lines 4a and 4b	198
d. Allowable operating expenses. Enter the smaller of line 3 or line 4c	182
5. Subtract line 4d from line 3. If zero or less, enter zero	182
6. a. Enter the rental portion of excess casualty and theft losses (see instructions)	335
b. Enter the rental portion of depreciation of the dwelling unit	335
c. Add lines 6a and 6b	182
d. Allowable excess casualty and theft losses and depreciation. Enter the smaller of line 5 or line 6c	0
7. a. Operating expenses to be carried over to next year. Subtract line 4d from line 4c	153
b. Excess casualty and theft losses and depreciation to be carried over to next year. Subtract line 6d from line 6c	—

Enter the amounts on lines 2e, 4d, and 6d on the appropriate lines of Schedule E (Form 1040), Part I.

Worksheet Instructions

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, including operating expenses, casualty and theft losses, and depreciation, because of the rental income limit, add these unused amounts to your expenses for this year.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of

Form 4684, enter 10% of your adjusted gross income figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet. **Note:** **Do not** file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 4b. On line 2a, you entered the mortgage interest you could deduct on Schedule A if you had not rented out the dwelling unit. Enter on line 4b of this worksheet the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan

that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 6a. To find the rental portion of excess casualty and theft losses you can deduct, follow these steps. Use the Form 4684 you prepared for line 2c of this worksheet.

- A. Enter the amount from line 10 of Form 4684
- B. Enter the rental portion of (A)
- C. Enter the amount from line 2c of the worksheet
- D. Subtract (C) from (B). Enter the result here and on line 6a of the worksheet

Allocating the limited deduction. If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

*

1997 Workbook

*Tax Court formula used rather than IRS formula.

Problem 3: Verification of Gambling Losses

A problem facing practitioners is how to treat real or alleged gambling losses of clients with Forms W-2G for gambling winnings. In many cases, the clients will insist that their losses exceed the total of amounts reported on Form W-2G. This problem is more common with the proliferation of various types of legalized gambling.

This is an area that can create friction between the client and the preparer. However, the rules are very clear. **Revenue Procedure 77-29** (1977-2 C.B. 538) was written by the IRS to specifically address the required documentation to support a deduction for gambling losses. The full contents of the Revenue Procedure follow:

SEC. 3. PROCEDURES

An accurate diary or similar record regularly maintained by the taxpayer, supplemented by verifiable documentation, will usually be acceptable evidence for substantiation of wagering winnings and losses. In general, the diary should contain at least the following information:

1. Date and type of specific wager or wagering activity.
2. Name of gambling establishment.
3. Address or location of gambling establishment.
4. Name(s) of other person(s) (if any) present with taxpayer at gambling establishment.
5. Amount(s) won or lost.

Verifiable documentation for gambling transactions includes but is not limited to Forms W-2G; Forms 5754. Statement by Person Receiving Gambling Winnings; wagering tickets, canceled checks, credit records, bank withdrawals, and statements of actual winnings or payment slips provided to the taxpayer by the gambling establishment.

Where possible, the diary and available documentation generated with the placement and settlement of a wager should be further supported by other documentation of the taxpayer's wagering activity or visit to a gambling establishment. Such documentation includes, but is not limited to , hotel bills, airline tickets, gasoline credit cards, canceled checks, credit records, bank deposits, and bank withdrawals.

Additional supporting evidence could also include affidavits or testimony from responsible gambling officials regarding wagering activity.

With regard to specific wagering transactions, winnings and losses may be further supported by the following items:

.01 *Keno*—Copies of keno tickets purchased by the taxpayer and validated by the gambling establishment,

1997 Workbook

copies of the taxpayer's casino credit records, and copies of the taxpayer's casino check cashing records.

.02 Slot Machines.—A record of all winnings by date and time that the machine was played. (In Nevada, the machine number is the number required by the State Gaming Commission and may or may not be displayed in a prominent place on the machine. If not displayed on the machine, the number may be requested from the casino operator.)

.03 Table Games: Twenty-One (Blackjack), Craps, Poker, Baccarat, Roulette, Wheel of Fortune, Etc.—The number of the table at which the taxpayer was playing. Casino credit card data indicating whether the credit was issued in the pit or at the cashier's cage.

.04 Bingo—A record of the number of games played, cost of tickets purchased and amounts collected on winning tickets. Supplemental records include any receipts from the casino, parlor, etc.

.05 Racing: Horse, Harness, Dog, Etc.—A record of the races, entries, amounts of wagers, and amounts collected on winning tickets and amounts lost on losing tickets. Supplemental records include unredeemed tickets and payment records from the racetrack.

.06 Lotteries—A record of ticket purchases, dates, winnings, and losses. Supplemental records include unredeemed tickets, payments slips, and winnings statement.

SEC. 4. LIMITATIONS

The recordkeeping suggestions set forth above are intended as general guidelines to assist taxpayers in establishing their reportable gambling gains and deductible gambling losses. While following these will enable most taxpayers to meet their obligations under the Internal Revenue Code these guidelines cannot be all inclusive and the tax liability of each depends on the facts and circumstances of particular situations.

It is suggested that practitioners show this **Revenue Procedure** to clients to try to convince them of what constitutes credible evidence. This is a highly litigated issue as attested by over 100 Tax Court cases tried as of September 1997.

Practitioner Caution. The strict and clear substantiation rules of **Revenue Procedure 77-29** will in all probability be used against your clients in an IRS examination. **This is a difficult area.** Most IRS examiners will consider oral testimony by and the credibility of the taxpayer. If you believe your client is credible, it may be helpful if you let the taxpayer relate his or her "story" to the IRS examiner. If, on the other hand, your client is not credible and the required records are missing, you may decide to refuse to prepare the tax return if the client insists that gambling losses exceed the winnings reported on Forms W-2G.

Gambling Questions and Answers

Question 1. *What about travel and transportation expenses incurred by a taxpayer in connection with W-2G gambling winnings? Are they deductible?*

Facts.

1997 Workbook

on the Ohio River gambling boat. They stayed in Metropolis for two nights. Charles and Rose kept the required records provided in **Rev. Proc.** 77-29 to prove their gambling winnings and losses for the three days they gambled. They are not professional gamblers.

Their records show the following:

Amount of Charles' total gambling winnings	\$5,724
Amount reported to Charles on two 1997 Forms W-2G	3,201
Amount of Charles' total gambling losses	(2,910)
Amount of Rose's total gambling winnings	8,756
Amount reported to Rose on four 1997 Forms W-2G	6,400
Amount of Rose's total gambling losses	(5,339)
Total amount of lodging and meals for both of them for the three-day period	270
Round-trip mileage from Indiana to Illinois (240 miles @ 31.5¢)	76

Answer 1. The \$270 in meals and lodging expenses and the \$76 mileage expenses are not deductible on their joint 1997 Form 1040. These expenses do not constitute "wagering losses" under I.R.C. §165(d).

Following are quotes from the **Stanley B. and Rose M. Whitten** Tax Court Case (T.C. Memo 1995-508). This case dealt with the transportation, meals, and lodging expenses for Mr. Whitten and his family. They lived in Illinois and traveled to Los Angeles, where Mr. Whitten appeared as a contestant for three days on the TV game show *Wheel of Fortune*. Mr. Whitten "won" \$14,850 in cash prizes and a vehicle on the show.

The respondent (IRS) characterizes these expenses either as nondeductible personal expenses under I.R.C. §262 or as miscellaneous itemized deductions subject to the 2% AGI floor. We (the Tax Court) conclude that wagering losses must be accounted for and reported **separately** from the expenses incurred in order to engage in the underlying wagering transactions. **We (the Tax Court) hold that the expenses incurred in order to attend and participate in the "Wheel of Fortune" game show are at best expenses, deductible as a miscellaneous itemized deduction under I.R.C. §67, rather than wagering losses under I.R.C. §165(d).**

In so holding, we reject the contention that the expenses are tantamount to a bet or wager. Unlike a wager or bet, Mr. Whitten and his family incurred the expenses in exchange for specific goods and services, such as transportation, meals, and lodging. Further, we doubt that Congress ever intended to allow **casual gamblers** to treat expenses for transportation, meals, and lodging as anything other than **either miscellaneous itemized deductions or nondeductible personal expenses**.

Note: In the facts for Question 1 above, Charles and Rose should report the following on their 1997 Form 1040:

Item	Where reported	Amount
Gambling winnings	Line 21, Form 1040	\$14,480 (5,724 + 8,756)

1997 Workbook

	(Other income)	
Gambling Losses	Line 27, Schedule A	8,249 (2,910 + 5,339)

See the examples of the completed 1997 Form 1040 (partial) and 1997 Schedule A (partial).

Income Attach Copy B of your Forms W-2, W-2G, and 1099-R here. If you did not get a W-2, see page 12. Enclose but do not attach any payment. Also, please use Form 1040-V.	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
	8a	Taxable interest. Attach Schedule B if required	8a	
	b	Tax-exempt interest. DO NOT include on line 8a	8b	
	9	Dividend income. Attach Schedule B if required	9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 12)	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required	13	
	14	Other gains or (losses). Attach Form 4797	14	
	15a	Total IRA distributions	15a	
	b	Taxable amount (see page 13)	15b	
	16a	Total pensions and annuities	16a	
	b	Taxable amount (see page 13)	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19		
20a	Social security benefits	20a		
b	Taxable amount (see page 15)	20b		
21	Other income. List type and amount—see page 15	21	14,480	
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22		

Other Miscellaneous Deductions Total Itemized Deductions	27	Other—from list on page A-5. List type and amount ▶	27	8,249
		Gambling Losses		
	28	Is Form 1040, line 33, over \$121,200 (over \$60,600 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 35, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A-5 for the amount to enter.	28	

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Cat. No. 11330X

Schedule A (Form 1040) 1997

1997 Workbook

Income Attach Copy B of your Forms W-2, W-2G, and 1099-R here. If you did not get a W-2, see page 12. Enclose but do not attach any payment. Also, please use Form 1040-V.	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7		
	8a	Taxable interest. Attach Schedule B if required	8a		
	b	Tax-exempt interest. DO NOT include on line 8a	8b		
	9	Dividend income. Attach Schedule B if required	9		
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 12)	10		
	11	Alimony received	11		
	12	Business income or (loss). Attach Schedule C or C-EZ	12		
	13	Capital gain or (loss). Attach Schedule D if required	13		
	14	Other gains or (losses). Attach Form 4797	14		
	15a	Total IRA distributions	15a		b Taxable amount (see page 13)
	16a	Total pensions and annuities	16a		b Taxable amount (see page 13)
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17		
	18	Farm income or (loss). Attach Schedule F	18		
	19	Unemployment compensation	19		
	20a	Social security benefits	20a		b Taxable amount (see page 15)
21	Other income. List type and amount—see page 15	21			
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶		22		
21	<i>Gambling Winnings</i>		21		14,480
Other Miscellaneous Deductions	27	Other—from list on page A-5. List type and amount ▶	27		
		<i>Gambling Losses</i>	27		8,249
Total Itemized Deductions	28	Is Form 1040, line 33, over \$121,200 (over \$60,600 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 35, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A-5 for the amount to enter.	28		

For Paperwork Reduction Act Notice, see Form 1040 Instructions. Cat. No. 11330X Schedule A (Form 1040) 1997

Question 2. *If gambling winnings exceed gambling losses in a tax year, are the losses fully deductible on Schedule A?*

Answer 2. Yes. The losses are not subject to the 2% AGI limitation.

Question 3

Facts. *My clients, a husband and wife, gamble heavily at the riverboats. They keep accurate records of winnings and losses. In 1996, the husband had net gambling losses of over \$10,000 and the wife had net gambling winnings of about \$15,000.*

Question. *Does the wife have to report her net winnings on the 1996 joint return with no offset of the husband's net losses? Or can the two figures be netted?*

Answer 3. The wife's winnings and the husband's losses are **combined** if they file a joint return for 1996.

1997 Workbook

Treasury Regulation 1.165-10 states that "in the case of a husband and wife making a joint return for the taxable year, the **combined losses of the spouses from wagering transactions shall be allowed to the extent of the combined gains of the spouses from wagering transactions.**"

Problem 4A: Deductibility of Unreimbursed Expenses Incurred by a Partner on Behalf of the Partnership

Partners normally are not allowed to deduct expenses that they pay for the benefit of the partnership. The rationale is that the business of the partnership is not necessarily the business of the partner. However, **under some circumstances**, a partner may deduct certain expenses paid on behalf of the partnership. Examples of allowed expenses are

1. Payment of wages of a partnership employee by a partner (**Rev. Rul. 70-253**, 1970-1 C.B. 31)
2. Travel and entertainment expenses paid by a partner (**Klein** (1956) 25 T.C. 1045)
3. Automobile, travel, and meals paid by a partner in a law firm where the partnership agreement did not require reimbursement but was otherwise clear as to what expenses would be reimbursed (**Letter Ruling 9316003**)
4. Under the standards of **Letter Ruling 9330004**, and/or **Letter Ruling 9330001**.

If a partnership has a reimbursement policy for expenses paid by a partner and the partner does not file for reimbursement, no deduction is allowed on the partner's tax return. (**Occhipinti** (1969) T.C. Memo 1969-191)

Practitioner Note.

If deductible, the unreimbursed expenses paid by the partner should be deducted in Part II of Schedule E. See the following Example. These expenses should also be deducted when computing the partner's net earnings from self-employment (if applicable). This treatment may also benefit the partner for state income tax purposes.

Example

Lonnie Jones is a partner in RBJ Accounting, a limited liability partnership. Per the partnership agreement or practice, each partner is responsible for paying his or her own automobile expenses attributable to the partnership business. In 1997, Lonnie's share of partnership distributable income is \$85,000 and his share of partnership I.R.C §179 deduction is \$6,000. He incurred \$4,200 of automobile expenses for partnership business. Lonnie's partially completed 1997 Schedules E and SE follow.

1997 Workbook

Part II Income or Loss From Partnerships and S Corporations Note: If you report a loss from an at-risk activity, you **MUST** check either column (e) or (f) on line 27 to describe your investment in the activity. See page E-4. If you check column (f), you must attach Form 6198.

27	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) All is at risk	(f) Some is not at risk
A	RBJ ACCOUNTING, LLP	P		37-1234567	X	
B	EXPENSES FOR RBJ	P		37-1234567	X	
C						
D						
E						

Passive Income and Loss				Nonpassive Income and Loss			
(g) Passive loss allowed (attach Form 8582 if required)		(h) Passive income from Schedule K-1		(i) Nonpassive loss from Schedule K-1	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
A				4,200 00	6,000 00	85,000 00	
B							
C							
D							
E							
28a Totals				4,200 00	6,000 00		
b Totals				4,200 00	6,000 00		
29 Add columns (h) and (k) of line 28a						85,000 00	
30 Add columns (g), (i), and (j) of line 28b						(10,200 00)	
31 Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below						74,800 00	

Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report.	2	74,800
3	Combine lines 1 and 2	3	74,800
4	Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax	4	69,078
5	Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> \$65,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 47. More than \$65,400, multiply line 4 by 2.9% (.029). Then, add \$8,109.60 to the result. Enter the total here and on Form 1040, line 47. 	5	10,113
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 26	6	5056 50

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 1997

Attachment to Schedule E

Expenses claimed on line 27(B), column(i):

Automobile expense:

1997 Workbook

Gas and oil	\$1,500
Insurance	700
Repairs/maintenance	600
Depreciation	1,400
Total	\$4,200

These expenses are unreimbursed partner expenses and are required pursuant to partnership agreement or practice. See **Rev. Rul.** 70-253 and **Letter Rulings** 93160003, 9330004, and 930001.

[Excerpt from the 1993 Tax School Book]

Adjusted gross income defined; trade or business expenses. (Code §§62, 162, and 274) [LTR 9330001, April 13, 1993]

If, under the partnership agreement or practice, the partner is required to pay certain partnership expenses out of his or her own funds, the partner is entitled to a §162 deduction for the amount of that expense on Part II of Schedule E.

Facts

- The taxpayer (hereafter referred to as **X**) is a general partner in a professional services partnership involved in the practice of accounting. **In 1990 X used his personal automobile for both out-of-town travel on behalf of the partnership and for local business travel.** The local travel was primarily to meet with clients at their homes or offices. The partnership reimbursed X at a prescribed mileage rate for the expenses X incurred for the out-of-town travel. **However, X represents that he was required, pursuant to the partnership rules, to personally pay the local automobile expenses, without reimbursement.**
- **X claimed a deduction from gross income on Part II of Schedule E (Form 1040) for the full amount of the local automobile expenses.**

Discussion. As a general rule a partner may not deduct the expenses of a partnership on his or her own income tax return, even if the expenses were incurred by the partner in furtherance to the partnership business. *Magruder v. Commissioner*, T.C.M. 1989-169 [CCH Dec. 45,619(M)]; *Cropland Chemical Corp. v. Commissioner*, 75 T.C. 288, 295 (1980) [CCH Dec. 37,413], *aff'd without published opinion*, 665 F.2d 1050 (7th Cir. 1981); *Farnsworth v. Commissioner*, 29 T.C. 1131, 1137 (1958) [CCH Dec. 22,895], *aff'd*, 270 F.2d 660 (3d Cir. 1959) [59-2 USTC ¶9705], *cert. denied*, 363 U.S. 902 (1960); *Klein v. Commissioner*, 25 T.C. 1045, 1051 (1956) [CCH Dec. 21,573]. As stated in *Wilson v. Commissioner*, 17 B.T.A. 976, 979 (1929) [CCH Dec. 5515].

Ordinary and necessary expenses of a partnership are properly deducted on the partnership return, and the partner then returns as an individual his or her distributive share of the net income of the partnership after making such deductions. He or she cannot take ordinary and necessary expenses of the partnership as a deduction on his or her individual return.

This is because, for the purposes of computing income and deductions, the business of a partnership is considered a separate business from that of the partners. *Brannen. v. Commissioner*, 722 F.2d 695, 703

1997 Workbook

(1984) [84-2 USTC ¶9144]; *Rosenthal v. Commissioner*, 48 T.C. 515, 530 (1967)[CCH Dec. 28,533], *aff'd*, 416 F.2d 491 (2d Cir. 1969) [69-1 USTC ¶9430]; *Estate of Freeland v. Commissioner*, 393 F.2d 573, 584 (9th Cir. 1968) [68-1 USTC ¶9278], *cert denied*, 393 U.S. 845 (1968); *Barham v. United States*, 301 F. Supp. 43, 46 (M.D. Ga. 1969) [69-1 USTC ¶9356], *aff'd*, 429 F.2d 40 (5th Cir. 1970) [70-2 USTC ¶9522].

However, if under the **partnership agreement or practice** the partner is required to pay certain partnership expenses out of his own funds, then the partner is entitled to a §162 deduction for the amount of such expenses.

Cropland v. Commissioner, 75 T.C. 188, 295 (1980) [CCH Dec. 37,413]; *Lewis v. Commissioner*, 65 T.C. 625 (1975) [CCH Dec. 33,563]; *Wallendal v. Commissioner*, 31 T.C. 1248, 1252 (1959) [CCH Dec. 23,514]. In *Klein v. Commissioner*, 25 T.C. 1045 (1956) [CCH Dec. 21,573], the partner incurred expenses for his personal automobile, meals, and lodging on behalf of the partnership. The Tax Court noted that under the partnership practice or agreement the taxpayer was expected to bear the unreimbursed expenses out of his personal funds. Thus, to the extent the taxpayer established that the expenses were not personal but were for travel and entertainment on behalf of the partnership, the Tax Court allowed the expenses to be deducted from gross income on the partner's individual income tax return. Accord, Rev. Rul. 70-253, 1970-1 C.B. 31, holding that where a partner is required under a partnership agreement to pay out of his personal funds the compensation of an employee who performs part of the partner's duties, the partner may deduct such payments as a business expense.

Transportation expenses. X represents that he incurred the local automobile expenses at issue on behalf of the partnership, in order to attend meeting with clients at their homes or offices. Pursuant to established partnership rules, X was required to bear the expenses without reimbursement.

Assuming that the automobile expenses are trade or business expenses that meet the requirements of §§162(a) and 274 of the Code, X may deduct the expenses from gross income under §62(a)(1) in computing adjusted gross income.

We appreciate the fact that the types of problems that Congress intended to address through imposition of the 2 percent floor under §67 of the Code may also be presented in partners' claims for deductions of unreimbursed business expenses in many situations. **We believe, however, that §67 as enacted does not apply to the deduction of business expenses by partners, as they are not considered employees of the partnership.** [See Rev. Rul. 69-184, 1969-1 C.B. 256.]

Problem 4B: Deductibility of Unreimbursed Expenses Incurred by a Shareholder on Behalf of a Corporation

It is rare that a personal deduction is allowed when a shareholder of either a C or S corporation pays corporate expenses. The courts have consistently held that such expenses are not deductible on the shareholder's Form 1040. A shareholder is a completely different entity from the corporation. The

1997 Workbook

payment of corporate expenses by a shareholder benefits the trade or business of the corporation. A shareholder is not engaged in a trade or business merely through his or her status as a shareholder or corporate officer.

There is an extensive list of cases where shareholder-paid expenses of the corporation have been disallowed. Some examples include the following:

- Expenditures by an officer were nondeductible on the grounds that they were ordinary and necessary expenses of the corporation and not the officer [*Roach*, (1930) 20 BTA 919].
- Taxpayer incurred auto expenses in performing services for his closely held corporation [*Snarski*, (1981) TC Memo 1981-328].
- The president and controlling shareholder incurred entertainment expenses in connection with the corporation's business [*Aisley* (1970) TC Memo 1970-63].
- A taxpayer incurred travel expenses on behalf of a corporation in which he was a majority shareholder. The taxpayer did not seek reimbursement. The amounts were either a loan to the corporation or a contribution to capital, either of which would have resulted in a deduction to the corporation [*Kliethermes* (1992) 92-2 USTC ¶50,584].

Problem 5: Form 4868 (Automatic Extension) Changes

In 1993, the IRS began an easing on the assessment of late filing penalties in cases where a Form 4868 was timely filed but the tax was not paid. **Treas. Reg.** §1.6081-4(T) and **Treasury Notice** 93-22 (1993-1 C.B. 305) eliminated the payment requirement with Form 4868, as long as a "reasonable estimate" of tax liability was entered on the form.

In late 1996, the IRS issued the final regulations (**Treas. Reg.** §1.6081-4). The final regulations adopted the rule that individuals could obtain an automatic four-month extension by filing Form 4868 without remittance. However, Form 4868 **must** show the full amount properly estimated as tax for the taxable year. The final regulations also eliminated the signature requirement on Form 4868. A new provision was added that allows the IRS to terminate an automatic extension (4868) by mailing a 10-day notice of termination to the taxpayer.

The 1996 Form 4868 and partial instructions relating to the "no remittance required" rule follow:

General Instructions

Purpose of Form

Use form 4868 to apply for 4 more months to file **Form 1040EZ**, **Form 1040A**, or **Form 1040**.

To get the extra time you **MUST**:

1997 Workbook

- Properly estimate your 1996 tax liability using the information available to you,
- Enter your tax liability on line 6a of Form 4868, **AND**
- File Form 4868 by the regular due date of your return.

You are not required to send a payment of the tax you estimate as due. However, it will benefit you to pay as much as you can. Any remittance you send with your application for extension will be treated as a payment of tax.

You do not have to explain why you are asking for the extension. We will contact you only if your request is denied.

Form 4868 Department of the Treasury Internal Revenue Service	Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	OMB No. 1545-0188 <div style="font-size: 2em; font-weight: bold;">1996</div>
1 Your name(s) (see instructions)		2a Amount due— Add lines 6c, d, and e . ▶ \$ _____
Address (see instructions)	3 Your social security number <div style="text-align: center;">.</div>	b Amount you are paying ▶ \$
City, town or post office, state, and ZIP code	4 Spouse's social security no. <div style="text-align: center;">.</div>	
5 I request an automatic 4-month extension of time to August 15, 1997, to file my individual tax return for the calendar year 1996 or to _____, 19____, for the fiscal tax year ending _____, 19____.		
6 Individual Income Tax Return— See instructions.		
Gift/GST Tax Return(s)— See instructions.		
a Total income tax liability for 1996. . . . \$ _____		Check here ONLY if filing a gift or GST tax return } Yourself ▶ <input type="checkbox"/> Spouse ▶ <input type="checkbox"/>
b Total payments for 1996. \$ _____		d Your gift/GST tax payment \$ _____
c Balance. Subtract 6b from 6a \$ _____		e Your spouse's gift/GST tax payment \$ _____

1997 Workbook

Form 4868 Department of the Treasury Internal Revenue Service	Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	OMB No. 1545-0188 <div style="font-size: 2em; font-weight: bold;">1996</div>
1 Your name(s) (see instructions)		2a Amount due— Add lines 6c, d, and e . ▶ \$ _____
Address (see instructions)	3 Your social security number : : : : : : : : :	b Amount you are paying ▶ \$
City, town or post office, state, and ZIP code	4 Spouse's social security no. : : : : : : : : :	
5 I request an automatic 4-month extension of time to August 15, 1997, to file my individual tax return for the calendar year 1996 or to _____, 19____, for the fiscal tax year ending _____, 19____.		
6 Individual Income Tax Return— See instructions. Gift/GST Tax Return(s)— See instructions.		
a Total income tax liability for 1996. . . . \$ _____		Check here ONLY if filing a gift or GST } Yourself ▶ <input type="checkbox"/> tax return } Spouse ▶ <input type="checkbox"/>
b Total payments for 1996. \$ _____		d Your gift/GST tax payment \$ _____
c Balance. Subtract 6b from 6a \$ _____		e Your spouse's gift/GST tax payment \$ _____

Practitioner Note 1.

The changes in the "no remittance required" rule only affect the late filing penalty (up to 25%) pursuant to I.R.C. §6651(a)(1). The estimated tax penalty, failure to pay penalty, and interest assessments still apply to the unpaid portion of the tax. Therefore, the final regulations should not be viewed as a way for clients to perpetuate late payments.

Practitioner Note 2.

The Tax Court found in a 1992 case that "properly estimated" means a bona fide and reasonable estimate of the tax liability based on the information available to the taxpayers at the time of the extension filing. This includes a bona fide and reasonable attempt to locate, gather, and consult the necessary information in order to properly estimate their liability [*O.B. Crocker, Jr.*, 92 T.C. 899].

In a more recent case, the IRS invalidated a Form 4868 of a senior partner in a law firm. In this case, the taxpayer, over a three-year period, underestimated the unpaid tax by 33%. The Tax Court, in upholding the IRS assessments for the 25% late filing penalty, determined that the taxpayer had unrestricted access to all financial records of the law firm and could have reasonably estimated the amount of unpaid tax [*Healey*, T.C. Memo 1996-260].

Problem 6: Bankruptcy from Credit Card Debt

1997 Workbook

I.R.C. §61(a)(12) specifically includes income from the discharge of indebtedness in the definition of gross income. However, a number of statutory exceptions to this general rule are found in I.R.C. §108, covering (1) **taxpayers in bankruptcy**, (2) insolvent taxpayers, (3) qualified farm debt, (4) qualified real property business debt, and (5) certain student loans.

The exclusion from gross income for the discharge of indebtedness applies to cases under Title 11 of the U.S. Code. **Chapters 7, 11, and 13 bankruptcy cases are included under Title 11.** The taxpayer must be under the jurisdiction of the court, and the debt discharge must be granted by the court or under a plan approved by the court.

Example. James White is an employee of XYZ, Inc. He has no other income, and he recently filed for bankruptcy under Chapter 7. James' financial position is as follows:

Assets	FMV	Adjusted Basis	Current Liability
Residence	\$60,000	\$52,000	\$48,000
Auto	12,000	16,000	11,000
Personal property	4,000	12,000	
Credit cards			28,000
Totals	\$76,000	\$80,000	\$87,000

James is current on both his house payment and his car payment, but he is significantly behind on his credit card payment. James will reaffirm both the mortgage on the house and the debt on the car. He will be totally discharged of the \$28,000 in credit card debt. Since James is in **bankruptcy** under the jurisdiction of the court, the debt discharge will be **excluded** from gross income.

Note: The exclusion from gross income of discharged debt under I.R.C. §108(a)(1)(B) applies **only if the taxpayer** (under a Chapter 12 or 13 discharge) reduces certain tax attributes by the amount of excluded debt discharge income. I.R.C. §108(b) lists the following attributes and the order of their use:

1. Net operating loss
2. General business credit
3. Minimum tax credit
4. Capital loss carryovers
5. Basis reduction
6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers.

Assuming that James has neither 1, 2, 3, or 4, above (which in most instances is the case), he must reduce the basis of his property by the amount of discharged debt (\$28,000). Pursuant to I.R.C. §1017(a), the basis reduction affects the property held by the taxpayer at the **beginning of the tax year that follows the tax year in which the discharge of debt occurs.** I.R.C. §1017(b) limits the reduction in basis to not more than the aggregate basis of the property held immediately after the discharge (\$80,000) minus the aggregate of the liabilities immediately after the discharge (\$59,000). As a result, **only \$21,000 (\$80,000 – 59,000) of the debt discharge of \$28,000 will reduce the basis of his property after the bankruptcy.**

1997 Workbook

Since James owns more than one asset after the bankruptcy, **Treas. Reg. §1017-1(a)(6)** requires that the basis of each unit of property be decreased in an amount equal to a proportion of the excess of the adjusted basis of each unit of property that bears to the sum of the adjusted basis of all of such property (i.e., a proportionate allocation using adjusted basis, not fair market value). Accordingly,

Asset	Adjusted Basis	%	Debt Discharge	New Basis (Adjusted Basis – Debt Discharge)
Residence	\$52,000	65%	\$13,650	\$38,350
Auto	16,000	20%	4,200	11,800
Personal property	12,000	15%	3,150	8,850
Totals	\$80,000	100%	\$21,000	\$59,000

James' adjusted basis for later gain or loss on the sale of these items is reflected in the New Basis column at the far right.

Problem 7: Corporate Downsizing Tax Issues

Three tax issues will be discussed: (1) severance pay, (2) moving expenses, and (3) job search expenses.

Severance Pay

I.R.C. §61(a)(1) states that "gross income means all income from whatever source derived, including **compensation for services.**" **Treas. Reg. §1.61-2(a)(1)** defines **compensation for services**. Included in this definition is **termination or severance pay**.

A lump-sum payment for cancellation of an employment contract is income to the employee in the year received. It must be included as salary and wage income in Box 1 (Wages, tips, other compensation) of the 1997 Form W-2. Severance pay is also **taxable for Social Security and Medicare taxes and for federal unemployment tax purposes** (page 31 of IRS Pub. #15, Circular E, Employer's Tax Guide, January 1997 Revision).

Severance pay generally has been viewed by the courts as **taxable compensation for past services rather than as a nontaxable gift**. There have been numerous court cases dealing with severance (also called dismissal or termination) pay. Most cases involve taxpayers' attempts to convince the courts that their severance payments were in reality disinterested gifts from former employers. Very few of these court cases have been successful. There are also 5 Revenue Rulings that hold that various types of severance pay are taxable [**Rev. Rul.** 55-520, 58-301, 59-227, 74-252, and 75-44].

Moving Expenses

1997 Workbook

General Rules

1. Reimbursed and employer-paid **qualified** moving expenses (those that would otherwise be deductible by the employee) are **not** includable in an employee's income **unless** the employer/payer has knowledge that the employee deducted the moving expenses in a prior year.
2. Reimbursed and employer-paid **nonqualified** moving expenses are **includable** in an employee's income **and** are subject to employment taxes and income tax withholding.

Moving Expense Reimbursements

Employers. If you are an employer and you reimburse employee moving expenses, how you treat the reimbursement(s) on the employee's Form W-2 depends in part on **whether you have an accountable plan**. Reimbursements treated as paid under an accountable plan are reported in **box 13** on the 1997 Form W-2 with **code P**.

Accountable Plans. To be an accountable plan, an employer's reimbursement arrangement must require the employees to meet **all three** of the following rules:

1. The reimbursed moving expenses must be of the type for which **a deduction would be allowed** if paid by the employee. Those are
 - a. Reasonable expenses to move household goods and personal effects from the former home to the new home
 - b. Reasonable travel (including lodging) expenses from the former home to the new home.
2. The employee must **adequately account** to the employer for these moving expenses within a reasonable period of time.
3. The employee must return any excess reimbursement within a reasonable period of time.

Nonaccountable Plans. A **nonaccountable** plan is a reimbursement arrangement that does not meet the three rules listed above for **accountable** plans. In addition, the following reimbursements will be treated as being paid under a **nonaccountable** plan:

1. Excess reimbursements that are not returned to the employer.
2. Reimbursements of **nondeductible** moving expenses. These include the following items:
 - a. Pre-move househunting expenses
 - b. Temporary living expenses
 - c. Meal expenses
 - d. Expenses of buying or selling a home
 - e. Expenses of obtaining or breaking a lease
 - f. Security deposits (including amounts forfeited due to the move)

1997 Workbook

- g. Home improvements to aid in the sale of the home
- h. Loss on the sale of the former home
- i. Mortgage penalties
- j. Losses from disposing of memberships in clubs
- k. Any part of the purchase price of the new home
- l. Real estate taxes on either the former or the new home
- m. Storage charges except those incurred in transit **or** for moves to a foreign country

Moving Expense Problem with Completed Forms

[See Announcement 97-77 in the What's New chapter for 1998 changes.]

Tom Smith is married and has two children. He owned his home in Detroit where he worked. His employer told him on February 8, 1997, that he would be transferred to San Diego as of April 10, 1997. His wife, Peggy, flew to San Diego on March 1 to look for a new home. She put down \$25,000 on a house being built

1997 Workbook

and came back to Detroit on March 4. The Smiths sold their Detroit home for \$1,500 less than they paid for it. They contracted to have their personal effects moved to San Diego on April 3. The family drove to San Diego, where they found that their new home was not finished. They stayed in a nearby motel until the house was ready on May 1. On April 10, Tom went to work in the San Diego plant where he still works. His records for the move show

1.	Peggy's premove househunting trip:		
	Travel and lodging:	\$449	
	Meals:	75	\$524
2.	Downpayment on San Diego home:		25,000
3.	Real estate commission paid on sale of Detroit home:		3,500
4.	Loss on sale of Detroit home (not including real estate commission):		1,500
5.	Amount paid for moving personal effects (furniture, other household goods, etc.):		8,000
6.	Expenses of driving to San Diego:		
	Mileage (start 14,278; end 16,478)		\$220
	2,200 miles at 10 cents a mile:		
	Lodging	180	
	Meals	320	720
7.	Cost of temporary living expenses in San Diego:		
	Motel rooms:	\$1,450	
	Meals:	2,280	3,730
		Total	\$42,974

Tom was reimbursed \$10,599 under an accountable plan as follows:

Moving personal effects	\$6,800
Travel (and lodging) to San Diego	400
Travel (and lodging) for househunting trip	449
Lodging for temporary quarters	1,450
Loss on sale of home	1,500
Total reimbursement	\$10,599

Tom's employer gave him Form 4782 to show him a breakdown of the amount of reimbursement. This form is shown later.

The employer included this reimbursement on Tom's Form W-2 for 1997. The reimbursement of deductible expenses, \$7,200 for moving household goods and travel to San Diego, was included in box 13 of Form W-2. His employer identified this amount with code P.

The employer included the balance, \$3,399 reimbursement of nondeductible expenses, in box 1 of Form W-2 with Tom's other wages. He must include this amount on line 7 of Form 1040. The employer withholds taxes

1997 Workbook

from the \$3,399. Also, Tom's employer could have given him a separate Form W-2 for his moving reimbursement.

Tom figures his deduction for moving expenses as follows:

Item 5, moving personal effects	\$8,000
Item 6, driving to San Diego (\$220 + \$180)	400
Total deductible moving expenses	\$8,400
Minus reimbursement included in box 13 of Form W-2	7,200
Deduction for moving expenses	\$1,200

Tom enters these amounts on Form 3903 to figure his deduction. His Form 3903 is shown later. He also enters his deduction, \$1,200, on line 25 [of 1997 Form 1040].

Nondeductible expenses: Of the \$42,974 moving expenses that Tom incurred, the following items cannot be deducted:

- Item 1, premove househunting expenses.
- Item 2, the downpayment on the San Diego home. If any part of it were for payment of deductible taxes or interest on the mortgage on the house, that part would be deductible as an itemized deduction.
- Item 3, the real estate commission paid on the sale of the Detroit home. The commission is used to figure the gain or loss on the sale.
- Item 4, the loss on the sale of the Detroit home. The Smiths cannot deduct it even though Tom's employer reimbursed him for it.
- Item 6, the meals expense while driving to San Diego. (However, the lodging and car expenses are deductible.)
- Item 7, temporary living expenses.

1997 Workbook

Form **3903**

Department of the Treasury
Internal Revenue Service

Name(s) shown on Form 1040

Moving Expenses

► Attach to Form 1040.

► See instructions on back.

OMB No. 1545-0062

1997

Attachment
Sequence No. 62

Tom and Peggy Smith

Your social security number
325:00:6437

Caution: If you are a member of the armed forces, see the instructions before completing this form.

- | | | | |
|---|--|---|-------------|
| 1 | Enter the number of miles from your old home to your new workplace . . . | 1 | 2,200 miles |
| 2 | Enter the number of miles from your old home to your old workplace. . . | 2 | 5 miles |
| 3 | Subtract line 2 from line 1. Enter the result but not less than zero . . . | 3 | 2,195 miles |

Is line 3 at least 50 miles?

Yes ► Go to line 4. Also, see **Time Test** in the instructions.

No ► You **cannot** deduct your moving expenses. Do not complete the rest of this form.

- | | | | | |
|---|--|---|-------|---|
| 4 | Transportation and storage of household goods and personal effects (see instructions) . . . | 4 | 8,000 | - |
| 5 | Travel and lodging expenses of moving from your old home to your new home. Do not include meals (see instructions). | 5 | 400 | - |
| 6 | Add lines 4 and 5 | 6 | 8,400 | - |
| 7 | Enter the total amount your employer paid for your move (including the value of services furnished in kind) that is not included in the wages box (box 1) of your W-2 form. This amount should be identified with code P in box 13 of your W-2 form. | 7 | 7,200 | - |

Is line 6 more than line 7?

Yes ► Go to line 8.

No ► You **cannot** deduct your moving expenses. If line 6 is less than line 7, subtract line 6 from line 7 and include the result in income on Form 1040, line 7.

- | | | | | |
|---|--|---|-------|--|
| 8 | Subtract line 7 from line 6. Enter the result here and on Form 1040, line ⁵ 27. This is your moving expense deduction | 8 | 1,200 | |
|---|--|---|-------|--|

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 12490K

Form **3903** (1997) ⁷

1997 Workbook

Form 4782 (Rev. September 1994) Department of the Treasury Internal Revenue Service Name of employee Tom Smith	Employee Moving Expense Information Payments made during the calendar year 19 97 ▶ See instructions on back.	OMB No. 1545-0182 Do not file. Keep for your records. Social security number 325 00 6437	
Moving Expense Payments	(a) Amount paid to employee	(b) Amount paid to a third party for employee's benefit and value of services furnished in kind	(c) Total (Add columns (a) and (b).)
Part I Expenses Incurred After 1993			
1 Transportation and storage of household goods and personal effects	1	6,800 —	6,800 —
2 Travel and lodging payments for expenses of moving from old to new home. Do not include meals	2	400 —	400 —
3 List all other payments (specify). Note: These amounts must be included in the employee's income ▶ <u>Loss on sale of home</u> <u>\$1,500</u> <u>Travel and lodging - House hunting</u> <u>\$ 449</u> <u>Lodging - Temporary quarters</u> <u>\$ 1,450</u>	3	3,399 —	3,399 —
4 Total payments for moving expenses incurred after 1993. Add the amounts in column (c) of lines 1 through 3. ▶			4 10,599 —
Part II Expenses Incurred Before 1994			
Section A—Transportation of Household Goods			
1 Transportation and storage of household goods and personal effects	1		
Section B—Expenses of Moving From Old To New Home			
2 Travel and lodging payments not including meals	2		
3 Meal payments for travel	3		
Section C—Pre-move Househunting Expenses and Temporary Quarters for any 30 Days in a Row After Obtaining Employment (90 Days for a Foreign Move)			
4 Pre-move travel and lodging payments not including meals	4		
5 Temporary quarters payments not including meals	5		
6 Total meal payments for both pre-move househunting and temporary quarters	6		
Section D—Qualified Real Estate Expenses			
7 Qualified expenses of selling, buying, or renting a home	7		
Section E—Miscellaneous Payments			
8 List all other payments (specify) ▶	8		
9 Total payments for moving expenses incurred before 1994. Add the amounts in column (c) of lines 1 through 8. Note: This amount must be included in the employee's income ▶			9

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 13079T

Form 4782 (Rev. 9-94)

1997 Workbook

Form 4782 (Rev. September 1994) Department of the Treasury Internal Revenue Service Name of employee Tom Smith	Employee Moving Expense Information Payments made during the calendar year 19 97 ▶ See instructions on back.	OMB No. 1545-0182 Do not file. Keep for your records. Social security number 325 00 6437	
Moving Expense Payments	(a) Amount paid to employee	(b) Amount paid to a third party for employee's benefit and value of services furnished in kind	(c) Total (Add columns (a) and (b).)
Part I Expenses Incurred After 1993			
1 Transportation and storage of household goods and personal effects	1	6,800 -	6,800 -
2 Travel and lodging payments for expenses of moving from old to new home. Do not include meals	2	400 -	400 -
3 List all other payments (specify). Note: These amounts must be included in the employee's income ▶ <u>Loss on sale of home</u> <u>\$1,500</u> <u>Travel and lodging - House hunting</u> <u>\$ 449</u> <u>Lodging - Temporary quarters</u> <u>\$ 1,450</u>	3	3,399 -	3,399 -
4 Total payments for moving expenses incurred after 1993. Add the amounts in column (c) of lines 1 through 3. ▶			4 10,599 -
Part II Expenses Incurred Before 1994			
Section A—Transportation of Household Goods			
1 Transportation and storage of household goods and personal effects	1		
Section B—Expenses of Moving From Old To New Home			
2 Travel and lodging payments not including meals	2		
3 Meal payments for travel	3		
Section C—Pre-move Househunting Expenses and Temporary Quarters for any 30 Days in a Row After Obtaining Employment (90 Days for a Foreign Move)			
4 Pre-move travel and lodging payments not including meals	4		
5 Temporary quarters payments not including meals	5		
6 Total meal payments for both pre-move househunting and temporary quarters	6		
Section D—Qualified Real Estate Expenses			
7 Qualified expenses of selling, buying, or renting a home	7		
Section E—Miscellaneous Payments			
8 List all other payments (specify) ▶	8		
9 Total payments for moving expenses incurred before 1994. Add the amounts in column (c) of lines 1 through 8. Note: This amount must be included in the employee's income ▶			9

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 13079T

Form 4782 (Rev. 9-94)

1997 Workbook

Other Moving Tax Issues

The Distance Test. The distance test is met if the new job location is **at least 50 miles** farther from the former home than was the old job location. The distances between the job locations (old and new) and the former home are the **shortest of the more commonly traveled routes between them**.

Mileage Test Formula

		(Enter # of miles)
a.	Distance between former home and new job location	
b.	Distance between former home and old job location	
c.	Subtract (b) from (a) (must exceed 50 miles)	

Note: The theory of the distance test is that the **commuting distance must increase by at least 50 miles**.

The 39-Week Test for Employees. Employees must work full-time for **at least 39 weeks during the first 12 months** after arrival in the **general area** of the new job location. For this time test, count only full-time work as an **employee**; do **not** count any work performed as **self-employed**. The 39 weeks of employment do not have to be consecutive, and they can be with different employers. The 39-week test is **waived** if the taxpayer is **transferred for the employer's benefit or is laid off for a reason other than willful misconduct**.

Note: The 39-week test is **not waived** if the time test is not met because the taxpayer **voluntarily** quits or resigns full-time employment.

Job Search Expenses

Expenses That May Be Deducted

The job search expenses that are deductible are those incurred in trying to find a job in the taxpayer's **present** occupation, **even if not successful** [Rev. Rul. 75-120, 1975-1, C.B. 55 and clarified by Rev. Rul. 77-16, 1997-1 C.B. 37]. If you are **unemployed**, the kind of work you did for your **last employer** determines your occupation.

Note: If a substantial period of time has elapsed between the date of your last job and the date you begin your new job search, the expenses are **not** deductible [IRS Pub. #529, "Miscellaneous Deductions"].

Question 1. *How do you define searching for a job in the taxpayer's "**present or current**"*

1997 Workbook

occupation?

Answer 1. The majority of the court cases in this area deal with taxpayers who switched careers, tried to deduct job search expenses, and went to Tax Court to defend their deductions.

Examples for Answer 1

1. A taxpayer retired from the Air Force and tried to find a job as a manager in a corporation. The Tax Court determined he was seeking employment in a **new** trade or business. Therefore, his job search expenses were not deductible.
2. A civil engineer was unhappy working for his current engineering firm. He engaged an employment career consulting company to assist him in finding a new supervisory engineering job at higher pay. The IRS disallowed the job search expenses, but the Tax Court disagreed and allowed them.

Note: Any deductible job search expenses of employees are subject to the 2% AGI limitation. If Form 2106 (Employee Business Expenses) is required to be filed, enter the amount of the expenses on line 4, Form 2106. If not, enter the amount of the expenses directly on the 1997 Schedule A, line 20 (Unreimbursed employee expenses).

Types of job search expenses that may be deducted

1. Employment and outplacement agency fees.
2. Resumé expenses (typing, printing, mailing).
3. Travel and transportation expenses to travel to an area to search for a new job in your **present** occupation if the trip was taken **primarily** to look for a new job. You can use the 1997 standard mileage rate of **31.5 cents per mile** to compute auto expenses.
4. Long-distance phone calls to prospective new employers.

Expenses That May Not Be Deducted

The following job search expenses may **not** be deducted:

1. Expenses incurred in searching for a job in a **new/different** occupation, **even if successful**.
2. Expenses incurred in seeking employment for the **first time, even if successful**. **Example:** A college student graduates with a degree in elementary education. The expenses incurred to obtain the first teaching job are **not** deductible.

Problem 8: Bad Debts and Worthless Securities

1997 Workbook

There are two kinds of bad debts—**business** bad debts and **nonbusiness** bad debts. A business bad debt is one that comes from operating your trade or business. Business bad debts are deductible as an expense in computing the net profit of the business. All other bad debts are nonbusiness bad debts and are deductible as short-term capital losses on Schedule D (Form 1040). As such, they are limited by the \$3,000 capital loss limitation.

Stocks, stock rights, and corporate or government bonds with interest coupons or in registered form that become worthless **during the tax year** are treated as though they were capital assets **sold on the last day of the tax year**. To determine whether they are long-term or short-term capital assets, you are considered to have held the securities until the **last day of the year** in which they become worthless.

Note: The applicable I.R.C. section is §166. The issue of whether a taxpayer is entitled to a bad debt deduction and, if so, the nature of the debt is a highly litigated issue. Following are examples taken from court cases.

Example 1. The taxpayer was initially a principal shareholder, as well as CEO, of a corporation. During difficult financial times, the taxpayer made loans and advances to the corporation to alleviate the corporation's severe cash flow problems. Despite selling a controlling interest in the corporation, the taxpayer, who continued as CEO, **personally guaranteed** the corporation's line of credit. In so doing, he took a huge risk because the dollar amount of the loans he personally guaranteed **far exceeded the value of his stock investment**. The corporation ultimately failed, and the taxpayer paid the corporate liability and incurred bad debt losses.

Question 1. *What type of bad debt is this?* **business or nonbusiness?**

Answer 1. Business—deductible as an employee business expense on Form 2106.

Question 1A. *Why is it a **business** bad debt (according to both the District Court and the Appeals Court) rather than a **nonbusiness** bad debt?*

Answer 1A. A **business** bad debt requires that (1) the taxpayer be engaged in a trade or business, and (2) the bad debt loss be **proximately related to the conduct of that trade or business**. In determining whether a bad debt has a proximate relation to the taxpayer's trade or business (and thus qualifies as a **business** bad debt), the test is one of **dominant motivation**.

If the taxpayer's **dominant motivation** is as an **investor**, i.e., realizing **capital gains**, then the loss is a **nonbusiness** bad debt. If the taxpayer's **dominant motivation** is as an **employee**, i.e., **obtaining increases in salary**, then the loss is a **business** bad debt.

The District Court determined (and the 10th Circuit Appeals Court affirmed) that the taxpayer's **dominant motive** for making the loans, advances, and guarantees was to **further his business interest in remaining employed and to obtain a salary to meet his financial needs**. The taxpayer's **financial risk**

1997 Workbook

exceeded the value of his stock investment in the company by more than three times. Also, he remained an active employee (CEO) after the sale of his controlling interest. Both of these facts suggested to the courts that the taxpayer was **primarily motivated by employee rather than investor concerns**. Thus, both courts found the losses to be business bad debt losses [*Litwin*, CA-10, 93-1 USTC ¶150,041, and on pages 313–14 of the 1993 Tax School Book].

Practitioner Caution. There are literally hundreds of court cases dealing with this exact issue. The *Litwin* case is just one of them. There are numerous other cases with similar though not exact facts that are in favor of the IRS position that the debt in question is **nonbusiness** rather than **business**. Do not rely on the *Litwin* case to form an assumption that your clients always or usually are entitled to similar **business** bad debt deductions. The *Litwin* case is shown above as an illustration of the factors considered by the courts in reaching a decision on this very difficult issue.

Example 2. The taxpayer was an 80% shareholder, president, treasurer, director, and full-time employee of his closely held electronics company. He advanced about \$182,000 to the company during the years 1981 to 1985 for payroll and current operating expenses. The corporation signed interest-bearing notes for each advance that were payable in two years.

But **no** interest or principal was ever **repaid by the corporation**. In 1988, the board of directors declared the notes to be worthless. The taxpayer deducted the \$182,000 as a **nonbusiness** bad debt on his 1988 Schedule D. But the IRS disallowed the short-term capital loss.

The IRS's position was that **although the advances appeared to be loans, they were actually contributions to capital**. The advances were necessary because the company no longer had outside borrowing sources. The company was thinly capitalized, as evidenced by heavy debt-to-equity ratios. Plus, the taxpayer continued to advance funds **after** the board of directors declared **prior notes worthless**.

Question 2. *Were the advances (evidenced by notes) bona fide loans?*

Answer 2. No. Both IRS and the Tax Court determined that the advances were not loans (debt).

Question 2A. *What were the advances?*

Answer 2A. They were contributions to capital rather than loans. Following are quotes from the Tax Court:

The characterization of advances to a corporation by a shareholder is a question of fact. Courts have considered the following nonexclusive list of **relevant factors** in determining whether advances are **loans** or **equity investments**:

1. the intent of the parties;
2. the identity between creditors and shareholders;

1997 Workbook

3. the extent of participation in management by the shareholder;
4. the ability of the corporation to obtain funds from outside sources;
5. the "thinness" of the capital structure in relation to debt (In other words, an analysis of the **debt-to-equity ratio** is required. If the **equity** dollar amount is **small and/or inadequate compared to the debt dollar amount**, this is an important factor in favor of IRS and against the taxpayer.);
6. the risk involved;
7. the formal indicia of the arrangement (in other words, **form** as opposed to **substance**);
8. the voting power of the shareholder;
9. the provision of a **fixed rate of interest**;
10. a contingency on the obligation to repay;
11. the source of interest payments;
12. the presence or absence of a **fixed maturity date**; and
13. a provision for redemption at the option of the shareholder.

These factors are only aids to be used in determining whether the investment constitutes **debt** or **equity**. The touchstone of economic reality is whether "an outside lender would have made the payments in the same form and on the same terms" (*J. M. Segel*, 89 TC 816). If the advances "were far more speculative than what an outsider would make, the payments would be loans in name only" (*Fin Hay Realty Co.*, 68-2 USTC ¶9438).

The Tax Court concluded by stating

Our review of the record convinces us that an **outside creditor would not have made the advances** in issue. We conclude that these advances were **contributions to capital** as opposed to bona fide debts. Therefore, the taxpayer is **not entitled to a bad debt deduction** in 1988 (*Kadlec*, 71 TCM 2399, and on pages 573–4 of the 1996 Tax School Book).

Question 2B. *Since the advances were deemed to be **contributions to capital rather than loans**, can the taxpayer ever have a "bad debt" deduction on his tax return?*

Answer 2B. No. Contributions to capital increase the shareholder's basis in his stock investment. If the stock in the closely held corporation becomes **worthless**, the stock basis will be the amount of the capital loss (short-term or long-term, depending on the holding period) to be deducted on Schedule D.

Practitioner Caution. This area of shareholder loans to closely held corporations is fraught with dangerous technical tax law interpretations. Careful tax planning is a necessity.

Problem 9: Alternative Minimum Tax

1997 Workbook

The minimum-tax concept was added to the Internal Revenue Code in the Tax Reform Act of 1969 to ensure that those taxpayers having a **substantial amount of economic income** but a **minimum amount of income tax liability** will pay at a rate greater than the lesser regular income tax rates. The Tax Reform Act of 1986 added the alternative minimum tax (AMT) structure that exists presently. It must be noted that the AMT is a **separate tax system** with a separate set of rules to compute alternative minimum taxable income. The AMT rate is either 26% or 28%.

Form 6251 is used to compute AMT liability. The form acts to convert regular tax income to **alternative minimum taxable income** by adding and subtracting the dollar amount of the difference between the two sets of rules to regular taxable income. **A taxpayer will report an AMT liability on Form 1040 if the AMT computation results in a tax greater than the regular tax.** Due to many differences between regular tax and AMT, any combination of items may result in an AMT liability.

However, there are several items that by themselves may trigger AMT:

- **Taxes.** An itemized deduction for taxes **cannot** be claimed for AMT purposes. Thus, the deduction on Schedule A, line 9, is added as an adjustment item on line 3 of Form 6251.
- **Miscellaneous itemized deductions.** An itemized deduction for any miscellaneous item is **not allowable** for AMT purposes. Thus the deduction on Schedule A, line 26 is added as an adjustment item on line 5 of Form 6251. **Example:** A taxpayer with a large amount of employee business expenses such as an **outside salesperson** may be subject to AMT.
- **Tax-exempt interest from private-activity bonds.** This tax preference is the interest on **tax-exempt** private-activity bonds issued by a state or local government unit after August 7, 1986. The income is added as a preference item on line 13 of Form 6251. **Tax-exempt interest is not required to be reported on Form 1099; however, most payers will send the bond owner a statement of the interest paid during the year and identify the interest as subject to AMT if the bond qualifies.** Any exempt-interest dividend from a mutual fund must be included as a preference item to the extent of its proportionate share of the interest on such bonds received by the mutual fund. **Example:** A taxpayer with low AGI and a significant amount of tax-exempt interest from private-activity bonds may be subject to AMT.
- **Post-1986 depreciation.** For AMT purposes a taxpayer must use the **Alternative Depreciation System (ADS)** to depreciate tangible property placed in service after 1986. To compute AMT depreciation (other than property depreciated for regular tax purposes under the straight-line method), a taxpayer must use the **150% declining balance over the ADS recovery period** (sometimes a longer period than for regular tax purposes). Thus, two depreciation schedules must be maintained in order to compute the **difference between the two methods.** This difference is shown as an adjustment on line 8 of Form 6251. This adjustment will generally be **positive** in the **early years** of the recovery period and **negative** in the **later years.** **Example:** A taxpayer with a large amount of depreciable personal property placed in service within the last several years may generate an AMT liability. If a taxpayer is a partner or an S corporation shareholder, his proportionate share of this adjustment will be shown on the Schedule K-1.

1997 Workbook

- **Adjusted gain or loss.** Because of the difference in the depreciation rules for regular tax and AMT purposes, if a taxpayer sold property during the year, the gain or loss from the sale must be recomputed using the **adjusted basis for AMT purposes**. The difference between the two calculations is the amount of the adjustment on line 9 of Form 6251.
- **Incentive stock options.** Mid-level and higher management employees of publicly held companies may receive a part of their compensation in the form of stock options of their **employer's shares**. For regular tax purposes, no income is recognized when an incentive stock option (ISO), as defined by I.R.C. §422(b), is granted or exercised. However, this exclusion rule does **not apply** for AMT purposes. **The AMT adjustment is the excess (if any) of the stock's fair market value at the time of exercise over the amount paid for the stock.** The AMT basis of the stock is the regular tax basis increased by the amount of the adjustment. **There is no AMT adjustment if the option is exercised and the stock sold in the same year.**

Note: See the example blank 1996 Form 6251. A comprehensive problem with completed forms and schedules has not been included for Problem 9.

Form 6251		Alternative Minimum Tax—Individuals		OMB No. 1545-0227	
Department of the Treasury Internal Revenue Service		▶ See separate instructions.		1996	
Name(s) shown on Form 1040		▶ Attach to Form 1040 or Form 1040NR.		Attachment Sequence No. 32	
		Your social security number			
Part I Adjustments and Preferences					
1 If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 34, here and go to line 6					
2 Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2½% of Form 1040, line 32					
3 Taxes. Enter the amount from Schedule A (Form 1040), line 9.					
4 Certain interest on a home mortgage not used to buy, build, or improve your home					
5 Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26					
6 Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21					
7 Investment interest. Enter difference between regular tax and AMT deduction					
8 Post-1986 depreciation. Enter difference between regular tax and AMT depreciation					
9 Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss					
10 Incentive stock options. Enter excess of AMT income over regular tax income					
11 Passive activities. Enter difference between AMT and regular tax income or loss					
12 Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 8					
13 Tax-exempt interest from private activity bonds issued after 9/7/86					
14 Other. Enter the amount, if any, for each item below and enter the total on line 14.					
a Charitable contributions					
b Circulation expenditures					
c Depletion					
d Depreciation (pre-1987)					
e Installment sales					
f Intangible drilling costs					
g Long-term contracts					
h Loss limitations					
i Mining costs					
j Patron's adjustment					
k Pollution control facilities					
l Research and experimental					
m Tax shelter farm activities					
n Related adjustments					
15 Total Adjustments and Preferences. Combine lines 1 through 14					
Part II Alternative Minimum Taxable Income					
16 Enter the amount from Form 1040, line 35. If less than zero, enter as a (loss)					
17 Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount					
18 If Form 1040, line 32, is over \$117,950 (over \$58,975 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28					
19 Combine lines 16 through 18					
20 Alternative tax net operating loss deduction. See page 5 of the instructions					
21 Alternative Minimum Taxable Income. Subtract line 20 from line 19. (If married filing separately and line 21 is more than \$165,000, see page 5 of the instructions.)					
Part III Exemption Amount and Alternative Minimum Tax					
22 Exemption Amount. (If this form is for a child under age 14, see page 6 of the instructions.)					
If your filing status is: And line 21 is not over: Enter on line 22:					
Single or head of household \$112,500 \$33,750					
Married filing jointly or qualifying widow(er) 150,000 45,000					
Married filing separately 75,000 22,500					
If line 21 is over the amount shown above for your filing status, see page 6 of the instructions.					
23 Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28					
24 If line 23 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 23 by 26% (26). Otherwise, multiply line 23 by 28% (28) and subtract \$3,500 (\$1,750 if married filing separately) from the result					
25 Alternative minimum tax foreign tax credit. See page 6 of the instructions					
26 Tentative minimum tax. Subtract line 25 from line 24					
27 Enter your tax from Form 1040, line 38 (excluding any amount from Form 4972), minus any foreign tax credit from Form 1040, line 41					
28 Alternative Minimum Tax. (If this form is for a child under age 14, see page 7 of the instructions.) Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 45					

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13600G Form **6251** (1996)

1997 Workbook

Form **6251**

Alternative Minimum Tax—Individuals

OMB No. 1545-0227

Department of the Treasury
Internal Revenue Service

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

1996

Attachment
Sequence No. **32**

Name(s) shown on Form 1040

Your social security number

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 34, here and go to line 6	1		
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2½% of Form 1040, line 32	2		
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9.	3		
4	Certain interest on a home mortgage not used to buy, build, or improve your home	4		
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26	5		
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	()
7	Investment interest. Enter difference between regular tax and AMT deduction	7		
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8		
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9		
10	Incentive stock options. Enter excess of AMT income over regular tax income	10		
11	Passive activities. Enter difference between AMT and regular tax income or loss	11		
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 8	12		
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13		
14	Other. Enter the amount, if any, for each item below and enter the total on line 14. a Charitable contributions h Loss limitations b Circulation expenditures i Mining costs c Depletion j Patron's adjustment d Depreciation (pre-1987) k Pollution control facilities e Installment sales l Research and experimental f Intangible drilling costs m Tax shelter farm activities g Long-term contracts n Related adjustments	14		
15	Total Adjustments and Preferences. Combine lines 1 through 14 ▶	15		

Part II Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 35. If less than zero, enter as a (loss) ▶	16		
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17		
18	If Form 1040, line 32, is over \$117,950 (over \$58,975 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	()
19	Combine lines 15 through 18 ▶	19		
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20		
21	Alternative Minimum Taxable Income. Subtract line 20 from line 19. (If married filing separately and line 21 is more than \$165,000, see page 5 of the instructions.) ▶	21		

Part III Exemption Amount and Alternative Minimum Tax

22	Exemption Amount. (If this form is for a child under age 14, see page 6 of the instructions.) If your filing status is: And line 21 is not over: Enter on line 22: Single or head of household \$112,500 \$33,750 Married filing jointly or qualifying widow(er) 150,000 45,000 Married filing separately 75,000 22,500 If line 21 is over the amount shown above for your filing status, see page 6 of the instructions. 23 Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ▶ 24 If line 23 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result 25 Alternative minimum tax foreign tax credit. See page 6 of the instructions 26 Tentative minimum tax. Subtract line 25 from line 24 ▶ 27 Enter your tax from Form 1040, line 38 (excluding any amount from Form 4972), minus any foreign tax credit from Form 1040, line 41 28 Alternative Minimum Tax. (If this form is for a child under age 14, see page 7 of the instructions.) Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 46 ▶	22		
		23		
		24		
		25		
		26		
		27		
		28		

For Paperwork Reduction Act Notice, see separate instructions.



Cat. No. 13600G

Form **6251** (1996)

1997 Workbook

Problem 10: Partners' K-1 Forms

The practitioner is usually able to easily handle the various line items from a Form 1065 K-1 of a partner. The various flow-through amounts include the following, which is not an all-inclusive list:

- Ordinary income (or loss)
- Net earnings from self-employment
- Passive rental income (or loss)
- Various items of portfolio income

Phantom Income

The realization of "phantom income" can materialize when a partner has a **negative basis** in his or her partnership interest. This **negative basis** generally is created by the partner's deduction of his or her share of partnership losses in excess of the partner's basis. Phantom income can be triggered by the following events:

- Sale of partnership property that results in a taxable gain to the partnership combined with little or no cash distribution to the partner
- Debt forgiveness at the partnership level combined with little or no cash distribution to the partner.
- Termination of the partnership (often referred to as a "**burned-out**" partnership)

When the first two events shown above occur, the I.R.C. §1231 gain can be determined by the partnership and reflected on the partners' Forms K-1. When the last event shown above (termination of the partnership—"burned out") occurs, the I.R.C. §1221 capital gain that results must be determined at the partner level. **In effect, the gain that must be reported on the partner's Schedule D is the amount of the negative basis in his or her partnership interest.**

Example. Judy is a partner in XYZ Partnership. The partnership had no assets when it was terminated in January 1997. No distributions were made by the partnership to Judy in 1997. Judy's basis in her partnership interest as of 12-31-96 was a negative \$10,300. The partnership was inactive in 1997. Judy will report the following on her 1997 Schedule D:

I.R.C. §1221 capital gain on the disposition of her partnership interest \$10,300

Note: The \$10,300 §1221 capital gain would be long-term, assuming that Judy's holding period exceeded one year. See Judy's completed 1997 Schedule D.

1997 Workbook

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

- ▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use lines 20 and 22 for more space to list transactions for lines 1 and 9.

OMB No. 1545-0074

1997

Attachment
Sequence No. **12**

Name(s) shown on Form 1040

Judy

Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-3)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
1						
2	Enter your short-term totals, if any, from line 21		2			
3	Total short-term sales price amounts. Add column (d) of lines 1 and 2		3			
4	Short-term gain from Forms 2119 and 6252, and short-term gain or loss from Forms 4684, 6781, and 8824		4			
5	Net short-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		5			
6	Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1996 Capital Loss Carryover Worksheet		6			
7	Add lines 1 through 6 in columns (f) and (g)		7	()		
8	Net short-term capital gain or (loss). Combine columns (f) and (g) of line 7 ▶		8			

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

9						
XYZ P Ship Interest	3-1-94	1-15-97	0	negative 10,300		10,300
10	Enter your long-term totals, if any, from line 23		10			
11	Total long-term sales price amounts. Add column (d) of lines 9 and 10		11	0		
12	Gain from Form 4797; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or loss from Forms 4684, 6781, and 8824		12			
13	Net long-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		13			
14	Capital gain distributions		14			
15	Long-term capital loss carryover. Enter the amount, if any, from line 14 of your 1996 Capital Loss Carryover Worksheet		15			
16	Add lines 9 through 15 in columns (f) and (g)		16	()		10,300
17	Net long-term capital gain or (loss). Combine columns (f) and (g) of line 16 ▶		17			10,300

Part III Summary of Parts I and II

18	Combine lines 8 and 17. If a loss, go to line 19. If a gain, enter the gain on Form 1040, line 13. Note: If both lines 17 and 18 are gains, see the Capital Gain Tax Worksheet on page 21	18	10,300
19	If line 18 is a loss, enter here and as a (loss) on Form 1040, line 13, the smaller of these losses: a The loss on line 18; or b (\$3,000) or, if married filing separately, (\$1,500)	19	()
Note: See the Capital Loss Carryover Worksheet on page D-3 if the loss on line 18 exceeds the loss on line 19 or if Form 1040, line 36, is a loss.			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 1997

1997 Workbook

Problem 11: Catch-Up of Depreciation Utilizing Rev. Proc. 97-37

Background. **Rev. Proc. 97-37** can and should be used by practitioners liberally to the benefit of their clients. The revenue procedure provides an **automatic** consent that permits a taxpayer who has claimed **less** than the depreciation or amortization allowable to change the taxpayer's method of accounting to claim the omitted or understated depreciation or amortization. **Rev. Proc. 97-37** supersedes the now obsolete **Rev. Proc. 96-31** (see pages 565–6 of the 1996 Tax School Book) and provides guidance to obtain **automatic** consent in a change of a variety of accounting methods. The taxpayer has the **option** of **either** making the **automatic** change in method of accounting under **Rev. Proc. 97-37** or requesting permission to make the change under **Rev. Proc. 97-27**. **There is no user fee** for requesting **automatic** consent under **Rev. Proc. 97-37**. There is, however, a \$900 user fee for requesting permission for **nonautomatic** accounting method changes under **Rev. Proc. 97-27**. **Rev. Proc. 97-37** is effective for tax years ending after August 17, 1997.

It is recommended that practitioners carefully review the depreciation schedules of new tax clients to ascertain if there has been omission or understatement of depreciation in order to use the revenue procedure. There are many errors made on depreciation schedules, including those relating to cost basis, useful life, allowable methods and conventions. **Rev. Proc. 97-37** applies to open **and closed** years prior to the year of change for understated depreciation.

Facts. Lucinda Blair inherited 80 acres of farmland from her aunt on October 13, 1990 (one month after the death of the aunt). The 80 acres was unimproved except for the subsurface drainage tile on the land. Lucinda's preparer omitted the tile on her 1990-through-1996 tax returns. The 80 acres is rented on a crop-share lease to a tenant farmer. The farm rental activity is reported on Form 4835.

Lucinda comes to you as a new client in March 1998 and asks you to prepare her 1997 tax return.

Question 1. *Can Rev. Proc. 97-37 be used to Lucinda's benefit?*

Answer 1. Yes.

Question 2. *What are the proper steps to take to utilize the benefits of Rev. Proc. 97-37?*

Answer 2

Step 1: Add the omitted tile to the 1997 depreciation schedule and claim the depreciation on Lucinda's 1997 Form 4835, line 12 (Depreciation and §179 expense deduction).

Step 2: Calculate the omitted depreciation on the tile for years 1990 through 1996. The total is the

1997 Workbook

amount of the "catch-up" depreciation adjustment that will be included on Lucinda's 1997 Form 4835, line 12.

Note. If the "catch-up" depreciation amount is **\$25,000 or more**, the adjustment must be made over four tax years beginning with the year of change. This I.R.C. §481(a) adjustment period (four tax years) requirement is identical to the requirement of **Rev. Proc. 97-27**. However, if the "catch-up" depreciation amount is **less than \$25,000**, the **entire** adjustment (either positive or negative) can be made in one tax year.

Step 3: Attach Form 3115 (Application for Change in Accounting Method) to the taxpayer's **timely filed** (including extensions) **original** income tax return **for the year of change**. For Lucinda, that year is 1997.

Note. The first 180-days filing-period rule for Form 3115 is eliminated. Taxpayers may now request a change in accounting method by filing Form 3115 **at any time during the year of change**, not merely within the first 180 days.

Question 3. *Does IRS charge any user fee for filing Form 3115 for Lucinda?*

Answer 3. No. According to the instructions for Form 3115, **no user fee is required** if Form 3115 is filed under an **automatic** change procedure. **Rev. Proc. 97-37** is such an **"automatic"** change in accounting method procedure.

Question 4. *How many copies of Form 3115 are needed and where are they sent?*

Answer 4. Two copies are needed—an original and one copy. The **original** Form 3115 must be filed (attached to) with a timely filed original tax return for the year the "catch-up" depreciation adjustment is deducted. For Lucinda, that will be her 1997 Form 1040. The **copy** of Form 3115 will be mailed to the IRS National Office using the following address:

Commissioner of Internal Revenue
Attention: CC:DOM:IT&A
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Question 5. *Will Lucinda receive an acknowledgment from the IRS National Office regarding the Form 3115 she filed?*

Answer 5. No.

1997 Workbook

Question 6. *How do you calculate Lucinda's depreciation on the omitted tile?*

Answer 6. The estate tax value shown for the inherited 80 acres on Form 706 for the aunt was \$160,000 (\$2,000/acre). You determine that the allocated cost of the tile is \$11,200, or 7% of \$160,000.

The aunt died on Sept. 13, 1990. The tile is used in Lucinda's farming business. It is 15-year MACRS property, a depreciable land improvement. **Table A-17** from IRS Pub. #946, "How to Depreciate Property," is used to calculate the depreciation. **Table A-17** is the **150% Declining Balance Method** using the **Mid-Quarter Convention** for property placed in service in the **Third Quarter**. (See page 87 of Pub. #946 for use in preparing 1996 returns.)

1. Calculation of the "catch-up" depreciation adjustment for Lucinda's 1997 Form 4835:

Year	Cost of Tile	Applicable Percentage	MACRS Deduction
1990	\$11,200	3.75	\$ 420
1991	11,200	9.63	1,079
1992	11,200	8.66	970
1993	11,200	7.80	874
1994	11,200	7.02	786
1995	11,200	6.31	707
1996	11,200	5.90	661
Total "catch-up" adjustment for the 1997 return			\$5,497

2. Calculation of the allowable MACRS for Lucinda's 1997 Form 4835:

1997	\$11,200	5.90	\$661
------	----------	------	-------

See the completed Form 3115 and the 1997 Forms 4835 and 4562.

Automatic Method Change under Section 2.01 of the Appendix of Rev. Proc. 97-37

1997 Workbook

Automatic Method Change under Section 2.01 of the Appendix of Rev. Proc. 97-37

Form 3115 (Rev. February 1996) Department of the Treasury Internal Revenue Service		Application for Change in Accounting Method ▶ See page 1 of the instructions for Automatic Change Procedures.		OMB No. 1545-0152	
Name of applicant (If joint return is filed, also give spouse's name.) Lucinda Blair		Identifying number (See page 2 of the instructions.) 000-00-0001			
Number, street, and room or suite no. (If a P.O. box, see page 2 of the instructions.) R.R. #1-Box 13B		Due date for filing Form 3115 First 180 days of 1997			
City or town, state, and ZIP code French Lick, IN 47432		District director's office having jurisdiction Indiana District			
Name of person to contact (If not the applicant, a power of attorney must be submitted.)		Contact person's telephone number/Fax number (812) 6661313 / ()			
Check the appropriate box to indicate who is filing this form. <input checked="" type="checkbox"/> Individual <input type="checkbox"/> Corporation <input type="checkbox"/> Cooperative (Sec. 1381) <input type="checkbox"/> Qualified Personal Service Corporation (Sec. 448(d)(2)) <input type="checkbox"/> Exempt organization. Enter code section ▶		Check the appropriate box to indicate the type of accounting method change being requested. (See page 2 of the instructions.) <input type="checkbox"/> Partnership <input type="checkbox"/> S Corporation <input type="checkbox"/> Insurance Co. (Sec. 816(a)) <input type="checkbox"/> Insurance Co. (Sec. 831) <input type="checkbox"/> Other (specify) ▶ <input checked="" type="checkbox"/> Depreciation or Amortization <input type="checkbox"/> Financial Products and/or Financial Activities of Financial Institutions <input type="checkbox"/> Other (specify) ▶			
Part I Eligibility To Request Change (All applicants complete Parts I through IV unless otherwise indicated.)					
1 Is the applicant changing its method of accounting under a revenue procedure or other published IRS document that provides for automatic changes? (See page 1 of the instructions.) (Rev. Proc. 97-37)		Yes		No	
If "Yes," enter the citation of the revenue procedure or the title of the applicable document. ▶		<input checked="" type="checkbox"/>		<input type="checkbox"/>	
2a Is the applicant a member of an affiliated group filing a consolidated return for the year of change?		<input type="checkbox"/>		<input checked="" type="checkbox"/>	
If "Yes," attach the parent corporation's (1) name, (2) identifying number, (3) address, and (4) tax year. If "No," go to line 3a.		<input type="checkbox"/>		<input type="checkbox"/>	
b Do all other members of the affiliated group use the method of accounting being requested on this application?		<input type="checkbox"/>		<input type="checkbox"/>	
If "No," attach an explanation.		<input type="checkbox"/>		<input type="checkbox"/>	
3a Prior to submitting Form 3115, has the applicant, or any member of the affiliated group that has been included in a consolidated return with the applicant, been contacted by the IRS to schedule an examination of any of its Federal income tax returns, or was an examination in process? See section 3.02 of Rev. Proc. 92-20, 1992-1 C.B. 685		<input type="checkbox"/>		<input checked="" type="checkbox"/>	
If "Yes," complete lines 3b and 3c.		<input type="checkbox"/>		<input type="checkbox"/>	
b Indicate the "window period" referred to in section 6 of Rev. Proc. 92-20 that applies, or state if the change is being requested with the consent of the district director under section 6.06. ▶		<input type="checkbox"/>		<input type="checkbox"/>	
c Has a copy of this Form 3115 been provided to the district director? See section 10.06 of Rev. Proc. 92-20		<input type="checkbox"/>		<input type="checkbox"/>	
4a Does the applicant have any Federal income tax returns under consideration by an appeals office? See section 4.02 of Rev. Proc. 92-20		<input type="checkbox"/>		<input checked="" type="checkbox"/>	
b If "Yes," has the applicant attached the required statement from the appeals officer?		<input type="checkbox"/>		<input type="checkbox"/>	
5a Does the applicant have any Federal income tax returns under consideration before any Federal court? See section 4.03 of Rev. Proc. 92-20		<input type="checkbox"/>		<input checked="" type="checkbox"/>	
b If "Yes," has the applicant attached the required statement from counsel for the Government?		<input type="checkbox"/>		<input type="checkbox"/>	
6 Is this the first tax year the applicant is required to change its method of accounting under the Internal Revenue Code or regulations? (i.e., sections 263A, 447, 448, 460, or 585)		<input type="checkbox"/>		<input checked="" type="checkbox"/>	
If "Yes," enter the applicable section. ▶		<input type="checkbox"/>		<input type="checkbox"/>	
Signature—All Applicants (See page 2 of the instructions.)					
Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.					
Applicant Lucinda Blair 5/14/98 Officer's signature and date		Parent corporation (if applicable) _____ Parent officer's signature and date			
Name and title (print or type) Lucinda Blair		Name and title (print or type)			
Signature(s) of individual or firm preparing the application and date Samual Banks 5/14/98		Name of firm preparing the application NIA. Samual Banks is self employed			
For Paperwork Reduction Act Notice, see page 1 of the instructions.		Cat. No. 19280E		Form 3115 (Rev. 2-96)	

1997 Workbook

Form 3115 (Rev. 2-96) 7

Page 2

Part II Description of Change

	Yes	No
7 Enter the gross receipts for the 4 tax years preceding the year of change. (See page 2 of the instructions.) \$ \$ \$ \$		
8 Tax year of change begins (month, day, year) ▶ 1-1-97 and ends (month, day, year) ▶ 12-31-97		
9 Is the applicant applying to change its overall method of accounting? If "Yes," check appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also complete Schedule A on page 3. Present method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Other (attach description) Proposed method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Other (attach description)		X
10 If the applicant is not changing its overall method of accounting, attach a description of each of the following: a The item(s) being changed. (See bottom of page 3 for information) b The applicant's present method for the item being changed. c The applicant's proposed method for the item being changed. d The applicant's overall method of accounting. (Rev. Proc. 97-37) • Applicants filing under an automatic change procedure: Skip lines 11 through 19 and go to line 20.		
11 Attach an explanation of the legal basis supporting the proposed change. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed change. The applicant is encouraged to include a discussion of any authorities that may be contrary to the proposed change in method of accounting.		
12 Attach a statement of the applicant's reasons for the proposed change.		
13 Attach a copy of all documents directly related to the proposed change. (See page 2 of the instructions.)		
14 Attach an explanation of whether the proposed method of accounting conforms to generally accepted accounting principles (GAAP) and state whether the proposed method will be used for financial accounting purposes, including financial statements. (Insurance companies, see page 2 of the instructions.)		
15 Does the applicant assert that its present method is a Category A method as defined in section 3.06 of Rev. Proc. 92-20? If "Yes," attach a statement giving the legal basis for the determination.		
16 Is the applicant's present method a "Designated B" method as defined in section 3.09 of Rev. Proc. 92-20? (See page 2 of the instructions.) If "Yes," enter the title of the designating document. ▶		
17 Attach a description of the applicant's trade or business, operations, goods and services, and any other types of activities generating gross income.		
18a Does the applicant have more than one trade or business as defined in Regulations section 1.446-1(d)? b If "Yes," is each trade or business accounted for separately? If "Yes," for each trade or business attach a description of the type of business, the overall method of accounting, whether the business has changed its accounting method in the last 6 years, and whether the business is changing its accounting method as part of this application or as a separate application.		
19 Attach a statement addressing whether the applicant has entered (or is considering entering) into a transaction (for example, a reorganization or merger) to which section 381(c)(4) or (5) applies during the tax year of change. Also include in the statement an explanation of any changes in method of accounting that resulted (or will result) from the transaction(s).		

Part III Section 481(a) Adjustment

	Yes	No
20 Enter the net section 481(a) adjustment for the year of change. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ \$ 5,497 decrease (-) in income for 1997		
21 Enter the adjustment that would have been required if the requested change had been made for the tax year preceding the year of change. Indicate (+) or (-). ▶ \$ 5,497 (-) (See page 3 of the instructions.)		
22 Is any part of the adjustment attributable to transactions between members of an affiliated group, a controlled group, or other related parties? If "Yes," attach an explanation.		X
23 Has the adjustment for the year of change been reduced by a pre-1954 amount?		X
24 Enter the number of years the present method has been used by the applicant. ▶ 1 (1997) (See page 3 of the instructions.)		
25 Enter the applicable period over which the applicant proposes to take the adjustment into account. ▶ 1 (1997)		
26 If the adjustment for the year of change is less than \$25,000, does the applicant elect to take the entire adjustment into account in the year of change? (Yes, on 1997 1040.)	X	
27 Enter the NOL, if any, that will expire in the year of change. ▶ \$		
28 Enter the credit carryover, if any, that will expire in the year of change. ▶ \$		

1997 Workbook

Form 3115 (Rev. 2-96)

Page 3

Part IV Additional Information (Applicants filing under an automatic change procedure, skip Part IV.)

	Yes	No
29 Has the applicant, predecessor, or related party requested or made a change in accounting method or accounting period in the past 6 years?		
If "Yes," attach a description of each change, the year of change, and whether a ruling letter was received. If a ruling letter granting the change was received but the change was not made, include an explanation.		
30 Does the applicant, predecessor, or related party currently have pending any request for a private letter ruling, a request for change in accounting method or accounting period, or a request for technical advice?		
If "Yes," for each such request, indicate the name(s) of the entity, type of request (method, tax year, etc.) and the specific issue in each request.		
31 Has the applicant attached Form 2848, Power of Attorney and Declaration of Representative? (See page 3 of the instructions.)		
32 Does the applicant request a conference of right at the IRS National Office if the IRS proposes an adverse response?		
33 Enter the amount of user fee attached to this application. ► \$ (See page 2 of the instructions.)		
34 If the applicant qualifies for a reduced user fee for identical accounting method changes, has the information required by Rev. Proc. 92-90, 1992-2 C.B. 501, been attached?		

Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I must be completed.)

Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. On a separate sheet, state the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the

Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, explain the differences on a separate sheet.

Part I Change in Overall Method (See page 3 of the instructions.)

- 1 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also provide a breakdown of the amounts entered on lines 1a through 1g.

	Amount
a Income accrued but not received	\$
b Income received or reported before it was earned. Attach a description of the income and the legal basis for the proposed method (See page 3 of the instructions.)	
c Expenses accrued but not paid	
d Prepaid expense previously deducted	
e Supplies on hand previously deducted	
f Inventory on hand previously deducted. Complete Schedule C, Part II.	
g Other amounts (specify) ►	
h Net section 481(a) adjustment (Add lines 1a—1g.) (See page 3 of the instructions.)	\$
2 Is the applicant also requesting the recurring item exception (section 461(h)) (See page 3 of the instructions)?	<input type="checkbox"/> Yes <input type="checkbox"/> No

Part II Change to the Cash Method (See page 3 of the instructions.)

Applicants requesting a change to the cash method must attach the following information.

- 1 A description of the applicant's investment in capital items and leased equipment used in the trade or business, and the relationship between these items and the services performed by the business.
- 2 A description of inventory items (items that produce income when sold) and materials and supplies used in carrying out the business.
- 3 The number of employees, shareholders, partners, associates, etc., and a description of their duties in carrying out the applicant's business.
- 4 A schedule showing the age of receivables for each of the 4 tax years preceding the year of change.
- 5 A schedule showing the applicant's taxable income (loss) for each of the 4 tax years preceding the year of change.
- 6 A profit and loss statement showing the taxable income (loss) based on the cash method for each of the 4 tax years preceding the year of change.

10a) MACRS on tile on inherited 80 acres located in Ford County, IL. The 80 acres were inherited from Lucinda Blair's aunt on 10-13-90.

10b) MACRS deductions on the tile were omitted for the tax years 1990 through 1996. The cost of the tile has been depreciated using MACRS on the 1997 1040 of Lucinda Blair.

1997 Workbook

10c) Per Rev. Proc. 97-37, Form 3115 is filed to enable Lucinda Blair a "catch up" MACRS adjustment on her 1997 1040 for the understated depreciation for the tax years 1990 through 1996. The total amount of MACRS allowable on the tile for the tax years 1990 through 1996 is \$5,497. See line 20, Part III, page 2 for the \$5,497 figure.

10d) Cash method of accounting.

Note: No entries are required on page 5 or 6 of Form 3115 for Lucinda.

Form 3115 (Rev. 2-96)

Page 7

Schedule D—Change in Reporting Advance Payments and Depreciation/Amortization

Part I Change in Reporting Advance Payments (See page 4 of the instructions.)

- 1 If the applicant is requesting to defer advance payment for services under Rev. Proc. 71-21, 1971-2 C.B. 549, attach the following information.
 - a Sample copies of all service agreements used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the service agreement that require the taxpayer to perform services.
 - b If any parts or materials are provided, explain how the parts or materials relate to the services provided and provide the cost of such parts or materials as an absolute number and a percentage of the contract price.
 - c If the change relates to contingent service contracts, explain how the contracts relate to merchandise that is sold, leased, installed, or constructed by the applicant and whether the applicant offers to sell, lease, install, or construct without the service agreement.
 - d A description of the method the applicant will use to determine the amount of income earned each year on contingent contracts and why that method clearly reflects income earned and related expenses in each year.
- 2 If the applicant is requesting a deferral of advance payments for goods under Regulations section 1.451-5, attach the following information.
 - a Sample copies of all agreements for goods or items requiring advance payments used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the agreement that require the applicant to provide goods or items.
 - b A statement providing that the entire advance payment is for goods or items. If not entirely for goods or items, a statement that an amount equal to 95% of the total contract price is properly allocable to the obligation to provide activities described in Regulations section 1.451-5(a)(1)(i) or (ii) (including services as an integral part of those activities).

Part II Change in Depreciation or Amortization (See page 4 of the instructions.) *(Per Rev. Proc. 97-37)*

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Supply this information for each item or class of property for which a change is requested.

Note: If the property has been disposed of before the beginning of the year of change, a method change is not permitted for that property. See **Automatic change for section 167 property** in the instructions for Part II, Schedule D, on page 4, for information regarding automatic changes under Rev. Proc. 74-11, 1974-1 C.B. 420. Also in Part II, see **When Not To File Form 3115** for information concerning retroactive elections and election revocations.

- 1 Is depreciation for the property figured under Regulations section 1.167(a)-11 (CLADR)? ☐ Yes ☒ No
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).
- 2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? ☐ Yes ☒ No
If "Yes," enter the applicable section ►
- 3 Has a depreciation or amortization election been made for the property (e.g., the election under section 168(f)(1))? ☐ Yes ☒ No
If "Yes," state the election made ►
- 4a To the extent not already provided, describe the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.
- b If the property is residential rental property, did the applicant live in the property before renting it? ☐ Yes ☐ No
- c Is the property public utility property? ☐ Yes ☒ No
- 5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).
- 6 If the property is not currently treated as depreciable or amortizable property, provide the facts supporting the proposed change to depreciate or amortize the property.
- 7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods.
 - a The Code section under which the property is depreciated or amortized (e.g., section 168(g)). *168(b)(2)*
 - b If the property is depreciated under section 168, identify the applicable asset class in Rev. Proc. 87-56, 1987-2 C.B. 674. (If none, state so and explain why.) Also provide the facts supporting the asset class under the proposed method.
 - c The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)). *150% Declining Balance Method (Table A-17 of IRS Pub. 946)*
 - d The useful life, recovery period, or amortization period of the property. *15-Year MACRS Property*
 - e The applicable convention of the property. *Mid-Quarter Convention (placed in service on 9-13-90)*

1997 Workbook

Form 3115 (Rev. 2-96)

Page 7

Schedule D—Change in Reporting Advance Payments and Depreciation/Amortization

Part I Change in Reporting Advance Payments (See page 4 of the instructions.)

- 1 If the applicant is requesting to defer advance payment for services under Rev. Proc. 71-21, 1971-2 C.B. 549, attach the following information.
 - a Sample copies of all service agreements used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the service agreement that require the taxpayer to perform services.
 - b If any parts or materials are provided, explain how the parts or materials relate to the services provided and provide the cost of such parts or materials as an absolute number and a percentage of the contract price.
 - c If the change relates to contingent service contracts, explain how the contracts relate to merchandise that is sold, leased, installed, or constructed by the applicant and whether the applicant offers to sell, lease, install, or construct without the service agreement.
 - d A description of the method the applicant will use to determine the amount of income earned each year on contingent contracts and why that method clearly reflects income earned and related expenses in each year.
- 2 If the applicant is requesting a deferral of advance payments for goods under Regulations section 1.451-5, attach the following information.
 - a Sample copies of all agreements for goods or items requiring advance payments used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the agreement that require the applicant to provide goods or items.
 - b A statement providing that the entire advance payment is for goods or items. If not entirely for goods or items, a statement that an amount equal to 95% of the total contract price is properly allocable to the obligation to provide activities described in Regulations section 1.451-5(a)(1)(i) or (ii) (including services as an integral part of those activities).

Part II Change in Depreciation or Amortization (See page 4 of the instructions.) (Per Rev. Proc. 97-37)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Supply this information for each item or class of property for which a change is requested.

Note: If the property has been disposed of before the beginning of the year of change, a method change is not permitted for that property. See *Automatic change for section 167 property* in the instructions for Part II, Schedule D, on page 4, for information regarding automatic changes under Rev. Proc. 74-11, 1974-1 C.B. 420. Also in Part II, see *When Not To File Form 3115* for information concerning retroactive elections and election revocations.

- 1 Is depreciation for the property figured under Regulations section 1.167(a)-11 (CLADR)? ☐ Yes ☒ No
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).
- 2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? ☐ Yes ☒ No
If "Yes," enter the applicable section ►
- 3 Has a depreciation or amortization election been made for the property (e.g., the election under section 168(f)(1))? ☐ Yes ☒ No
If "Yes," state the election made ►
- 4a To the extent not already provided, describe the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.
 - b If the property is residential rental property, did the applicant live in the property before renting it? ☐ Yes ☐ No
 - c Is the property public utility property? ☐ Yes ☒ No
- 5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).
- 6 If the property is not currently treated as depreciable or amortizable property, provide the facts supporting the proposed change to depreciate or amortize the property.
- 7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods.
 - a The Code section under which the property is depreciated or amortized (e.g., section 168(g)). **168(b)(2)**
 - b If the property is depreciated under section 168, identify the applicable asset class in Rev. Proc. 87-56, 1987-2 C.B. 674. (If none, state so and explain why.) Also provide the facts supporting the asset class under the proposed method.
 - c The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)). **150% Declining Balance Method (Table A-17 of IRS Pub. 946)**
 - d The useful life, recovery period, or amortization period of the property. **15-Year MACRS Property**
 - e The applicable convention of the property. **Mid-Quarter Convention (placed in service on 9-13-90)**

1997 Workbook

4a) Tile on inherited 80 acres located in Ford County, IL.

Date placed in service: 10-13-90.

Property's use: In crop share rental of farmland reported on Form 4835.

Cost of Property: \$11,200.

Form 4835		Farm Rental Income and Expenses		OMB No. 1545-0187	
Department of the Treasury Internal Revenue Service		(Crop and Livestock Shares (Not Cash) Received by Landowner (or Sub-Lessor)) (Income not subject to self-employment tax)		1997	
		▶ Attach to Form 1040. ▶ See instructions on back.		Attachment Sequence No. 37	
Name(s) shown on Form 1040 Lucinda Blair				Your social security number 000 : 00 : 0001	
				Employer ID number (EIN), if any	
A Did you actively participate in the operation of this farm during 1996? See instructions <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
Part I Gross Farm Rental Income—Based on Production. Include amounts converted to cash or the equivalent.					
1 Income from production of livestock, produce, grains, and other crops				1 7,314 07	
2a Total cooperative distributions (Form(s) 1099-PATR) 2a 421 86				2b Taxable amount 2b 421 86	
3a Agricultural program payments. See instructions 3a 793 00				3b Taxable amount 3b 793 00	
4 Commodity Credit Corporation (CCC) loans. See instructions:					
a CCC loans reported under election 4a				4a	
b CCC loans forfeited 4b				4c Taxable amount 4c	
5 Crop insurance proceeds and certain disaster payments. See instructions:					
a Amount received in 1996 5a				5b Taxable amount 5b	
c If election to defer to 1997 is attached, check here <input type="checkbox"/> 5d Amount deferred from 1995 5d					
6 Other income, including Federal and state gasoline or fuel tax credit or refund. See instructions 6					
7 Gross farm rents. Add amounts in the right column for lines 1 through 6. Enter the total here and on Schedule E (Form 1040), line 41 ▶				7 8,528 93	
Part II Expenses—Farm Rental Property. Do not include personal or living expenses.					
8 Car and truck expenses. See Schedule F instructions—also attach Form 4562 8				21 Pension and profit-sharing plans 21	
9 Chemicals 9 1,230 34				22 Rent or lease. See instructions:	
10 Conservation expenses (see instructions) 10				a Vehicles, machinery, and equipment 22a	
11 Custom hire (machine work) 11				b Other (land, animals, etc.) 22b	
12 Depreciation and section 179 expense deduction not claimed elsewhere 12 6,158 00				23 Repairs and maintenance 23	
13 Employee benefit programs other than on line 21. See Schedule F instructions 13				24 Seeds and plants purchased 24 604 15	
14 Feed purchased 14				25 Storage and warehousing 25	
15 Fertilizers and lime 15 977 18				26 Supplies purchased 26	
16 Freight and trucking 16				27 Taxes 27 1,328 89	
17 Gasoline, fuel, and oil 17				28 Utilities 28	
18 Insurance (other than health) 18				29 Veterinary, breeding, and medicine 29	
19 Interest:				30 Other expenses (specify):	
a Mortgage (paid to banks, etc.) 19a				a Auto Exp. (110 mi X 31.5) 30a 129 15	
b Other 19b				b Accounting Fee 30b 40 00	
20 Labor hired (less employment credits). See Schedule F instructions 20				c 30c	
				d 30d	
				e 30e	
				f 30f	
				g 30g	
31 Total expenses. Add lines 8 through 30g ▶				31 10,467 71	
32 Net farm rental income or (loss). Subtract line 31 from line 7. If the result is income, enter it here and on Schedule E, line 39. If the result is a loss, you MUST go on to line 33				32 (1,938 78)	
33 If line 32 is a loss, you MUST check the box that describes your investment in this activity. See instructions				33a <input checked="" type="checkbox"/> All investment is at risk.	
You may need to complete Form 8582 to determine your deductible loss, regardless of which box you check (see instructions). However, if you checked 33b, you MUST complete Form 6198 before going to Form 8582. In either case, enter the deductible loss here and on Schedule E, line 39				33b <input type="checkbox"/> Some investment is not at risk.	
				33c	

For Paperwork Reduction Act Notice, see instructions on back.

363

Cat. No. 13117W

Form 4835 (1997)

Form 4562 <small>Department of the Treasury (X) Internal Revenue Service</small>		Depreciation and Amortization (Including Information on Listed Property)		OMB No. 1545-0172 19967 <small>Attachment Sequence No. 67</small>		
		▶ See separate instructions. ▶ Attach this form to your return.		Identifying number 000-00-0001		
Name(s) shown on return Lucinda Blair		Business or activity to which this form relates Farm Rental - Form 4835		Identifying number 000-00-0001		
Part I Election To Expense Certain Tangible Property (Section 179) (Note: If you have any "listed property," complete Part V before you complete Part I.)						
1 Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions				1 \$17,500		
2 Total cost of section 179 property placed in service. See page 2 of the instructions				2		
3 Threshold cost of section 179 property before reduction in limitation				3 \$200,000		
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-				4		
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions				5		
(a) Description of property		(b) Cost (business use only)		(c) Elected cost		
6						
7 Listed property. Enter amount from line 27.		7				
8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7				8		
9 Tentative deduction. Enter the smaller of line 5 or line 8				9		
10 Carryover of disallowed deduction from 1996. See page 2 of the instructions				10		
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)				11		
12 Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11				12		
13 Carryover of disallowed deduction to 1997. Add lines 9 and 10, less line 12 ▶				13		
Note: Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.						
Part II MACRS Depreciation For Assets Placed in Service ONLY During Your 1996 Tax Year (Do Not Include Listed Property.)						
Section A—General Asset Account Election						
14 If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 2 of the instructions <input type="checkbox"/>						
Section B—General Depreciation System (GDS) (See page 3 of the instructions.)						
(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
15a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
Section C—Alternative Depreciation System (ADS) (See page 4 of the instructions.)						
16a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	
Part III Other Depreciation (Do Not Include Listed Property.) (See page 4 of the instructions.)						
17 GDS and ADS deductions for assets placed in service in tax years beginning before 1997				17 6,158		
18 Property subject to section 168(f)(1) election				18		
19 ACRS and other depreciation				19		
Part IV Summary (See page 4 of the instructions.)						
20 Listed property. Enter amount from line 26.				20		
21 Total. Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions				21 6,158		
22 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs				22		
For Paperwork Reduction Act Notice, see page 1 of the separate instructions. Cat. No. 12906N Form 4562 (1996)						

1997 Workbook

Additional Statement Required by §6.02(5) of Revenue Procedure 97-37:

I, Lucinda Blair, agree to all the terms and conditions of Rev. Proc. 97-37.

The I.R.C. §481(a) adjustment is a **negative adjustment** (a decrease in taxable income) **in the amount of \$5,497**. See Part III on page 2 of Form 3315 for additional details on this I.R.C. §481(a) adjustment. **The reason for claiming this negative adjustment is as follows:**

I inherited 80 acres of farmland from my aunt on Oct. 13, 1990 (one month after her date of death). There was subsurface drainage tile on the 80 acres. This asset was omitted on my depreciation schedules for the years 1990 through 1996. The allowable MACRS on the asset for this 7-year period is \$5,497. I am including this \$5,497 I.R.C. §481(a) negative adjustment on line 12 (Depreciation) on my 1997 Form 4835, Farm Rental Income and Expenses.

Problem 12: Tax issues of Ministers

Most of the following information is taken from two IRS sources: (1) the MSSP (Market Segment Specialization Program) training guide prepared for use by IRS examiners when examining tax returns of clergy members and (2) IRS Pub. #517, "Social Security and Other Information for Members of the Clergy."

Self-Employed or Common-Law Employee of Congregation?

A duly ordained, commissioned, or licensed minister who is employed by a congregation on a salaried basis is a **common-law employee and not a self-employed individual for income tax purposes**. This issue was settled (at least in the opinion of the IRS) by the *Weber* Appeals Court case (4th Cir. case) (95-2 USTC, ¶50, 409. See pages 255–56 of the 1995 Tax School Book), which was decided in 1995. **However, special rules apply.**

Note: See the *James T. Alford* court case (97-2 USTC ¶50, 512) for independent contractor status of clergy. This court case is discussed in the What's New chapter.

A minister's salary is subject to federal income tax but not federal income tax withholding. Minister's **may elect** to have income tax voluntarily withheld under §3402(p)(1) of the Code if agreed to by the employer church.

The employer church is required to issue a Form W-2 whether income tax was withheld or not. The amount of wages shown in Box 1 of the 1997 Form W-2 must be reported on line 7 (Wages, salaries, and tips) of the minister's 1997 Form 1040.

1997 Workbook

Different Rules for Social Security Coverage

Ministers are hybrid employees, as they are treated differently for social security coverage than they are for income tax purposes. The wages they receive from their employer church **are not subject to FICA taxes**. Instead, the wages are treated as earnings from self-employment, unless the minister is a member of a religious order who has taken a vow of poverty or has requested and received from the IRS an exemption from self-employment tax by application using Form 4361.

The W-2 wages should be included on line 2 of the 1997 Schedule SE (Self-Employment Tax), **but adjustments may be necessary in order to arrive at the correct amount to enter on line 2.**

Income and expense items to be included on line 2 of 1997 Schedule SE

- W-2 wages from employer church.
- **All unreimbursed professional expenses.** (Note: These may be deducted in full for SE purposes **even if they were not deducted for income tax purposes.**)

Examples:

- Cost of robes (unreimbursed) even if not deducted on Schedule A due to 2% AGI limitation for miscellaneous itemized deductions or because the standard deduction was used.
- Unreimbursed auto expense. **Example:** Pastor Ann drove her auto 5,220 miles for church business in 1997. She was paid a **nonaccountable auto allowance** of \$2,500 in 1997. The \$2,500 allowance **must be included in box 1 (Wages) on her 1997 Form W-2.** She uses the standard mileage rate for her 5,220 business miles: $5,220 \times 31.5¢ = \$1,644.30$. **Both the \$2,500 allowance and the \$1,664.30 employee business auto expense will be included in the line 2, Schedule SE, figure.** The \$2,500 allowance is included as wages. The \$1,664.30 expense will be deducted in full, even if **deductible** employee business expenses on Forms 2106 or 2106-EZ are **reduced** by the "**expenses allocable to tax-free income**" rule discussed later.
- **Fair rental value of parsonage provided by employer church.** (Note: An estimate from a local real estate agent is usually the best evidence. The figure should be without utilities and unfurnished.)
- **Cost of utilities** paid by employer church for parsonage.
- **Rental (parsonage) allowance** paid in lieu of providing a parsonage (including separate utility allowance paid, if applicable).
- **Social Security (self-employment tax) allowance** paid by employer church, if applicable.
- **Net profit from Schedule C or C-EZ** for income and expenses related to weddings, funerals, etc. (Note: All expenses are deducted in arriving at the line 2, Schedule SE, figure, **even if reduced on Schedule C or C-EZ by the "expenses allocable to tax-free income" rule.**)

Income items to be excluded from line 2 of the 1997 Schedule SE

1997 Workbook

Note: The following income items should **not be included as wages** on the 1997 Form W-2 of the minister:

- **Pension payments made to a third party** on behalf of the minister by the employer church.
- **Health insurance premium payments made to a third party** on behalf of the minister by the employer church.
- **Housing annuity premiums paid to an insurance company** on behalf of the minister by the employer church.

Rental (Parsonage) and Utilities Allowances

The amount ministers receive that is officially designated in church records as a rental allowance (includes payment of utilities) is excluded from gross income under I.R.C. §107 if

1. the amount is used to provide or rent a home, and
2. the amount is not more than reasonable pay for services performed by the minister.

This exclusion applies **only for income tax purposes**. It does not apply for self-employment tax purposes. The exclusion is limited to the **lowest** of the following amounts:

- The amount actually used to provide a home
- The amount officially designated as a rental allowance
- The fair rental value of the home, including furnishings, utilities, garage, etc.

The IRS **recommends** that the amounts and identification of the allowance(s) be shown in box 14 of the 1997 Form W-2.

Practitioner Caution. The Tax Court has held in three cases that if a minister receives **tax-free income** such as a rental (parsonage) or utilities allowance, a portion of the otherwise "deductible unreimbursed professional expenses" of Form 2106 or 2106-EZ is **not deductible**.^{*} The authority is I.R.C. §265. IRS examiners will likely raise this issue in an exam if the proper allocation is ignored.

^{*} Pub. 517 (and the example at the end of the problem) requires Schedule C expenses as well as Form 2106 expenses to be reduced by the percent of exempt income. The three cases (Deason, Daltan, and McFarland) can be read to give that conclusion, although they are a little ambiguous. If that is the correct reading of § 265, then the previous sentence should say "... of Schedule C, Schedule C-EZ, Form 2106, or Form 2106-EZ is **not deductible**."

Example. Pastor White receives a \$25,000 cash salary and a \$5,000 rental (parsonage) allowance in 1997. This is his only ministry income. He has \$2,000 of unreimbursed professional expenses in 1997. He used the entire \$5,000 parsonage allowance in providing expenses for his personally owned home.

He would be entitled to deduct only **83.33%** of the \$2,000 of unreimbursed professional expenses on line 20 of the 1997 Schedule A (unreimbursed employee expenses from Form 2106). The computation is as follows:

$$\frac{\text{Taxable ministry income (\$25,000 salary)}}{\text{Total ministry income of \$30,000}} = 83.33\%$$

1997 Workbook

$$\frac{\text{Taxable ministry income (\$25,000 salary)}}{\text{Total ministry income of \$30,000}} = 83.33\%$$

Practitioner Tip. This problem can be eliminated if the congregation and the minister would agree that all professional expenses are to be reimbursed, preferably through a monthly voucher arrangement supported by receipts and records.

Employee Business Expenses of Ministers

Ministers who are employees may deduct the following types of professional expenses on line 20 of the 1997 Schedule A (from Forms 2106 or 2106-EZ) subject to the 2% AGI limitation:

- Unreimbursed professional expenses for which the minister is not reimbursed under an I.R.C. §62(c) **accountable** plan
- "Nonaccountable" professional expenses for which the minister receives an **allowance rather than reimbursement**

Notes: Generally, **reimbursements** made to the minister by the employer church under an **accountable plan** are **not** included **either** in the minister's gross income or on the Form W-2. Also, they are excluded in computing self-employment tax.

If the reimbursement arrangement is **nonaccountable**, the **allowances** must be included in the minister's gross income and must be shown as wages (Box 1) on the 1997 Form W-2. However, the minister may deduct all professional expenses he actually pays in 1997 in computing self-employment tax, **even if he does not itemize deductions**.

Comprehensive Example (from IRS Pub. #517)

This involves the 1996 tax year, but the rationale would also apply to 1997.

Rev. John Michaels is the minister of the First United Church. He is married and has one child. He is a common-law employee of the church. He has not applied for an exemption from self-employment tax. The church paid him a salary of \$31,000. In addition, as a self-employed person, he earned \$4,000 during the year for weddings, baptisms, and honoraria.

In an earlier year, Rev. Michaels bought a home next to the church. He makes an \$800 per month mortgage payment of principal and interest only. The church paid him \$800 per month as his parsonage allowance (excluding utilities). The home's fair rental value is \$900 per month. The utility bills for the year totaled \$960. The Church paid him \$100 per month designated as an allowance for utility costs.

The church did not withhold social security, Medicare, or federal income taxes because Rev. Michaels had not requested it. The church reports his salary for income tax purposes on Form W-2, box 1, leaving blank the boxes for social security and Medicare wages. Box 1 of the Form W-2 shows his wages of \$31,000. He made estimated tax payments during the year totaling \$8,400.

1997 Workbook

Rev. Michaels taught a course at a local community college. He was paid \$3,400, which was reported on a Form W-2. The federal income tax withheld was \$272. As an employee of the college, he was subject to social security and Medicare withholding. His Form W-2 shows \$210.80 withheld for social security taxes and \$49.30 withheld for Medicare taxes.

Form 1040. On Form 1040, Rev. Michaels reports \$34,400 (\$31,000 from the church and \$3,400 from the college) on line 7 and \$240 (the excess of the utility allowance over the utility costs) on line 21. (The parsonage allowance is not taxable for income tax purposes.)

Schedule C-EZ (Form 1040). On Schedule C-EZ, Rev. Michaels reports the \$4,000 from weddings, baptisms, and honoraria. His related expenses for the year were \$87 for marriage and family booklets and \$158 for 503 miles of business use of his car figured at the standard mileage rate of 31 cents a mile (mainly for trips in connection with honoraria). He cannot deduct the part of his expenses allocable to his tax-free income. He attaches the required statement (example shown later) to his tax return that explains how he figures the nondeductible part (\$56). He subtracts the \$56 from the \$243 and enters the \$187 difference on line 2 of Schedule C-EZ. He reports his net profit of \$3,813 on line 12 of Form 1040.

Schedule SE (Form 1040). On Schedule SE, Rev. Michaels includes the \$800 per month parsonage allowance (\$9,600), the entire \$100 per month utility allowance (\$1,200), his salary from the church (\$31,000), and the net income from Schedule C-EZ (\$3,813). He subtracts from this the \$56 of nondeductible Schedule C-EZ expenses and the \$1,103 (\$884 + \$219) of allowable employee business expenses (discussed below). He reports his net income of \$44,454 in Section A of Schedule SE. (As a minister, his church salary is not considered "church employee income.")

After completing Schedule SE (Form 1040), Rev. Michaels enters the self-employment tax (\$6,281) on Form 1040, line 45. Also, he enters half the amount (\$3,141) on Form 1040, line 25.

Form 2106-EZ. Rev. Michaels completes lines 7–11b. His car was used 2,852 miles for church business. Using the standard mileage rate, he figures that his car expense is \$884. He enters the \$884 on line 1. He has \$219 of expenses for publications and booklets that he enters on line 4.

Before entering the total expenses on line 6, he must reduce them by the amount that is allocable to his tax-free parsonage allowance. On the attached required statement (shown later), he shows how he figured the nondeductible part of his expenses. The result is \$254 of expenses allocable to the tax-free income. He subtracts \$254 from \$1,103 and enters the result, \$849, on line 6. He then enters the line 6 amount on line 20 of Schedule A (Form 1040).

Schedule A (Form 1040). Rev. Michaels contributed \$4,800 in cash during the year to various qualifying charities. Each individual contribution was for less than \$250. He deducts the \$4,800 as an itemized deduction on line 15. He deducts \$1,750 in real estate taxes on line 6 and \$6,810 of home mortgage interest on line 10. He limits his employee business expenses to the amount exceeding 2% of his adjusted gross income. He enters \$143 as the total of his miscellaneous deductions on line 26. The total of all itemized deductions is \$13,503, which he enters on line 28 of schedule A and on line 34 of Form 1040.

1997 Workbook

a Control number		OMB No. 1545-0008				
b Employer's identification number 00-1357913		1 Wages, tips, other compensation 3400.00		2 Federal income tax withheld 272.00		
c Employer's name, address, and ZIP code Hometown College 40 Honor Rd. Hometown, Texas 77099		3 Social security wages 3400.00		4 Social security tax withheld 210.80		
		5 Medicare wages and tips 3400.00		6 Medicare tax withheld 49.30		
		7 Social security tips		8 Allocated tips		
d Employee's social security number 011-00-2222		9 Advance EIC payment		10 Dependent care benefits		
e Employee's name, address, and ZIP code John E. Michaels 1040 Main St. Hometown, Texas 77099		11 Nonqualified plans		12 Benefits included in box 1		
		13 See Instrs. for box 13		14 Other		
		15 Statutory employee <input type="checkbox"/>		Deceased <input type="checkbox"/>	Pension plan <input type="checkbox"/>	Legal rep. <input type="checkbox"/>
				Hshld emp. <input type="checkbox"/>	Subtotal <input type="checkbox"/>	Deferred compensation <input type="checkbox"/>
16 State	Employer's state I.D. No.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax

(O)

Department of the Treasury—Internal Revenue Service

Form **W-2 Wage and Tax Statement 1996**

Copy B To Be Filed With Employee's FEDERAL Tax Return

This information is being furnished to the Internal Revenue Service



5 WA

a Control number		OMB No. 1545-0008				
b Employer's identification number 00-0246810		1 Wages, tips, other compensation 31000.00		2 Federal income tax withheld		
c Employer's name, address, and ZIP code First United Church 1042 Main St. Hometown, Texas 77099		3 Social security wages		4 Social security tax withheld		
		5 Medicare wages and tips		6 Medicare tax withheld		
		7 Social security tips		8 Allocated tips		
d Employee's social security number 011-00-2222		9 Advance EIC payment		10 Dependent care benefits		
e Employee's name, address, and ZIP code John E. Michaels 1040 Main St. Hometown, Texas 77099		11 Nonqualified plans		12 Benefits included in box 1		
		13 See Instrs. for box 13		14 Other Parsonage Allowance - 9600.00 Utilities Allowance - 1200.00		
		15 Statutory employee <input type="checkbox"/>		Deceased <input type="checkbox"/>	Pension plan <input type="checkbox"/>	Legal rep. <input type="checkbox"/>
				Hshld emp. <input type="checkbox"/>	Subtotal <input type="checkbox"/>	Deferred compensation <input type="checkbox"/>
16 State	Employer's state I.D. No.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax

(O)

Department of the Treasury—Internal Revenue Service

Form **W-2 Wage and Tax Statement 1996**

Copy B To Be Filed With Employee's FEDERAL Tax Return

This information is being furnished to the Internal Revenue Service



5 WA

1997 Workbook

Form	1040	Department of the Treasury—Internal Revenue Service	1996	(X) IRS Use Only—Do not write or staple in this space.
U.S. Individual Income Tax Return				
For the year Jan. 1–Dec. 31, 1996, or other tax year beginning _____, 1996, ending _____, 19				
OMB No. 1545-0074				

Label (See page 11.)	L A B E L H E R E	Your first name and initial John E.	Last name Michaels	Your social security number 011 002 222
		If a joint return, spouse's first name and initial Susan R.	Last name Michaels	Spouse's social security number 011 001 111
		Home address (number and street). If you have a P.O. box, see page 11. 1040 Main Street		Apt. no.
		City, town or post office, state, and ZIP code. If you have a foreign address, see page 11. Hometown, TX 77099		

Presidential Election Campaign (See page 11.)	Do you want \$3 to go to this fund? If a joint return, does your spouse want \$3 to go to this fund?	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>	Note: Checking "Yes" will not change your tax or reduce your refund.
--	---	--	--------------------------------	--

Filing Status	1	Single	
	2	<input checked="" type="checkbox"/> Married filing joint return (even if only one had income)	
	3	<input type="checkbox"/> Married filing separate return. Enter spouse's social security no. above and full name here. ▶	
	4	<input type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶	
	5	<input type="checkbox"/> Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See instructions.)	

Exemptions	6a	<input type="checkbox"/> Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.		No. of boxes checked on lines 6a and 6b 2
	b	<input checked="" type="checkbox"/> Spouse		
	c	Dependents: (1) First name Last name (2) Dependent's social security number. If born in Dec. 1996, see inst. (3) Dependent's relationship to you (4) No. of months lived in your home in 1996		No. of your children on line 6c who: • lived with you 1 • did not live with you due to divorce or separation (see instructions)
		Robert Michaels 111 001 113 Son 12		
	d	Total number of exemptions claimed		Add numbers entered on lines above ▶ 3

Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2		34,400
	8a	Taxable interest. Attach Schedule B if over \$400.		
	b	Tax-exempt interest. DO NOT include on line 8a	8b	
	9	Dividend income. Attach Schedule B if over \$400		
	10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions)		
	11	Alimony received		
	12	Business income or (loss). Attach Schedule C or C-EZ		3,813
	13	Capital gain or (loss). If required, attach Schedule D		
	14	Other gains or (losses). Attach Form 4797		
	15a	Total IRA distributions	15b	
	16a	Total pensions and annuities	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		
	18	Farm income or (loss). Attach Schedule F		
	19	Unemployment compensation		
	20a	Social security benefits	20b	
	21	Other income. List type and amount—see instructions		240
	22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶		38,453

Adjusted Gross Income	23a	Your IRA deduction (see instructions)		
	23b	Spouse's IRA deduction (see instructions)		
	24	Moving expenses. Attach Form 3903 or 3903-F		
	25	One-half of self-employment tax. Attach Schedule SE		
	26	Self-employed health insurance deduction (see inst.)		
	27	Keogh & self-employed SEP plans. If SEP, check ▶ <input type="checkbox"/>		
	28	Penalty on early withdrawal of savings		
	29	Alimony paid. Recipient's SSN ▶		
	30	Add lines 23a through 29		3,141
	31	Subtract line 30 from line 22. This is your adjusted gross income ▶		35,312

For Privacy Act and Paperwork Reduction Act Notice, see page 7.

Cat. No. 11320B

Form 1040 (1996)

1997 Workbook

Form 1040 (1996)

Page 2

Tax Computation

32	Amount from line 31 (adjusted gross income)	32	35,312
33a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here	33a	
b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see instructions and check here	33b	<input type="checkbox"/>
34	Enter the larger of: Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But see the instructions if you checked any box on line 33a or b or someone can claim you as a dependent. • Single—\$4,000 • Married filing jointly or Qualifying widow(er)—\$6,700 • Head of household—\$5,900 • Married filing separately—\$3,350	34	13,503
35	Subtract line 34 from line 32	35	21,809
36	If line 32 is \$88,475 or less, multiply \$2,550 by the total number of exemptions claimed on line 6d. If line 32 is over \$88,475, see the worksheet in the inst. for the amount to enter	36	7,650
37	Taxable income. Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	14,159
38	Tax. See instructions. Check if total includes any tax from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	38	2,126

If you want the IRS to figure your tax, see the instructions for line 37.

Credits

39	Credit for child and dependent care expenses. Attach Form 2441	39	
40	Credit for the elderly or the disabled. Attach Schedule R	40	
41	Foreign tax credit. Attach Form 1116	41	
42	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	42	
43	Add lines 39 through 42	43	
44	Subtract line 43 from line 38. If line 43 is more than line 38, enter -0-	44	2,126

Other Taxes

45	Self-employment tax. Attach Schedule SE	45	6,281
46	Alternative minimum tax. Attach Form 6251	46	
47	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	47	
48	Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	48	
49	Advance earned income credit payments from Form(s) W-2	49	
50	Household employment taxes. Attach Schedule H	50	
51	Add lines 44 through 50. This is your total tax	51	8,407

Payments

52	Federal income tax withheld from Forms W-2 and 1099	52	272
53	1996 estimated tax payments and amount applied from 1995 return	53	8,400
54	Earned income credit. Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount and type	54	
55	Amount paid with Form 4868 (request for extension)	55	
56	Excess social security and RRTA tax withheld (see inst.)	56	
57	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136	57	
58	Add lines 52 through 57. These are your total payments	58	8,672

Attach Forms W-2, W-2G, and 1099-R on the front.

Refund

59	If line 58 is more than line 51, subtract line 51 from line 58. This is the amount you OVERPAID	59	265
60a	Amount of line 59 you want REFUNDED TO YOU	60a	
b	Routing number	c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
61	Amount of line 59 you want APPLIED TO YOUR 1997 ESTIMATED TAX	61	265

Amount You Owe

62	If line 51 is more than line 58, subtract line 58 from line 51. This is the AMOUNT YOU OWE. For details on how to pay and use Form 1040-V, see instructions	62	
63	Estimated tax penalty. Also include on line 62	63	

Sign Here

Keep a copy of this return for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature <i>John E. Michaels</i>	Date 2/14/97	Your occupation Minister
Spouse's signature. If a joint return, BOTH must sign. <i>Susan R. Michaels</i>	Date 2/14/97	Spouse's occupation Housewife

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's social security no.
Firm's name (or yours if self-employed) and address	EIN		
	ZIP code		

1997 Workbook

SCHEDULES A&B (Form 1040)

Department of the Treasury (X)
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

► Attach to Form 1040. ► See instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

1996

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

John E. Michaels and Susan R. Michaels

Your social security number

011 00 2222

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others.			
1	Medical and dental expenses (see page A-1)	1		
2	Enter amount from Form 1040, line 32. 2	2		
3	Multiply line 2 above by 7.5% (.075)	3		
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4		
Taxes You Paid		5		
5	State and local income taxes	6	1,750	
6	Real estate taxes (see page A-2)	7		
7	Personal property taxes	8		
8	Other taxes. List type and amount ►	9		
9	Add lines 5 through 8	9		1,750
Interest You Paid		10	6,810	
10	Home mortgage interest and points reported to you on Form 1098	11		
11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-2 and show that person's name, identifying no., and address ►	12		
12	Points not reported to you on Form 1098. See page A-3 for special rules	13		
13	Investment interest. If required, attach Form 4952. (See page A-3.)	14		6,810
14	Add lines 10 through 13	15	4,800	
Gifts to Charity		16		
15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-3	17		
16	Other than by cash or check. If any gift of \$250 or more, see page A-3. If over \$500, you MUST attach Form 8283	18		4,800
17	Carryover from prior year	19		
18	Add lines 15 through 17			
Casualty and Theft Losses		20		
19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.)	21	849	
Job Expenses and Other Miscellaneous Deductions		22		
20	Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you MUST attach Form 2106 or 2106-EZ. (See page A-4.) ►	23	849	
21	Tax preparation fees	24	35,312	
22	Other expenses—investment, safe deposit box, etc. List type and amount ►	25	706	
23	Add lines 20 through 22	26		143
24	Enter amount from Form 1040, line 32. 24			
25	Multiply line 24 above by 2% (.02)			
26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			
Other Miscellaneous Deductions		27		
27	Other—from list on page A-4. List type and amount ►			
Total Itemized Deductions		28		13,503
28	Is Form 1040, line 32, over \$117,950 (over \$58,975 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 34, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A-5 for the amount to enter.			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11330X

Schedule A (Form 1040) 1996

1997 Workbook

SCHEDULES A&B (Form 1040)

Department of the Treasury (X)
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

1996

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

John E. Michaels and Susan R. Michaels

Your social security number

011 00 2222

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others.				
1	Medical and dental expenses (see page A-1)	1			
2	Enter amount from Form 1040, line 32. 2	2			
3	Multiply line 2 above by 7.5% (.075)	3			
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4			
Taxes You Paid	5 State and local income taxes	5			
(See page A-1.)	6 Real estate taxes (see page A-2)	6	1,750		
	7 Personal property taxes	7			
	8 Other taxes. List type and amount ▶	8			
	9 Add lines 5 through 8	9		1,750	
Interest You Paid	10 Home mortgage interest and points reported to you on Form 1098	10	6,810		
(See page A-2.)	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-2 and show that person's name, identifying no., and address ▶	11			
	12 Points not reported to you on Form 1098. See page A-3 for special rules	12			
Note: Personal interest is not deductible.	13 Investment interest. If required, attach Form 4952. (See page A-3.)	13			
	14 Add lines 10 through 13	14		6,810	
Gifts to Charity	15 Gifts by cash or check. If you made any gift of \$250 or more, see page A-3	15	4,800		
If you made a gift and got a benefit for it, see page A-3.	16 Other than by cash or check. If any gift of \$250 or more, see page A-3. If over \$500, you MUST attach Form 8283	16			
	17 Carryover from prior year	17			
	18 Add lines 15 through 17	18		4,800	
Casualty and Theft Losses	19 Casualty or theft loss(es). Attach Form 4684. (See page A-4.)	19			
Job Expenses and Most Other Miscellaneous Deductions	20 Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you MUST attach Form 2106 or 2106-EZ. (See page A-4.) ▶	20	849		
(See page A-4 for expenses to deduct here.)	21 Tax preparation fees	21			
	22 Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23 Add lines 20 through 22	23	849		
	24 Enter amount from Form 1040, line 32. 24 135,312	24			
	25 Multiply line 24 above by 2% (.02)	25	706		
	26 Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	26		143	
Other Miscellaneous Deductions	27 Other—from list on page A-4. List type and amount ▶	27			
Total Itemized Deductions	28 Is Form 1040, line 32, over \$117,950 (over \$58,975 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 34, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A-5 for the amount to enter.	28		13,503	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11330X

Schedule A (Form 1040) 1996

1997 Workbook

SCHEDULE C-EZ (Form 1040)

Department of the Treasury
Internal Revenue Service (X)

Name of proprietor

Net Profit From Business

(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065.

► Attach to Form 1040 or Form 1041. ► See instructions on back.

OMB No. 1545-0074

1996

Attachment
Sequence No. 09A

Social security number (SSN)

011002222

Part I General Information

You May Use
This Schedule
Only If You:

- Had business expenses of \$2,500 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as a sole proprietor.

And You:

- Had no employees during the year.
- Are not required to file Form 4562, Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-3 to find out if you must file.
- Do not deduct expenses for business use of your home.
- Do not have prior year unallowed passive activity losses from this business.

A Principal business or profession, including product or service

Minister

B Enter principal business code

(see page C-6) ► 8771

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN), if any

E Business address (including suite or room no.). Address not required if same as on Form 1040, page 1.

1042 Main Street

City, town or post office, state, and ZIP code

Hometown, TX 77099

Part II Figure Your Net Profit

1 Gross receipts.

Caution: If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see **Statutory Employees** in the instructions for Schedule C, line 1, on page C-2 and check here ► ☐

1 4,000

2 Total expenses. If more than \$2,500, you **must** use Schedule C. See instructions

2 187 *

3 Net profit. Subtract line 2 from line 1. If less than zero, you **must** use Schedule C. Enter on Form 1040, line 12, and ALSO on Schedule SE, line 2. (Statutory employees do not report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.)

3 3,813

Part III Information on Your Vehicle. Complete this part **ONLY** if you are claiming car or truck expenses on line 2.

4 When did you place your vehicle in service for business purposes? (month, day, year) ► 7 / 15 / 94.

5 Of the total number of miles you drove your vehicle during 1996, enter the number of miles you used your vehicle for:

a Business 503 b Commuting -0- c Other 7,301

6 Do you (or your spouse) have another vehicle available for personal use? ☒ Yes ☐ No

7 Was your vehicle available for use during off-duty hours? ☒ Yes ☐ No

8a Do you have evidence to support your deduction? ☒ Yes ☐ No

b If "Yes," is the evidence written? ☒ Yes ☐ No

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 14374D

Schedule C-EZ (Form 1040) 1996

1997 Workbook

*See Attached Statement.

SCHEDULE SE (Form 1040)		Self-Employment Tax		OMB No. 1545-0074
Department of the Treasury Internal Revenue Service		▶ See Instructions for Schedule SE (Form 1040). ▶ Attach to Form 1040.		1996 Attachment Sequence No. 17
Name of person with self-employment income (as shown on Form 1040) John E. Michaels		Social security number of person with self-employment income ▶ 011 002 222		

Who Must File Schedule SE

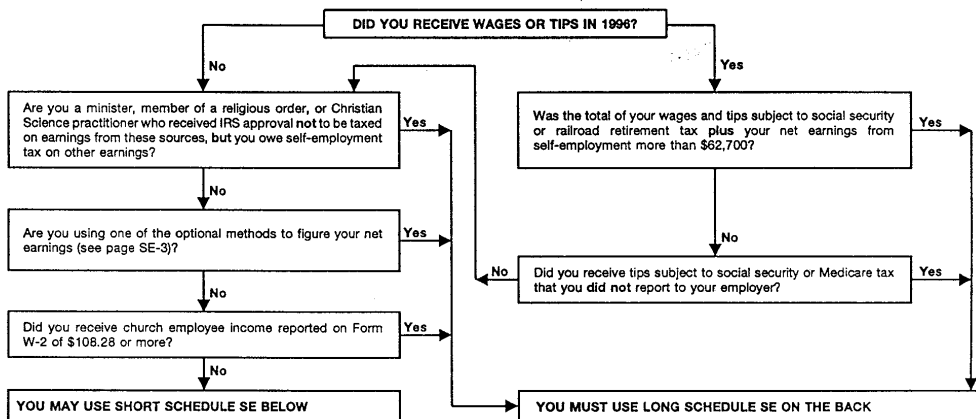
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, **OR**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is **not** church employee income. See page SE-1.

Note: Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 45.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report.	2	44,454	*
3	Combine lines 1 and 2	3	44,454	
4	Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax	4	41,053	
5	Self-employment tax. If the amount on line 4 is: • \$62,700 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 45. • More than \$62,700, multiply line 4 by 2.9% (.029). Then, add \$7,774.80 to the result. Enter the total here and on Form 1040, line 45.	5	6,281	
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 25	6	3,141	

For Paperwork Reduction Act Notice, see Form 1040 instructions. 147

Cat. No. 11358Z

Schedule SE (Form 1040) 1996

1997 Workbook

*See Attached Statement.

Form 2106-EZ	Unreimbursed Employee Business Expenses	OMB No. 1545-1441 1996 Attachment Sequence No. 54A
▶ See instructions on back.		
▶ Attach to Form 1040.		
Department of the Treasury Internal Revenue Service	(X)	
Your name John E. Michaels	Social security number 011 002222	Occupation in which expenses were incurred Minister

Part I General Information

You May Use This Form ONLY if All of the Following Apply:

- You are an employee deducting expenses attributable to your job.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense,
 - a You own your vehicle, and
 - b You are using the standard mileage rate for 1996 and also used it for the year you first placed the vehicle in service.

Part II Figure Your Expenses

1 Vehicle expense using the standard mileage rate. Complete Part III and multiply line 8a by 31¢ (.31)	1	884	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3		
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	219	
5 Meals and entertainment expenses: \$ _____ x 50% (.50)	5		
6 Total expenses. Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). (Qualified performing artists and individuals with disabilities, see the instructions for special rules on where to enter this amount.)	6	849	*

Part III Information on Your Vehicle. Complete this part ONLY if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business purposes? (month, day, year) ▶ **7 / 15 / 94**

8 Of the total number of miles you drove your vehicle during 1996, enter the number of miles you used your vehicle for:

a Business **2,852** b Commuting **-0-** c Other **4,952**

9 Do you (or your spouse) have another vehicle available for personal use? ☒ Yes ☐ No

10 Was your vehicle available for use during off-duty hours? ☒ Yes ☐ No

11a Do you have evidence to support your deduction? ☒ Yes ☐ No

b If "Yes," is the evidence written? ☒ Yes ☐ No

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 20604Q

Form **2106-EZ** (1996)

1997 Workbook

Form 2106-EZ Department of the Treasury Internal Revenue Service	Unreimbursed Employee Business Expenses ▶ See instructions on back. ▶ Attach to Form 1040.	OMB No. 1545-1441 <div style="font-size: 2em; font-weight: bold;">1996</div> Attachment Sequence No. 54A
Your name John E. Michaels		Social security number 011 002222
Occupation in which expenses were incurred Minister		

Part I General Information

You May Use This Form ONLY if All of the Following Apply:

- You are an employee deducting expenses attributable to your job.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense,
 - a You own your vehicle, and
 - b You are using the standard mileage rate for 1996 and also used it for the year you first placed the vehicle in service.

Part II Figure Your Expenses

1 Vehicle expense using the standard mileage rate. Complete Part III and multiply line 8a by 31¢ (.31)	1	884	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3		
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	219	
5 Meals and entertainment expenses: \$ _____ x 50% (.50)	5		
6 Total expenses. Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). (Qualified performing artists and individuals with disabilities, see the instructions for special rules on where to enter this amount.)	6	849	*

Part III Information on Your Vehicle. Complete this part ONLY if you are claiming vehicle expense on line 1.

- 7 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 7 / 15 / 94
- 8 Of the total number of miles you drove your vehicle during 1996, enter the number of miles you used your vehicle for:
- a Business 2,852 b Commuting -0- c Other 4,952
- 9 Do you (or your spouse) have another vehicle available for personal use? ☒ Yes ☐ No
- 10 Was your vehicle available for use during off-duty hours? ☒ Yes ☐ No
- 11a Do you have evidence to support your deduction? ☒ Yes ☐ No
- b If "Yes," is the evidence written? ☒ Yes ☐ No

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 20604Q

Form **2106-EZ** (1996)

1997 Workbook

*See Attached Statement.

I.R.C. §265—Computation of Expenses, Allocable to Tax-Free Ministerial Income, That Are Nondeductible:

		Taxable	Tax-Free	Total
Salary as a minister		\$31,000		\$31,000
Parsonage allowance:				
Mortgage (\$800 × 12)			\$9,600	9,600
Utilities				
\$100 × 12 =	\$1,200			
minus costs	960		960	960
excess	240	240		240
Gross income from weddings, baptisms, and honoraria		4,000		4,000
Ministerial income		35,240	10,560	45,800
Percentage of nondeductible expenses: \$10,560 ÷ \$45,800 = 23%				
Schedule C-EZ Deduction Computation				
\$87	Marriage and family booklets			
+156	Business use of car			
\$243	Unadjusted Schedule C-EZ expenses			
× 23%				
\$56	Nondeductible part of expenses			
\$243	Unadjusted Schedule C-EZ expenses			
–56	Nondeductible part of expenses			
\$187	Schedule C-EZ deductions (line 2)			
Employee Business Expense Deduction Computation				
\$884	Car expenses for church business			
+219	Publications and booklets			
\$1,103	Unadjusted employee business expenses (Form 2106-EZ)			
× 23%				
\$254	Nondeductible part of expenses			
\$1,103	Unadjusted employee business expenses (Form 2106-EZ)			
–254	Nondeductible part of expenses			
\$849	Employee business expense deduction (Form 2106-EZ, line 6)			
None of the other deductions claimed in the return are allocable to tax-free income.				
Attachment to Schedule SE (Form 1040)				
Church wages				\$31,000
Parsonage allowance—Mortgage			\$9,600	
Utilities			1,200	10,800

1997 Workbook

Net operating profit from Schedule C-EZ		3,813
		\$45,613
Less:		
Schedule C-EZ expenses allocable to tax-exempt income	\$56	
Ministerial employee business expenses (unadjusted)	1,103	1,159
Net Self-Employment Income		
Schedule SE, Section A, line 2		\$44,454

Problem 13: Disabled Access Credit/Expenditures to Remove Barriers

A. Disabled Access Credit [I.R.C. §44]

I.R.C. §44 provides a **tax credit** of up to \$5000 dollars **per year** for expenses incurred by certain **small businesses** to provide access to disabled individuals. The tax credit is claimed on Form 8826 and is part of the General Business Credit. The credit is nonrefundable and any excess credit must be carried back 3 years and then forward 15 years.

Eligible Small Business: An eligible small business includes a business under **any entity form** that meets **either** of the following two tests:

1. the business's gross receipts **did not exceed** \$1,000,000 during the **prior** tax year, or
2. the business employed **not more than 30** full-time employees during the **prior** tax year.

Note: For test 2 above, **full-time** is defined as at least 30 hours per week for 20 calendar weeks during the prior year.

Eligible access expenditures include amounts paid or incurred

- (a) for the purpose of removing architectural, communication, physical, or transportation barriers that prevent a business from being accessible to, or usable by, individuals with disabilities,

Note: There is an **exception** for expenditures to remove barriers. These expenses **do not qualify for the credit** if they are paid or incurred for **new construction first placed in service after Nov. 5, 1990**.

- (b) to provide qualified interpreters or other effective methods of making aurally delivered materials available to individuals with hearing impairments,
- (c) to provide qualified readers, taped text and other effective methods of making visually delivered materials available to individuals with visual impairments,
- (d) to acquire or modify equipment or devices for individuals with disabilities, or
- (e)

1997 Workbook

(e) to provide other similar services modifications, materials, or equipment.

Any amount claimed as the credit **reduces the basis** of the item for purposes of computing costs recovery deductions. The amount of the credit for any taxable year is equal to 50% of the eligible expenses for the taxable year that exceed \$250 but do not exceed \$10,250. This places an annual limit on the credit of \$5,000 ($\$10,250 - \$250 \times 50\%$).

B. Expenditures to Remove Barriers [I.R.C. §190]

In addition to the disabled access **tax credit**, I.R.C. §190 provides a **tax deduction** for a taxpayer who elects to deduct qualified architectural and transportation barrier removal expenses that are paid or incurred in a taxable year. The expenses would otherwise be chargeable to a capital account. The annual limit for any taxable year is \$15,000.

Treas. Reg. 1.190-(2)(b) lists specific modifications, by item, which may qualify for the deduction. Readers are advised to review the regulations of the modifications to these items which may qualify for the deduction.

There does not appear to be a required priority of the credit of the deduction or vice versa. I.R.C. §44(d)(7) simply **denies a double benefit** providing that to the extent of the credit claimed, no deduction of the credit in that amount is allowed under any other provision of the Code.

From a planning standpoint, it would seem advisable to look at I.R.C. §44 disabled access credit first, especially when the expenditure would be properly capitalized and subject to a long MACRS cost recovery life. After claiming the maximum credit allowable, the remaining cost of the expenditures qualifies for I.R.C. §190 removal of barriers deduction. Any remaining basis may be depreciated. If the expenditure is not depreciable, such as in land improvements, grading, and so on, the amount is capitalized to the basis of the land.

Example. In 1997, John Smith, a sole proprietor operating a dental practice, paid for the following upgrades to the dental office building he constructed in 1980. John's tax liability, before consideration of these expenditures, is \$45,000.

1. Construction on a wheelchair ramp and parking lot—\$3,500 (15-year MACRS life)
2. Construction of chairlift from first floor to second floor—\$21,000 (7-year MACRS life)
3. Costs to grading and widening public walks to conform the Americans with Disabilities Act of 1990—\$4,500 (15-year MACRS life)
4. Remarking parking lot to comply with handicap parking—\$500 (15-year MACRS life)

The entire \$29,500 of expenditures qualifies for both I.R.C. §44 access credit and §190 barrier removal deduction.

Assuming the I.R.C. §44 credit is claimed, John would claim the \$5,000 credit as shown on Form 8826.

For basic reduction purposes, John's accountant would subtract the credit from the cost of the longer life assets, in this case, item 3 (grading and walks) and item 4 (marking parking lot). The remaining cost of

1997 Workbook

the expenses after the \$5,000 credit is \$24,500. This \$24,500 is attributed to items 1 and 2, the wheelchair ramp and chairlift.

For purposes of I.R.C. §190 barrier removal deduction, a \$15,000 limit would be applied first to item 1, leaving a \$11,500 deduction for the \$21,000 spent on item 2. The remaining basis of \$9,500 in item 2 (chairlift) would be depreciated using MACRS (7-year recovery period) on John's 1997 Form 4562.

Recap

Total expenditures	\$29,500
Less basis reduction required by I.R.C. §44	(5,000)
	24,500
Less I.R.C. §190 deduction	(15,000)
Remaining basis subject to MACRS	\$9,500
Computation of allowable MACRS on chairlift for 1997	
Depreciable basis	\$9,500
Recovery period	7 years
Method	200% DB-Half-year convention
Table in IRS Pub. #946, "How to Depreciate Property"	A-1
MACRS percentage for 1997	14.29%
Allowable MACRS for 1997 ($\$9,500 \times 14.29\%$)	\$1,358

Note: John is claiming the maximum \$5,000 Disabled Access Credit on line 18 on his 1997 Form 8826. If he has no other General Business Credits in 1997, he will not be required to attach a 1997 Form 3800 (General Business Credit) to his 1997 Form 1040. The \$5,000 Disabled Access Credit from line 18, Form 8826, will be entered on line 44 on John's 1997 Form 1040. Check the box for line 44d and specify "Form 8826."

Credits	40	Credit for child and dependent care expenses. Attach Form 2441	40				
	41	Credit for the elderly or the disabled. Attach Schedule R	41				
	42	Adoption credit. Attach Form 8839	42				
	43	Foreign tax credit. Attach Form 1116	43				
	44	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396	44	5,000.00			
		c <input type="checkbox"/> Form 8801 d <input checked="" type="checkbox"/> Form (specify) 8826					
	45	Add lines 40 through 44	45	5,000.00			
	46	Subtract line 45 from line 39. If line 45 is more than line 39, enter -0-	46	40,000.00			

1997 Workbook

Credits		40	41	42	43	44	45	46
40	Credit for child and dependent care expenses. Attach Form 2441							
41	Credit for the elderly or the disabled. Attach Schedule R							
42	Adoption credit. Attach Form 8839							
43	Foreign tax credit. Attach Form 1116							
44	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input checked="" type="checkbox"/> Form (specify) 8826					5,000.00		
45	Add lines 40 through 44						5,000.00	
46	Subtract line 45 from line 39. If line 45 is more than line 39, enter -0-							40,000.00

Form **8826** **Disabled Access Credit** OMB No. 1545-1205
Department of the Treasury Internal Revenue Service **19967**
Name(s) shown on return **JOHN SMITH** Attach to your return. Identifying number **663-21-4801**

Part I Current Year Credit

1	Total eligible access expenditures	1	29,500.00
2	Minimum amount	2	\$ 250.00
3	Subtract line 2 from line 1. (If less than zero, enter -0-)	3	29,250.00
4	Maximum amount	4	\$10,000.00
5	Enter smaller of line 3 or line 4	5	10,000.00
6	Current year credit. Multiply line 5 by 50% (.50)	6	5,000.00
7	Disabled access credits from flow-through entities: If you are a— Then enter total of current year disabled access credit(s) from— a Shareholder Schedule K-1 (Form 1120S), lines 12d, 12e, or 13 b Partner Schedule K-1 (Form 1065), lines 13c, 13d, or 14	7	-
8	Total current year disabled access credit. Add lines 6 and 7, but do not enter more than \$5,000.	8	5,000.00

Part II Tax Liability Limit (See Who Must File Form 3800 to find out if you complete Part II or file Form 3800.)

9	Regular tax before credits: • Individuals. Enter amount from Form 1040, line 38 • Corporations. Enter amount from Form 1120, Schedule J, line 3 (or Form 1120-A, Part I, line 1) • Other filers. Enter regular tax before credits from your return	9	45,000.00
10a	Credit for child and dependent care expenses (Form 2441, line 10)	10a	
b	Credit for the elderly or the disabled (Schedule R (Form 1040), line 20)	10b	
c	Mortgage interest credit (Form 8396, line 11)	10c	
d	Foreign tax credit (Form 1116, line 32, or Form 1118, Sch. B, line 12)	10d	
e	Possessions tax credit (Form 5735)	10e	
f	Credit for fuel from a nonconventional source	10f	
g	Qualified electric vehicle credit (Form 8834, line 19)	10g	
h	Add lines 10a through 10g	10h	-0-
11	Net regular tax. Subtract line 10h from line 9	11	45,000.00
12	Alternative minimum tax: • Individuals. Enter amount from Form 6251, line 28 • Corporations. Enter amount from Form 4626, line 15 • Estates and trusts. Enter amount from Form 1041, Schedule I, line 41	12	
13	Net income tax. Add lines 11 and 12	13	45,000.00
14	Tentative minimum tax (see instructions): • Individuals. Enter amount from Form 6251, line 26 • Corporations. Enter amount from Form 4626, line 13 • Estates and trusts. Enter amount from Form 1041, Schedule I, line 37	14	
15	If line 11 is more than \$25,000, enter 25% (.25) of the excess (see instructions)	15	
16	Enter the greater of line 14 or line 15	16	-0-
17	Subtract line 16 from line 13. If zero or less, enter -0-	17	45,000.00
18	Disabled access credit allowed for current year. Enter the smaller of line 8 or line 17 here and on Form 1040, line 42; Form 1120, Schedule J, line 4d; Form 1120-A, line 2a; Form 1041, Schedule G, line 2c; or the applicable line of your return	18	5,000.00

Section references are to the Internal Revenue Code.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to

give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB

control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

1997 Workbook

Form 8826	Disabled Access Credit	OMB No. 1545-1205
Department of the Treasury Internal Revenue Service	► Attach to your return.	1997 Attachment Sequence No. 86
Name(s) shown on return JOHN SMITH		Identifying number 663-21-4801

Part I Current Year Credit

1	Total eligible access expenditures	1	29,500.00
2	Minimum amount	2	\$ 250.00
3	Subtract line 2 from line 1 (if less than zero, enter -0-)	3	29,250.00
4	Maximum amount	4	\$10,000.00
5	Enter smaller of line 3 or line 4	5	10,000.00
6	Current year credit. Multiply line 5 by 50% (.50)	6	5,000.00
7	Disabled access credits from flow-through entities:		
	If you are a—	Then enter total of current year disabled access credit(s) from—	
	a Shareholder	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13	
	b Partner	Schedule K-1 (Form 1065), lines 13c, 13d, or 14	
8	Total current year disabled access credit. Add lines 6 and 7, but do not enter more than \$5,000.	8	5,000.00

Part II Tax Liability Limit (See Who Must File Form 3800 to find out if you complete Part II or file Form 3800.)

9	Regular tax before credits:		
	• Individuals. Enter amount from Form 1040, line 38 9		
	• Corporations. Enter amount from Form 1120, Schedule J, line 3 (or Form 1120-A, Part I, line 1)		
	• Other filers. Enter regular tax before credits from your return	9	45,000.00
10a	Credit for child and dependent care expenses (Form 2441, line 10)	10a	
b	Credit for the elderly or the disabled (Schedule R (Form 1040), line 20)	10b	
c	Mortgage interest credit (Form 8396, line 11)	10c	
d	Foreign tax credit (Form 1116, line 32, or Form 1118, Sch. B, line 12)	10d	
e	Possessions tax credit (Form 5735)	10e	
f	Credit for fuel from a nonconventional source	10f	
g	Qualified electric vehicle credit (Form 8834, line 19)	10g	
h	Add lines 10a through 10g.	10h	-0-
11	Net regular tax. Subtract line 10h from line 9	11	45,000.00
12	Alternative minimum tax:		
	• Individuals. Enter amount from Form 6251, line 28		
	• Corporations. Enter amount from Form 4626, line 15		
	• Estates and trusts. Enter amount from Form 1041, Schedule I, line 41	12	
13	Net income tax. Add lines 11 and 12	13	45,000.00
14	Tentative minimum tax (see instructions):		
	• Individuals. Enter amount from Form 6251, line 26		
	• Corporations. Enter amount from Form 4626, line 13		
	• Estates and trusts. Enter amount from Form 1041, Schedule I, line 37	14	
15	If line 11 is more than \$25,000, enter 25% (.25) of the excess (see instructions).	15	
16	Enter the greater of line 14 or line 15	16	-0-
17	Subtract line 16 from line 13. If zero or less, enter -0-	17	45,000.00
18	Disabled access credit allowed for current year. Enter the smaller of line 8 or line 17 here and on Form 1040, line 42; Form 1120, Schedule J, line 4d; Form 1120-A, line 2a; Form 1041, Schedule G, line 2c; or the applicable line of your return	18	5,000.00

Section references are to the Internal Revenue Code.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to

give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB

control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 4 hr., 47 min.

Learning about the law or the form 47 min.

Preparing and sending the form to the IRS 55 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS at the address listed in the instructions of the tax return with which this form is filed.

General Instructions

Purpose of Form

Eligible small businesses use Form 8826 to claim the disabled access credit. This credit is part of the general business credit.

A partnership or S corporation that is an eligible small business completes Part I of the form to figure the credit to pass through to its partners or shareholders.

Definitions

Eligible small business.—For purposes of the credit, an eligible small business is any business or person that (a) had gross receipts for the preceding tax year that did not exceed \$1 million or had no more than 30 full-time employees during the preceding tax year and (b) elects (by filing Form 8826) to claim the disabled access credit for the tax year.

For purposes of the definition:

1. Gross receipts are reduced by returns and allowances made during the tax year.

2. An employee is considered full time if that employee is employed at least 30 hours per week for 20 or more calendar weeks in the tax year.

3. Generally, all members of the same controlled group and all persons under common control are considered to be one person. See section 44(d)(2).

Eligible access expenditures.—For purposes of the credit, these expenditures are amounts paid or incurred by the eligible small business to comply with applicable requirements under the Americans With Disabilities Act of 1990 (Public Law 101-336) as in effect on November 5, 1990.

Eligible access expenditures include amounts paid or incurred:

1. To remove barriers that prevent a business from being accessible to or usable by individuals with disabilities;

2. To provide qualified interpreters or other methods of making audio materials available to hearing-impaired individuals;

3. To provide qualified readers, taped texts, and other methods of making visual materials available to individuals with visual impairments; or

4. To acquire or modify equipment or devices for individuals with disabilities.

The expenditures must be reasonable and necessary to accomplish the above purposes.

Eligible expenditures do not include expenditures in 1 above that are paid or incurred in connection with any facility first placed in service after November 5, 1990.

Eligible access expenditures must meet those standards issued by the Secretary of the Treasury as agreed to by the Architectural and Transportation Barriers Compliance Board and set forth in regulations. See section 44(c) for other details.

Disability.—For an individual, this means:

1. A physical or mental impairment that substantially limits one or more of the major life activities of that individual;

2. A record of such an impairment; or

3. Being regarded as having such an impairment.

Specific Instructions

Part I

Line 1.—Enter total eligible access expenditures paid or incurred during the tax year. See **Eligible access expenditures** above for a definition and other details.

Controlled groups.—All members of a controlled group of corporations (within the meaning of section 52(a)) and all persons under common control (within the meaning of section 52(b)) are treated as one person for purposes of the credit. The group member with the most eligible access expenditures should figure the group credit in Part I and skip Part II.

On separate Forms 8826, each member of the group skips lines 1 through 5 and enters its share of the group credit on line 6. Each member then completes the remaining applicable lines (or Form 3800, if required) on its separate form. Each member must also attach to its Form 8826 a schedule showing how the group credit was divided among all members. The members share the credit in the same proportion that they contributed eligible access expenditures.

Denial of double benefit.—To the extent of the credit shown on line 6, the eligible access expenditures may not be claimed as a deduction in figuring taxable income, capitalized, or used in figuring any other credit.

Who Must File Form 3800

If for this year you have more than one of the credits included in the general business credit listed below, or have a carryback or carryforward of any of the credits, or have a disabled access credit from a passive activity, you must complete **Form 3800, General Business Credit**, instead of completing **Part II** of Form 8826 to figure the tax liability limitation.

The general business credit consists of the following credits:

- Investment (Form 3468),
- Work opportunity (Form 5884),
- Alcohol used as fuel (Form 6478),
- Research (Form 6765),
- Low-income housing (Form 8586),
- Enhanced oil recovery (Form 8830),
- Disabled access (Form 8826),
- Renewable electricity production (Form 8835),
- Indian employment (Form 8845),
- Employer social security and Medicare taxes paid on certain employee tips (Form 8846),
- Orphan drug (Form 8820),
- Contributions to selected community development corporations (Form 8847), and
- Trans-Alaska pipeline liability fund.

The empowerment zone employment credit (Form 8844), while a component of the general business credit, is figured separately and is never carried to Form 3800.

Part II

Complete Part II if you do not have to file Form 3800.

Line 14.—Enter the tentative minimum tax (TMT) that was figured on the appropriate alternative minimum tax (AMT) form or schedule. Although you may not owe AMT, you must still compute the TMT to figure your credit.

Line 15.—See section 38(c)(3) for special rules that apply to married couples filing separate returns, controlled corporate groups, regulated investment companies, and real estate investment trusts.

Line 18.—If you cannot use part of the credit because of the tax liability limit (line 17 is smaller than line 8), carry it back 3 years, then forward 15 years. See the separate Instructions for Form 3800 for details.

1997 Workbook

Problem 14: Repossession of Personal Property

Law and other information: If a borrower does not make payments due on a loan secured by personal property, the lender may repossess the property. The repossession is treated as a sale or exchange, and the borrower will realize gain or loss. This is true even if the personal property is voluntarily returned to the lender.

Rules for Repossessions Involving Recourse Debt

A. Amount Realized on a Recourse Debt

If the borrower is personally liable for the debt (**defined as recourse debt**), the amount realized (sales price of the repossessed asset) **does not include** the amount of the cancelled debt that represents income to the borrower from cancellation of debt [I.R.C. §61(a)(12)].

However, if the fair market value of the transferred property is less than the amount of cancelled debt, the amount realized by the borrower includes the amount of cancelled debt up to the fair market value of the property. The borrower is treated as receiving ordinary income from the amount of cancelled debt for that part of the debt that is not included in calculating the amount realized.

B. Cancellation of Debt Income [I.R.C. §61(a)(12)]

If property that is repossessed secures a recourse debt, the general rule is that the amount by which the cancelled debt **exceeds** the fair market value of the property must be reported as **ordinary income**. This ordinary income amount is **separate** from any gain or loss realized from the repossession. Report the **ordinary income** from cancellation of **business debt as business income**. Report the **ordinary income** from cancellation of non-business debt as miscellaneous income on line 21, Form 1040.

Since most debts incurred by individuals and businesses are **recourse debts**, the factual situation that follows involves **recourse debt** rather than nonrecourse debt.

Facts. Hugo is a former self-employed trucker. He bought a new International tractor-trailer in 1995. Following are the facts regarding the truck:

Date purchased:	April 20, 1995
Cost (purchased outright with no trade-in):	\$86,000
Amount of original loan from Navistar Credit Co.:	\$75,000
Date of repossession by the lender:	May 10, 1997

1997 Workbook

Remaining loan principal on date of repossession: \$61,750

[See the 1997 Form 1099-A which Navistar Credit Co. sent to Hugo.]

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no. Navistar Credit Company 1060 W. Belmont Chicago, IL 60613		OMB No. 1545-0877 1997 Form 1099-A		Acquisition or Abandonment of Secured Property Copy B For Borrower This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
LENDER'S Federal identification number 36-0000000	BORROWER'S identification number 111-11-1111	1 Date of lender's acquisition or knowledge of abandonment May 10, 1997	2 Balance of principal outstanding \$ 61,750.00	
BORROWER'S name Hugo M. Trucker		3 [REDACTED]	4 Fair market value of property \$ 60,000.00	
Street address (including apt. no.) 142 Paradise Lane City, state, and ZIP code Beaver City, NE 68926		5 Was borrower personally liable for repayment of the debt? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
Account number (optional) 5196370014-1		6 Description of property 1995 International semi-tractor SN: C1103T778X427		

Form 1099-A (Keep for your records.) Department of the Treasury - Internal Revenue Service

Instructions for Borrower

Certain lenders who acquire an interest in property that was security for a loan or who have reason to know that such property has been abandoned must provide you with this statement. You may have reportable income or loss because of such acquisition or abandonment. Gain or loss from an acquisition generally is measured by the difference between your adjusted basis in the property and the amount of your debt canceled in exchange for the property, or, if greater, the sale proceeds. If you abandoned the property, you may have income from the discharge of indebtedness in the amount of the unpaid balance of your canceled debt. You may also have a loss from abandonment up to the adjusted basis of the property at the time of abandonment. Losses on acquisitions or abandonments of property held for personal use are not deductible. See **Pub. 544, Sales and Other Dispositions of Assets**, for information about foreclosures and abandonments.

Property means all real property, such as a personal residence; all intangible property; and tangible personal property that is held for investment or used in a trade or business.

If you borrowed money on this property with someone else, each of you should receive this statement.

Box 1.—For a lender's acquisition of property that was security for a loan, the date shown is generally the earlier of the date title was transferred to the lender or the date possession and the burdens and benefits of ownership were transferred to the lender. This may be the date of a foreclosure or execution sale or the date your right of redemption or objection expired. For an abandonment, the date shown is the date on which the lender first knew or had reason to know that the property was abandoned or the date of a foreclosure, execution, or similar sale.

Box 2.—Shows the amount of the debt (principal only) owed to the lender on the loan at the time the interest in the property was acquired by the lender or on the date the lender first knew or had reason to know that the property was abandoned.

Box 4.—Shows the fair market value of the property. If the amount in box 4 is less than the amount in box 2, and your debt is canceled, you may have cancellation of debt income.

Box 5.—Shows whether you were personally liable for repayment of the loan at the time the debt was created or, if modified, at the time of the last modification.

Box 6.—Shows the description of the property acquired by the lender or abandoned by you. If "CCC" is shown, the form indicates the amount of any Commodity Credit Corporation loan outstanding when you forfeited your commodity.

1997 Workbook

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no. Navistar Credit Company 1060 W. Belmont Chicago, IL 60613		OMB No. 1545-0877 <div style="font-size: 2em; font-weight: bold;">1997</div> Form 1099-A	Acquisition or Abandonment of Secured Property Copy B For Borrower <small>This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.</small>	
LENDER'S Federal identification number 36-0000000	BORROWER'S identification number 111-11-1111	1 Date of lender's acquisition or knowledge of abandonment May 10, 1997		2 Balance of principal outstanding \$ 61,750.00
BORROWER'S name Hugo M. Trucker Street address (including apt. no.) 142 Paradise Lane City, state, and ZIP code Beaver City, NE 68926		3 <div style="background-color: #cccccc; width: 100px; height: 20px;"></div>		4 Fair market value of property \$ 60,000.00
Account number (optional) 5196370014-1		5 Was borrower personally liable for repayment of the debt? <div style="text-align: right;"> <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No </div>		
		6 Description of property 1995 International semi-tractor SN: C1103T778X427		

Form 1099-A (Keep for your records.) Department of the Treasury - Internal Revenue Service

Instructions for Borrower

Certain lenders who acquire an interest in property that was security for a loan or who have reason to know that such property has been abandoned must provide you with this statement. You may have reportable income or loss because of such acquisition or abandonment. Gain or loss from an acquisition generally is measured by the difference between your adjusted basis in the property and the amount of your debt canceled in exchange for the property, or, if greater, the sale proceeds. If you abandoned the property, you may have income from the discharge of indebtedness in the amount of the unpaid balance of your canceled debt. You may also have a loss from abandonment up to the adjusted basis of the property at the time of abandonment. Losses on acquisitions or abandonments of property held for personal use are not deductible. See Pub. 544, Sales and Other Dispositions of Assets, for information about foreclosures and abandonments.

Property means all real property, such as a personal residence; all intangible property; and tangible personal property that is held for investment or used in a trade or business.

If you borrowed money on this property with someone else, each of you should receive this statement.

Box 1.—For a lender's acquisition of property that was security for a loan, the date shown is generally the earlier of the date title was transferred to the lender or the date possession and the burdens and benefits of ownership were transferred to the lender. This may be the date of a foreclosure or execution sale or the date your right of redemption or objection expired. For an abandonment, the date shown is the date on which the lender first knew or had reason to know that the property was abandoned or the date of a foreclosure, execution, or similar sale.

Box 2.—Shows the amount of the debt (principal only) owed to the lender on the loan at the time the interest in the property was acquired by the lender or on the date the lender first knew or had reason to know that the property was abandoned.

Box 4.—Shows the fair market value of the property. If the amount in box 4 is less than the amount in box 2, and your debt is canceled, you may have cancellation of debt income.

Box 5.—Shows whether you were personally liable for repayment of the loan at the time the debt was created or, if modified, at the time of the last modification.

Box 6.—Shows the description of the property acquired by the lender or abandoned by you. If "CCC" is shown, the form indicates the amount of any Commodity Credit Corporation loan outstanding when you forfeited your commodity.

Note: Hugo was **not insolvent or bankrupt** on the repossession date. The debt **does not qualify as farm debt**. [See I.R.C. §108(g).]

MACRS deducted on the truck on Hugo's Schedule C:

Year	MACRS Deducted on Schedule C	
1995	\$28,664	(\$86,000 × 33.33%—Table A-1, IRS Pub. 946)
1996	38,227	(\$86,000 × 44.45%)

1997 Workbook

1997	6,368 (\$86,000 × 14.81% ÷ 2: disposed of in 1997)
	\$73,259 (Total MACRS deducted by Hugo)

Question 1. Does Hugo have a taxable event in 1997?

Answer 1. Yes. The repossession of his truck by the lender will produce two types of income on Hugo's 1997 tax return. See the completed worksheet from IRS Pub. #544, "Sales and Other Dispositions of Assets."

Table 1-2. **Worksheet for Foreclosures and Repossessions**
(Keep for your records)



Step 1. Figure your income from cancellation of debt. (<i>Note: If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Step 1 and go to Step 2.</i>)	
1. Enter the amount of debt canceled by the transfer of property	<u>61,750</u>
2. Enter the fair market value of the transferred property	<u>60,000</u>
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero	<u>1,750</u>
Step 2. Figure your gain or loss from foreclosure or repossession.	
4. Enter the smaller of line 1 or line 2. (If you are not personally liable for the debt, enter the amount of debt cancelled by the transfer of property.)	<u>60,000</u>
5. Enter the adjusted basis of the transferred property	<u>12,741</u>
6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4	<u>47,259</u>

*The income may not be taxable. See *Cancellation of debt*.

- The cancellation is intended as a gift,
- The debt is qualified farm indebtedness (see chapter 4 of Publication 225, *Farmer's Tax Guide*),
- The debt is qualified real property indebtedness (see chapter 5 of Publication 334, *Tax Guide for Small Business*), or
- You are insolvent or bankrupt (see Publication 908, *Bankruptcy Tax Guide*).

You can use Table 1-2 to figure your income from cancellation of debt.

1997 Workbook

Table 1-2. **Worksheet for Foreclosures and Repossessions**
(Keep for your records)



Step 1. Figure your income from cancellation of debt. (*Note: If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Step 1 and go to Step 2.*)

1. Enter the amount of debt canceled by the transfer of property	<u>61,750</u>
2. Enter the fair market value of the transferred property	<u>60,000</u>
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero	<u>1,750</u>

Step 2. Figure your gain or loss from foreclosure or repossession.

4. Enter the smaller of line 1 or line 2. (If you are not personally liable for the debt, enter the amount of debt cancelled by the transfer of property.)	<u>60,000</u>
5. Enter the adjusted basis of the transferred property	<u>12,741</u>
6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4.....	<u>47,259</u>

*The income may not be taxable. See *Cancellation of debt*.

- The cancellation is intended as a gift,
- The debt is qualified farm indebtedness (see chapter 4 of Publication 225, *Farmer's Tax Guide*),
- The debt is qualified real property indebtedness (see chapter 5 of Publication 334, *Tax Guide for Small Business*), or
- You are insolvent or bankrupt (see Publication 908, *Bankruptcy Tax Guide*).

You can use Table 1-2 to figure your income from cancellation of debt.

1997 Workbook

Question 2. Where should Hugo report the \$1,750 income from cancellation of debt?

Answer 2. Cancellation of debt income is generally **not** subject to self-employment tax pursuant to **Treas. Reg. 1.1402(a)-6**. Therefore, it is recommended that the \$1,750 be reported on Hugo's 1997 Form 1040, line 21, Other income. See the partially completed 1997 Form 1040 that follows.

Income Attach Copy B of your Forms W-2, W-2G, and 1099-R here. If you did not get a W-2, see page 12. Enclose but do not attach any payment. Also, please use Form 1040-V.	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
	8a	Taxable interest. Attach Schedule B if required	8a	
	b	Tax-exempt interest: DO NOT include on line 8a	8b	
	9	Dividend income. Attach Schedule B if required	9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 12)	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required	13	
	14	Other gains or (losses). Attach Form 4797	14	
	15a	Total IRA distributions	15a	
	b	Taxable amount (see page 13)	15b	
	16a	Total pensions and annuities	16a	
	b	Taxable amount (see page 13)	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18	Farm income or (loss). Attach Schedule F	18	
	19	Unemployment compensation	19	
	20a	Social security benefits	20a	
	b	Taxable amount (see page 15)	20b	
	21	Other income. List type and amount—see page 15 <i>Cancellation of debt income on repossession of truck per Form 1099-A</i>	21	1,750
	22	Add the amounts in the far right column for lines 7 through 21. This is your total income ►	22	

Income Attach Copy B of your Forms W-2, W-2G, and 1099-R here. If you did not get a W-2, see page 12. Enclose but do not attach any payment. Also, please use Form 1040-V.	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
	8a	Taxable interest. Attach Schedule B if required	8a	
	b	Tax-exempt interest: DO NOT include on line 8a	8b	
	9	Dividend income. Attach Schedule B if required	9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 12)	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required	13	
	14	Other gains or (losses). Attach Form 4797	14	
	15a	Total IRA distributions	15a	
	b	Taxable amount (see page 13)	15b	
	16a	Total pensions and annuities	16a	
	b	Taxable amount (see page 13)	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18	Farm income or (loss). Attach Schedule F	18	
	19	Unemployment compensation	19	
	20a	Social security benefits	20a	
	b	Taxable amount (see page 15)	20b	
	21	Other income. List type and amount—see page 15 <i>Cancellation of debt income on repossession of truck per Form 1099-A</i>	21	1,750
	22	Add the amounts in the far right column for lines 7 through 21. This is your total income ►	22	

1997 Workbook

Question 3. Where should Hugo report the \$47,259 gain from the repossession?

Answer 3. In Part III of his 1997 Form 4797. The entire gain is §1245 ordinary recapture income. See the completed Form 4797.

Form 4797 (1997) 7

Page 2

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

21	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	1995 International Semi-Tractor (repossessed by lender)	4-20-95	5-10-97
B			
C			
D			

Relate lines 21A through 21D to these columns		Property A	Property B	Property C	Property D
22	Gross sales price (Note: See line 1 before completing.)	60,000			
23	Cost or other basis plus expense of sale	86,000			
24	Depreciation (or depletion) allowed or allowable	73,259			
25	Adjusted basis. Subtract line 24 from line 23	12,741			
26	Total gain. Subtract line 25 from line 22	47,259			
27	If section 1245 property:				
a	Depreciation allowed or allowable from line 24	73,259			
b	Enter the smaller of line 26 or 27a	47,259			
28	If section 1250 property: If straight line depreciation was used, enter -0- on line 28g, except for a corporation subject to section 291.				
a	Additional depreciation after 1975 (see instructions)				
b	Applicable percentage multiplied by the smaller of line 26 or line 28a (see instructions)				
c	Subtract line 28a from line 26. If residential rental property or line 26 is not more than line 28a, skip lines 28d and 28e				
d	Additional depreciation after 1969 and before 1976				
e	Enter the smaller of line 28c or 28d				
f	Section 291 amount (corporations only)				
g	Add lines 28b, 28e, and 28f				
29	If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.				
a	Soil, water, and land clearing expenses				
b	Line 29a multiplied by applicable percentage (see instructions)				
c	Enter the smaller of line 26 or 29b				
30	If section 1254 property:				
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)				
b	Enter the smaller of line 26 or 30a				
31	If section 1255 property:				
a	Applicable percentage of payments excluded from income under section 126 (see instructions)				
b	Enter the smaller of line 26 or 31a (see instructions)				

Summary of Part III Gains. Complete property columns A through D through line 31b before going to line 32.

32	Total gains for all properties. Add property columns A through D, line 26	32	47,259
33	Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14	33	47,259
34	Subtract line 33 from line 32. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	34	

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less
See instructions.

	(a) Section 179	(b) Section 280F(b)(2)
35	Section 179 expense deduction or depreciation allowable in prior years	35
36	Recomputed depreciation. See instructions	36
37	Recapture amount. Subtract line 36 from line 35. See the instructions for where to report	37

* U.S. GOVERNMENT PRINTING OFFICE: 1996-407-382

1997 Workbook

Form 4797 (1996) 7

Page 2

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

21	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	1995 International semi-tractor (repossessed by lender)	4-20-95	5-10-97
B			
C			
D			

Relate lines 21A through 21D to these columns		Property A	Property B	Property C	Property D
22	Gross sales price (Note: See line 1 before completing.)	22 60,000			
23	Cost or other basis plus expense of sale	23 86,000			
24	Depreciation (or depletion) allowed or allowable	24 73,259			
25	Adjusted basis. Subtract line 24 from line 23	25 12,741			
26	Total gain. Subtract line 25 from line 22	26 47,259			
27	If section 1245 property:				
a	Depreciation allowed or allowable from line 24	27a 73,259			
b	Enter the smaller of line 26 or 27a	27b 47,259			
28	If section 1250 property: If straight line depreciation was used, enter -0- on line 28g, except for a corporation subject to section 291.				
a	Additional depreciation after 1975 (see instructions)	28a			
b	Applicable percentage multiplied by the smaller of line 26 or line 28a (see instructions)	28b			
c	Subtract line 28a from line 26. If residential rental property or line 26 is not more than line 28a, skip lines 28d and 28e	28c			
d	Additional depreciation after 1969 and before 1976	28d			
e	Enter the smaller of line 28c or 28d	28e			
f	Section 291 amount (corporations only)	28f			
g	Add lines 28b, 28e, and 28f	28g			
29	If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.				
a	Soil, water, and land clearing expenses	29a			
b	Line 29a multiplied by applicable percentage (see instructions)	29b			
c	Enter the smaller of line 26 or 29b	29c			
30	If section 1254 property:				
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	30a			
b	Enter the smaller of line 26 or 30a	30b			
31	If section 1255 property:				
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	31a			
b	Enter the smaller of line 26 or 31a (see instructions)	31b			

Summary of Part III Gains. Complete property columns A through D through line 31b before going to line 32.

32	Total gains for all properties. Add property columns A through D, line 26	32 47,259
33	Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14	33 47,259
34	Subtract line 33 from line 32. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	34

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less See instructions.

	(a) Section 179	(b) Section 280F(b)(2)
35	Section 179 expense deduction or depreciation allowable in prior years	35
36	Recomputed depreciation. See instructions	36
37	Recapture amount. Subtract line 36 from line 35. See the instructions for where to report	37

* U.S. GOVERNMENT PRINTING OFFICE: 1996-407-382

1997 Workbook

Problem 15: Taxation of Aliens

With the growth of the global economy, each year more practitioners encounter potential clients who are not citizens of the United States. Even those practitioners who attempt to limit their practice to tax returns of U.S. residents often have clients with international business or family affiliations. Since federal income taxation of noncitizens can be substantially different from taxation of citizens, all practitioners need to be conversant with potential issues in this area. This discussion is intended as an introduction and does not cover every possible scenario.

I. Residency Status

For tax purposes, the term "alien" includes anyone with U.S. income who is not a resident of the United States. Noncitizens are classified under I.R.C. §7701(b) as either **resident aliens** or **nonresident aliens**. I.R.C. criteria for residency must be distinguished from those under immigration law. While physical presence does not always confer tax resident status, an **undocumented (illegal) alien** under Immigration and Naturalization Service (INS) regulations frequently is taxed as a **resident alien**.

A person can be **both** a resident alien and a nonresident alien in the same tax year. This generally occurs during the **first or last year** of U.S. residency. Such taxpayers must file **dual status returns** (discussed later).

There are two tests to determine whether a person is a **resident alien** under the Internal Revenue Code.

A. Green Card

The first test is tied to INS status. If an individual receives a **permanent immigrant residency permit ("green card")**, he or she is classified as a tax resident. He or she does **not** need to reside physically in the United States. Tax residency status for permanent immigrants remains in force unless the green card is rescinded by INS or surrendered by the alien, or there is a final administrative or judicial determination that the individual's immigrant standing has been abandoned.

Example 1. Anne received a green card and came to the United States in 1949. She never became a U.S. citizen. Her husband died in 1991, and in 1994 she decided to return to England to share a home with her sister. Since she did not relinquish her green card, she is still a resident alien in 1997.

B. Substantial Presence

The second test for residency is based on **physical presence** in the United States. Whether that presence

1997 Workbook

is legal is not an issue. **Actual days of presence during the current tax year and the two prior tax years are counted.** It is not necessary to be present in the United States for some part of all three years; the test can be met with sufficient presence in a single year. Dual status rules apply.

1. Days Counted. Meeting the substantial presence test requires a total of 183 days, with at least 31 of those days in the current year. In counting days of presence, one counts

- All days of presence in the current year,
- One-third of the days in the first prior year, and
- One-sixth of the days in the second prior year.

Fractions are included when adding days, but the total is always rounded down.

Example 2. Allan, who is not a U.S. citizen or permanent resident, limits his presence in the United States to exactly 120 days a year. In applying the substantive presence test, 120 days are counted for 1997, 40 ($\frac{1}{3}$ of 120) days are counted for 1996, and 20 ($\frac{1}{6}$ of 120) days are counted for 1995. Since this totals 180 days ($120 + 40 + 20$), Allan does **not** meet the substantial presence test and is classified as a **nonresident**.

Example 3. Chris was present in the United States on a business visa for 68 days in 1997, 337 days in 1996, and 26 days in 1995. Using the 68 days in 1997, and counting $112\frac{1}{3}$ days in 1996 and $4\frac{1}{3}$ days in 1995, his total is $184\frac{2}{3}$ days, which is **rounded down to 184 but is still enough to meet the substantial presence test.**

Example 4. Chris in Example 3 was present in the United States for only 66 days in 1997. Now his total is $182\frac{2}{3}$, rounded down to 182, and Chris is a **nonresident** for 1997.

2. Closer Connection. Individuals who meet the **substantive presence test** nevertheless can be taxed as **nonresidents** if they have a **closer connection to another country**. To qualify they must

- Have been in the United States for **fewer than 183 days** during the year,
- Maintain a tax home in a **foreign** country, and
- Have a **closer connection** to that country.

Facts considered include the country of residence designated on forms and documents; the location of the taxpayer's permanent home, family, and personal belongings; social, political, cultural and religious affiliations; driver's license jurisdiction; and voting jurisdiction.

Form 8840, Closer Connection Exception Statement for Aliens, must be attached to the individual's U.S. tax return. If a return is not required, the statement should be sent separately to the Philadelphia Service Center.

3. Days Not Counted. Some individuals temporarily present in the United States are exempt from the residency test. They are not, however, exempt from U.S. taxes. The exemption only means that they are automatically classified as nonresidents for tax purposes.

Exempt categories include individuals with diplomatic status and full-time employees of qualified

1997 Workbook

international organizations, professional athletes competing in charitable events (only on the actual days of competition), and some teachers, trainees (including many researchers), and students. Family members whose visa statuses are linked to the exempt individual's classification are also exempt.

Student, teacher, and researcher exemptions are limited to specific visas for finite periods of time.

- **Eligible teachers and trainees** may have J or Q visas and are exempt for two years. A six-year lookback rule applies: If the taxpayer was exempt as a teacher, trainee, or student for any part of two of the preceding six calendar years, he or she cannot exclude days in the current year.
- **Eligible students** may have F, J, M, or Q visas. They can exclude days for up to five calendar years, which normally covers four academic years. Years for which days were excluded as a teacher or trainee are included in the five-year student limit.

Individuals who are excluding days from the substantial presence test must file **Form 8843, Statement for Exempt Individuals**. Generally, it is attached to the tax return; however, if no return is being filed, it may be sent separately to the Philadelphia Service Center.

Exemption from the substantial presence test applies only to the specific visas listed for teachers, trainees, and students. An individual admitted to the United States with an H visa, for example, must count all days of presence even if his or her approved work is as a teacher or trainee.

If family members with related visas enter the United States in a later year than the primary visa holder, their years for excluding days will not coincide with those for the primary visa holder.

Example 5. Patrick entered the United States on a J visa in July 1996 as a **visiting professor** for two academic years at the University of Illinois. His wife and children joined him in January 1997. Patrick was **automatically a nonresident in 1996 and 1997**, since his days in the United States were **excluded from the substantial presence test**. **For 1998, he will be a resident alien if he stays in the United States beyond July 1 (183 days)**. His wife and children will be nonresidents for 1998.

Practitioner Note.

Under I.R.C. §152(b)(3), a dependent must be a citizen or national of the United States, or a resident of the United States or a **contiguous** country (Canada or Mexico). Residency in the United States is determined under the **green card** and **substantial presence tests**. It is possible for an exempt individual to reside in the United States for the **entire** year and **not** meet the residency test for a dependency exemption.

II. Resident Aliens

Resident aliens under I.R.C. §7701(b) are taxed in the same way as U.S. citizens. It generally makes no difference whether the classification as a resident comes through a green card or through the substantial presence test.

1997 Workbook

A. Full Year

If a taxpayer is determined to be a **resident alien for the entire tax year**, the following precepts apply:

- Worldwide income must be reported on a U.S. tax return.
- Form 1040, 1040A, or 1040EZ is to be filed.
- Deductions and exemptions may be used to reduce taxable income.
- The graduated income tax rates apply.
- Most credits may be claimed, including the foreign tax credit.

Practitioner Note.

The Earned Income Tax Credit (EITC) is limited to taxpayers with social security numbers (SSNs). Green card holders and individuals with INS permission to work in the United States are eligible for SSNs. However, many persons who are classified as tax residents under the substantial presence test are not eligible for SSNs. On a joint return, both the primary and secondary taxpayers must have SSNs. If the EITC is based on qualifying children, the children must have SSNs. IRS-issued individual taxpayer identification numbers (ITINs) are not valid for the EITC. ITIN information is provided in question-and-answer format at the end of this chapter.

Resident aliens who are **self-employed** may pay the self-employment tax. Whether the taxpayer will qualify for social security benefit payments makes no difference in application of the tax.

Example 6. Ivan was a 62-year-old retiree when he immigrated to the United States in 1994. In 1997, he returned to the workforce part-time as a self-employed consultant, netting \$1,800. Ivan is liable for self-employment tax.

B. Part-Year Residents

Many noncitizens who receive a green card or meet the substantial presence test during a tax year presume that they are residents for the full year. This is not always the case: Many have dual status.

A dual-status return splits income and taxation into resident and nonresident periods. A combined Form 1040 and Form 1040NR is filed. Dual status does not confer all the tax benefits of resident status:

- A joint return is not allowed.
- Head of household filing status is not available.
- The standard deduction cannot be used.
- Spousal and dependency exemptions are limited to residency-period income minus deductions.

1. First Year. In the first year an alien is present in the United States, he or she is considered a nonresident for the time period before his or her arrival. This is true under either residency test. A **dual-status alien** can elect to be treated as a resident for the entire year **only** when he or she is married to

1997 Workbook

someone who is a U.S. citizen or resident alien at the end of the tax year [**Treas. Reg.** §1.6013-7].

However, an alien who does not satisfy a residency test and normally would be considered a nonresident for the full year can elect to be dual-status if certain conditions are met [Reg. §301.7701(b)-4(c)(3)].

2. Final Year. Dual-status years can occur when an alien who satisfied the substantial presence test leaves the United States permanently before his or her tax year ends or when a green card is formally abandoned or rescinded. Dual-status years do **not** occur when a person who has met a residency test leaves in one year and returns the next year.

Example 7. Fred has resided in the United States since 1993, but he does not have a green card. In September 1996, he moved to Kenya for a six-month assignment, returning to the United States in April 1997. **Fred is taxed as a U.S. resident for the entire years of 1996 and 1997, despite his physical absence in each year.**

3. Immigration Status Change. A dual-status year can occur when a green card is issued during an otherwise "exempt" year.

Example 8. Ruth entered the United States in 1993 on an F visa as a student. She completed her studies in May 1997 and was granted a green card as of September 1. She does not meet the substantial presence test because the days under the F visa are not counted as days of presence. Her residency starting date is September 1.

III. Nonresident Alien

A **nonresident alien** is generally subject to U.S. tax only on income earned in the United States. Business-related income is reduced by allowable deductions and a personal exemption and is then taxed at the graduated rates. Nonbusiness income is not reduced by exemptions or deductions and is taxed at a flat 30% rate, unless a lower rate is established by a tax treaty. **Nonresident aliens must file Form 1040NR or Form 1040NR-EZ.**

A. Filing Limitations

Generally, filing-status choices are single or married filing separately. Joint returns and head of household filing status are **not** available. Qualifying widow(er) status is allowed only for residents of Canada, Mexico, Japan, and South Korea and for U.S. nationals. Married residents of those countries who meet head of household qualifications are permitted to file as single.

Practitioner Note.

A nonresident who is married to a U.S. citizen or resident can elect to be treated as a resident by filing a joint return with a required statement. The joint return must report worldwide income of both spouses, and treaty benefits are not allowed [Reg. §1.6013-6].

1997 Workbook

Nonresidents with U.S. business income generally can claim only their own personal exemptions. Spousal and dependency exemptions are not allowed. This is true even when potential dependents meet all five dependency tests. Statutory exceptions apply to residents of Canada and Mexico and to U.S. nationals. Treaty exceptions apply to residents of Japan and South Korea and to students from India.

B. Scheme of Taxation

Unlike U.S. citizens and resident aliens, nonresidents are taxed in the United States only on their income from a U.S. source. The source of income for **personal services (including pensions)** is generally determined by **where the services are performed**. The source of income from **property** is generally determined by the **location of the property** (see [table](#)).

Summary of Source Rules for Income of Nonresident Aliens

Type of Income	Source Determined by
Compensation for personal services	Where services are performed
Dividends	Residence of paying corporation
Interest	Residence of payor
Rents	Where property is located
Royalties—Natural resources	Where property is located
Royalties—Patents, copyrights, etc.	Where property is used
Pensions	Where services were performed
Sale of inventory property	Where property is sold
Sale of personal property (other than inventory property)	Tax home of seller
Sale of real property	Where property is located

Example 9. Alex is a Canadian citizen who works in Toronto for a U.S. corporation. The source of his compensation is Canada, even though the payer is based in the United States.

Example 10. Elena is a Mexican citizen who works in San Antonio for a Mexican corporation. The source of her compensation is the United States, even though the payer is based in Mexico.

Example 11. Zoe is a citizen of Greece who is employed by a U.S. corporation. She worked 240 days for the corporation during the year, divided into 24 days in the United States and 216 days in Greece. Ten percent of her compensation is U.S.-source; the remainder is Greek-source, although her payer is based in the United States.

After the source of income is determined, U.S.-source income must be divided into income from a trade or business activity (called "effectively connected") and income that is not effectively connected to a trade or business [I.R.C. §871(a) and (b)].

The two categories of income are entered on separate pages of Form 1040NR and are taxed differently. Exemptions and deductions can only offset effectively connected income, which is taxed at the same graduated rates that apply to resident returns. Income that is not effectively connected is subject to a flat

1997 Workbook

tax.

IV. Taxpayer Identification Numbers

Any individual required to file a U.S. tax return must have a taxpayer identification number. If an alien is not eligible for a social security number, he or she can apply for an ITIN (Individual Taxpayer Identification Number) issued by the IRS's Philadelphia Service Center. The following answers were provided by the IRS in response to questions received from practitioners and taxpayers.

Question 1. *What is an ITIN?*

Answer 1. An ITIN, or Individual Taxpayer Identification Number, is a new tax processing number that became available July 1, 1996 for certain aliens, their spouses, and dependents. The ITIN is **only** available to individuals who cannot get a social security number (SSN).

Question 2. *What are the characteristics of an ITIN?*

Answer 2. An ITIN is a nine-digit number, beginning with the number "9", formatted like an SSN (NNN-NN-NNNN). The temporary tax-identifying numbers previously assigned (also beginning with "9") are no longer valid.

Question 3. *What is the purpose of an ITIN?*

Answer 3. ITINs are used only for processing U.S. federal income tax returns. Issuance of an ITIN does not affect the individual's immigration status or authorization to work in the U.S. When completing a federal income tax return, the individual will enter the ITIN in the space for the SSN.

Question 4. *Who needs an ITIN?*

Answer 4. Individuals who must file a U.S. tax return (or are listed on a tax return as a spouse or dependent) and do not have and cannot obtain a valid SSN must apply for an ITIN.

As of January 1, 1997, the IRS no longer accepts "SSA205c," "applied for," "NRA," or blanks instead of an identification number. Each person listed on the return must have a valid number, either an SSN or an ITIN. An individual who previously was assigned an IRS temporary identification number (900-number) must now apply for an SSN or ITIN.

If a return requesting a refund is filed without an SSN or ITIN for the primary filer and spouse, the refund is delayed until the identification number is obtained. If a dependent SSN/ITIN is missing, the exemption is denied and the refund adjusted accordingly.

Question 5.

1997 Workbook

Question 5. *Who are the most likely candidates for ITINs?*

Answer 5. A resident or nonresident alien who does not have and cannot get an SSN, and who is

- Required to file a U.S. tax return,
- Claimed as a dependent on a U.S. citizen's U.S. tax return,
- Claimed as an exemption by a spouse on a U.S. tax return,
- The spouse of a U.S. citizen electing to file a joint U.S. tax return, or
- Filing a U.S. tax return only to claim a refund.

Question 6. *How does one apply for an ITIN?*

Answer 6. Form W-7, Application for IRS Individual Taxpayer Identification Number, is used to obtain an ITIN. A taxpayer may complete and sign a Form W-7 for a minor dependent, but other dependents and spouses must complete and sign their own Forms W-7.

Form W-7 is an information form and requires documentation substantiating foreign or alien status and identity of the individual. The original documentation, along with Form W-7, can be mailed to the Philadelphia Service Center (PSC) or presented at IRS walk-in offices.

Problem 16: Required Minimum Distributions from SEPs

Under I.R.C. §408, the minimum distribution rules of §401(a)(9), relating to qualified employer retirement plans, also apply to individual retirement arrangements (IRAs). Simplified Employee Pensions (SEPs) use IRAs to receive plan contributions. Thus, the IRA distribution rules apply to SEPs. A 50% excess accumulations penalty applies when a minimum required distribution is not taken timely.

The first distribution must be taken for the year in which the IRA owner attains age 70½. It can be taken in that year (and taxed in that year), or it can be delayed until the next year, when it must be taken by April 1. If the first required distribution is delayed until the year after the owner attains age 70½, a second distribution also must be taken before the end of that year, resulting in two distributions being taxable in one year.

Note. A 1996 law change permits qualified plan distributions to be postponed until retirement for employees who are still working for the employer who maintains the plan. **However, this change does not apply to IRAs, including SEPs.**

Facts. Jim Bodkins was born June 24, 1926. He was 70 on June 24, 1996, and 70½ on Dec. 24, 1996. When preparing Jim's 1996 federal income tax return in February 1997, his preparer advised him that since no IRA distribution had been taken in 1996, his first distribution was required by April 1, 1997,

1997 Workbook

and a second distribution was required by Dec. 31, 1997. A week after meeting with his preparer, Jim was critically injured in an automobile accident and was still in rehabilitation at year end. In preparing Jim's 1997 federal tax return, the practitioner discovered that no IRA distribution had been made.

Question. *What actions should Jim and the preparer take?*

Answer. Jim should take the two required distributions immediately. The practitioner must include a completed Form 5329 (Part III) with Jim's 1997 return, calculating the excess accumulation penalty. However, when Jim takes the required prior-year distributions, he can request a waiver of the penalty. A letter should be sent to the IRS Service Center explaining the reasons for the shortfall and stating that it has been corrected. If the distribution is taken before the return is filed, the letter can be attached to the return. If the IRS agrees that reasonable cause exists, a refund will be issued.

Facts. Assume that Jim was born in 1916 and had taken required minimum distributions through 1996. Each year his bank sent a letter reminding him of the distribution rule. In 1997 the bank was involved in a merger, and Jim did not receive a reminder. He did not take a 1997 distribution.

Question. *What actions should Jim and the preparer take?*

Answer. The same as in the first scenario (take the distribution, file Form 5329, and request a waiver). Forgetfulness generally does not provide a basis for reasonable cause, according to Internal Revenue Manual XX. However, Jim's record of taking required distributions in prior years might result in a waiver.

Note. A required distribution must be computed for each IRA, since beneficiaries and distribution elections may differ. However, taxpayers with multiple IRAs may withdraw the total required amount from any one IRA or any combination of IRAs [Announcement 88-38]. Taxpayers with more than one IRA frequently choose to deplete the IRA with the lowest annual earnings first. Therefore, trustees are not responsible for ensuring that distributions are made.

Problem 17: Nondiscrimination Rules for SEPs

Facts. Brenda Stoner owns a self-service laundry and an alterations business as a sole proprietor. In 1997 she had eight part-time employees at the laundry and two full-time employees at the alterations shop. All employees are over age 21. Most laundry employees have worked for her for only a few months. However, one laundry employee has been employed by Brenda since 1994. Another quit in June 1997 after working for her since 1992. Both alterations employees have been with Brenda for nearly 10 years.

1997 Workbook

Question. *Brenda would like to establish a SEP plan only for the alterations employees. Is that allowable?*

Answer. No. Employees of trades or businesses that are under common control are treated as employed by a single employer. If Brenda established a SEP plan, employees of both businesses must be covered.

Question. *Could she incorporate one business to avoid this problem?*

Answer. No, incorporation would not make a difference. The common control rules affect ownership through corporations, partnerships, trusts, and estates, as well as sole proprietorships. See I.R.C. §414(b) and (c).

Question. *Can she exclude any employees?*

Answer. Brenda must establish written criteria when she adopts an SEP plan. The plan is permitted to exclude employees under age 21, employees who have worked for her in fewer than three of the preceding five years, and employees who earned less than \$400 during the plan year [see §408(k)(2)].

Applying these factors, Brenda would be required to make SEP contributions for the alterations employee and the two laundry employees who satisfied the years of service requirement. **Note that the laundry employee who quit must still be included for 1997 since she met the eligibility criteria.** Other employees must be added in any year they meet the criteria.

The amount contributed for each employee is a percentage of the compensation paid to that employee during the year. Brenda can change the contribution percentage each year, but it cannot exceed 15%. If the former employee cannot be located, Brenda must open a SEP-IRA on her behalf.

Question. *Presume the same facts, except that Brenda owns only half of the laundry. The remaining 50% of the laundry is owned by unrelated persons. Can she establish a SEP plan only for the alterations business?*

Answer. Yes. Commonly controlled businesses are defined in Treas. Reg. §1.414(c)-1. Since Brenda does not own more than 50% of the laundry, and the other owner(s) of the laundry have no interest in the alterations business, the businesses are not under common control. The special aggregation rules for owner-employees of unincorporated businesses **were repealed** for years beginning **after 1996** by the 1996 Small Business Job Protection Act [§401(d)]. If Brenda establishes the SEP only for the alterations business, the SEP contribution for herself is based only on her profit from the alterations business.

Note. Common control can be measured under a parent-subsidary group, a brother-sister group, or a combined group. A parent-subsidary relationship requires 80% ownership, and a brother-sister group is established when five or fewer persons together own more than 50% of each business. Combined groups