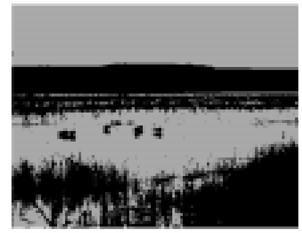
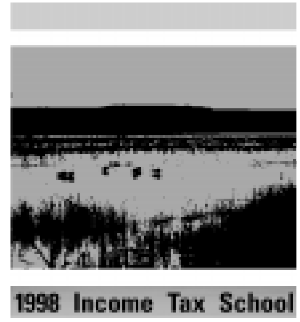


1998 Income Tax School

PRACTITIONER QUESTION AND ANSWER



PRACTITIONER QUESTION AND ANSWER

NON-AGRICULTURE-RELATED QUESTIONS AND ANSWERS

ADOPTION CREDIT

Question 1. *Regarding the adoption credit:*

Facts. *A married couple tried to adopt a child who was a U.S. citizen in 1997. They paid over $3,000 for attorney and adoption agency fees in 1997. The adoption attempt was unsuccessful. The attempted adoption process was very stressful, and they have decided that they will not attempt another adoption.*

Question. *Are they entitled to claim an adoption credit on either their 1997 or 1998 tax returns?*

Answer 1. The answer is **no for 1997.** But they are entitled to claim a $3,000 adoption credit on their 1998 Form 8839 (Qualified Adoption Expenses). [I.R.C. §23(a)(2)] See **Notice 97-9** (I.R.B. 1997-2, page 22).

Notes. Following are excerpts from IRS Pub #968, *Tax Benefits for Adoption* (Rev. January 1998):

1. **Child who is a U.S. Citizen or resident.** If the eligible child is a U.S. citizen or resident, you can take the adoption credit or exclusion **even if the adoption never becomes final.** Take the credit or exclusion as shown in the following table.

IF you pay qualifying expenses in...	THEN take the credit in...
• Any year before the year the adoption becomes final	The year after the year of the payment
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year after the year of the payment

IF your employer pays for qualifying expenses under an adoption assistance program in...	THEN take the exclusion in...
• Any year	The year of the payment

Note: You cannot take a credit for any expenses paid before 1997. You cannot take a credit for any expenses paid after 2001, except for expenses to adopt a child with special needs. You cannot take an exclusion for any payment your employer makes after 2001.

2. **Foreign child.** If the eligible child is **not** a U.S. citizen or resident, you **cannot** take the adoption credit or exclusion **unless the adoption becomes final**.

Question 2. *A divorced man remarries a divorced woman with two small children. He wants to adopt her children. May he claim the adoption credit for the expenses he pays in connection with the adoption?*

Answer 2. No. Only **qualifying** adoption expenses are eligible for the credit on Form 8839. **Nonqualifying expenses** include those incurred for the adoption of a child of the taxpayer's spouse. [I.R.C. §23(d)(1)(C)]

BANKRUPTCY

Question 3. *I thought bankruptcy could not extinguish IRS tax liability, but on page 229 of the 1997 Farm Income Tax Book, bankruptcy is shown as an option to an Offer in Compromise. Please comment on which strategy you would utilize for a client who had large unpaid IRS income tax bills and little cash flow.*

Answer 3. We will answer with a hypothetical example.

Facts. Your client owes over $100,000 in delinquent income taxes, interest, and penalties for his 1991, 1992, and 1993 Forms 1040. His current annual income is less than $20,000, and his future income projections are even more bleak.

Recommendations. Since the final due dates (including extensions) of his 1991–93 Forms 1040 predate the date of filing of a possible bankruptcy petition by **more than three years**, bankruptcy should at least be considered. If the Bankruptcy Court approves the petition (as it usually does), all of the unpaid taxes, penalties, and interest relating to the 1991–93 Forms 1040 will be discharged.

Some individuals will resist the suggestion of filing a bankruptcy petition for various reasons. But an explanation of this option is recommended. From a cost standpoint, filing for and the approval of a bankruptcy petition will normally be less expensive for a client than utilizing an Offer-in-Compromise. If the client in this hypothetical example refuses to file a bankruptcy petition, an Offer-in-Compromise should be considered. The single biggest obstacle in most Offer-in-Compromise cases is solving the dilemma of the source of funding to pay an accepted offer. [**But see the information on Offers in Compromise in the previous chapter.**]

CHILD TAX CREDIT

Question 4. *Regarding the child tax credit effective for 1998 returns:*

You mentioned that it is possible that some parents who claim the child tax credit on their 1998 returns could be adversely affected by AMT (alternative minimum tax).

Question. **If that is the case, does a taxpayer have to claim the credit for 1998?**

Answer 4. Yes. The new child tax credit code section states **"There shall be allowed as a credit against the tax . . . ."** [I.R.C. §24(a)] The term "shall" means "must" for Internal Revenue Code purposes.

Claiming the child tax credit on 1998 tax returns will **never increase** the total tax liability. The **tentative minimum tax** shown on line 24 of the 1998 Form 6251 merely limits the allowable child tax credit. **See the Child Tax Credit problems in the Individual and Small Business Problems chapter.**

CORPORATIONS

Question 5. *For fiscal year corporations, when are the §179 increases effective?*

Answer 5. The effective date of the increases is dependent on when the fiscal corporation's tax year **begins**. For example, for the year that begins April 1, 1997, the §179 deduction limit is $18,000. For the next fiscal year, the limit is $18,500.

Question 6. *If a Subchapter S election is terminated on September 30, 1998, does the corporation have to annualize its income for the period October 1 through December 31, 1998 on its initial Form 1120 tax return?*

Answer 6. Yes, assuming the S corporation's accounting period was the calendar year. (I.R.C. §1362(e)(5) and **Treas. Reg.** 1.1362-3)

The result is that there will be two short tax year returns filed for 1998: an 1120S for the first nine months and an 1120 for the last three months. Income is computed for all of 1998, and the profit or loss is allocated (prorated) to the 1120S and the 1120. [I.R.C. §1362(e)(2)]

However, there is an **exception** to the general rule requiring that the income for the C short year be determined on an annualized basis. An **election** can be made under I.R.C. §1362(e)(3) to assign items of income, gain, loss, deduction, and credit to **each short tax year under normal accounting rules.** In order to make a valid election, each person who is a shareholder at **any** time during the S short year and all shareholders on the first day of the C short year must consent to the election. This election is made by attaching a statement to the timely filed original or amended Form 1120S. [**Treas. Reg.** §1.1362-6(a)]

Practitioner Caution. The **exception** explained above is for computing **income (not tax)** for the year. Once the C corporation's short year **income** is determined, whether by annualizing or by closing the books, the **tax computation itself must be annualized**. [I.R.C. §1362(e)(5) and **Treas. Reg.** §1.443-1(b)] In essence, this limits the 15 percent bracket for the **three-month** (October 1–December 31) short year Form 1120 to $12,500 (one-fourth of $50,000).

Question 7. *Can the sole shareholder of an S corporation take advantage of an I.R.C. §105 insured medical plan, as a sole proprietor can?*

Answer 7. No, not to the same extent that a sole proprietor can. **Rev. Rul.** 91-26 treats a more than 2% shareholder/employee of an S corporation like a partner in a partnership. Therefore, health insurance premiums paid by the S corporation on behalf of a more than 2% shareholder/employee are treated in a similar manner as guaranteed payments are to a partner. Therefore, the S corporation can deduct the health insurance premiums on the Form 1120S. The more than 2% shareholder must then include the premiums as **additional compensation** reportable in box 1 (wages, tips, other compensation) on the form W-2. In addition, the S corporation is required to report that amount in box 14 on the shareholder's Form W-2.

Note. See pages 100–103 in the 1995 *Farm Income Tax Book* for a thorough discussion of this issue, including completed forms and schedules.

Question 8. Facts. A shareholder of a closely held C corporation owns a building and leases it to the corporation at fair rental value under a written lease agreement. The real estate tax bill shows the shareholder's name as the owner of the building.

Question. *Can the corporation pay and deduct the real estate taxes on the leased building?*

Answer 8. No, due to the technical issue of **"constructive dividends."** The real estate taxes are the responsibility of the shareholder, since he owns the leased building. If the corporation pays the taxes on behalf of the shareholder, the amount paid would be considered as an additional rental payment. [**Treas. Reg.** §1.61-8(c)]

Since the corporation is already paying a fair rental amount to the shareholder for use of the building, the payment of the real estate taxes would constitute an excessive rental payment by the corporation. As such, it would be treated as a **constructive dividend and would not be deductible** by the corporation. [**Treas. Reg.** §1.316-2(e)]

A second technical issue is, "Which taxpayer is entitled to the real estate tax deduction?" According to **Treas. Reg.** §1.164-1(a), "in general, taxes are deductible **only** by the person on whom they are imposed." This would imply that **only** the shareholder would be entitled to deduct the real estate taxes on the leased building and **only** if paid by the shareholder. Therefore, if the corporation pays the real estate taxes, it could not deduct the payment as taxes.

Note. If the corporation's payment of **actual** rent per the lease agreement **plus** the **additional** rent paid in the form of lessor real estate taxes constituted **no more than a fair rental amount,** both payments would be deductible as rent. This is a fairly common situation for closely held corporations and their shareholders. The key is to ensure that the rental payments made by the corporation to the shareholder(s) are not excessive, but are reasonable.

DEPRECIATION

Question 9. Facts. I rent office space in a brand new building of which I'm the original tenant. I spend $20,000 on wallpaper and painting costs in 1998.

Question 9A. *Does the $20,000 have to be capitalized?*

Answer 9A. Probably. Even though wallpaper and painting are normally **not** considered improvements, the facts given are unusual. You **were the original tenant** of the **new building,** and the leasehold expenditure was a **significant amount.** These factors are important. The key question is, does the $20,000 constitute an **"improvement?"** [I.R.C. §168(i)(8)(A)]

Note. IRS has not acquiesced in the *Hospital Corporation of America* Tax Court case. IRS has appealed this decision. See pages 494–95 in the 1997 *Farm Income Tax Book* for a discussion of this interesting case.

Question 9B. *If the answer (Answer 9A) to my first question is yes, what is the depreciable life?*

Answer 9B. The $20,000 must be amortized over the 39-year MACRS life for nonresidential real property. [I.R.C. §168(i)(8)(A)]

Note. If the lease is terminated before the 39-year MACRS recovery period ends, the lessee may deduct the unamortized balance of the $20,000 leasehold improvement in the year of termination.

Question 10. *Regarding the "catch-up" of depreciation utilizing Rev. Proc. 97-37 (pages 45–46 and 123–132 of the 1997 Farm Income Tax Book):*

Question 10A. *If a farmer omits farm drainage tile from his 1990 depreciation schedule, can he use Rev. Proc. 97-37 to file a Form 3115 (Application for Change in Accounting Method) to claim the omitted §179 expense deduction on his 1998 Form 4562?*

Answer 10A. No. The §179 deduction can be taken **only** on

1. the **original** (first) tax return (whether or not timely filed) for the tax year the property was placed in service, or
2. an **amended** return filed by the due date (including extensions for the return for the tax year the property was placed in service. [**Treas. Reg.** §1.179-5(a)]

Note. The §179 deduction is not automatic. It is an **election** that must be made on a Form 4562 that is attached with either (1) or (2) shown above. A taxpayer cannot make an **election** to claim the §179 deduction on an amended return filed after the due date (including extensions). See the *Fors* Tax Court Memo case in the **What's New** chapter for more information on how to make a valid §179 election.

Question 10B. Facts. Taxpayer sold an asset in 1994. No depreciation was ever claimed on the asset, but gain was reported (recognized) on the 1994 Form 4797 because the "allowed or allowable" depreciation rule reduced the adjusted basis to zero.

Question. *Can I use Rev. Proc. 97-37 to claim the understated depreciation on the asset by filing Form 3115 with the taxpayer's 1998 Form 1040?*

Answer 10B. No. **Rev. Proc. 97-37** "applies to any taxpayer that has used an impermissible method of accounting for depreciation in **at least two** taxable years immediately **preceding** the year of change, and is changing that accounting method to a permissible method of accounting for depreciation, for any item of property that is **owned by the taxpayer at the beginning of the year of change."** (Section 2.01(2)(a)(iii)of **Rev. Proc. 97-37**)

Since the asset was not owned on January 1, 1998, the taxpayer **cannot** use **Rev. Proc 97-37** to make a "catch-up" depreciation adjustment on the taxpayer's 1998 Form 1040.

Notes. Rev. Proc. 97-37 applies to situations where the taxpayer has claimed **less** than the depreciation allowable. The revolutionary aspect of this Revenue Procedure is that it applies to open **and closed years** prior to the year of change for understated depreciation.

We recommend that **Rev. Proc. 97-37** be used in the **first year available**. Keep in mind that the original Form 3115 must be filed with (attached to) a **timely filed** (including extensions) original tax return for the year the "catch-up" depreciation adjustment is deducted.

The "allowed or allowable" depreciation rule is harsh. Apparently IRS ameliorated the harsh effects of the "allowed or allowable" depreciation rule by issuing **Rev. Proc. 97-37.** But as explained previously, in order to take advantage of this Revenue Procedure, the asset for which depreciation was omitted or understated must be owned by the taxpayer at the beginning of the year of change.

DIVORCE ISSUES

Question 11. Facts. A father sold his son 200 acres with a house for $42,000. The son later gets divorced. The divorce decree requires the son to pay the ex-wife $60,000 for her share of the 200 acres and the house, which the son got to keep. The son later sells the 200 acres and the house.

Question. *Can the son add $60,000 to his basis in the property for computing gain or loss?*

Answer 11. No. The $60,000 is a nondeductible property settlement. It does not increase the son's basis in the property. The son's basis for computing gain or loss on the 200 acres and the house will be the $42,000 he paid for it (assuming that was fair market value when purchased from father) plus the cost of improvements less any allowed or allowable depreciation. See **Treas. Reg.** §1.1041-1T for the tax treatment rules involving transfers of property incident to divorce.

EARNED INCOME CREDIT

Question 12. Facts. A woman has custody of her two young sons (under age 19) in 1998. She allows her ex-husband to claim the exemptions for the sons by signing Form 8332. She has $8,000 of wages in 1998. She and her two sons live **for the last 10 months of 1998** with her partner, who is the father of their new child. His 1998 AGI is $300,000. He furnishes chief support during the last 10 months of 1998 for everyone living with him in his expensive home. He is entitled to claim the exemption of the new child on his 1998 return, although it is lost due to his high AGI.

Question. *Can the woman claim Earned Income Credit (EIC) based on two qualifying children (the two sons by her previous marriage) in 1998?*

Answer 12. Yes. She does not have to own the home where the two sons reside. A qualifying child for EIC purposes has to meet 3 tests: (1) relationship, (2) residency, and (3) age. An unmarried child does not have to be a dependent of the taxpayer who claims EIC. The woman meets all three tests. Therefore, she is entitled to claim EIC for 1998 for herself and two qualifying children.

Notes:

1. Under I.R.C. §32(c)(3)(c), if a child is a qualifying child for **more than one taxpayer,** then **only the taxpayer with the higher AGI is eligible for EIC with respect to that child.** If the two young sons had lived with the mother's domestic partner for **the entire 1998 tax year,** the two children **would have been his qualifying children for EIC purposes.** This is due to the liberal **foster child** provisions of I.R.C. §32(c)(3).
2. The ex-husband is probably **not** entitled to the dependency exemptions for his two sons in 1998. The Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents) waiver is valid **only if the parents between them furnish more than half of the children's support.** Since the mother's domestic partner provided more than half of the support for her two young sons in 1998, he (the domestic partner) is the only one legally entitled to the exemptions. If the mother marries her domestic partner in 1998, the Form 8332 would regain its validity since support provided by a spouse (stepparent) is considered to be provided by the other spouse (mother in this case).

Note. If the woman's 1998 modified AGI is $8,000 (consisting solely of her wages), she is entitled to $3,210 EIC on her 1998 return.

EDUCATION IRAS

Question 13. *Can a contribution to an Education IRA be made in 1998 for a 17-year-old beneficiary if the beneficiary will be 18 before December 31, 1998?*

Answer 13. Yes, as long as the contribution is made on or before the beneficiary's 18th birthday. [I.R.C. §530(b)(1)(A)(ii)]

See the chart from IRS Pub. #970 **(Tax Benefits for Higher Education),** which follows.

Education IRA Contributions At a Glance

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
Are contributions deductible?	No.
Why should someone contribute to an education IRA?	It is a new tax benefit for families saving for higher education costs.
What is the **contribution limit**?	$500 each year for each child.
What if more than one education IRA has been opened for the same child?	The annual contribution limit is $500 for each child, no matter how many education IRAs are set up for that child.
What if more than one individual makes contributions for the same child?	The contribution limit is $500 per child, no matter how many individuals contribute.
Can contributions other than cash be made to an education IRA?	No.
When can a taxpayer first contribute to an education IRA?	1998.
When must contributions stop?	No contributions can be made to a child's education IRA after he or she reaches age 18.

HOPE CREDIT

Question 14. *Regarding the HOPE credit effective in 1998:*

Facts. *The parents of a college student are divorced. The father is allowed to claim the student as a dependent on his 1998 return, as he has custody. The mother pays the college tuition in 1998, as the father's business has cash flow problems.*

Question. *Who is entitled to claim the HOPE credit in 1998?*

Answer 14. No one. IRS Pub. #970 (*Tax Benefits for Higher Education*) states:

> "In any one tax year, only one person can claim a higher education credit for an eligible student's expenses. If you are paying higher education costs for **your dependent child,** either you or your dependent child, but not both, can claim a credit for a particular year. If **you claim an exemption for your child on your tax return, only you can claim a credit.** If you do

not claim an exemption for your child on your tax return, **only your child can claim a credit.**
Tip. If you claim an exemption for your child on your tax return, **treat any expenses paid by your child as if you had paid them.** Include these expenses when figuring the amount of **your** HOPE or Lifetime Learning credit."

Editorial comment. Following is a clarification of the quotes above from IRS Pub #970:

1. If your child claims his own personal exemption on his return, only he/she can claim either the HOPE credit or the Lifetime Learning credit. [I.R.C. §25A(g)(3) and IRS Notice 97-60]
2. If the parent claims the student's dependency exemption, only that parent can claim either of the education credits. In this case, the higher education expenses may be paid by that parent or the student.

Note. A divorce decree and/or support agreement should be written to provide that the parent who pays the tuition also be allowed to claim the child as a dependent. Per the **Facts** given for **Question 14,** that could be accomplished if the custodial father signed Form 8332 (Release of Claim to Exemption for Child of Divorced Parents). Then the ex-wife/mother would be entitled to claim the HOPE credit on her 1998 return.

Caution. If your filing status is **Married filing separate return,** you **cannot** claim either the HOPE credit or the Lifetime Learning credit. [I.R.C. §25A(g)(6)]

Question 15. Facts. One of my clients (a married couple) bought EE U.S. Savings Bonds in 1990 in order to take advantage of the interest exclusion for a child's college tuition. The child will enter college in August 1998. The client will cash the EE bonds in 1998 to help pay the tuition.

Question. *Will the HOPE Credit that they claim on their 1998 return affect the calculation of the interest exclusion on the EE bonds?*

Answer 15. Yes. The exclusion of interest from Series EE U.S. savings bonds issued **after 1989** is allowed by I.R.C. §135(a). Form 8815 is used to calculate the allowable exclusion, which is shown on line 3 on Schedule B. The amount of the interest exclusion depends on the amount of college tuition and similar fees paid in 1998 **reduced by nontaxable educational benefits** and the 1998 modified AGI.

The 1997 TRA amended I.R.C. §135. **Prior** to 1998, **nontaxable educational benefits** included the portion of college tuition and similar fees covered by:

a. Scholarship or fellowship grants excludable under I.R.C. 117,
b. Veteran's educational assistance benefits,
c. Employer-provided educational assistance benefits that were not included in box 1 (wages of the W-2 form(s),
d. Payments, waivers, or reimbursements of educational expenses under a qualified state tuition program, and
e. Any other payments (but **not** gifts or inheritances) for educational expenses that were exempt for income tax by any U.S. law.

Beginning in 1998, the 1997 TRA added a new **reduction** in calculating the amount of tuition and similar fees that qualify for the exclusion of interest from Series EE U.S. savings bonds. I.R.C. §135(d)(2) was added by the 1997 TRA. This amendment **prevents** taxpayers from receiving a **double tax benefit** by claiming **both** the EE savings bond interest exclusion on the 1998 Form 8815 **and either** the HOPE credit or the Lifetime Learning credit for the **same** college expenses paid in 1998.

In summary, your clients (husband and wife) must **choose** which tax benefit they wish to utilize first on their 1998 return. It will probably be most beneficial for them to claim the HOPE credit first.

for college tuition and related expenses paid in 1998. Then report any remaining expenses on the 1998 Form 8815 to calculate the interest exclusion.

Note. See the blank 1997 Form 8815, which follows, for reference.

Form **8815**
Department of the Treasury
Internal Revenue Service

Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989
(For Filers With Qualified Higher Education Expenses)
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1173
1997
Attachment Sequence No. 57

Caution: *If your filing status is married filing separately, do not file this form. You cannot take the exclusion even if you paid qualified higher education expenses in 1997.*

Name(s) shown on return | Your social security number

1 (a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution	(b) Name and address of eligible educational institution

If you need more space, attach additional sheets.

2	Enter the total qualified higher education expenses you paid in 1997 for the persons listed in column (a) of line 1. See the instructions to find out which expenses qualify	2	
3	Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 1997 for the persons listed in column (a) of line 1. See instructions	3	
4	Subtract line 3 from line 2. If zero or less, **stop.** You **cannot** take the exclusion	4	
5	Enter the total proceeds (principal and interest) from all series EE U.S. savings bonds **issued after 1989** that you **cashed during 1997**	5	
6	Enter the interest included on line 5. See instructions	6	
7	**Is line 4 less than line 5?** **No.** Enter "1.00." **Yes.** Divide line 4 by line 5. Enter the result as a decimal (rounded to two places)	7	× .
8	Multiply line 6 by line 7	8	
9	Enter your modified adjusted gross income. See instructions (9) **Note:** *If line 9 is $65,850 or more ($106,250 or more if married filing jointly or qualifying widow(er)), **stop.** You **cannot** take the exclusion.*		
10	Enter $50,850 ($76,250 if married filing jointly or qualifying widow(er)) (10)		
11	Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14 (11)		
12	Divide line 11 by $15,000 (by $30,000 if married filing jointly or qualifying widow(er)). Enter the result as a decimal (rounded to two places)	12	× .
13	Multiply line 8 by line 12	13	
14	**Excludable savings bond interest.** Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3, or Schedule 1 (Form 1040A), line 3, whichever applies ▶	14	

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

If you cashed series EE U.S. savings bonds in 1997 that were issued after 1989, you may be able to exclude from your income part or all of the interest on those bonds. Use Form 8815 to figure the amount of any interest you may exclude.

Who May Take the Exclusion

You may take the exclusion if **all four** of the following apply:

1. You cashed qualified U.S. savings bonds in 1997 that were issued after 1989.
2. You paid qualified higher education expenses in 1997 for yourself, your spouse, or your dependents.
3. Your filing status is any status **except** married filing separately.
4. Your modified AGI (adjusted gross income) is less than $65,850 (less than $106,250 if married filing jointly or qualifying widow(er)). See the line 9 instructions to figure your modified AGI.

U.S. Savings Bonds That Qualify for Exclusion

To qualify for the exclusion, the bonds must be series EE U.S. savings bonds issued after 1989 in your name, or, if you are married, they may be issued in your name and your spouse's name. Also, you must have been age 24 or older before the bonds were issued. A bond bought by a parent and issued in the name of his or her child under age 24 does not qualify for the exclusion by the parent or child. **Bond information may be verified with Department of the Treasury records.**

Recordkeeping Requirements

Keep the following to verify the amount of interest you exclude:

• Bills, receipts, canceled checks, or other documents showing you paid qualified higher education expenses in 1997.

• A written record of each post-1989 series EE U.S. savings bond that you cash. Your written record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You may use **Form 8818,** Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989.

Specific Instructions

Line 1

Column (a).—Enter the name of the person who was enrolled at or attended an eligible educational institution. This person must be you, your spouse, or your dependent(s) claimed on line 6c of Form 1040 or Form 1040A. An **eligible educational institution** is a college, university, or vocational education school.

Column (b).—Enter the name and address of the institution. If the person was enrolled at or attended more than one, list all of them.

Line 2

Qualified higher education expenses include only tuition and fees required for the enrollment or attendance of the person(s) listed on line 1, column (a), at the institution(s) listed in column (b). They **do not** include expenses for:

• Room and board, or

• Courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.

Do not include on line 2 expenses that were covered by nontaxable educational benefits paid directly to, or by, the educational institution.

Line 3

Enter on this line the total qualified higher education expenses included on line 2 that were covered by nontaxable educational benefits. **Nontaxable educational benefits** include:

• Scholarship or fellowship grants excludable from income under section 117.

• Veterans' educational assistance benefits.

• Employer-provided educational assistance benefits that are not included in box 1 of your W-2 form(s).

• Payments, waivers, or reimbursements of educational expenses under a qualified state tuition program.

• Any other payments (but **not** gifts, bequests, or inheritances) for educational expenses that are exempt from income tax by any U.S. law.

Do not include on line 3 nontaxable educational benefits paid directly to, or by, the educational institution.

Example. You paid $10,000 of qualified higher education expenses in 1997 to the college your son attended. You claim your son as a dependent on line 6c of your 1997 tax return. Your son received a $2,000 nontaxable scholarship grant for 1997, which was paid directly to him. In this case, enter $10,000 on line 2 and $2,000 on line 3.

Line 6

Did you use Form 8818 to record bonds you cashed in 1997?

Yes. Enter on line 6 the amount from Form 8818, line 5.

No. Use the worksheet below to figure the amount to enter on line 6.

Worksheet—Line 6
(keep a copy for your records)

1. Enter the face value of all post-1989 bonds cashed in 1997 . . . . **1.** ________
2. Enter the amount from Form 8815, line 5 . **2.** ________
3. Multiply line 1 above by 50% (.50) . . . . **3.** ________
4. Subtract line 3 from line 2. This is the interest on the bonds. Enter the result here and on Form 8815, line 6 . . . . **4.** ________

Line 9

Follow these steps before you fill in the line 9 worksheet below.

Step	Action
1	If you received social security benefits, use **Pub. 915** to figure the taxable amount of your benefits.
2	If you made IRA contributions for 1997 and you were covered by a retirement plan at work or through self-employment, use **Pub. 590** to figure your IRA deduction.
3	Complete the following lines on your return if they apply. **IF you file Form... → THEN complete lines...** 1040 → 8b, 9–21, and 23–31 1040A → 8b, 9–13b, and 15
4	If any of the following apply, see **Pub. 550:** • You file **Form 2555** or **2555-EZ** (relating to foreign earned income), or **Form 4563** (exclusion of income for residents of American Samoa), • You have employer-provided adoption benefits for 1997, • You exclude income from Puerto Rico, or • You have investment interest expense attributable to royalty income.

Worksheet—Line 9
(keep a copy for your records)

1. Enter the amount from line 2 of **Schedule B** (Form 1040) or **Schedule 1** (Form 1040A) . **1.** ________
2. **Form 1040 filers,** add the amounts on lines 7, 9 through 14, 15b, 16b, 17 through 19, 20b, and 21. Enter the total. **Form 1040A filers,** add the amounts on lines 7, 9, 10b, 11b, 12, and 13b. Enter the total. } **2.** ________
3. Add lines 1 and 2 . . . . **3.** ________
4. Enter the amount from **Form 1040,** line 31, or **Form 1040A,** line 15 . . . . **4.** ________
5. Subtract line 4 from line 3. Enter the result here and on Form 8815, line 9 . . . . . **5.** ________

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 53 min.; **Learning about the law or the form,** 13 min.; **Preparing the form,** 35 min.; and **Copying, assembling, and sending the form to the IRS,** 34 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for Form 1040 or Form 1040A.

3

INCOME

Question 16. Facts. *Taxpayer bought an older home in 1993 for $45,000. While doing some electrical repairs in December, 1996, he found seven silver bars that appeared to have been placed in the walls when the house was built in the 1920s. The 1993 sales contract, of course, allocated nothing specifically to the unknown bars. The contract did state that everything on the property, including an old garage and shed, was being sold. The taxpayers sold the bars in March, 1997 for $3,500.*

Question. *What are the tax consequences?*

Answer 16.

Editorial Introduction. This may be the most interesting tax practitioner question ever received! The answer may be even more interesting and implausible than the question!

Answer. The taxpayer is required to report as ordinary income in 1996 the fair market value of the silver bars. That 1996 fair market value amount becomes the cost basis in the bars. When sold in 1997, the sale will be reported on the 1997 Schedule D as a short-term capital gain or loss. The authority is as follows.

a. **Rev. Rul. 53-61, 1953-1 CB 17.** "The finder of a **'treasure-trove'** is in receipt of taxable income, to the extent of its value in U.S. currency, for the taxable year in which it is reduced to **undisputed possession."**

Note. Treas. Reg. §1.61-14 contains the identical language as found in **Rev. Rul. 53-61.**

b. **Ermenegildo and Mary C. Cesarini V. United States of America**, U.S. Ct. of Appeals, 6th Cir. 70-2 USTC ¶9509 (1970).

In this case the taxpayers purchased a used piano at an auction sale for $15.00 in 1957. In 1964, while cleaning the piano, they found $4,467 in old currency. The $4,467 was held to be ordinary taxable income in 1964, the year it was reduced to their undisputed possession.

INTEREST EXPENSE

Question 17. Facts. A taxpayer operated a gasoline station as a sole proprietor. During 1998, he closed the business and took a salaried job. During the 10-year period he operated the business, he incurred debt for operating expenses. He is still paying on this past debt after closing the business.

Question. *Can he deduct the interest on this debt as a business interest on his 1998 Schedule C?*

Answer 17. Yes, pursuant to **Rev. Rul. 67-12.** This is **business interest**, because the loan proceeds were used to pay business expenses. This will result in an unusual 1998 Schedule C, as it will show little or no income. The 1998 Schedule C may show a substantial loss. If so, it is suggested that an explanatory statement be attached to the 1998 return.

Note. I.R.C. §163(a) allows interest deductions. Following is an excerpt from IRS Pub. #535 **(Business Expenses):**

> **Allocation of Interest.** The rules for deducting interest vary, depending on whether the loan proceeds are used for business, personal, home mortgage, investment, or passive activities. Loan proceeds and the related interest are allocated **based on the use of the proceeds.** The allocation is **not** affected by the **use** of property that secures the loan.
>
> **Example**. You secure a loan with property used in your business. You use the loan proceeds to buy an automobile for **personal use.** You must allocate interest expense on

the loan to personal use (purchase of the automobile), even though the loan is secured by business property.

MEDICAL SAVINGS ACCOUNTS

Question 18. *Is it correct that a self-employed person may establish a Medical Savings Account (MSA) for himself and not offer MSAs to his employees?*

Answer 18. Yes. A self-employed person who satisfies the 50-employee rule can establish an MSA for himself without offering them to employees. MSAs can be established by either employers or employees, and a self-employed person is considered an employee for purposes of an MSA. A qualifying employer has several options. He could choose:

A. To provide a high-deductible health plan and to establish and fund MSAs for all employees;

B. To provide a high-deductible health plan but leave the establishment and funding of MSAs up to employees; or

C. To provide neither and leave both health plan coverage and MSAs up to the employees.

A self-employed person who chooses option B or C can then establish his own MSA as a qualifying employee without contributing to MSAs for his employees. The high-deductible plan does not have to be a group plan. For more information, see IRS Notice 96-53 and Publication 969.

PASSIVE ACTIVITY LOSSES

Question 19. Facts. A single taxpayer has three sources of income in 1998: 1) Wages of over $200,000 from his regular job; 2) a $30,000 loss on an apartment building rental; and 3) a $20,000 net profit from a restaurant he owns in San Diego. He lives in St. Louis. His brother manages the restaurant and is paid a salary. The taxpayer does not materially participate in the restaurant, as neither the 500- nor 100-hour test is met, nor are any of the other material participation tests met. The brother does perform all of the management duties.

Question. *How should the “material participation” box (Line G) on the 1998 Schedule C be answered: yes or no?*

Answer 19A. It should be answered “no” (**Treas. Reg.** §1.469-5T and Instructions for Schedule C regarding Line G).

Question 19B. *Since the answer (Answer 19A) to my first question is “no,” does this permit the taxpayer to use the $20,000 restaurant net profit to partially offset the $30,000 rental real estate loss on the 1998 Form 8582 (Passive Activity Loss Limitations)?*

Answer 19B. Yes. $20,000 of the $30,000 rental real estate loss may be deducted on line 23 (Deductible rental real estate loss) on the 1998 Schedule E. See the completed 1998 Form 8582 that follows. The remaining $10,000 is **not** deductible, because the taxpayer does not qualify for the special allowance in Part II of Form 8582.

Note. The Medicare portion of self-employment tax will be owed on the $20,000 Schedule C net profit, because the material participation requirements are different for I.R.C. §1402 purposes than for I.R.C. §469 purposes. He owes only the Medicare portion, because his salary is $200,000. [**Treas. Reg.** §1.1402(a)-2(b)

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.

OMB No. 1545-1008
1998
Attachment Sequence No. 88

Name(s) shown on return | Identifying number

Part I **1998 Passive Activity Loss**
Caution: *See the instructions for Worksheets 1 and 2 on page 7 before completing Part I.*

Rental Real Estate Activities With Active Participation (For the definition of active participation see **Active Participation in a Rental Real Estate Activity** on page 3 of the instructions.)

1a Activities with net income (enter the amount from Worksheet 1, column (a))	1a			
b Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	( )		
c Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	( )		
d Combine lines 1a, 1b, and 1c			1d	30,000

All Other Passive Activities

2a Activities with net income (enter the amount from Worksheet 2, column (a))	2a			
b Activities with net loss (enter the amount from Worksheet 2, column (b))	2b	( )		
c Prior years unallowed losses (enter the amount from Worksheet 2, column (c))	2c	( )		
d Combine lines 2a, 2b, and 2c			2d	20,000
3 Combine lines 1d and 2d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c or 2c. **Do not** complete Form 8582. Take the losses to the form or schedule you normally report them on. If this line and line 1d are losses, go to line 4. Otherwise, enter -0- on line 9 and go to line 10			3	<10,000>

Part II **Special Allowance for Rental Real Estate With Active Participation**
Note: *Enter all numbers in Part II as positive amounts. See page 7 of the instructions for examples.*

4 Enter the **smaller** of the loss on line 1d or the loss on line 3			4	10,000
5 Enter $150,000. If married filing separately, see page 7 of the instructions	5	150,000		
6 Enter modified adjusted gross income, but not less than zero (see page 7 of the instructions)	6	200,000		
Note: *If line 6 is equal to or greater than line 5, skip lines 7 and 8, enter -0- on line 9, and then go to line 10. Otherwise, go to line 7.*				
7 Subtract line 6 from line 5	7			
8 Multiply line 7 by 50% (.5). **Do not** enter more than $25,000. If married filing separately, see page 9 of the instructions			8	
9 Enter the **smaller** of line 4 or line 8			9	0

Part III **Total Losses Allowed**

10 Add the income, if any, on lines 1a and 2a and enter the total	10	20,000
11 **Total losses allowed from all passive activities for 1998.** Add lines 9 and 10. See page 9 of the instructions to find out how to report the losses on your tax return	11	20,000

RETIREMENT PLANS

Question 20. *Can you use 10-year averaging on Form 4972 to figure the tax on conversion of regular IRAs to a Roth IRA in 1998?*

Answer 20. No. Ten-year averaging applies only to lump sum distributions from **qualified plans** for taxpayers born before 1936. In any case, ten-year averaging on Form 4972 was not and is not applicable to any kind of IRA distribution.

Question 21. *A self-employed taxpayer has 2 Keogh plans: a profit sharing plan and a money purchase plan. He was born in 1931. In order to use 10-year averaging on a lump-sum distribution, is it necessary that both plans be totally distributed to him in the same tax year? Or can one plan be distributed in lump-sum form one tax year and the other plan be handled similarly in the next tax year?*

Answer 21. Ten-year averaging is an **election** available to taxpayers. It is available only to taxpayers who elect it for **all** qualifying lump-sum distributions received in a **single tax year** from all of the **same employer's qualified plans of one kind.** [I.R.C. §402(d)(4)(B)] Also see the *T.F. Middleton* court case (DC Ala., 93-1 USTC ¶50, 150) for authority.

While **profit-sharing** and **money purchase** plans are both **defined contribution** plans, this does not affect 10-year averaging. The rules treat **profit-sharing** and **money purchase** plans differently. Qualifying plans for 10-year averaging are divided into two "baskets": (a) **stock bonus plans** and (b) **pension and profit-sharing plans,** rather than **defined contribution** and **defined benefit** plans.

If both plans are distributed in the **same** tax year, the taxpayer must elect averaging on **both** or use it for **either**. However, it is possible for the taxpayer to receive a lump-sum distribution from the **money purchase** plan in one year and **elect averaging,** then receive another lump-sum distribution from the **profit-sharing** plan in the **next year** and **roll it to an IRA.** (Or the ordering could be reversed.)

However, the election to average on Form 4972 is generally a once-in-a-lifetime-election, as explained by the following excerpt from the Instructions for Form 4972:

> **How Often You Can Choose. After 1986,** you may choose to use Form 4972 **only once** for each plan participant. If you receive **more than one** lump-sum distribution for the same plan participant in **one tax year,** you must treat **all** those distributions in the **same** way. Combine them on a single Form 4972.
> **Note.** An **earlier election** on Form 4972 for a lump-sum distribution received **before 1987** does not prevent you from making **another election** for a lump-sum distribution received **after 1986**. This is true **provided the participant was under age 59½ at the time of the pre-1987 distribution.**

Question 22. *I graduated from college in 1995. In 1998, can I receive a taxable distribution from my 401(k) plan at work to repay my large student loan and avoid the 10% early distribution penalty?*

Answer 22. No. That is not one of the allowable exceptions to the penalty. If the 401(k) plan permits loans, you may want to borrow from it to refinance your student loan if the 401(k) loan interest rate is lower than the student loan interest rate. However, if this is done, the 401(k) plan loan interest may not be deductible. Deduction of interest on Sec. 401(k) loans generally is prohibited by I.R.C. Sec. 72(p)(3). If the loan is secured by elective deferrals, the student loan interest deduction (adjustment to AGI) would be disallowed.

The 1997 TRA allows an "above-the-line" (deducted as an adjustment in arriving at AGI) for interest paid on a qualified student loan even if the loan was taken out before 1998. Regardless of when the original student loan was received, the interest payments can be deducted **only during the first 60 months** that interest payments are required. Refinancing the original student loan **does not extend the 60-month period.** The 60-month period is based on the original student loan (I.R.C. §221, as added by the 1997 TRA).

Note. The **maximum deduction** for student loan interest is $1,000 for 1998, $1,500 for 1999, $2,000 for 2000, and $2,500 for 2001 and later years. There is a phaseout of the deduction, which depends on the borrower taxpayer's modified adjusted gross income. See the 1997 TRA chapter for details.

Question 23. *Is there a minimum age restriction for Roth IRA contributions? Example. A 13-year-old teenager has $4,000 of summer wages.*

Answer 23. No. There are no age restrictions for Roth IRA contributions, neither minimum nor maximum. [I.R.C. §408A(c)(4)] Many financial planners recommend a Roth IRA for young workers. The advantage is the tax-free distributions of accumulated earnings, which could be substantial over a long period of time. This tax advantage is not available to owners of traditional IRAs.

Question 24. *Regarding traditional IRA contributions:*

Facts. *Both husband and wife are 62 and receive pension payments from their former employers. They both have part-time businesses that are profitable.*

Question. *Are they considered active participants for purposes of traditional IRA contribution deductions for tax years 1997 and 1998?*

Answer 24. No. The mere receipt of pension benefits is **not** considered active participation in an employer plan. Nor is the receipt of Social Security or Railroad Retirement benefits. [I.R.C. §219(g)(5)]

Question 25. *What are the options for a sole proprietor who does not wish to provide retirement plan coverage for his employees other than a traditional IRA?*

Answer 25.

Practitioner Caution. If a sole proprietor establishes a retirement plan for himself, the plan **must** cover all eligible employees.

A SIMPLE-IRA plan is worth considering, as it is relatively easy to administer and is fairly inexpensive for the self-employed owner. The owner is required to make either

1. deductible matching contributions equal to 3% of each eligible employee's compensation (limited to $6,000), or
2. deductible nonelective contributions equal to 2% of each eligible employee's compensation (limited to $3,200).

For sole proprietors who have several employees with average or low compensation, a SIMPLE-IRA plan can be considered.

Example. A sole proprietor has four employees, who each receive $30,000 of wages in 1998. Each employee elects to defer 5% of compensation to a SIMPLE-IRA for 1998. If the owner chooses to make **matching** rather than **nonelective contributions,** the cost to business owner in 1998 will be $3,600 ($900 per employee).

If the sole proprietor is in the 28% tax bracket, the $3,600 of deductible matching contributions he makes in 1998 will save him approximately $1,400 of income and self-employment taxes. Therefore, the after-tax cost to the business owner is approximately $2,200 for the $3,600 of matching SIMPLE-IRA employee contributions he makes in 1998.

Note. The employer's matching SIMPLE plan contribution limit remains at $6,000 per eligible employee for 1998. The employer's limit would reach $6,000 **only** for a highly paid employee, since the employer contribution cannot exceed 3 percent of the employee's salary. If, as in the above **Example,** an employee earns $30,000, the **maximum** employer contribution is $900. Even if the **employee** elected to defer the full $6,000, the **employer limit remains at $900.**

Question 26A. *Are there deadlines for adopting a SIMPLE plan?*

Answer 26A. Yes.

An **existing** employer may establish a SIMPLE plan effective on **any day between January 1 and October 1** of a year that begins after December 31, 1996, provided that the employer (or any other predecessor employer) did **not previously** maintain a SIMPLE plan.

A **new** employer (one that commences business after October 1) may establish a SIMPLE plan **as soon as administratively feasible** after the (**new**) employer comes into existence.

If an employer (or predecessor employer) **previously** maintained a SIMPLE plan, the employer may establish a SIMPLE plan effective **only** on January 1 of a year (IRS Notice 97-6, as shown on page 555 of the 1997 *Farm Income Tax Book*).

Note. See **IRS Notice 98-4** in the **What's New** chapter. It modifies and supersedes **IRS Notice** 97-6.

Question 26B. *Can a SIMPLE plan be set up after December 31, 1997 for the 1997 tax year (as allowed for traditional IRAs)?*

Answer 26B. No. See Answer 26A.

Question 27. Facts. A self-employed taxpayer establishes a SIMPLE plan in 1998. She has no employees. She contributes an "elective" $6,000 plus a "matching" $1,800 to her SIMPLE-IRA for the 1997 tax year.

Question. *I assume the $6,000 "elective" contribution will be deducted on line 28 (Keogh and self-employed SEP and SIMPLE plans) on the front page of her 1998 Form 1040. But what about the $1,800 "matching" contribution? Can it be deducted on line 19 (Pension and profit-sharing plans) on her 1998 Sch. C?*

Answer 27. No. The entire $7,800 will be deducted on line 28 on her 1998 Form 1040 as an adjustment in arriving at AGI. According to the 1997 Instructions for Schedule C, line 19 is for "deductions for contributions to a pension, profit-sharing, or annuity plan, or plans for the benefit of your **employees**. If the plan includes you as a self-employed person, enter contributions made as an employer **on your behalf on Form 1040, line 28, not on Schedule C**."

Question 28. *Will a Roth IRA qualified distribution be considered in calculating taxable Social Security benefits?*

Answer 28. Not yet. Several **editorial comments** follow.

- **a.** "Qualified distributions" from Roth IRA won't be made until the year 2003, because of the five-tax-year rule.
- **b.** Presently, the only **common** nontaxable income that is considered in calculating the taxable portion of a Social Security benefit is tax-exempt interest reported on line 8b on Form 1040.
- **c.** Present tax law is not guaranteed in the future. Congress can pass any tax legislation it desires at any time.

Question 29. *401(k) salary reductions are subject to FICA and Medicare taxes. Is this also true for an employee's elective salary reduction contribution to his or her SIMPLE IRA?*

Answer 29. Yes. An **employee's elective contribution** to his or her SIMPLE IRA are subject to FICA, Medicare, and FUTA taxes and must be properly reported on the employee's Form W-2. [I.R.C. §3121(a)(5)(H) and 3306(b)(5)(H)]

Note. However, the **employer's matching** (up to 3% of each employee's compensation) or **nonelective** (2% of each employee's compensation) contribution to the employee's SIMPLE IRA is **not** subject to FICA, Medicare, or FUTA taxes. [I.R.C. §§ 3121(a)(5)(H) and 3306(b)(5)(H)]

SALES OF PRINCIPAL RESIDENCES

Question 30. *Regarding the new exclusion ($250,000 or $500,000) for the gain on the sale of a principal residence for sales after May 6, 1998:*

Facts. *Bob, a single taxpayer, buys a home in January 1996 and lives in it alone for 1½ years. He then marries in July 1997 and transfers ownership to joint tenancy with his new spouse, who moves in with him. This ownership transfer occurs in September 1997. The house is sold one year later in July 1998. He obviously meets the two-year ownership and use tests. His spouse does not meet either of the two tests.*

Question. *How does this affect the exclusion?*

Answer 30. It is assumed that the married taxpayers will file a joint return for 1998. Since **both** spouses do **not** meet the two-year **use test** as of July 1998 when the house is sold, the gain exclusion is $250,000, even if a joint return is filed for 1998, because she does not meet the two-year use test. [I.R.C. §121(b)(2)(C)]

Notes:

1. If the ownership (or partial ownership) of a principal residence is transferred by one spouse to another spouse (or former spouse if the transfer was incident to a divorce), the transferee spouse is considered to **own** the residence during the period the transferor spouse owned it. This is referred to as the "tacking of holding periods" rule. [I.R.C. §121(d)(3)(A)] But it applies **only** to the two-year **ownership test.** Thus, under the **Facts** for **Question 30,** the wife (transferee spouse) has met only the two-year **ownership test** on the date of the sale in July 1998.
2. If the transfer to joint tenancy ownership had occurred **before August 5, 1997,** the new spouse **would be entitled to a prorated exclusion** based on the number of months she had **used** the home as her principal residence. **Since the transfer occurred in September 1997, she is entitled to no exclusion.** [I.R.C. §121(b)(2); see §6005(e)(1) of the IRS Restructuring and Reform Act of 1998 or I.R.C. §121(b)(2).]
3. **Exception to Notes #1 and 2 in divorce situations.** I.R.C. §121(d)(3)(B) provides a **special tacking rule** for the two-year **use test** in the case of a **divorce.** Use by the taxpayer's spouse or former spouse is treated as use by the taxpayer for purposes of meeting the two-year **use test** if the use is **granted under a divorce or separation instrument.** This **special tacking rule** makes it easier for the spouse who moves out of the house to qualify for the $250,000 exclusion.

Example for Note 3 (the exception). Jack and Jill **jointly owned** a residence in which they both lived until their divorce in March 1995. Jack was given the right to live in the house under their divorce decree and has lived in it since the divorce. Jill moved out of the house after the divorce. The house was sold in July 1998. The total gain on the sale was $450,000. One-half of the total gain, or $225,000, is allocated **each** to Jack and to Jill. Each files a single return for 1998. Each will be entitled to exclude their full $225,000 gain on their 1998 tax returns. Jack meets both the two-year **ownership and use tests.** Jill also meets **both tests,** as Jack's use of the house **after the divorce** is treated as Jill's use also.

Question 31. *Regarding the new $250,000 or $500,000 exclusion of gain on the sale of a principal residence:*

Facts. *A married couple moved out of their old principal residence, which they purchased on 8-26-92, and into a new home on May 3, 1994. The former residence was sold on August 25, 1997, for a gain of $280,000. The old home was used as a residence for more than three years, but it did not meet the use rule for two years out of the five-year period ending on the date of sale.*

Question. *Do they qualify for a reduced (prorated) exclusion for 1997?*

Answer 31. Yes. Since the taxpayers (husband and wife) owned the former residence on August 5, 1997, and sold it during the two-year period that begins on August 5, 1997, and ends on August 4, 1999, they are entitled to a reduced (prorated) exclusion.

The worksheet in IRS Pub. #523 **(Selling Your Home)** is helpful in making this prorated exclusion calculation. It is completed and shown below.

Reduced Exclusion

The maximum amount of gain you can exclude will be reduced if:

1) You owned a home on August 5, 1997, sold it before August 5, 1999, and did not meet the ownership and use tests, or

2) Due to a change in health or place of employment, you either:

a) Did not meet the ownership and use tests, or

b) Are excluding gain on the sale of another home after May 6, 1997.

Use this worksheet to figure your reduced exclusion.

Caution: *Complete column (b) only if you are married filing a joint return.*

		(a) You	(b) Your spouse
1.	Maximum amount	$250,000	$250,000
2a.	Enter the number of days that you used the property as a main home during the 5-year period ending on the date of sale. (If married filing jointly, fill in columns a and b.)	616 *	616
2b.	Enter the number of days that you owned the property during the 5-year period ending on the date of sale. (If married filing jointly and one spouse owned the property longer than the other spouse, both spouses are treated as owning the property for the longer period.)	1825	1825
2c.	Enter the smaller of line 2a or 2b.	616	616
3.	Are you (or your spouse if filing jointly) excluding gain from the sale of another home after May 6, 1997? No. Skip line 3 and enter the number of days from line 2c on line 4. **Yes.** If the other home was sold before this home, enter the number of days between the date of sale of the other home and the date of sale of this home. Otherwise, skip line 3 and enter the number of days from line 2c on line 4.		
4.	Enter the smaller of line 2c or line 3.	616	616
5.	Divide the amount on line 4 by 730 days. Enter the result as a decimal.	.8438	.8438
6.	Multiply the amount on line 1 by the decimal amount on line 5.	210,950	210,950
7.	Add the amounts in columns a and b of line 6. This is your reduced maximum exclusion. Enter it here and on Form 2119, line 25.	421,900	

* The 5-year period begins on 8-26-92 and ends on 8-25-97, the date of sale. During this period, the taxpayers lived in the home for 616 days, calculated as follows:

Year	*From*	*To*	*# of Days*
1992	Aug. 26	Dec. 31	128
1993	Jan. 1	Dec. 31	365
1994	Jan. 1	Aug. 25	123
Line 2a in worksheet			**616**

3

Notes.
1) The entire $280,000 gain on the sale of the former principal residence is excludable.
2) In this situation, the person responsible for the closing of the sale is not required to prepare a 1997 Form 1099-S if the taxpayers give written certification that the full gain is excludible from income under the new I.R.C. §121 rules.
3) A 1997 Form 2119 must still be filed, even though the gain is fully excludable and a 1997 Form 1099-S was not received by the taxpayers. See the completed 1997 Form 2119 that follows.
4) **Form 2119 has been eliminated for 1998.** Any 1998 recognized gain on the sale of a personal residence will be reported directly on the 1998 Schedule D.

3

Form **2119** Department of the Treasury Internal Revenue Service (U)

Sale of Your Home

▶ **Attach to Form 1040 for year of sale.**

▶ **See separate instructions.** ▶ **Please print or type.**

OMB No. 1545-0072

1997

Attachment Sequence No. 20

Your first name and initial. If a joint return, also give spouse's name and initial | Last name | Your social security number

If you are filing this form by itself and not with your tax return, see instructions on page 3. Present address (no., street, and apt. no., rural route, or P.O. box no. if mail is not delivered to street address) | Spouse's social security number

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

Part I Gain on Sale

1	Date your former main home was sold. If sold after May 6, 1997, see page 3 ▶	1	8 / 25 / 97 (mo day yr)
2	Have you bought or built a new main home?		☐ Yes ☐ No
3	If any part of either main home was ever rented out or used for business, check here ▶ ☐ and see page 3		
4	Selling price of home. Do not include personal property items you sold with your home	4	406,500
5	Expense of sale (see page 4)	5	16,500
6	Subtract line 5 from line 4	6	390,000
7	Adjusted basis of home sold (see page 4)	7	110,000
8	**Gain on sale.** Subtract line 7 from line 6. **If zero or less, stop** and attach this form to your return	8	280,000

- For sales **before May 7, 1997,** you must go to Part II or Part III, whichever applies. **But** if line 2 is "No," go to line 9.
- For sales **after May 6, 1997,** you must go to Part IV on the back to figure any exclusion. **But** if you qualify and elect to use the rules for sales before May 7, 1997, go to Part II or Part III, whichever applies.

9 If you haven't replaced your home, do you plan to do so within the **replacement period** (see page 1)? ☐ Yes ☐ No

- If line 9 is "Yes," stop here, attach this form to your return, and see **Additional filing requirements** on page 1.
- If line 9 is "No," you **must** go to Part II or Part III, whichever applies.

Part II **One-Time Exclusion of Gain for People Age 55 or Older**—By completing this part, you are electing to take the one-time exclusion (see page 2). If you are not electing to take the exclusion, go to Part III now.

10	Who was age 55 or older on the date of sale?		☐ You ☐ Your spouse ☐ Both of you
11	Did the person who was 55 or older own and use the property as his or her main home for a total of at least 3 years of the 5-year period before the sale? See page 2 for exceptions. If "No," go to Part III now		☐ Yes ☐ No
12	At the time of sale, who owned the home?		☐ You ☐ Your spouse ☐ Both of you
13	Social security number of spouse at the time of sale if you had a different spouse from the one above. If you were not married at the time of sale, enter "None" ▶	13	
14	**Exclusion.** Enter the **smaller** of line 8 or $125,000 ($62,500 if married filing separate return). Then, go to line 15	14	

Part III **Adjusted Sales Price, Taxable Gain, and Adjusted Basis of New Home**

15	If line 14 is blank, enter the amount from line 8. Otherwise, subtract line 14 from line 8	15	
	• If line 15 is zero, stop and attach this form to your return. • If line 15 is more than zero and line 2 is "Yes," go to line 16 now. • If you are reporting this sale on the installment method, stop and see page 4. • All others, stop and **enter the amount from line 15 on Schedule D, line 4 or line 11.**		
16	Fixing-up expenses (see page 4 for time limits)	16	
17	If line 14 is blank, enter amount from line 16. Otherwise, add lines 14 and 16	17	
18	**Adjusted sales price.** Subtract line 17 from line 6	18	
19a	Date you moved into new home ▶ ___ / ___ / ___ **b** Cost of new home (see page 5)	19b	
20	Subtract line 19b from line 18. If zero or less, enter -0-	20	
21	**Taxable gain.** Enter the **smaller** of line 15 or line 20	21	
	• If line 21 is zero, go to line 22 and attach this form to your return. • If you are reporting this sale on the installment method, see the line 15 instructions and go to line 22. • All others, **enter the amount from line 21 on Schedule D, line 4 or line 11,** and go to line 22.		
22	Postponed gain. Subtract line 21 from line 15	22	
23	**Adjusted basis of new home.** Subtract line 22 from line 19b	23	

Part IV **Exclusion and Taxable Gain for Sales After May 6, 1997**

24	Did you (or your spouse if filing a joint return) own and use the property as your main home for a total of at least 2 years of the 5-year period before the sale? See page 3 for exceptions		☐ Yes ☒ No
25	Maximum exclusion. See page 5 for the amount to enter	25	421,900
26	Enter the amount from line 6	26	280,000
27	**Exclusion.** Enter the **smaller** of line 25 or line 26. If line 26 is the smaller amount, stop and attach this form to your return. Otherwise, go to line 28	27	280,000
28	**Taxable gain.** Subtract line 27 from line 26	28	0
	• If you are reporting this sale on the installment method, see the line 15 instructions • All others, enter the amount from line 28 on **Schedule D, line 4 or line 11.**		

Sign here only if you are filing this form by itself and not with your tax return.	Under penalties of perjury, I declare that I have examined this form, including attachments, and to the best of my knowledge and belief, it is true, correct, and complete.
	Your signature ______ Date ______ Spouse's signature ______ Date ______ If a joint return, both must sign.

Question 32. *Does the "tacking" of holding periods for sales of principal residences for I.R.C. §1034 (rollover and deferral rule which was repealed by the 1997 TRA) purposes apply to sales after 5-6-1997? (refer to page 384 in the 1997 Farm Income Tax Book):*

Explanation of the 1997 TRA. For purposes of meeting the two-year ownership and use tests of I.R.C. §121 for sales of principal residences after May 6, 1997, the holding period of the residence for which gain is **rolled over** under the old I.R.C. §1034 rollover and deferral rules is tacked (added) to the holding period of the replacement residence. [I.R.C. §121(g)]

Question. *May you "tack" for more than the former principal residence to meet the two-year ownership and use tests? In other words, can you "tack" for the three previous homes rather than the immediate prior home if the taxpayers had used the old rollover and deferral rules for the three previous homes?*

Answer 32. Yes. IRS Pub #523 *(Selling Your Home)* gives the following explanation. "For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you owned and lived in the home (sold after May 6, 1997) on which you wish to exclude gain (using the new I.R.C. §121 exclusion rules). You can do this **if you postponed all or part of the gain on the sale of the previous home** (using the old I.R.C. §1034 rules) because of buying a replacement home on which you wish to exclude gain.

In addition, if buying the previous home enabled you to postpone all or part of the gain on the sale of a home **you owned earlier, you can also include the time you owned and lived in that earlier home.**

Question 33. *What prevents a building contractor from constructing a new principal residence every two years and then taking advantage of the new $250,000 (single) or $500,000 (married) exclusion?*

Answer 33. Nothing, as long as the contractor meets the two-year ownership and use tests. Every taxpayer is entitled to have a principal residence. However, it must qualify as the taxpayer's principal residence. A contractor is not penalized simply because he builds his own residence.

Caution. This practice had been prevalent before the passage of the 1997 TRA. Practitioners are cautioned that a frequent IRS exam issue for contractors is the disallowance of all direct and indirect expenses incurred for the construction of the house that becomes the contractor's residence. Those costs are not deductible on the business schedule if the house is used for personal purposes.

Question 34. Facts. Taxpayer's daughter lives in a home owned by her father for five years. The father lives in another home he owns.

Question 34A. *Does the daughter's use of the home constitute the father's use so that the sale by the father qualifies for the $250,000 exclusion?*

Answer 34A. No. The home owned by the father and occupied by his daughter will not meet the two-year **use test** required by I.R.C. §121(a).

Question 34B. *Can the father make a gift of the home to the daughter, therefore permitting the daughter to tack on the father's ownership period to hers in order for her to meet the two-year ownership test?*

Answer 34B. No. The father's holding period does **not** transfer to the daughter for the purpose of meeting the **ownership test**.

Question 35. Facts. A single taxpayer bought his first principal residence on Aug. 21, 1996 for $250,000. He made substantial improvements and did all the work himself. He incurred $15,000 in material costs for the improvements. Assume that he sells the home on Mar. 15, 1998, for $345,000.

Question. *Is any of the $80,000 gain taxable?*

Answer 35. No. The home was owned on Aug. 5, 1997, and was sold during the two-year period beginning Aug. 5, 1997, and ending Aug. 4, 1999. The prorated exclusion rule applies even though neither the two-year ownership nor use tests are met.

$$\frac{\text{\# of Days owned and used}}{\text{730 (\# of days in 2 yrs)}} \text{ or } \frac{572}{730} = 78.36 \times 250{,}000 = \$195{,}000 \text{ exclusion}$$

Note. See Question and Answer 31 on pages 87 and 88 for more information. [This is because of the transitional rule; see page 30 of IRS Pub. #523]

Question 36. Facts. Taxpayers (husband and wife) make a §1031 tax-free exchange in October, 1996. The replacement property received is rental real estate, a condo. In January, 1998, they sell their principal residence and move into the condo. They exclude the gain on the principal residence in 1998 using the new $500,000 exclusion.

Question 36A. *Are there any tax consequences as a result of the taxpayers moving into the condo in January, 1998?*

Answer 36A. No, other than the condo now becomes the principal residence.

Question 36B. *What are the tax consequences if the taxpayer sells the condo in 2000?*

Answer 36B. If the two-year use and ownership tests have been met and if the date of sale of the condo is more than two years after the date of sale of the original principal residence in January 1998, the $500,000 exclusion can be used again in 2000. (I.R.C. §121 (a) & (b))

SALES OF OTHER PROPERTY

Question 37. Facts. I own a 1951 Mercury auto, a 1959 Ford auto, and a 1952 Allstate motorscooter. I am going to sell the Mercury auto in 1998 and will realize a sizable gain. I think these assets meet the definition of "collectibles."

Question. *Will the gain on the sale of the 1951 Mercury be considered the sale of a "collectible" and therefore not eligible for the new lower 20% or 10% capital gain rates?*

Answer 37. We think the answer is yes. The difficulty lies in defining the term "antique." "Antique" autos appear to be included in the collectibles definition. IRS Pub. #544 *(Sales of Assets)* states the following regarding "collectibles:" "This is a work of art, rug, **antique,** metal, gem, stamp, coin, or alcoholic beverage held more than one year."

The term "collectible is defined by I.R.C. §408(m)(2), which deals with IRAs. In addition to the list shown above, I.R.C. §408(m)(2) includes as a collectible "any other tangible personal property specified by the Secretary." The 1997 TRA categorizes all long-term gains or losses on the sale of a collectible as a 28% rate transaction. The long-term definition for a "collectible" is "held more than one year." (1998 and later years.)

In Illinois, special antique auto plates can be obtained for a vehicle that is at least 25 years old. A 1951 Mercury would, we think, meet the I.R.C. §408(m)(2) definition of "any antique."

Question 38. Facts. A man owns a duplex which he bought in October 1987. He lives in one part of it and rents the other unit. The units are of equal value. He marries in May 1998. The man sells the duplex for a large gain in June 1998. The new wife sells her home at the same time and has a gain of $70,000. Then they purchase a new home in joint tenancy.

Question. *What is the tax consequence of this transaction?*

Answer 38. Regarding the duplex sale, this is a sale of two assets, the first a sale of a principal residence and the second a sale of rental property. The man's gain on the residence unit will be excluded using the $250,000 gain exclusion. The sale of the rental unit will be reported on the 1998 Form 4797, which flows to the 1998 Schedule D. Since the duplex was bought in 1987 and MACRS was used, any gain on the rental unit due to MACRS depreciation will be taxed at a maximum 25% tax rate. See the completed 1998 Form 4797 and Schedule D that follows.

The wife may exclude her $70,000 gain on the sale of her residence using the $250,000 exclusion rule.

Note. Since the duplex was purchased in 1987, there can be no I.R.C. §1250 ordinary income, as MACRS depreciation for real property utilizes the **straight-line method.** If the duplex had been purchased prior to 1987, any I.R.C. §1250 amount due to depreciation recapture would be taxed as ordinary income in Part II of Form 4797.

Form **4797**

Department of the Treasury (O)
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

~~1997~~ 8

Attachment Sequence No. 27

Name(s) shown on return | Identifying number

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1997 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 . . . 1

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year**

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) for entire year. Subtract (f) from the sum of (d) and (e)	(h) 28% RATE GAIN or (LOSS) * (see instr. below)
2							

3	Gain, if any, from Form 4684, line 39	3		
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4		
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5		
6	Gain, if any, from line 32, from other than casualty or theft	6	64,669	
7	Combine lines 2 through 6 in columns (g) and (h). Enter gain or (loss) here, and on the appropriate line as follows:	7	64,669	

Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, lines 6a and 6b. Skip lines 8, 9, 11, and 12 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7, column (g) is a gain and the S corporation is subject to the capital gains tax.

All others—If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	0	
9	Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):	9	64,669	

S corporations—Enter only the gain in column (g) on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others—If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below, and enter the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D.

* Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain. 28% rate gain or loss includes all gains and losses in column (g) from sales, exchanges, or conversions (including installment payments received) **either (a) before** 5/7/97 **or (b) after** 7/28/97 for assets held more than 1 year but not more than 18 months.

Part II **Ordinary Gains and Losses**

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11	Loss, if any, from line 7, column (g)	11	
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g) if applicable	12	
13	Gain, if any, from line 31	13	0
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18	Combine lines 10 through 17 in column (g). Enter gain or (loss) here, and on the appropriate line as follows:	18	
a	For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.		
b	For individual returns:		
	(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
	(2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	18b(2)	

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

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Duplex Rental Unit, 1428 Elm St. Clear Lake, IA	10-1-87	6-15-98
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	92,500			
21 Cost or other basis plus expense of sale	21	47,300			
22 Depreciation (or depletion) allowed or allowable	22	19,469			
23 Adjusted basis. Subtract line 22 from line 21	23	27,831			
24 Total gain. Subtract line 23 from line 20	24	64,669			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	0			
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	64,669
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	0
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6, column (g), and if applicable, column (h)	32	

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

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

1998

Attachment Sequence No. 12

Name(s) shown on Form 1040 | Your social security number

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)
1					

2 Enter your short-term totals, if any, from Schedule D-1, line 2	2		
3 **Total short-term sales price amounts.** Add column (d) of lines 1 and 2	3		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824		4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1997 Capital Loss Carryover Worksheet		6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) ▶		7	

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) *(see instr. below)
8						

9 Enter your long-term totals, if any, from Schedule D-1, line 9	9			
10 **Total long-term sales price amounts.** Add column (d) of lines 8 and 9	10			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824		11	64,669	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		12		
13 Capital gain distributions. See pages D-1 and D-6		13	7312	5678
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet		14	( )	( )
15 Combine lines 8 through 14 in column (g)		15		5678
16 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) ▶		16	71,981	

Next: Go to Part III on the back.

*__28% Rate Gain or Loss__ includes **all** "collectibles gains and losses" (as defined on page D-4) and part or all of the eligible gain on qualified small business stock (see page D-4).

3

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074
1998
Attachment Sequence No. **12**

Name(s) shown on Form 1040 | Your social security number

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)
1					

2 Enter your short-term totals, if any, from Schedule D-1, line 2	2		
3 **Total short-term sales price amounts.** Add column (d) of lines 1 and 2	3		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824		4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1997 Capital Loss Carryover Worksheet		6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f). ▶		7	

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN * or (LOSS) (see instr. below)
8						

9 Enter your long-term totals, if any, from Schedule D-1, line 9	9			
10 **Total long-term sales price amounts.** Add column (d) of lines 8 and 9	10			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824		11	64,669	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1		12		
13 Capital gain distributions. See pages D-1 and D-6		13	7312	5678
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet		14	( )	( )
15 Combine lines 8 through 14 in column (g)		15		5678
16 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). ▶		16	71,981	

Next: Go to Part III on the back.

***28% Rate Gain or Loss** includes **all** "collectibles gains and losses" (as defined on page D-4) and part or all of the eligible gain on qualified small business stock (see page D-4).

* In this case, line 22 in Part III Form 4797 (MACRS depreciation on the duplex rental unit)

Question 39. Facts. Mrs. A inherited 75 shares of stock on February 7, 1998. She sold 25 shares on March 15, 1998, another 25 shares on May 15, 1998, and the remaining 25 shares on August 15, 1998.

Question. *What are the holding periods for each sale?*

Answer 39. There is a special rule for inherited property. Heirs are automatically entitled to long-term capital gain treatment for inherited assets that are not considered as income in respect of a decedent (see I.R.C. §691). So the actual holding period for the inherited stock is immaterial in determining long-term capital gain treatment (I.R.C. §1223(11) and (12) and 1235(a)).

Note: In column (b) of Schedule D (the acquisition date), insert **"INHERITED"** instead of a date.

Question 40. *Regarding the new capital gain rules for sale of a business building:*

Question. Assume that a business building is sold after July 28, 1998 and has been held for more than 12 months. What is the **maximum** rate of tax on the gain attributable to the amount of the sales price that exceeds the original purchase of the building, 20% or 25%?

Answer 40. 20%, an explained with a hypothetical example.

Facts. Jane sells her retail store building in 1998. She is single. Her other 1998 income is $150,000. Therefore, her 1998 tax bracket is **above 28%** before considering the gain on the sale of the business building. Following are the facts regarding that sale.

Date of sale	October 15, 1998
Sales Price	$350,000
Expense of sale	$20,000
Purchase price in 1988 (31.5 year MACRS property)	$275,000
MACRS deductions on building	$92,400

Computation of Gain:

Sales price	$350,000
Less: Adjusted Basis ($275,000-$92,400 of MACRS)	(182,600)
Less: Expense of sale	(20,000)
Total Gain	**$147,400**

Jane's 1998 tax on the $147,400 gain is $34,100 as shown below.

1. Portion of gain due to MACRS (unrecaptured Section 1250 gain): $92,400 taxed at the maximum 25% rate equals	$23,100
2. Remaining portion of gain: $55,000 taxed at the maximum 20% rate equals	11,000
Jane's 1998 tax on the $147,400 gain	**$34,100**

Note. The sales price of $350,000 exceeded the original purchase price of $275,000 by $75,000. If there had been no expense of sale, that $75,000 would have been taxed at the 20% maximum rate. But the $20,000 expense of sale reduced the $75,000 to $55,000.

TRAVEL EXPENSE

Question 41. Facts. I have two clients who are NASCAR crew members. They receive W-2s from the driving team. They travel to various track sites where they spend about 3 days a week. They are not reimbursed for their meals and lodging. They both have regular jobs in Iowa where they live with their families.

Question. *Are they entitled to use the per diem allowances for both meals and lodging for their temporary NASCAR work assignments?*

Answer 41. No. The authority is **Rev. Proc. 97-59**, as explained in IRS Pub. #463 **(Travel, Entertainment, Gift, and Car Expenses).** They may use the standard meal allowance as an **alternative** to the actual cost method. However, there is **no optional standard lodging amount** similar to the standard meal allowance. Their allowable lodging expense deduction is their **actual cost.** Some additional comments follow.

a. For a self-employed person, the 1998 standard meal allowance is $32 a day for most areas in the United States and is slightly changed from the 1997 allowance.

b. Some locations are designated as high-cost areas, which qualify for a higher standard meal allowance of $40 a day. See **Rev. Proc. 97-59** for more information. These high-cost areas are listed in IRS Pub. 463 in Appendix A.

c. Only 50% of the standard meal allowance is deductible on Form 2106 or Form 2106-EZ or on Schedules C or F.

d. The standard meal allowance includes **incidental expenses** such as laundry, dry cleaning, and tips to food servers and luggage handlers. Incidental expenses do **not** include taxicab fares or the costs of telegrams or telephone calls.

e. The standard meal allowance may be used by **employees** or **self-employed taxpayers,** whether or not reimbursement is received.

Exception. The standard meal allowance cannot be used by an employee who is **related to the employer** as defined by I.R.C. §267(b).

f. Taxpayers who use the standard meal allowance must still keep records to prove the time, place, and business purpose of the travel.

VACATION HOMES

Question 42. Background Information. Regarding General Rule #1 for vacation homes when the dwelling unit **has been used as a home** (used for **personal** use more than the **greater** of (1) 14 days or (2) 10% of the total days rented to others at a fair rental price). General Rule #1 applies when the number of days rented at a fair rental price is **less than 15 days in the tax year**. If that is the case, the dwelling unit is **treated as a residence (home) and not as rental property**. However, any rental income received is excludable. Similarly, any expenses incurred during the period of temporary rental are not deductible. (See pages 93 and 94 of the 1997 *Farm Income Tax Book*.)

Question 42. *Do the loss disallowance rules for vacation homes (I.R.C. §280A) apply to timeshare condominiums?*

Answer 42. Yes, according to a decision reached in a Tax Court Memo case. [*Efrem Fudim v. Commissioner,* T.C. Memo 1994-235, 67 T.C.M. 3011 (1994) (CCH Dec. 49, 867(M)]. The Tax Court stated that "time share condominiums were **'dwelling units'** within the meaning of I.R.C. §280A(f)(1)(A)."

Question 42B. *If the timeshare is rented for 14 or fewer days and the owner does not use it for personal use during the year, is the rental income received tax-free (excludable)? (See pages 242 and 243 in the 1997 Farm Income Tax Book.)*

Answer 42B. No, for two reasons.

1. General Rule #1 applies only when the timeshare unit **has been used as a home**. The facts for **Question 42B** state that the time share was **not** used for personal use during the year. Therefore, the timeshare unit was **not used as a home**.

2. In order to prove that a dwelling unit has been **used as a home** during the year, a taxpayer must know the total number of days the timeshare unit was rented at a fair price and the total number of days used for personal use **for the entire year**, not just during the period the taxpayer had the right to use the unit. From a **practical standpoint,** this is nearly impossible to do, as implied in the *Fudim* TCM case:

"Neither petitioners nor any member of their family used their time share condominiums during the years in issue. However, section 280A(d)(2) also requires that petitioners show that no "other person who has an interest in such unit" used them during the taxable year. Because petitioners did not submit any evidence as to the use of the condominiums during the weeks other than their own, they have not shown that their condominiums were not used "for personal purposes by *** any other person who has an interest in such unit". ld. Accordingly, we hold that petitioners may not deduct their time share condominium losses.

Petitioners agrue that their interests in their time-share condominiums were property interests separate from those owned by the persons who had rights to use the condominiums during the other weeks of the year, and, therefore, the use of the condominiums during the other weeks of the year has no bearing on whether their dwelling units were used as a residence within the meaning of section 280A(d). While we agree that petitioners' time share interests were property interests separate from the interests held by other persons for the remaining weeks of the year, the statute requires that, in considering whether the dwelling unit was used for person purposes, we take into account use by all persons who have an *interest in such unit*. Sec. 280A(d)(2)(A). Accordingly, the statute requires that we examine how the condominiums were used for the entire taxable year, not just during petitioners' period of ownership. See sec. 1.280A-3(f)(3), Proposed Income Tax Regs., 45 Fed. Reg. 52406 (Aug. 7, 1980)."

Therefore, the rental income and all allocable expenses should be reported on Schedule E **if there is a net rental profit**. However, as explained in the *Fudim* TCM case, a net rental loss on the timeshare will be disallowed by I.R.C. §280A.

Note. The *Fudim* Tax Court Memo case is very enlightening, especially since there is so little information in the Code and Regulations concerning timeshare units.

Question 43. Facts. A former vacation home is no longer used for personal use and is up for sale. In 1998, the home was rented for 3 months.

Question. Are 100% of utilities and taxes deductible on the 1998 Schedule E or are only $\frac{3}{12}$ deductible?

Answer 43. They are fully deductible. Since the home was not used for personal use in 1998, it has **not been used as a home**. Therefore, all expenses on the home for 1998 are allocated to the 1998 Schedule E rental activity. Any net rental loss on the 1998 Schedule E is allowable in full subject to the passive loss limitation rules.

Note. Since the home was not used for personal use at all in 1998, the loss limitations of I.R.C. §280A do **not** apply. The home is treated as rental property. For a complete discussion of this issue, see pages 92–97 of the 1997 *Farm Income Tax Book*.

AG-RELATED QUESTIONS AND ANSWERS

§179 DEDUCTION: CROP-SHARE LANDLORDS—TILE

Question 1. *Can a materially participating crop-share landlord qualify for the I.R.C. §179 deduction on tile, grain storage facilities, fences, and concrete lots used in livestock production, or single-purpose livestock facilities? What about a non-materially participating landlord or a cash rent landlord?*

Answer 1. In order to claim a §179 deduction for qualifying property, the individual must be actively participating in a trade or business. In addition, if the person is a lessor, that individual may have to satisfy the noncorporate lessor requirements of §179.

Note: It is the author's and editor's opinion that the noncorporate lessor requirements of §179 were not intended to apply (and should not apply) to permanent improvements to land such as tile, grain storage facilities, fences, and single-purpose livestick facilities.

Non-materially participating landowner. This individual can actively participate in the trade or business of farming without materially participating and therefore still claim an I.R.C. §179 deduction without paying self-employment tax and/or losing Social Security benefits.

- The noncorporate lessor rules "may" also have to be satisfied in order for this person to claim a §179 deduction for the assets described above.
- **First**, the term of the lease must be less than 50 percent of the useful life of the property. *Peterson*, T.C. Memo 1982-442 indicated that the term of the lease is determined on a case-by-case basis after considering the facts and circumstances. Just because a lease is for a one-year term does not control. This is especially problematic when there are leases of qualifying property to related individuals and entities. However, even when there is a lease to an unrelated party, the IRS might argue that a longer lease term is implied than stated in the agreement [see *Hokanson*, T.C. Memo 1982-414]. Generally, if the lease is for a term that is less than 50% of the useful life of the property, to an unrelated party, and the taxpayer can establish that a termination could realistically occur at the end of the lease period, the terms of the lease will be respected by the IRS.
- **The other requirement of the noncorporate lessor provision** is that the I.R.C. §162 deductions with respect to the property must exceed 15% of the rental income produced by the property. Conceptually, this is difficult because tile, grain storage facilities, fences, and concrete lots are traditionally not separately leased but are premanent imporvements to the farmland leased on a crop-share basis. [This is one reason why it seems unlikely that the non-corporate lessor rules apply to these kind of assets.]

1. Crop-share rental agreements would almost always produce §162 deductions in excess of 15% of the rental income.
2. If single-purpose livestock facilities or grain storage facilities **were leased separately,** on a net lease arrangement, this test would be more difficult to meet.

Materially participating landowner. This individual meets the active participation test but "might" have to meet the noncorporate lessor requirements described above.

Landowner cash leasing. This taxpayer would have difficulty meeting both the active participation test and the noncorporate lessor test and would rarely qualify for a §179 deduction for the leased assets.

Question 2. *Can a farmer who purchased a tractor and leased it to an unrelated neighbor claim a §179 deduction?*

Answer 2. Not unless the noncorporate lessor requirements are met. **Noncorporate lessors** must meet one of the following requirements of I.R.C. §179(d)(5):

- **a.** The property subject to the lease has been manufactured or produced by the lessor, **or**
- **b.** The term of the lease is less than 50% of the depreciable life of the property and the lessor's §162 expenses are greater than 15% of the rental income during the first 12 months of the lease.

> **Note:** The tractor is clearly property that is subject to the noncorporate lessor rules.

DEPRECIATION

Question 2. *Regarding Problem 11 in the 1997 Individual and Small Business Problems chapter, "Catch-up" of Depreciation Utilizing Rev. Proc. 97-37 (pages 123-132 of the 1997 Farm Income Tax Book):*

Facts. The facts in the problem state that the taxpayer inherited 80 acres of farmland in 1990 and that the preparer omitted the subsurface drainage tile on the 1990-96 tax returns. **Rev. Proc. 97-37** was used to deduct the "catch-up" depreciation adjustment for 1990-96 on the 1997 Form 4835 (Farm Rental Income and Expenses).

Question. *How was the $11,200 depreciable cost of the tile arrived at? Was it via an appraisal at the time of death of the decedent in 1990? Or was it via an appraisal done seven years later in 1997?*

Answer 2. Neither. This issue of valuation of drainage tile on purchased or inherited farmland is difficult. See a thorough explanation on pages 11-12 of the 1995 *Farm Income Tax Book*. The facts in Problem 11 are not hypothetical. The Farm Income Tax School staff member who wrote Problem 11 visited the inherited 80 acres of his client. He knew there was tile on the land, as it drains into a drainage ditch. The **first step** in determining this issue is to ensure that there is indeed subsurface tiling.

The **second step** is to allocate the proper cost of inherited farmland to the tiling. As indicated previously, this can be a difficult and time-consuming allocation. The $11,200 allocated cost of the tile in Problem 11 was determined by multiplying the $160,000 estate tax value of the inherited 80 acres shown on Form 706 of the decedent by 7% ($16,000 × 7% = $12,600).

Notes:

1. There are many farming areas of the United States where subsurface drainage tile is rare or nonexistent. For example, tiling is not a necessity in the western Plains area due to sparse rainfall. Some farmland in the Cornbelt area of the Midwest does not contain tiling for various reasons including the fact that there is no logical location to terminate the tile line.
2. There are various ways to prove that there is depreciable subsurface tiling on purchased or inherited land.
   - **a.** Tile maps from the previous owner are helpful.
   - **b.** Depreciation schedules from the previous owner are helpful.
   - **c.** An infrared aerial photograph taken within 24-48 hours after a heavy spring rain will disclose tile lines.
   - **d.** Records including aerial photographs from the Soil Conservation Service office of the county USDA Service Center may occasionally be helpful.

3. The recent MSSP Audit Technique Guide (ATG) for Grain Farmers is silent on this issue. However, a previous IRS training manual for the examination of farm returns recommends that **absent hard facts and evidence,** the depreciable cost of tile for a purchased farm (with tile) should be **approximately 5% of the recent MSSP cost of the bare land.**

Question 3. Regarding earned income credit (EIC) and "disqualified income" from capital gains from the sale of raised breeding livestock (pages 5-6 and 257 of the 1997 *Farm Income Tax Book*).

Question. Would it be permissible for a farmer to report the sale of raised breeding sows held one year or more on Schedule F rather than in Part I of Form 4797? (The additional self-employment tax is more than offset by EIC.)

Answer 3. No. They are properly reported on Form 4797. In an IRS exam, the examiner would be required to switch the improper reporting of the sale of the sows from Schedule F to Form 4797. The results would be a decrease in self-employment income and a possible disallowance of the earned income credit.

ESTATE TAX PLANNING

Question 4. *Regarding the 1997 TRA relaxation of recapture of the tax benefits of the §2032A special use valuation when the heir(s) cash rent the farm to a family member (pages 395-96 in the 1997 Farm Income Tax Book).*

Facts. The father/farmer died in 1993. His wife died in 1990. His only remaining child inherited the farm. The estate elected the §2032A special use valuation for the farmland. The son actively farmed the inherited farm himself until 1997, when he cash rented the farm to an unrelated farmer.

Question. *Will this trigger recapture of the §2032A estate tax savings in 1997?*

Answer 4. Yes. The amendment to I.R.C. §2032A by the 1997 TRA is beneficial to **lineal descendants** (children, grandchildren, etc.) who cash rent the inherited farm to a **member of the family of the lineal descendant.**

Per the facts for **Question 4,** the son (the lineal descendant) cash rented the farm to an **unrelated** individual rather than to one of his family members. Therefore, qualified use of the farm ceases in 1997, and recapture is required (I.R.C. §2032A(c)(7) as amended by the 1997 TRA).

ESTIMATED TAX

Question 5. *In figuring the "two-thirds gross income from farming" test for estimated tax purposes, is the gain from sales of farm machinery reported on Form 4797 included in "total gross income from farming"?*

Answer 5. No. The only gains that would be included in "gross income from farming" are gains (but not losses) from the sale of **livestock** used for a draft, breeding, sport, or dairy purposes reported on Form 4797.

FICA TAX

Question 6. *Is the employee share of FICA and Medicare tax paid by a farmer on behalf of his agricultural employee a noncash wage and therefore not subject to FICA and Medicare taxes?*

Answer 6. Yes. The amount must be included in box 1 of the employee's Form W-2. It is considered addition compensation. It is **not,** however, considered a cash wage for FICA and Medicare (boxes 3 and 5 on Form W-2) or federal unemployment tax (Form 940 or 940-EZ) purposes (IRS Publication 225, *Farmer's Tax Guide*).

INCOME AVERAGING

Question 7. *Regarding income averaging for farmers that is available for the years 1998, 1999, and 2000.*

Facts. A married farmer has a 1998 Schedule F net profit of $15,000. His wife has 1998 off-farm wages of $60,000.

Question. *Since the majority of their joint 1998 taxable income is attributable to the wife's wages, will the farmer be entitled to use Income Averaging for 1998?*

Answer 7. Yes, however only the **"elected farm income"** is eligible for averaging. [I.R.C. §1301(b)(1)] The wife's $60,000 wages will not qualify for averaging. See the Agricultural Issues chapter for an extensive discussion of this issue.

INCOME IN RESPECT OF DECEDENT

Question 8. Regarding the *Gavin* Court of Appeals case on page 514 of the *1997 Farm Income Tax Book*.

The court held that where there was no material participation by a cropshare landlord, the crops were income in respect of a decedent (IRD).

Question. *Where is the subsequent sale of the crops reported: on the decedents' final Form 1040, or on the fiduciary tax return (Form 1041)?*

Answer 8. IRD by I.R.C. §691 definition is income received after the date of death of the decedent. The subsequent sale of a decedent landlord's cropshare is reported on the income tax return of the beneficiary or heir who sells the cropshare. The sale could be reported on the fiduciary return (Form 1041) or on the heir's return (Form 1040).

Note. The *Gavin* Court of Appeals case held that cropshare income of a non-materially-participating cropshare landlord is income in respect of a decedent. As such, whoever subsequently sells the cropshare is **not** entitled to a step-up in basis under I.R.C. §1014 to its fair market value on date of death. The basis of the cropshare will normally be zero.

However, the opposite is true in the case of a materially participating cropshare landlord who reports farm rental income and expenses on **Schedule F** rather than on Form 4835. In that case, a fair market value at date of death step-up in basis is allowed to the beneficiary who subsequently sells the decedent's cropshare. This is a very important issue. It is also one that is misapplied frequently.

JOINT OWNERSHIP

Question 9. *Three neighbors decide to buy a $90,000 combine together in 1998. Each writes out his own check for $30,000. They each own one-third of the combine. They aren't related and don't farm together as a partnership. Each has his own separate and distinct farming operation.*

Is each entitled to claim the maximum I.R.C. §179 deduction in the year of purchase, or do they have to split the $18,500 ($5,833.33 each)?

Answer 9. Each is entitled to the maximum $18,500 §179 deduction. This is co-ownership of an asset by three individuals. They each own one-third of a single asset. A written agreement among them stating this is not a joint venture or partnership is advised.

PARTNERSHIP

Question 10. *Two brothers farm together in an informal family farm joint venture. There is no written partnership agreement. They split all income and expenses. Do they have to file a partnership return, Form 1065?*

Answer 10. Technically, yes. "A partnership is the relationship between two or more persons who join together to carry on a trade or business. For federal income tax purposes, the term "partnership" includes a syndicate, group, pool, joint venture, or similar organization that is carrying on a trade or business and is **not** classified as a trust, estate, or corporation" (IRS Publication 541, *Tax Information on Partnerships*).

However, the "failure to file a partnership return" penalty can be waived under the following circumstances:

1. Reasonable cause for failure to file a complete or timely partnership return can be shown.
2. For certain small partnerships with 10 or fewer partners, the reasonable cause test is met if **all** of the following conditions apply:
   a. Each partner is a natural person (other than a nonresident alien) or an estate,
   b. Each partner's share of each partnership item is the same as his or her share of every other item, and
   c. All partners have fully reported their shares of partnership income, deductions, and credits on their **timely filed individual** income tax returns (Rev. Proc. 84-35, 1994-1 C.B. 509)

Conclusion. Even though there is a technical requirement to file a federal partnership return, the penalty for failure to do so can be waived if **each** partner (the two brothers, in this case) reports his or her share of the joint venture income, deductions, and credits properly on a **timely filed** individual Form 1040. The Revenue Procedure is substantial authority and can be used by taxpayers and practicioners to thwart an IRS determination that a partnership return **must** be filed and that failure-to-file penalties are applicable.

MEALS DEDUCTION

Question 11. *Regarding the 1997 TRA clarification of de minimis no-charge employee meals (pages 421-22 of the 1997 Farm Income Tax Book):*

Facts. A farmer's wife buys food at a fast food restaurant in the fall of 1998 and takes it to the field during the busy harvest season for several farm employees to eat.

Question. *Will the 50% limitation on the cost of the meals still apply in 1998? Or will 100% of the cost of the meals be deductible?*

Answer 11. 50% will be deductible. The clarification made by the 1997 TRA applies to I.R.C. §132(e)(2) no-charge employee meals furnished by the employer as a de minimis fringe benefit for the convenience of the employer. I.R.C. §132(e)(2) applies only to employer-operated **eating facilities** such as company cafeterias.

The eating of meals in the field by the farmer's employees does not constitute an **eating facility**. Therefore, the clarification made by the 1997 TRA does not apply.

RETIREMENT PLANS

Question 12. Facts. A farmer, filing a joint return, adopted a 15% profit-sharing SEP plan in 1994. He has no employees. His 1998 Sch. F net profit is $70,000. He is married and files a joint 1998 Form 1040.

Question 12A. *May he make a 1998 SEP-IRA contribution of $8,485 [$70,000 – $4,945 (1/2 of S-E tax) × .130435] and also make a 1998 $2,000 Roth IRA contribution?*

Answer 12. Yes, assuming the Roth IRA AGI limitation of $150,000 for joint return filers is not exceeded.

Note. Roth IRA contributions are not affected by contributions to a SEP-IRA or to a SIMPLE IRA as they are not considered to be other "individual retirement plans" (I.R.C. §408a(f) as amended by the Technical Corrections Bill).

Active participation in a qualified employer plan such as a SEP plan or a SIMPLE plan has no affect on the eligibility to establish and contribute to a Roth IRA.

Question 12B. May he make a 1998 SEP-IRA contribution of $8,485 and also make a 1998 $2,000 deductible regular IRA contribution?

Answer 12B. *Probably not. The SEP-IRA is a qualified plan, and the AGI limitation may eliminate the IRA contribution deductibility.*

TIMBER SALES

Question 13. Facts. Taxpayer, a farmer, bought 120 acres of farmland in 1943. At that time, there was a grove of small walnut trees on 5 of the acres. The sales contract did not allocate any of the sales price to the trees. The mature trees were sold via a lump sum contract in 1998 for $45,000 to a timber company. This is the first and last timber sale the farmer will ever make.

Question 13A. *Where should this sale be reported on the 1998 return? On Schedules F and SE? On Schedule D?*

Answer 13A. In Part II (long-term capital gain) on the 1998 Schedule D. Standing timber held as **investment property** is a capital asset. The tax treatment is governed by I.R.C. §1221. The facts indicate that the timber was **not** held primarily for sale to customers.

Question 13B. *What is the allowable cost basis? I assume zero.*

Answer 13B. Two factors are against the taxpayer in arguing that he is entitled to a cost basis in the trees.

- **a.** The trees were young when purchased in 1943 and probably had little if any value.
- **b.** The sales contract did not allocate any of the purchase price to the trees.

See pages 76-77 of the 1997 *Farm Income Tax Book* for a discussion of retroactively establishing the basis of timber.

In summary, our best guess is that most IRS examiners would conclude, based on the given facts, that the taxpayer's basis in the walnut trees sold in 1997 is zero.