2000 Income Tax School

SMALL BUSINESS ISSUES

ISSUE 1: FORMS W-2

The accurate preparation of Forms W-2 is important since workers' social security earnings information **and** information for filing individual income tax returns is contained on the forms.

Important points to remember:

1. Employers that are required to file 250 or more Forms W-2 must file them on magnetic media or electronically.
2. When printing Forms W-2, use only black ink and at least 10-point font.
3. Do **not** use dollar signs or commas for dollar entries.
4. **Do** use decimal points and the cents portion of the money amounts.
5. If a box does not apply, leave it blank.
6. Send the whole Copy A page of Form W-2 with Form W-3 to the SSA even if one of the Forms W-2 is blank or void.
7. Do not show titles or academic degrees at the beginning or end of the employee's name.
8. If an employee loses a Form W-2, write "REISSUED STATEMENT" on a new copy and provide it to the employee. Do not send copy A of the reissued Form W-2 to the SSA.
9. Employers must furnish Copies B, C, and 2 of Form W-2 to employees by January 31 of the following year. The "furnish by" requirement is met if the form is properly addressed and mailed on or before the due date.
10. Employers are required to keep for four years any employee copies of Forms W-2 for which delivery was attempted but was unsuccessful.

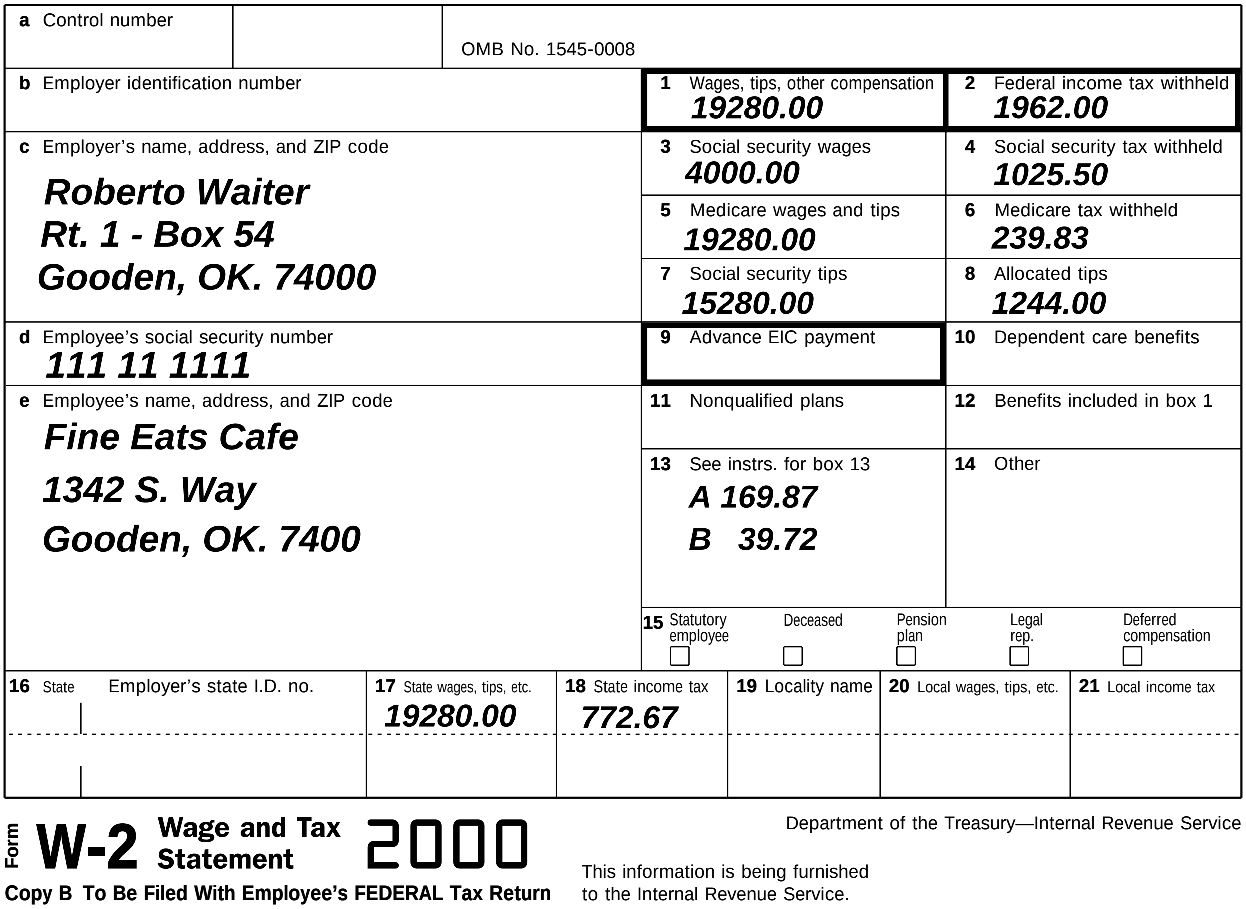
Example 1: Allocated Tips

Practitioner Note. A common error in preparing returns is overlooking allocated tips shown in box 8 of Form W-2.

Facts. Roberto, who is single, is a waiter for the Fine Eats Café. His employer is subject to the large food or beverage establishment rules and is required to **allocate** tips up to 8% of daily gross receipts from the café. Roberto reported tips to his employer of $15,280 for the year 2000. The amount of reported tips should be included in box 1 of his W-2 and also in box 7. Total reported tips are less than

8%, and Fine Eats Café allocates $1,244 of tips to Roberto and reports the amount in box 8 of his W-2. The amounts in box 13A of $169.87 and box 13B of $39.72 are **uncollected** social security and Medicare taxes the employer was unable to withhold on Roberto's tip income. See Roberto's W-2 in Figure 1.

Figure 1



a Control number

OMB No. 1545-0008

b Employer identification number

c Employer's name, address, and ZIP code
Roberto Waiter
Rt. 1 - Box 54
Gooden, OK. 74000

d Employee's social security number 111 11 1111

e Employee's name, address, and ZIP code
Fine Eats Cafe
1342 S. Way
Gooden, OK. 7400

1 Wages, tips, other compensation 19280.00

2 Federal income tax withheld 1962.00

3 Social security wages 4000.00

4 Social security tax withheld 1025.50

5 Medicare wages and tips 19280.00

6 Medicare tax withheld 239.83

7 Social security tips 15280.00

8 Allocated tips 1244.00

9 Advance EIC payment

10 Dependent care benefits

11 Nonqualified plans

12 Benefits included in box 1

13 See instrs. for box 13
A 169.87
B 39.72

14 Other

15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ Deferred compensation ☐

16 State	Employer's state I.D. no.	**17** State wages, tips, etc.	**18** State income tax	**19** Locality name	**20** Local wages, tips, etc.	**21** Local income tax
		19280.00	772.67			

Form **W-2** **Wage and Tax Statement** 2000

Department of the Treasury—Internal Revenue Service

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

This information is being furnished to the Internal Revenue Service.

Question 1. How should Roberto's information be reported on his 2000 tax return if he has incomplete records of his tip income?

Answer 1. Both the amounts in box 1, $19,280, and box 8, $1,244, should be reported on line 7 (Wages) of his 2000 Form 1040 as taxable income. The total of these two amounts is $20,524. The amount of reported tips in box 7, $15,280, is included in the box 1 amount of $19,280. Roberto's $95.16 share of social security and Medicare tax on the allocated tips of $1,244 is computed on Form 4137 (Figure 2) and reported on line 53 of Form 1040. The amounts reported in box 13A and B are entered on line 57 of Form 1040 (Figure 3).

Figure 2

Form **4137**

Department of the Treasury
Internal Revenue Service

Social Security and Medicare Tax on Unreported Tip Income

▶ See instructions on back.
▶ Attach to Form 1040.

OMB No. 1545-0059

2000

Attachment Sequence No. **24**

Name of person who received tips (as shown on Form 1040). If married, complete a separate Form 4137 for each spouse with unreported tips. *Roberto Waiter*

Social security number *111 11 111*

Name(s) of employer(s) to whom you were required to, but did not, report your tips: *Fine Eats Cafe*

1 Total cash and charge tips you **received** in 2000. See instructions	**1**	*16,524*	
2 Total cash and charge tips you **reported** to your employer in 2000	**2**	*15,280*	
3 Subtract line 2 from line 1. This amount is income you **must** include in the total on Form 1040, line 7	**3**	*1,244*	
4 Cash and charge tips you received but did not report to your employer because the total was less than $20 in a calendar month. See instructions	**4**		
5 Unreported tips subject to Medicare tax. Subtract line 4 from line 3. Enter here and on line 2 of Schedule U below	**5**	*1,244*	
6 Maximum amount of wages (including tips) subject to social security tax — **6** 76,200 00			
7 Total social security wages and social security tips (total of boxes 3 and 7 on Form(s) W-2) or railroad retirement (tier 1) compensation — **7** *19,280*			
8 Subtract line 7 from line 6. If line 7 is more than line 6, enter -0- here and on line 9 and go to line 11	**8**	*56,920*	
9 Unreported tips subject to social security tax. Compare the amounts on lines 5 and 8 above. Enter the **smaller** of the two amounts here and on line 1 of Schedule U below. If you received tips as a Federal, state, or local government employee, see instructions	**9**	*1,244*	
10 Multiply line 9 by .062	**10**	*77*	*13*
11 Multiply line 5 by .0145	**11**	*18*	*03*
12 Add lines 10 and 11. Enter the result here and on Form 1040, line 53 ▶	**12**	*95*	*16*

For Paperwork Reduction Act Notice, see instructions on back. Form **4137** (2000)

Do Not Detach

SCHEDULE U (Form 1040)

Department of the Treasury
Internal Revenue Service

U.S. Schedule of Unreported Tip Income

For crediting to your social security record

2000

Note: *The amounts you report below are for your social security record. This record is used to figure any benefits, based on your earnings, payable to you and your dependents or your survivors. Fill in each item accurately and completely.*

Print or type name of person who received tip income (as shown on Form 1040) *Roberto Waiter*

Social security number *111 11 111*

Address (number, street, and apt. no., or P.O. box if mail is not delivered to your home) *Rt. 1 - Box 54*

Occupation *waiter*

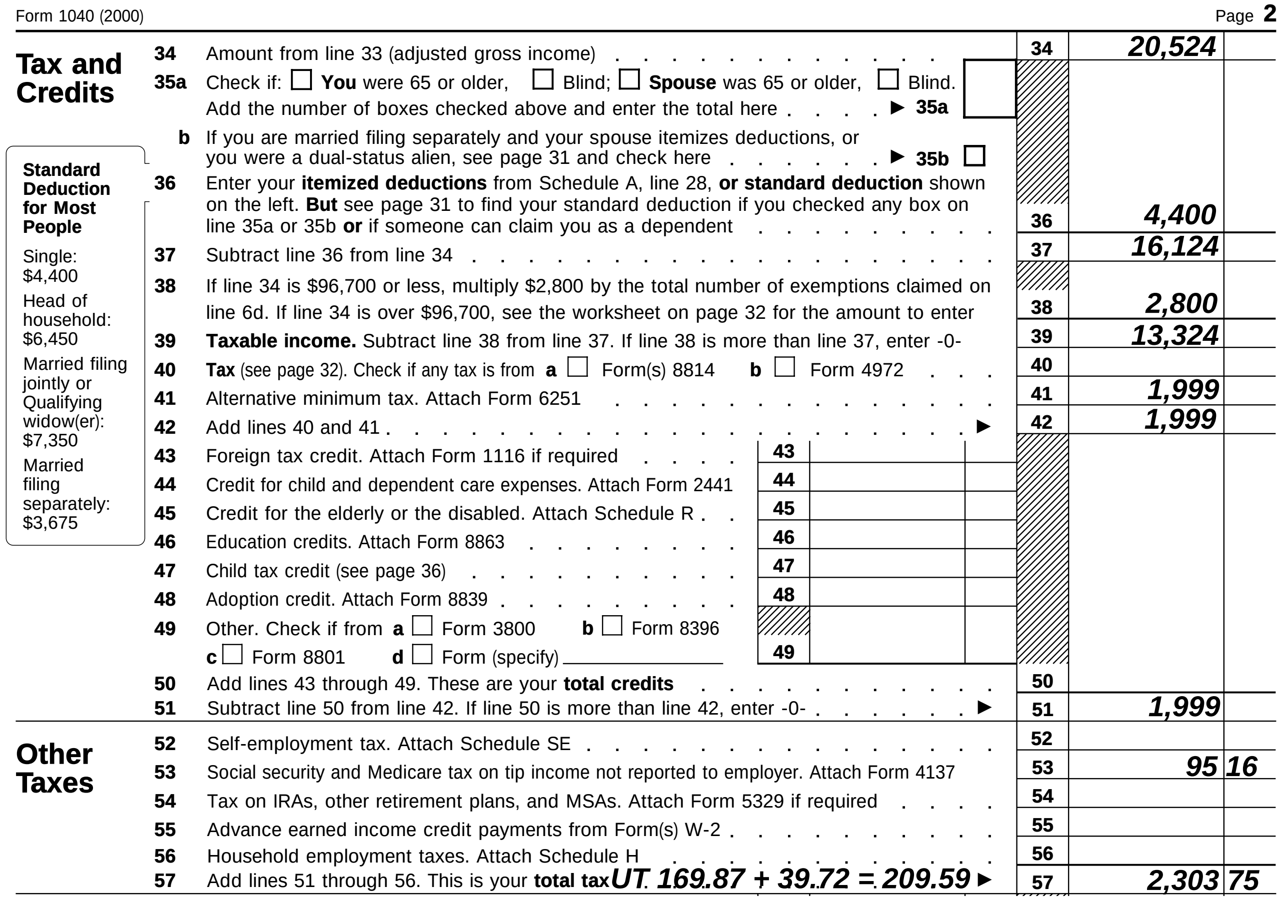
City, town or post office, state, and ZIP code *Gooden, OK. 74000*

1 Unreported tips subject to social security tax. Enter the amount from line 9 (Form 4137) above ▶	**1**	*1,244*	
2 Unreported tips subject to Medicare tax. Enter the amount from line 5 (Form 4137) above ▶	**2**	*1,244*	

Please do not write in this space

DLN—

Figure 3



Form 1040 (2000) Page 2

Tax and Credits	34	Amount from line 33 (adjusted gross income)			34	20,524	
	35a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here . . . . ▶ 35a ☐					
	b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here . . . . ▶ 35b ☐					
Standard Deduction for Most People Single: $4,400 Head of household: $6,450 Married filing jointly or Qualifying widow(er): $7,350 Married filing separately: $3,675	36	Enter your **itemized deductions** from Schedule A, line 28, **or standard deduction** shown on the left. **But** see page 31 to find your standard deduction if you checked any box on line 35a or 35b **or** if someone can claim you as a dependent			36	4,400	
	37	Subtract line 36 from line 34			37	16,124	
	38	If line 34 is $96,700 or less, multiply $2,800 by the total number of exemptions claimed on line 6d. If line 34 is over $96,700, see the worksheet on page 32 for the amount to enter			38	2,800	
	39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-			39	13,324	
	40	**Tax** (see page 32). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972 . . .			40		
	41	Alternative minimum tax. Attach Form 6251			41	1,999	
	42	Add lines 40 and 41 . . . . ▶			42	1,999	
	43	Foreign tax credit. Attach Form 1116 if required	43				
	44	Credit for child and dependent care expenses. Attach Form 2441	44				
	45	Credit for the elderly or the disabled. Attach Schedule R . .	45				
	46	Education credits. Attach Form 8863	46				
	47	Child tax credit (see page 36)	47				
	48	Adoption credit. Attach Form 8839	48				
	49	Other. Check if from **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify)	49				
	50	Add lines 43 through 49. These are your **total credits**			50		
	51	Subtract line 50 from line 42. If line 50 is more than line 42, enter -0- . . . . ▶			51	1,999	
Other Taxes	52	Self-employment tax. Attach Schedule SE			52		
	53	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			53	95	16
	54	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required			54		
	55	Advance earned income credit payments from Form(s) W-2			55		
	56	Household employment taxes. Attach Schedule H			56		
	57	Add lines 51 through 56. This is your **total tax** UT 169.87 + 39.72 = 209.59 ▶			57	2,303	75

Question 2 Facts. Roberto provides to his tax preparer **accurate** records that prove the actual amount of tips received was $15,280.

Question 2. Does this change the amount of income he will report?

Answer 2. Yes. If Roberto can prove he reported all of his tips to his employer, **he should not include** the $1,244 amount in box 8 on line 7 of his Form 1040. He should attach a statement explaining the facts. Not reporting the $1,244 on line 7 will probably generate a CP 2000 notice. Roberto should retain his tip records to respond to a CP 2000 notice if necessary.

Practitioner Note. IRS Form 4070A (Employee's Daily Record of Tips) in Publication 1244 may be used by employees to keep accurate tip records.

ISSUE 2: INSTALLMENT SALES

Form 6252, Installment Sale Income, is used to reflect income from casual sales of real and personal property (other than inventory) if the taxpayer will receive any payment in a tax year **after** the year of sale. A taxpayer can "elect out" of an installment sale by reporting the full amount of gain on Form 4797 or Schedule D, whichever applies.

Practitioner Caution. Planning is key for taxpayers choosing not to use installment sale reporting. For example, a taxpayer may want to recognize a full gain on an installment sale if the taxpayer has a large capital loss carryforward or anticipates greater income in future years.

The two examples that follow illustrate the proper reporting of installment sales.

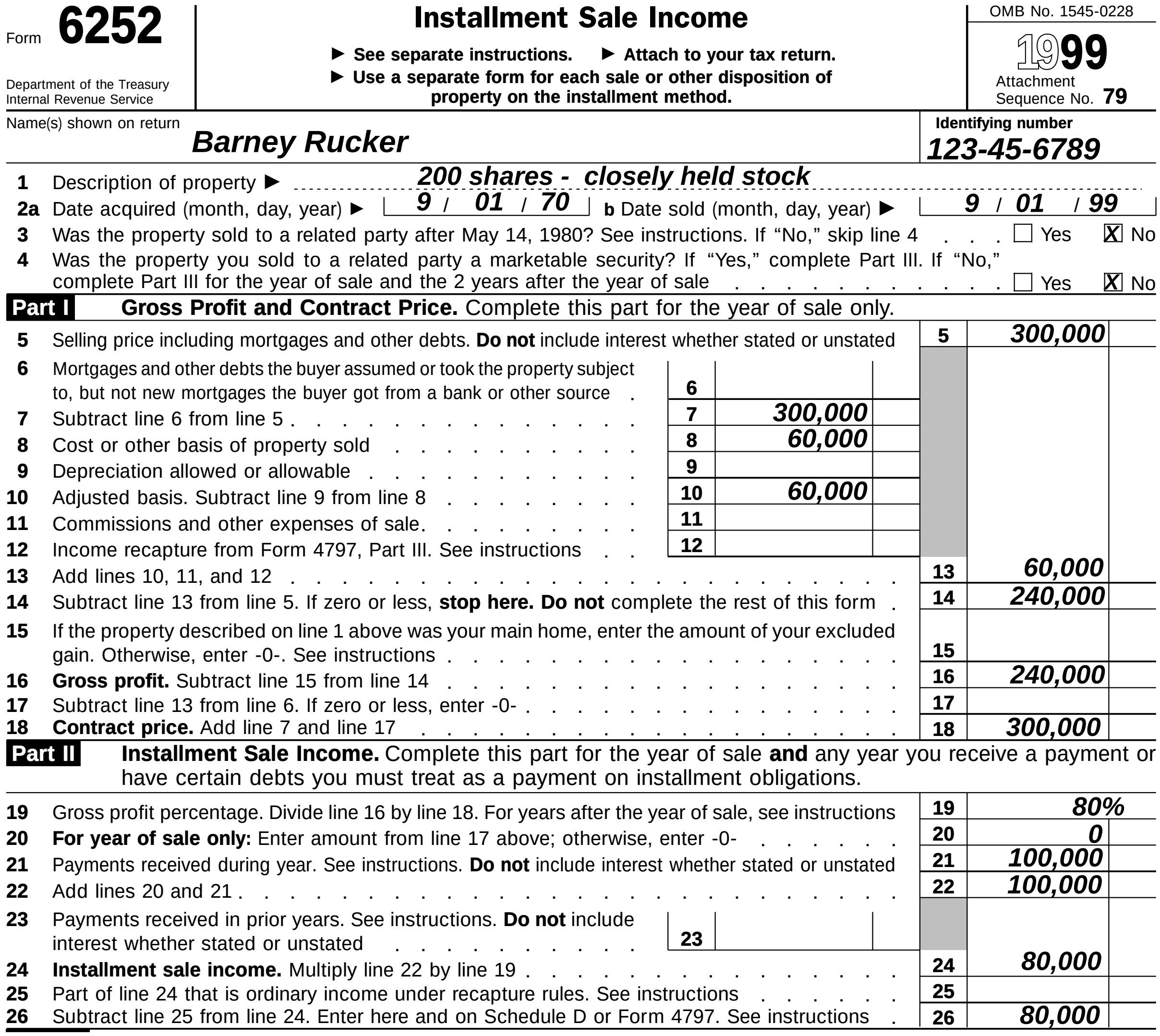
Example 2

Facts. Barney Rucker owned 200 shares, or 20%, of Almost Straight Paving Co., a closely held corporation. His cost basis for this stock was $60,000. Almost Straight Paving Co. is buying back his stock for $300,000; $100,000 of the purchase price was paid on September 1, 1999, and the balance of $200,000 will be paid over five years at $400,000 annually plus 9% interest on the unpaid balance.

Barney will use the installment method to report his gain. Form 6252 (Figure 4) illustrates the first year's reporting of installment income, and Schedule D (Figure 5) shows the current-year capital gain. In future years, Barney will report his interest income on Schedule B of Form 1040.

Practitioner Note. The sale of stock traded on an established securities exchange **cannot** be reported as an installment sale.

Figure 4



Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ **See separate instructions.** ▶ **Attach to your tax return.**
▶ **Use a separate form for each sale or other disposition of property on the installment method.**

OMB No. 1545-0228
1999
Attachment Sequence No. **79**

Name(s) shown on return: *Barney Rucker*
Identifying number *123-45-6789*

1 Description of property ▶ *200 shares - closely held stock*
2a Date acquired (month, day, year) ▶ *9 / 01 / 70* **b** Date sold (month, day, year) ▶ *9 / 01 / 99*
3 Was the property sold to a related party after May 14, 1980? See instructions. If "No," skip line 4 . . . ☐ Yes ☒ No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . ☐ Yes ☒ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated			**5**	*300,000*
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	**6**			
7	Subtract line 6 from line 5	**7**	*300,000*		
8	Cost or other basis of property sold	**8**	*60,000*		
9	Depreciation allowed or allowable	**9**			
10	Adjusted basis. Subtract line 9 from line 8	**10**	*60,000*		
11	Commissions and other expenses of sale	**11**			
12	Income recapture from Form 4797, Part III. See instructions	**12**			
13	Add lines 10, 11, and 12			**13**	*60,000*
14	Subtract line 13 from line 5. If zero or less, **stop here. Do not** complete the rest of this form			**14**	*240,000*
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. Otherwise, enter -0-. See instructions			**15**	
16	**Gross profit.** Subtract line 15 from line 14			**16**	*240,000*
17	Subtract line 13 from line 6. If zero or less, enter -0-			**17**	
18	**Contract price.** Add line 7 and line 17			**18**	*300,000*

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			**19**	*80%*
20	**For year of sale only:** Enter amount from line 17 above; otherwise, enter -0-			**20**	*0*
21	Payments received during year. See instructions. **Do not** include interest whether stated or unstated			**21**	*100,000*
22	Add lines 20 and 21			**22**	*100,000*
23	Payments received in prior years. See instructions. **Do not** include interest whether stated or unstated	**23**			
24	**Installment sale income.** Multiply line 22 by line 19			**24**	*80,000*
25	Part of line 24 that is ordinary income under recapture rules. See instructions			**25**	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			**26**	*80,000*

Figure 5

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: *Barney Rucker*
Your social security number: *123-45-6789*

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							
9	Enter your long-term totals, if any, from Schedule D-1, line 9		**9**				
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9		**10**				
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				**11**	*80,000*	
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**	*80,000*	

Example 3

Facts. Arthur Velmer sold his welding business on December 1, 1999, to an unrelated buyer for $120,000. Mr. Velmer had rented his machine shop building for a number of years and personally owned all equipment. Mr. Velmer and the buyer of his business agreed on the following sales price allocations for the assets sold:

	Sales Price	**Cost**	**Prior Depreciation**
Goodwill	$ 20,000	$ —	$ —
Inventory	32,000	32,000	—
Equipment	68,000	160,000	160,000
Totals	**$120,000**	**$192,000**	**$160,000**

The buyer gave Mr. Velmer a $35,000 down payment at the December 1, 1999 closing, with the balance of $85,000 payable monthly with 10% interest on unpaid balances beginning January 1, 2000.

The practitioner must report this transaction as **three separate sales** (Rev. Rul. 55-79). The **first** is the sale of inventory; this is reported as ordinary income on Mr. Velmer's final (1999) Schedule C. The **second** is the equipment sale of $68,000.

Practitioner Notes

1. The sale of inventory items **cannot** be reported using the installment method. All gain or loss on the sale of inventory must be reported in the year of sale, even if no principal payments are received.
2. The sale of the fully depreciated equipment does not qualify for installment reporting since all of the gain is subject to §1245 recapture and must be reported in the year of sale. The sale is reported in Part III of Form 4797. The §1245 recapture amount of $68,000 is carried over to Part II of Form 4797, Ordinary Gains and Losses.

The **third** sale is the $20,000 sale of goodwill. Of the total sales price of $120,000, only $20,000 constitutes the **contract price** for an installment sale. The **gross profit percentage** (line 19, Form 6252–Figure 7) for the installment sale of goodwill is 100%.

Since Mr. Velmer's sale includes assets sold via the installment method (goodwill) and assets that do not qualify for installment reporting, the principal payments he receives must be allocated as follows (Rev. Ruls. 68-13 and 76-110):

Sales price for good will (line 5, Form 6252–Figure 7)	$ 20,000
Sales price of inventory and equipment	100,000
Total sales price of all assets sold	**$120,000**

Percentage of total sales price allocated to installment sale of goodwill:

$20,000/$120,000 = **16.67%**

Percentage of total sales price allocated to inventory and equipment:

$100,000/$120,000 = **83.33%**

Allocation of the 1999 down payment of $35,000 received by Mr. Velmer to his installment sale of goodwill:

$35,000 × 16.67% = $5,835 (line 21, Form 6252–Figure 7)

Practitioner Note. In years after 1999, Mr. Velmer will apply the same 16.67% to principal payments he receives to determine the installment sale payments for goodwill. That figure will be entered on line 21, Form 6252 (Payments received during year).

See the completed Forms 4797 (Figure 6) and 6252 (Figure 7) for Arthur Velmer. His 1999 Schedule C, which will include the $32,000 sale of inventory, is not shown. Nor is his 1999 Schedule D, which will include the $5,835 long-term capital gain on the sale of goodwill from line 26 of Form 6252.

Observation. Mr. Velmer must include $105,835 in gross income ($32,000 + $68,000 + $5,835) even though he received only a $35,000 principal payment in 1999.

Figure 6

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

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

► **Attach to your tax return.** ► **See separate instructions.**

OMB No. 1545-0184

1999

Attachment
Sequence No. **27**

Name(s) shown on return: *Authur Velmer*

Identifying number: *978 - 99 - 0111*

Part II Ordinary Gains and Losses

10	Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):		
11	Loss, if any, from line 7	**11**	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	**12**	
13	Gain, if any, from line 31	**13**	*68,000*
14	Net gain or (loss) from Form 4684, lines 31 and 38a	**14**	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	**15**	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	**16**	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	**17**	
18	Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows:	**18**	*68,000*
a	For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.		
b	For individual returns:		
(1)	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions	**18b(1)**	
(2)	Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	**18b(2)**	*68,000*

Form 4797 (1999) Page **2**

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

19	**(a)** Description of section 1245, 1250, 1252, 1254, or 1255 property:	**(b)** Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)
A	*Equipment*	*Various*	*12 - 1 - 99*
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	**20**	*68,000*			
21	Cost or other basis plus expense of sale	**21**	*160,000*			
22	Depreciation (or depletion) allowed or allowable	**22**	*160,000*			
23	Adjusted basis. Subtract line 22 from line 21	**23**	*0*			
24	Total gain. Subtract line 23 from line 20	**24**	*68,000*			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	**25a**	*68,000*			
b	Enter the **smaller** of line 24 or 25a	**25b**	*68,000*			

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

30	Total gains for all properties. Add property columns A through D, line 24	**30**	*68,000*
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	**31**	*68,000*
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	**32**	*0*

Figure 7

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ **See separate instructions.** ▶ **Attach to your tax return.**
▶ **Use a separate form for each sale or other disposition of property on the installment method.**

OMB No. 1545-0228
1999
Attachment
Sequence No. **79**

Name(s) shown on return *Arthur Velmer*
Identifying number *978-99-0111*

1 Description of property ▶ *Goodwill from welding business*
2a Date acquired (month, day, year) ▶ *7 / 01 / 80* **b** Date sold (month, day, year) ▶ *12 / 1 / 99*
3 Was the property sold to a related party after May 14, 1980? See instructions. If "No," skip line 4 . . . . ☐ Yes ☒ No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☐ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated			5	*20,000*
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source .	6			
7	Subtract line 6 from line 5	7	*20,000*		
8	Cost or other basis of property sold	8	*0*		
9	Depreciation allowed or allowable	9	*0*		
10	Adjusted basis. Subtract line 9 from line 8	10	*0*		
11	Commissions and other expenses of sale.	11	*0*		
12	Income recapture from Form 4797, Part III. See instructions . .	12	*0*		
13	Add lines 10, 11, and 12			13	*0*
14	Subtract line 13 from line 5. If zero or less, **stop here. Do not** complete the rest of this form .			14	*20,000*
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. Otherwise, enter -0-. See instructions			15	*0*
16	**Gross profit.** Subtract line 15 from line 14			16	*20,000*
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	*0*
18	**Contract price.** Add line 7 and line 17			18	*20,000*

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	*100%*
20	**For year of sale only:** Enter amount from line 17 above; otherwise, enter -0-			20	*0*
21	Payments received during year. See instructions. **Do not** include interest whether stated or unstated			21	*5,835*
22	Add lines 20 and 21			22	*5,835*
23	Payments received in prior years. See instructions. **Do not** include interest whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	*5,835*
25	Part of line 24 that is ordinary income under recapture rules. See instructions			25	*0*
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions .			26	*5,835*

Practitioner Notes regarding the provision in the Ticket to Work and Work Incentives Act of 1999 pertaining to the limitation on the use of the installment method for accrual basis taxpayers.

1. See page 14 in the *What's New Supplement* dated December 18, 2000, received by enrollees of the 1999 Farm Income Tax Schools. This limitation applies to installment sales made **on or after December 17, 1999.**
2. At the time of printing (early October 2000), the fate of this controversial limitation was unknown. Congress may repeal the limitation.
3. The limitation does not affect Example 3 as Arthur Velmer sold his welding business on December 1, 1999, **before** the limitation applied.
4. See pages 123–27 for a thorough discussion of Rev. Proc. 2000-22, which was the IRS response to mitigate the limitation.

ISSUE 3: LIKE KIND EXCHANGES

I.R.C. §1031 tax-deferred exchanges are widely used in the commercial and investment real estate markets. A qualified exchange is an excellent tool to defer recognized gain and the resulting tax into the replacement property. However, keep in mind that I.R.C. §1031 encompasses "tax-deferred" exchanges, not "tax-free" exchanges.

Some of the more commonly misunderstood points in the §1031 language are

A. The 45-day rule

B. The 180-day rule

C. The definition of "like kind"

In this problem, these points will be thoroughly explained.

A. THE 45-DAY RULE

I.R.C. §1031(a)(3) reads

> (3) **Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.**
> For purposes of this subsection any property received by the taxpayer shall be treated as property which is not like-kind property if–
>
> (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.

Example. Assume a closing date of **March 1, 2000,** for the sale of a qualified property. I.R.C. §1031(a)(3)(A) specifically states that the replacement property must be **identified** on or before the day that is 45 days after the date of closing. The day **after closing** is March 2, leaving 30 days in March and 15 days in April. April 15, 2000, is the day (by code definition) on which the replacement property must be identified.

The purpose of the 45-day rule is to allow the exchanger sufficient time in which to locate and identify qualified replacement property. The identification of the replacement property must be made in a **signed, written document** that is **delivered to the other party involved in the exchange.** This identification must clearly describe the replacement property.

Example. "I (the exchanger) have identified the replacement property to be received in the deferred exchange under I.R.C. §1031. It is a mini-storage warehouse building located at 304 Oak Street, Provo, Utah. The legal description provided by the county recorder of deeds is ______________________."

Identifying Alternative and Multiple Properties. More than one replacement property can be identified. Regardless of the number of properties the exchanger gives up, the **maximum** number of replacement properties that can be identified is the **larger** of

- Three (3)
- Any number of properties whose total fair market value (FMV) at the end of the 45-day identification period is **not more than double** the total FMV, on the date of transfer, of all properties given up.
- Any number of replacement properties received by the taxpayer before the end of the 45-day identification period.
- Any number of replacement properties identified before the end of the 45-day identification period, if the taxpayer receives 95% of the identified property before the end of the 180-day exchange period.

B. THE 180-DAY RULE

The identified replacement property must be **received** by the **earlier** of two dates:

- The 180th day after the date on which the exchanger **transfers** the property given up in the exchange
- The due date, including extensions, for the exchanger's tax return for the tax year in which the transfer of the property given up occurs

Example 4

Facts. Cindy wanted to make a like-kind deferred exchange of her inherited farmland for an apartment building. She transferred her farmland to a title company on December 11, 1999. The 180-day period begins on December 11, 1999, and ends on June 7, 2000. Cindy did not file her 1999 return by April 17, the due date. Nor did she request an automatic extension to file on Form 4868.

Question. By what date must Cindy receive the apartment building in order to meet the 180-day rule?

Answer. April 17, 2000, which is **earlier** than the end of the 180-day period on June 7, 2000.

Practitioner Planning Suggestions

1. Try to convince clients to transfer the property given up **before October 15** in order to take advantage of the full 180-day rule for taking title to the replacement property
2. If that is not possible, request an automatic extension on Form 4868 to preserve the 180-day period.

Caution. The I.R.C. §1031 requirements are very strict, including the 180-day rule. See page 487 of the 1998 *Farm Income Tax Book* for the harsh decisions reached by both the Tax Court and the 9th Circuit Court of Appeals in the *Christensen* case.

C. THE "LIKE KIND" REQUIREMENT

Treasury Regulation §1.1031(a)-1(b) states

> **Definition of "like kind."** As used in §1031(a), the words "like kind" have reference to the **nature or character** of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

The following exchanges have been considered exchanges of like-kind property.

1. Bare land for timberland
2. Improved land for unimproved land
3. Real estate in a city for a farm or ranch
4. Undeveloped ranch land for a commercial building
5. A commercial building for commercial condo offices
6. An apartment building for vacant land plus golf course improvements
7. Rental property for farm property
8. An improved lot and house that is not the taxpayer's principal residence

Additional rules apply for exchanges of **personal property.** Treasury Regulation §1.1031(a)-1(b) provides that the nonrecognition rules of I.R.C. §1031 **do not apply** to an exchange of one kind or class of property for property of a different kind or class. **Personal properties of a like class are considered to be of a "like kind" for purposes of §1031.** Depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (ADR tables) and the General Asset Class is one of the 13 listed in the regulations or within the same Product Class [Standard Industrial Classifications Manual (1987)]. Finally, an exchange of properties of a like kind may qualify under I.R.C. §1031 regardless of whether the properties are of a like class.

The General Asset Classes include the following (partial list):

Asset Class	Items
00.11	Office furniture, fixtures, and equipment
00.12	Information systems (computers and peripherals)
00.13	Data handling equipment, except computers
00.22	Automobiles, taxis
00.23	Buses
00.241	Light general-purpose trucks
00.26	Tractor units for use over the road

In many §1031 exchanges, the sale of specific items of personal property (e.g., automobiles, class 00.22) followed by the timely purchase of other items of personal property (e.g., light trucks, class 00.241) do not qualify as "like kind" due to the fact that the two items are not within the same asset class.

Practitioner Note. See Chapter 14, "Like-Kind Exchanges," in the 1997 *Farm Income Tax Book* for a comprehensive discussion of this complex issue.

ISSUE 4: SALE OF PERSONAL RESIDENCE

Example 5

Facts. John Daly, who is single and self-employed, bought his personal residence in 1994. He has claimed a deduction for business use of the residence for his job duties as an outside salesman since he bought it. John sold the residence on October 10, 2000, for $140,000. The business use percentage that John reported on Form 8829 in prior tax years was 14%. Following are the pertinent facts concerning John's office-in-home deductions and the home sale in 2000.

Purchase price of residence in 1994	$92,000
Less: Lot value	(12,000)
Cost of home excluding the lot	$80,000
Business use percentage reported on Form 8829 in prior years	14%
Depreciation allowed on office portion prior to 2000	$1,398
Depreciation claimed on the 2000 Form 8829	185
Total depreciation on office portion prior to sale	$1,583
Depreciation deducted **after May 6, 1997,** through 2000	$787
Date of home sale	Oct. 10, 2000
Sale price of home	$140,000
Expenses of sale in 2000	$10,000

Question 1. Can John exclude all of his gain on the sale of his home in 2000?

Answer 1. No. John **meets** the 2-out-of-5-year **ownership test** but **does not meet** the 2-out-of-5-year **use test.** The business use of his home lasted for **more than** 3 years during the 5-year period ending on the date of sale. Therefore, the portion of the gain attributable to the office portion cannot be excluded under I.R.C. §121.

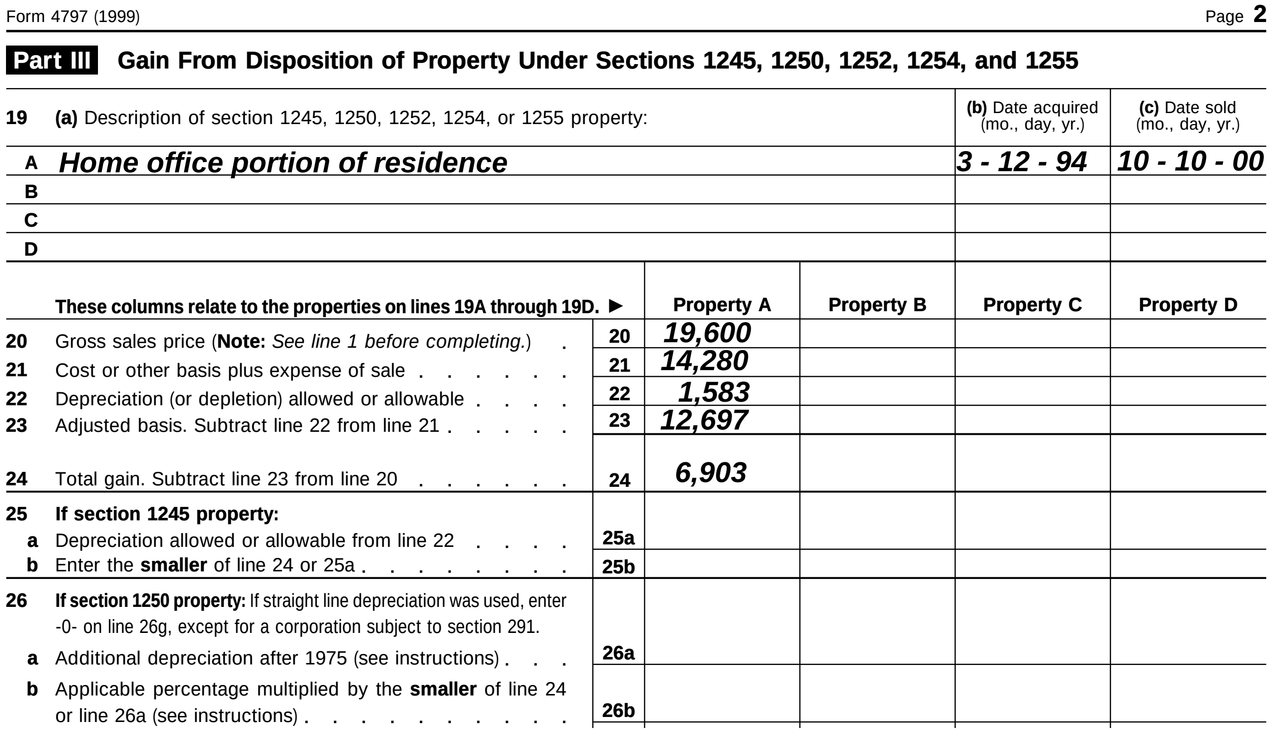
> **Practitioner Note.** John has two sales. The first sale for the 86% of the home that meets the ownership and use tests is excludable. The second sale for the 14% of the home used for business is taxable.

Question 2. What is the amount of the taxable gain on the office portion of the home?

Answer 2. The gain must be shown on John's 2000 Form 4797, which is shown in Figure 8. Following is the information for various lines in Part III of Form 4797:

Line 20:	Gross sales price (14% × $140,000)		$19,600
Line 21:	Cost plus expense of sale		
	(a) 14% of purchase price in 1994	$12,880	
	(b) 14% of selling expenses in 2000	1,400	14,280
Line 22:	Depreciation allowed or allowable		1,583
Line 23:	Adjusted basis (line 21 less line 22)		$12,697
Line 24:	Total gain (line 20 less line 23)		6,903
Line 26g:	(MACRS used on office portion—zero is entered)		-0-

Figure 8



Form 4797 (1999) Page **2**

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

19	**(a)** Description of section 1245, 1250, 1252, 1254, or 1255 property:	**(b)** Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)
A	*Home office portion of residence*	*3 - 12 - 94*	*10 - 10 - 00*
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ▶		**Property A**	**Property B**	**Property C**	**Property D**
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	*19,600*			
21	Cost or other basis plus expense of sale	21	*14,280*			
22	Depreciation (or depletion) allowed or allowable	22	*1,583*			
23	Adjusted basis. Subtract line 22 from line 21	23	*12,697*			
24	Total gain. Subtract line 23 from line 20	24	*6,903*			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a				
b	Enter the **smaller** of line 24 or 25a	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a				
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				

Figure 8 (continued)

c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	**26c**				
d Additional depreciation after 1969 and before 1976 . . .	**26d**				
e Enter the **smaller** of line 26c or 26d	**26e**				
f Section 291 amount (corporations only)	**26f**				
g Add lines 26b, 26e, and 26f	**26g**	*0*			

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

30	Total gains for all properties. Add property columns A through D, line 24	**30**	*6,903*
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	**31**	*0*
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	**32**	*6,903*

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

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

Question 3. If John is in the 28% tax bracket for 2000, will the entire $6,903 gain shown in Part III of Form 4797 be taxed at the maximum 20% rate?

Answer 3. No. **$1,583** of the gain attributable to the entire MACRS deduction (line 22 in Figure 8) will be taxed at **25%.** The remainder of the gain, **$6,116,** will be taxed at the maximum 20% capital gain rate in Part IV of John's 2000 Schedule D (not shown).

Practitioner Note. $1,583 will be entered on line 25, Part IV on John's 2000 Schedule D as **unrecaptured section 1250 gain.**

Question 4. What could John have done to reduce the recognized gain?

Answer 4. He could have intentionally disqualified his home office from meeting the regular and exclusive use test during 1998 and later years. **Then he would not have been entitled to deduct any home office expenses in 1998, 1999, or 2000 (the year of sale).** Consequently, the 2-out-of-5-year **use test** for the home office portion of the home would have been met on the date of sale in 2000. John could then exclude all of the gain **except for** the post–May 6, 1997, MACRS deduction of $266.

Question 5. If John did deduct home office expenses on his 1998 and 1999 Schedule Cs, can he file amended returns for those years to remove the deductions?

Answer 5. Yes, **if he can prove that his home office did not meet the regular and exclusive use test in those two years.** If not, he would not qualify to file the amended returns.

Example 6

Facts. Chad and Jane owned a personal residence in Dayton, Ohio, and a vacation home on Hilton Head Island, SC. In June 1997 Chad retired. In July 1997 they sold their personal residence in Dayton for $295,000. They had bought the home in 1990 for $125,000.

The house on Hilton Head was used primarily as rental property for the years 1992 through 1996. After 1996 it was used solely as a vacation home. After the sale of their personal residence in Dayton, they moved to Hilton Head and converted the former vacation home to their new primary residence. They moved into the Hilton Head home on July 4, 1997.

They decided that their new residence on Hilton Head was too large, and on September 30, 2000, they sold the house for $370,000. They had bought it in 1992 for $220,000. The depreciation allowed for the years 1992 through 1996, when it was rented, was $28,450. They incurred selling expenses of $26,675. The computation of their $151,775 capital gain follows.

Gross sales price on Sept. 30, 2000		$370,000
Less: Expenses of sale		(26,675)
Net sales proceeds		$343,325
Less adjusted basis		
Purchase price in 1992	$220,000	
Less: MACRS deductions (1992–1996)	(28,450)	(191,550)
Gain on sale in 2000		**$151,775**

Question. Is any portion of the $151,775 gain taxable in 2000?

Answer. No part of the sale of the Hilton Head Island home is taxable.

The ownership and the use tests are met. Since the taxpayers used the house as their primary residence for two years or more (or the equivalent stated in months) during the 5-year period ending on the sale date, the use test is met and none of the gain is taxable.

Practitioner Note. The IRS takes the position that the post–May 6, 1997 depreciation rule applies if the taxpayer could have claimed depreciation but didn't. A taxpayer cannot avoid what would otherwise be a taxable gain by choosing not to claim any depreciation otherwise allowable.

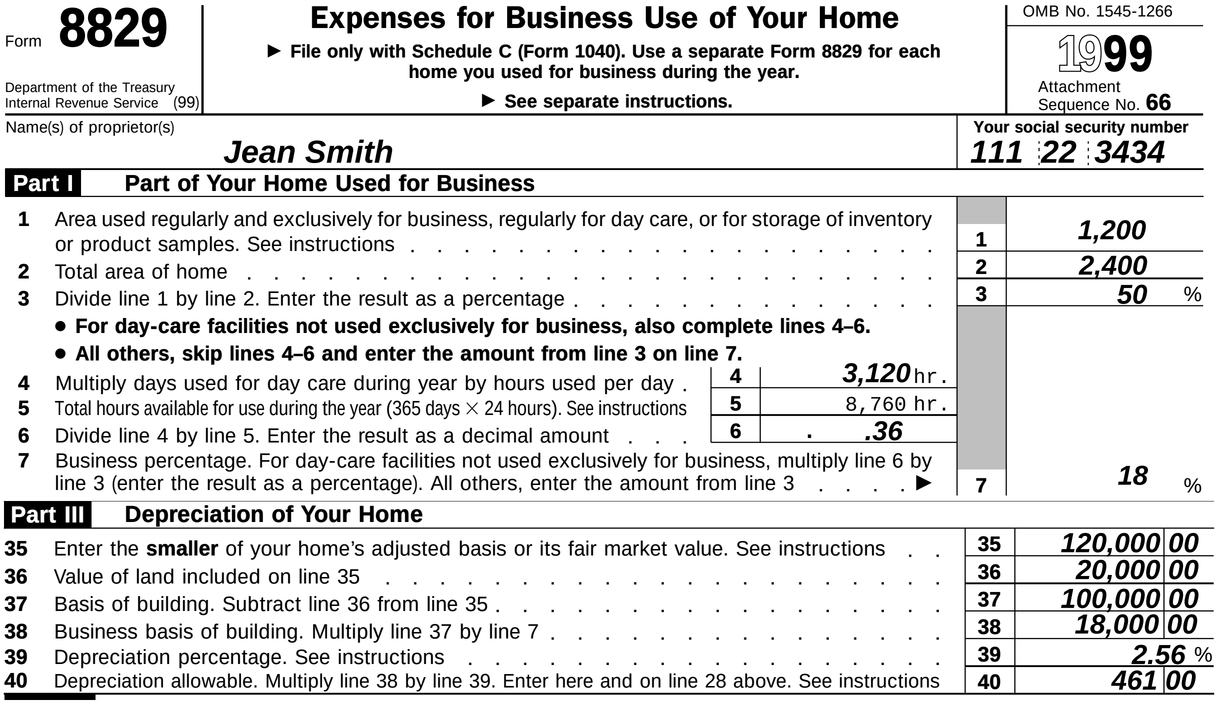
Example 7: Sale of Residence with Day Care Center

Facts. Jean Smith, a single person, has operated a day care center in her home for the past 7 years. She uses 1,200 square feet of a 2,400-square-foot residence for the day care center, and the business is open 6 A.M. to 6 P.M., 5 days a week, 52 weeks per year.

Jean paid $120,000 for the residence 8 years ago and has not made any substantial improvements since the purchase. When calculating depreciation on the business portion of the residence, she estimated the land value as $20,000, leaving $100,000 as the basis for depreciation calculations.

The following portions of the 1999 Form 8829 reflect the calculations of the business use percentage and depreciation deductions (Figure 9).

Figure 9



Form **8829**

Department of the Treasury
Internal Revenue Service (99)

Expenses for Business Use of Your Home

▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

▶ See separate instructions.

OMB No. 1545-1266

1999

Attachment
Sequence No. 66

Name(s) of proprietor(s): *Jean Smith*

Your social security number: *111 22 3434*

Part I **Part of Your Home Used for Business**

1	Area used regularly and exclusively for business, regularly for day care, or for storage of inventory or product samples. See instructions	1	*1,200*
2	Total area of home	2	*2,400*
3	Divide line 1 by line 2. Enter the result as a percentage	3	*50* %
	• **For day-care facilities not used exclusively for business, also complete lines 4–6.**		
	• **All others, skip lines 4–6 and enter the amount from line 3 on line 7.**		
4	Multiply days used for day care during year by hours used per day — 4: *3,120* hr.		
5	Total hours available for use during the year (365 days × 24 hours). See instructions — 5: 8,760 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount — 6: . *.36*		
7	Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶	7	*18* %

Part III **Depreciation of Your Home**

35	Enter the **smaller** of your home's adjusted basis or its fair market value. See instructions	35	*120,000 00*
36	Value of land included on line 35	36	*20,000 00*
37	Basis of building. Subtract line 36 from line 35	37	*100,000 00*
38	Business basis of building. Multiply line 37 by line 7	38	*18,000 00*
39	Depreciation percentage. See instructions	39	*2.56* %
40	Depreciation allowable. Multiply line 38 by line 39. Enter here and on line 28 above. See instructions	40	*461 00*

On August 5, 2000, Jean sold the residence. The selling price was $185,000, and she paid selling expenses of $13,000. During the 7-year period in which she operated the business, she had claimed a total of $3,150 in depreciation deductions for the business use of the residence, of which $1,500 was for the period after May 6, 1997.

Question. What is the tax result of Jean's sale in 2000?

Answer. Jean has made two sales, as shown below.

	Total	**82% Personal**	**18% Business**
Selling price	$185,000	$151,700	$33,300
Selling expenses	(13,000)	(10,660)	(2,340)
Net selling price	172,000	141,040	30,960
Less: Adjusted basis			
Original cost	120,000	98,400	21,600
Less depreciation	(3,150)	N/A	(3,150)
	(116,850)	(98,400)	(18,450)
Gain on sale	**$ 55,150**	**$ 42,640**	**$ 12,510**

Since the day care portion of the home did not meet the 2-out-of-5-year **use test,** the $12,510 gain is taxable. It will be reported in Part III of Jean's 2000 Form 4797. The $3,150 prior depreciation is unrecaptured §1250 gain. It will be shown on line 25 in Part IV of Jean's 2000 Schedule D.

The $42,640 gain on the portion of the home used as a residence is excludable under I.R.C. §121.

ISSUE 5: CHANGE IN ACCOUNTING METHOD

See the boxed Practitioner Notes on page 544 for the change in accounting method topic of most interest to practitioners in preparing 2000 returns. Rev. Proc. 2000-22 is explained thoroughly on pages 123–27.

2000 Income Tax School

RULINGS AND CASES

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CASES

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