

## 5 Practitioner Question and Answer

### Non–Agriculture-Related Questions and Answers

#### Adoption Credit

**Question 1.** *Regarding the new adoption credit provision in the 1996 tax legislation:*

**Facts.** *Taxpayers receive a child for adoption late in 1996. They will pay approximately \$6,000 for various adoption-related expenses, including \$4,000 to their attorney. Some of the \$6,000 has already been paid in 1996, and the balance will be paid in 1997, when (hopefully) the adoption process becomes final.*

**Question.** *Will they be entitled to an adoption credit on their 1997 Form 1040?*

**Answer 1.** I.R.C. §23 is effective for tax years beginning after Dec. 31, 1996. Unfortunately, none of the qualified adoption expenses paid in 1996 by a cash basis taxpayer is eligible for the adoption credit. Since the adoption will be completed in 1997, the adoption expenses actually **paid during 1997** will qualify for the adoption credit on the 1997 Form 1040. This assumes that the taxpayers' 1997 AGI is low enough (\$75,000 or below) to not be affected by the **phaseout** restrictions of I.R.C. §23.

**Notes:** The adoption credit is allowed in the tax year **after** the tax year in which qualified adoption expenses are paid, **with one exception**. If the expenses are paid **in the year the adoption is finalized**, the credit is allowed in that tax year rather than in the subsequent tax year.

The **nonrefundable** credit is limited to \$5,000 per adopted child (\$6,000 for a child with "special needs"). This credit limit is **per child, not per year**. New Form 8839 is used to claim the credit.

The phaseout of the credit begins with AGIs in excess of \$75,000. The credit is completely disallowed at \$115,000 of AGI.

An eligible child can be either (1) under the age of 18 at the time of the adoption or (2) one who is physically or mentally incapable of taking care of himself or herself (a "special needs" child).

The adoption credit will **terminate** for adoption expenses paid after Dec. 31, 2001, **except for adoption of a "special needs" child**.

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**Example 1.** A husband and wife initiate adoption action in late 1997. They pay the following qualified adoption expenses for one child (not a "special needs" child) (assume AGI is under \$75,000 in 1997, 1998, and 1999):

| Year         | Amount of Adoption Expenses Paid | Adoption Credit Allowed |
|--------------|----------------------------------|-------------------------|
| 1997         | \$1,000                          | None                    |
| 1998         | 3,000                            | \$1,000                 |
| 1999         | 3,000 (adoption becomes final)   | 4,000                   |
| <b>Total</b> | <b>\$7,000</b>                   | <b>\$5,000</b>          |

**Example 2.** Dennis and Michelle Martell commenced and finalized adoption proceedings for Brady Martell in 1997. Brady was born January 4, 1997. He is not a "special needs" child. The Martells paid a total of \$8,000 for qualified adoption expenses in 1997. Their modified adjusted gross income for 1997 is \$68,320. See the completed 1997 Form 8839 for Dennis and Michelle.

Form **8839** **Qualified Adoption Expenses** OMB No. 1545-xxxx  
 Department of the Treasury Internal Revenue Service  
 Attach to Form 1040 or 1040A. See separate instructions.  
 1997 Attachment Sequence No. 38  
 Name(s) shown on return: Dennis and Michelle Martell Your social security number: 000-00-000

Before you begin, you need to understand the following terms. See Definitions on page 1 of the instructions.

- Eligible Child
- Employer-Provided Adoption Benefits
- Qualified Adoption Expenses

**Part I** Information About Your Eligible Child or Children—You must complete this part. See the instructions for details, including what to do if you need more space.

| 1       | (a) Child's name |                | (b) Child's year of birth | Check if child was—                   |                                |                          | (f) Child's identifying number |
|---------|------------------|----------------|---------------------------|---------------------------------------|--------------------------------|--------------------------|--------------------------------|
|         | First            | Last           |                           | (c) born before 1979 and was disabled | (d) a child with special needs | (e) a foreign child      |                                |
| Child 1 | <u>Brady</u>     | <u>Martell</u> | <u>1997</u>               | <input checked="" type="checkbox"/>   | <input type="checkbox"/>       | <input type="checkbox"/> | <u>123-45-6789</u>             |
| Child 2 |                  |                | <u>19</u>                 | <input type="checkbox"/>              | <input type="checkbox"/>       | <input type="checkbox"/> |                                |

Caution: If you received employer-provided adoption benefits, complete Part III on the back next.

**Part II** Adoption Credit—Complete this part only if the adoption was final in 1997.

|  | Child 1      | Child 2       |              |
|--|--------------|---------------|--------------|
| 2 Enter \$5,000 (\$6,000 if a child with special needs)  | <u>5,000</u> |               |              |
| 3 Enter the total qualified adoption expenses you paid in 1997   | <u>8,000</u> |               |              |
| 4 Enter the smaller of line 2 or line 3  | <u>5,000</u> |               |              |
| 5 Add the amounts on line 4  |              |               | <u>5,000</u> |
| 6 Enter your modified adjusted gross income (see the instructions)   |              | <u>68,320</u> |              |
| 7 Is line 6 more than \$75,000?<br>No. Skip lines 7 and 8 and enter -0- on line 9.<br>Yes. Subtract \$75,000 from the amount on line 6                           |              |               |              |
| 8 Divide line 7 by \$40,000. Enter the result as a decimal (rounded to two places). Do not enter more than "1.00"  |              |               | <u>X</u>     |
| 9 Multiply line 5 by line 8  |              |               | <u>0</u>     |
| 10 Subtract line 9 from line 5. Enter the result. Then, see the instructions for the amount of credit to enter on Form 1040, line 42, or on Form 1040A, line 24c |              |               | <u>5,000</u> |
| 11 1997 credit carryforward, if any, to 1998 (see the instructions)  |              | <u>0</u>      |              |

For Paperwork Reduction Act Notice, see page 4 of instructions. Cat. No. 22843L Form 8839 (1997)



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## C Corporations

### Question 2

**Facts.** *My shareholder client owns 100% of the stock in his C corporation. He is a cash basis taxpayer, and the corporation uses the accrual method. Due to cash flow problems, the shareholder lent \$30,000 to the corporation on May 1, 1996. The \$30,000 was outstanding on Dec. 31, 1996. I am aware of the below-market interest rate loan provisions of I.R.C. §7872.*

**Question.** *How should I handle this so that an IRS agent won't raise the issue if the 1120 is examined?*

**Answer 2.** There should be a note executed. Preferably it should be a demand loan (payable in full at any time on the demand of the lender). The corporation should compute and pay interest to the shareholder on Dec. 31, 1996, using the **blended annual rate** for calendar year 1996 (see **Rev. Rul. 96-34**, I.R.B. 1996-28, page 4).

### Computation of the interest

$$\$30,000 \times \frac{245}{365} \times 5.77\% \text{ blended rate} = \$1,162$$

The corporation should pay the \$1,162 of interest to the shareholder sometime in late December 1996. Since the corporation is on the accrual method, it is entitled to deduct the interest on the day the interest is includable on the related shareholder's Form 1040 [I.R.C. §267(a)(2)].

This matching rule places the accrual basis payor on the cash basis for the purpose of deducting interest owed to a related cash basis taxpayer.

### Question 3

**Facts.** *Regarding a fiscal year corporation Form 1120 for the period beginning April 1, 1996, and ending March 31, 1997:*

*During the fiscal year, the corporation places in service the following depreciable assets that qualify for the §179 expense deduction:*

| Time Period             | Cost of Qualifying Depreciable Assets |
|-------------------------|---------------------------------------|
| 4-1-96 through 12-31-96 | \$17,500                              |
| 1-1-97 through 3-31-97  | 18,000                                |
| <b>Total</b>            | <b>\$35,500</b>                       |

**Question.** *Can the corporation deduct \$35,500 of §179 expense on Form 4562 for the fiscal year ended March 31, 1997?*

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**Answer 3.** This is a good question but the answer is no. The fiscal year **begins in 1996**, so the §179 limit is \$17,500.

## Question 4

**Facts.** *An accrual basis C corporation with a March 31 fiscal year pays a bonus to the sole shareholder on March 31, 1996 (the **last** day of its 1995 tax year).*

**Question.** *May the corporation deduct the bonus on its 1995 (fiscal year ending 3-31-96) Form 1120 and the shareholder report the bonus on his 1996 Form 1040 (via the 1996 Form W-2)?*

**Answer 4.** Yes, assuming the bonus check was **given** to the shareholder (SH) on March 31, 1996. **If** the bonus check was **mailed** to the SH on March 31, 1996, and **if** the SH uses the **cash basis** for his Form 1040, the answer is **no**.

The corporation can deduct the bonus on the day the related party has to include it as income [I.R.C. §267(a)(2)]. See page 44 of the 1996 *Farm Income Tax Book* for a thorough explanation.

**Question 5.** *Can the standard mileage rate be used to reimburse a 10% shareholder of a C corporation for legitimate corporate use of his personally owned auto?*

**Answer 5.** Yes. There should be a resolution in the corporate minutes showing that this reimbursement arrangement was approved. The shareholder should submit a monthly or quarterly signed voucher that shows dates, business mileage, and a brief description of where he drove.

This is an **accountable plan**. **The standard mileage rate for 1997 is 31.5 cents per mile, a half-cent increase from the 1996 figure.** The reimbursement is deductible by the corporation. It is not taxable to the shareholder/employee.

**Note:** This arrangement is often preferable to providing a corporate-owned vehicle to a shareholder. The latter involves employing the cumbersome "special valuation rules" (including the automobile lease rule) for personal use of the corporate auto.

## Deductions

### Question 6

**Facts for Question 6A.** *The wife operates a retail store as a sole proprietor. The store is located in a building owned by her husband (he inherited it).*

**Question 6A.** *Can the wife pay rent to the husband and deduct it on her Schedule C?*

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**Answer 6A.** Yes, if certain criteria are met. IRS examiners are instructed to scrutinize transactions between related parties. This is especially true for spousal transactions, as spouses normally file a joint tax return. Generally, there must be some valid business purpose for spousal transactions. The goal of reducing the self-employment tax burden of the wife (in this case) **is not such a valid business purpose.**

The Tax Court allowed a Schedule C rent deduction for Mr. Cox, an attorney who used a building owned by his wife and him as **tenants by the entirety** (*D. Sherman Cox*, T.C. Memo 1993-326) for one half the rental amount. (The equity interest he didn't own.) But in **Ltr. Rul. 9206008** (based on an IRS exam case), the IRS upheld the disallowance of cash rent paid by a farmer to his spouse for her half ownership (joint tenancy) of farmland. **However, there were serious defects in the rental arrangement addressed by the Letter Ruling including inconsistent treatment of some rental expenses.**

The Tax Court case and the Letter Ruling cited above show that IRS examiners may raise the issue that spousal rental payments are questionable. IRS examiners will use the following arguments to disallow the spousal rent expense:

1. There is no bona fide landlord-tenant relationship.
2. There is no valid business/economic purpose for the lease arrangement.

**Summary for Answer 6A.** Based on the facts and the *Cox* case, the deduction of rent by the wife on her Schedule C is likely OK. The fact that the wife does not own any portion of the store building (husband inherited it) is a factor that clearly favors the taxpayers.

## Planning Tips for Successful Spousal Rental Arrangements

1. Have a formal written lease.
2. The owner of the leased property should pay his/her rental expenses (taxes, mortgage payments, insurance, repairs, etc.) from separate and uncommingled funds. A separate rental checking account is recommended. All spousal rental payments should be deposited to this separate account.
3. A Form 1099-MISC must be prepared if required.
4. The owner of the rented building ideally should avoid participation in the tenant spouse's business.

## Question 6B

**Facts.** *A sole proprietor veterinarian acquired the clinic building through a dissolution of the former veterinary partnership in late 1995. The clinic building was previously owned by the dissolved partnership. The 1996 Schedule C will report approximately \$140,000 of profit before any building depreciation or building rent deduction.*

**Question.** *May the veterinarian pay rent expense to herself in 1996, deduct it on her Schedule C, and report the rental income and building expenses on her Schedule E?*

**Comments.** *The building is nearly depreciated out, so the rental on Schedule E will show a profit and*

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*not a loss. Fair market rent has been determined.*

**Answer 6B.** No. Trade or business rental deductions are **not** allowable if the rental property is owned by the taxpayer who pays the rent. "Owned by the taxpayer" is defined as "**property to which the taxpayer has taken or is taking title or in which he has equity**" [I.R.C. §162(a)(3)].

**Question 7.** *My client purchased a mobile home court for rental purposes and decided to replace many of the older trailers. Are the disposal costs deductible on his Schedule C, or must they be added to the value of the allocated cost of the land?*

**Editorial Note:** In other words, is the removal of the old mobile homes considered a demolition and governed by I.R.C. §280B (effective for demolition of **structures** where the demolition commences after July 18, 1984)?

**Answer 7.** Since mobile homes don't qualify as **structures** under your facts, the disposal costs **would not be treated as demolition costs**. See **Treas. Regs.** §§1.280B-1(b) and 1.48-1(e)(2) (the old investment credit definition) for the definition of a **structure**. *Structure* means a building.

Therefore, the following is the correct way to handle the factual situation of **Question 7**:

1. Don't allocate any of the purchase price to the old trailers that were disposed of. If the purchase contract and/or Form 8594 (Asset Acquisition Statement) did allocate part of the purchase price to the trailers which were disposed of, the total allocated cost of the discarded trailers is deductible as an "**abnormal retirement**" loss (**Treas. Reg.** §1.167(a)-8). This "**abnormal retirement**" loss will be shown as an ordinary business loss on the Schedule C.

**Note:** Most tax professionals would use the term "**abandonment loss**" to describe the factual situation in **Question 7**. But the correct terminology is "**abnormal retirement loss**." See the **DeCou** Tax Court case (103 T.C. #6 (CCH Dec. 49, 998), July 27, 1994 and shown on page 242 of the 1995 *Farm Income Tax Book* ). However, the **DeCou** facts are unusual, but the court's discussion of the law is helpful.

2. Deduct the disposal costs for the discarded trailers in Part V of Schedule C as an Other Expense.

**Note: Answer 7** assumes that the mobile home park business is properly reported on Schedule C and not Schedule E. Schedule E is used for "**rental real estate**" activities.

## Question 8

**Facts.** *The wife is the sole proprietor of an over-the-road trucking business. Her husband is her employee. They both drive the same truck as a team.*

**Question.** *Can **both** deduct \$32 per day for meals in 1996?*

**Answer 8.** Yes, subject to the 50% reduction rule. The \$32 per 24-hour-period allowance for

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**transportation industry workers** applies to **both employees and self-employed** individuals.

**Note:** The \$32 allowance figure will increase to \$36 for tax years beginning in 1997. The \$36 amount is for a 24-hour period for travel within the continental United States (CONUS). The 1997 rate for travel outside CONUS is \$40.

## Question 9

**Facts.** *A nonprofessional executor pays distribution expenses (postage, long-distance phone calls, etc.) for an estate.*

**Question.** *Where can these be deducted on the executor's Form 1040?*

**Answer 9.** The expenses of a nonprofessional executor are deductible under I.R.C. §212 (expenses for production of income). As such, they are deductible as miscellaneous itemized deductions and are subject to the 2% AGI limitation. See **Rev. Rul. 55-447**. The expenses should **not** be netted against (subtracted from) the executor fee on line 21 (Other income) of Form 1040.

A proper tax planning technique is to have the estate **reimburse** the executor for all estate expenses. Then the expenses paid personally by the executor are fully deductible as administrative expenses on Form 1041.

**Note:** Self-Employment tax is **not** due for fees received by nonprofessional executors.

## Question 10

**Facts.** *It is my understanding that if one spouse is self-employed and **can be** covered by the other employed spouse's group health plan, no deduction may be claimed on line 26 of Form 1040 (Self-employed health insurance deduction).*

**Question.** *What if the self-employed husband is not covered by the employed wife's group health plan due to preexisting conditions? May the deduction then be taken on line 26 of Form 1040 if the couple buys a health insurance policy to cover the preexisting condition?*

**Answer 10.** There are no court cases or other authority to interpret I.R.C. §162(l).

From the facts, it **appears** that the husband is **eligible to participate in the subsidized health plan of his wife's employer, with the exception that the preexisting medical condition is not covered.** That, of course, implies that the husband **could be covered for all other medical conditions.** The issue of whether the husband was or was not covered (included) on his wife's group medical plan is **irrelevant.**

I.R.C. §162(l) states: "Paragraph (l) shall not apply to any taxpayer for any calendar month **for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer.**"

Therefore it appears that **no deduction is allowable** on line 26 of Form 1040 based on the facts for

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**Question 10.** [However, the TRA of 97 Act treatment of long-term health care costs qualifying for a §162(l) deduction if the employer doesn't provide that coverage is a point that may create an argument for deduction.]

**Note:** There is one more, unambiguous exception that most IRS examiners are aware of in this area. The amount of the health insurance deduction **may not exceed the net profit reported by the self-employed spouse from the self-employed activity** (usually reported on Schedule C or F or from Schedule K-1, Form 1065 and flowing to Schedule SE, Self-Employment Tax) [I.R.C. §162(l)(2)(A)].

## Depreciation

**Question 11.** *For a new corporation with a first tax year of less than 12 months (starting April 1 with a December 31 year end), is the §179 deduction for 1996 prorated for 9 months (\$13,125 allowable), or is the full \$17,500 allowed on Form 1120 for the tax year ended Dec. 31, 1996?*

**Answer 11.** The full \$17,500 is allowable. No proration is required for a short tax year [**Treas. Reg.** §1.179(c)(ii)]. However, MACRS depreciation would have to be prorated for the initial short tax year.

**Question 12.** *Regarding **Rev. Proc. 96-31** (pages 565-66 in the 1996 Farm Income Tax Book) that permits "catch-up" (omitted or understated) depreciation for open and closed years:*

*Question. If you use this Rev. Proc. and the "catch-up" depreciation is significant for the year of change, could this create a NOL which could be carried back?*

**Answer 12.** Absolutely. That's one of the many reasons this Revenue Procedure is so taxpayer friendly.

**Note: Rev. Proc. 96-31** has been modified and superseded by **Rev. Proc. 97-37**. See pages 123–32 in this book for complete details.

**Question 13.** *Regarding the 1996 tax legislation that disallows the §179 deduction for "property used in connection with furnishing lodging" effective for property placed in service after 1990 (page 672 of the 1996 Farm Income Tax Book):*

*Question. Please define "lodging." Does it mean residential rental property? Does it mean hotel/motel property?*

**Answer 13.** We will answer by examples. [The authority is I.R.C. §§179(d)(1) and 50(b)(2).]

**Example 1.** A taxpayer owns an apartment building and buys new stoves and refrigerators to replace old ones in 1995. The cost of the new appliances **does not qualify for the §179 deduction.**

**Example 2.** A taxpayer buys new beds and TVs for his motel in 1996. The cost of these assets **does qualify for the §179 deduction.** The 1996 tax legislation does not affect this situation.

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**Question 14.** *Regarding the controversy over whether water heaters should have a 7-year or 27.5/39-year MACRS life:*

*Question. How about using flexible pipes and putting water heaters on wheels? Then they would be movable and not permanently attached and therefore qualify as an appliance!*

**Answer 14. Preface: We assume the question is facetious and was written for its humorous value. Our answer, however, is serious.**

Since water heaters are permanently attached to the building, the strongest argument favors the 27.5/39-year treatment. However, a reasonable argument could be made that a water heater is 7-year property.

## Earned Income Credit

### Question 15

*Facts. My client has been divorced for four years. She has custody of her minor child and has filed as head of household and claimed the Earned Income Credit (EIC) for four years. She was remarried in November 1996. After the marriage, the husband moved into the home she owns. She and her husband are considering filing a joint return for 1996.*

*Question. If they do file jointly, may they claim the EIC if their combined incomes allow and they meet the other requirements?*

**Answer 15.** Yes. Generally, a taxpayer who is married must file a joint return with his/her spouse in order to claim EIC. However, there is an important **exception** to the general rule. Even though a taxpayer is married, he/she **may file as head of household and claim EIC if:**

1. The spouse did not live in the home at **any time during the last 6 months of the year,**
2. The taxpayer paid more than half the cost to keep up his/her home for their entire year, and
3. The home was, for more than half the year, the main home of the taxpayer's child, stepchild, adopted child, or foster child. In addition, the taxpayer must be entitled to claim an exemption for the child.

Requirement 3 above **will be met even if the child cannot be claimed as an exemption because:**

1. Form 8332 or a similar written statement was executed relinquishing the right to claim the child's exemption to the other parent, or
2. There is pre-1985 agreement (divorce decree, separate maintenance decree, or written agreement) granting the exemption of the child to the other parent.

Based on the facts, this **exception** will **not** apply to your client. Therefore, she will have to file a 1996 joint return with her husband in order to claim EIC.

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**Question 16.** *Does alimony or separate maintenance income count as earned income for purposes of the Earned Income Credit?*

**Answer 16. No.** See Table 35-1 from IRS Pub. #17, "Your Federal Income Tax" (for 1996 returns, page 265) reproduced below. This can also be found in IRS Pub. #596, "Earned Income Credit."

**Table 35-1. Examples of Earned Income When Figuring the Earned Income Credit**

| Earned Income  |  |
|--|--|
| Includes:  | Does not include:  |
| <p><b>TAXABLE EARNED INCOME</b><br/>(Enter on EIC Worksheet, line 1)*</p> <p>Wages, salaries, and tips</p> <p>Union strike benefits</p> <p>Long-term disability benefits received prior to minimum retirement age</p> <p>Net earnings from self-employment (enter on line 5 of the Form 1040 EIC Worksheet)</p>  | <p>Interest and dividends</p> <p>Social security and railroad retirement benefits</p> <p>Welfare benefits</p> <p>Pensions or annuities</p> <p>Veterans' benefits (including VA rehabilitation payments)</p>  |
| <p><b>NONTAXABLE EARNED INCOME</b><br/>(Enter on EIC Worksheet, line 4)*</p> <p>* Voluntary salary deferrals (for example: 401(k) plans or the Federal Thrift Savings Plan)</p> <p>* Pay earned in a combat zone (box 13, Code Q, of your W-2)</p> <p>* Basic quarter and subsistence allowances and in-kind quarters and subsistence from the U.S. military (box 13, Code Q, of your W-2)</p> <p>* The value of meals or lodging provided by an employer for the convenience of the employer</p> <p>* Housing allowance or rental value of a parsonage for the clergy (see "Ministers and members of religious orders")</p> <p>* Excludable dependent care benefits (line 19 of either Form 2441 or Schedule 2)</p> <p>* Voluntary salary reductions such as under a cafeteria plan</p> | <p>Workers' compensation benefits</p> <p>Alimony</p> <p>Child support</p> <p>Unemployment compensation (insurance)</p> <p>Taxable scholarship or fellowship grants that were not reported on Form W-2</p> <p>Variable housing allowance for the military</p> <p>Earnings for work performed while an inmate at a penal institution</p> |

\* If you want IRS to figure your credit for you, enter the amount and type of your nontaxable earned income on line 8 (Form 1040EZ), line 29c (Form 1040A), or line 54 (Form 1040). For more information see, "IRS will figure your credit for you" in this chapter.

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| <b>Earned Income</b>   |   |
|--|---|
| <b>Includes:</b>   | <b>Does not include:</b>  |
| <b>TAXABLE EARNED INCOME</b><br>(Enter on EIC Worksheet, line 1)*  |   |
| <ul style="list-style-type: none"> <li>Wages, salaries, and tips</li> <li>Union strike benefits</li> <li>Long-term disability benefits received prior to minimum retirement age</li> <li>Net earnings from self-employment (enter on line 5 of the Form 1040 EIC Worksheet)</li> </ul>   | <ul style="list-style-type: none"> <li>Interest and dividends</li> <li>Social security and railroad retirement benefits</li> <li>Welfare benefits</li> <li>Pensions or annuities</li> <li>Veterans' benefits (including VA rehabilitation payments)</li> </ul>  |
| <b>NONTAXABLE EARNED INCOME</b><br>(Enter on EIC Worksheet, line 4)*   |   |
| <ul style="list-style-type: none"> <li>* Voluntary salary deferrals (for example: 401(k) plans or the Federal Thrift Savings Plan)</li> <li>* Pay earned in a combat zone (box 13, Code Q, of your W-2)</li> <li>* Basic quarter and subsistence allowances and in-kind quarters and subsistence from the U.S. military (box 13, Code Q, of your W-2)</li> <li>* The value of meals or lodging provided by an employer for the convenience of the employer</li> <li>* Housing allowance or rental value of a parsonage for the clergy (see "Ministers and members of religious orders")</li> <li>* Excludable dependent care benefits (line 19 of either Form 2441 or Schedule 2)</li> <li>* Voluntary salary reductions such as under a cafeteria plan</li> </ul> | <ul style="list-style-type: none"> <li>Workers' compensation benefits</li> <li>Alimony</li> <li>Child support</li> <li>Unemployment compensation (insurance)</li> <li>Taxable scholarship or fellowship grants that were not reported on Form W-2</li> <li>Variable housing allowance for the military</li> <li>Earnings for work performed while an inmate at a penal institution</li> </ul> |

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## Filing Status

### Question 17

**Facts.** *The husband died in May 1996. The wife remarried in July 1996. There are two children, and the wife and new husband will file jointly for 1996 and claim the children.*

**Questions.** *Would you file the deceased husband's 1996 tax return as a single person? Should Form 1310 be filed with it to give the wife the refund due, if any?*

**Answer 17.** The 1996 final return of the deceased husband must be filed using **married filing separately** status since the wife remarried before the end of the year of death. The executor or administrator of the deceased husband is responsible for filing and signing the final 1996 tax return.

Assuming that the surviving spouse has been appointed executor or administrator of her deceased husband's estate, Form 1310 (Statement of Person Claiming Refund Due a Deceased Taxpayer) is **not** necessary. However, a copy of the court certificate showing such appointment must be attached to the final return.

## Fringe Benefits

**Question 18.** *Regarding the lease value method of reporting the personal use of a corporate-owned vehicle for a shareholder/employee:*

**Questions.** *Can the personal use dollar amount be posted to a shareholder loan receivable or a loan payable account instead of being included on the shareholder's Form W-2? If so, could the payroll tax issue be ignored?*

**Answer 18.** The answer to both questions is no, because any employer-provided fringe benefit must be included in an employee's gross income as **wages** unless specifically excluded by the Internal Revenue Code or regulations. A fringe benefit is a form of compensation for the performance of services by the employee. See IRS Pub. #535, "Business Expenses," for a thorough discussion of this topic.

## Income

**Question 19A.** *When there is a strike, the union members must walk a picket line in order to receive strike benefits. Where are strike benefits reported, and are they subject to the self-employment tax?*

**Answer 19A.** Strike benefits paid to union members from union dues are **usually included as wages** on line 7 of Form 1040. They are not subject to the self-employment tax.

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**Note:** There is a Supreme Court case (*Kaiser*, 60-2 USTC ¶9517) which held that strike benefits paid to a union member were considered to be tax-free gifts. However, the facts in that case are very unusual, and the rationale seldom applies. See also **Rev. Rul. 61-136**, 1961-2 C.B. 20.

**Question 19B.** *How can strike benefits be considered "earned income" for earned income credit purposes?*

**Answer 19B.** The authority is **Rev. Rul. 78-192**, 1978-1 C.B. 8. It states that strike benefit payments made by a labor union to members who perform duties assigned by the union during the strike are eligible for the earned income credit. See also Table 35-1 on page 241.

## Question 20

**Facts.** *I have a wealthy client in Atlanta who rented his home during the Olympics for two weeks to a large corporation for \$20,000. He insists that the \$20,000 is tax-free and does not have to be reported on his 1996 Form 1040. This seems too good to be true.*

**Question.** *Please comment. Did the 1996 tax legislation affect this situation?*

**Answer 20.** Your client is right, and no, the 1996 tax legislation did **not** change the rule. Neither did the TRA of 1997.

If a taxpayer owns a residential unit (house, apartment, condo, etc.) that he/she uses as a residence **and** that unit is actually rented to a third party for **less than 15 days during the taxable year, the rental income is not included in the gross income of the taxpayer under I.R.C. §61** [I.R.C. §280A(g)(2)]. See pages 93 and 94 of this book for more information on this topic.

## Interest Expense

**Question 21.** *Regarding the 1996 **Redlark** Tax Court case (106 T.C. 31(1996)(CCH Dec. 51,104) and shown on pages 627-29 of the 1996 Farm Income Tax Book) issue of **business interest versus personal interest**:*

**Facts.** *In 1995 the taxpayers paid a substantial amount of taxes, interest, and penalties to the IRS as a result of an examination of their 1987 and 1988 Forms 1040. They had previously pled guilty to filing false returns for understating Schedule C income for these two tax years.*

**Question.** *Does the interest paid to the IRS in 1995 constitute **deductible business interest** on the 1995 Schedule C under the **Redlark** rationale or **nondeductible personal interest**?*

**Note:** The practitioner added this comment after the question: "My position is that this interest arising from substantial understatement of business income **does not meet the 'ordinary and necessary'** rationale of the **Redlark** decision."

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**Answer 21.** The interest paid to the IRS in 1995 is **personal interest** for several reasons:

1. Per the *Miller* Appeals Court case (8th Circuit, 95-2 USTC ¶150,485 and shown on pages 626-27 of the 1996 *Farm Income Tax Book*), the Appeals Court **upheld the position of the IRS that such interest is per se nondeductible personal interest.** [See **Temp. Treas. Reg.** §1.163-9T(b)(2)(i)(A) for the IRS's authority.]

**Note:** The temporary regulation shown above was issued by the IRS in 1987 and remains as a temporary regulation. The decision reached in the *Miller* Appeals Court case is **law in the Eighth Circuit** (AK, IA, MN, MO, NE, ND, and SD).

2. In both the *Miller* and *Redlark* court decisions (*Miller* was originally a District Court case and *Redlark* is a Tax Court case), the issue of the deductibility of interest paid on a noncorporate income tax deficiency was **construed narrowly.**  
The *Miller* case involved a bookkeeping scheme to improperly defer the reporting of grain income. The District Court held the conduct of Mr. Miller that led to the underlying tax deficiency **was not "ordinary and necessary"** in the operation of a farming business. The District Court noted that Mr. Miller chose **"an obviously improper income deferral scheme"** in order to underreport farm income.  
The Tax Court in *Redlark* also relied on an **"ordinary and necessary" test and allowed a business interest deduction.** But the Tax Court offered little guidance on what was or wasn't ordinary and necessary conduct.

**Conclusion for Answer 21.** If Mr. Miller's conduct did not meet the **"ordinary and necessary"** test, then certainly the taxpayer according to the facts for **Question 21** does not meet that test. Consequently, the interest paid to the IRS in 1995 constitutes **nondeductible personal interest.**

**Practitioner Caution.** Based on the Appellate Court's decision in the *Miller* case, IRS examiners and Appeals officers will in all likelihood **deny all tax deficiency related interest deductions of noncorporate taxpayers.** But if a client insists on deducting the interest, it is strongly suggested that you use the disclosure **Form 8275-R (to disclose a position contrary to a Treasury Regulation) and that you cite the *Redlark* case as your authority** in Part II of the form, Detailed Explanation. Even in situations where the "ordinary and necessary" test is not a gray area (the facts strongly favor the taxpayer), a Tax Court petition and determination will probably be necessary for a taxpayer to prevail.

**Question 22.** *My client borrowed money to buy part of a C corporation. He used his share of the business as collateral for the loan. He receives a W-2 from the corporation. He has very little investment income. Is the interest paid on the loan to buy stock in a C corporation considered business or investment interest?*

**Answer 22.** It is investment interest. [See **Rev. Rul. 93-68**, 1993-2 C.B. 72. Also see the *Russon* Tax

# 1997 Workbook

Court case in the What's New chapter (107 T.C. #15 (CCH Dec. 51,639), November 6, 1996).]

**Note:** Use **Form 4952**, Investment Interest Expense Deduction, to calculate the amount of investment interest to deduct on line 8, Schedule A. Any unused (disallowed) investment interest may be carried over to future years.

Your shareholder client potentially could have taken advantage of the **home equity loan** rules. He could have borrowed **up to \$100,000** using these rules to buy all or a portion of the corporate stock. If so, that interest would have been fully deductible as **home mortgage interest** rather than **limited** by the **investment interest** rules.

## Medical Savings Accounts

**Question 23.** *Is there a "use it or lose it" aspect to Medical Savings Accounts (MSAs)? In other words, if deposits exceed medical expenses for a year, do you "lose" the excess amount? Or does the excess accumulate to be available to pay medical expenses in the next year?*

**Answer 23.** Medical Savings Accounts are similar to a health expenses flexible spending account (FSA) of a cafeteria plan (I.R.C. §125) **without the detrimental "use it or lose it" provision of FSAs**. The year-end excess funds can be accumulated to pay medical expenses of the next year.

However, contributions are subject to an annual limit. You can make fully deductible contributions to your MSA (even if you do not itemize deductions) **up to certain limits**. The annual contribution limit is **prorated on a monthly basis** if the medical insurance plan is established during the current year (is not effective for the entire current year). Those maximum annual contribution limits are:

1. **75%** of the **annual deductible** of the required "high-deductible" health insurance plan for a **"family"** health plan, and
2. **65%** of the **annual deductible** of the required "high-deductible" health insurance plan for an **"individual"** health plan.

**Note:** As mentioned above, these annual limits are prorated on a monthly basis if the health insurance plan is not in effect the entire year.

**Example.** Phil is a self-employed mechanic. He established the required **"high-deductible" family** health insurance plan (it covers him, his wife, and his children) on July 1, 1997. The annual deductible amount is \$4,000. **Phil may contribute to his MSA and deduct from gross income \$1,500 ( $\$4,000 \div 2 \times 75\%$ ) on his 1997 Form 1040.** (Assuming the same deductible in 1998, the contribution and deduction would be \$3,000.)

Employer payments to your MSA. Assume that Phil in the above **Example** is employed rather than self-employed in 1997. His employer contributed \$1,500 to Phil's MSA in October 1997. This \$1,500 will be **excluded from wages in box 1 (Wages) and box 3 (Social Security Wages) of Phil's 1997 W-2 form**. Phil cannot make any deductible contributions to his MSA in 1997 as his employer has contributed to his MSA in 1997.

# 1997 Workbook

contributed to his MSA in 1997.

**Note:** Phil's employer will deduct the \$1,500 on the "Employee benefit programs" line of the business tax return (line 14, Schedule C or line 25, Form 1120).

## Partnerships

**Question 24.** *May a general partnership treat one of two partners as an employee and give him a W-2 form?*

**Answer 24.** No. A general partner may **not** be treated as an employee. However, the partnership may use **guaranteed payments** to "compensate" **one** of the partners (and not the others) for services rendered. Guaranteed payments are reported on Form 1065, Schedule K-1, line 5 and are subject to self-employment tax. See the completed Schedule K-1 from IRS Pub. #541, "Partnerships," shown on the following page.

| SCHEDULE K-1<br>(Form 1065)<br>Department of the Treasury<br>Internal Revenue Service  |  | Partner's Share of Income, Credits, Deductions, etc.   |  | OMB No. 1545-0099  |  |                                     |   |   |  |  |  |               |                 |              |
|--|--|--|--|--|--|-------------------------------------|---|---|--|--|--|---------------|-----------------|--------------|
|  |  | ▶ See separate instructions.   |  | <b>19967</b>   |  |                                     |   |   |  |  |  |               |                 |              |
|  |  | For calendar year 1996 or tax year beginning   |  | , 19   |  |                                     |   |   |  |  |  |               |                 |              |
| Partner's identifying number ▶ <b>123-00-6789</b>  |  | Partnership's identifying number ▶ <b>10:9876543</b>   |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| Partner's name, address, and ZIP code<br><b>Frank W. Able<br/>10 Green Street<br/>Orange, MD 20904</b>   |  | Partnership's name, address, and ZIP code<br><b>Able Baker Book Store<br/>334 West Main Street<br/>Orange, MD 20904</b>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>A</b> This partner is a <input checked="" type="checkbox"/> general partner <input type="checkbox"/> limited partner<br><input type="checkbox"/> limited liability company member   |  | <b>F</b> Partner's share of liabilities (see instructions):<br>Nonrecourse . . . . . \$ .....<br>Qualified nonrecourse financing . . . . . \$ .....<br>Other . . . . . \$ <b>10,900</b>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>B</b> What type of entity is this partner? ▶ <b>Individual</b>  |  | <b>G</b> Tax shelter registration number . . . . . ▶ <b>N/A</b>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>C</b> Is this partner a <input checked="" type="checkbox"/> domestic or a <input type="checkbox"/> foreign partner?   |  | <b>H</b> Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) . . . . . <input type="checkbox"/>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>D</b> Enter partner's percentage of: <table style="width: 100%; border: none;"> <tr> <td style="width: 50%;">(i) Before change or termination</td> <td style="width: 50%;">(ii) End of year</td> </tr> <tr> <td>Profit sharing . . . . . % <b>.50</b></td> <td>% <b>.50</b></td> </tr> <tr> <td>Loss sharing . . . . . % <b>.50</b></td> <td>% <b>.50</b></td> </tr> <tr> <td>Ownership of capital . . . . . % <b>.50</b></td> <td>% <b>.50</b></td> </tr> </table> |  | (i) Before change or termination   | (ii) End of year   | Profit sharing . . . . . % <b>.50</b>  | % <b>.50</b>                             | Loss sharing . . . . . % <b>.50</b> | % <b>.50</b>  | Ownership of capital . . . . . % <b>.50</b> | % <b>.50</b>   | <b>I</b> Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1 |  |               |                 |              |
| (i) Before change or termination   | (ii) End of year   |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| Profit sharing . . . . . % <b>.50</b>  | % <b>.50</b>   |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| Loss sharing . . . . . % <b>.50</b>  | % <b>.50</b>   |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| Ownership of capital . . . . . % <b>.50</b>  | % <b>.50</b>   |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>E</b> IRS Center where partnership filed return: <b>Philadelphia</b>  |  | <b>J</b> Analysis of partner's capital account: <table style="width: 100%; border: none;"> <tr> <td style="width: 20%;">(a) Capital account at beginning of year</td> <td style="width: 20%;">(b) Capital contributed during year</td> <td style="width: 20%;">(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2</td> <td style="width: 20%;">(d) Withdrawals and distributions</td> <td style="width: 20%;">(e) Capital account at end of year (combine columns (a) through (d))</td> </tr> <tr> <td style="text-align: right;"><b>4,050</b></td> <td></td> <td style="text-align: right;"><b>24,460</b></td> <td style="text-align: right;"><b>(26,440)</b></td> <td style="text-align: right;"><b>2,070</b></td> </tr> </table> |  |  | (a) Capital account at beginning of year | (b) Capital contributed during year | (c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2 | (d) Withdrawals and distributions           | (e) Capital account at end of year (combine columns (a) through (d)) | <b>4,050</b>   |  | <b>24,460</b> | <b>(26,440)</b> | <b>2,070</b> |
| (a) Capital account at beginning of year   | (b) Capital contributed during year  | (c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2  | (d) Withdrawals and distributions  | (e) Capital account at end of year (combine columns (a) through (d))   |  |                                     |   |   |  |  |  |               |                 |              |
| <b>4,050</b>   |  | <b>24,460</b>  | <b>(26,440)</b>  | <b>2,070</b>   |  |                                     |   |   |  |  |  |               |                 |              |
| <b>(a) Distributive share item</b>   |  | <b>(b) Amount</b>  |  | <b>(c) 1040 filers enter the amount in column (b) on:</b>  |  |                                     |   |   |  |  |  |               |                 |              |
| Income (Loss)  | <b>1</b> Ordinary income (loss) from trade or business activities . . . . .  | <b>1</b>   | <b>24,685</b>  | } See pages 5 and 6 of Partner's instructions for Schedule K-1 (Form 1065).  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>2</b> Net income (loss) from rental real estate activities . . . . .  | <b>2</b>   |  |  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>3</b> Net income (loss) from other rental activities . . . . .  | <b>3</b>   |  |  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>4</b> Portfolio income (loss):  | <b>4</b>   |  | } Sch. B, Part I, line 1<br>Sch. B, Part II, line 5<br>Sch. E, Part I, line 4<br>Sch. D, line 5, col. (f) or (g)<br>Sch. D, line 13, col. (f) or (g)<br>Enter on applicable line of your return. |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>a</b> Interest . . . . .  | <b>4a</b>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>b</b> Dividends . . . . .   | <b>4b</b>  | <b>75</b>  |  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>c</b> Royalties . . . . .   | <b>4c</b>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>d</b> Net short-term capital gain (loss) . . . . .  | <b>4d</b>  |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>e</b> Net long-term capital gain (loss) . . . . .   | <b>4e</b>  |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>f</b> Other portfolio income (loss) (attach schedule) . . . . .   | <b>4f</b>  |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>5</b> Guaranteed payments to partner . . . . .  | <b>5</b>   | <b>20,000</b>  | } See page 6 of Partner's instructions for Schedule K-1 (Form 1065).<br>Enter on applicable line of your return. |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>6</b> Net gain (loss) under section 1231 (other than due to casualty or theft) . . . . .  | <b>6</b>   |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>7</b> Other income (loss) (attach schedule) . . . . .   | <b>7</b>   |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| Deductions   | <b>8</b> Charitable contributions (see instructions) (attach schedule) . . . . .   | <b>8</b>   | <b>325</b>   | } Sch. A, line 15 or 16<br>} See page 7 of Partner's instructions for Schedule K-1 (Form 1065).  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>9</b> Section 179 expense deduction . . . . .   | <b>9</b>   |  |  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>10</b> Deductions related to portfolio income (attach schedule) . . . . .   | <b>10</b>  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| <b>11</b> Other deductions (attach schedule) . . . . .   | <b>11</b>  |  |  |  |  |                                     |   |   |  |  |  |               |                 |              |
| Investment interest  | <b>12a</b> Interest expense on investment debts . . . . .  | <b>12a</b>   |  | } Form 4952, line 1<br>} See page 8 of Partner's instructions for Schedule K-1 (Form 1065).  |  |                                     |   |   |  |  |  |               |                 |              |
|  | <b>b</b> (1) Investment income included on lines 4a, 4b, 4c, and 4f above<br>(2) Investment expenses included on line 10 above . . . . . | <b>b(1)</b><br><b>b(2)</b>   | <b>75</b>  |  |  |                                     |   |   |  |  |  |               |                 |              |

| Schedule K-1 (Form 1065) 19967 |   | Page 2     |               |   |
|--------------------------------|---|------------|---------------|---|
| (a) Distributive share item    |   | (b) Amount |               | (c) 1040 filers enter the amount in column (b) on:  |
| Self-employment                | <b>15a</b> Net earnings (loss) from self-employment . . . . . | <b>15a</b> | <b>44,685</b> | } Sch. SE, Section A or B<br>} See page 9 of Partner's instructions for Schedule K-1 (Form 1065). |
|                                | <b>b</b> Gross farming or fishing income . . . . .            | <b>15b</b> |               |   |
|                                | <b>c</b> Gross nonfarm income . . . . .                       | <b>15c</b> |               |   |

# 1997 Workbook

**SCHEDULE K-1**  
**(Form 1065)**  
Department of the Treasury  
Internal Revenue Service

## Partner's Share of Income, Credits, Deductions, etc.

OMB No. 1545-0099

▶ See separate instructions.

1997

For calendar year 1996 or tax year beginning , 1997, and ending , 19

|   |   |
|---|---|
| <b>Partner's identifying number ▶ 123-00-6789</b><br>Partner's name, address, and ZIP code<br><p style="text-align: center; font-size: 1.2em;">Frank W. Able<br/>10 Green Street<br/>Orange, MD 20904</p> | <b>Partnership's identifying number ▶ 10:9876543</b><br>Partnership's name, address, and ZIP code<br><p style="text-align: center; font-size: 1.2em;">Able Baker Book Store<br/>334 West Main Street<br/>Orange, MD 20904</p> |
|---|---|

|   |                          |        |    |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |
|---|--------------------------|--------|----|---|------------------------|---|----|---|--------------------------------|---|----|---|--|-----------------------|----|--|---|----|--|-----------------|----|--------|
| <p><b>A</b> This partner is a <input checked="" type="checkbox"/> general partner <input type="checkbox"/> limited partner<br/><input type="checkbox"/> limited liability company member</p> <p><b>B</b> What type of entity is this partner? ▶ <b>Individual</b></p> <p><b>C</b> Is this partner a <input checked="" type="checkbox"/> domestic or a <input type="checkbox"/> foreign partner?</p> <p><b>D</b> Enter partner's percentage of:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Profit sharing . . . . .</td> <td style="width: 10%; text-align: center;">%</td> <td style="width: 10%; text-align: center;">50</td> <td style="width: 10%; text-align: center;">%</td> </tr> <tr> <td>Loss sharing . . . . .</td> <td style="text-align: center;">%</td> <td style="text-align: center;">50</td> <td style="text-align: center;">%</td> </tr> <tr> <td>Ownership of capital . . . . .</td> <td style="text-align: center;">%</td> <td style="text-align: center;">50</td> <td style="text-align: center;">%</td> </tr> </table> <p><b>E</b> IRS Center where partnership filed return: <b>Philadelphia</b></p> | Profit sharing . . . . . | %      | 50 | % | Loss sharing . . . . . | % | 50 | % | Ownership of capital . . . . . | % | 50 | % | <p><b>F</b> Partner's share of liabilities (see instructions):</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Nonrecourse . . . . .</td> <td style="width: 20%;">\$</td> <td style="border-bottom: 1px solid black;"></td> </tr> <tr> <td>Qualified nonrecourse financing . . . . .</td> <td>\$</td> <td style="border-bottom: 1px solid black;"></td> </tr> <tr> <td>Other . . . . .</td> <td>\$</td> <td style="text-align: right;">10,900</td> </tr> </table> <p><b>G</b> Tax shelter registration number . ▶ <b>N/A</b></p> <p><b>H</b> Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) . . . . . <input type="checkbox"/></p> <p><b>I</b> Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1</p> | Nonrecourse . . . . . | \$ |  | Qualified nonrecourse financing . . . . . | \$ |  | Other . . . . . | \$ | 10,900 |
| Profit sharing . . . . .  | %                        | 50     | %  |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |
| Loss sharing . . . . .  | %                        | 50     | %  |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |
| Ownership of capital . . . . .  | %                        | 50     | %  |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |
| Nonrecourse . . . . .   | \$                       |        |    |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |
| Qualified nonrecourse financing . . . . .   | \$                       |        |    |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |
| Other . . . . .   | \$                       | 10,900 |    |   |                        |   |    |   |                                |   |    |   |  |                       |    |  |   |    |  |                 |    |        |

**J Analysis of partner's capital account:**

| (a) Capital account at beginning of year | (b) Capital contributed during year | (c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2 | (d) Withdrawals and distributions | (e) Capital account at end of year (combine columns (a) through (d)) |
|--|-------------------------------------|---|-----------------------------------|--|
| 4,050                                    |                                     | 24,460  | ( 26,440 )                        | 2,070  |

|  | (a) Distributive share item  |                            | (b) Amount | (c) 1040 filers enter the amount in column (b) on:   |
|--|--|----------------------------|------------|--|
| Income (Loss)  | <b>1</b> Ordinary income (loss) from trade or business activities . . . . .  | <b>1</b>                   | 24,685     | See pages 5 and 6 of Partner's Instructions for Schedule K-1 (Form 1065).  |
|  | <b>2</b> Net income (loss) from rental real estate activities . . . . .  | <b>2</b>                   |            |  |
|  | <b>3</b> Net income (loss) from other rental activities . . . . .  | <b>3</b>                   |            |  |
|  | <b>4</b> Portfolio income (loss):  |                            |            | Sch. B, Part I, line 1<br>Sch. B, Part II, line 5<br>Sch. E, Part I, line 4<br>Sch. D, line 5, col. (f) or (g)<br>Sch. D, line 13, col. (f) or (g)<br>Enter on applicable line of your return. |
|  | <b>a</b> Interest . . . . .  | <b>4a</b>                  |            |  |
|  | <b>b</b> Dividends . . . . .   | <b>4b</b>                  | 75         |  |
|  | <b>c</b> Royalties . . . . .   | <b>4c</b>                  |            |  |
| <b>d</b> Net short-term capital gain (loss) . . . . .              | <b>4d</b>  |                            |            |  |
| <b>e</b> Net long-term capital gain (loss) . . . . .               | <b>4e</b>  |                            |            |  |
| <b>f</b> Other portfolio income (loss) (attach schedule) . . . . . | <b>4f</b>  |                            |            |  |
| Deductions   | <b>5</b> Guaranteed payments to partner . . . . .  | <b>5</b>                   | 20,000     | See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).<br>Enter on applicable line of your return.   |
|  | <b>6</b> Net gain (loss) under section 1231 (other than due to casualty or theft) . . . . .  | <b>6</b>                   |            |  |
|  | <b>7</b> Other income (loss) (attach schedule) . . . . .   | <b>7</b>                   |            |  |
|  | <b>8</b> Charitable contributions (see instructions) (attach schedule) . . . . .   | <b>8</b>                   | 325        |  |
| Investment Interest  | <b>9</b> Section 179 expense deduction . . . . .   | <b>9</b>                   |            | See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).<br><br>Form 4952, line 1<br>See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).                              |
|  | <b>10</b> Deductions related to portfolio income (attach schedule) . . . . .   | <b>10</b>                  |            |  |
|  | <b>11</b> Other deductions (attach schedule) . . . . .   | <b>11</b>                  |            |  |
|  | <b>12a</b> Interest expense on investment debts . . . . .  | <b>12a</b>                 |            |  |
|  | <b>b</b> (1) Investment income included on lines 4a, 4b, 4c, and 4f above<br>(2) Investment expenses included on line 10 above . . . . . | <b>b(1)</b><br><b>b(2)</b> | 75         |  |

|                 | (a) Distributive share item                                   |            | (b) Amount | (c) 1040 filers enter the amount in column (b) on:  |
|-----------------|---|------------|------------|---|
| Self-employment | <b>15a</b> Net earnings (loss) from self-employment . . . . . | <b>15a</b> | 44,685     | Sch. SE, Section A or B<br>See page 8 of Partner's Instructions for Schedule K-1 (Form 1065). |
|                 | <b>b</b> Gross farming or fishing income . . . . .            | <b>15b</b> |            |   |
|                 | <b>c</b> Gross nonfarm income . . . . .                       | <b>15c</b> |            |   |

# 1997 Workbook

## Question 25

**Facts.** *Three individuals are general partners. The partnership rents part of a building as its headquarters. Partner A has an office in her home where she pays bills, does invoicing, and creates designs on a computer. She cannot use an office in the rented partnership building due to dust.*

**Question.** *May the partnership pay Partner A a reasonable rent of \$200 a month for the use of her home?*

**Note:** The enrollee added this comment after the question: "I realize that A cannot deduct any home office expenses on her Form 1040."

**Answer 25.** The partnership may pay and deduct a reasonable rent to Partner A as an ordinary and necessary business expense. And A **might** qualify to deduct home office expenses under the **Soliman** decision. It appears from the facts that Partner A's principal place of business is her home office. She does not use space in the partnership's rented building to perform her duties.

The comment refers to I.R.C. §280A(c)(6) regarding treatment of home office rental to an employer. The 1986 Tax Reform Act added this provision to the Code. It prevents employees from deducting any home office expenses (except for home mortgage interest and taxes that are deductible on Schedule A under other Code sections) **if the employee rents a portion of his or her home to the employer.**

However, partners are not considered employees of the partnership. Therefore, arguably the Code section cited above does not apply. If Partner A can meet the principal place of business test, she should be entitled to deduct her properly allocated home office expenses.

Both rental income received from the partnership and the home office expenses should be reported in Part 1 of Schedule E, Income from Rental Real Estate. Form 8829 could be used to compute the home office expenses, with the total expenses on line 34 carried to line 18 (Other expenses) of Schedule E. On line 18, Schedule E, write "Home Office expenses. See attached Form 8829."

**Note:** See the 1997 TRA chapter for changes in the office in home deduction for tax years after 1998, and the impact of claiming an office in the home in regard to the new exclusion from income rules under I.R.C. §121.

## Procedure

**Question 26.** *In Illinois, one is required to have a license to cut hair and "do nails." However, no license is required to prepare tax returns. Why is this?*

**Answer 26.** Apparently because there is nothing worse than suffering a bad hair day!

**Question 27.** *What is the IRS web site address on the Internet?*

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**Answer 27.** [www.irs.ustreas.gov](http://www.irs.ustreas.gov). Items available include forms and instructions, publications, IRS Press Releases, and Fact Sheets.

## Retirement Plans

**Question 28.** Regarding the *1996 tax legislation (effective for tax years beginning in 1997)* that allows participants in qualified plans who are 70½ to delay required distributions until April 1 of the calendar year *after the year they retire*:

Facts for Questions 28A and 28B. *My client is an employee who is covered under her company's qualified pension plan. She will be 70½ in March 1997. She wants to begin working part-time (10-20 hours per week) for the same employer beginning April 1, 1997. This part-time arrangement will end during the summer of 1998.*

**Question 28A.** *According to the 1996 tax legislation, what is the latest date her minimum required distributions from the plan must begin?*

**Answer 28A.** If the employer **has amended or intends to amend** the plan to allow delaying commencement of benefits until April 1 following the year of retirement, the answer to **Question 28A** is **April 1, 1999**. See **IRS Announcement 97-24** [I.R.B. 1997-11,24].

**Note:** Employers should contact their retirement plan administrator to have their plans amended to comply with the new laws.

**Question 28B.** *How is the word "retire" defined? Does it mean 100% retired with absolutely no work allowed?*

**Answer 28B.** Generally, yes. But each qualified plan should contain a provision defining "retirement" in exact, unambiguous terms.

Facts for Question 28C. *My client has three IRAs and intends to work after she reaches age 70½ in 1997.*

**Question 28C.** *May she delay receiving distributions from her three IRAs until April 1 of the year following the year she retires?*

**Answer 28C.** No. This new exception does not pertain to distributions from IRAs, including SEP-IRAs and SIMPLE-IRAs. Her minimum required IRA distributions must begin by April 1, 1998.

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## Question 29

**Facts.** *The IRS seized part of my client's retirement plan in 1996 to satisfy an unpaid tax liability. He was 40 years old when this happened. I'm sure he will receive a 1996 Form 1099-R for the seized distribution.*

**Question.** *Will he owe the 10% early withdrawal penalty?*

**Answer 29.** Yes. Use Form 5329 to compute the penalty. This event does not qualify under any of the statutory exceptions to the 10% early distribution penalty.

**Note:** There have been three court cases that have sanctioned IRS tax levies on taxpayers' retirement plans, including IRAs, Keogh plans, and qualified employer pension plans. The ERISA ban against assignment (the alienation provision) does not apply to IRS tax levies.

## Question 30

**Facts.** *My client will defer the maximum \$9,500 of his wages in 1996 via contributions to his employer's 401(k) plan. He has started a sideline computer consulting business in 1996 and expects to net at least \$15,000 in 1996 from this home-based Schedule C business.*

**Question.** *Does the amount contributed to the 401(k) plan affect (reduce or diminish) the amount of his Keogh plan deduction for 1996 for the business?*

**Answer 30.** No. Each plan is independent of the other. The answer would be the same if your client established a SEP plan rather than a Keogh plan for the consulting business.

**Note:** The **maximum** elective salary deferral amount for 401(k) plans for **1997 is unchanged**. It remains at \$9,500 for 1997. The same \$9,500 limit applies to salary deferral arrangements of qualified SEP plans (SARSEPS) that were established **before 1997**.

## Question 31

**Facts.** *An employee turned 70½ in 1995 and received a \$13,500 minimum required distribution from her employer's qualified noncontributory pension plan on April 1, 1996. She is still working in 1996 and 1997. I assume she will receive a 1996 Form 1099-R for the \$13,500.*

**Question.** *Is there any way that the new 1996 tax legislation allowing deferral of distributions until retirement can benefit her? For example, may she return the \$13,500 to her employer's pension plan or roll it over even though the 60-day rollover period has elapsed?*

**Answer 31.** The answer to both questions is no for two reasons. First, the new law applies to employees who attained age 70½ **after 1995**. The employee became 70½ **in 1995**. Second, the required distribution was made on April 1, 1996. And under prior law, it was required. Since it was made, it is taxable under prior law.

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**Note:** If the employee had attained age 70½ **after 1995**, the IRS has announced that employers are allowed the **option** of delaying commencement of pension distributions until April 1 of the year following the year the employee retires. To accomplish this, the employer **must amend the plan retroactively** to provide for the **option**. The date by which a plan providing for this **option** must be retroactively amended will **in no event be earlier than January 1, 1998** [Announcement 97-24, I.R.B. 1997-11, 24]. (See also **Announcement 97-70** in the What's New chapter.)

## Question 32

**Facts.** *A sole proprietor during the first year of his business establishes a SEP plan. He has no employees in that first year. The business is profitable, and he makes a SEP contribution for himself.*

*In year 2 of the business, the business suffers a loss and no SEP contribution is made for the owner. There are no employees during the second year of business.*

*In year 3 of the business, one employee is hired, and the business is profitable. A SEP contribution is made for the owner.*

**Questions.** *May the sole proprietor exclude the one employee from SEP coverage in year 3? Since the owner made a SEP contribution for himself in the first year of the business, must he now make SEP contributions for all new employees in the first year of their employment?*

**Answer 32.** The answer to the first question is **no**, the employee may **not** be excluded from SEP coverage for year 3. The answer to the second question is yes. The reasons are as follows:

Before the sole proprietor could make a SEP contribution for himself for year 1 (the first year of business), he had to adopt a SEP plan. The plan was required to specify eligibility requirements for all employees (**including himself**). See **Article I—Eligibility Requirements** of page 4, Form 5305-SEP, shown on the following page.

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Form **5305-SEP**

(Rev. January 1997)

Department of the Treasury  
Internal Revenue Service

## Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499

**DO NOT File With  
the Internal  
Revenue Service**

\_\_\_\_\_ makes the following agreement under section 408(k) of the  
(Name of employer)  
Internal Revenue Code and the instructions to this form.

### Article I—Eligibility Requirements (Check appropriate boxes—see Instructions.)

The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least \_\_\_\_\_ years old (not to exceed 21 years old) and have performed services for the employer in at least \_\_\_\_\_ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP)  includes  does not include employees covered under a collective bargaining agreement,  includes  does not include certain nonresident aliens, and  includes  does not include employees whose total compensation during the year is less than \$400\*.

### Article II—SEP Requirements (See Instructions.)

The employer agrees that contributions made on behalf of each eligible employee will be:

- A. Based only on the first \$160,000\* of compensation.
- B. Made in an amount that is the same percentage of compensation for every employee.
- C. Limited annually to the smaller of \$30,000\* or 15% of compensation.
- D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

\_\_\_\_\_  
Employer's signature and date

\_\_\_\_\_  
Name and title

Since the sole proprietor made a SEP contribution for himself for year 1, he obviously chose **zero years** for the prior service eligibility requirement in Article I, page 4 of Form 5305-SEP. Therefore, since his SEP plan allowed him to make a contribution for himself in year 1 of the business, he must make a contribution to the new employee's SEP-IRA for year 3.

However, had he been in business for several years before he adopted the SEP plan, the scenario could be different. Suppose he began the business in 1993 but did not adopt a SEP plan until 1996. Then he could make a SEP contribution for himself for 1996 **even if** he specified **three years** of prior service in Article I, page 4 of Form 5305-SEP. Conversely, a new employee hired in 1996 would not need to be covered for SEP purposes **until 1999**.

A qualifying employee for SEP purposes is an individual who:

1. Has reached the age of 21,
2. Worked for you **at any time in at least 3 of the immediately preceding 5 years**, and
3. Received at least \$400 in compensation from you in 1996 (\$400 for 1997).

**Note:** Employers may establish **less** restrictive participation requirements for employees than the three tests listed, but **not more restrictive ones**.

# 1997 Workbook

## Question 33

**Facts.** *At my previous employment, I participated in a SARSEP (salary reduction arrangement of the employer's SEP plan). My new employer has no retirement plan.*

**Question.** *May my new employer withhold part of my salary and contribute to my existing SARSEP (a mutual fund)?*

**Answer 33.** No. However, if the new employer had adopted a SARSEP prior to Jan. 1, 1997, the answer would be yes.

## Question 34

**Facts.** *My client, a well-paid employee, has substantial vested assets in her 401(k) plan. She rents an apartment.*

**Question.** *May she borrow from her 401(k) plan to buy a new car rather than finance it with her car dealer or a bank?*

**Answer 34.** Maybe. Not all 401(k) plans permit loans. But if hers does, it might be good planning for her. A home equity loan would be preferable, but she doesn't have that option. A 401(k) plan loan would make sense if the interest rate on it is less than the rate for financing with the car dealer or a bank.

However, since she is an **employee**, the interest on the 401(k) plan auto loan will **not be deductible**. **This is true even if the car is used 100% for her employment duties.** (See I.R.C. §163(h)(2)(A) as explained in detail on page 511 of the 1995 *Farm Income Tax Book*.)

## Question 35

**Facts.** *I understand that an employee covered by an employer's profit-sharing plan is **not** considered as **participating if no contribution is made to the plan**. This allows the employee to contribute to his IRA without regard to the AGI limitation rules.*

**Question.** *I thought an employee is considered participating (covered by a retirement plan at work) in a profit-sharing plan **regardless** of whether a contribution is made on behalf of the employee. Please clarify.*

**Answer 35.** Our answer quotes and paraphrases IRS Pub. #590, "IRAs":

Special rules apply to determine whether you are considered to be **covered** by (an active participant in) a plan for a tax year. These rules differ depending on whether the plan is a **defined contribution** (includes profit-sharing plans, stock bonus plans, and money purchase pension plans) or **defined benefit** plan.

**Generally, you are considered covered by a defined contribution plan if amounts are *contributed or allocated* to your account *for the plan year that ends within your tax year*.**

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**Example.** Company A has a profit-sharing plan. Its plan year is from July 1 to June 30. The plan provides that contributions must be allocated as of June 30. Bob, an employee, terminates his employment with Company A on Dec. 30, 1996. The contribution for the plan year ending on June 30, 1997, is not made until Feb. 15, 1998 (when Company A files its Form 1120). In this case, Bob is considered **covered by the plan for his 1997 tax year.**

**Notes:** The profit-sharing contribution for the plan year ending June 30, 1997 was **allocated to Bob's account on June 30, 1997.** Therefore, he is considered **covered by (an active participant in) the plan during 1997.**

Bob's 1997 Form W-2 should have the pension plan box marked in item/box 15.

**Question 36.** *Regarding the "substantially equal periodic payments" (commonly referred to as "annuity") exception to avoid the 10% early distribution penalty:*

**Facts.** *I know this option can be used by IRA owners to negate the 10% penalty for early IRA distributions. But I have a client who retired at age 55. He sold his business. He has a Keogh plan that's worth over \$400,000, and he is considering the annuity option as he needs funds for personal living expenses.*

**Question.** *May he use the annuity option to avoid the 10% early distribution penalty?*

**Answer 36.** Yes. However, based on the facts, the annuity option would be unnecessary, as he sold the business and is over age 55. It appears he has met the "separated from service" exception for "employees" (he is considered an employee of his Keogh plan). Therefore, **any type** of Keogh distribution he receives after age 55 but before age 59½ **will not be subject to the 10% penalty.**

**Note:** The use of the annuity option by self-employed taxpayers to avoid the 10% early distribution penalty is widely misunderstood. However, it is sanctioned by the TRA of 1986, which allows the exception to the penalty to **all participants in qualified plans, whether common-law employees or owner-employees.**

## S Corporations

**Question 37.** *What is reasonable compensation for a sole shareholder of an S Corporation? My goal is to save FICA taxes for the S corporation! Has the IRS developed a minimum figure?*

**Answer 37.** If the S corporation pays **no salary to the shareholder**, the IRS may treat distributions (shown on line 20 of the 1996 Schedule K-1) as shareholder salary.

However, the general rule is that the S corporation has to pay a working or managing shareholder a salary that is reasonable. Reasonable salary factors include the number of hours worked, what the industry salary average is, the amount of fringe benefits received by the shareholder, and numerous others.

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**Note:** The taxpayer has the burden of proving that the IRS's determination of reasonable salary is incorrect. There are many litigated "unreasonable salary" cases, but the great majority deal with unreasonably **high** salaries rather than unreasonably **low** salaries. However, see the *Spicer Accounting, Inc. Appeals Court case* (CA-9, 91-1 USTC ¶50,103). See also pages 556–58 of the 1995 *Farm Income Tax Book* for an analysis of this troublesome issue.

## Question 38

**Facts.** *The taxpayer is a 50% shareholder in ABC, an S corporation, and a 100% shareholder in XYZ, an S corporation. Each S corporation has enough profit to elect the maximum §179 deduction and each does elect the maximum \$17,500 for its 1996 calendar year 1120S.*

**Questions.** *What happens to the amount of §179 elected deductions in excess of \$17,500 on the taxpayer's Form 1040? Is it lost? If so, isn't this a tax trap?*

**Answer 38.** The §179 deduction limits **apply at both the S corporation and the shareholder levels.** Per the facts, the shareholder has been allocated a total of \$26,250 in §179 deductions by the two S corporations. But the shareholder is limited to \$17,500 on his 1996 Form 1040. The excess (unused or disallowed) amount of \$8,750 is lost forever. It cannot be carried over to following years.

This is a tax trap, as three limits apply to the §179 deduction. The three limitations are:

1. The taxable income limitation,
2. The maximum value of property placed in service (or investment) limitation, and
3. The maximum dollar limitation (\$17,500 for 1996, \$18,000 for 1997, \$18,500 for 1998, \$19,000 for 1999, \$20,000 for 2000, \$24,000 for 2001 and 2002, and \$25,000 for years after 2002).

Carryover of any unused §179 deduction is allowed **only when the elected cost exceeds the taxable income limit, not when either of the other two limits is exceeded.** The maximum dollar limitation is absolute. If the 1120S flowthrough allocations of the §179 deduction exceed it, the **reduction in basis of the elected S corporation property must be made with no corresponding tax benefit to the shareholder.**

**Note:** This tax trap can be avoided or diminished if a tax preparer prepares all of the S corporation returns and all of the Forms 1040 for the various S corporation shareholders. In that case, the amount of the §179 deductions **elected** by the multiple S corporations can be adjusted to maximize the benefit to the S corporation shareholders.

See the §179 Deduction Worksheet from IRS Pub. #946, "How to Depreciate Property" (For Use in Preparing 1996 Returns), shown below.

# 1997 Workbook

## Section 179 Deduction Worksheet

Step 1: Maximum dollar limit ..... \$ 17,500

Step 2: Enter total business  
cost of all qualifying  
property placed in  
service in tax year. .... \$

---

**Note.** If Step 2 is \$217,500 or more, you cannot elect section 179 for this year.

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Step 3: Threshold cost of section 179  
property. .... \$ 200,000

Step 4: Subtract Step 3 from Step 2. If Step  
2 is less than Step 3, enter -0-. .... \$

Step 5: Subtract Step 4 from Step 1. This is  
your reduced maximum dollar limit. If  
Step 1 is less than Step 4, enter -0-. \$

Step 6: Enter amount you elect to expense  
under section 179. (Do not enter  
more than Step 2.). .... \$

Step 7: Enter the smaller of Step 5 or Step  
6. This is your tentative deduction. \$

Step 8: Enter any section 179 carryover  
from prior years. .... \$

Step 9: Enter the smaller of your 1996  
taxable income limit or the Step 5  
amount. .... \$

Step 10: Add Step 7 and Step 8. Do not enter  
more than your Step 9 amount. (No  
more than \$3,060 can be entered on  
this line for a passenger  
automobile.) This is your 1996  
section 179 deduction. .... \$

### Carryover to 1997:

Step 11: Add Steps 7 and 8. .... \$

Step 12: Enter Step 10 amount. \$

Step 13: Subtract Step 12 from Step 11. This  
is your carryover to 1997. .... \$

# 1997 Workbook

## Sales and Exchanges

### Question 39

**Facts.** A woman and her ex-husband sell their jointly owned personal residence in July 1993. The home qualified as her main home. She reinvests her one-half of the sales price of the old home by buying her new male "partner's" main home in August 1993. He was over 55 on the date of the sale. He uses the once-in-a-lifetime exclusion to avoid taxation on his gain on the sale of his main home to his new "partner" in August 1993. The two of them live together in this home but do not marry.

She waits until she is 55 and then sells the house in November 1996. She then uses her once-in-a-lifetime exclusion to exclude the gain on the sale on her 1996 Form 1040.

In January 1997 they (the "partners") get married and buy a new main home jointly.

**Question.** Are there any tax problems here? Do the 3-out-of-5-year ownership and occupancy tests prohibit use of this tax planning idea?

**Answer 39.** No. **First:** The male partner owned the home in 1993. He can sell it to whomever he wants. He sells his house in August 1993 to an **unrelated** party. He is over 55 in 1993 and has met the 3-out-of-5-year ownership and occupancy tests. Therefore, he can use his once-in-a-lifetime exclusion on his 1993 Form 1040.

**Second:** The female partner owns the home as of August 1993. If she owns and resides in it for three years and if she is 55 or older in November 1996, she can use her once-in-a-lifetime exclusion when she sells the home. The fact that her partner lives with her after she bought the home and before she sells it is **irrelevant**.

### Question 40

**Facts.** A married couple (both age 53) sell their former personal residence and immediately reinvest in a replacement home. The gain on the sale of the old home is deferred by I.R.C. §1034. Two years later the husband retires (at age 55) and wants to use the one-time exclusion.

**Question 40A.** Is the holding period of the former residence added to the holding period of the new residence for the 3-out-of-5-year requirement?

**Answer 40A.** No.

**Question 40B.** Or do they have to live in the new residence one more year before they are eligible?

**Answer 40B.** Yes. The **home that is sold** must meet the 3-out-of-5-year ownership and occupancy test.

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The only exceptions are for:

1. Short temporary absences such as vacations,
2. Homeowners who have to enter a nursing home or similar facility due to mental or physical disability, and
3. Cases where the previous residence was destroyed by casualty or was condemned.

**Note:** See the 1997 TRA chapter for the new rules for sales of residences after May 6, 1997.

## Question 41

**Facts.** *Our client intends to sell a warehouse in 1997. It was constructed in June 1993. The building was depreciated under MACRS using the 39-year life for nonresidential real property. The land improvements (parking lot and access road) were depreciated using the first MACRS table [Table A-1 in **IRS Pub. #946**, which is regular MACRS or **GDS (General Depreciation System)** with a half-year convention] for 15-year MACRS property.*

**Question.** *Will he be subject to recapture of depreciation on the land improvements as ordinary income?*

**Answer 41.** Yes. Section 1250 property is depreciable real property. This includes the land improvements. Section 1250 recapture applies when an accelerated depreciation method was used. Regular MACRS or **GDS** uses the 150% declining balance method for 15-year-life MACRS property such as land improvements.

**Notes:** Section 1250 recapture could have been avoided by using **ADS** (Alternative Depreciation System) for the land improvements. **ADS** uses the straight-line method. Table A-8 in **IRS Pub. #946 "How to Depreciate Property"** is the **ADS** table (straight-line method with a half-year convention).

The tax implications for this sale would be different if the sale occurred after May 6, 1997. See the 1997 TRA chapter for details.

## Question 42

**Facts.** *A client sold a personal residence in early 1995. Form 2119 was included with the 1995 Form 1040. Only Part 1 of the 1995 Form 2119 was completed as the new home was purchased in the fall of 1996. The purchase price of the new home exceeded the sales price of the old home.*

**Questions.** *How is this reinvestment in the new home reported in 1996? Is a fully completed Form 2119 filed with the client's 1996 Form 1040?*

**Answer 42.** The answer to the second question is no. IRS Pub. #523, "Selling Your Home," states:

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**New Home purchased after return is filed:** If you postponed gain from the sale of your old home, and your new home costs at least as much as the adjusted sales price of your old home, **file a second Form 2119 by itself. Your address, signature, and the date are required on this second Form 2119. If you filed a joint return for the year of sale, both you and your spouse must sign the second Form 2119. File it with the Internal Revenue Service Center where you would file your next tax return.**

**Note:** If the new home costs **less** than the adjusted sales price of the old home, you must file an amended return (Form 1040X) for the year of the sale of the old home. Attach a second completed Form 2119 and Schedule D showing the gain reportable.

## Question 43

**Facts.** *An S corporation files for bankruptcy. The trustee liquidates all corporate assets and pays a pro rata amount to creditors. The sole shareholder receives nothing.*

**Question.** *Is the shareholder's loss limited to his basis?*

**Answer 43.** Yes. His basis is equal to the total of **stock basis plus certain debt basis**. See the discussion on pages 241–59 of the 1995 *Farm Income Tax Book* for a thorough analysis of this difficult concept.

**Notes:** The shareholder's loss will be a capital loss reported on Schedule D unless the stock qualified under I.R.C. §1244 as "small business stock." Losses on the sale or exchange of "1244 stock" are usually reported in Part II, Form 4797 as an ordinary loss. See pages 319–24 in the 1995 *Farm Income Tax Book* for a problem explaining how to deduct a loss on worthless "1244 stock."

The year of loss is the year the S corporation stock becomes **totally worthless**. That normally would be the date that the trustee or bankruptcy judge determined that the corporate assets were insufficient to pay liabilities and that, consequently, the shareholder(s) would receive nothing.

## Question 44

**Facts.** *A contractor built a spec house that he cannot sell. The house was completed in May 1996. So the contractor sold his personal residence in October 1996 and moved into the spec house. There is a \$50,000-plus gain on the sale of the former residence.*

**Question.** *Can he roll over the gain under I.R.C. §1034 to the spec house?*

**Answer 44.** Yes, assuming the cost basis of the spec home exceeds the adjusted sales price of the former residence.

**Note:** Do we need to mention that the entire cost of the spec home (all direct and indirect costs) must be subtracted from the cost-of-goods-sold figure on the contractor's business schedule? This is a fairly common situation for home builders. Most IRS examiners are aware of this issue which often leads to substantial exam adjustments.

# 1997 Workbook

## Self-Employment Tax

### Question 45

**Facts.** *In 1995 my Schedule C client suffered a \$100,000 net operating loss. 1995 was the first year of business. The 1995 NOL will be carried forward to the 1996 Form 1040 and entered on line 21, Other income, as a negative figure. In 1996 the business will generate a net profit in excess of \$100,000.*

**Question.** *Is there any way to avoid paying self-employment tax on the 1996 Schedule C profit? It seems equitable that the 1995 NOL carryover and the 1996 net profit should be combined for 1996 SE tax purposes.*

**Answer 45.** The answer is no, 1996 SE tax cannot be avoided.

## Ag-Related Questions and Answers

### Depreciation

#### Question 1

**Facts.** *I have a new client who is a farmer. I learned that he bought a farm 10 years ago. None of the purchase price was allocated to the grain bins, machine shed, or drainage tile.*

**Question.** *Can I use **Rev. Proc. 96-31** (pages 565-66 of the 1996 Farm Income Tax Book) to "catch up" the omitted depreciation in the current year (1996)?*

**Note:** The date of this question is November 1996. The answer is current and reflects the present IRS instructions.

**Answer 1.** **Rev. Proc. 96-31** was modified and superseded by **Rev. Proc. 97-37** (I.R.B. 1997-33, page 18, dated Aug. 18, 1997). The new **Rev. Proc. 97-37** could be used for 1996 Forms 1040 **only if Form 3115 is attached to the taxpayer's original timely filed (including extensions) 1996 Form 1040. If it is too late to meet that requirement, Rev. Proc. 97-37 can be used to deduct the "catch up" (omitted) depreciation on the taxpayer's 1997 Form 1040.**

**Note:** See the comprehensive problem in this book on pages 123-32 that explains how to use the new **Rev. Proc. 97-37**. See also the What's New chapter for a synopsis of this new revenue procedure.

### Earned Income Credit

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**Question 2.** *Regarding the 1996 tax legislation that denies Earned Income Credit to taxpayers whose investment income exceeds \$2,200 and that expanded investment income to include **capital gain net income** (page 649 of the 1996 Farm Income Tax Book):*

Question. *Does "**capital gain net income**" include the gain reported originally in Part I, Form 4797 from the sale of raised sows and boars held over one year?*

Comment Added by Enrollee. This gain can be substantial (sometimes in excess of \$20,000) and does flow to Schedule D.

**Note:** This "\$1231 gain" is not technically a "capital gain," but it is afforded long-term capital gain treatment.

**Answer 2. Preface:** The enrollee who asked this question was very astute, as he anticipated an eventual problem of interpretation. The answer given has the advantage of the passage of time and is not the answer given at the 1996 Tax School.

Per the 1996 1040 Instructions, the IRS and its Service Centers are applying the following interpretation to the term **investment income**: "For most people, **investment income** is the total of the amounts of Form 1040, lines:"

|     |   |
|-----|---|
| 8a) | Taxable interest  |
| 8b) | Tax-exempt interest   |
| 9)  | Dividends   |
| 13) | Capital gain or (loss) from Schedule D, <b>but only if more than zero</b> (in other words, include a net capital gain but do not subtract a net capital loss) |

This is how Service Center computers are programmed. So according to the IRS and the way it processes returns, the answer to **Question 2** is yes. The gain on the sale of raised swine held for breeding purposes for over one year does constitute **capital gain net income for purposes of denying Earned Income Credit on 1996 Forms 1040**. See pages 5 and 6 in the Agricultural Issues chapter for more details on this topic.

## Estate Tax Planning

**Question 3.** *Please discuss split-interest purchases of farmland.*

Example. *A father and son purchase farmland using the split-interest technique. The son (the remainderman) buys the **remainder interest** and father buys the **life estate interest** (also called the **term** interest). After the death of the father 20 years later, the farmland automatically is owned by the son, who already owns the remainder interest.*

Question. *Isn't this a legal way to reduce the estate tax burden of the father, as on his death he doesn't own the farmland?*

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**Answer 3.** Yes. This technique has been used for a number of years and is an effective estate tax planning tool.

**Note:** One loophole in this technique was closed for split-interest purchases by **related parties** for split-interests created or acquired **after July 27, 1989. Before July 28, 1989**, the father (holder of the life estate interest) was entitled to **amortize** his cost (purchase price) in the life estate interest over the period of his estimated remaining life.

This loophole in effect allowed depreciation (in the form of amortization) to be deducted on land by the purchaser of the life estate interest (the father in the **example**). This loophole was closed by the Revenue Reconciliation Act of 1989.

## Hedging vs. Speculation

**Question 4.** *Regarding hedging versus speculation:*

**Question.** *What about the purchase of a call option **in conjunction with** a cash forward contract? This marketing technique is essentially the same as a **guaranteed minimum price contract**.*

**Comment by Enrollee.** The rationale for the call option is to protect against **direct production risk (not indirect price risk) should there be a crop failure with insufficient crop to deliver to satisfy the obligations of the cash forward contract.**

**Answer 4.** Based on **Treas. Reg. §§1.446-4 and 1.1221-2** (issued July 13, 1994), the gain or loss on the call option qualifies as a hedge and would be reported on Schedule F.

**Note:** **Treas. Reg. §1.1221-2(c)** states:

### (1) Reducing risk:

- (i) **Transactions that reduce risk:** Whether a transaction reduces a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's **hedging strategies and policies as reflected in the taxpayer's minutes or other records are *evidence* of whether particular transactions reduce the taxpayer's risk.**
- (ii) **Micro and macro hedges: In General.** A taxpayer has risk of a particular type **only if it is at risk *when all of its operations are considered***. Nonetheless, a **hedge of a particular asset (or liability) generally will be respected as reducing risk if it reduces the risk attributable to the asset (or liability) and if it is reasonably expected to reduce the overall risk of the taxpayer's operations.**

See pages 164–167 of the 1996 *Farm Income Tax Book* for useful information on this topic.

## Reporting

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## Question 5

**Facts.** *A farmland owner (age 75) got disgusted with her crop share lease with her tenant farmer. She hired a farm manager who found a farmer who would "custom-farm" her land. She now gets 100% of the crops and pays all farm expenses. She lives in Arizona and the farm is in Iowa. The farm manager receives 7% of all farm receipts as his fee.*

**Question.** *Where should this custom farming arrangement be reported?*

**Answer 5.** On her Schedule F. This landowner is engaged in the trade or business of farming. If there is a net profit of over \$400, she will owe self-employment tax.

## Question 6

**Facts.** *I picked up a new client<sup>3</sup>four sisters who have a farm partnership. The Forms 1065 from prior years had a Form 4835 (Crop Share Farm Rental) attached to them. The partnership **cash-rents** the farm ground and the grain bins. Their expenses are bin depreciation, repairs, and property taxes.*

**Question.** What form or schedule should be used in this case?

**Answer 6.** Form 8825 should be attached to the Form 1065. Page 1 of the 1996 Form 8825 is shown next.

# 1997 Workbook

Form **8825**

## Rental Real Estate Income and Expenses of a Partnership or an S Corporation

OMB No. 1545-1186

Department of the Treasury  
Internal Revenue Service

▶ See instructions on back.  
▶ Attach to Form 1065 or Form 1120S.

1996

Name

Employer identification number

**1** Show the kind and location of each property. See page 2 for additional properties.

**A** .....

**B** .....

**C** .....

**D** .....

|   |            | Properties |   |   |                        |
|---|------------|------------|---|---|------------------------|
|   |            | A          | B | C | D                      |
| <b>Rental Real Estate Income</b>  |            |            |   |   |                        |
| <b>2</b> Gross rents . . . . .  | <b>2</b>   |            |   |   |                        |
| <b>Rental Real Estate Expenses</b>  |            |            |   |   |                        |
| <b>3</b> Advertising . . . . .  | <b>3</b>   |            |   |   |                        |
| <b>4</b> Auto and travel . . . . .  | <b>4</b>   |            |   |   |                        |
| <b>5</b> Cleaning and maintenance . . . . .   | <b>5</b>   |            |   |   |                        |
| <b>6</b> Commissions . . . . .  | <b>6</b>   |            |   |   |                        |
| <b>7</b> Insurance . . . . .  | <b>7</b>   |            |   |   |                        |
| <b>8</b> Legal and other professional fees . . . . .  | <b>8</b>   |            |   |   |                        |
| <b>9</b> Interest . . . . .   | <b>9</b>   |            |   |   |                        |
| <b>10</b> Repairs . . . . .   | <b>10</b>  |            |   |   |                        |
| <b>11</b> Taxes . . . . .   | <b>11</b>  |            |   |   |                        |
| <b>12</b> Utilities . . . . .   | <b>12</b>  |            |   |   |                        |
| <b>13</b> Wages and salaries . . . . .  | <b>13</b>  |            |   |   |                        |
| <b>14</b> Depreciation (see instructions) . . . . .   | <b>14</b>  |            |   |   |                        |
| <b>15</b> Other (list) ▶ .....  | <b>15</b>  |            |   |   |                        |
| .....   |            |            |   |   |                        |
| .....   |            |            |   |   |                        |
| <b>16</b> Total expenses for each property. Add lines 3 through 15 . . . . .  | <b>16</b>  |            |   |   |                        |
| <b>17</b> Total gross rents. Add gross rents from line 2, columns A through H . . . . .   | <b>17</b>  |            |   |   |                        |
| <b>18</b> Total expenses. Add total expenses from line 16, columns A through H . . . . .  | <b>18</b>  |            |   |   | (                    ) |
| <b>19</b> Net gain (loss) from Form 4797, Part II, line 20, from the disposition of property from rental real estate activities . . . . .   | <b>19</b>  |            |   |   |                        |
| <b>20a</b> Net income (loss) from rental real estate activities from partnerships, estates, and trusts in which this partnership or S corporation is a partner or beneficiary (from Schedule K-1) . . . . . | <b>20a</b> |            |   |   |                        |
| <b>b</b> Identify below the partnerships, estates, or trusts from which net income (loss) is shown on line 20a. Attach a schedule if more space is needed:  |            |            |   |   |                        |
| (1) Name  |            |            |   |   |                        |
| (2) Employer identification number  |            |            |   |   |                        |
| .....   |            |            |   |   |                        |
| .....   |            |            |   |   |                        |
| .....   |            |            |   |   |                        |
| <b>21</b> Net income (loss) from rental real estate activities. Combine lines 17 through 20a. Enter result here and on Schedule K, line 2 . . . . .   | <b>21</b>  |            |   |   |                        |

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## Question 7

**Facts.** A farmer lets his neighbor farmer use his tractor and is paid \$1,000. A Form 1099-MISC is received by the farmer. The \$1,000 is reported in Box 1, Rents, on the Form 1099.

**Question.** Where should the \$1,000 be reported? On his Schedule F or Schedule E?

**Answer 7.** Generally on line 9, Schedule F, Custom hire income. Schedule E cannot be used to report the rental of personal property. However, if this is a one-time or a very unusual arrangement the farmer **may** not be subject to SE tax on this income because there is no trade or business. In this case the \$1,000 would be reported on page 1 of Form 1040.

|   |   |   |
|---|---|---|
| <b>SCHEDULE F</b><br><b>(Form 1040)</b><br><br><small>Department of the Treasury<br/>Internal Revenue Service</small>   | <b>Profit or Loss From Farming</b><br><br>▶ Attach to Form 1040, Form 1041, or Form 1065.<br><br>▶ See Instructions for Schedule F (Form 1040). | OMB No. 1545-0074<br><br><div style="text-align: center; font-size: 2em; font-weight: bold;">1997</div> Attachment<br>Sequence No. 14 |
| Name of proprietor  |   | Social security number (SSN)  |
| A Principal product. Describe in one or two words your principal crop or activity for the current tax year.   |   | B Enter principal agricultural activity code (from page 2) ▶  |
| C Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual   |   | D Employer ID number (EIN), if any  |
| E Did you "materially participate" in the operation of this business during 1997? If "No," see page F-2 for limit on passive losses. <input type="checkbox"/> Yes <input type="checkbox"/> No   |   |   |
| <b>Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.)</b><br>Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797. |   |   |
| 1 Sales of livestock and other items you bought for resale  | 1   |   |
| 2 Cost or other basis of livestock and other items reported on line 1   | 2   |   |
| 3 Subtract line 2 from line 1   |   | 3   |
| 4 Sales of livestock, produce, grains, and other products you raised  |   | 4   |
| 5a Total cooperative distributions (Form(s) 1099-PATR)  | 5a  | 5b Taxable amount   |
| 6a Agricultural program payments (see page F-2)   | 6a  | 6b Taxable amount   |
| 7 Commodity Credit Corporation (CCC) loans (see page F-2):  |   | 7a  |
| a CCC loans reported under election   |   | 7c  |
| b CCC loans forfeited   | 7b  | 7c Taxable amount   |
| 8 Crop insurance proceeds and certain disaster payments (see page F-2):   |   | 8b  |
| a Amount received in 1997   | 8a  | 8b Taxable amount   |
| c If election to defer to 1998 is attached, check here ▶ <input type="checkbox"/>   |   | 8d  |
| 8d Amount deferred from 1996  |   | 9   |
| 9 Custom hire (machine work) income   |   | 10  |
| 10 Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-2)   |   | 11  |
| 11 Gross income. Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51  |   | 11  |

# 1997 Workbook

**SCHEDULE F  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

## Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, or Form 1065.  
▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074

1997

Attachment  
Sequence No. **14**

|   |  |
|---|--|
| Name of proprietor  | Social security number (SSN)                                 |
| A Principal product. Describe in one or two words your principal crop or activity for the current tax year.   | B Enter principal agricultural activity code (from page 2) ▶ |
| C Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual   | D Employer ID number (EIN), if any                           |
| E Did you "materially participate" in the operation of this business during 1997? If "No," see page F-2 for limit on passive losses. <input type="checkbox"/> Yes <input type="checkbox"/> No |  |

**Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.**

|  |    |  |  |                   |       |
|--|----|--|--|-------------------|-------|
| 1 Sales of livestock and other items you bought for resale . . . . .   | 1  |  |  |                   |       |
| 2 Cost or other basis of livestock and other items reported on line 1 . . . . .  | 2  |  |  |                   |       |
| 3 Subtract line 2 from line 1 . . . . .  |    |  |  | 3                 |       |
| 4 Sales of livestock, produce, grains, and other products you raised . . . . .   |    |  |  | 4                 |       |
| 5a Total cooperative distributions (Form(s) 1099-PATR) . . . . .   | 5a |  |  | 5b Taxable amount |       |
| 6a Agricultural program payments (see page F-2) . . . . .  | 6a |  |  | 6b Taxable amount |       |
| 7 Commodity Credit Corporation (CCC) loans (see page F-2):   |    |  |  |                   |       |
| a CCC loans reported under election . . . . .  |    |  |  | 7a                |       |
| b CCC loans forfeited . . . . .  | 7b |  |  | 7c Taxable amount |       |
| 8 Crop insurance proceeds and certain disaster payments (see page F-2):  |    |  |  |                   |       |
| a Amount received in 1997 . . . . .  | 8a |  |  | 8b Taxable amount |       |
| c If election to defer to 1998 is attached, check here ▶ <input type="checkbox"/> . . . . .  |    |  |  | 8d                |       |
| d Amount deferred from 1996 . . . . .  |    |  |  | 8d                |       |
| 9 Custom hire (machine work) income . . . . .  |    |  |  | 9                 | 1,000 |
| 10 Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-2) . . . . .  |    |  |  | 10                |       |
| 11 Gross income. Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . . ▶ |    |  |  | 11                |       |

## Retirement Plans

### Question 8

*Facts. My wife and I own farmland that each of us inherited. We both crop-share rent to our tenant farmers. Both of us show a considerable profit from the farm rental activity, which we report on two Forms 4835. My wife is an employed physician with W-2 wages in excess of \$100,000. I am retired and have investment and pension income. My wife's employer has no retirement plan. Both of us have IRAs.*

*Question. May each of us establish a Keogh plan based on the large profit each of us reports on Form 4835?*

**Answer 8.** No. Only self-employed persons can establish Keogh plans, and neither of you is self-employed. Neither of you has net earnings from self-employment, as you both report your farm rental incomes on Forms 4835 rather than on Schedules F.

# 1997 Workbook

If either of you meets any of the four **material participation tests** for crop-share landlords, the farm rental activity of that spouse should be reported on Schedule F rather than Form 4835. In that case, self-employment tax would be due and consequently a Keogh plan could be established.

## Sales and Exchanges

### Question 9

**Facts.** *A farmer owns two parcels of farmland **each** worth \$100,000. Tract A has a basis of \$100,000 and Tract B has a basis of \$10,000.*

**Question.** *Can the farmer sell Tract A to another farmer for \$100,000 (no gain or loss) and then execute a like-kind exchange (tax-free) of Tract B for Tract A with that other farmer?*

**Comment Added by Enrollee.** What we are doing (or trying to do) is to dispose of the low-basis Tract B without recognizing the \$90,000 gain. Please comment.

**Answer 9.** This is interesting planning, but an IRS examiner would treat the two transactions as a single transaction. The farmer **started out** with Tracts A and B and **wound up** with Tract A plus \$100,000. So the end result (economic reality) is that he **sold** Tract B to the other farmer for \$100,000 and therefore has a recognized gain of \$90,000 on the sale or exchange of Tract B.

### Question 10

**Facts.** *My client had a show horse. After several years, but before showing the horse, the animal had to be destroyed.*

**Questions.** *Is this loss deductible? If so, what is the basis of the horse? Does it include the feed, insurance, and other expenses paid for the horse in prior years? (These expenses have never been deducted.)*

**Answer 10.** A show horse is either a personal or business asset. Some might argue that it could be investment property like stocks and bonds. But that is probably a weak argument. Since the horse never produced any income for its owner, the horse is probably a **personal asset**. A show horse (as opposed to a race horse) activity typically involves much expense and very little, if any, income. Losses on the sale of personal assets are nondeductible.

The basis of the horse does not include feed, insurance, and other expenses. If the horse was raised, its basis is zero. If it was purchased, its basis is the purchase price.

**Note:** I.R.C. §165(c)(2) allows "losses incurred in any transaction entered into for profit." This language naturally leads to the rationale of I.R.C. §183, the "hobby loss" disallowance section of the Code.

# 1997 Workbook

## Self-Employment Tax

**Question 11.** *Regarding (1) the **Mizell** court case (see pages 617-18 of the 1996 Farm Income Tax Book) which holds that self-employment tax is due for a partner who leases farmland he owns to the partnership via a crop share lease, and (2) **Ltr. Rul. 9637004** (see pages 618-21 of the 1996 Farm Income Tax Book) which extends that rationale to a shareholder/employee of a farm corporation who cash-rents ranchland to the corporation:*

*Question. What about hog buildings owned by a shareholder and cash-leased to the farm corporation? Does this trigger SE tax also?*

**Answer 11.** No, because I.R.C. §1402(a)(1) provides an exception for "any income derived by the **owner or tenant of land.**" And hog buildings are not *land*. See pages 7-9 in this book (Agricultural Issues chapter) for complete details on this topic.