2000 Income Tax School

INDIVIDUAL TAXPAYER ISSUES

ISSUE 1: PLANNING FOR HIGH-TAX-BRACKET CLIENTS

The obvious advice to high-income taxpayers is to delay the recognition of income and to accelerate deductions. Several methods of accomplishing this are offered as planning suggestions.

PLANNING SUGGESTION 1: MAXIMIZING INVESTMENT INTEREST EXPENSE DEDUCTION

If your client incurs investment interest expense that exceeds ordinary investment income, it is generally advantageous to make the election to include all or part of net capital gain from investment property in investment income. This election is made on line 4e of Form 4952, Investment Interest Expense Deduction.

With the increased stock market activity, you may have clients who pay margin interest to their brokers. If they also have net gains from selling stock in 2000, making the election on line 4e of Form 4952 will generally produce tax savings. For taxpayers in the **28% and higher tax brackets who itemize deductions**, the tax savings equal **20% of the amount elected**. This assumes that the increase in the investment interest deduction (line 13, Schedule A) equals the capital gain amount **elected** to be included in investment income (line 4e, Form 4952).

Practitioner Note. This planning strategy is most effective when the total of interest, dividend, and annuity income (line 4a, Form 4952) is equal to or less than net capital gain income from sale of investment property such as stocks (line 4c, Form 4952).

Example. Ryan and Carrie file jointly, have no dependents, and itemize deductions. They paid $3,000 of margin interest in 2000. Their 2000 income is

Income

Wages	$150,000
Interest and dividend income	2,000
Long-term capital gains on stock sales	46,000
Short-term capital loss on stock sales	(6,000)
Adjusted gross income for tax year 2000	**$192,000**

They make the election on line 4e of Form 4952 to include $1,000 of their $40,000 net capital gain as investment income. This permits inclusion of the entire $3,000 of margin interest on Schedule A.

They have no other deductible investment expenses. Their Form 4952 is completed as follows:

Form **4952**

Department of the Treasury
Internal Revenue Service (99)

Investment Interest Expense Deduction

► Attach to your tax return.

OMB No. 1545-0191

2000

Attachment Sequence No. **72**

Name(s) shown on return	Identifying number
Ryan and Carrie	

Part I — Total Investment Interest Expense

1	Investment interest expense paid or accrued in 2000. See instructions			1	*3,000*
2	Disallowed investment interest expense from 1999 Form 4952, line 7			2	
3	**Total investment interest expense.** Add lines 1 and 2			3	*3,000*

Part II — Net Investment Income

4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)			4a	*2,000*
b	Net gain from the disposition of property held for investment	4b	*40,000*		
c	Net capital gain from the disposition of property held for investment	4c	*40,000*		
d	Subtract line 4c from line 4b. If zero or less, enter -0-			4d	*0*
e	Enter all or part of the amount on line 4c, if any, that you elect to include in investment income. Do not enter more than the amount on line 4b. See instructions ▶			4e	*1,000*
f	Investment income. Add lines 4a, 4d, and 4e. See instructions			4f	*3,000*
5	Investment expenses. See instructions			5	*0*
6	**Net investment income.** Subtract line 5 from line 4f. If zero or less, enter -0-			6	*3,000*

Part III — Investment Interest Expense Deduction

7	Disallowed investment interest expense to be carried forward to 2001. Subtract line 6 from line 3. If zero or less, enter -0-	7	*0*
8	**Investment interest expense deduction.** Enter the **smaller** of line 3 or 6. See instructions	8	*3,000*

Because their 2000 AGI exceeds $128.950, their itemized deductions are limited. Their completed Itemized Deductions Worksheet from the Form 1040 instructions and Schedule A are shown next.

Itemized Deductions Worksheet—Line 28

Keep for Your Records

1. Add the amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, and 27 . . . . . 1. *31,700*
2. Add the amounts on Schedule A, lines 4, 13, and 19, plus any gambling and casualty or theft losses included on line 27 . . . . . 2. *3,000*

CAUTION Be sure your total gambling and casualty or theft losses are clearly identified on the dotted line next to line 27.

3. Is the amount on line 2 less than the amount on line 1?

☐ **No.** STOP Your deduction is not limited. Enter the amount from line 1 above on Schedule A, line 28.

☐ **Yes.** Subtract line 2 from line 1 . . . . . 3. *28,700*

4. Multiply line 3 above by 80% (.80) 4. *22,960*
5. Enter the amount from Form 1040, line 34 . . . . . 5. *192,000*
6. Enter: $128,950 if single, married filing jointly, head of household, or qualifying widow(er); $64,475 if married filing separately 6. *128,950*
7. Is the amount on line 6 less than the amount on line 5?

☐ **No.** STOP Your deduction is not limited. Enter the amount from line 1 above on Schedule A, line 28.

☒ **Yes.** Subtract line 6 from line 5 . . . . . 7. *63,050*

8. Multiply line 7 above by 3% (.03) 8. *1,892*
9. Enter the **smaller** of line 4 or line 8 . . . . . 9. *1,892*
10. **Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 28. . . . . . 10. *29,808*

16

SCHEDULES A&B (Form 1040) Department of the Treasury Internal Revenue Service (99)	Schedule A—Itemized Deductions (Schedule B is on back) ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).	OMB No. 1545-0074 2000 Attachment Sequence No. 07

Name(s) shown on Form 1040: *Ryan and Carrie*

Your social security number

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-1)	1			
	2	Enter amount from Form 1040, line 34 [2]				
	3	Multiply line 2 above by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	
Taxes You Paid (See page A-2.)	5	State and local income taxes	5	*7,500*		
	6	Real estate taxes (see page A-2)	6	*8,200*		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	*15,700*
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	*12,000*		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13	*3,000*		
	14	Add lines 10 through 13			14	*15,000*
Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	15	*1,000*		
	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **MUST** attach Form 8283 if over $500	16			
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	*1,000*
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19	
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You **MUST** attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶	20			
	21	Tax preparation fees	21			
(See page A-5 for expenses to deduct here.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23			
	24	Enter amount from Form 1040, line 34 [24]				
	25	Multiply line 24 above by 2% (.02)	25			
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26	
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			27	
Total Itemized Deductions	28	Is Form 1040, line 34, over $128,950 (over $64,475 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 36. ☒ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶			28	*29,808*

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2000**

Making the Form 4952 election increases their itemized deductions and thus reduces their taxable income by $1,000. Their 2000 Form 1040 will show

Adjusted gross income	$192,000
Less: Itemized deductions	(29,808)
Less: Personal exemptions (2 × $2,800)	(5,600)
Taxable income	**$156,592**

Without the election, the itemized deductions would be $28,808 and taxable income $157,592.

Ryan and Carrie are in the 31% tax bracket. Their tax is computed using Schedule D, Part IV. With the election, the tax is $35,375. Without it, the tax would be $35,575. **The tax saved is $200, or 20% of the $1,000 amount elected on line 4e, Form 4952.**

Practitioner Note. Ryan and Carrie are not liable for alternative minimum tax since their regular tax exceeds their tentative minimum tax. However, a lower tentative minimum tax (TMT) also is achieved through the election: Without the election, the TMT is $33,675; with it, the TMT is $33,410, a difference of $255. This can affect the use of any business credits.

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Practitioner Note. See pages 341–351 in the 1999 *Farm Income Tax Book* for more details on investment interest. When reviewing page 349, be advised of the following corrections, which are previously identified in the *What's New Supplement* dated December 18, 1999:

Line	Shown	Correction
4e	Blank	$1,250
4f	$1,600	2,850
6	1,600	2,850
7	4,400	3,150
8	1,600	2,850

PLANNING SUGGESTION 2: TAX-FREE PARTIAL EXCHANGE OF ANNUITY

Facts. Barbara purchased a deferred fixed annuity from Ajax Insurance Company in 1995 for $125,000. Due to a decrease in the annuity interest rate and a booming stock market, Barbara asks you if she can switch from the fixed annuity to a variable annuity with a mutual fund company. Following are the facts concerning the Ajax annuity contract as of March 1, 2000.

Initial purchase price in 1995	$125,000
Earnings from date of purchase to Mar. 1, 2000	48,763
Total contract value before surrender charge	$173,763
Less: Surrender charge (expires July 23, 2002)	(5,000)
Net contract value if surrendered on March 1, 2000	**$168,763**

Barbara wants to exchange $100,000 of the Ajax fixed annuity for a variable annuity in the Telecom Fund with the Advantage group of mutual funds.

Question 1. Can Barbara make a $100,000 exchange tax-free under the nonrecognition rules of I.R.C. §1035(a)(3) (exchanges of annuity contracts)?

Answer 1. Yes, per the *Conway* Tax Court (111 T.C. No. 20) decision issued in 1998. The IRS argued in that case that only an entire exchange qualified for tax-free status. The Tax Court disagreed, and the IRS announced in late 1999 that it will follow the holding.

Question 2. How should Barbara handle this exchange?

Answer 2. She should contact the Advantage mutual fund company and request a Section 1035 exchange form. After it is properly completed and returned, a $100,000 check will be issued by Ajax directly to Advantage to establish the variable annuity in the Telecom Fund.

Practitioner Caution. The Security and Exchange Commission (SEC) issued a warning to individuals considering an exchange of variable annuities under I.R.C. §1035 in June 2000. This information is available on the "Investor Assistance" section of the SEC web site at www.sec.gov.

Editorial Comment. When distributions are received from annuity contracts, they are taxed as **ordinary income**. Capital gain treatment is not permitted. Instead of purchasing a variable annuity with the insurance arm of a mutual fund company, your client may decide to buy and hold a stock mutual fund. Capital gain distributions are taxable whether or not reinvested, but the sale of all shares several years later may result in favorable long-term capital gain treatment.

Practitioner Note. Many insurers have issued 1997, 1998, and 1999 Forms 1099-R to incorrectly report taxable gain on partial exchanges of annuities. The IRS announced its acquiescence to the *Conway* Tax Court decision in November 1999. Subsequently, some insurers issued corrected 1099-R forms to show zero as the taxable amount in box 2a of the corrected Form 1099-R. If you have any clients who reported gains from the partial exchange of annuities in an open year, amended returns can be filed.

PLANNING SUGGESTION 3: DONATION OF APPRECIATED PROPERTY

If your client itemizes deductions, owns appreciated assets such as stock, and regularly gives to charitable organizations, your client should consider donating the appreciated stock rather than giving cash.

Example. Doug, who is a 65-year-old bachelor, meets the criteria discussed above. He owns 1,600 shares of Walgreen common stock, which he inherited from his father in 1960.

Facts Regarding the Walgreen Shares

Number of shares Doug initially inherited	200
Date-of-death value ($60 per share)	$12,000
Number of shares Doug owns in 2000 (four 2-for-1 splits)	1,600
Present cost basis per share ($12,000 ÷ 1,600)	$ 7.50

Instead of giving cash to his church in 2000, Doug decides to give 200 shares of Walgreen stock.

Facts Regarding the Stock Donation

Date of donation (certificate for 200 shares given to church treasurer)	June 13, 2000
High Walgreen stock reached on June 13, 2000	$28 9/16
Low Walgreen stock reached on June 13, 2000	$28
Median price of Walgreen stock on June 13, 2000	
($28.5625 + 28 = 56.5625 \div 2 = 28.28$)	$28.28
Amount of Doug's contribution (200 shares × $28.28)	$5,656

Summary. Doug is entitled to a $5,656 contribution deduction. Form 8283 (Noncash Charitable Contributions) must be prepared. Only Part I (Information on Donated Property) of Form 8283 must be completed. Other parts of the form are not required for publicly traded stock.

The $5,656 deduction is limited to **30%** of Doug's 2000 AGI. If Doug makes no other charitable contributions in 2000 and his 2000 AGI exceeds $18,852, he is entitled to deduct the entire $5,656 on line 16, Schedule A ("other than by cash or check").

Practitioner Note. The most foolish thing Doug could do taxwise is sell the 200 shares on June 13, 2000, pay the capital gains tax, and then donate cash to his church. Doug's gain on the sale of 200 shares would be $4,175 without commissions. If Doug's 2000 taxable income exceeds $26,250, the $4,175 gain would result in $835 of tax (20% of gain).

Form **8283** (Rev. October 1998)
Department of the Treasury
Internal Revenue Service

Noncash Charitable Contributions

▶ **Attach to your tax return if you claimed a total deduction of over $500 for all contributed property.**

▶ **See separate instructions.**

OMB No. 1545-0908

Attachment Sequence No. **55**

Name(s) shown on your income tax return | **Identifying number**

Note: *Figure the amount of your contribution deduction before completing this form. See your tax return instructions.*

Section A—List in this section **only** items (or groups of similar items) for which you claimed a deduction of $5,000 or less. Also, list certain publicly traded securities even if the deduction is over $5,000 (see instructions).

Part I **Information on Donated Property—**If you need more space, attach a statement.

1	**(a)** Name and address of the donee organization	**(b)** Description of donated property
A	*First Baptist Church Pewee Valley, KY 40056*	*200 shares Walgreen common stock*
B		
C		
D		
E		

Note: *If the amount you claimed as a deduction for an item is $500 or less, you do not have to complete columns (d), (e), and (f).*

	(c) Date of the contribution	**(d)** Date acquired by donor (mo., yr.)	**(e)** How acquired by donor	* **(f)** Donor's cost or adjusted basis	**(g)** Fair market value	**(h)** Method used to determine the fair market value
A	*June 13, 2000*	*July 15, 1960*	*Inherited*		*5,626*	*median value on 6/13/2000*
B						
C						
D						
E						

*Column (f) is not completed when the donation is publicly traded stock held 12 months or more (Form 8283 Instructions)

PLANNING SUGGESTION 4: ALTERNATING STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

If your client itemizes deductions and consistently has deductions only slightly exceeding the standard deduction, consider "doubling up" on itemized deductions every other year and take the standard deduction in other tax years. This will necessitate making charitable contributions every other year at twice the annual rate, or "doubling up."

Whether a taxpayer can "double up" on real estate taxes on personal residences is difficult to answer. State law controls. Many states assess and collect real estate taxes in the same calendar year. Others, including Illinois, assess on January 1 but don't collect until the following calendar year.

Example. Sam and Virginia live in Illinois. They receive their 1999 real estate bill from the county treasurer for their home in June 2000. They pay the 1999 tax of $3,500 in 2000 and can deduct it on their 2000 Schedule A on line 6. If they attempt to prepay their 2000 real estate taxes on December 31, 2000, the county treasurer will **not** accept payment due to state law. Therefore, they cannot "double up" on real estate taxes in 2000.

Practitioner Note. If Sam and Virginia lived in a state that did accept their check for prepayment of 2000 real estate taxes, the payment would be deductible on their 2000 Schedule A.

In the years itemized deductions are claimed, clients should make estimated state income tax payments before year end to fully cover their current year's state income tax liability. Any payments due in January–March of the following year (when the standard deduction will be claimed) should be accelerated to December of the current year.

Prepaid state and local income tax estimates are deductible if there is a **good faith determination** that the taxes are owed, even if they are later refunded (Rev. Rul. 71-190). They are **not** deductible if there is no expected state liability (Rev. Rul. 82-208). Thus, a client cannot deduct a December 2000 state tax estimated payment for 2000 that he expects to carry forward to 2001. State estimated tax penalties should be considered in determining if a client should delay payment of state taxes for one year until the following January.

Prepaid interest is not deductible. I.R.C. §461(g) requires that prepaid interest be capitalized and deducted in the period to which it is allocable. The exception is points paid for acquisition or improvement of a principal residence.

Medical and dental expenses generally are deductible in the year paid, but payments for future services are **not** deductible if there is no legal obligation when the payment is made [Treas. Reg. §1.213-1(a)]. Some planning is possible by shifting appointments from January to December (or vice versa) and timing the bulk purchase of prescription drugs used regularly.

Did you know? High-income taxpayers pay a disproportionate share of the total federal tax burden. The most recent statistics from the Tax Foundation show that the top 5% of all individual U.S. taxpayers, based on income, paid 52% of total federal individual income taxes in 1997, up from 43% in 1987. Qualification for the "top 5%" category required 1997 AGI in excess of $108,000. This group accounted for 32% of total reported 1997 AGI, up from 26% in 1987. These statistics are based on IRS data. The Tax Foundation attributes the trend to a strong economy and higher

PLANNING SUGGESTION 5: AVOIDING AMT WHEN EXERCISING INCENTIVE STOCK OPTIONS

Strategies to reduce the impact of the **alternative minimum tax** (AMT) for high-income taxpayers is a complex issue. Most tax planning is done to reduce **regular tax,** which can result in AMT liability. Income deferral and acceleration of deductions may not be a wise strategy if AMT liability is created. As a further complication, creation of AMT for the current year may produce a minimum tax credit (MTC) in subsequent years.

This planning suggestion is limited to **reducing AMT when exercising incentive stock options (ISOs).**

General Information

Corporations are increasingly using ISOs as a fringe benefit. Due to the bull market of the 1990s, more employees at all levels of compensation are taking advantage of ISOs. Many employees exercise their ISOs and sell their employer's stock immediately in a **cashless exercise.** This strategy results in compensation income, which is reported on the employee's W-2 form. A cashless exercise of an ISO does not result in current-year AMT liability.

Practitioner Note. See pages 334–340 in the 1999 *Farm Income Tax Book* for a thorough discussion of a cashless exercise of an ISO.

The following example discusses the situation where the exercise of an ISO may create current-year AMT and subsequent-year minimum tax credit on Form 8801. (**Note.** This is not a cashless exercise.)

Example. Sandra is employed in mid-level management by General Electric. She exercised an ISO on GE stock in 2000. Following are the facts concerning her ISO exercise.

Date of exercise	November 12, 2000
Number of shares acquired	600
Grant price per share	$30
Median price of GE stock on NYSE on Nov. 12, 2000	$58
Bargain element (spread) gain due to the exercise of her ISO (600 × $28)	$16,800

Sandra expects GE stock to appreciate, so she plans to hold the 600 shares as a long-term investment. The $16,800 "paper" gain she realized by exercising her ISO is **not** taxable for regular tax purposes in 2000. **However, the $16,800 gain is an AMT adjustment on line 10, Form 6251.**

Sandra's 2000 Form 6251 is shown below. She is single. The $32,800 entry on line 16 on her 2000 Form 6251 consists of:

Wages		$83000
Schedule C loss as Amway dealer (initial year)		*(29,000)
Interest income		500
Dividend income		3,500
*State income tax refund (line 6, Form 6251)		800
Adjusted gross income		$58,800
Less: Itemized deductions		
*State income tax	$7,000	
*City income tax	80	
*Real estate tax on home	6,700	
*Subtotal (line 3, Form 6251)	$14,500	
Home mortgage interest	7,100	
Contributions	4,400	(26,000)
*Line 37, Form 1040 (line 16, Form 6251)		$32,800

***Form 6251 item**

16

***Practitioner Note.** Sandra's only cost recovery deduction on her 2000 Schedule C is a §179 deduction. Therefore, no entry is required on line 8, Form 6251.

Form **6251**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax—Individuals

► See separate instructions.

► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227

2000

Attachment Sequence No. 32

Name(s) shown on Form 1040: *Sandra*

Your social security number

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 **or** 2½% of Form 1040, line 34	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	*14,500*
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	(*800*)
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	*16,800*
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 9	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item below and enter the total on line 14.		

a Circulation expenditures		**h** Loss limitations	
b Depletion		**i** Mining costs	
c Depreciation (pre-1987)		**j** Patron's adjustment	
d Installment sales		**k** Pollution control facilities	
e Intangible drilling costs		**l** Research and experimental	
f Large partnerships		**m** Section 1202 exclusion	
g Long-term contracts		**n** Tax shelter farm activities	
		o Related adjustments	

		14	
15	Total Adjustments and Preferences. Combine lines 1 through 14 ►	15	*30,500*

Part II Alternative Minimum Taxable Income

16	Enter the amount from **Form 1040, line 37.** If less than zero, enter as a (loss) ►	16	*32,800*
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 34, is over $128,950 (over $64,475 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 15 through 18 ►	19	*63,300*
20	Alternative tax net operating loss deduction. See page 6 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 7 of the instructions.) ►	21	*63,300*

Part III Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 7 of the instructions.)

IF your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is **over** the amount shown above for your filing status, see page 7 of the instructions.

22	Exemption amount	22	*33,750*
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ►	23	*29,550*
24	If you reported capital gain distributions directly on Form 1040, line 13, **or** you completed Schedule D (Form 1040) and have an amount on line 25 or line 27 (or would have had an amount on either line if you had completed Part IV) (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. **All others:** If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ►	24	*7,683*
25	Alternative minimum tax foreign tax credit. See page 7 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ►	26	*7,683*
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 43)	27	*4,995*
28	**Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 41 ►	28	*2,688*

For Paperwork Reduction Act Notice, see page 8 of the instructions. Cat. No. 13600G Form **6251** (2000)

Observations

1. The bargain element (spread) amount of $16,800 on the exercise of the ISO is taxed for AMT purposes at 26%.
2. Sandra's **AMT basis** in the 600 shares of GE stock is the $58 per share market value exercise price, or $34,800.
3. Sandra's **regular tax basis** in the 600 shares is the $30 per share grant price, or $18,000.
4. Assume she sells the 600 shares in 2010 for $130 per share. Assume also that the 600 shares did not split and that current tax laws concerning AMT do not change. The tax consequences on her 2010 return would be
   - A long-term capital gain of $60,000 on her 2010 Schedule D ($78,000 sales price minus regular cost basis of $18,000)
   - An AMT gain of $43,200 ($78,000 sales price minus AMT cost basis of $34,800)
   - A negative entry of $16,800 on line 9 of her 2010 Form 6251 ("Adjusted gain or loss")

Tax Planning Suggestions: Strategies Sandra Could Employ to Eliminate or Reduce AMT Liability

1. She could have exercised her ISO **earlier** than November 2000. She expects the price of GE stock to rise steadily. If so, the earlier she exercises her ISO, the less the "spread" amount will be. The result is less likelihood that an AMT liability will be created in the year of the earlier exercise.
2. Assume that her ISO on the 600 shares does not expire until July 2001. She could have made a **partial** exercise of 300 shares in 2000 and completed the exercise of the remaining 300 shares in 2001. Her 2000 "spread" amount would be $8,400 and her 2000 AMT would only be $504 rather than $2,688. Assuming similar income and deductions in 2001, her AMT for 2001 would be about $500. Therefore, her total AMT liability for the two-year period would be about $1,000 rather than $2,688.
3. She could have taken steps to **lower her 2000 income.** For example, she could have deferred a year-end 2000 bonus from GE to 2001.

Practitioner Note. It appears that she did take a significant step to lower her 2000 income by starting an extremely unprofitable Amway dealership! However, see the *Nissley* Tax Court decision in the Rulings and Cases chapter where an Amway business was held to be a nonprofit activity.

PLANNING SUGGESTION 6: GUIDELINES FOR MAXIMIZING EDUCATION CREDITS

For 2000 returns, the following guidelines can be used. These assumptions are made:

- The parents of the student file a joint 2000 return.
- The child is a college freshman who qualifies as the parent's dependent.
- The tuition paid in 2000 is more than $2,000.
- The child's 2000 taxable income is subject to the lowest tax rate (15%).

1. If the parents' 2000 AGI is under $80,000, the parents should claim the child's exemption. **Result:** The parents will be able to deduct the full exemption amount of $2,800 and use the entire Hope credit of $1,500.
2. If the parents' 2000 AGI exceeds $315,900, they should not claim the child's exemption. **Reason:** The parents lose the $2,800 exemption deduction due to the AGI phaseout rules, and they don't qualify for the $1,500 Hope credit. If the parents forgo the child's dependency

exemption, the child may be able to at least partially use the Hope credit to reduce his or her tax (possibly to zero).

3. If the parents' 2000 AGI is between $80,000 and $315,900, use a calculator or software to reach a conclusion. The bottom line is to calculate whether the Hope credit alone provides a larger benefit to the child than the credit and the exemption deduction provide to the parents.

Points to remember when making these calculations:

- Parents whose 2000 AGI is between $80,000 and $100,000 may claim a **partial** Hope credit.
- Parents whose 2000 AGI is between $100,000 and $193,400 get **full benefit** of a child's $2,800 exemption deduction for **regular tax** purposes (but not for AMT).
- Parents whose 2000 AGI is between $193,401 and $315,900 are subject to the **phaseout rules** for a child's $2,800 exemption deduction.
- Different thesholds apply to taxpayers with filing statuses other than married filing jointly.

ISSUE 2: MORTGAGE INTEREST DEDUCTION LIMITATIONS

GENERAL INFORMATION

For the vast majority of homeowners, all mortgage interest paid and reported to them by lenders on Form(s) 1098 is fully deductible on line 10 on Schedule A. However, there may be situations when preparers cannot rely on Form(s) 1098 to arrive at the deduction.

> **Practitioner Caution.** Lenders are not required to issue a Form 1098 if the mortgage interest received is **under $600** for the year. This often occurs when an individual's mortgage is **sold** by one lending institution to another, especially if the transfer occurs early or late in the year.

Taxpayers are allowed to **fully** deduct **two** types of mortgage interest payments on Schedule A.

- Mortgages obtained after October 13, 1987, to **buy, build, or improve a main home or a second home**, but only if throughout 2000 the total mortgage debt was **$1 million or less** ($500,000 or less if married filing separately). These are called **home acquisition loans.**

> **Practitioner Note.** Home mortgage loans obtained **before October 14, 1987,** are treated as **"grandfathered debt."** The $1 million ($500,000) limit shown above applies to the **total** of debt on mortgages obtained after October 13, 1987, **plus** any prior "grandfathered debt."

- Mortgages obtained after October 13, 1987, **other than** to buy, build, or improve a home, but only if throughout 2000 this debt was **$100,000 or less** ($50,000 or less if married filing separately). These are called **home equity loans**.

To be deductible on Schedule A, both types of mortgages (home acquisition loans and home equity loans) **must be secured debt**. The mortgage on either the main home or second home **must be recorded with the county recorder or otherwise perfected under state law.**

> **Practitioner Note.** Mortgage interest paid on either acquisition loans or home equity loans that exceed the limitation amounts is **nondeductible personal interest** [I.R.C. §163(h)(2)(D)]. However, an **exception** applies if the disallowed mortgage interest is deductible under another Code section [I.R.C. §163(h)(2)(A), (B), (C), (E), and (F)]. The following example explains this **exception.**

Example. Rick and Lynette Mehall bought their home in 1971 for $100,000. As of January 1, 2000, they had no debt on the home. The fair market value of the home is $205,000. Due to poor investment decisions in technology stock, they obtained a **home equity loan** on May 1, 2000, to meet margin calls from their on-line broker. Following are the facts regarding the loan.

Date of loan	May 1, 2000
Amount of loan	$175,000
Interest rate	8.75%
When payments are due	Monthly beginning June 1, 2000
Amount of monthly payment	$3,000
Number of payments made in 2000	7 (June through December)
Interest paid in 2000	$8,665.08 (see Form 1098)

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, address, and telephone number ***Third State Bank***	* **Caution:** *The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.*	OMB No. 1545-0901 **2000** Form **1098**	**Mortgage Interest Statement**
RECIPIENT'S Federal identification no. ***45 - 0000000*** / PAYER'S social security number ***111 - 11 - 1111***	**1** Mortgage interest received from payer(s)/borrower(s)* $ ***8665.08***		**Copy B For Payer** The information in boxes 1, 2, and 3 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points or because you did not report this refund of interest on your return.
PAYER'S/BORROWER'S name ***Rick and Lynette Mehall***	**2** Points paid on purchase of principal residence (See **Box 2** on back.) $		
Street address (including apt. no.)	**3** Refund of overpaid interest (See **Box 3** on back.) $		
City, state, and ZIP code	**4**		
Account number (optional) ***22 - 2345 - 00***			

Loan Amortization Schedule for 2000

Date	Total Payment	Interest	Principal	Loan Balance
5-1-2000	N/A	N/A	N/A	$ 175,000.00
6-1-2000	$ 3,000	$1,276.04	$ 1,723.96	173,276.04
7-1-2000	3,000	1,263.47	1,736.53	171,539.51
8-1-2000	3,000	1,250.81	1,749.19	169,790.32
9-1-2000	3,000	1,238.05	1,761.95	168,028.37
10-1-2000	3,000	1,225.21	1,774.79	166,253.58
11-1-2000	3,000	1,212.27	1,787.73	164,465.85
12-1-2000	3,000	1,199.23	1,800.77	162,665.08
Totals	**$21,000**	**$8,665.08**	**$12,334.92**	**$1,351,018.75**

16

Question 1. Can Rick and Lynette deduct the entire $8,665.08 on line 10 on Schedule A as home mortgage interest?

Answer 1. No, the **average loan balance** of $112,585 for their home equity loan exceeds $100,000.

Question 2. How is the average loan balance of $112,585 computed?

Answer 2. The total of the **monthly loan balances** for their home equity loan is $1,351,018.75, as show in the far right-hand column of the loan amortization schedule. That figure includes the May loan balance of $175,000 prior to their first mortgage payment on June 1. **Therefore, their average loan balance is $1,351.018.75 divided by 12 months, or $112,585.**

Information from IRS Publication 936, *Home Mortgage Interest Deduction* (boldface added for editorial purposes):

> If you receive monthly statements showing the closing balance or the average balance for the month, you can use **either** to figure your average balance for the year. Figure your average balance by adding your **monthly closing or average balances** and dividing that total by **the number of months the home that secures the mortgage was a qualified home during the year.** If your lender can give you your average balance for the year, you can use that amount.

Practitioner Notes

1. Assuming Rick and Lynette continue to make the $3,000 monthly mortgage payments in 2001, their average loan balance figure for 2001 will be higher than the $112,585 figure for 2000. **Reason:** They will have a month-ending loan balance for all 12 months of 2001, unlike 2000, when they had balances for only 7.
2. Because they obtained the home equity loan on May 1, 2000, they are not allowed to use the simplified method worksheets shown on page 9 of IRS Publication 936. These worksheets can be used only if mortgage payments were made for the entire year.

Question 3. How much can they deduct as home mortgage interest for 2000?

Answer 3. $7,695. See their completed **Table 1 worksheet** from Publication 936. Lines 1 through 5 are blank, as explained in the boxed excerpt below Table 1.

Table 1. **Worksheet To Figure Your Qualified Loan Limit and Deductible Home Mortgage Interest For the Current Year**

(Keep for your records.) See the ***Table 1 Instructions.***

Part I Qualified Loan Limit			
1 Enter the average balance of all your grandfathered debt. See line 1 instructions	1		
2 Enter the average balance of all your home acquisition debt. See line 2 instructions . . .	2		
3 Enter $1,000,000 ($500,000 if married filing separately)	3		
4 Enter the **larger of** the amount on line 1 or the amount on line 3	4		
5 Add the amounts on lines 1 and 2. Enter the total here	5		
6 Enter the **smaller of** the amount on line 4 or the amount on line 5	6	*0*	
7 Enter $100,000 ($50,000 if married filing separately). See line 7 instructions for a limit that may apply	7	*100,000*	
8 Add the amounts on lines 6 and 7. Enter the total. This is your qualified loan limit	8	*100,000*	

Part II Deductible Home Mortgage Interest			
9 Enter the total of the average balances of **all** mortgages on **all** qualified homes. See line 9 instructions	9	*112,585*	
• If line 8 is less than line 9, GO ON to line 10. • If line 8 is equal to or more than line 9, STOP HERE. All of your interest on all the mortgages included on line 9 is deductible as home mortgage interest on Schedule A (Form 1040).			
10 Enter the total amount of interest that you paid. See line 10 instructions	10	*8,665*	
11 Divide the amount on line 8 by the amount on line 9. Enter the result as a decimal amount (rounded to three places)	11	×	*.888*
12 Multiply the amount on line 10 by the decimal amount on line 11. Enter the result. This is your **deductible home mortgage interest.** Enter this amount on Schedule A (Form 1040) . . .	12	*7,695*	
13 Subtract the amount on line 12 from the amount on line 10. Enter the result. This is **not home mortgage interest.** See line 13 instructions	13	*970*	

Excerpt from Publication 936 regarding Table 1: "If all of your mortgages are home equity debt, do not fill in lines 1 through 5. Enter zero on line 6 and complete the rest of the worksheet."

Question 4. What type of interest is the $970 amount shown on line 13 of the Table 1 worksheet?

Answer 4. It is **investment interest,** since Rick and Lynette used the home equity loan proceeds to pay their broker for margin calls. It is deductible on line 13 on their 2000 Schedule A subject to the investment interest limitations.

Practitioner Caution

1. The $7,695 that Rick and Lynette can deduct as home mortgage interest is **not** allowed for AMT purposes. It will be entered as a positive figure on line 4 on their 2000 Form 6251 (AMT). **The $7,695 is recharacterized as investment expense for AMT purposes on Form 4952.**
2. Assume Rick and Lynette have the following investment income and losses in 2000.
   - $2,000 of dividend income on Schedule B
   - $200,000 net capital loss from stock sales on Schedule D

The result is that for **regular tax,** they are allowed a **$970 investment interest expense deduction on** Form 4952 (not shown). However, for **AMT** purposes, they are allowed a **$2,000 investment interest expense deduction, the amount of their investment income.** Therefore, line 7 on their 2000 Form 6251 will show a **negative $1,030** ($2,000 AMT deduction less $970 regular tax deduction).

Form **6251** — **Alternative Minimum Tax—Individuals** — OMB No. 1545-0227 — **2000**

Department of the Treasury
Internal Revenue Service

► See separate instructions.
► Attach to Form 1040 or Form 1040NR.

Attachment Sequence No. **32**

Name(s) shown on Form 1040: *Rick and Lynette Mehall* — Your social security number: *111 11 111*

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 **or** 2½% of Form 1040, line 34	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	*7,695*
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	( )
7	Investment interest. Enter difference between regular tax and AMT deduction	7	*(1,030)*
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 9	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item below and enter the total on line 14.	14	
15	Total Adjustments and Preferences. Combine lines 1 through 14 ►	15	

Line 14 items:

a Circulation expenditures		h Loss limitations	
b Depletion		i Mining costs	
c Depreciation (pre-1987)		j Patron's adjustment	
d Installment sales		k Pollution control facilities	
e Intangible drilling costs		l Research and experimental	
f Large partnerships		m Section 1202 exclusion	
g Long-term contracts		n Tax shelter farm activities	
		o Related adjustments	

16

Question 5. Assume Rick and Lynette borrowed **$130,000** at an 8.75% interest rate on May 1, 2000, rather than $175,000 as previously discussed. The loan proceeds were used for the same purpose, to pay brokerage margin calls. Would all of the interest paid on the $130,000 home equity loan be deductible as home mortgage interest on line 10 on their 2000 Schedule A?

Answer 5. Yes, since the average loan balance for 2000 would be $81,808 (computations not shown).

> **Practitioner Note.** Even though the proceeds of a home equity loan obtained during the current year exceed $100,000, the **average loan balance** may not. If not, the $100,000 limitation for home equity loans does not apply. The result is that all of the interest paid in the current year is deductible as **home mortgage interest.**

Question 6. Assume Rick and Lynette continue to make the $3,000 monthly mortgage payment on their $175,000 home equity loan in 2001. The year-end loan balances are as follows.

Date	Loan Balance
December 31, 2000	$162,665 (shown on page 505)
December 31, 2001	139,385

How is their average loan balance for 2001 computed?

Answer 6. Since they did not borrow any new amounts in 2001 and they made 12 monthly payments in 2001, they can use the first worksheet found in IRS Publication 936. **Their average loan balance for 2001 is $151,025**.

Average of first and last balance method. You can use this method if all the following apply.

1) You did not borrow any new amounts on the mortgage during the year. (This does not include borrowing the original mortgage amount.)
2) You did not prepay more than one month's principal during the year. (This includes prepayment by refinancing your home or by applying proceeds from its sale.)
3) You had to make level payments at fixed equal intervals on at least a semi-annual basis. You treat your payments as level even if they were adjusted from time to time because of changes in the interest rate.

To figure your average balance, complete the following worksheet.

1. Enter the balance as of the first day of the year that the mortgage was secured by your qualified home during the year (generally January 1) ***162,665***
2. Enter the balance as of the last day of the year that the mortgage was secured by your qualified home during the year (generally December 31) ***139,385***
3. Add amounts on lines 1 and 2 .... ***302,050***
4. Divide the amount on line 3 by 2. Enter the result ***151,025***

Using the Table 1 Worksheet, **66.2%** of their 2001 mortgage could be deducted as **home mortgage interest.** The remaining **33.8%** would be treated as **investment interest expense.**

ISSUE 3: CLERGY TAX ISSUES

TOPIC 1: REVOCATION OF PRIOR EXEMPTION FROM SELF-EMPLOYMENT TAX

Clergy who opted out of social security coverage using Form 4361 have a two-year window to revoke the exemption and pay self-employment tax on future ministerial earnings. The revocation itself is irrevocable and is made on Form 2031.

Form **2031**
(Rev. April 2000)
Department of the Treasury
Internal Revenue Service

Revocation of Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders, and Christian Science Practitioners

OMB No. 1545-1679

Please type or print

1 Name (as shown on Form 1040)	**Social security number**
Number and street (including apt. no.)	
City, town or post office, state, and ZIP code	

2 Check **one** box: ☐ Christian Science practitioner ☐ Ordained minister, priest, rabbi ☐ Member of religious order not under a vow of poverty ☐ Commissioned or licensed minister

3 Date ordained, licensed, etc. (month, day, year) / /

4 Legal name of ordaining, licensing, or commissioning body or religious order

Address

Employer identification number

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

5 Election effective beginning with tax year ►

6 I understand that by filing this Form 2031, I am revoking my previously filed and approved **Form 4361,** Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners. I elect under section 403 of Public Law 106-170 to have social security and Medicare coverage apply to earnings from any service performed by me as a duly ordained, commissioned, or licensed minister; member of a religious order not under a vow of poverty; or Christian Science practitioner. I would like this election to take effect beginning with the tax year shown on line 5. I understand that as a result of this election, I will be subject to tax as a self-employed person in accordance with the provisions of chapter 2 of subtitle A of the Internal Revenue Code with respect to self-employment income derived from such service for such tax year and each tax year thereafter. I further understand that this election is **irrevocable.**

Signature ► **Date ►**

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Use Form 2031 to revoke your exemption from self-employment tax if you are a minister, member of a religious order not under a vow of poverty, or Christian Science practitioner. You must be currently exempt from self-employment tax because you previously filed **Form 4361,** Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners, and received IRS approval for exemption. If you revoke your exemption, you will be liable for self-employment tax, and social security and Medicare coverage will apply to your earnings as a minister, member of a religious order, or Christian Science practitioner.

When To File

File Form 2031 no later than the due date (including extensions) of your Federal income tax return for your second tax year beginning after 1999. In most cases, this means you must file Form 2031 by April 15, 2002.

Effective Date

You can make the revocation effective for either your first or second tax year beginning after 1999. In most cases, this will be either your 2000 or 2001 tax year. Indicate your choice on line 5. You will be liable for any additional self-employment tax for the tax year for which the election is effective.

How and Where To File

File Form 2031 by:

- Faxing it to 859-292-7867 or
- Mailing it to:

  Internal Revenue Service
  Stop 14M
  Attn.: Exemption Revocation
  P.O. Box 12267
  Covington, KY 41012-0267

Do not file Form 2031 with your tax return. When you file your tax return for the tax year for which you want your election to be effective, complete **Schedule SE (Form 1040),** Self-Employment Tax, to figure any self-employment tax due. If you have already filed that tax return, you **must** file **Form 1040X,** Amended U.S. Individual Income Tax Return, with Schedule SE attached, and pay any additional self-employment tax due when you file Form 2031.

For Privacy Act and Paperwork Reduction Act Notice, see back of form. Cat. No. 63863X Form **2031** (Rev. 4-2000)

16

Information Regarding Form 2031 Procedure

- It must be filed no later than the due date (including extensions) of the minister's return for the 2001 tax year.
- It can be effective for **either** the 2000 or 2001 tax year. See line 5 on Form 2031 (revised April 2000).
- It should be submitted (faxed or mailed) to the Cincinnati Service Center, regardless of where the minister lives. It should **not** be attached to the minister's tax return.
- Self-employment tax is due for the year indicated on line 5 of Form 2031 (for either 2000 or 2001). There is no provision for waiving any resulting estimated tax penalty.

> **Planning Tip.** Ministers who have never paid self-employment tax and are contemplating retirement should consider making the election to begin coverage for the 2000 tax year. **Reason.** The result is four quarters of coverage for 2000. Generally, it takes 40 quarters to be **fully (permanently) insured** for social security and Medicare benefits'

TOPIC 2: RETIRED MEMBERS OF THE CLERGY

Facts. Elmo Smith retired from the ministry of the United Methodist Church in 1993 at age 65. He died on Sept. 12, 2000. He and his surviving spouse, Roxanne, each received a Form 1099-R from the church board of pensions for 2000. Roxanne received a **70% survivor annuity** after her husband's death. They jointly owned their residence, which was purchased for $85,000 in 1993. Roxanne is a retired nurse. Elmo's monthly pension was $1,520 per month, and Roxanne's pension is $1,064 per month.

Form 1099-R Information

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code ***Board of Pensions*** ***of the United Methodist Church*** ***Incorporated in Missouri*** ***1201 David Street*** ***Evanston, Il 60201***	**1** Gross distribution $ *12768.00* **2a** Taxable amount $	OMB No. 1545-0119 2000 Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
	2b Taxable amount not determined ☒	Total distribution ☐	**Copy B**
PAYER'S Federal identification number: ***43 - 0000000*** / RECIPIENT'S identification number	**3** Capital gain (included in box 2a) $	**4 Federal income tax withheld** $ *810.37*	**Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name ***Elmo T. Smith (Dec'd)***	**5** Employee contributions or insurance premiums $	**6** Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) ***34 Sesame Street***	**7** Distribution code *7* / IRA/SEP/SIMPLE ☐	**8** Other $ %	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code ***Happy, TX 79042***	**9a** Your percentage of total distribution %	**9b** Total employee contributions $	
Account number (optional)	**10** State tax withheld $ $	**11** State/Payer's state no.	**12** State distribution $ $
	13 Local tax withheld	**14** Name of locality	**15** Local distribution

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code
Board of Pensions
of the United Methodist Church
Incorporated in Missouri
1201 David Street
Evanston, Il 60201

1 Gross distribution
$*3830.40*

2a Taxable amount
$

OMB No. 1545-0119
2000
Form **1099-R**

Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

2b Taxable amount not determined ☐ Total distribution ☐

Copy B
Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.

PAYER'S Federal identification number
43 - 0000000

RECIPIENT'S identification number

3 Capital gain (included in box 2a)
$

4 **Federal income tax withheld**
$

RECIPIENT'S name
Roxanne L. Smith

5 Employee contributions or insurance premiums
$

6 Net unrealized appreciation in employer's securities
$

Street address (including apt. no.)
34 Sesame Street

7 Distribution code
4

IRA/ SEP/ SIMPLE ☐

8 Other
$ %

This information is being furnished to the Internal Revenue Service.

City, state, and ZIP code
Happy, TX 79042

9a Your percentage of total distribution %

9b Total employee contributions
$

Account number (optional)

10 State tax withheld
$
$

11 State/Payer's state no.

12 State distribution
$
$

13 Local tax withheld

14 Name of locality

15 Local distribution

I.R.C. §107 provides an exclusion from income for qualified housing allowances paid to clergy members.

Actual Housing Expenses Paid by the Smiths in 2000

Type of Expense	Total Paid	Paid Before the 9-12-00 D/O/D	Paid After 9-11-00
Home mortgage ($500/month)	$ 6,000	$4,500 (9 months)	$1,500
Real estate taxes	1,100	1,100	None
Insurance	400	None	400
Utilities	1,540	1,145	395
Furniture purchases	1,315	None	1,315
Appliance repairs	170	170	None
Remodeling costs	300	200	100
House repairs and maintenance items	220	80	140
Yard maintenance costs	340	240	100
Totals	**$11,385**	**$7,435**	**$3,950**

The **fair rental value** of their home is $1,000 a month, including furnishings and the cost of utilities.

The following resolution was adopted by the annual church conference. Resolution 1 has been boxed, indicating its importance.

HOUSING/RENTAL ALLOWANCE RESOLUTION

WHEREAS, the religious denomination known as The United Methodist Church has and functions through Ministers of the Gospel who are duly ordained or licensed; and
WHEREAS, the practice of The United Methodist Church is to provide a parsonage or a housing/rental allowance as part of the gross compensation for each of its active ordained or licensed ministers; and
WHEREAS, pensions paid to retired and disabled ordained or licensed ministers of The United Methodist Church are considered as deferred compensation and are paid to said retired and disabled ordained or licensed ministers in consideration of previous, active service; and
WHEREAS, the Internal Revenue Service has recognized that the Illinois Great Rivers Annual Conference is the appropriate organization to designate a housing/rental allowance for retired and disabled ordained or licensed ministers who are members of this Annual Conference;
THEREFORE BE IT RESOLVED

1. An amount equal to 100% of the pension payments received during the year of 2000 be and is hereby designated as a housing/rental allowance for each retired and disabled ordained or licensed minister of the United Methodist Church who is or was a member of the Illinois Great Rivers Annual Conference or a predecessor Annual Conference at the time of his or her retirement;
2. This housing/rental allowance shall apply to each retired and disabled ordained or licensed minister who has been granted the retired relation or placed on disability leave by the Illinois Great Rivers Annual Conference or a predecessor Annual Conference and whose name and relationship to the Annual Conference is recorded in the Journal-Yearbook of the Illinois Great Rivers Annual Conference or a predecessor Conference and in other appropriate records maintained by the Annual Conference.
3. The pension payment to which this housing/rental allowance applies shall be the pension payment resulting from all service of such retired and disabled ordained or licensed minister from all employment by any local church, Annual Conference or institution of The United Methodist Church or of any former denomination that is now a part of The United Methodist Church, or from any other employer who employed the minister to perform services related to the ministry and who elected to make contributions to the pension funds of The United Methodist Church for such retired minister's pension.

Practitioner Note. The amount of Elmo's housing allowance exclusion for 2000 is the **lesser** of the following three amounts.

1. The amount of the housing allowance designated by the appropriate church body (**$12,768**, or 100% of his pension).
2. The amount actually expended by Elmo to provide his housing (**$7,435**).
3. The fair rental value of the home, including furnishing and the cost of utilities (**$8,400**, or $1,000/month × 8.4 months–Elmo lived for 8.4 months in 2000). [Rev. Rul. 71-280 and Ltr. Rul. 8825025]

Question 1. How much of Elmo's $12,768 pension is taxable on line 16b on the joint 2000 Form 1040 of the Smiths?

Answer 1. $5,333 ($12,768 less the housing exclusion amount of $7,435).

Practitioner Note. The rationale is that the I.R.C. §107 housing allowance exclusion applies to all compensation income received by clergy members, including pension payments made for past services. Elmo's exclusion amount of $7,435 is the amount of his housing costs paid prior to his death. This is the lowest of the three figures shown in the boxed note above.

Question 2. How much of Roxanne's survivor annuity of $3,830 is taxable on line 16b on the joint 2000 Form 1040?

Answer 2. All of it. A surviving spouse of a retired minister is **not** entitled to a housing allowance exclusion unless he or she is also a qualifying minister (Rev. Rul. 72-249).

Question 3. Is self-employment tax due on the **taxable portion** of pension income of retired ministers or their surviving spouses?

Answer 3. No. [I.R.C. §1402(a)(8)] See IRS Publications 533 (*Self-Employment Tax*) and 517 (*Social Security Information for Members of the Clergy*).

Partially Completed 2000 Form 1040 for Elmo (Deceased) and Roxanne Smith

Deseased - Elmo T. Smith - Sept. 12, 2000 Date of Death

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2000** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2000, or other tax year beginning , 2000, ending , 20 OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type.

L A B E L H E R E

Your first name and initial: ***Elmo T.***	Last name: ***Smith***	**Your social security number**
If a joint return, spouse's first name and initial: ***Roxanne L.***	Last name: ***Smith***	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 19.: ***34 Sesame St.***	Apt. no.	**Important!** You **must** enter your SSN(s) **above.**
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.: ***Happy, TX 79042***		

Presidential Election Campaign (See page 19.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☐ **Yes** ☒ **No** Spouse ☐ **Yes** ☒ **No**

Filing Status

Check only one box.

1	☐	Single
2	☒	Married filing joint return (even if only one had income)
3	☐	Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4	☐	Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5	☐	Qualifying widow(er) with dependent child (year spouse died ▶). (See page 19.)

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2,

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9	Ordinary dividends. Attach Schedule B if required		9	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	Total IRA distributions	15a	b Taxable amount (see page 23) 15b	
16a	Total pensions and annuities	16a ***16,598***	b Taxable amount (see page 23) 16b	***9,163***

Practitioner Note. Line 16a is $12,768 + $3,830, or $16,598. Line 16b is $5,333 + $3,830, or $9,163.

Concluding Observations for Topic 2

1. Copy B of the 1099-R for Elmo must be attached to the return, since income tax was withheld.
2. The recent *Warren* Tax Court decision (114 T.C. 23) does not affect the tax result as shown for the Smiths. In the *Warren* decision, the Tax Court held that the exclusion for a housing allowance **is not limited to the fair rental value of the home**. (See limitation 3 in the boxed note on page 512.) However, the IRS is appealing this decision. See the Rulings and Cases chapter for a complete discussion of the *Warren* case.
3. An attached statement explaining Elmo's $7,435 housing exclusion and the $9,163 taxable pension amount on line 16b on the Form 1040 is advised. However, it is not mandatory.

TOPIC 3: ACCOUNTABLE PLANS

The preparation of a minister's tax return can be complex and time-consuming. A simple and effective way for church employers to reduce this burden is to adopt an accountable reimbursement plan for all employee business expenses incurred by the minister.

Advantages of an Accountable Reimbursement Plan

- Ministers who do not itemize deductions avoid the elimination of the deduction for unreimbursed employee business expenses.
- Ministers who do itemize deductions avoid the 2% AGI limitation on unreimbursed employee business expenses. This limitation also applies to "nonaccountable" professional expenses for which the minister receives an **allowance rather than reimbursement**.
- The I.R.C. §265 allocation rule that reduces employee business expenses proportionately by the tax-free part of total ministerial income is avoided. (See pages 143–144 in the 1997 *Farm Income Tax Book* for details on this confusing allocation rule.)
- The 50% limitation rule for business meals and entertainment is avoided.
- A possible AMT adjustment for miscellaneous itemized deductions is eliminated.

Following is a list of possible ministry expenses that could be reimbursed tax free under the **accountable plan** rules.

- Church-related continuing education
- Robes and vestments worn for worship
- Church-related books and magazines
- Auto expenses (the 2000 mileage rate of 32.5¢ can be used)
- Supplies and equipment purchased for church-related duties
- Lodging and meal expenses for overnight church-related travel
- Lunch meetings with church officers for business discussions

The following expense voucher form could be used by the church for accountable plan reimbursements.

"CHURCH NAME"
Expense Voucher

Date:________________________ Amount $______________

Pay to: Name____

Address____

Description of Expense____

Business Purpose of Expense____

Receipt/Bill ❑ Attached ❑ No

Account Number or Budget Line Item Number______________________________

Person Requesting Payment:____

Approved By:____

Special Instructions:____

Practitioner Note. For a comprehensive clergy example with completed forms and schedules, see IRS Publication 517, *Social Security and Other Information for Members of Clergy and Religious Workers.*

ISSUE 4: HOUSEHOLD EMPLOYMENT TAXES

Who Is a Household Employee?

Some examples of workers who may be household employees are

- Babysitters
- Cleaning people
- Drivers
- Health aides, including private nurses
- Housekeepers
- Nannies
- Yard workers

Practitioner Note. If a taxpayer hires someone to do household work and controls what work is done and how it is done, the worker is a household employee. Rev. Rul. 61-196 discusses the employment status of nurses.

16

Who Is Not a Household Employee?

- Self-employed workers are not household employees. These individuals usually provide their own tools and offer their services to the general public.

Example. Your client, Ken, pays Fred Jones to care for his lawn. Fred owns a lawn care business and offers his services to the general public. He hires his own employees and provides his own tools and supplies. Neither Fred nor his helpers are Ken's household employees.

- Agency workers are not household employees if the agency is responsible for who does the work and how it is done.
- Individuals who work for the taxpayer's trade or business are not household employees.

Who Needs to File Schedule H (Household Employment Taxes)?

Schedule H reports only the wages paid to domestic employees that are subject to social security and Medicare taxes. Employers who are liable for FICA or FUTA taxes or who withhold federal income tax must file Schedule H. This is easily determined by answering questions A, B, and C at the top of Schedule H.

> **Practitioner Note.** Many household employers will need to complete only eight lines on Schedule H. Those eight are lines A, 1 through 4, 6, 8, and 9.

Total Cash Wages (Line 1, Schedule H). Cash wages include wages paid by checks, money orders, etc. They do **not** include the value of food, lodging, clothing, or other noncash items given to a household employee.

Cash wages of **$1,200 or more** paid to **any one** household employee in 2000 are subject to FICA and Medicare taxes. These cash wages must be entered on line 1, Schedule H. Cash wages of **less than $1,200** paid to **any one** household employee in 2000 are exempt from FICA and Medicare taxes. These cash wages are omitted on line 1, Schedule H.

> **Practitioner Note.** For 2000, an employer can give as much as $65 per month to a household employee for his or her commuting expenses by **public transportation (bus, train, or other forms of mass transit).** This payment for or reimbursement of mass transit commuting expenses is not counted as cash wages and is omitted from line 1.

Wages Omitted on Line 1 (Total Cash Wages). Omit wages paid to the following individuals in 2000, even if they are $1,200 or more.

- Spouse
- Child under age 21
- Employee who was **under age 18** at **any** time during 2000 **unless** the employee was **not a student and providing household services was his or her principal occupation**
- Parent (see exception)

Exception. Include wages paid to a parent on line 1 if **both** of the following conditions apply:

1. A parent cares for your child who lives with you and either is under age 18 or has a physical or mental condition that requires the personal care of an adult for at least four continuous weeks in a calendar quarter.
2. You are divorced and have not remarried, or you are a widow or widower, or you are living with a spouse whose physical or mental condition prevents him or her from caring for your child for at least four continuous weeks in a calendar quarter.

Example of Exception: Wages Paid to Parent Are Included on Line 1. Jim was divorced in 1996. He was awarded custody of his two children, who are ages 7 and 10 in 2000. Jim's mother, Sandy, lives with Jim and her grandchildren in Jim's house and cares for them while Jim works. Jim paid Sandy $9,000 cash wages in 2000 for her household services. The $9,000 is included on line 1 on Jim's 2000 Schedule H.

See Jim's completed 2000 Schedule H. Jim withheld the employee share of FICA and Medicare taxes but did not withhold federal income tax since Sandy did not request it via Form W-4. Nor did he pay Sandy advance earned income credit because Sandy did not give him a Form W-5.

SCHEDULE H (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

▶ **Attach to Form 1040, 1040NR, 1040NR-EZ, 1040-SS, or 1041.**

▶ **See separate instructions.**

OMB No. 1545-0074

2000

Attachment Sequence No. **44**

Name of employer: *Jim*

Social security number *444 44 444*

Employer identification number *28 1 1 1 1 1 1 1*

A Did you pay **any one** household employee cash wages of $1,200 or more in 2000? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page 3 before you answer this question.)

- [X] **Yes.** Skip lines B and C and go to line 1.
- [ ] **No.** Go to line B.

B Did you withhold Federal income tax during 2000 for any household employee?

- [ ] **Yes.** Skip line C and go to line 5.
- [ ] **No.** Go to line C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1999 or 2000 to household employees? (**Do not** count cash wages paid in 1999 or 2000 to your spouse, your child under age 21, or your parent.)

- [ ] **No.** **Stop.** Do not file this schedule.
- [ ] **Yes.** Skip lines 1-9 and go to line 10 on the back.

Part I Social Security, Medicare, and Income Taxes

1	Total cash wages subject to social security taxes (see page 3)	1 *9,000*	
2	Social security taxes. Multiply line 1 by 12.4% (.124)		2 *1,116*
3	Total cash wages subject to Medicare taxes (see page 3)	3 *9,000*	
4	Medicare taxes. Multiply line 3 by 2.9% (.029)		4 *261*
5	Federal income tax withheld, if any		5
6	**Total social security, Medicare, and income taxes** (add lines 2, 4, and 5)		6 *1,377*
7	Advance earned income credit (EIC) payments, if any		7
8	**Net taxes** (subtract line 7 from line 6)		8 *1,377*

9 Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1999 or 2000 to household employees? (**Do not** count cash wages paid in 1999 or 2000 to your spouse, your child under age 21, or your parent.)

- [X] **No.** **Stop.** Enter the amount from line 8 above on Form 1040, line 55. If you are not required to file Form 1040, see the line 9 instructions on page 4.
- [ ] **Yes.** Go to line 10 on the back.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 12187K **Schedule H (Form 1040) 2000**

16

Observations

1. Jim must attach Schedule H to his 2000 Form 1040. He must report the $1,377 amount from line 8, Schedule H on line 55 on his 2000 Form 1040.
2. In order to prepay the $1,377, Jim must either increase his income tax withholding from his wages or make estimated tax payments for 2000. If he doesn't, Jim may be liable for the estimated tax penalty.
3. Jim must prepare a 2000 Form W-2 for Sandy since her FICA and Medicare wages are **$1,200 or more.** He must also prepare Form W-3. He must send Copy A of Form W-2 with Form W-3 to the Social Security Administration by February 28, 2001.
4. Jim does not have to complete page 2 of Schedule H.

Household Employment Taxes: Questions and Answers

Question 1 Facts. Susan is a single mother with two small children. She occasionally hires a 15-year-old high school student, Kim, to babysit for her children on the weekends. Susan paid Kim a total of $1,750 in 2000.

Question 1. Must Susan include the $1,750 she pays Kim in 2000 on line 1, Schedule H?

Answer 1. No, as Kim is a student under the age of 18 in 2000. The wages paid to students under the age of 18 are **not** included on line 1, Schedule H, **regardless** of the amount of wages.

Question 2 Facts. Brian and Linda, who both work outside the home, have three children under the age of 5. They hire Brenda, a 17-year-old single mother, to provide childcare services in their home during the week. They pay Brenda a total of $20,000 in 2000.

Question 2. Must Brian and Linda include the $20,000 they pay Brenda in 2000 on line 2, Schedule H?

Answer 2. Yes. Even though Brenda is under age 18 in 2000, she is not a student and household service is her principal occupation.

Question 3 Facts. Ed and Diane employ two household workers in 2000 on a part-time basis. They paid Oscar $1,100 cash wages in 2000 for gardening and lawn care. They paid Olivia $1,175 cash wages in 2000 for house cleaning.

Question 3. Must Ed and Diane include the $1,100 paid to Oscar and the $1,175 paid to Olivia on line 1, Schedule H?

Answer 3. No. The $1,200 threshold test applies **separately** to each household employee. Since neither employee met the threshold amount, Ed and Diane are not liable for household employment taxes for 2000. They do not have to prepare a 2000 Schedule H.

ISSUE 5: SALE OF PRINCIPAL RESIDENCES

Example 1 Facts. Adam and Sonya sold their jointly owned principal residence in Atlanta on December 1, 1998, and excluded the $110,000 gain from their joint 1998 return.

> **Practitioner Note.** I.R.C. §121 permits an **exclusion** of up to $500,000 on a joint return for sales after May 6, 1997. The exclusion applies to only **one** sale **every two years** [I.R.C. §121(b)(3)].

They bought a new residence in suburban Atlanta for $375,000 on November 15, 1998, and moved into it on December 1, 1998. Adam's employer transferred him to a new job in Dallas in 2000. They sold the suburban Atlanta home on March 31, 2000, for a gain of $40,000. They moved to Dallas on April 1, 2000.

Question 1. Even though the second home in suburban Atlanta was sold **before** the end of the two-year period, may Adam and Sonya exclude all or a portion of the $40,000 gain on the second home sale on their 2000 return?

Answer 1. Yes, since the sale was caused by **a change in employment**, health, or unforeseen circumstances (not yet defined by Treasury regulations) [I.R.C. §121(c)(2)].

Question 2. Is the entire $40,000 gain on the sale of the second home excludable in 2000?

Answer 2. Yes. A prorated exclusion of $333,550 applies even though neither the two-year ownership nor use test was met. The calculations are

$$\frac{\text{No. of days owned and used} \quad 487}{\text{No. of days in 2 years} \quad 730} = 0.6671 \times \$500{,}000 \quad = \mathbf{\$333{,}550\ exclusion}$$

> **Practitioner Note.** In most cases, this calculation can be done quickly to determine that all of the gain is excludable. However, if the gain is large or the excludable percentage small, use Worksheet 3 in IRS Publication 523 (*Selling Your Home*) to determine the exclusion.

Excerpt from IRS Publication 523, *Selling Your Home*

Reduced Maximum Exclusion. You can claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if any of the following are true.

- You did not meet the two-year ownership and use tests for a home you owned on **August 5, 1997**, and sold **before August 5, 1999**.
- You did not meet the two-year ownership and use tests for a home you sold **due to a change in health or place of employment**.

Worksheet 3. **Reduced Maximum Exclusion**

Caution: *Complete this worksheet only if you qualify for a reduced exclusion.* (See *Reduced Maximum Exclusion* in this chapter.) *Complete column (B) only if you are married filing a joint return.*

			(A) You	(B) Your Spouse
1.	Maximum amount	**1.**	$250,000.00	$250,000.00
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))	**2a.**		
b.	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)	**b.**		
c.	Enter the smaller of line 2a or 2b	**c.**		
3.	Have you (or your spouse if filing jointly) excluded gain from the sale of another home during the 2-year period ending on the date of this sale (not counting any sales before May 7, 1997)? **NO.** Skip line 3 and enter the number of days from line 2c on line 4. **YES.** Enter the number of days between the date of the most recent sale of another home on which you excluded gain and the date of sale of this home	**3.**		
4.	Enter the smaller of line 2c or 3	**4.**		
5.	Divide the amount on line 4 by 730 days. Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.000	**5.**		
6.	Multiply the amount on line 1 by the decimal amount on line 5	**6.**		
7.	Add the amounts in column (A) and (B) of line 6. This is your reduced maximum exclusion. Enter it here and on Worksheet 2, line 8	**7.**		

Example 2 Facts. Ed and Donna owned two homes, their principal residence in Fargo and a vacation home in Arizona. They sold their jointly owned principal residence in Fargo on May 10, 1998, and excluded the $90,000 gain on their joint 1998 return.

They moved into their Arizona home on May 1, 1998. It had been purchased jointly in 1990. They lived in it until July 15, 2000, except for two months in 1999 when they took an extended vacation. During those two months, the home was rented. They sold their Arizona home on August 1, 2000, for a gain of $325,000.

Question 1. Is all of the $325,000 gain on the sale of the Arizona home excludable on their joint 2000 return?

Answer 1. Yes, except for any depreciation claimed on the 1999 Schedule E. They met the dual two-year ownership and use tests. IRS Publication 523 (*Selling Your Home*) states the following: "**Short temporary absences** for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of **your use.**"

Practitioner Note. Worksheet 2 in Publication 523 is used to compute the exclusion and taxable gain. The taxable gain is **unrecaptured §1250 gain** that will be included on **line 25 in Part IV** of **Schedule D.**

Question 2. What is the definition of **short temporary absences**?

Answer 2. Treasury regulations under prior law's once-in-a-lifetime $125,000 exclusion contained five examples. Those examples showed that two-month vacations **qualified** as a short temporary absence. However, a one-year absence by a professor on sabbatical leave **did not**.

It is not clear if these regulations written for prior law continue to apply to the new exclusion rules as amended by the TRA of 1997. However, it appears that they do, as the example involving the professor is shown in the current IRS Publication 523. Therefore, a two-month absence qualifies as a **short temporary absence**, during which the owner is deemed to use the home for his or her residential purposes.

Editorial Comment. The situation that is unclear is a temporary absence exceeding two months. Many taxpayers vacate their principal residences for extended vacations.

Example. Bob and Marla leave their main home in Chicago every year for five months to spend the winter in Texas. They rent their house while they are gone.

In many cases, the two-year ownership and use tests may be met regardless of whether five-month absences qualify **as short temporary absences**. If the issue is critical for permitting the new $250,000 ($500,000) exclusion, preparers may want to resolve the issue in favor of the client and complete Form 8275 (Disclosure Statement).

Example 3 Facts. Mark, a single taxpayer, bought a residence in 1968 and lived in it alone for many years. He married in July 1999 and transferred ownership to joint tenancy with his new spouse, Jane, who moved in with him. The ownership transfer occurred in September 1999. **The house was sold in July 2000 for a gain of $260,000.** The sale was **not** due to a change in employment or health. Mark obviously meets the two-year ownership and use tests. However, **Jane does not meet the use test.** They will file a joint 2000 return.

Question. What is their exclusion on their joint 2000 return?

Answer. $250,000. Only one spouse is required to meet the **two-year ownership test** to claim the $500,000 exclusion, but **both** spouses must meet the **two-year use test.** Since Mark meets the use test, he can claim the $250,000 exclusion on their joint return.

Practitioner Note. 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. Jack and Jill **jointly owned** a residence where they both lived until their divorce in March 1997. 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 2000 for a total gain of $300,000. **One-half of the total gain, or $150,000, is allocated to each Jack and Jill.** Each files a single return for 2000. **Each is entitled to exclude the full $150,000 gain** on their 2000 returns. Jack meets both the two-year ownership and use tests. Jill also meets both tests since Jack's use of the house **after the divorce** is treated as Jill's use also.

Example 4 Facts. Rich, a single building contractor, constructs single-family homes. He lives in one of his homes for two years, sells it at a profit, and moves into another of his homes.

Question. Is he allowed to take advantage of the $250,000 exclusion every other year?

Answer. Yes, assuming he meets the dual two-year tests. Every taxpayer is entitled to have a principal residence. A contractor is not penalized simply because he builds his own residence.

ISSUE 6: FORM 8801 (CREDIT FOR PRIOR YEAR MINIMUM TAX)

BACKGROUND INFORMATION REGARDING ALTERNATIVE MINIMUM TAX (AMT)

The AMT credit allows taxpayers to reduce regular income tax liability to the extent they have previously paid AMT because of certain adjustment and preference items called deferral adjustments and preferences. The credit also includes any unallowed fuel credit for producing fuel from a nonconventional source.

The effect of the credit is to make part of the AMT paid an acceleration in the payment of regular tax rather than an addition to the regular tax. It is an acceleration because the tax must be paid in the year the AMT on the deferral items is due or the fuel credit is disallowed, but it does not increase taxes in the long run because the credit will reduce regular taxes in subsequent years.

The minimum tax credit is calculated by subtracting from the AMT actually due for each prior year (after 1986) the AMT that would have been due if the deferral adjustments and preferences had been excluded from the AMT calculation. In other words, the AMT credit is the amount of AMT caused by the deferral adjustments and preferences. The unallowed credit for producing fuel from a nonconventional source is then added [I.R.C. §53(a)].

Example. Assume the same facts as shown for Sandra, who is single, on pages 501–503. Those pertinent facts are as follows:

1. Sandra exercised her incentive stock option (ISO) on her GE stock on November 12, 2000 and acquired 600 shares of GE stock.
2. This is not a cashless exercise. Because she did not sell the 600 shares acquired via the exercise of her ISO in 2000, she created a potential **AMT deferral preference** in 2000.
3. She reported three AMT adjustment and perference items on her **2000 Form 6251** as shown below:
   - **a.** $14,500 on line 3 for Schedule A taxes (from line 9 of her 2000 Schedule A). This is an **exclusion** adjustment item on line 2 on her 2001 Form 8801.
   - **b.** ($800) on line 6 for refund of state income tax (from line 10 of her 2000 Form 1040). This is an **exclusion** adjustment item on line 2 on her 2001 Form 8801.
   - **c.** $16,800 on line 10 for the **"bargain element"** of her ISO exercise. This is not taxed for regular tax purposes in **2000** but it is for AMT purposes. It is a **deferral** adjustment item and therefore is not included on line 2 of her 2001 Form 8801.
4. Sandra's **2001 Form 1040** shows $51,200 on line 37 and a regular tax liability of $7,205 after allowable credits.
5. Her **2001 Form 6251** (not shown) shows a tentative minmum tax (line 26) of $8,151.

See Sandra's completed **2001 Form 8801.**

Form **8801**

Department of the Treasury
Internal Revenue Service (99)

Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts

► **Attach to your tax return.**

OMB No. 1545-1073

2001

Attachment Sequence No. **74**

Name(s) shown on return: *Sandra* | **Identifying number**

Part I **Net Minimum Tax on Exclusion Items**

1	Combine lines 16 through 18 of your 2000 Form 6251. Estates and trusts, see instructions	1	*32,800*
2	Enter adjustments and preferences treated as exclusion items. See instructions 14,500 - 800	2	*13,700*
3	Minimum tax credit net operating loss deduction. See instructions	3	( )
4	Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than $165,000 and you were married filing separately for 2000, see instructions	4	*46,500*
5	Enter: $45,000 if married filing jointly or qualifying widow(er) for 2000; $33,750 if single or head of household for 2000; or $22,500 if married filing separately for 2000. Estates and trusts, enter $22,500	5	*33,750*
6	Enter: $150,000 if married filing jointly or qualifying widow(er) for 2000; $112,500 if single or head of household for 2000; or $75,000 if married filing separately for 2000. Estates and trusts, enter $75,000	6	*112,500*
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	*0*
8	Multiply line 7 by 25% (.25)	8	*0*
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	*33,750*
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15 and go to Part II. Form 1040NR filers, see instructions	10	*12,750*
11	If for 2000 you reported capital gain distributions directly on Form 1040, line 13, **or** completed Schedule D (Form 1040 or 1041) and had an amount on line 25 or line 27 of Schedule D (Form 1040) (line 24 or line 26 of Schedule D (Form 1041)) or would have had an amount on either of those lines had you completed them, go to Part III of Form 8801 to figure the amount to enter on this line. **All others:** Multiply line 10 by 26% (.26) **if** line 10 is: $175,000 or less if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 2000; or $87,500 or less if married filing separately for 2000. **Otherwise,** multiply line 10 by 28% (.28) and subtract from the result: $3,500 if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 2000; or $1,750 if married filing separately for 2000	11	*3,315*
12	Minimum tax foreign tax credit on exclusion items. See instructions	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	*3,315*
14	Enter the amount from your 2000 Form 6251, line 27, or Form 1041, Schedule I, line 38	14	*4,999*
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	*0*

Part II **Minimum Tax Credit and Carryforward to 2002**

16	Enter the amount from your 2000 Form 6251, line 28, or 1999 Form 1041, Schedule I, line 39	16	*2,688*
17	Enter the amount from line 15 above	17	*0*
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	*2,688*
19	**2000 minimum tax credit carryforward.** Enter the amount from your 2000 Form 8801, line 26	19	
20	Enter the total of your 2000 unallowed nonconventional source fuel credit and 2000 unallowed qualified electric vehicle credit. See instructions	20	
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	*2,688*
22	Enter your 2001 regular income tax liability minus allowable credits. See instructions	22	*7,205*
23	Enter the amount from your 2001 Form 6251, line 26, or 2001 Form 1041, Schedule I, line 37	23	*8,151*
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	*0*
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on your 2001 Form 1040, line 49; Form 1040NR, line 46; or Form 1041, Schedule G, line 2d	25	*0*
26	**Minimum tax credit carryforward to 2002.** Subtract line 25 from line 21. Keep a record of this amount because you may use it in future years	26	*2,688*

For Paperwork Reduction Act Notice, see page 4. Cat. No. 10002S Form **8801** (2000)

16

Observations regarding Sandra's 2001 Form 8801

1. Her **2001** minmum tax credit on line 25 is zero.
2. Her minmum tax credit carryforward to **2002** on line 26 is $2,688.

Exclusion Preferences

Exclusion preferences reported on prior Form(s) 6251 can **never create current-year minimum tax credit (MTC).** Exclusion preferences that produced prior-year AMT liability result in a permanent increase **in total tax.** The following list shows all exclusion adjustments and preferences and their respective line numbers on Form 6251.

1. Standard deduction from line 36, Form 1040 (line 1)
2. Medical expenses (line 2)
3. State and local taxes from line 9, Schedule A (line 3)
4. Mortgage (including home equity loans) interest where loan proceeds are **not** used to buy, build, or improve a principal residence or a qualifying second residence (line 4)
5. Miscellaneous itemized deductions from line 26, Schedule A (line 5)
6. Refund of taxes (line 6)
7. Deduction for personal exemptions (no specific line–factored into line 16, which is line 37, Form 1040)
8. Depletion (line 14b)
9. Tax-exempt interest from private activity bonds issued after August 7, 1986 (line 13)
10. 42% of the I.R.C. §1202 exclusion for gain on qualified small business stock (line 14m)

ISSUE 7: DAY TRADING

GENERAL INFORMATION

The term "day trading" until recent years was generally applied to commodity traders. However, the bull market in stocks led to the phenomenon of day trading in stock. It is doubtful that many preparers will have clients who actually qualify as traders as opposed to investors, but some clients who trade stocks frequently might try to convince the preparer that they do qualify as traders.

Distinguishing between traders and investors involves looking at goals and frequency of trading activity. A **trader** tries to capture short-term market swings. An **investor** seeks either significant dividend income or a benefit from long-term appreciation in securities prices.

TAX ADVANTAGES FOR TRADERS

Traders are allowed to deduct all investment expenses on Schedule C as a trade or business expense. A taxpayer who qualifies as a trader can deduct the following investment expenses on Schedule C and avoid the 2% AGI limitation imposed on investors:

- Margin interest
- Office-in-home expenses, assuming a net profit from trading
- Investment publications and newsletters

- §179 deduction on the **trading use portion** of a computer, fax machine, and office equipment **used more than 50%** for the trading business
- Travel expenses to attend investment seminars
- Investment management software (generally depreciable over a 36-month period)

By contrast, the identical investment expenses of **investors** are governed by I.R.C. §212. An investor deducts allowable expenses as miscellaneous itemized deductions on Schedule A (line 22) subject to the 2% AGI limit. Investors are entitled to **no deduction** for office in home expenses, I.R.C. §179, or for investment seminar or convention expenses.

HOW DO TRADERS REPORT STOCK SALES?

Both traders and investors report stock and bond sales on Schedule D. Both are subject to the $3,000 maximum net capital loss deduction each year and to the wash sale rules. A trader's tax return will show the following:

- A Schedule C with investment expenses and no income
- A Schedule D with numerous short-term securities transactions
- A Schedule SE is **not required,** since any net trading profit shown on Schedule D is exempt from self-employment tax

Practitioner Note. Traders should attach a statement to their returns explaining that they qualify as self-employed traders. This will alert IRS examiners if the return is selected for examination at service centers. Although not required, the statement should explain why the taxpayer has a Schedule C with expenses only.

WHO QUALIFIES AS A TAX-ADVANTAGED TRADER?

The issue of what constitutes a trade or business is not addressed specifically in the Internal Revenue Code or the regulations. As stated previously, it is extremely difficult for a taxpayer to meet the definition of a trader, especially in the view of the IRS.

The only way to answer the question is to follow the guidelines in court cases. In virtually all such cases, the IRS view that the taxpayer was an **investor and not a trader** prevailed in the courts. One of the court cases is analyzed below.

Paoli, T.C. Memo 1991-351, 62 T.C.M. 275 (1991) [CCH Dec. 47,506(M)]

Facts. Stephen Paoli was an employee of his closely held manufacturing corporation. He and his wife filed jointly for 1982. On that return, they reported 326 sales of stocks and option contracts on Schedule D. Many of the 326 sales were day trades. Following is a recap of the 1982 Schedule D:

Net short-term capital loss	$ (759,444)
Net long-term capital loss	(271,778)
Net capital loss reported on 1982 Sched. D	**$(1,031,222)**

In addition, they filed a 1982 Schedule C showing a $64,300 deduction for margin interest paid to eight brokerage firms. **The IRS reclassified the Schedule C business interest as investment interest.**

Mr. Paoli contended at Tax Court that he was a **stock trader** who was "actively and continuously engaged in the **business** of buying and selling corporate stocks." He further argued that he "did not hold the stocks for long periods of time hoping for capital appreciation, but sought short-term swing gains on a regular and active basis." Therefore, his margin interest constituted **business** interest deductible under I.R.C. §163(a).

16

Tax Court Holding. "In order to qualify as a **trader** who is engaged in a trade or business, a taxpayer's activities must first be **frequent, regular, and continuous**." To be engaged in a trade or business, the taxpayer must be involved in the activity **with continuity and regularity**. The primary purpose for engaging in the activity must be for income or profit.

A trader's activities must seek profit from short-term market swings, unlike those of an **investor**, who seeks capital appreciation and income and who is usually not concerned with short-term developments.

Whether Mr. Paoli's activities constitute a trade or business is a question of fact. He has **not** proved that his pattern of buying and selling stocks was sufficiently regular and continuous during the entire year of 1982 to constitute a trade or business.

Summary

At best, this is a fuzzy area of tax law. However, three scenarios follow, each with an **opinion** about whether the activity qualifies as trader or investor activity.

Scenario 1 Facts. Sarah quit her job as a nurse in June 1999 to devote at least 40 hours a week to buying and selling stocks and stock options from her home office. She has done this from June 1999 through December 2000. She focuses on a fairly narrow list of biotech and technology stocks and options. She generally makes at least three trades each day the major stock exchanges are open. She did take two 2-week vacations in 2000 in which she did not make any trades. She is married. Her husband, Steve, is a full-time employee.

Scenario 1 Opinion. Sarah qualifies as a **trader** as she meets the **continuous and regular** requirement. The fact that she is **not employed** is a very favorable factor. One **two**-week vacation would have been better than two, but that factor alone is not sufficient to deny her trader status.

Scenario 2 Facts. Kurt is a single full-time loan officer at a bank. In 2000, he made 310 stock purchases and 282 stock sales. Many were short sales in which he was betting that stocks he sold short would decline in price. He spent an average of 15 hours a week at his home office and at his employer's office in this activity. He never held a stock in a long position more than two months during 2000. Of the 282 completed transactions he made in 2000, 140 were day trades.

Scenario 2 Opinion. Steve is **probably an investor**, although the verdict is not entirely clearcut. An IRS examiner is likely to conclude that Steve's full-time employment is a factor that strongly indicates investor status.

Scenario 3 Facts. Dawn is a workaholic, single, 30-year-old self-employed consultant. She works 40–50 hours a week at her consulting business, which is conducted mainly from her home office. She also spends a minimum of 20 hours a week trading only six technology stocks, which she tracks extensively. She made a total of 110 completed trades in 2000 in these six stocks; 65 were short sales. Her longest holding period for a completed long-position sale in 2000 was 21 days. Her stock trading activity is done at her home office.

Scenario 3 Opinion. Dawn is an **investor.** She has a more-than-full-time consulting business, and the number of trades she made in 2000 (110) was small compared with the activity of a legitimate trader.

> **Practitioner Note for Scenario 3.** Technically, Dawn should not use her home office for both her consulting and her stock trading activity. If she does and admits it to an IRS examiner, the home office expenses deducted on her 2000 consulting business Schedule C could be disallowed, as she has violated the "exclusive use" test.

Other Day Trader Issues

1. Day traders are more likely than investors to be affected by the **wash sale disallowance of loss** rule. See the Investments chapter for complete details on this topic.
2. Preparation of Schedule D and/or D-1 (Continuation Sheet) is time-consuming and frustrating. You may want to recommend that your day trader clients use a spreadsheet that keeps track of stock transactions.

ISSUE 8: DETERMINING STOCK BASIS

GENERAL INFORMATION

Determining the basis of stock sold is generally not difficult. However, with the increasing number of spin-offs by companies to increase shareholder value, the task of computing basis may sometimes become complex. The problem that follows involves a tax-free spin-off of Palm, Inc. common stock to shareholders of 3Com Corporation common stock. The date of the spin-off was July 27, 2000. The facts given are actual, not hypothetical. In the facts that follow, the common stock of 3Com Corporation is referred to as 3Com stock. The common stock received as a spin-off–Palm, Inc.–is referred to as Palm stock.

Facts. Amber bought 3Com stock on two occasions, as shown in the chart below

Number of Shares Bought	Date Bought	Price/Share	Total Cost, Including Commission
(1) 300	2-25-99	$32 7/16	$ 9,935.29
(2) 200	3-16-99	25 1/2	5,246.10
Total cost of the 500 shares			**$15,181.39**

She sold 250 shares of 3Com on March 7, 2000, for $70.25 per share. **The total sales price after commissions was $17,287.57.** Amber used the **FIFO** (**first in, first out**) method to determine the cost basis of the 250 shares, as shown in the following calculation.

FIFO cost basis calculation: $9,935.29 × 250/300 = **$8,279.41**

Practitioner Note. Since Amber did **not** instruct her broker as to the specific shares of 3Com stock sold, she **must** use the FIFO method.

IRS Publication 551 (*Basis of Assets*) states, "If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the **basis** of the securities you sell is the **basis of the securities you acquired first.**

Amber's long-term capital gain on the sale of the 250 shares is shown in the following calculation.

Sales price on March 7, 2000	$17,287.57
Less: FIFO cost basis	(8,279.41)
Long-term capital gain	**$ 9,008.16**

See Amber's completed 2000 Schedule D, which is shown later in this problem.

On March 31, 2000, Amber gave 38 shares of the remaining 50 shares bought February 25, 1999, to her church. The median price of 3Com stock on March 13, 2000, was $63.50.

After the gift, Amber had **212 remaining shares of 3Com:**

Number of shares purchased in 1999	500
Less: Number of shares sold in 2000	(250)
Less: Number of shares donated to charity in 2000	(38)
Remaining shares of 3Com stock as of March 14, 2000	**212**

Her remaining cost basis in the 212 3Com shares is shown in the following calculation:

(1) 12 shares bought Feb. 25, 1999 ($9,935.29 × 12/300)	$ 397.41
(2) 200 shares bought March 16, 1999	5,246.10
Amber's cost basis in the remaining 212 shares	**$5,643.51**

In the spin-off of July 27, 2000, Amber received 1.4832 shares of Palm stock for every share of 3Com stock she owned as of July 11, 2000. **Amber received 314 shares of Palm stock due to the spin-off.**

Practitioner Note. Amber also received **$17.05 cash in lieu of the .444025 fractional share of Palm stock** she received in the spin-off. The date of sale was July, 27, 2000. Her holding period for the fractional share of Palm stock is the **same** as her holding period for the 212 shares of 3Com stock she owned prior to the spin-off. Therefore, her **gain** on the sale of the fractional Palm share is **long-term.** See Amber's completed 2000 Schedule D for details on the sale of the fractional share of Palm stock.

Question. What is Amber's cost basis in the 3Com and Palm stock after the spin-off?

Answer. The best source of information to help Amber's tax preparer compute her new cost basis figures can usually be found on the web site of the company that originated the spin-off. A portion of the information shown on the web site of 3Com follows. "Calculating Cost Basis" has been boxed, indicating its importance.

3Com Completes Separation of Palm, Inc.

Santa Clara, Calif., July 28, 2000–3Com Corporation (Nasdaq: COMS) announced today it has completed the separation of Palm, Inc. through the distribution of all of its 532 million shares of Palm, Inc. (Nasdaq: PALM). After the close of market yesterday, July 27, 3Com shareholders were issued 1.4832 shares of Palm, Inc. common stock for each share of 3Com common stock held. Cash will be issued in lieu of fractional shares. As a result of the distribution of shares of Palm, Inc. common stock, Palm is now a fully independent company.

Calculating Cost Basis. On July 24, an information statement was mailed to 3Com shareholders which included information on the distribution ratio, as well as information on how to calculate the tax basis for 3Com and the Palm shares received as a dividend. Applying the calculation method outlined in that information statement and using the valuation of 3Com ex-dividend and Palm at the open of trading on July 28, **shareholders may allocate 21.02% of pre-distribution tax basis to their 3Com shares and the remaining 78.98% to their Palm shares (including any fractional interest).** Shareholders should consult their tax advisors regarding the application of this calculation to their particular circumstances.

The ratio to allocate cost basis is shown in the following chart.

Stock	Ratio to Allocate Cost Basis
3Com	21.02
Palm	78.98

Using the ratio, Amber's basis in the two securities is shown next.

Item	Total Basis	Allocated to 3Com Stock		Allocated to Palm Stock	
(1) 12 shares bought 2-25-99	$ 397.41	$ 83.54	(21.02%)	$ 313.87	(78.98%)
(2) 200 shares bought 3-16-99	5,246.10	1,102.73	(21.02%)	4,143.37	(78.98%)
Totals	**$5,643.51**	**$1,186.27**		**$4,457.24**	

Total number of Palm shares Amber received in the spin-off, including fractional share	314.44025
Allocated cost of Palm per share ($4,457.24 ÷ 314.44025)	$14.175

Practitioner Note. Calculation of long-term gain on sale of .44025 fractional share on July 27, 2000 (day of the spin-off):

Sales price	$17.05
Less: Cost basis ($14.175 × .44025)	(6.24)
Long-term gain	**$10.81**

See Amber's completed 2000 Schedule D for details on this sale.

Amber has two different cost-per-share figures for the remaining 3Com stock, as shown in the following chart.

Item	Allocated Basis	Basis per share
(1) 12 shares bought 2-25-99	$ 83.54	$6.96 (rounded)
(2) 200 shares bought 3-16-99	1,102.73	5.51 (rounded)

Conclusion. Even though the computations in this problem involve simple math, they are time-consuming.

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
2000
Attachment Sequence No. 12

Name(s) shown on Form 1040: *Amber* | 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-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)
1					

16

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-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) *(see instr. below)
8	250 s.h. 3 Com	2-25-99	3-7-00	17,287 57	8,279 41	9,008 16	
	44025 sh. Palm	2-25-99	7-27-00	17 05	6 24	10 81	
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			17,311 62			
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		
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 page D-1				13		
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1998 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine lines 8 through 14 in column (g)				15		
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) ▶ **Next:** Go to Part III on the back.				16	9,018 97	

***28% Rate Gain or Loss** includes **all** "collectibles gains and losses" (as defined on page D-5) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 1999**

ISSUE 9: SUMMARY TABLE OF MOST COMMON TAX ELECTIONS

Election	Method	Due Date	Can It Be Revoked?	Authority	Year and Page Number of Discussion in the Farm Income Tax Book
Elections That Affect Income					
Basis adjustment of partnership assets	Attach statement to partnership return	Due date (including extensions) of partnership tax return for year the election is to be effective	Only with consent of IRS Commissioner; request must be filed within 30 days of the end of the partnership year the revocation is to be effective	I.R.C. §754	1999, pages 291–294
Basis of mutual fund shares: Averaging methods	Attach a statement to the return for the year of the election	Six months after due date of the return for the year of election or on a delinquent return	Only with the consent of the Commissioner	Treas. Reg. §1.1012-1(e)	1998, pages 216–221

Election	Method	Due Date	Can It Be Revoked?	Authority	Year and Page Number of Discussion in the Farm Income Tax Book
		Elections That Affect Income			
CCC loans: Election to treat as income	Attach a statement to the tax return	Six months after due date of the return for the year of election	Only with the consent of the Commissioner; a request to revoke the election must be filed within 90 days for the beginning of the tax year the revocation is to be effective.	I.R.C. §77; Treas. Reg. §1.77; Rev. Rul. 56-358, 1956-2 C.B. 99	1999, pages 151–160
Disaster payments or crop insurance	Attach statement to tax return	Due date for amending return for the year of sale	Only with the consent of district director	I.R.C. §451(d)	1999, pages 160–163
Installment sale, election out of installment method	Report gain on return for year of sale	Six months after due date of the return for the year of sale	Only with consent of the Secretary of the Treasury	I.R.C. §453(d)	See index of each book for discussion of installment sales within other topics
IRAs: election to recalculate life expectancies	Notify plan administrator	By due date of first required distribution	No	I.R.C. §401(a)(9)	1999, pages 186–193
Roth IRA conversion, election by surviving spouse to continue four-year spread	Attach statement to return and report four-year spread amount	Six months after due date of surviving spouse's return for year of IRA owner's death	Only within period for making the election	I.R.C. §408A(d)(3)(E)(ii)(II) and Treas. Reg. §1.408A-4, Q/A-11	1999, pages 416–417
Roth IRAs: Election to recharacterize a conversion	Notify Roth IRA trustee and file an amended return	Varies by year; see IRS Publication 590	Yes, within the period for making the election	I.R.C. §408A and Announcement 99-57, 1999-24 I.R.B. __	1999, pages 418–419
S corporation election	File Form 2553	15th day of the third month of the tax year the election is effective	Yes, by election of more than 50% of the shareholders	I.R.C. §1362	1999, pages 266–271
Weather related livestock sales: postpone gain for one year	Attach statement to return for the year of sale	Due date for amending return for the year of sale	Only with the consent of the district director	I.R.C. §451(e)	1999, pages 163–167
Weather related livestock sales: roll gain into replacements	Attach statement to return for the year of sale	Due date for amending return for the year of sale	Yes	I.R.C. §1033(e) and Rev. Rul. 63-127, 1963-2 C.B. 333	1999, pages 163–167

Election	Method	Due Date	Can It Be Revoked?	Authority	Year and Page Number of Discussion in the Farm Income Tax Book
Elections That Affect Deductions and Credits					
Capitalize taxes, interest, and carrying charges on property	Attach statement to the return for the year of election	Six months after due date of the return for the year of election or on a delinquent return	?—Code and regulations are silent	I.R.C. §266	
Disaster losses: election to deduct in preceding year	Attach statement to return or claim for refund for year prior to the year of loss	Later of the due date (without extensions) of tax return for the year of the loss, or the due date (including extensions) for the year before the year of the loss	Yes, within 90 days after the election is made	I.R.C. §165(i) and Treas. Reg. §1.165-11	
Expense deduction (I.R.C. §179)	Attach Form 4562 to income tax return	Filing of tax return for the year of purchase	Only with the consent of the Secretary of the Treasury	I.R.C. §179(c)	1999, pages 324–329
Foreign tax deduction or credit	File Form 1116	10 years after the due date of the return for the year the foreign taxes are paid or accrued	Yes, within the period for making the election	I.R.C. §§901(a) and 6511(d)(3), and Treas. Reg. §1.901-1(d)	
Hobby losses: election to postpone determination of motive	File Form 5213	Three years after due date (without extensions) of tax return for the first year of the activity	No	I.R.C. §183(e) and Treas. Reg. 12.9	
Investment interest: election to treat capital gains as investment income	Complete line 4e of Form 4952	Six months after due date of the return for the year of capital gain	Only with the consent of the Commissioner	I.R.C. §163(d)(4)	1999, pages 341–351
Net operating loss, election to forgo carryback	Attach statement to return for the NOL year	Six months after due date of the return for the NOL year	Only with consent of IRS Commissioner	I.R.C. §172(b)(3)	1999, pages 124–129 1998, pages 26–27
Start-up expenses: Election to amortize over 60-month period	Attach Form 4562 to income tax return. Complete Part VI.	Due date (including extensions) of the tax return for the year the business becomes active	No	I.R.C. §195(d)	1998, pages 331–336
Elections That Affect Method of Calculating Tax					
Lump-sum distributions from retirement plans	File Form 4972 for the year of the lump-sum distribution	Due date for amending return for year of lump-sum distribution	Yes, within the period for amending return for year of lump-sum distribution	I.R.C. §402(d) and Tax Reform Act of 1986 §1122(h)	1998, pages 579–583
Optional self-employment tax method	Fill in appropriate lines on Schedule SE (Form 1040)	Due date for amending return for year of election	Yes, within the period for amending return for year of election	I.R.C. §1402(a)	1998, page 141 1996, pages 168–174

SMALL BUSINESS ISSUES