SMALL BUSINESS ISSUES

Issue 1: Business Use of Home 203
Issue 2: Vehicle Expenses 218
Issue 3: I.R.C. §1245 Depreciation Recapture . . 221
Issue 4: I.R.C. §1250 Depreciation Recapture . . 224
Issue 5: I.R.C. §179 Expense Election Allowable Deductions. 228
Issue 6: Recapture of I.R.C. §179 Deductions . . 232
Issue 7: Like-Kind Exchange, IRS Notice 2000-4. 234
Issue 8: Sales to Relatives 241
Issue 9: Nonresident Alien Workers 244
Issue 10: Net Operating Losses 254
Issue 11: Discharge of Indebtedness 263
Issue 12: Fringe Benefits 268
Issue 13: Uniform Capitalization 288

ISSUE 1: BUSINESS USE OF HOME

TOPIC 1: PURCHASE OR SALE OF PERSONAL RESIDENCE USED FOR BUSINESS

For Sales and Exchanges of a Personal Residence before May 7, 1997

- The gain on the sale of a principal residence was not taxed if a new principal residence was purchased within a two-year replacement period at a cost that was greater than or equal to the adjusted sales price of the old principal residence. If the cost of the new principal residence was less than the adjusted sales price of the old principal residence, all or a portion of the realized gain was taxed. The basis of the new residence was reduced by any unrecognized gain on the sale of the old. I.R.C. §1034(a).
- The realized gain on the sale of a principal residence—up to $125,000 ($62,500 for individuals who were married on the date of sale and who filed separate returns)—could have been **completely excluded from income**, not just tax-deferred. This once-in-a-lifetime income exclusion was available only to taxpayers who were age 55 or older on the date of sale and who met certain ownership and occupancy tests. To qualify for the exclusion, the taxpayer had to file an election (I.R.C. §121 before amendment by §312(a) PL 105-34, 8/5/97).

For Sales and Exchanges of a Personal Residence after May 6, 1997

- The gain may be excluded up to $250,000 ($500,000 for certain joint return filers) from the sale or exchange of property that the taxpayer has owned and used as the taxpayer's principal residence for periods of two years or more during the five-year period ending on the date of the sale or exchange.

© 2001 Copyrighted by the Board of Trustees of the University of Illinois

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

- The taxpayer must not have applied the exclusion to another sale or exchange during the two years before the sale or exchange.
- A reduced exclusion applies if the ownership, use, or prior exclusion requirements are not met and the sale or exchange occurs by reason of a change in place of employment, health, or unforeseen circumstances.

For Business Use of a Personal Residence

The home sale exclusion does not apply to the portions of the gain attributable to depreciation adjustments allowed after May 6, 1997 [I.R.C. §121(d)(6)]. Where the two-of five-year use requirement is met for only part of the residence, the I.R.C. §121 exclusion applies only to the gain from the portion used as a principal residence for two years or more. The gain attributable to depreciation after May 6, 1997 is treated as unrecaptured section 1250 gain (taxed at a maximum rate of 25%) [Prop Reg §1.121-1(e)].

Qualification for Deductions. If the taxpayer uses a portion of the home for business, the expenses for that portion of the home can be deducted if any one of the following five tests is met.

1. A portion of the home is used exclusively for business and is the principal place of business of the taxpayer.

> **Practitioner Note.** The definition of "principal place of business" was liberalized for 1999 and later years by the Taxpayer Relief Act of 1997. Under the new rules, the home is the principal place of business if it is used by the taxpayer for the administrative or management activities of any business of the taxpayer and there is no other fixed location of such business where the taxpayer conducts substantial administrative or management activities of the business. Self-employed taxpayers who perform service outside of the home office but do all of their administrative work in the home office benefit from this new rule.

2. A portion of the home is used exclusively by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of business. This test does not require the home to be the principal place of business. Therefore, use of the home as a satellite office to meet with clients will qualify even though the taxpayer has a principal office in another location.
3. There is a separate structure that is used exclusively for business. This test requires neither that the home be the principal place of business nor that it be used to meet with patients, clients, or customers.
4. The home is the sole fixed location of the business, and a portion of the home is used on a regular basis as a storage unit for the inventory or product samples of the taxpayer for use in the business of selling products.

> **Practitioner Note.** The test does not require that a portion of the home be used exclusively for business.

5. A portion of the home is used on a regular basis in the taxpayer's business of providing day care.

> **Practitioner Note.** This test does not require exclusive use, but it allocates cost based on both the percentage of the home that is used for day care as well as the percentage of time it is used for day care.

Example 1. Ralph Bosworth, who is married to Joyce, files a joint return. He has lived and worked in all regions of the United States as a consultant. He and Joyce over the years have used the provisions of I.R.C. §1034(a) to defer gain by purchasing successively more expensive new homes. In each home

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Ralph has used 25% of the residence for business use as an office in the home. His current home, purchased June 30, 1997, had a fair market value of $225,000 and unadjusted basis of $45,000. Ralph sold his home on December 31, 2000, for $500,000.

Question 1. Can Ralph exclude a portion of the gain?

Purchase price	$225,000
Deferred gain I.R.C. §1034	$180,000
Unadjusted basis	$ 45,000
Depreciation after May 7, 1997	$1,010
Selling price	$500,000
Selling expenses	$ 10,000

Ralph meets the ownership and use test by living in this residence for more than 2 years. Since Ralph used 25% of the residence as a home office in the year of the sale, he must treat this as two separate transactions: a sale of a residence (75%) and a sale of business property (25%). The home office portion does not qualify for the exclusion because Ralph did not use that portion as a personal residence for 2 out of the 5 years before the sale.

	Personal 75%	Business 25%
Unadjusted basis	$33,750	$11,250
Minus: Depreciation	–0–	$ 1,010
Adjusted basis	$33,750	$10,240

	Personal 75%	Business 25%
Selling price	$375,000	$125,000
Minus: Selling expenses	$ 7,500	$ 2,500
Minus: Adjusted basis	$ 33,750	$ 10,240
Gain	$333,750	$112,260
Allowed exclusion	$333,750	–0–

Answer 1. Gain from the portion used as Ralph's personal residence does not have to be reported on his tax return, because it is less than the allowable exclusion. Report the gain from the business portion ($112,260) in Part III of Form 4797 (see Ralph and Joyce's completed Form 4797).

Question 2. If Ralph is in the 28% tax bracket for 2000, will the $112,260 gain be taxed at the maximum 20% capital gain rate?

Answer 2. Yes and No. Gain equal to the depreciation, $1,010, is taxed at 25% as unrecaptured I.R.C. §1250 gain. The remaining $111,250 is taxed at 20% and reported in Part IV, Year 2000 Schedule D (see Ralph and Joyce's completed Schedule D).

Practitioner Note. Since the portion of the home used as an office does not qualify for the I.R.C. §121 exclusion, it does not matter whether the depreciation was claimed before May 7, 1997 or after May 6, 1997.

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form 4797 (2000) *Ralph and Joyce B. Bosworth* *123-45-6789* 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	*Sale personal residence (Business)*	*6/30/97*	*12/31/00*
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	*125,000*			
21	Cost or other basis plus expense of sale	21	*13,750*			
22	Depreciation (or depletion) allowed or allowable	22	*1,010*			
23	Adjusted basis. Subtract line 22 from line 21	23	*12,740*			
24	Total gain. Subtract line 23 from line 20	24	*112,260*			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a				
b	Enter the **smaller** of line 24 or 25a	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a				
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d	Additional depreciation after 1969 and before 1976	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f	26g	*0*			
27	**If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a	Soil, water, and land clearing expenses	27a				
b	Line 27a multiplied by applicable percentage (see instructions)	27b				
c	Enter the **smaller** of line 24 or 27b	27c				
28	**If section 1254 property:**					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b	Enter the **smaller** of line 24 or 28a	28b				
29	**If section 1255 property:**					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b	Enter the **smaller** of line 24 or 29a (see instructions)	29b				

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

30	Total gains for all properties. Add property columns A through D, line 24	30	*112,260*
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	*112,260*

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		

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Part III Summary of Parts I and II

Line	Description		Amount
17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13	17	*112,260*
	Next: Complete Form 1040 through line 39. Then, go to **Part IV** to figure your tax if: ● Both lines 16 and 17 are gains **and** ● Form 1040, line 39, is more than zero. Otherwise, **stop here.**		
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses: ● The loss on line 17 **or** ● ($3,000) or, if married filing separately, ($1,500)	18	( )
	Next: Skip **Part IV** below. Instead, complete Form 1040 through line 37. Then, complete the **Capital Loss Carryover Worksheet** on page D-6 if: ● The loss on line 17 exceeds the loss on line 18 **or** ● Form 1040, line 37, is a loss.		

Part IV Tax Computation Using Maximum Capital Gains Rates

Line	Description	Inner line	Inner amount	Line	Amount
19	Enter your taxable income from Form 1040, line 39			19	*191,329*
20	Enter the **smaller** of line 16 or line 17 of Schedule D	20	*112,260*		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21			
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	*112,260*		
23	Combine lines 7 and 15. If zero or less, enter -0-	23	*0*		
24	Enter the **smaller** of line 15 or line 23, but not less than zero	24			
25	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-8	25	*1,010*		
26	Add lines 24 and 25	26	*1,010*		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	*111,250*
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	*80,079*
29	Enter the **smaller** of: ● The amount on line 19 **or** ● $26,250 if single; $43,850 if married filing jointly or qualifying widow(er); $21,925 if married filing separately; or $35,150 if head of household			29	*43,850*
30	Enter the **smaller** of line 28 or line 29	30	*43,850*		
31	Subtract line 22 from line 19. If zero or less, enter -0-	31	*79,069*		
32	Enter the **larger** of line 30 or line 31 ▶	32	*79,069*		
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies			33	*16,441*
	Note. If the amounts on lines 29 and 30 are the same, skip lines 34 through 37 and go to line 38.				
34	Enter the amount from line 29	34			
35	Enter the amount from line 30	35			
36	Subtract line 35 from line 34 ▶	36			
37	Multiply line 36 by 10% (.10)			37	
	Note. If the amounts on lines 19 and 29 are the same, skip lines 38 through 51 and go to line 52.				
38	Enter the **smaller** of line 19 or line 27	38	*111,250*		
39	Enter the amount from line 36	39			
40	Subtract line 39 from line 38 ▶	40	*111,250*		
41	Multiply line 40 by 20% (.20)			41	*22,250*
	Note. If line 26 is zero or blank, skip lines 42 through 51 and go to line 52.				
42	Enter the **smaller** of line 22 or line 25	42	*1,010*		
43	Add lines 22 and 32 — 43: *191,329*				
44	Enter the amount from line 19 — 44: *191,329*				
45	Subtract line 44 from line 43. If zero or less, enter -0-	45	*0*		
46	Subtract line 45 from line 42. If zero or less, enter -0- ▶	46	*1,010*		
47	Multiply line 46 by 25% (.25)			47	*253*
	Note. If line 24 is zero or blank, skip lines 48 through 51 and go to line 52.				
48	Enter the amount from line 19	48			
49	Add lines 32, 36, 40, and 46	49			
50	Subtract line 49 from line 48	50			
51	Multiply line 50 by 28% (.28)			51	
52	Add lines 33, 37, 41, 47, and 51			52	*38,944*
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	*51,927*
54	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 40			54	*38,944*

Schedule D (Form 1040) 2000

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Question 3. Did Ralph make money by claiming an office-in-home deduction?

Answer 3. It depends on the amount of deductible home office expenses claimed in 1997–2000.
In year 2000 Ralph will pay the following income tax:

Federal income tax:		
I.R.C. §1250 recapture	(1,010 × .25) =	$ 252.50
Capital gain	(111,250 × .20) =	$22,250.00
State income tax:	(112,260 × .09) =	$10,103.40
Total		$32,605.90

Ralph's marginal tax rate for 1997-2000 is computed as follows:

Federal	28.0%
Self-employment	15.3%
State	9.0%
Total	52.3%

If his discount rate or alternative investment rate was 8%, then office-in-home deductible expenses must average $13,835 in 1997–2000 for the tax saving to equal the tax paid on sale of the business portion of the personal residence in 2000.

Question 4. If the tax benefit of deductible home office expenses was less than the tax paid on the gain, could Ralph avoid these negative tax consequences?

Answer 4. Yes. If Ralph had deliberately used his home office for personal purposes for two years before the sale, the home office expenses would not be allowed and all of the gain would qualify for the I.R.C. §121 exclusion except the gain equal to depreciation claimed after May 6, 1997.

Observation. If a taxpayer has a deferred gain on a personal residence prior to 1997, a low tax basis, and an appreciated fair market value, a significant taxable gain could result if a portion of the residence is used for business purposes. The current economic benefits of home office deductions now must be weighed against potential taxation later if there is a likelihood the residence will be sold in the future.

Practitioner Note. In many states, claiming that a portion of a personal residence is used for business purposes may cause the taxpayer to lose favorable property tax reductions and bankruptcy protection allowed for a personal residence.

TOPIC 2: SECOND HOME

The term "second home" originated in the 1986 Tax Reform Act to describe the application of deductibility of qualified home mortgage interest to the principal residence and one additional residence elected by the taxpayer, I.R.C. §163(h)(4)(A)(i). In order to qualify as a second residence, a property must be a residence.

Definition of residence. Whether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer. A residence can be a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television that, in accordance with the applicable local law, is not a fixture [Treas. Reg. §1.163-10T(p)(3)(i)].

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

A taxpayer cannot have more than one second residence at any time. A property will qualify as a second residence only if it is:

- A residence
- The taxpayer uses it as a residence, and
- The taxpayer properly elects to treat it as his second residence for purposes of the qualified residence interest rules

For purposes of this rule, principal residence has the same meaning as under I.R.C. §121, the exclusion of gain from the sale or exchange of a principal residence.

For sales and exchanges before May 7, 1997, principal residence had the same meaning as under the now repealed I.R.C. §1034 that allowed nonrecognition of gain when one principal residence was sold and another was purchased.

The IRS uses the layman's term "main home" in Publication 523, *Selling Your Home*, p. 2, to describe a taxpayer's principal residence. While a second home can qualify for deduction of interest, **only the principal residence** can qualify for exclusion of gain.

Prop. Reg. §1.121-1(b) provides that whether property is the taxpayer's residence, and whether property is the taxpayer's principal residence (in the event of a taxpayer using more than one property as a residence), depends on all the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year is ordinarily the taxpayer's principal residence.

The facts and circumstances to be examined in deciding whether a home is a taxpayer's principal residence may include:

- Where the taxpayer filed state income tax returns
- Where the taxpayer's driver's license was issued
- Where the taxpayer was registered to vote
- Where the taxpayer's family and social connections were located
- Where the taxpayer's business or job was located
- The mailing address used for most purposes (e.g., tax returns, driver's licenses)
- Where the taxpayer maintained bank accounts
- Where the taxpayer maintained memberships (e.g., places of worship, clubs, etc.)

These factors were used by the courts to determine whether a taxpayer used his or her home as a principal residence under prior home sale exclusion (I.R.C. §121) and rollover of gain (I.R.C. §1034).

However, in *Taylor vs. Commissioner*, T.C. Summary Opinion 2001-17, a tax court has concluded that a long-term New Jersey resident's home didn't lose its status as a principal residence while he was transitioning to a Florida retirement, even though he owned a residence in Florida, lived and worked in Florida in the winter, and was registered to vote in Florida. As a result, he was able to exclude from income gain from the sale of his New Jersey residence.

TOPIC 3: INTERMITTENT USE OF HOME OFFICE

To deduct home office expenses, business use must be regular and exclusively for business purposes. If business use is intermittent, home office expenses can be deducted only if there is no personal use, continuation of the business, and business income greater than the other home office expenses.

Example 2. Ralph Bosworth has been a long-time independent consultant. For the first six months of 1999, his net consulting income was $25,000. As of July 1, 1999, he was employed to work full-time as an employee for Tech-Tech, one of his former consulting clients. While his new employment agreement did not prohibit continuing his consulting business, Ralph did not think time would permit, but still

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

2001 Workbook

wanted to keep the business open in case his job with Tech-Tech did not continue. Ralph had no consulting income for the last half of 1999.

Ralph's home expenses included:

Description	1997	1998	1999	2000
Interest and taxes	2,550	5,100	5,800	6,000
Insurance, utilities, repairs	2,055	4,425	4,650	4,950
Depreciation	156	288	288	288
Total home office expenses	$4,761	$9,813	$10,738	$11,238

Question 1. Can Ralph deduct office-in-home expenses on his Schedule C (Form 1040) for the 1999 tax year?

Answer 1. Assuming Ralph used the home office regularly and exclusively for business purposes for the entire year, total home office expenses of $10,738 are deductible on Form 8829 and his Schedule C (Form 1040).

Example 3. Assume that in the year 2000, Ralph continued his consulting business and used his home office only for business purposes but had no consulting income.

Question 1. What home office expenses for the year 2000 can be deducted?

Answer 1. Ralph can deduct interest and taxes of $6,000, line 14, Form 8829 (see Ralph's completed Form 8829). The interest and taxes are allowed to increase the loss on Schedule C (Form 1040). However, the $4,950 of other home office expenses, insurance, repairs, utilities, and $288 of depreciation, are limited to tentative profit and loss, line 29, Schedule C. Both other expenses and depreciation could be carried over to next year but would again be subject to the income limitation. The tax benefit Ralph will receive is limited to interest and taxes unless he has net business income in the future.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

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

2000

Attachment Sequence No. 66

Name(s) of proprietor(s): *Ralph Bosworth*

Your social security number: *123 45 7890*

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	*500*
2	Total area of home	2	*2000*
3	Divide line 1 by line 2. Enter the result as a percentage	3	*25.00* %
	• **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: hr.		
5	Total hours available for use during the year (366 days × 24 hours). See instructions — 5: 8,784 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount — 6: .		
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	*25.00* %

Part II Figure Your Allowable Deduction

Line	Description		(a) Direct expenses	(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions				8	*0 00*
	See instructions for columns (a) and (b) before completing lines 9–20.					
9	Casualty losses. See instructions	9				
10	Deductible mortgage interest. See instructions	10		*12,000*		
11	Real estate taxes. See instructions	11		*12,000*		
12	Add lines 9, 10, and 11	12		*24,000*		
13	Multiply line 12, column (b) by line 7	13		*6,000*		
14	Add line 12, column (a) and line 13				14	*6,000 00*
15	Subtract line 14 from line 8. If zero or less, enter -0-				15	*0 00*
16	Excess mortgage interest. See instructions	16				
17	Insurance	17		*2,500*		
18	Repairs and maintenance	18		*650*		
19	Utilities	19		*1,500*		
20	Other expenses. See instructions	20				
21	Add lines 16 through 20	21		*4,650*		
22	Multiply line 21, column (b) by line 7	22		*1,162 50*		
23	Carryover of operating expenses from 1999 Form 8829, line 41	23		*0 00*		
24	Add line 21 in column (a), line 22, and line 23				24	*1,162 00*
25	Allowable operating expenses. Enter the **smaller** of line 15 or line 24				25	*0 00*
26	Limit on excess casualty losses and depreciation. Subtract line 25 from line 15				26	*0 00*
27	Excess casualty losses. See instructions	27				
28	Depreciation of your home from Part III below	28		*288*		
29	Carryover of excess casualty losses and depreciation from 1999 Form 8829, line 42	29				
30	Add lines 27 through 29				30	*288*
31	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 26 or line 30				31	*0 00*
32	Add lines 14, 25, and 31				32	*6,000 00*
33	Casualty loss portion, if any, from lines 14 and 31. Carry amount to **Form 4684**, Section B				33	*0 00*
34	Allowable expenses for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶				34	*6,000 00*

Part III Depreciation of Your Home

35	Enter the **smaller** of your home's adjusted basis or its fair market value. See instructions	35	*45,000*
36	Value of land included on line 35	36	
37	Basis of building. Subtract line 36 from line 35	37	*45,000*
38	Business basis of building. Multiply line 37 by line 7	38	*11,250*
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	*288*

Part IV Carryover of Unallowed Expenses to 2001

41	Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0-	41	*1,162 50*
42	Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0-	42	*288 00*

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 13232M Form **8829** (2000)

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Question 2. If Ralph expects to sell his home in the near future, should he continue to use the office exclusively for business so that he can claim home office expenses?

Answer 2. No. If Ralph stopped using his home office exclusively for business purposes, he could deduct the interest and taxes on Schedule A (assuming Ralph would otherwise itemize deductions). The date Ralph stopped using the home office exclusively for business purposes would start the two-year personal use requirement to treat his entire home as a personal residence and exclude the gain.

Example 4. Assume Ralph sold his personal residence on January 10, 2002, for $50,000 gain.

Question 1. Can Ralph exclude the $50,000 gain on the sale of his personal residence?

Answer 1. Assuming Ralph did not use a portion of his residence for business purposes after January 9, 2000 he would meet the 2-year test to exclude gain. Ralph would recognize $732, of unrecaptured I.R.C. §1250 gain to the extent of depreciation taken after May 6, 1997, at a maximum rate of 25%.

Question 2. What if Ralph had sold his house on July 10, 2001? Would the gain be excluded?

Answer 2. Only if Ralph had terminated the business use of his home office by July 9, 1999. He could deduct home office expenses incurred only up to July 9, 1999. Thus, he would meet the 2-year test and exclude gain on the entire personal residence. However, he would be required to recognize $588 of unrecaptured I.R.C. §1250 gain due to depreciation taken after May 6, 1997, at a maximum tax rate of 25%.

Practitioner Note. Economic benefits of deducing home office expenses would depend upon:

- Marginal tax rate now versus the year of sale
- Amount of potential gain (fair market value–adjusted basis)
- Likelihood that the residence will be sold
- Consistent business income to allow current deduction of home office expenses

TOPIC 4: EFFECTS OF NOT CLAIMING DEPRECIATION

The exclusion of gain from the sale or exchange of a principal residence does *not* apply to so much of the gain from the sale of any property as does not exceed the portion of the depreciation adjustments for periods after May 6, 1997. The term **depreciation adjustments** as defined in I.R.C. §1250(b)(3) includes all adjustments reflected in the adjusted basis of property on account of deductions whether allowed or allowable for exhaustion, wear and tear, obsolescence, or amortization.

Planning Pointer. However, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed as a deduction for any period was less than the amount allowable, the amount taken into account for such period shall be the amount allowed [I.R.C. §1250(b)(3)].

Example 5. In Example 4, Question 2 above, Ralph Bosworth met the requirements to deduct $11,238 of home office expenses for year 2000. Of that amount, allowable depreciation of $288 was not allowed because his tentative profit or loss from the business use of home was zero or a loss.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Practitioner Note. Home office deductions reduce 28% income tax and 15.3% self-employment tax and applicable state income tax in the current year. Nondepreciation home office deductions are not recaptured. These current economic benefits must be weighed against recapture depreciation after May 6, 1997, at a maximum of 25% and 20% capital gain on the home office portion in a future year of sale.

Proposed Regulations Clarify Depreciation Recapture. The exclusion does not apply to the extent that depreciation attributable to periods after May 6, 1997, exceeds gain allocable to the business-use portion of the property [Prop. Reg. §1.121-1(e)].

Example 6. Jack buys a house in year 1 (a post-May 6, 1997 year). For 5 years, Jack uses a portion of the property as his principal residence and a portion of the property for business purposes. Jack claims depreciation deductions of $20,000 for the business use of the property. Jack sells the property in year 6, realizing a gain of $50,000. Jack had no other I.R.C. §1231 or capital gains or losses for year 6. Jack determines that $15,000 of the gain is allocable to the business-use portion of the property and that $35,000 of the gain is allocable to the portion of the property used as his residence. Under the proposed regulations, Jack would have to recognize $15,000 of the gain allocable to the business-use portion of the property. This $15,000 of gain would be unrecaptured I.R.C. §1250 gain. In addition, under the proposed regulations, the I.R.C. §121 exclusion would not apply to the extent that Jack's post-May 6, 1997 depreciation ($20,000) exceeds the gain allocable to the business-use portion of the property ($15,000). Therefore, under the proposed regulations, Jack would exclude $30,000 of the gain from the sale of the property, and would recognize $20,000 as unrecaptured I.R.C. §1250 gain [Prop. Reg. §1.121-1(f), Ex 8].

TOPIC 5: MORE THAN ONE BUSINESS USE OF HOME

One of the reasons that taxpayers use a portion of their personal residence as a home office is to reduce the cost of renting and maintaining a separate commercial office space. For the same reasons, one taxpayer may use a home office for more than one business, or two individuals or spouses may share a home office between each of their businesses. These situations raise questions about allocating and reporting such expenses.

Example 7. Ralph Bosworth, married to Joyce, files a joint tax return. As of July 1, 1999, he was employed to work full-time as an employee for Tech-Tech. However, Ralph kept his Schedule C consulting business active after July 1, 1999. Ralph uses 25% of his residence for business use as an office in home. Also in 1999, Joyce started a marketing and promotional products business. Since she expects a tight budget for the first years, they have agreed to share the same office. Tech-Tech requires Ralph to travel among their locations or to be at the Tech-Tech office 8:00 A.M. to 5:00 P.M. Monday through Friday. Joyce will use the home office during the week. Ralph will generally use the office at night and on weekends. If Joyce wants to use the office other than 8:00 A.M. to 5:00 P.M., they will share the office space.

Question 1. How should Ralph and Joyce allocate home office expenses?

Answer 1. In general, IRS recommends allocation of items on any consistent (year-to-year) basis. Also, IRS recommends using a logbook to record business and nonbusiness use of listed property.

Description	Business Use Ralph	Business Use Joyce	Total
Hours of use	975	2,200	3,175
% based on use	30.7%	69.3%	100%
Gross income	$55,000	$35,000	$90,000
% based on income	61.1%	38.9%	100%

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Question 2. How will Ralph and Joyce report their respective share of the home office expenses?

Answer 2. Ralph and Joyce will each report their share of the home office expenses and tentative net profit or loss on separate Forms 8829. Ralph will report his share on line 30 of his Schedule C (Form 1040). Joyce will report her share on line 30 of her Schedule C (Form 1040). Separate reporting on individual Forms 8829 will ensure that the appropriate net income limitations will be applied to each business.

> **Practitioner Note.** A similar procedure could be used to allocate expenses to one taxpayer's multiple businesses, or between farm and nonfarm businesses.

TOPIC 6. CONVERSION TO RENTAL PROPERTY

For various economic and lifestyle reasons, taxpayers convert their personal residence to rental property. Correct determination of the rental property's cost basis is critical. Information necessary to ensure proper tax treatment includes:

- Adjusted cost basis of the personal residence:

  (original costs + improvements – depreciation – casualty losses – deferred gain under I.R.C. §1034(a))

- Was a portion of the residence used as a home office or for business purposes?
- Fair market value date of conversion

Example 8. Tech-Tech, Ralph's employer, was a typical dot.com wonder financed by junk bonds, with Internet service providers for customers. In July 2000, Ralph and most of his coworkers were laid off. As a part of his severance, Ralph negotiated a deal to rent his large home effective January 1, 2001, to the new CEO who was highly paid to come in and "turn around" Tech-Tech. Joyce continued her successful marketing business and claimed office-in-home deductions for the year 2000. Joyce and Ralph will rent a smaller home until Ralph can find a job.

Ralph and Joyce over the years have used the provisions of I.R.C. §1034(a) to defer gain by paying an amount for a new home greater than the sales price of their old home each time. In each home Ralph has used 25% of the residence for business use as an office in home. His current home, purchased June 30, 1997, had a fair market value of $225,000 and unadjusted basis of $45,000.

The fair market value of Ralph's home on January 1, 2001 is **$42,500.**

Question 1. What is the basis for depreciation of their personal residence converted to rental property January 1, 2001?

Answer 1. Basis for depreciation is limited to the lesser of fair market value or adjusted basis in the property on date of conversion [Reg. §1.165-9(b)]. See *Bundren v. Commissioner,* T.C. Memo 2001-2 for a recent case that determines the basis of a personal residence converted to rental property.

Purchase price June 30, 1997	$225,000
Deferred gain I.R.C. §1034	$180,000
Unadjusted basis	$ 45,000
Depreciation, home office	$ 1,010

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

	Personal 75%	Business 25%	Total Basis
Adjusted basis	33,750	11,250	45,000
Minus: Depreciation	0	1,010	1,010
Lesser of:			
Adjusted basis	33,750	10,240	43,990
or			
Fair market value	31,875	N/A*	42,500
Basis for depreciation	31,875	10,240	42,115

*The basis of the business portion is not limited to fair market value.

TOPIC 7: RENTAL OF HOME OFFICE TO A CORPORATION

A 1986 amendment to the office-in-home rules provides that no business deduction shall be allowed for any portion of a home rented to the taxpayer's employer [I.R.C. §280A(c)(6)].

In IRS Technical Assistance (ITA) 200121070, the IRS has concluded that:

- An individual who rents a portion of a dwelling unit to his or her employer and uses that dwelling unit in performing services as an employee of that employer may deduct home mortgage interest, real property taxes, and personal casualty losses.
- Those deductions, however, are allowable only to the extent permitted under I.R.C. §163, §164, and §165(c)(3) and (h).
- The individual may not deduct otherwise allowable trade or business expenses under I.R.C. §162, business casualty losses under I.R.C. §165(c)(1), or depreciation under I.R.C. §167, to the extent those expenses and losses are attributable to the use by the employee of the dwelling unit in performing services for the employer.

Example 9. Joyce's marketing business is going great but Ralph still can't find a job. In fact, Joyce's business is doing so well that her accountant recommends forming an S Corporation, Y&RCO, and hiring Ralph and Joyce as employees. Assume both use separate parts of their home (but not a separate structure detached from the dwelling unit) in performing services for their employer, and are the only shareholders in Y&RCO.

Joyce will be paid a salary and receive a Form W-2 from Y&RCO for $50,000. Joyce has no other un-reimbursed employee business expenses (other than office in home) and is not required to file Form 2106, Employee Business Expenses. Joyce will continue to use the same portion of their rented personal residence as an office where she will perform management and administrative activities **for the convenience of her employer.** Ralph will use a different portion of the personal residence to conduct sales and promotional activities for Y&RCO.

Ralph will be paid a salary of $25,000 and he will receive a reasonable rent of $400 per month from Y&RCO for the use of his portion of the personal residence.

Question 1. How should Joyce report her qualified home-office expense deduction?

Answer 1. As an employee, Joyce must itemize deductions on Schedule A (Form 1040) to claim expenses for the business use of her home and any other employee business expenses.

> **Practitioner Note.** Statutory employees, use Form 8829 and Schedule C (Form 1040) to claim the home-office expenses.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Mortgage Interest. Although expenses for the business use of a taxpayer's home are generally deducted on line 20, unreimbursed employee expenses, Schedule A (Form 1040), any deductible home mortgage interest is not included on that line. Instead, both the business and nonbusiness parts of this interest are deducted on line 10 or 11 of Schedule A. If the home mortgage interest on lines 10 or 11 is limited by the home mortgage interest rules, the excess cannot be deducted as an employee business expense on line 20 of Schedule A, even though part of the home is used for business. (For a discussion of limits on home mortgage, see the 2000 *Farm Income Tax School Workbook*, page 504.)

Real Estate Taxes. Both the business and nonbusiness parts of real estate taxes are deducted on line 6 of Schedule A.

Casualty Losses. The business part of casualty losses (line 31 of the worksheet) are reported on line 27 of Form 4684, Section B. Write "See attached statement" above line 27.

Other Expenses. If Form 2106 or Form 2106-EZ is filed, report on line 4 the following expenses:

- The business part of otherwise nondeductible expenses (utilities, maintenance, insurance, depreciation, etc.) that do not exceed the deduction limit
- The employee business expenses not related to the use of the home, such as advertising

Enter the total from Form 2106, or Form 2106-EZ, on line 20 of Schedule A, where it is subject to the 2%-of-adjusted-gross-income limit. If Form 2106 or Form 2106-EZ is not required, enter total expenses directly on line 20 of Schedule A.

Observation. Remember deductibility of other expenses is subject to income limitations. The worksheet in IRS Publication 587, *Business Use of Your Home*, can be used to determine if other expenses are deductible or must be carried forward to a future year when business income allows the deduction (See Form 8829 earlier in this chapter, relating to deductions for business use of a home).

Practitioner Note. By operating a home office for the convenience of her employer, Joyce is able to deduct all home-office expenses subject to the 2% of AGI limitation and potential alternative minimum tax on miscellaneous itemized deductions.

Question 2. How must Ralph report the rental income and home office expenses?

Answer 2. Ralph must report as taxable income $4,800 rental income received from Y&RCO on Schedule E (Form 1040) of their personal tax return.

- While Ralph can deduct interest, real estate taxes, and casualty losses subject to limitation, he cannot deduct other business expenses attributable to the rental income [I.R.C. §280A(c)(6)].

Practitioner Note. The rental income is taxed the same as pass-through income from the S corporation. Since Ralph cannot deduct other business expenses attributable to the rental income, he gets the same tax result if the corporation does not pay rent to him and reports more pass-through income to Ralph and Joyce.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

2000	Deduction for Business Use of Your Home	Page 1
Client 99EMPLY	Ralph and Joyce B. Bosworth	123-45-7890
7/26/01		08:56PM

Name of Activity
Schedule A

PART 1 - Part of Your Home Used for Business:

Line	Description	(a) Direct Expenses	(b) Indirect Expenses	Amount
1)	Area of home used for business			500
2)	Total area of home			2,000
3)	Percentage of home used for business (divide line 1 by line 2)			25.00 %
	PART 2 - Figure Your Allowable Deduction:			
4)	Gross income from business			50,000
5)	Casualty losses			
6)	Deductible mortgage interest			
7)	Real estate taxes			
8)	Total of lines 5 through 7			
9)	Multiply line 8, column (b), by line 3			
10)	Add line 8, column (a), and line 9			
11)	Business expenses not from business use of home			
12)	Add lines 10 and 11			
13)	Gross income limit. Subtract line 12 from line 4			50,000
14)	Excess mortgage interest			
15)	Insurance		4,800	
16)	Repairs and maintenance		5,000	
17)	Utilities		10,000	
18)	Rent		13,600	
19)	Add lines 14 through 18		33,400	
20)	Multiply line 19, column (b) by line 3		8,350	
21)	Carryover of operating expenses from prior year			
22)	Add line 19, column (a), line 20, and line 21			8,350
23)	Allowable operating expenses. Enter the **smaller** of line 13 or line 22			8,350
24)	Limit on excess casualty losses and depreciation. Subtract line 23 from line 13			41,650
25)	Excess casualty losses			
26)	Depreciation of your home from line 38 below			
27)	Carryover of excess casualty losses and depreciation from prior year			
28)	Add lines 25 through 27			
29)	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 24 or line 28			
30)	Add lines 10, 23, and 29			8,350
31)	Casualty losses included on lines 10 and 29			
32)	Allowable expenses for business use of your home. (Subtract line 31 from line 30).			8,350
	PART 3 - Depreciation of Your Home Business Use of Home			8,350
33)	Smaller of adjusted basis or fair market value of home			
34)	Basis of land			
35)	Basis of building (Subtract line 34 from line 33)			
36)	Business basis of building (Multiply line 35 by line 3)			
37)	Depreciation percentage (from applicable table or method)			
38)	Depreciation allowable (multiply line 36 by line 37)			
	PART 4 - Carryover of Unallowable Expenses to Next Year			
39)	Operating expenses. Subtract line 23 from line 22. If less than zero, enter -0-			0
40)	Excess casualty losses and depreciation. Subtract line 29 from line 28. If less than zero, enter -0-			0

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

ISSUE 2: VEHICLE EXPENSES

Vehicle expenses include the costs of fuel, oil, tires, repairs, insurance, licenses, registration fees, taxes, and depreciation (for owned vehicles), or lease payments (for leased vehicles). All expenses must be reduced by the percentage of any personal use. Vehicle interest expense is deductible by self-employed individuals but no interest expense deduction is permitted to an employee, regardless of the percentage business use.

PASSENGER AUTOMOBILES

For vehicles falling under the passenger automobile definition, there are special limits on total I.R.C. §179 and depreciation deductions. For such vehicles first placed in service in 2001, the limits are as follows:

Year	Limit (Assuming 100% Business Use)
2001 (first tax year)	$3,060
2002 (second tax year)	$4,900
2003 (third tax year)	$2,950
2004 and later tax years (fourth and later years)	$1,775

I.R.C. §280F(d)(5)(A) defines a passenger automobile as any four-wheeled vehicle that is manufactured primarily for use on public streets, roads, and highways, and that is rated at 6,000 pounds unloaded gross vehicle weight or less. In the case of a truck or van, the term gross vehicle weight is substituted for the term unloaded gross vehicle weight.

Passenger Automobiles Other Than Trucks and Vans

All vehicles have a Manufacturer's Certification Label on either the back edge of the driver's door or on the frame for that door. The certification label provides the gross vehicle weight rating (GVWR) for that vehicle, which is the maximum approved weight for the sum of the unloaded gross vehicle weight of the vehicle, plus the weight of passengers and cargo. Passenger cars also have a Vehicle Capacity label located near the Manufacturer's Certification label, that provides the maximum passenger and luggage weight for the vehicle. By subtracting the total passenger and cargo weight from the GVWR, the unloaded gross vehicle weight for the vehicle can be determined.

Example 1

The Manufacturer's Certification and Vehicle Capacity Labels of a Chrysler Concorde show a gross vehicle weight rating (GVWR) of 4,585 pounds and a total passenger and luggage weight capacity of 1,015 pounds. By subtracting the passenger and luggage weight from the gross vehicle weight rating, an unloaded gross vehicle weight (curb weight) of 3,570 pounds can be determined (4,585 – 1,015 = 3,570).

Trucks and Vans

The 6,000 pound limit is based on the "gross vehicle weight" of trucks and vans rather than the "unloaded gross vehicle weight." Consequently, there is no need to subtract the passenger and cargo weight from the gross vehicle weight of trucks and vans.

There are several 2001 model vans and sport utility vehicles (sport utility vehicles are classified as a van for purposes of the passenger automobile test) that have a gross vehicle weight rating of **more than** 6,000 pounds and are therefore **not passenger automobiles.** There are several pickup trucks that have a gross vehicle weight of **less than** 6,000 pounds and therefore **are passenger automobiles**. The information in the following tables was obtained from the vehicle manufacturers. The gross vehicle weight rating for a specific model may vary from year to year.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

2001 Sport Utility Vehicles, Utility Vehicles and Vans with Gross Vehicle Weight Ratings (GVWR) Greater Than 6,000 Pounds

Manufacturer	Vehicles
DaimlerChrysler	Dodge Durango, Dodge Ram Van / Wagon
Ford Motor Company	E Series vans, Excursion, Expedition
General Motors	AM General Hummer
	Cadillac Escalade / Chevrolet Tahoe / GMC Yukon
	Chevrolet Astro / GMC Safari (AWD only)
	Chevrolet Express / GMC Savanna
	Chevrolet Suburban / GMC Yukon XL
Toyota	Land Cruiser, Sequoia

2001 Pickup Trucks with Gross Vehicle Weight Rating (GVWR) Less Than or Equal To 6,000 Pounds

Manufacturer	Vehicles
DaimlerChrysler	Dodge Dakota
Ford Motor Company	Explorer Sport Trac
	F150 regular cab (V-6 engine only), Ranger
General Motors	Chevrolet S-10 / GMC Sonoma
Mazda	B Series
Nissan	Frontier
Toyota	Tacoma, Tundra (V-6 Engine only)

6

Example 2. James Ross is a private farm management consultant. In April 2001 he purchased a Toyota Tacoma pickup for $22,500. Eighty percent of the truck's use is for business. Because the Toyota Tacoma's GVWR is not more than 6,000 pounds, it is considered a passenger automobile under I.R.C. §280F(d)(5)(A). If James uses the **actual cost method** for his 2001 business vehicle expenses, his **maximum** MACRS deduction is limited to the **lesser** of:

1. Business cost of $18,000 ($22,500 × 80%) × 20% (first-year 200% DB MACRS rate)	$3,600
2. 80% of the first-year passenger automobile limit ($3,060 × 80%)	$2,448

Practitioner Note. James may choose to use the **standard mileage rate** for claiming his business vehicle expenses. Taxpayers who choose to use the standard mileage rate for the first year an owned vehicle is placed in service may change in later years to deducting actual expenses. If the deduction of actual expenses is chosen first, the taxpayer **must** use that method for that vehicle for its entire period of business use in the taxpayer's hands. If a taxpayer uses two or more vehicles **in the same business at the same time,** the standard mileage rate is not permitted.

Whether or not James will benefit more from using the standard mileage rate or from deducting actual expenses will depend on the amount of his other vehicle expenses. Since James is self-employed, he is permitted to deduct any interest expense related to the vehicle on his Schedule C.

LIMITATIONS ON VEHICLES OTHER THAN PASSENGER AUTOMOBILES

Example 3. Bill Dozier is a self-employed grading contractor. In March 2001 he purchased a Chevrolet Suburban for $36,000, which is used 80% of the time for business. Because the GVWR of the Suburban exceeds 6,000 pounds, Bill is not subject to the passenger automobile depreciation limits on this vehicle. If he uses the actual cost method for his 2001 business vehicle expenses, the maximum

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

MACRS depreciation expense he can claim is $28,800 ($36,000 × 80%) × 20% (the first-year 200% DB MACRS rate) = $5,760.

Bill may also elect to use the I.R.C. §179 expense deduction for the business basis of this vehicle, subject to the $24,000 limitation for 2001, and subject to the limitation based on trade or business income. If Bill is able to take the maximum I.R.C. §179 expense deduction, his 2001 depreciation deduction is:

I.R.C. §179 Deduction	$24,000
200% DB MACRS deduction calculation	
$4,800 (($36,000 × 80%) – $24,000) × 20%	$ 960
Total	$24,960

BUSINESS USE 50% OR LESS

When business use of listed property is 50% or less, no I.R.C. §179 expense is permitted, and depreciation is limited to the alternative MACRS rate under I.R.C. §168(g).The definition of listed property includes any passenger automobile [I.R.C. §280F(d)(4)(A)(i)], and any other property used as a means of transportation [I.R.C. §280F(d)(4)(A)(ii)]. Qualified non–personal-use vehicles (vehicles designed to carry cargo with a loaded gross weight (GVWR) in excess of 14,000 pounds are excluded from I.R.C. §280F(d)(4)(A)(ii).

Example 4. Assume that Bill purchased the Chevrolet Suburban in Example 3 primarily for family use, and its business use is limited to 35%. In this case, depreciation is limited to $12,600 ($36,000 × 35%) × 10% (the first-year alternate MACRS rate) = $1,260, and no I.R.C. §179 deduction is permitted.

Subsequent Reduction in Business Use to 50% or Less

If business use begins above 50% and later falls to 50% or less, any I.R.C. §179 expense and the excess MACRS depreciation expense claimed since the asset was placed in service must be reported as income for both income and self-employment taxes.

Example 5. Assume the same facts as in Example 3, 200% DB MACRS depreciation and no I.R.C. §179 deduction. In 2003, Bill begins to use the Suburban more as a family vehicle, dropping its business use to 35%. Bill must recompute his depreciation deduction for the Suburban **from the time he placed it in service**, using the alternative MACRS method. The difference between the depreciation previously claimed and the recomputed depreciation is reported as in Part IV of Form 4797, and is subject to both income and self-employment taxes.

Year	200% DB MACRS Depreciation	Alternative MACRS Depreciation	Depreciation Recapture
2001	5,760	2,880	2,880
2002	9,216	5,760	3,456
Total	14,976	8,640	6,336

LEASED VEHICLES

Rev. Proc. 97-58 permits taxpayers to use either actual expenses or the standard mileage rate for leased vehicles for 1998 and later years, even if the lease began before 1998. The standard mileage rate may be used for leased vehicles only if it is used for the entire lease period, including renewals. For leases commencing before January 1, 1998, the "entire lease period" means that portion of the lease period (including renewals) remaining after that date.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

REQUIRED RECORDS

To claim an expense for vehicle use, I.R.C. §274(d)(4) requires taxpayers to substantiate by adequate records or other sufficient evidence:

- The time and place of travel
- The business purpose of the trip
- The amount of the vehicle expense

These rules apply to all taxpayers, except that **farmers** are permitted to claim 75% of the use of a vehicle as business use without substantiation if the vehicle is used during most of the normal business day directly in connection with the business of farming under Temp. Reg. §1.274-6(T)(b). This 75% safe harbor must be elected on the first return filed after the vehicle is placed in service, and is interpreted by the IRS as being permitted for **one vehicle only**.

ISSUE 3: I.R.C. §1245 DEPRECIATION RECAPTURE

I.R.C. §1245 requires the lesser of the gain realized or the depreciation previously claimed, to be reported as ordinary income upon sale or other transfer of an asset that is defined as I.R.C. §1245 property. This includes personal property for which depreciation was allowed or allowable, and certain real property, such as single-purpose agricultural and horticultural structures and property used as an integral part of production.

The transaction's gain is reported in Part III of Form 4797. Gain resulting from depreciation is ordinary income reported on line 13 of Form 4797. Gain that exceeds the original purchase price is I.R.C. §1231 capital gain reported on line 6 of Form 4797.

For recapture purposes (in addition to regular depreciation), the following are treated as depreciation:

- Any amount claimed as a deduction under I.R.C. §179
- Any basis reduction as a result of discharge of indebtedness under I.R.C. §108
- The basis reduction from claiming the investment credit I.R.C. §50(c)(4)(A)
- The deduction for qualified clean-fuel vehicle property or refueling property
- Deductions claimed under I.R.C. §190 (removal of architectural and transportation barriers to the handicapped and elderly), I.R.C. §193 (deduction for tertiary injectant expenses), or I.R.C. §1253(d)(2) or (3) (transfers of franchises, trademarks, and trade names) (as in effect before the Omnibus Budget Reconciliation Act of 1993)

Example 1. In 1998, Builder F. Roads purchased a heavy-duty earthmover for use in his road building business. He claimed MACRS, 7-year life and half-year convention on this earthmover. The original cost was $250,000. In September 2001, Builder F. sold the earthmover for $175,000. The computation of the I.R.C. §1231 and I.R.C. §1245 gain, with completed forms, follows:

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

ADJUSTED BASIS COMPUTATION

		Depreciation
Cost	$250,000	
Depreciation claimed:		
1998	14.29%	$ 35,725
1998	24.49%	$ 61,225
1999	17.49%	$ 43,725
2001	12.49% × 1/2	$ 15,612
Accumulated depreciation		$156,287
Selling price	$175,000	
Less adjusted basis	$(93,713)	$(250,000 – $156,287)
Realized gain (I.R.C. §1231)	$ 81,287	

Pursuant to I.R.C. §1245, the amount of the I.R.C. §1231 gain that is taxed as ordinary income is the lesser of depreciation taken ($156,287) or the realized gain ($81,287). The entire gain is taxed as ordinary income.

Form 4797 (2000) 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 *Earth-mover*	*7-1-1998*	*9-6-2001*
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	*175,000*			
21 Cost or other basis plus expense of sale	21	*250,000*			
22 Depreciation (or depletion) allowed or allowable	22	*156,287*			
23 Adjusted basis. Subtract line 22 from line 21	23	*93,713*			
24 Total gain. Subtract line 23 from line 20	24	*81,287*			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	*156,287*			
b Enter the **smaller** of line 24 or 25a	25b	*81,287*			

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	*81,287*
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	*81,287*
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*

Example 2. If in Example 1 the earthmover had been sold for $260,000, the gain would have included both ordinary gain I.R.C. §1245 and gain treated as capital gain I.R.C. §1231.

Selling price	$260,000
Less adjusted basis	$ (93,713)
Realized gain (I.R.C. §1231)	$166,287

Pursuant to I.R.C. §1245, the amount of the I.R.C. §1231 gain that is taxed as ordinary income is the lesser of depreciation taken ($156,287) or the realized gain ($166,287). Of the $166,287 realized gain, $156,287 is taxed as ordinary income under I.R.C. §1245 and $10,000 is taxed as capital gain under I.R.C. §1231.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

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 — **2000** — Attachment Sequence No. **27**

Name(s) shown on return: *Builder F. Roads* — Identifying number:

1	Enter the gross proceeds from sales or exchanges reported to you for 2000 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I — Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (See instructions.)

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2							

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	*10,000*
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	*10,000*

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	*156,287*

Form 4797 (2000) 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		*7-1-1998*	*9-6-2001*
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	*260,000*			
21	Cost or other basis plus expense of sale	21	*250,000*			
22	Depreciation (or depletion) allowed or allowable	22	*156,287*			
23	Adjusted basis. Subtract line 22 from line 21	23	*93,713*			
24	Total gain. Subtract line 23 from line 20	24	*166,287*			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	*156,287*			
b	Enter the **smaller** of line 24 or 25a	25b	*156,287*			

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	*166,287*
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	*156,287*
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	*10,000*

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

ISSUE 4: I.R.C. §1250 DEPRECIATION RECAPTURE

Section 1250 requires gain realized on the sale of property to be reported as ordinary income to the extent that depreciation claimed on the property exceeded straight-line depreciation.

Example 1. Office O. Knor purchased an office complex (nonresidential real property) on January 1, 1974, and is claiming double declining balance depreciation based on a 35-year useful life. Her accountant switched the double declining balance (DDB) to straight-line (S/L) when the accelerated method started to produce lower depreciation deductions. Office O. Knor paid $380,000 for the office complex, of which $30,000 was allocated to the land. Office O. Knor sold the property on July 1, 2000, for $550,000. The computation of depreciation claimed, adjusted basis, realized gain, and I.R.C. §1231 and I.R.C. §1250 gain follows:

DEPRECIATION CLAIMED (35-YEAR LIFE DDB, CONVERTING TO S/L): COST $350,000

Tax Year	DDB	S/L	Difference
1974	$ 20,000	$ 10,000	$ 10,000
1975	18,857	10,000	8,857
1976	17,780	10,000	7,780
1977	16,764	10,000	6,764
1978	15,806	10,000	5,806
1979	14,902	10,000	4,902
1980	14,051	10,000	4,051
1981	13,248	10,000	3,248
1982	12,491	10,000	2,491
1983	11,777	10,000	1,777
1984	11,104	10,000	1,104
1985	10,470	10,000	470
1986	9,871	10,000	(129)
1987	9,307	10,000	(693)
1988	8,776	10,000	(1,224)
1989	8,274	10,000	(1,726)
1990	7,801	10,000	(2,199)
1991	7,355	10,000	(2,645)
1992 (converts to S/L)	7,139	10,000	(2,861)
1993	7,139	10,000	(2,861)
1994	7,139	10,000	(2,861)
1995	7,139	10,000	(2,861)
1996	7,139	10,000	(2,861)
1997	7,139	10,000	(2,861)
1998	7,139	10,000	(2,861)
1999	7,139	10,000	(2,861)
2000	3,570	5,000	(1,430)
	$ 289,316	$ 265,000	$ 24,316
Selling price			$ 550,000
Cost		$ 380,000	
Less: Depreciation		$ (289,316)	
Adjusted basis			$ (90,684)
Realized gain			$ 459,316

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Office O. Knor reports the sale of the office complex on Part III of Form 4797. Her original purchase price is reported on line 20. The depreciation claimed is the depreciation claimed through 1999 plus the depreciation she claims in 2000. She calculates her 2000 depreciation on the office complex by prorating the $7,139 of depreciation she would have claimed for the whole year based on the number of days she actually held the property.

Observation. Before 1981 taxpayers had the option of using the mid-month convention or using a daily method for depreciating property placed in service during the tax year.

Because the office complex is I.R.C. §1250 property and Office O. Knor did not use straight-line depreciation, she is required to calculate her depreciation recapture on line 26. That is done by entering the depreciation she claimed in excess of straight-line depreciation for the period after 1975 on line 26a. For that period, Office O. Knor has $5,459 of additional depreciation calculated as follows:

Total additional depreciation	$ 24,316
Less:	
Additional depreciation for 1974	– 10,000
Additional depreciation for 1975	– 8,857
Additional depreciation after 1975	$ 5,459

The $5,459 of additional depreciation after 1975 is entered on line 26a and also on line 26b since the applicable percentage is 100%.

Office O. Knor enters $453,857 on line 26c ($459,316 total gain less the $5,459 on line 26b). The excess depreciation for the period after 1969 and before 1976 is $18,857. This is entered on line 26d.

Observation. If straight-line depreciation claimed after 1975 had been greater than the accelerated depreciation after 1975, Office O. Knor could reduce the amount on line 26d by the deficit for the period after 1975 [Treas. Reg. §1.1250-2(b)(6)].

On line 26e she enters the lesser of $453,857 or $18,857. Office O. Knor enters $24,316 on line 26g as the sum of line 26b ($5,459) and line 26e ($18,857).

The I.R.C. §1250 recapture gain is reported on line 31 ($24,316) and is then carried to Part II of Form 4797 (on line 13). Thus, this gain will be taxed at ordinary income tax rates. The remaining gain of $435,000 (line 32 of Part III) is then carried to Part I of Form 4797 (line 6), and is therefore treated as I.R.C. §1231 gain. Assuming there are no I.R.C. §1231 losses, this gain carries over to Schedule D. However, to the extent of prior straight-line depreciation claimed [$265,000, or ($289,316 – $24,316)], this I.R.C. §1231 gain will be taxed at a maximum rate of 25%. The remaining gain of $170,000 will be eligible for the 20% capital gain rate.

Type of Gain	Amount	Maximum Tax Rate
I.R.C. §1250 ordinary income recapture	$ 24,316	Ordinary income tax rate
I.R.C. §1231 (to extent of prior S/L depreciation)	$265,000	25%
I.R.C. §1231 (in excess of prior depreciation)	$170,000	20%

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

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

2000

Attachment Sequence No. 27

Name(s) shown on return: *Office O. Knor*

Identifying number

1	Enter the gross proceeds from sales or exchanges reported to you for 2000 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

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

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2							

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	*435,000*
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	

Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

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

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

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

S corporations. Enter any gain from line 9 on Schedule D (Form 1120S), line 15, and skip lines 11 and 12 below.

All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.

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	*24,316*

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

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 *Office Building*		
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	*550,000*			
21 Cost or other basis plus expense of sale	21	*380,000*			
22 Depreciation (or depletion) allowed or allowable	22	*289,316*			
23 Adjusted basis. Subtract line 22 from line 21	23	*90,684*			
24 Total gain. Subtract line 23 from line 20	24	*459,316*			
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	*5,459*			
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b	*5,459*			
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	*453,857*			
d Additional depreciation after 1969 and before 1976	26d	*18,857*			
e Enter the **smaller** of line 26c or 26d	26e	*18,857*			
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	*24,316*			
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

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

30 Total gains for all properties. Add property columns A through D, line 24	30	*459,316*
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	*24,316*
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	*435,000*

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		

Form **4797** (2000)

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

ISSUE 5: I.R.C. §179 EXPENSE ELECTION, ALLOWABLE DEDUCTIONS

Taxpayers, except trusts, estates, and certain noncorporate lessors, can elect to expense up to $24,000 (for tax year 2001), of the cost of certain MACRS property purchased and placed in service during the tax year. The expense election can be made only for qualifying personal property used in the active conduct of a trade or business. Property used for the production of income is disqualified. Property held for the production of income includes investment property, rental property, and property that produces royalty income. However, there are limits to the amount that can be expensed in a tax year.

What Costs Can Be Deducted?

Costs that can be expensed include:

- The cost of property purchased for use in a trade or business
- The cash or "boot" paid for property acquired in a like-kind exchange for use in a trade or business.

Example 1. John Jones traded his business truck that had an adjusted basis of $5,000, and paid cash boot of $4,000, for a new truck. Only the $4,000 cash boot paid is eligible for the I.R.C. §179 expense election.

Practitioner Note. The full expense deduction is allowed no matter when in the tax year the qualifying property is placed in service, even on the last day of the year. Also, a full deduction is allowed even if the property is placed in service in a short tax year.

Planning Pointer. For qualifying expense property, the mid-quarter and half-year depreciation conventions are avoided to the extent of the amount expensed.

Is the I.R.C. §179 Expense Election Optional?

The expense deduction **is elective** and can be taken or not taken as the taxpayer chooses. And if taken in one year, it need not be taken again in a later year in which the taxpayer buys qualifying property. However, it can only be taken in the year in which a depreciation deduction is first allowable with respect to the property, I.R.C. §179(c).

How to Make the Election

The I.R.C. §179 deduction is not automatic. Make the election by reporting the deduction on Form 4562. Attach and **file Form 4562** with either of the following:

- The original tax return filed for the year the property was placed in service (whether or not timely filed)
- An amended return filed by the due date (including extensions) for the year the property was placed in service. The I.R.C. §179 election cannot be made on an amended return filed after the due date (including extensions)

If the return is timely filed without making the election, the election can still be made by filing an amended return within six months of the due date of the return (excluding extensions).

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

What Property Qualifies for the Election?

Qualifying I.R.C. §179 property is depreciable property and includes the following:

1. Tangible personal property
2. Other tangible property (except buildings and their structural components) used as:
   a. An integral part of manufacturing, production, or extraction or furnishing transportation, communications, electricity, gas, water, or sewage disposal services
   b. A research facility used in connection with any of the activities in (a) above
   c. A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities
3. Single purpose agricultural (livestock) or horticultural structures
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum

Leased Property. Generally, the I.R.C. §179 deduction cannot be claimed for the cost of property leased to someone else. (This rule does not apply to corporations.) However, a taxpayer can claim an I.R.C. §179 deduction for the cost of the following:

1. Property the taxpayer manufactures or produces and leases to others
2. Property the taxpayer purchases and leases to others if both the following apply:
   a. The term of the lease (including options to renew) is less than half of the property's class life
   b. For the first 12 months after the property is transferred to the lessee, the total business deductions allowed on the property (other than rent and reimbursed amounts) are more than 15% of the rental income from the property

For a complete discussion and list of qualifying property see the *2000 Farm Income Tax School Workbook*, page 175.

What is the Annual Maximum Dollar Deduction Limit?

The I.R.C. §179 expense deduction cannot be more than the property's cost and is subject to the taxable income limit and the following annual maximum dollar limits, which are reduced if qualified investments exceed $200,000:

If the Tax Year Begins In:	The Applicable Amount Is:
1998	18,500
1999	19,000
2000	20,000
2001	**24,000**
2002	24,000
2003 or thereafter	25,000

The annual maximum dollar limitation applies to each taxpayer and not to each trade or business in which the taxpayer has an interest [Reg. §1.179-2(a), and Reg §1.179-2(b)(1)].

Example 2. Mult I. Business-Owner has a Schedule C business in which he purchased $20,000 of qualifying property. Mult I. also operates a Schedule F business in which he purchased $12,000 of qualifying property. In 2001, Mult. I. has purchased a total of $32,000 of qualifying property. However, his annual maximum dollar limitation is $24,000.

Example 3. Assume Mult I. Business-Owner's wife, Uno, also owns a Schedule C business that purchased $8,000 of qualifying property. Mult I. and Uno file a joint return in 2001. Among their three

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

businesses, they have purchased a total of $40,000 of qualifying property. However, their maximum annual dollar limit is $24,000. The maximum amount, $24,000, can be allocated to any of the qualifying assets.

What is the Investment Limit?

The deduction for any year is reduced (but not below zero) by the amount of qualifying property placed in service during the tax year that exceeds the **$200,000** investment limit [I.R.C. §179(b)(2)].

Example 4. Big Buyer placed $215,000 of qualifying property in service during his 2001 tax year. The expense deduction for that year is limited to $9,000.

2001 limit		$24,000
2001 qualifying purchases	$215,000	
Investment limit	200,000	
Excess		15,000
Limit on §179 deduction		$ 9,000

A husband and wife who file a joint return are treated as one taxpayer in applying the dollar limitation, regardless of which spouse bought the property or which spouse placed it in service. Reg. §1.179-2(b)(5)(i). A husband and wife may not deduct more than a total of the applicable maximum annual deduction even if they each bought separate properties and each owns separate businesses. The $200,000 investment ceiling is figured using the total cost of qualifying property that **both** spouses placed in service during the year.

Example 5. Mult I. and Uno are both calendar-year taxpayers. During the 2001 tax year, Mult. I. places $195,000 of qualifying property in service and Uno places $9,000 of qualifying property in service. **Whether or not** Mult. I. and Uno file a joint return for 2001, their dollar limitation is $20,000. [Reg. §1.179-2(b)(6)(ii)].

2001 limit		$24,000
Mult I.'s qualifying purchases	$195,000	
Uno's qualifying purchases	9,000	
Total qualifying purchases	$204,000	
Investment limit	200,000	
Excess		4,000
Limit on §179 deduction		$20,000

What is the Taxable Income Limit?

The otherwise allowable expense deduction is limited to the aggregate amount of taxable income from any of the taxpayer's active trades or businesses [I.R.C. §179(b)(3)(A)].

Taxable income from a trade or business includes the following items:

- I.R.C. §1231 gains and losses
- Interest from trade or business working capital
- Wages, salaries, tips, or other pay earned as an employee

How is the Income Limitation Applied to Married Taxpayers?

A husband and wife who file a joint return must:

- Combine their taxable income for purposes of the taxable income limitation
- The same rule applies to a husband and wife who file separate returns for a tax year and then elect to file a joint return after the time prescribed for filing the return for that year has expired

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

- Married taxpayers filing separately determine their taxable income limitations separately

Example 6. John has a $10,000 loss from his Schedule C business; Mary has $12,000 net income from her business. John and Mary have no other income and file a joint return. John and Mary could elect to expense $2,000 I.R.C. §179 property even if it were purchased and used in John's business.

Observation. The taxable income limitation doesn't prevent an expense deduction simply because the trade or business in which the qualifying property is used produces no income for the year of investment. As long as the taxpayer has aggregate taxable income from active trades or businesses, the deduction is allowed.

The converse is also true. If the taxpayer has taxable income from the business in which the qualifying property is used but does not have aggregate taxable income because another business showed a loss, no expense deduction is available. In that case, however, a carryover would be allowed.

How is Taxable Income Computed?

Taxable income, for purposes of the taxable income limitation, is computed without regard to the expense deduction itself, and without regard to:

1. The deduction under I.R.C. §164(f) for one-half of self-employment tax
2. Any net operating loss carryback or carryforward, and
3. Any deductions suspended under other I.R.C. sections. [Reg. §1.179-2(c)(1)]

Example 7. Jim Smith bought an item of construction equipment for $10,000. The net income from Jim Smith's construction business is $200,000. Jim also owns and actively manages an office building that produces a $200,000 rental loss. For Jim, however, the I.R.C. §469 passive activity rules prevent current deduction of the rental loss. Under the above "deduction-suspension" rule, the rental loss does not reduce the income from Jim Smith's construction business for purposes of the taxable income limitation. Therefore, Jim may elect to expense $10,000, the full cost of the construction equipment.

Can Deductions in Excess of the Taxable Income Limit Be Carried to a Future Year?

Only §179 deductions in excess of the taxable income limitation can be carried forward. Deductions that exceed the maximum annual dollar limitation are wasted and cannot be carried forward.

Example 8. Ralph Roush in 2001 has taxable income from his Schedule C business of $30,000. He has purchased $28,000 of qualified property and attempted to expense the full amount. However, his deduction is limited to the maximum annual dollar limitation for 2001, $24,000. The excess $4,000 cannot be carried forward.

Example 9. Assume the same facts as above except Ralph's taxable income is $15,000. Ralph elects $24,000, the maximum I.R.C. §179 expense election for 2001. He can deduct $15,000 for 2001. The remaining $9,000 can be carried to any future year.

Observation. Even if the business in the above example doesn't have $24,000 of taxable income for 2001, the benefit of the election is not lost, but only postponed to future years to the extent the expensed amount exceeds taxable income. If the business has zero taxable income (before the election) for Year 2001, the expense election ensures the business a deduction for *any* future year when the business does have taxable income. Without the election, the carryover deduction is lost for any later year. However, the taxpayer can take regular depreciation for the property in the later year.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

How Does the Carryover of the I.R.C. §179 Expense Effect Future Year's Annual Dollar Limitation?

Any expense deduction that cannot be used because of the taxable income limitation is carried forward indefinitely to future years. The carryover can be deducted to the extent that, when added to amounts for which the taxpayer makes the expense election for that year, it does not exceed the dollar limitations and the taxable income limitation for that year. Carryovers not deductible because the taxable income limitations can continue to be carried forward to future years [I.R.C. §179(b)(3)(B)].

Example 10. Mary, a calendar-year taxpayer, has a $3,000 carryover of a disallowed I.R.C. §179 expense deduction from a past tax year. In 2001 Mary places in service qualifying property that cost $25,000. Mary's 2001 taxable income from active trades and businesses is $100,000. Mary elects to expense $22,000 of the cost of the qualifying property placed in service in 2001. Because of the $24,000 limitation (for 2001), Mary can deduct the $22,000 of current year expense and $2,000 of the carryover. Mary has a $1,000 carryover remaining for use in future years [Reg. §1.179-3(d)].

Can Personal-Use Property Converted to Business Use Qualify for the I.R.C. §179 Expense?

The determination of whether property is qualifying property is made in the first year the property is placed in service. If the taxpayer places property in service in a tax year and the property does not qualify for the expense deduction**, no expense deduction is allowed** for the property even though the property later becomes qualifying property in a future tax year [IRS Pub No. 946, (2000), p. 14]. However, the taxpayer can take regular depreciation for the property in the later year.

Example 11 . In year 1, Mike bought a new car and used it 100% for personal purposes. In the following year (year 2), Mike begins to use the car in his business. The car is not qualifying property to Mike for purposes of the expense election. However, Mike can depreciate the car in year 2.

ISSUE 6: RECAPTURE OF I.R.C. §179 DEDUCTIONS

An I.R.C. §179 recapture is triggered when the **business use** of property placed in service in a previous year is reduced to 50% or less during the recapture period. The recapture period of the expense election is the entire recovery period of the qualifying I.R.C. §179 property I.R.C. §179(d)(10).

The **recapture amount** (reported on Form 4797) equals the I.R.C. §179 expense deduction taken minus the MACRS depreciation amount that **would have been allowed** on the expense amount from the time the property was placed in service up to and **including** the year of recapture [Treas. Reg. §1.179-1(e)(1)].

Listed Property

If an I.R.C. §179 deduction is claimed on listed property, and the business use of the property later falls to 50% or less, the I.R.C. §179 recapture is included with the recapture of the excess depreciation I.R.C. §280F(d). The I.R.C. §280F(b)(2) recapture rule requires the taxpayer to report as income the difference between the depreciation and §179 deduction that has been claimed, and the depreciation that would have been allowed using the alternative MACRS depreciation rules.

Listed property includes any of the following:

1. Any passenger automobile
2. Any other property used for transportation
3. Any property of a type generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment)

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

4. Any computer and related peripheral equipment, unless it is used only at a regular business establishment and is owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit if and only if that portion is used both regularly and exclusively for business
5. Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989

Example 1. Steve Jones paid $10,000 for a horse trailer in 1998. Steve used the trailer 80% in his farming business and 20% for personal use. Therefore, his basis in the portion used for business was $8,000. He claimed a $6,000 I.R.C. §179 deduction for the trailer on his 1998 income tax return. He depreciated the remaining $2,000 business basis using MACRS. He deducted the following depreciation:

Year	Depreciation Rate	Depreciation Basis	Depreciation Amount
1998	15.00%	$2,000	$ 300
1999	25.50%	$2,000	$ 510
2000	17.85%	$2,000	$ 358
			$1,168

The total depreciation deducted through 2000 is $7,168.

In 2001, Steve used the trailer only 40% for business. Therefore, he must recapture the I.R.C. §179 deduction and depreciation claimed to the extent they exceed the depreciation that is allowed under alternative MACRS. The recapture is calculated as follows:

Alternative MACRS Depreciation Allowable (Straight-Line Method)

Year	Depreciation Rate	Depreciation Basis	Depreciation Amount
1998	10.00%	$8,000	$ 800
1999	20.00%	$8,000	$1,600
2000	20.00%	$8,000	$1,600
			$4,000
Total depreciation taken	$ 7,168		
Total depreciation allowable	$(4,000)		
Excess depreciation recapture	$ 3,168		

Steve reports the recapture on Part IV of Form 4797. He carries the $3,168 recapture amount to his 2001 Schedule C, line 6 (Other Income). The $3,168 originally taken reduced his self-employment income in 1998–2000; likewise, the $3,168 recapture amount in 2001 is subject to self-employment tax.

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

		Line	(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33		7,168
34	Recomputed depreciation. See instructions	34		4,000
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		3,168

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Practitioner Note. Steve's depreciation for 2001 is zero. The $10,000 cost × 40% business use gives a $4,000 business basis. When the $4,000 of depreciation claimed in prior years is subtracted, there is no remaining business basis to be depreciated.

Other than Listed Property

If business use of property that is not listed property falls to 50% or below, the taxpayer must report as ordinary income the difference between the I.R.C. §179 expense claimed and the depreciation that **would have been allowed** on that amount had it not been expensed.

Example 2. In 1999 Needfor Speed bought a super-fast copier that cost $20,000. In 1999 and 2000 he used the machine 100% in his accounting business. He claimed $4,000 of his $20,000 business basis as an I.R.C. §179 deduction in 1999 and depreciated the remaining $16,000 business basis using 200% declining balance.

In 2001, Needfor's wife used the copier for her volunteering activities, which reduced his business use of the copier to 40%. That reduction in business use requires Needfor to report his excess I.R.C. §179 deduction as other income on line 10 of his 2001 Schedule C. The amount of the excess I.R.C. §179 deduction is calculated as follows:

Year	Depreciation Rate	Business Use	Depreciation Basis	Allowable Depreciation Amount
1999	20.00%	100%	$4,000	$ 800.00
2000	32.00%	100%	$4,000	$1,280.00
2001	19.20%	40%	$4,000	$ 307.20
Total allowable				$2,387.20

The excess recapture amount is $1,612.80 ($4,000 – $2,387.20). Needfor reports the recapture amount on Form 4797. He also reports $1,612.80 as other income on his 2001 Schedule C, line 6 (other income), and adds that amount to the basis of the printer at the beginning of 2001.

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		*4,000.00*
34	Recomputed depreciation. See instructions	34		*2,387.20*
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		*1,612.80*

Form **4797** (2000)

ISSUE 7: LIKE-KIND EXCHANGE, IRS NOTICE 2000-4

Notice 2000-4 sets out the procedure for claiming depreciation on property received in a like-kind exchange or in an involuntary conversion. Prior to Notice 2000-4, most practitioners added the basis carried over from the relinquished property to any new basis in the acquired property, and the total was depreciated over the life of the acquired property.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Example 1. Cust M. Harvester paid $100,000 for combine-1 in 1995 and depreciated it using MACRS 150% declining balance rates for 7-year property. In 1998, he traded the old combine for a new, 30-foot wide platform combine-2 and paid $40,000 cash. His $89,005 basis in combine-2 is calculated as follows:

Unadjusted basis of combine-1		$100,000
Less depreciation:		
1995: $100,000 × 10.71% =	$10,710	
1996: $100,000 × 19.13% =	$19,130	
1997: $100,000 × 15.03% =	$15,030	
1998: $100,000 × 12.25% × 0.5 =	$ 6,125	– 50,995
Subtotal		$ 49,005
Plus boot (cash)		$ 40,000
Basis in combine-2		$ 89,005

Cust M. depreciates the $89,005 over 7 years beginning in 1998. Therefore, his total depreciation on combine-1 and combine-2 for the year of the trade (1998) is:

Depreciation on combine-1	
$100,000 × 12.25% × 0.5 =	$ 6,125
Depreciation on combine-2	
$89,005 × 10.71% =	$ 9,532
Total	$15,657

Notice 2000-4 requires Cust M. to continue depreciating the carried-over basis over the remaining life of the relinquished property using the depreciation rate that was used for the relinquished property. Any new basis in the acquired property is depreciated over the life of the acquired property at the rate allowed for the acquired property.

Example 2. If Cust M. Harvester (from Example 1) had bought combine-1 in 1997 and made the trade in 2000, he would continue to depreciate the basis carried over from combine-1 over the useful life of combine-1 and would depreciate the $40,000 of new basis the same as any other new purchases of equipment in 2000. The 2000 depreciation combine-2 is calculated as follows:

Fourth year depreciation on basis from combine-1	
$100,000 × 12.25% =	$12,250
First year depreciation on new basis	
$40,000 × 10.71% =	$ 4,284
Total	$16,534

Observation. Notice 2000-4 does not require any particular record keeping system. One way to keep a record of depreciation on the acquired property is to leave the relinquished property on the depreciation schedule with a note that it was traded for the acquired property. The new basis can be entered on a new line of the depreciation schedule with a note that there is additional basis on the line for the relinquished property. If a taxpayer makes frequent trades, there can be more than two lines that reflect the depreciation and basis in the most recently acquired property.

Effective Date

The new method of depreciating property received in a trade is mandatory for property placed in service on or after January 3, 2000. Taxpayers have the option of using the old method or the new method for property placed in service before January 3, 2000.

If property placed in service before January 3, 2000, has been reported on a tax return using the old method, the **taxpayer can elect** to use the new method of depreciation for that property. The

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

change is treated as a change in method of accounting, so Form 3115 must be filed. Notice 2000-4 indicates that this change has automatic consent and the procedures of Rev. Proc. 99-49 must be followed. Revenue Procedure 99-49 requires the adjustment resulting from the change in method of accounting to be spread over the 4-year period beginning with the year of change. However, there is a ***de minimis* rule** that allows the taxpayer to elect to make the full adjustment in the year of change if the adjustment is less than $25,000, positive or negative.

Example 3. Assume that Cust M. Harvester from Example 1 (1998 trade) wants to elect the new method of depreciating combine-2 that he acquired in 1998. He made this decision after he had filed his 1999 return and before he filed his 2000 return. His adjustment resulting from the change in method of accounting is the net difference between the depreciation he claimed on combine-2 and combine-1 in 1998 and combine-2 in 1999, and the amount he would claim using the new method. It is calculated as follows:

Year	Depreciation Claimed Under Old Method	Depreciation Claimed Under New Method	Net Difference
1998	$ 15,657	$16,534	$ 877
1999	$ 17,027	$19,902	$2,875
Total	$32,684	$36,436	$3,752

Since the total change is less than $25,000, Cust M. can elect to make the full change on his 2000 income tax return. He also claims $18,262 of depreciation for combine-2 in 2000, calculated as follows:

Sixth-year depreciation on $100,000	
$100,000 × 12.25% =	$12,250
Third-year depreciation on $40,000	
$40,000 × 15.03% =	$ 6,012
Total	$18,262

Practitioner Note. Taxpayers who want to change to the new method on property reported under the old method must make the change in method of accounting in the first or second tax year ending after January 3, 2000. For calendar-year taxpayers, that is 2000 or 2001.

I.R.C. §1245 DEPRECIATION RECAPTURE, LIKE-KIND EXCHANGE

Gain that is recognized from a like-kind exchange of property is subject to the same recapture rules as gain recognized from the sale of the property.

- Gain recognized from the exchange of I.R.C. §1245 property is ordinary income to the extent of depreciation claimed on the property. Gain in excess of the depreciation claimed is I.R.C. §1231 gain.
- Gain recognized from the exchange of I.R.C. §1250 property is ordinary income to the extent that depreciation claimed on the property exceeds straight-line depreciation. The remaining gain is I.R.C. §1231 gain.
- If I.R.C. §1231gain from the I.R.C. §1250 property is treated as long-term capital gain, the gain due to straight-line depreciation is subject to the 25% maximum capital gain rate. The gain in excess of depreciation claimed is subject to the 20%, 10%, or 8% maximum capital gain rate.

Example 4. Assume that Cust M. Harvester from Example 3 does elect to use the new method under Notice 2000-4 for the 1998 trade of combine-1 for combine-2. He also filed Form 3115, application for change in accounting method, following Revenue Procedure 99-49 and claimed the $3,752 depreciation

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

adjustment in 2000. Cust M. used combine-2 in 1998, 1999, and 2000. In September 2000 he sold combine-2 for $99,000.

When Cust M. reports the sale of combine-2, he must recapture not only depreciation claimed on combine 2, but also any depreciation recapture that was carried over from combine 1.

The depreciation recapture carried over from combine 1 is the lesser of:

1. The gain carried over from combine 1, or
2. Depreciation claimed on combine 1.

The $10,995 gain deferred from combine is computed on Form 8824 as follows:

Form **8824** — Department of the Treasury, Internal Revenue Service

Like-Kind Exchanges
(and nonrecognition of gain from conflict-of-interest sales)
▶ Attach to your tax return.

OMB No. 1545-1190 — **1998** — Attachment Sequence No. **109**

Name(s) shown on tax return: ***Cust M. and Linda N. Harvester*** — Identifying number: ***128-65-9438***

Part I — Information on the Like-Kind Exchange

Note: *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶ ***Combine-1***

2 Description of like-kind property received ▶ ***Combine-2***

Part III — Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred* ***and*** *received* ***(a)*** *more than one group of like-kind properties, or* ***(b)*** *cash or other (not like-kind) property, see* ***Reporting of multi-asset exchanges*** *in the instructions.*

Note: *Complete lines 12 through 14* ***only*** *if you gave up property that was not like-kind. Otherwise, go to line 15.*

Line	Description		Amount
12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions	15	
16	FMV of like-kind property you received	16	*100,000*
17	Add lines 15 and 16	17	*100,000*
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions	18	*89,005*
19	**Realized gain or (loss).** Subtract line 18 from line 17	19	*10,995*
20	Enter the smaller of line 15 or line 19, but not less than zero	20	*0*
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions	21	*0*
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions	22	
23	**Recognized gain.** Add lines 21 and 22	23	
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	*10,995*
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23	25	*89,005*

For Paperwork Reduction Act Notice, see back of form. Cat. No. 12311A Form **8824** (1998)

Practitioner Note. It is very important to determine the fair market value of the relinquished property at the time of the trade and to file Form 8824 to document the deferred gain on the relinquished property.

Since that $10,995 deferred gain carried over is less than the $50,995 depreciation claimed on combine 1, Cust M. must add the $10,995 deferred gain to the depreciation on combine 2 when he calculates his depreciation recapture on Form 4797.

Cust M. must also determine the depreciation he has claimed on combine 2. That is not obvious from the depreciation schedule because part of the depreciation is reported as depreciation of the carry over basis from combine 1 and part of it is reported as deprecation of the boot paid for combine 2.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

The following table shows the two parts and the total.

DEPRECIATION OF COMBINE 2

Carryover Basis			New Basis	Total
Unadjusted basis	$49,005	Unadjusted basis	$40,000	$89,005
Less depreciation:		Less depreciation		
1998: 12.25% × .5 =	$ 6,125	1998: 10.71% =	$ 4,284	$10,409
1999: 12.25% =	$12,250	1999: 19.13% =	$ 7,652	$19,902
2000: 12.25% × .5 =	$ 6,125	2000: 15.03 × .5 =	$ 3,006	$ 9,131
Total	$24,500		$14,942	$39,442
Adjusted basis	$24,505		$25,058	$49,563

As the above table shows, the $39,442 total depreciation of combine 2 is one-half the 1998, and all of the 1999 and 2000 depreciation for the basis carried over from combine 1 plus all of the 1998, 1999 and 2000 depreciation for the new basis.

Therefore, Cust. M reports $50,437 on line 22 of Form 4797, calculated as follows:

Depreciation on combine 2	$39,442
Depreciation recapture carried over from combine 1	10,995
Total	$50,437

The $10,995 increase in the amount reported on line 22 will result in an incorrect adjusted basis on line 23 unless the same $10,995 is also added to the basis reported on line 21. Therefore, the amount reported on line 21 is:

Basis in combine 2	$ 89,005
Depreciation recapture deferred from combine 1	10,995
Total	$100,000

Form 4797 (2000) 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 *Combine 2*	*6-1-1998*	*9-2-2000*
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	*99,000*			
21 Cost or other basis plus expense of sale	21	*100,000*			
22 Depreciation (or depletion) allowed or allowable	22	*50,437*			
23 Adjusted basis. Subtract line 22 from line 21	23	*49,563*			
24 Total gain. Subtract line 23 from line 20	24	*49,437*			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	*50,437*			
b Enter the **smaller** of line 24 or 25a	25b	*49,437*			

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

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	49,437
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	49,437
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

Example 5. Assume that Cust M. could have sold combine-2 for $125,000. What are the tax consequences?

Cust M.'s sale of combine-2 for $125,000 results in $50,437 of I.R.C. §1245 recapture and $25,000 of I.R.C. §1231 gain as shown on the following Part III of Form 4797.

Form 4797 (2000) 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 Combine 2	6-1-1998	9-2-2000
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	125,000			
21 Cost or other basis plus expense of sale	21	100,000			
22 Depreciation (or depletion) allowed or allowable	22	50,437			
23 Adjusted basis. Subtract line 22 from line 21	23	49,563			
24 Total gain. Subtract line 23 from line 20	24	75,437			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	50,437			
b Enter the **smaller** of line 24 or 25a	25b	50,437			

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	75,437
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	50,437
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	25,000

Effect of Notice 2000-4

Notice 2000-4 changes the error practitioners are likely to make if they do not compute the deferred gain at the time of a like-kind exchange and use that deferred gain to calculate depreciation recapture at the time of the sale of the acquired property.

- Before Notice 2000-4, failure to account for deferred gain from the relinquished property would result in **under-reporting** depreciation recapture upon the sale of the acquired property
- After Notice 2000-4, failure to account for deferred gain from the relinquished property will result in **over-reporting** depreciation recapture

Before Notice 2000-4. When practitioners reported a like-kind exchange prior to Notice 2000-4, they typically added the carryover basis from the relinquished property to the boot paid for the acquired property and entered the total on the depreciation schedule as the new basis in the acquired property. The relinquished property was removed from the depreciation schedule by reporting that it was sold

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

for its basis (so that no gain or loss was reported) or by simply deleting it. If the practitioner relies solely on the information on the depreciation schedule to report depreciation recapture upon sale of the acquired asset, depreciation recapture will be under-reported in some cases because there is no record of the depreciation recapture that was deferred from the relinquished property.

After Notice 2000-4. After Notice 2000-4, most practitioners will leave the information for the relinquished property on the depreciation schedule to compute depreciation on the carryover part of the basis of the acquired property. They will make a new entry on the depreciation schedule to compute depreciation on the boot paid for the acquired property. If the practitioner relies solely on the information on the depreciation schedule to report depreciation recapture on the sale of the acquired property, depreciation recapture will be over-reported in some cases because there is no record of the deferred gain from the relinquished property, which is the limit on depreciation recapture deferred from the relinquished property.

Practitioner Note. The deferred gain is reported on line 24 of Form 8824. Therefore, filing that form and keeping a copy in the file reduces the chances of making the above errors.

Example 6. Assume the same facts as in Example 1 above. In addition, assume that Cust. M sold combine 2 in 2000 for $125,000. Depreciation on the acquired combine 2 under the pre-Notice 2000-4 method would have been $33,408.

Pre-Notice 2000-4 method. As shown on the following Part III of Form 4797, if there is no record of the $10,995 deferred gain from combine 1, depreciation recapture on sale of combine 2 is likely to be reported incorrectly as $33,408 rather than correctly as $33,408 + $10,995 = $44,403.

Notice 2000-4 method. As shown on the following Part III of Form 4797, if there is no record of the $10,995 deferred gain from combine 1, depreciation recapture on sale of combine 2 is likely to be reported incorrectly as $75,437 rather than $50,437.

Form 4797 (2000) 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	***Combine 2: Pre-Notice 2000-4 method without accounting for deferred gain***	*6/1/1998*	*9/2/2000*
B	***Combine 2: Pre-Notice 2000-4 with accounting for deferred gain***	*6/1/1998*	*9/2/2000*
C	***Combine 2: Notice 2000-4 method without accounting for deferred gain***	*6/1/1998*	*9/2/2000*
D	***Combine 2: Notice 2000-4 with accounting for deferred gain***	*6/1/1998*	*9/2/2000*

	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	*125,000*	*125,000*	*125,000*	*125,000*
21	Cost or other basis plus expense of sale	21	*89,005*	*100,000*	*140,000*	*100,000*
22	Depreciation (or depletion) allowed or allowable	22	*33,408*	*44,403*	*90,437*	*49,563*
23	Adjusted basis. Subtract line 22 from line 21	23	*55,597*	*55,597*	*49,563*	*49,563*
24	Total gain. Subtract line 23 from line 20	24	*69,403*	*69,403*	*75,437*	*75,437*
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	*33,408*	*44,403*	*90,437*	*50,437*
b	Enter the **smaller** of line 24 or 25a	25b	*33,408*	*44,403*	*75,437*	*50,437*

Notes for Form 4797

1. Depreciation is reported improperly on line 22 in the Property A column because it does not include the $10,995 of depreciation recapture that was deferred from combine 1. The correct amount is reported in the Property B column.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Practitioner Note. The depreciation recapture that is deferred from combine 1 is the lesser of the $50,995 depreciation claimed on combine 1 or the $10,995 gain deferred from combine 1. The gain deferred from combine 1 is reported on line 24 of Form 8824.

2. To make the adjusted basis on line 23 correct, the $10,995 of depreciation that was added to the depreciation on line 22 in the Property B column must also be added to the cost basis on line 21.

Practitioner Note. The cost basis of combine 2 is reported on line 25 of Form 8824.

3. The cost basis reported on line 21 in the Property C column incorrectly includes the original cost of both combine 1 and combine 2 as shown on the depreciation schedule. The correct amount is the $89,005 cost basis of combine 2 increased by the $10,995 of deferred depreciation recapture from combine 1 as shown in the Property D column.
4. Depreciation is reported improperly on line 22 in the Property C column because it includes all of the $50,995 of depreciation on combine 1 rather than just the depreciation that was deferred from combine 1. The correct amount is the $39,442 of depreciation on combine 2 plus the $10,995 deferred depreciation from combine 1, as shown in the Property D column.

Non-Income Tax Issues

The Notice 2000-4 method could be confusing for some non-income tax issues since both the original cost basis of both the relinquished property and the acquired property are still on the depreciation schedule. For example, if the depreciation schedule is used to report the taxpayer's assets to a bank to get a loan, the bank should be informed that the relinquished asset is no longer owned so that it does not erroneously rely on both assets for collateral. Similarly, if the depreciation schedule is used to report assets for local property tax purposes, the tax liability will be overstated if the cost of relinquished assets is included in the tax base.

ISSUE 8: SALES TO RELATIVES

Losses on the sale or exchange of property are not allowed if made directly or indirectly between certain related persons. I.R.C. §267(a). The members of a family for purposes of the related taxpayer rule I.R.C. §267(c)(4) include only the taxpayer's:

- Wife or husband
- Brother or sister (including half-brother and half- sister)
- Father, mother, grandparent, or any other "ancestor", and
- Children, grandchildren, or any other "lineal descendant"

Nonrecognition on sales between related taxpayers applies **only to a loss.** Any gain resulting from a sale to a related taxpayer other than a spouse is taxable. Recognized gain from a sale or exchange of depreciable property is taxable and may be subject to recapture as ordinary income if made either directly or indirectly between related persons. Excess gain is treated as I.R.C. §1231 capital gain.

Example 1. John Sr. and John Jr. have operated successful but separate farming operations. John Sr. would like to retire and sell his farming assets to his son, John Jr. The following table lists the assets to be sold.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Description	Land	Cattle	Equipment	Total
John Sr. Cost	$125,000	$45,000	$100,000	$270,000
Depreciation	–0–	$28,550	$ 78,500	$107,050
Adjusted basis	$125,000	$16,450	$ 21,500	$162,950
Sales price	$100,000	$50,000	$ 75,000	$225,000
Realized G/L	(25,000)	$33,550	$ 53,500	
Recognized G/L	–0–	$33,550	$ 53,500	$ 87,050

Question 1. What are the tax consequences of this transaction to John Sr.?

Answer 1. John Sr. will recognize $82,050 of I.R.C. §1245 recapture of depreciation as ordinary income from the sale and $5,000 of §1231 gain.

	§1245	§1231
Cattle	$28,550	$5,000
Equipment	$53,500	–0–
Total	$82,050	$5,000

The loss of $25,000 from the sale of land to John Jr., a related party, is nondeductible.

Question 2. Can John Jr. claim the I.R.C. §179 expense election on the purchase of the equipment from his father, John Sr.?

Answer 2. No. John Jr. cannot take the I.R.C. §179 expense election, $24,000, for 2001. Tangible personal property doesn't qualify for the expense election if it is acquired from any person whose relationship to the purchaser would cause the disallowance of losses [(I.R.C. §179(d)(2)(A)].

Example 2. Assume that John Sr. had asked you to determine the tax consequences of the above transaction to see if he should sell his assets to John Jr. Of course, John Sr. did not like the part about paying tax on the gains and not deducting the losses.

John Sr. decides to reduce his tax liability and help his son by transferring the assets partly by sale and partly through gift. You advise John Sr. to obtain a certified appraisal of the assets, and recommend filing of gift tax returns. John Sr. decided to sell-gift his assets at 50% of the appraised value.

Treas. Reg. §1.1001-1(e) requires a taxpayer who makes a part gift/part sale of property to report gain to the extent the amount realized exceeds basis, if any. No loss is allowed if the amount realized is less than basis.

If John Sr. made a 50% gift/50% sale of each of the three categories of assets, he must recognize gain as follows:

	Land	Cattle	Equipment	Total
Sale price	$ 50,000	$25,000	$37,500	$112,500
Adjusted basis	125,000	16,450	21,500	162,950
Realized G/L	$(75,000)	$ 8,550	$16,000	$ (50,450)
Recognized G/L	-0-	$ 8,550	$16,000	$ 24,550

The cattle and equipment sales are reported on Part III of Form 4797 where all of the $24,550 of gain is treated as ordinary income under the depreciation recapture rules.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

John Jr.'s basis in the assets is John Sr.'s carry-over basis plus gain recognized on the gift/sale. Therefore, John Jr.'s bases are as follows:

	Land	Cattle	Equipment	Total
John Sr.'s basis	$125,000	$16,450	$21,500	$162,950
Recognized gain	-0-	$ 8,550	$16,000	$ 24,550
John Jr.'s basis	$100,000 *	$25,000	$37,500	$162,500
or	$125,000		or	$187,500

*John Jr.'s basis is the lesser of FMV ($100,000) or John Sr.'s basis ($125,000) for purposes of calculating a loss on a subsequent sale. It is John Sr.'s $125,000 carryover basis for purposes of calculating a gain on a subsequent sale.

Practitioner Note. If there had been gift taxes due on the gift, the gift tax attributable to the depreciation on the property would also be added to John Jr.'s basis.

A Better Way

John Sr. could reduce the gain he has to report to zero by allocating the $112,500 purchase price among the three categories of assets so that no asset is sold for more than the lesser of its FMV or basis. For example he could allocate $100,000 to the land (its FMV), $12,500 to the equipment and zero to the cattle. His gain and loss on the part gift/part sale is then calculated as follows:

	Land	Cattle	Equipment	Total
Sale price	$100,000	$12,500	-0-	$112,500
Adjusted basis	125,000	16,450	21,500	162,950
Realized G/L	$(25,000)	$(3,950)	$(21,500)	$(50,450)
Recognized G/L	-0-	-0-	-0-	-0-

Assuming that there is no gift tax due on the gift, John Jr.'s bases in the assets are:

	Land	Cattle	Equipment	Total
John Sr.'s basis	$125,000	$16,450	$21,500	$162,950
Recognized gain	-0-	-0-	-0-	-0-
John Jr.'s basis	$100,000 *	$16,450	$21,500	$137,950
or	$125,000		or	$162,950

*John Jr.'s basis is the lesser of FMV ($100,000) or John Sr.'s basis ($125,000) for purposes of calculating a loss on a subsequent sale. It is John Sr.'s $125,000 carryover basis for purposes of calculating a gain on a subsequent sale.

Observation. These two examples illustrate that there is a trade off between taxes paid by John Sr. and taxes paid by John Jr. The gain recognized by John Sr. when half of each category of assets was sold to John Jr. gave John Jr. a higher depreciable basis in the cattle and equipment. If the added depreciation reduces the present value John Jr.'s income and self-employment taxes by more than the gain increases the present value of John Sr.'s income taxes, John Sr. may want to recognize the gain.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Later Sale to an Unrelated Party

If a taxpayer acquires property by purchase or exchange from a transferor who sustained a loss not allowable as a deduction by reason of the related taxpayer rules, I.R.C. §267(a), then any gain realized by the taxpayer on a sale or other disposition of the property to an unrelated taxpayer is recognized only to the extent that the gain exceeds the amount of the loss that is properly allocable to the property sold or otherwise disposed of by the taxpayer.

Example 3. John Jr. later sells the land he bought for $100,000 from John Sr. in Example 1 to farmer Smith (not a related party) for $160,000.

Question 1. What is John Jr.'s taxable gain?

Answer 1. John Jr. can add to his basis the loss disallowed to John Sr. from the previous related party transaction.

Sales price		$160,000
John Jr.'s basis	$125,000	
Related party loss	25,000	
Total basis		$150,000
John Jr.'s taxable gain		$ 10,000

ISSUE 9: NONRESIDENT ALIEN WORKERS

TAX ISSUES OF NONRESIDENT ALIENS

For tax purposes, an alien is an individual who is not a U.S. citizen. Aliens are classified as nonresident aliens and resident aliens. Nonresident aliens are taxed only on their income from sources within the United States and on certain income connected with the conduct of a trade or business in the United States.

An alien is a **nonresident alien** if he or she does not satisfy one of the tests for being a **resident alien.** Those tests are the green card test and the substantial presence test.

GREEN CARD TEST

An alien is a resident for tax purposes if he or she is a lawful permanent resident of the United States at any time during the calendar year. An individual who has been given the privilege of residing permanently in the United States is a lawful permanent resident. Individuals generally have this status if the Immigration and Naturalization Service (INS) has issued an alien registration card, commonly known as a green card. Resident status continues under this test unless the status is rescinded or determined to have been abandoned.

SUBSTANTIAL PRESENCE TEST

An alien without a green card will be considered a U.S. resident for tax purposes if he or she meets the substantial presence test for the current calendar year. To meet this test, an individual must be physically present in the United States on at least:

1. 31 days during the current year
2. 183 days during the 3-year period that includes the current year and the two years immediately before, counting:
   a. All the days present in the current year
   b. One-third of the days present in the first year before the current year, and
   c. One-sixth of the days present in the second year before the current year

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Example 1. Greta Holz was physically present in the United States on 122 days in 2001, 93 days in 2000, and 156 days in 1999. To determine if she qualifies as a resident alien for tax purposes in 2001, Greta counts all of the 2001 days (122), plus 1/3 of the 2000 days (93 ÷ 3), plus 1/6 of the 1999 days (156 ÷ 6). Greta's total days for the physical presence test are:

$$122 + 31 + 26 = 179$$

Greta is considered a nonresident alien for 2001 since her days under the physical presence test are less than the 183 day requirement.

Days of Presence

Individuals are generally treated as being present in the United States on any day they are physically present in the U.S. at any time during the day, with the following exceptions:

- Individuals who reside in Canada or Mexico, who commute to work in the United States from those countries on a regular basis
- Days during which an individual is in the United States for less than 24 hours when in transit between two places outside the United States
- Days in the United States as a crew member of a foreign vessel
- Days during which an individual is unable to leave the United States due to a medical condition which developed while in the United States
- Days when classified as an exempt individual

Practitioner Note. An exempt individual is someone who is:

- Temporarily present in the United States as a foreign-government-related person
- A teacher or trainee temporarily present in the United States under a "J" or "Q" visa, who substantially complies with the visa requirements
- A student temporarily present in the U.S. under an "F", "J", "M", or "Q" visa, who substantially complies with the visa requirements, or
- A professional athlete temporarily in the United States to compete in a charitable sports event

Immediate family members (spouses and unmarried children) are considered to be exempt individuals if their visa statuses are dependent on the exempt individual's visa classification. Unmarried children are included only if they:

- Are under 21 years of age
- Reside regularly in the exempt individual's household, and
- Are not members of another household

Closer Connection to a Foreign Country

Individuals who meet the substantial presence test may still be considered nonresident aliens if they:

1. Are present in the United States for less than 183 days during the current year
2. Maintain a tax home in a foreign country during the year, and
3. Have closer connection during the year to one foreign country in which he or she has a tax home than to the United States

In determining whether or not an individual has a closer connection to a foreign country, the following facts and circumstances are considered:

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

1. The country of residence designated on forms and documents
2. The types of official forms and documents filed, such as Form W-9, Form W-8BEN, or Form W-8ECI
3. The location of:
   a. The individual's permanent home
   b. The individual's family
   c. Personal belongings, particularly those of significant value
   d. Current social, political, cultural, or religious affiliations
   e. Business activities other than those which constitute the individual's tax home
   f. The jurisdiction under which a driver's license is held, and
   g. The jurisdiction in which the individual votes

NONRESIDENT ALIENS MARRIED TO U.S. CITIZENS OR RESIDENT ALIENS

A nonresident alien who is married to a U.S. citizen or resident alien at the end of the year may choose to be treated as a U.S. resident. If this choice is made, both individuals are treated as residents for the entire tax year. Making this choice generally prohibits either spouse from claiming any tax treaty benefits as a resident of a foreign country for the tax year for which the choice is in effect. Worldwide income of both spouses will be taxed in the United States under this choice. The choice is made on an annual basis, and spouses making this choice must file a joint return for the year of the choice. They may file either joint or separate returns in future years.

The choice is made by both spouses signing a statement and attaching it to their joint return for the first year for which the choice applies. The choice can be made on either an original or an amended return. The statement must contain:

- A declaration that one spouse was a nonresident alien and the other spouse a U.S. citizen or resident alien on the last day of the tax year, and that both spouses choose to be treated as U.S. residents for the entire tax year, and
- The name, address, and identification number of each spouse. If one spouse died during the year, the name, address and identification number of the person making the choice for the deceased spouse should also be included

SUMMARY OF SOURCE OF INCOME RULES FOR NONRESIDENT ALIENS

Item of Income	Factor Determining Source
Salaries, wages, other compensation	Where services performed
Business income from:	
Personal services	Where services performed
Sale of purchased inventory	Where sold
Sale of produced inventory	Allocation
Interest	Residence of payer (See Exclusions from Gross Income, item 1, following)
Dividends	Whether a U.S. or foreign corporation
Rents	Location of property
Royalties from:	
Natural Resources	Location of property
Patents, copyrights, etc.	Where is property is used
Sale of real property	Location of property
Sale of personal property	Seller's tax home
Pensions	Where services that earned the pension were performed
Sale of natural resources	Allocation based on fair market value of the product at an export terminal

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Personal Services

All wages and any other compensation for services performed in the United States are considered to be from U.S. sources. If a nonresident alien receives compensation for personal services performed both inside and outside the U.S., only that portion of the income that is for services performed in the U.S. is considered to be U.S. source income. The allocation of income is made on the basis of the amount of time spent performing the services inside and outside the U.S.

Example 2. Greg Fonsah is a nonresident alien employed by a U.S. corporation. He worked 235 days for the corporation, 141 days in the United States, and 94 days in other countries. His salary from the corporation was $48,000. His U.S. source income is determined by dividing the number of days worked in the United States by the total days worked, and multiplying the fraction by the total compensation:

$$(141\text{days} \div 235 \text{ days}) \times \$48{,}000 = \$28{,}800$$

EXCLUSIONS FROM GROSS INCOME

Nonresident aliens can exclude the following items from their gross income:

1. U.S. source interest income if it is not connected with a U.S. trade or business
2. Services performed for a foreign employer if all of the following three conditions are met:
   a. The services are performed as an employee or under a contract with a nonresident alien individual, or a foreign partnership or corporation, not engaged in a trade or business in the United States; or for work in an office or place of business maintained in a foreign country or possession of the United States by a U.S. corporation, partnership, or a U.S. citizen or resident
   b. The services are performed while a nonresident alien temporarily present in the United States for not more than a total of 90 days during the tax year, and
   c. Payment for these services is not more than $3,000 (If the payment for these services is more than $3,000, the entire amount is income from a U.S. trade or business. The $3,000 limit does not include travel expense advances or reimbursements, if made under an accountable plan. If advances and/or reimbursements exceed actual travel expenses, the excess is included in computing the pay for services.)
3. Scholarships and Fellowship Grants

   Grants from non-U.S. sources received by nonresident aliens are not subject to U.S. tax. Grants from U.S. sources are generally excluded from U.S. income to the extent that conditions of the grant specify that it be used for:
   a. Tuition and fees required to enroll in, or to attend, an educational institution
   b. Fees, books, supplies, and equipment that the educational institution requires for the courses of instruction (Amounts used from a scholarship or fellowship for other expenses, such as food, lodging, and travel, are not excludable from income. Amounts received through a scholarship, fellowship or tuition reduction that represent payment for teaching, research, or other services cannot be excluded from income).

Example 3. Cesar Escalante is awarded a scholarship of $6,000 for the fall semester. A condition of the scholarship requires him to serve as a part-time teaching assistant. Of the $6,000 total scholarship, $2,000 is considered to be compensation for his teaching services. Assuming that all other qualifications are met, Cesar can exclude $4,000 of the $6,000 from income as a qualified scholarship.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

TAXATION OF NONRESIDENT ALIEN INCOME

Nonresident aliens are taxed based on the source of their income and whether or not their income is effectively connected with a U.S. trade or business. Nonresident alien income subject to U.S. income tax is divided into two categories:

1. Income that is effectively connected with a trade or business in the United States (taxed at the regular U.S. income tax rates)
2. Income that is not effectively connected with a trade or business in the United States (taxed at a flat 30% rate, unless a lower tax treaty rate applies)

Personal Services

Personal services performed by a nonresident alien in the United States are considered to be trade or business income in the United States. This includes owning and operating a business, membership in a partnership engaged in a trade or business in the United States, and being the beneficiary of an estate or trust. Also included are students and trainees in the United States as a nonimmigrant under an "F", "J", "M", or "Q" visa. The only exception is for services performed for a foreign employer meeting all of the conditions discussed previously in the Exclusions from Gross Income section.

Effectively Connected Income

If a nonresident alien is engaged in a trade or business in the United States, all income, gain, or loss for the tax year from sources within the United States (except for certain investment income) is considered to be effectively connected income. This rule applies whether or not there is any actual connection between the income and the U.S. trade or business.

If a nonresident alien is considered engaged in a U.S. trade or business solely because he or she performed personal services in the United States during the tax year, then income and gains from assets, and gains and losses from the sale or exchange of assets, are generally considered to be not effectively connected income.

Foreign Income

Under three circumstances, foreign source income is treated as effectively connected income. The circumstances are:

1. There is a fixed place of business in the United States to which the income can be attributed
2. The place of business is a material factor in producing the income, or
3. The income is produced in the ordinary course of the trade or business conducted through the place of business described above

There are three kinds of foreign source income:

1. Rents and royalties for the use of, or the right to use, intangible personal property located outside the United States
2. Dividends or interest from the active conduct of banking, financing, or similar businesses in the United States, and
3. Income, gain, or loss from the sale outside the United States, through the U.S. place of business, of stock in trade, inventory, and property primarily held for sale to customers in the ordinary course of business. This type of income is not foreign source income if it is sold for consumption or use outside the United States, and a place of business outside the United States was a material factor in the sale.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

TAX ON EFFECTIVELY CONNECTED INCOME

Effectively connected income is taxed, after allowable deductions, at the rates that apply to U.S. citizens and residents. Income received in a tax year after a tax year when a nonresident alien was considered to be engaged in a trade or business, will be considered effectively connected income if it would have been effectively connected income had it been received in the year the transaction took place or services were performed.

Example 4. April Smythe is a nonresident alien who performed personal services in the United States for her foreign employer between October 1 and December 31, 2000. April left the United States on January 15, 2001, after receiving the final paycheck for her 2000 calendar year services on January 10, 2001. All of April's income relating to her personal services performed in the United States is U.S. source income. The paycheck received in 2001 is U.S. source income because it is effectively connected to personal services she performed in the United States in 2000.

THE 30% TAX

A flat 30% (or lower treaty) rate tax applies to the gross amount of fixed or determinable U.S. source annual or periodic gains, profits or income, and to income or gains from U.S. sources, but only if the items are not effectively connected income. Fixed income is income paid in amounts that are known ahead of time. Determinable income is any income for which there is a basis for computing the amount to be paid.

Practitioner Note. It is important to remember that the 30% (or tax treaty rate) tax applies only to fixed or determinable income not effectively connected to the conduct of a trade or business. Even though wages and salaries are either fixed or determinable, they are not subject to the 30% tax, since they are considered to be trade or business income. It is also important to remember that U.S. source interest income that is not connected with a U.S. trade or business is excluded from gross income.

A Table of Tax Treaties is included in IRS Publication 519, *U.S. Tax Guide for Aliens*.

SOCIAL SECURITY BENEFITS

Nonresident aliens must include 85% of any U.S. social security benefit (and the social security equivalent part of a tier 1 railroad retirement benefit) in U.S. source fixed or determinable annual or periodic income. This income may be exempt for individuals from certain countries under the terms of tax treaties.

TAX IDENTIFICATION NUMBERS

Social Security Numbers (**SSN**) are available to individuals lawfully admitted to the United States under any immigration category which includes U.S. employment authorization.

Individual Taxpayer Identification Numbers (**ITIN**) are required for individuals admitted under terms that prohibit U.S. employment. ITINs are for tax use only. Form W-7 is used to apply for an ITIN. ITINs should be obtained for all aliens who are required to furnish a tax identification number and are not eligible for an SSN, and:

- Alien individuals claimed as dependents who are not eligible for an SSN
- Alien spouses who are claimed as exemptions who are not eligible for an SSN

Employer Identification Numbers are available to nonresident aliens lawfully engaged in a trade or business in the United States that requires reporting of business tax information via such a number.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

COMPUTATION OF NONRESIDENT ALIEN TAXES

Filing Status

Nonresident aliens are limited in the filing statuses they can use. Filers of Form 1040NR-EZ may use only the Single nonresident alien or Married nonresident alien filing statuses.

Nonresident aliens filing Form 1040NR are also limited in their filing status selections. Generally, only the Single and Married Filing Separately filing statuses are available. Only nonresident aliens married to U.S. citizens or residents may use the Married Filing Jointly status. If this status is used, all income of both spouses will be taxed in the United States.

The **Qualifying Widow(er)** filing status is available in 2001 if:

1. The taxpayer was a resident of Canada, Mexico, Japan, or South Korea, or a U.S. national
2. The taxpayer's spouse died in 1999 or 2000 and the taxpayer has not remarried, and
3. The taxpayer has a dependent child living with him or her

The **Head of Household** filing status is not available to nonresident aliens. However, the spouse of a nonresident alien may qualify as a head of household if:

1. The spouse is a resident alien or U.S. citizen for the entire tax year
2. The nonresident alien spouse does not choose to be treated as a resident alien for tax purposes, and
3. The resident alien or citizen spouse meets all other requirements for this filing status

Married nonresident aliens who are not married to U.S. citizens or residents must generally use the **Married Filing Separately** filing status. Married residents of Canada, Mexico, Japan, or South Korea, and married U.S. nationals, may be able to use the Single filing status if they lived apart from their spouse during the last 6 months of the year.

Deductions

Nonresident aliens are permitted to claim deductions in computing their effectively connected U.S. source income. No deduction is permitted for expenses related to income not connected with U.S. business activities.

Nonresident aliens may make deductible contributions to IRA, SEP, SIMPLE, and qualified retirement plans, subject to the same limits as other taxpayers.

Exemption Deductions

Nonresident aliens are generally allowed to claim only one personal exemption deduction on their tax return. Exemption deductions for spouses and dependents are available under certain circumstances. In these situations, described below, the spouse or dependent must have an SSN or ITIN in order to be claimed on the return.

Nonresident aliens who are married to residents of Canada, Mexico, and U.S. nationals are permitted a personal exemption deductions for their spouse if the spouse had no gross income for U.S. purposes, and was not the dependent of any other taxpayer. Exemption deductions for dependents are permitted, subject to the same rules as U.S. citizens.

Nonresident aliens who are residents of Japan or South Korea may claim spousal and dependent exemption deductions, subject to two additional requirements, imposed by tax treaties with these nations:

1. The spouse and all children claimed must live with the nonresident alien in the United States at some time during the tax year, and

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

2. The additional exemption deductions must be prorated based on the ratio of the alien's U.S. source effectively connected gross income for the tax year to the alien's entire income from all sources for the tax year.

Example 5. Mr. Takimoto, a Japanese resident, lives temporarily in the United States as a nonresident alien. His wife and child accompanied and stayed with him in the United States. During the tax year he received $15,000 in U.S. compensation. He also received $25,000 of income from non-U.S. sources that is not effectively connected income. His total income for the tax year is $40,000. Mr. Takimoto meets all requirements for claiming exemption deductions for his spouse and child. The permitted exemption deduction for Mr. Takimoto's spouse and child is:

$$(\$15{,}000 \div \$40{,}000) \times (\$2{,}900 \times 2) = \$2{,}175$$

Mr. Takimoto is also permitted his own personal exemption deduction of $2,900 for 2001.

Students and business apprentices from India eligible for the benefits of Article 21(2) of the United States–India Income Tax Treaty can claim an exemption deduction for a spouse if he or she had no gross income during the year and is not a dependent of another taxpayer. Exemption deductions are also permitted for dependents **not** admitted to the U.S. on "F-2", "J-2", or "M-2" visas if they meet the same rules as U.S. citizens.

Itemized Deductions

The standard deduction is not permitted for nonresident aliens, with the exception of students and business apprentices from India eligible for the benefits of Article 21(2) of the United States–India Income Tax Treaty. All other nonresident aliens must itemize deductions. Itemized deductions are permitted for nonresident aliens under the same rules as for residents, with the exception that deductions for state and local income taxes, and for job expenses and unreimbursed travel expenses, must be related to effectively connected income.

Tax Credits

Tax credits are permitted to nonresident aliens only if they have effectively connected income.

The **Child and Dependent Care Credit** is generally available to nonresident aliens who have such expenses and are able to claim an exemption for the individual for whom the credit is claimed. Married nonresident aliens can claim the credit only if they choose to file a joint return with a U.S. citizen or resident spouse, or if they qualify as *Certain Married Persons Who Live Apart* under the filing status instructions for Form 1040NR.

The **Child Tax Credit** is available to nonresident aliens who have a child who is:

- A U.S. citizen, national, or resident alien
- Claimed as a dependent on the nonresident alien's tax return
- A son, daughter, adopted child, grandchild, stepchild, or foster child, and
- Under age 17 at the end of the year

Education Credits are not available to nonresident aliens, unless they are married to a U.S. citizen or resident, and elect to file a joint return.

The **Earned Income Credit** is not available to nonresident aliens, unless they are married to a U.S. citizen or resident, and elect to file a joint return. Furthermore, this credit can only be claimed if all individuals listed on the tax return (taxpayer and spouse, and dependents) have work-related social security numbers. The credit cannot be claimed if an individual holding an Individual Taxpayer Identification Number (ITIN) is or should be listed on the return.

The **Foreign Tax Credit** is permitted to nonresident aliens who have foreign income effectively connected to a U.S. trade or business. The credit is not permitted for U.S. taxes paid on foreign source

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

income not effectively connected. Further, the credit may not be taken for taxes imposed by another country or U.S. possession, if those taxes were imposed only because the individual is a citizen or resident of the taxing body.

The **Credit for Prior Year Minimum Tax** is available to nonresident aliens who paid the alternative minimum tax in a prior year.

The **Adoption Credit** is available to nonresident aliens, except that married nonresident aliens may claim the credit only if they are married to a U.S. citizen or resident, and elect to file a joint return.

FILING

A U.S. income tax return must be filed if any of the following conditions are met:

1. The nonresident alien is engaged or considered to be engaged in a trade or business in the United States during the current tax year. A return must be filed even if:
   a. The income did not come from a trade or business conducted in the United States
   b. There is no income from U.S. sources
   c. The income is exempt from U.S. income tax
2. The nonresident alien not engaged in a trade or business in the United States has U.S. income on which the tax liability was not satisfied by withholding of tax at the source.
3. A representative or agent is responsible for filing a return for an individual described in (1) or (2).
4. A fiduciary is responsible for filing a return for a nonresident alien estate or trust.

Practitioner Note. Nonresident aliens temporarily present in the United States as students or trainees under an "F", "J", "M", or "Q" visa are considered to be engaged in a trade or business in the United States. Form 1040NR (or Form 1040NR-EZ) must be filed only if there is income subject to tax, such as wages, tips, scholarship and fellowship grants, dividends, etc.

A U.S. income tax return must also be filed if a nonresident alien wants to:

1. Claim a refund of overwithheld or overpaid tax
2. Claim the benefit of any deductions or credits

Form 1040NR-EZ

Nonresident aliens may use Form 1040NR-EZ if all of the following conditions are met:

1. No dependents are claimed.
2. The taxpayer cannot be claimed as a dependent on someone else's return.
3. No spousal exemption is permitted for married taxpayers.
4. Taxable income is less than $50,000.
5. State and local income taxes are the only itemized deductions claimed.
6. The only income is from wages, salaries, tips, taxable refunds of state and local income taxes, and scholarship or fellowship grants. If income includes taxable interest or dividends, Form 1040NR-EZ cannot be used.
7. No adjustments to income are claimed other than the student loan interest deduction or the exclusion of scholarship and fellowship grants.
8. No credits are claimed.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

9. The only taxes owed are:
   a. Income tax from the Tax Table
   b. Social Security and Medicare taxes on tip income not reported to an employer, or
   c. Household employment taxes

WITHHOLDING

Nonresident aliens who are employees should complete Form W-4 as follows:

1. The Single marital status should be checked on line 3, regardless of actual marital status.
2. Only one allowance can be claimed on line 5, unless the nonresident alien employee is a resident of Canada, Mexico, Japan, or South Korea, or a U.S. national.
3. Request additional withholding on line 6 as follows:

Pay Period	Additional Withholding
Weekly	$ 7.60
Biweekly	$15.30
Semimonthly	$32.93
Monthly	$32.93

4. The Exempt withholding status on line 7 may not be claimed.

Allowance for Personal Exemption

Withholding on payments for independent personal services is based on the amount of compensation payment minus the value of one exemption. One personal exemption is allowed for determining the amount of independent personal services performed in the United States to which the 30% (or lower treaty) tax rate will apply, if the nonresident alien is not a resident of Canada, Mexico, Japan, or South Korea. The personal exemption is prorated at $7.95 per day in 2001 ($2,900 ÷ 365) for the purposes of 30% withholding.

Example 6. Claude LeBlanc, a resident of France, worked under a contract with a U.S. firm (not as an employee) in the United States for 120 days during 2001. He earned $18,000 for the services performed. Claude is married and has two children. His wife is not employed and has no income subject to U.S. tax. The amount of the personal exemption to be allowed against his income for independent personal services is $954 ($7.95 × 120 days), and withholding at 30% is applied against the balance. $5,113.80 in income tax is withheld from Claude's earnings [($18,000 – $954) × 30%].

Practitioner Note. Nonresident aliens who are residents of Canada, Mexico, Japan, or South Korea, or who are U.S. nationals, are subject to the same 30% withholding on independent personal services. However, U.S. nationals and residents of Canada and Mexico are allowed the same personal exemptions as U.S. citizens, prorated on the daily basis. Residents of Japan and South Korea are permitted personal exemptions for themselves and for their spouses and children who have lived with them at any time during the tax year, prorated on the daily basis. The exemptions for the spouse and children, however, must be further prorated as noted previously under Exemption Deductions.

Example 7. Assume the same facts as in Example 6, except that Claude is a resident of Canada. In this case, Claude may claim four withholding exemptions, and the amount that will be allowed against his income for independent personal services is $3,816 ($7.95 × 4 × 120 days). Withholding at 30% (or lower treaty rate) will be applied against the $14,184 balance, resulting in withholding of $4,255.20.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

SOCIAL SECURITY AND MEDICARE TAXES

In general, social security and Medicare taxes apply to payments of wages for services performed as an employee in the United States, regardless of the citizenship or residency of either the employee or the employer. Self-employed nonresident aliens, however, are *not* subject to self-employment tax. Residents of the U.S. Virgin Islands, Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, or American Samoa are considered U.S. residents in this situation, and are subject to self-employment tax.

ISSUE 10: NET OPERATING LOSSES

A loss incurred in a taxpayer's profession or his unincorporated business is first deducted from other income and reported on the taxpayer's Form 1040. If the taxpayer's 2001 loss, including casualty losses, exceeds income, the excess loss may be carried back first to 1999, then to the year 2000, and then forward for twenty years starting with 2002 through 2021 until the loss is used up. The net operating rules are applicable to self employed individuals, taxpayers whose casualty losses exceed income, shareholders in S corporations, and partners with flow through partnership losses.

Current law provides that net operating losses can be carried back two years and then carried forward for up to twenty years. However, taxpayers can make an election to forgo the NOL (net operating loss) carryback period, and instead carry the NOL forward into future years. If no election is made, the NOL has to be first carried back to the earliest of two years even if there is no benefit available due to the carryback. This is the first determination that a tax practitioner needs to make once a current year net operating loss becomes known.

Practitioner Note. The election to forgo the carryback (elect NOT to carry back the loss) must be made on the tax return in which the NOL occurred or on an amended return for that year which can be filed within six months (excluding extensions) of the due date for the original return. For example, a 2001 calendar year taxpayer has until October 15, 2002, to make the election on an amended return. If this deadline is not met, the taxpayer cannot forgo the carryback.

Example 1. Davy Filbeck operates an over-the-road trucking business as a Schedule C sole proprietorship. He employed two drivers and had three trucks in this business activity during 2000. Due to the general downturn in the economy and the higher prices for fuel, the trucking business suffered a large loss during the year. Mr. Filbeck is married with two children, and his wife, Regina, works full-time in a data processing position at the local junior college.

A snapshot of the Filbecks' 2000 income is as follows:

Wages (Regina Filbeck)	$ 25,500
Interest income	$ 800
Dividend income	$ 1,100
State income tax refund	$ 600
Other income lottery winner	$ 1,200
Trucking Schedule C (Davy Filbeck)	(72,200)
Total adjusted gross income	$(43,000)

To illustrate the calculation of the net operating loss and the carryback of this NOL, comparative income/expense amounts are reflected for the loss year and the carryback years as follows:

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Davy and Regina Filbeck	1998 First Carryback Year	1999 Second Carryback Year	2000 Loss Year
Income			
Wages (line 7 of Form 1040)	$21,400	$23,600	$ 25,500
Interest income (line 8a of Form 1040)	600	700	800
Dividend income (line 9 of Form 1040)	500	1,400	1,100
State income tax refund (line 10 of Form 1040)	200	1,200	600
Schedule C business income (loss) (line 12 of Form 1040)	12,000	24,000	(72,200)
Other income (line 21 of Form 1040)	0	0	1,200
Total Income (line 22 of Form 1040)	$34,700	$50,900	$(43,000)
Adjustments			
50% of SE tax (line 27 of Form 1040)	$848	$ 1,696	0
IRA deduction (line 23 of Form 1040)	4,000	4,000	4,000
Total adjustments (line 32 of Form 1040)	4,848	5,696	4,000
Adjusted Gross Income (line 33 of Form 1040)	$29,852	$45,204	$(47,000)
Standard Deduction (line 36 of Form 1040)			$7,350
Itemized deductions			
Medical expenses (line I Schedule A)	$6,200	$3,200	N/A
Less 7.5% AGI (line 3 Schedule A)	(2,239)	(3,390)	N/A
Medical deduction (line 4 Schedule A)	3,961	0	N/A
State income tax (line 5 Schedule A)	1,200	1,500	N/A
Real estate tax (line 6 Schedule A)	800	900	N/A
Personal property tax (line 7 Schedule A)	200	200	N/A
Mortgage interest (line 10 Schedule A)	2,500	5,400	N/A
Contributions (line 18 Schedule A)	600	800	N/A
Misc. itemized deductions (line 23 Schedule A)	$900	$800	N/A
Less 2% AGI (line 25 Schedule A)	(597)	(904)	N/A
Net misc. itemized deductions (line 26 Schedule A)	303	0	N/A
Total itemized deductions	$9,564	$8,800	N/A
Personal Exemption Deduction (line 38 of Form 1040)	$10,800	$11,000	$11,200
Taxable Income (line 39 of Form 1040)	$9,488	$25,404	($65,550)
Income tax (line 40 of Form 1040)	1,421	3,814	0
Child tax (line 43 of Form 1040)	(800)	(1,000)	0
Balance tax (line 49 of Form 1040)	$ 621	$2,814	0
Self employment tax (line 52 of 1040)	1,695	3,391	0
Total Tax Liability (line 57 of Form 1040)	$2,316	$6,205	0

CARRYBACK OF THE NET OPERATING LOSS

There are two optional methods to carry a net operating loss back. One is to file a Form 1045 (Application for Tentative Refund) no later than the end of the tax year following the year in which the loss occurred. In the Filbeck example, the use of Form 1045 to claim the refund could be filed by December 31, 2001. However, the Filbecks need to first file their 2000 regular income tax return before submitting Form 1045.

The second option is to file Form 1040-X for each of the carryback years. This amended return can be used anytime during the 3-year period from the due date of NOL return, including any extensions. In the case of the Filbecks, a Form 1040-X could be filed as late as April 16, 2004, to carry the 2000 net operating loss back to 1999 and 2000.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Schedule A of Form 1045 details the computation of the Filbecks' net operating loss for the year 2000. The Schedule A of Form 1045 serves as the method of calculating the allowable current year net operating loss available to be carried back to prior years.

Line 1

Enter the $47,000 adjusted gross income as a negative number.

Line 2a

Enter the $7,350 standard deduction for the year. Note: If the taxpayer had itemized deductions, that amount would have been entered here.

Line 2b

Enter the total of taxpayers' four exemptions for the year: $11,200.

Line 2c

Enter the the total of lines 2a and 2b as a negative number: ($18,550)

Line 3

Enter the ($65,550) total of ($47,000) from line 1 and ($18,550) from line 2. (If line 3 is positive, there is no net operating loss in the current year.)

Line 4

Enter the $11,200 pesonal exemption deduction. It is added back to the negative taxable income on line 2 to reduce the NOL.

Line 9

Enter the $11,350 total of the $7,350 standard deduction and the taxpayers' combined $4,000 IRA deduction. The NOL is not increased by the IRA deduction.

Lines 10 & 11

Enter the $3,700 nonbusiness income consisting of interest, dividends, state tax refund, and lottery winnings.

Line 12

Enter the $7,650 net of nonbusiness deductions less nonbusiness income, which serves to reduce the allowable net operating loss carryback.

Line 27

Enter the ($46,700) that results from combining (65,550) from line 3, $11,200 from line 4, and $7,650 from line 12.

Application for Tentative Refund, Form 1045, reflects the carryback of the NOL as determined in Schedule A (Form 1045). The net operating loss is first carried back to the second preceding year, and, to the extent it is not absorbed in that year (1998 in the case of the Filbecks), the NOL is then carried forward into the first preceding year, and if still not fully absorbed, carried forward for up to twenty years.

The 2000 year NOL, as determined per Schedule A of Form 1045, is $46,700. The Filbecks' 1998 adjusted gross income was only $29,852, so the NOL was able to offset all 1998 taxable income and a full refund of regular tax is due. Note that there is no refund of self-employment tax for 1998, as this tax

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form 1045 (2000) *DAVY S AND REGINA FILBECK* *978-65-4321* Page 2

Schedule A—Net Operating Loss (NOL). See page 4 of the instructions.

Line	Description	Inner line	Inner amount	Middle line	Middle amount	Line	Amount
1	Adjusted gross income from your 2000 Form 1040, line 34. Estates and trusts, skip lines 1 and 2					1	*-47,000*
2	Deductions (individuals only):						
a	Enter the amount from your 2000 Form 1040, line 36			2a	*7,350*		
b	Enter your deduction for exemptions from your 2000 Form 1040, line 38			2b	*11,200*		
c	Add lines 2a and 2b					2c	(*18,550*)
3	Combine lines 1 and 2c. Estates and trusts, enter taxable income increased by the sum of the charitable deduction and income distribution deduction					3	*-65,500*
	Note: *If line 3 is zero or more, do not complete the rest of the schedule. You* ***do not*** *have an NOL.*						
4	Deduction for exemptions from line 2b above. Estates and trusts, enter the exemption amount from tax return					4	*11,200*
5	Total nonbusiness capital losses before limitation. Enter as a positive number			5			
6	Total nonbusiness capital gains (without regard to any section 1202 exclusion)			6			
7	If line 5 is more than line 6, enter the difference; otherwise, enter -0-			7	*0*		
8	If line 6 is more than line 5, enter the difference; otherwise, enter -0-	8	*0*				
9	Nonbusiness deductions. See page 4 of the instructions			9	*11,350*		
10	Nonbusiness income other than capital gains. See page 4 of the instructions	10	*3,700*				
11	Add lines 8 and 10			11	*3,700*		
12	If line 9 is more than line 11, enter the difference; otherwise, enter -0-					12	*7,650*
13	If line 11 is more than line 9, enter the difference; otherwise, enter -0-. **But do not enter more than line 8**	13	*0*				
14	Total business capital losses before limitation. Enter as a positive number			14			
15	Total business capital gains (without regard to any section 1202 exclusion)	15					
16	Add lines 13 and 15			16			
17	If line 14 is more than line 16, enter the difference; otherwise, enter -0-			17	*0*		
18	Add lines 7 and 17			18			
19	Enter the loss, if any, from line 17 of Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 16, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line (and do not have a section 1202 exclusion), skip lines 19 through 24 and enter on line 25 the amount from line 18			19			
20	Section 1202 exclusion. Enter as a positive number					20	
21	Subtract line 20 from line 19. If zero or less, enter -0-			21			
22	Enter the loss, if any, from line 18 of Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 17 of Schedule D (Form 1041).) Enter as a positive number			22			
23	If line 21 is more than line 22, enter the difference; otherwise, enter -0-			23			
24	If line 22 is more than line 21, enter the difference; otherwise, enter -0-					24	
25	Subtract line 23 from line 18. If zero or less, enter -0-					25	
26	Net operating loss deduction for losses from other years. Enter as a positive number					26	
27	**Net operating loss.** Combine lines 3, 4, 12, 20, 24, 25, and 26. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you **do not** have a net operating loss					27	*-46,700*

Form **1045** (2000)

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

is determined on the 1998 self-employment income of the taxpayer(s) without regard to net operating losses from earlier or later years. Note in line 13 of Form 1045 for the 1998 year, that itemized deductions increase by $2,836 from $9,564 to $12,400. This is attributable to the "modified AGI" as determined by the NOL carryback. In this year, modified AGI is zero **after** the NOL carryback, which then reduces the $2,239 floor on medical expenses and the $597 floor on miscellaneous itemized deductions to zero. The increased deductions in 1998 provided no tax benefit since no regular tax resulted after application of the 2000 NOL carryback. Also, the Filbecks lost their $800 child tax credit that was used to offset regular tax on their original tax return.

The $46,700 NOL carried to 1998 is reduced by the $20,288 of 1998 modified taxable income as shown on the following Schedule B (Form 1045). The remaining $26,412 NOL is carried to 1999. It does not reduce the 1999 self-employment income. It reduces adjusted gross income for 1999 to $18,792, which becomes the base for computing the floor amounts for allowable itemized deductions as shown on Form 1045.

Form 1045 (2000) Page **3**

Schedule B—Net Operating Loss Carryover. See page 4 of the instructions.

Complete one column before going to the next column. Start with the earliest carryback year.	*2nd* preceding tax year ended ▶ *1998*		*1st* preceding tax year ended ▶ *1999*		____ preceding tax year ended ▶	
1 Net operating loss deduction. See page 4 of the instructions		*46,700*		*26,412*		
2 Taxable income before 2000 NOL carryback. Estates and trusts, increase this amount by the sum of the charitable deduction and income distribution deduction. See page 4 of the instructions	*9,488*		*25,404*			
3 Net capital loss deduction. See page 4 of the instructions						
4 Section 1202 exclusion. Enter as a positive number						
5 Adjustments to adjusted gross income. See page 4 of the instructions						
6 Adjustment to itemized deductions. See page 4 of the instructions						
7 Deduction for exemptions. Estates and trusts, enter exemption amount	*10,800*		*11,000*			
8 Modified taxable income. Combine lines 2 through 7. If zero or less, enter -0-		*20,288*		*36,404*		
9 Net operating loss carryover. Subtract line 8 from line 1. If zero or less, enter -0-. See page 5 of the instructions		*26,412*		*0*		

Form 1040-X as shown reflects the carryback of the net operating loss. A 1040-X is filed for each year (1998 and 1999). Page 2 of Form 1040-X should clearly detail the NOL computation and adjustments made, for example, the greater itemized deductions due to modified AGI as redetermined in the carryback years.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form **1045**

Department of the Treasury
Internal Revenue Service

Application for Tentative Refund

▶ Before you fill in this form, read the separate instructions.
▶ Do not attach to your income tax return—mail in a separate envelope.
▶ For use by individuals, estates, or trusts.

OMB No. 1545-0098

2000

Please type or print

Name (and name of spouse if filing jointly): **DAVY S AND REGINA FILBECK**

Social security or employer identification number: **978-65-4321**

Number, street, and apt. or suite no. If you have a P.O. box, see page 2 of the instructions.: **#7 WATERFORD PLACE**

Spouse's social security number (SSN): **987-32-4110**

City, town or post office, state, and ZIP code. If you have a foreign address, see page 2 of the instructions.: **OVERLAND PARK, KS 66210**

Telephone number (optional): ( )

1 This application is filed to carry back: **a** Net operating loss (from Schedule A, line 27, on page 2) $ **46,700** | **b** Unused general business credit $

2a For the calendar year 2000, or other tax year beginning , 2000, ending , 20 | **b** Date tax return was filed **4/15/01**

3 If this application is for an unused credit created by another carryback, enter year of the first carryback ▶

4 If you filed a joint return (or separate return) for some, but not all, of the tax years involved in figuring the carryback, list the years and specify whether joint (J) or separate (S) return for each ▶

5 If SSN for carryback year is different from above, enter **a** SSN ▶ and **b** Year(s) ▶

6 If you changed your accounting period, give date permission to change was granted ▶

7 Have you filed a petition in Tax Court for the year(s) to which the carryback is to be applied? ☐ Yes ☒ No

8 Is any part of the decrease in tax due to a loss or credit from a tax shelter required to be registered? ☐ Yes ☒ No

9 If you are carrying back a net operating loss, did this cause the release of foreign tax credits or the release of other credits due to the release of the foreign tax credit? See page 2 of the instructions ☐ Yes ☒ No

6

Computation of Decrease in Tax See page 2 of the instructions. **Note:** *If 1a is blank, skip lines 10 through 16.*	___ preceding tax year ended ▶		**2nd** preceding tax year ended ▶ **12/31/98**		**1st** preceding tax year ended ▶ **12/31/99**	
	Before carryback	After carryback	Before carryback	After carryback	Before carryback	After carryback
10 Adjusted gross income			29,852	29,852	45,204	45,204
11 Net operating loss deduction after carryback. See page 2 of the instructions				46,700		26,412
12 Subtract line 11 from line 10			29,852	-16,848	45,204	18,792
13 Deductions. See page 3 of the instructions			9,564	12,400	8,800	11,015
14 Subtract line 13 from line 12			20,288	-29,248	36,404	7,777
15 Exemptions. See page 3 of the instructions			10,800	10,800	11,000	11,000
16 Taxable income. Line 14 minus line 15			9,488	-40,048	25,404	-3,223
17 Income tax. See page 3 of the instructions and attach an explanation			1,421		3,814	1,091
18 General business credit. See page 3 of the instructions						
19 Other credits. Identify			800		1,000	
20 Total credits. Add lines 18 and 19			800		1,000	
21 Subtract line 20 from line 17			621		2,814	
22 Recapture taxes						
23 Alternative minimum tax						
24 Self-employment tax			1,695	1,695	3,391	3,391
25 Other taxes						
26 Total tax. Add lines 21 through 25			2,316	1,695	6,205	3,391
27 Enter the amount from the "After carryback" column on line 26 for each year			1,695		3,391	
28 Decrease in tax. Line 26 minus line 27			621		2,814	

29 Overpayment of tax due to a claim of right adjustment under section 1341(b)(1) (attach computation)

30 Suspended research credit allowed for current year (see page 3 of the instructions)

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form **1040X** (Rev. November 1998)

Department of the Treasury—Internal Revenue Service

Amended U.S. Individual Income Tax Return

▶ See separate instructions.

OMB No. 1545-0091

This return is for calendar year ▶ *1998* , or fiscal year ended ▶ ,*19* .

Please print or type

Your first name and initial	Last name	Your social security number
DAVY	*FILBECK*	*978-65-4321*
If a joint return, spouse's first name and initial	**Last name**	**Spouse's social security number**
REGINA	*FILBECK*	*987-32-4110*
Home address (no. and street) or P.O. box if mail is not delivered to your home	**Apt. no.**	**Phone number**
#7 WATERFORD PARK		
City, town or post office, state, and ZIP code. If you have a foreign address, see page 2 of the instructions.		**For Paperwork Reduction Act Notice, see page 6.**
OVERLAND PARK KS 66210		

A If the name or address shown above is different from that shown on the original return, check here . . . . . . ▶ ☐

B Has the original return been changed or audited by the IRS or have you been notified that it will be? . . ☐ Yes ☒ No

C Filing status. Be sure to complete this line. **Note.** You cannot change from joint to separate returns after the due date.

On original return ▶ ☐ Single ☒ Married filing joint return ☐ Married filing separate return ☐ Head of household ☐ Qualifying widow(er)

On this return ▶ ☐ Single ☒ Married filing joint return ☐ Married filing separate return ☐ Head of household* ☐ Qualifying widow(er)

* If the qualifying person is a child but not your dependent, see page 2.

Use Part II on the Back to Explain any Changes	Line	A. Original amount or as previously adjusted (see page 2)	B. Net change—amt. of increase or (decrease)—explain in Part II	C. Correct amount
Income and Deductions (see pages 2–5)				
1 Adjusted gross income (see page 3)	1	*29,852*	*-29,852*	*0*
2 Itemized deductions or standard deduction (see page 3)	2	*9,564*		*9,564*
3 Subtract line 2 from line 1	3	*20,288*	*-29,852*	*-9,564*
4 Exemptions. If changing, fill in Parts I and II on page 2	4	*10,800*		*10,800*
5 Taxable income. Subtract line 4 from line 3	5	*9,488*	*-9,488*	*0*
Tax Liability				
6 Tax (see page 4). Method used in col. C *TABLE*	6	*1,421*	*-1,421*	*0*
7 Credits (see page 4)	7	*800*		*800*
8 Subtract line 7 from line 6. Enter the result but not less than zero	8	*621*		
9 Other taxes (see page 4)	9	*1,695*		*1,695*
10 Total tax. Add lines 8 and 9	10	*2,316*	*-621*	*1,695*
Payments				
11 Federal income tax withheld and excess social security and RRTA tax withheld. If changing, see page 4	11	*3,000*		*3,000*
12 Estimated tax payments, including amount applied from prior year's return	12			
13 Earned income credit	13			
14 Additional child tax credit from Form 8812	14			
15 Credits from Form 4136 or Form 2439	15			
16 Amount paid with Form 4868, 2688, or 2350 (applications for extension of time to file)	16			*0*
17 Amount of tax paid with original return plus additional tax paid after it was filed	17			*0*
18 Total payments. Add lines 11 through 17 in column C	18			*3,000*
Refund or Amount You Owe				
19 Overpayment, if any, as shown on original return or as previously adjusted by the IRS	19			*684*
20 Subtract line 19 from line 18 (see page 4)	20			*2,316*
21 **Amount you owe.** If line 10, column C, is more than line 20, enter the difference and see page 4	21			
22 If line 10, column C, is less than line 20, enter the difference	22			*621*
23 Amount of line 22 you want **refunded to you**	23			*621*
24 Amount of line 22 you want **applied to your 19** estimated tax	24			

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form 1040X (Rev. 11-2000) Page 2

Part I **Exemptions.** See Form 1040 or 1040A instructions.

If you are **not changing your exemptions,** do not complete this part.
If claiming **more exemptions,** complete lines 25–31 and, if applicable, line 32.
If claiming **fewer exemptions,** complete lines 25–30.

		A. Original number of exemptions reported or as previously adjusted	B. Net change	C. Correct number of exemptions
25 Yourself and spouse	25			
Caution. If your parents (or someone else) can claim you as a dependent (even if they chose not to), you cannot claim an exemption for yourself.				
26 Your dependent children who lived with you	26			
27 Your dependent children who did not live with you due to divorce or separation	27			
28 Other dependents	28			
29 Total number of exemptions. Add lines 25 through 28	29			
30 Multiply the number of exemptions claimed on line 29 by the amount listed below for the tax year you are amending. Enter the result here and on line 4.	30			

Tax year	Exemption amount	But see the instructions for line 4 on page 3 if the amount on line 1 is over:
1998	$2,700	$93,400
1997	2,650	90,900
1996	2,550	88,475
1995	2,500	86,025

31 Dependents (children and other) not claimed on original (or adjusted) return:
Note. For tax years after 1997, do not complete column (e) below. For tax year 1997, do not complete column (d) below.

(a) First name Last name	(b) Dependent's social security number	(c) Dependent's relationship to you	(d) ✓ if qualifying child for child tax credit (see page 5)	(e) No. of months lived in your home
			☐	
			☐	
			☐	
			☐	
			☐	
			☐	

No. of your children on line 31 who:
- lived with you ▶ ☐
- **did not** live with you due to divorce or separation (see page 5) ▶ ☐

Dependents on line 31 not entered above ▶ ☐

Part II **Explanation of Changes to Income, Deductions, and Credits**

Enter the line number from page 1 of the form for each item you are changing and give the reason for each change. Attach only the supporting forms and schedules for the items changed. If you do not attach the required information, your Form 1040X may be returned. Be sure to include your name and social security number on any attachments.

If the change relates to a net operating loss carryback or a general business credit carryback, attach the schedule or form that shows the year in which the loss or credit occurred. See instructions. Also, check here ▶ ☒

NET OPERATING LOSS CARRYBACK FROM THE YEAR 2000.

2000 NET OPERATING LOSS	***$46,700***
1998 MODIFIED TAXABLE INCOME	***($20,288)***
BALANCE TO BE CARRIED FORWARD	***$26,412***

Part III **Presidential Election Campaign Fund.** Checking below will not increase your tax or reduce your refund.

If you did not previously want $3 to go to the fund but now want to, check here ▶ ☐
If a joint return and your spouse did not previously want $3 to go to the fund but now wants to, check here ▶ ☐

Form **1040X** (Rev. 11-2000)

6

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form **1040X** (Rev. November 2000)

Department of the Treasury—Internal Revenue Service

Amended U.S. Individual Income Tax Return

▶ See separate instructions.

OMB No. 1545-0091

This return is for calendar year ▶ *99* , or fiscal year ended ▶ ,

Please print or type

Your first name and initial	Last name	Your social security number
DAVY S.	*FILBECK*	*978 65 4321*
If a joint return, spouse's first name and initial	**Last name**	**Spouse's social security number**
REGINA	*FILBECK*	*987 32 4110*
Home address (no. and street) or P.O. box if mail is not delivered to your home	**Apt. no.**	**Phone number**
#7 WATERFORD PLACE		( )
City, town or post office, state, and ZIP code. If you have a foreign address, see page 2 of the instructions.		**For Paperwork Reduction Act Notice, see page 6.**
OVERLAND PARK, KS 66210		

A If the name or address shown above is different from that shown on the original return, check here ▶ ☒

B Has the original return been changed or audited by the IRS or have you been notified that it will be? ☒ Yes ☐ No

C Filing status. Be sure to complete this line. **Note.** You cannot change from joint to separate returns after the due date.

On original return ▶ ☐ Single ☒ Married filing joint return ☐ Married filing separate return ☐ Head of household ☐ Qualifying widow(er)

On this return ▶ ☐ Single ☒ Married filing joint return ☐ Married filing separate return ☐ Head of household* ☐ Qualifying widow(er)

* If the qualifying person is a child but not your dependent, see page 2.

Use Part II on the Back to Explain any Changes	Line	A. Original amount or as previously adjusted (see page 2)	B. Net change—amount of increase or (decrease)—explain in Part II	C. Correct amount
Income and Deductions (see pages 2–6)				
1 Adjusted gross income (see page 3)	1	*45,204*	*-26,412*	*18,792*
2 Itemized deductions or standard deduction (see page 3)	2	*8,800*	*2,215*	*11,015*
3 Subtract line 2 from line 1	3	*36,404*	*-28,627*	*7,777*
4 Exemptions. If changing, fill in Parts I and II on the back	4	*11,000*		*11,000*
5 Taxable income. Subtract line 4 from line 3	5	*25,404*	*-25,404*	*0*
Tax Liability				
6 Tax (see page 4). Method used in col. C	6	*3,814*	*-3,814*	*0*
7 Credits (see page 4)	7	*1,000*		*1,000*
8 Subtract line 7 from line 6. Enter the result but not less than zero	8	*2,814*		*0*
9 Other taxes (see page 4)	9	*3,391*		*3,391*
10 Total tax. Add lines 8 and 9	10	*6,205*	*-3,814*	*3,391*
Payments				
11 Federal income tax withheld and excess social security and RRTA tax withheld. If changing, see page 5	11	*3,000*		*3,000*
12 Estimated tax payments, including amount applied from prior year's return	12			
13 Earned income credit (EIC)	13			
14 Additional child tax credit from Form 8812	14			
15 Credits from Form 2439 or Form 4136	15			
16 Amount paid with request for extension of time to file (see page 5)	16			
17 Amount of tax paid with original return plus additional tax paid after it was filed	17			*3,205*
18 Total payments. Add lines 11 through 17 in column C	18			*6,205*
Refund or Amount You Owe				
19 Overpayment, if any, as shown on original return or as previously adjusted by the IRS	19			
20 Subtract line 19 from line 18 (see page 5)	20			*6,205*
21 **Amount you owe.** If line 10, column C, is more than line 20, enter the difference and see page 5	21			
22 If line 10, column C, is less than line 20, enter the difference	22			*3,814*
23 Amount of line 22 you want **refunded to you**	23			*3,814*
24 Amount of line 22 you want **applied to your** estimated tax	24			

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form 1040X Davy and Regina Filbeck

Part II Explanation of Changes to Income, Deductions, and Credits

Enter the line number from the front of the form for each item you are changing and give the reason for each change. Attach only the supporting forms and schedules for the items changed. If you do not attach the required information, your Form 1040X may be returned. Be sure to include your name and social security number on any attachments.

If the change relates to a net operating loss carryback or a general business credit carryback, attach the schedule or form that shows the year in which the loss or credit occurred. See page 2 of the instructions. Also, check here . . . . . . ▶ ☒

NET OPERATING LOSS CARRYBACK FROM 2000

ORIGINAL LOSS WAS	*$46,700*
1998 MODIFIED TAXABLE INCOME	*$20,288*
BALANCE AVAILABLE	*$26,412*

TAXPAYERS' MODIFIED AGI IS REDUCED BY $26,412 WHICH NOW PROVIDES FOR

ADDITIONAL ITEMIZED DEDUCTIONS OF $2,215 (MEDICAL $1,791 AND MISC $424)

ISSUE 11: DISCHARGE OF INDEBTEDNESS

Generally, a discharge of indebtedness is treated as the receipt of income and is taxable pursuant to I.R.C. §61, since the taxpayer's wealth is increased by the amount of debt no longer owed. But, I.R.C. §108 provides several exceptions to this rule that may either postpone the recognition of income or even permanently forgive the income ever being taxed. If the taxpayer's debt is discharged and the income is not recognized due to I.R.C. §108, the taxpayer may be required to reduce certain "tax attributes," and this calculation is made on Form 982.

DISCHARGE OF DEBT BECOMES TAXABLE INCOME

A transfer of property back to a lender to discharge a debt, is a taxable transfer even if the taxpayer receives no cash. The lending institution will provide both the taxpayer and the IRS with a Form 1099-A that notes both the fair market value of the property and the amount owed by the taxpayer at time of foreclosure. The fair market value of the property is critical because the measure of discharge of indebtedness income is the difference between the fair market value (not the taxpayer's adjusted basis) of the property forfeited and the amount of debt discharged.

DISCHARGE OF DEBT EXCLUDED FROM INCOME

There are several exemptions to the recognition of discharge of indebtedness income in I.R.C. §108. Discharge-of-indebtedness income is excluded from gross income if the taxpayer meets any one of the following:

- Exception 1: No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.
- Exception 2: The discharge is in a bankruptcy case.
- Exception 3: The discharge occurs when the taxpayer is insolvent (defined as the excess of liabilities over the fair market value of assets).
- Exception 4: The original seller of property under an installment contract discharged the debt and the original purchaser under the contract owed the debt that was discharged.
- Exception 5: The discharge of qualified farm indebtedness of a qualifying farm debtor who is solvent.
- Exception 6: The discharge of qualified real-property indebtedness.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

REDUCTION OF TAX ATTRIBUTES

Even though the insolvent taxpayer does not have to reflect discharge of indebtedness income under Exception 2 or 3 of I.R.C. §108, this taxpayer is required to reduce certain "tax attributes." These attribute reductions are made after the determination of the tax imposed for the taxable year of the discharge. The tax attributes are reduced by the amount of debt forgiven and excluded from income in the following order:

1. Net operating losses (NOL)–any NOL for the taxable year of discharge, and any NOL carryforward to such taxable year
2. Certain credit carryovers–I.R.C. §38 investment tax credit, I.R.C. §40 work incentive tax credit, and I.R.C. §44 employment and alcohol used as fuel credits
3. Minimum tax credit as of the beginning of the year immediately following the year of debt discharge
4. Basis reduction of taxpayer's property held at the beginning of the tax year following the year of discharge
5. Passive activity losses and credit carryovers
6. Foreign tax credit carryovers

Practitioner Note. Except for credit carryovers, the tax attribute reductions are one dollar for each dollar of debt reduction excluded from income. Credit carryovers, except for foreign taxes, are 33 1/3 cents for each dollar of debt reduction excluded from income. Taxpayers can to elect to reduce their basis in depreciable property first, and thereby preserve net operating loss and tax credit carryovers.

Example 1. Gary and Brenda Yaeger have owned and operated a miniature golf course for a number of years as a Schedule C operation. The Yaegers have had to incur bank debt to make improvements in their business and pay general operating expenses. Their business has operated at a loss over the past four years, but the Yaegers' bank has been willing to extend credit because the fair market value of their property has been increasing due to the area's suburban development extending out to the miniature golf course.

The Yaegers' cash flow in 2001 was not sufficient to service the bank debt. The taxpayers' bank suggested that they sell the miniature golf course, which would enable the taxpayers to pay off the bank loan. The Yaegers owed the bank $680,000 on the property which was appraised for $625,000. The taxpayers were unable to sell the property and simply gave the property back to the bank in exchange for the bank discharging the debt. The adjusted basis in the miniature golf course property was $310,000.

The taxpayers did not file for bankruptcy protection and were considered solvent at the time of this transaction. Gary and Brenda did not know the tax consequences of this transaction and were shocked to learn that giving the property back was a taxable transfer.

The gain on this sale is measured by the difference between the fair market value of the property transferred and taxpayers' adjusted basis.

Selling price (fair market value)	$625,000
Adjusted basis	310,000
Gain from transfer of assets	$315,000

The $315,000 of gain is subject to the §1245 and §1250 depreciation recapture rules. Gain in excess of depreciation recapture is I.R.C. §1231 gain.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

> **Practitioner Note.** The I.R.C. §108 exceptions do not exclude this income because it is not discharge of indebtedness income.

The $55,000 discharge of indebtedness income is the difference between the $680,000 debt that was written off and the $625,000 fair market value of the property.

Debt reduction	$680,000
Fair market value	625,000
Discharged debt	$ 55,000

> **Practitioner Note.** If none of the I.R.C. §108 exceptions apply, the $55,000 must be reported as income.

> **Observation.** This example is an actual situation of a client. When the taxpayers were notified of a tax liability of well over $100,000, they sought a "second opinion" from another tax firm, which agreed that such amount was owed. The taxpayers filed their tax return correctly, then filed an Offer In Compromise with the Internal Revenue Service, which was accepted in the amount of $25,000.

Example 2. Sam Jolley has owned and operated a full-service car wash for a number of years. For a variety of reasons, Sam has not made much progress in reducing his bank debt, and the bank is reluctant to foreclose because the property was formerly a gas station and has underground storage tanks needing to be removed. As a result, the bank worked with the taxpayer to discharge some of the debt owed by Mr. Jolley during 2001.

A snapshot of Mr. Jolley's financial situation is as follows:

Asset	Tax Basis	FMV	Liability
Cash	$ 5,000	$ 5,000	
Land	$200,000	$200,000	$300,000
Depreciable business assets	$100,000	$100,000	$130,000
Totals	$305,000	$305,000	$430,000

As part of the reorganization outside of bankruptcy, the bank reduces the mortgage debt on the land by $100,000, and the secured debt on the equipment and building by $30,000.

Mr. Jolley has $35,000 in net operating loss carryforward coming into tax year 2001, and $15,000 in unused investment tax credits.

Question 1. Does Mr. Jolley meet the insolvent exception under I.R.C. §108 for the discharge of indebtedness income?

Answer 1. Yes, Mr. Jolley will qualify to exclude almost all of the discharge-of-indebtedness income, because immediately before the discharge he was insolvent by $125,000 ($430,000 minus $305,000). Since $130,000 of debt was forgiven and he was $125,000 insolvent, Mr. Jolley is solvent for $5,000 of the discharged indebtedness, which must be reported as income.

Question 2. Can the taxpayers still benefit from his net operating loss carryforward and investment tax credit carryforward?

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Answer 2. Yes. Mr. Jolley's $35,000 NOL and $15,000 investment tax credit are available for his 2001 income tax return. For example, assume Mr. Jolley's income and deductions before the NOL carryover were as follows:

AGI (including $5,000 discharge of indebtedness income)	$10,000
Standard deduction	– 4,550
Personal exemption deduction	– 2,900
Taxable income	$ 2,550

The $35,000 NOL carryover reduces his taxable income to zero. Since his modified taxable income is $5,450 ($2,550 + $2,900), the NOL is reduced by that amount to $29,550. If Mr. Jolley had a tax liability for 2001, the investment tax credit could be used to reduce that liability.

Mr. Jolley is required to reduce his tax attributes by the $125,000 discharge of indebtedness income that was excluded under the insolvency exception. If he does not elect to reduce depteciable basis first, the attribute reduction is as follows:

Excluded discharged debt		$125,000
NOL remaining after 2001		29,550
Balance of excluded discharged debt		$ 95,450
Investment credit remaining after 2001	$15,000	
$3 for $1 offset	× 3	
Offset of excluded discharged debt		$ 45,000
Balance of excluded discharged debt		$ 50,450

I.R.C. §1017(b)(2) limits the reduction of basis to the amount by which the taxpayer's basis in all assets exceed his or her debt after the discharge. After the $125,000 discharge that is excluded from income under the insolvency exception Mr. Jolley's remaining debt is:

Debt before discharge	$430,000
Discharge	125,000
Remaining debt	$305,000

Since Mr. Jolley's basis in all assets is also $305,000, he is not required to reduce his basis as a result of the excluded discharge of indebtedness income

Practitioner Note. Mr. Jolley's $50,450 discharge of debt in excess of his tax attributes will never reduce any tax attributes and will never be included in income.

Form 982 completed for Mr. Jolley illustrates the reduction of his tax attributes. The Form 982 will be an attachment to his 2001 income tax return.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form **982** (Rev. September 2000) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

► Attach this form to your income tax return.

OMB No. 1545-0046 Attachment Sequence No. 94

Name shown on return: *SAM JOLLEY* Identifying number: *482-59-0999*

Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☒
- c Discharge of qualified farm indebtedness ☐
- d Discharge of qualified real property business indebtedness ☐

2 Total amount of discharged indebtedness excluded from gross income . . . 2

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Part II Reduction of Tax Attributes (You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements.)

Enter amount excluded from gross income:

		Line	Amount
4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	*29,550*
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	*45,000*
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	

Question 3. Can the taxpayer elect to reduce the basis of his depreciable assets?

Answer 3. Yes. Mr. Jolley's depreciable assets were $100,000, and an election to reduce depreciable assets would then apply the $125,000 discharge first to these assets (and thereby reduce to "0"), with the remaining $25,000 applied to his NOL carryforward of $29,550. As a result, the taxpayer would have a remaining net operating loss carryforward of $5,450 and the full benefit from his $15,000 in investment tax credit carryforward. Form 982 illustrates this election by the taxpayer.

Form **982** (Rev. September 2000) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

► Attach this form to your income tax return.

OMB No. 1545-0046 Attachment Sequence No. 94

Name shown on return: *SAM JOLLEY* Identifying number: *482-59-0999*

Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☒
- c Discharge of qualified farm indebtedness ☐
- d Discharge of qualified real property business indebtedness ☐

2 Total amount of discharged indebtedness excluded from gross income . . . 2

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Part II Reduction of Tax Attributes (You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements.)

Enter amount excluded from gross income:

		Line	Amount
4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	*100,000*
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	*25,000*
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

ISSUE 12: FRINGE BENEFITS

INTRODUCTION

Employee's Income

Current economic conditions highlight the need for fringe benefits as an important way to reward and retain quality employees. The Internal Revenue Code defines gross income as all income from whatever source derived, including, but not limited to, compensation for services, such as fees, commissions, fringe benefits, and similar payments. Consequently, wages include more than just the salaries paid to employees; they also include fringe benefits offered to employees for services rendered. Any fringe benefit provided is taxable unless specifically excluded from income by statute.

An employee who receives a fringe benefit must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of:

- The amount, if any, that the employee paid for the benefit
- The amount, if any, specifically excluded from gross income by some other section of the Internal Revenue Code [Treas. Reg. §1.61-21(b)(1)]

Thus, if an employee pays fair market value for the benefit received, no amount is includable in the gross income of the employee. The determination of the fair market value of a fringe benefit must be made before subtracting out the amount, if any, paid for the benefit and the amount, if any, specifically excluded from gross income under another income tax provision.

If, by the terms of the exclusion, the cost of a fringe benefit is excluded from a recipient's income, then any excess of the fair market value of the benefit over the cost is *not* included in income [Treas. Reg. §1.61-21(b)(3)].

However, if the cost exclusion is a limited amount, then the excess of the fair market value of the benefit attributable to any excess cost is includable in the recipient's income, unless another exclusion applies [Treas. Reg. §1.61-21(b)(3)].

Example 1. An employer furnishes dependent care assistance that meets the requirements of I.R.C. §129. However, under that provision, the amount of the exclusion is limited to $5,000 on a joint return. The employer provides taxpayers with dependent care assistance for which the employer paid $7,000, but which is worth $10,000. The taxpayers, who file a joint return, must include in income the market value of the dependent care assistance attributable to the non-excluded amount, figured as follows:

(Employer's Cost)	− (Limit of Cost Exclusion)	= (Excess Cost)
$7,000	− $5,000	= $2,000
$2,000 excess cost / $7,000 total cost	× $10,000	= $2,857 (Value of benefit included in income)

The following is a list of common fringe benefits:

- Airline VIP-club memberships
- Automobile allowances
- Awards or prizes
- Back pay awards
- Bonuses (cash or non-cash)
- Legal counseling
- Loans (low-interest or interest-free)
- Local transportation for commuting
- Luncheon-club memberships
- Meal money because of overtime

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

- Cafeteria plans
- Chauffeur service
- Communications equipment (such as car phones)
- Company-owned or leased aircraft
- Company-owned or leased vehicles
- Company WATS line (personal use)
- Country club memberships
- Dependent care assistance programs
- Disability payments
- Discounts on property or service
- Discounted airline passes
- Educational reimbursements
- Executive dining rooms
- Estate planning
- Financial counseling
- Financial seminars
- Free or subsidized lodging
- Frequent flyer tickets used for personal purposes
- Golden parachute payments
- Group-term life insurance
- Home security systems
- Income tax preparation
- Meal allowances/reimbursements (not away overnight)
- Memberships in athletic facilities
- Moving expense reimbursements
- Nonqualified stock bonus plans
- Nonqualified stock option plans
- Outplacement services
- Personal computers allowed to be taken home
- Personal liability insurance
- Physical examinations
- Qualified stock options
- Reimbursements of expenses on sale of personal residence
- Reserved parking
- Safety awards
- Severance pay
- Scholarships or fellowships
- Sick pay
- Spousal travel
- Use of recreation vehicles or boats
- Use of vacation homes
- Vacations (all expense paid or discounted)
- Whole-life insurance

Several fringe benefits are specifically excluded from taxable income in order to encourage employers to provide the fringe benefits or to reduce the burden of keeping track of insignificant benefits provided by employers. The following table lists the most common excluded benefits and the code section that excludes each.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Fringe Benefit	Code Section	Brief Description
Qualifying group-term life insurance	79	$50,000 cap except for disabled employees who are retired.
Accident or health plans	104, 105, 106	Employer can purchase insurance or be self-insured.
Dependent care assistance programs	129	Limited to the lesser of (1) $5,000 ($2,500 MFS) or (2) earned income.
Meals and lodging	119	Must be (1) on the premises, (2) for the convenience of employer, and (3) (lodging only) a condition of employment.
Vehicles for business use	132(a)(3), 132(a)(4)	Working condition fringe or de minimis.
Death benefits	101(h)	Annuity paid to Survivor of a Public safety officer killed on duty.
Cafeteria plans	125	Cash and nontaxable benefits must be on the menu.
Educational assistance programs	127	$5,250 cap.
Qualified tuition reductions	117(d)(2)	Undergraduate and teaching or research only.
Employee achievement awards	74	$400 cap per employee.
No-additional-cost services	132(a)(1)	Service must be offered for sale to customers.
Qualified employee discount	132(a)(2)	20% limit for services; gross profit percentage limit for goods.
Working condition fringe	132(a)(3)	Must be deductible by employee if paid by employee.
Demonstration automobiles	132(h)(3)	There must be restrictions on personal use.
Parking	132(h)(4)	Must be on or near the business premises.
De minimis fringe	132(a)(4)	Accountability must be difficult.
On-premises athletic facilities	132(h)(5)	Substantially all use must be by employees.

Employer's Deduction

The employer's cost of providing fringe benefits is a deductible expense as long as the cost of providing the benefit is reasonable compensation or otherwise qualifies as an ordinary and necessary business expense [I.R.C. §162(a)]. The deduction is allowed regardless of the employee's ability to exclude the value of the benefit from taxable income or the amount the employee must include in taxable income under the valuation of benefit rules (National Bancorp of Alaska, Inc., TC Memo 2001-202).

FRINGE BENEFIT WITHHOLDING RULES

While salaries and most other "wages" must be included in an employee's gross income and are subject to federal income tax (FIT), federal income tax withholding (FITW), Social Security and Medicare taxes (FICA), federal unemployment insurance tax (FUTA), and other benefits are not. Some benefits are provided tax-free and are not considered "wages"; others are exempt from FITW but still subject to FICA and FUTA.

Special withholding rules apply to some taxable benefits (or wages that are considered to be in addition to regular earnings), including bonuses, prizes and awards, reimbursements for business or moving expenses, dismissal pay, retirement incentive pay, and non-cash fringe benefits. Under Treas. Reg. §31.3402(g)-1 there are two methods for calculating the taxable portion of these supplemental wage payments: the aggregate method and the supplemental method.

Aggregate Method

When supplemental wage payments are combined with the wages of the current payroll period, the employer must use the withholding allowances on the employee's Form W-4 and the appropriate with-

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

2001 Workbook

holding tables to determine FITW. A separate amount may be calculated for the supplemental earnings by combining the last regular payment with the supplemental earnings to calculate the total amount of federal income tax to be withheld, then subtracting the taxes withheld from the last regular payroll to come up with the taxes to be taken from the supplemental pay.

Supplemental Method

When supplemental wage payments are paid separately from regular wages, employers may withhold federal income tax at the supplemental rate of 28% if federal income tax was withheld from the last regular wage payment. This method is applied without regard to withholding allowances or tables. If the employer does not withhold income tax from the employee's regular wages, it must use the aggregate method.

Example 2. Clara claims married with five allowances on her Form W-4. For the week ending March 13, 2000, her employer pays her $500 in regular wages plus a $50 production bonus. Using the wage-bracket withholding method, the FITW due on Clara's regular wages is $17. Since FITW is due on the regular amount, Clara's employer can use the flat 28% to figure the FITW on the $50 bonus – $14.

Example 3. If Clara claims married with eight allowances, her wages are not subject to FITW. Consequently, the employer must

1. Add the supplemental wage payment ($50) to the regular wage payment ($500) to determine the aggregate amount of taxable wages ($550)
2. Compute the FITW due on the $550 ($1 under wage-bracket withholding method)
3. Subtract the FITW amount calculated in Step 2 from the total wage amount in Step 1 to arrive at Clara's net wage (prior to FICA and any other non-FIT withholding) of $549

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Overview of Employment Tax Treatment of Fringe Benefits

Type of Fringe Benefit	Treatment Under Employment Taxes		
	Income Tax Withholding	Social Security and Medicare	Federal Unemployment
Accident and health benefits	Exempt[1,2], except for certain long-term care benefits.	Exempt	Exempt
Achievement awards	Exempt[1] up to certain limits		
Adoption assistance	Exempt[1]	Taxable	Taxable
Athletic facilities	Exempt if substantially all use during the calendar year is by employees, their spouses, and their dependents.		
De minimis (minimal benefits	Exempt	Exempt	Exempt
Dependent care assistance	Exempt[3] up to certain limits		
Educational assistance	Exempt up to $5,250 of benefits each year.		
Employee discounts	Exempt[4] up to certain limits.		
Employee stock options	See **Employee Stock Options** in this chapter.		
Group-term life insurance coverage	Exempt	Exempt[1,5] up to cost of $50,000 of coverage. (Special rules apply to former employees)	Exempt
Lodging on your business premises	Exempt[1] if furnished for your convenience as a condition of employment.		
Meals	Exempt[1] if furnished on your business premises for your convenience.		
	Exempt if de minimis.		
Moving expense reimbursements	Exempt[1] if expenses would be deductible if the employees had paid them.		
No-additional cost services	Exempt[4]	Exempt[4]	Exempt[4]
Transportation (commuting) benefits	Exempt[1] up to certain limits if for rides in a commuter highway vehicle., transit passes, or qualified parking.		
	Exempt if de minimis.		
Tuition reduction	Exempt[4] if for undergraduate education (or graduate education if the employee performs teaching or research activities).		
Working condition benefits	Exempt	Exempt	Exempt

[1]Exemption does not apply to S corporation employees who are 2% shareholders.

[2]Exemption does not apply to certain highly compensated employees under a self-insured plan that favors those employees.

[3]Exemption does not apply to certain highly compensated employees under a program that favors those employees.

[4]Exemption does not apply to certain highly compensated employees.

[5]Exemption does not apply to certain key employees under a plan that favors those employees.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

PREPARING THE FORM W-2

a Control number	22222	Void ☐	For Official Use Only ► OMB No. 1545-0008

b Employer identification number	1 Wages, tips, other compensation $	2 Federal income tax withheld $
c Employer's name, address, and ZIP code	3 Social security wages $	4 Social security tax withheld $
	5 Medicare wages and tips $	6 Medicare tax withheld $
	7 Social security tips $	8 Allocated tips $
d Employee's social security number	9 Advance EIC payment $	10 Dependent care benefits $
e Employee's first name and initial / Last name	11 Nonqualified plans $	12a See instructions for box 12 Code $
	13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code $
	14 Other	12c Code $
f Employee's address and ZIP code		12d Code $

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
		$	$	$	$	
		$	$	$	$	

Form **W-2** Wage and Tax Statement **2001**

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

Cat. No. 10134D

6

Because the IRS uses optical scanners to read the Forms W-2, the rules are restrictive for preparing and filing those forms. If possible, type the entries on Form W-2 using dark black ink in 12-point Courier font. Handwritten entries, or the use of inks other than black, hinder processing by the SSA.

- Do not use script type, inverted font, italics, or dual case alpha characters.
- Do not cross one or more of the vertical or horizontal lines that separate the boxes.
- Do not erase, white out, or strike over an entry.
- Make all dollar entries without the dollar sign and comma but with the decimal point (00000.00). Show the cents portion of the money amounts.
- If a box does not apply, leave it blank.

Common Errors

- Use of ink that is too light (use only black ink)
- Entries that are too small or too large (use 12-point Courier font)
- Add dollar signs to the money amount boxes (copy A is preprinted with dollar signs)

W-2 Changes for 2001. If 2001 Forms W-2 are filed with the Social Security Administration (SSA) electronically (not by magnetic media), the due date is extended to April 1, 2002. For information on how to file electronically, call the SSA at 1-800-772-6270.

- Increased form **width** (to 8.5 inches)
- Reformatted employee's name in box e
- Enlarged boxes for money amounts, adding shading and dollar signs
- Deleted former box 12, "Benefits included in box 1"

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

- Reformatted former box 13 (new box 12) for four entries
- Deleted "Deceased," "Legal rep.," and "Deferred compensation" checkboxes in new box 13 (formerly box 15)
- Relabeled "Pension plan" checkbox in new box 13 as "Retirement plan"
- Added a checkbox for "Third-party sick pay" in new box 13
- Relocated "Locality name," "Local wages, tips, etc.," and "Local income tax" boxes (formerly boxes 19-21)

There are penalties for failing to file Forms W-2 and for filing incorrect Forms W-2. The penalties increase as the time of the late filing increases. Therefore, there is an incentive to make the late or corrected filing as soon as possible.

- $15 per Form W-2 if you correctly file within 30 days (by March 30 if the due date is February 28); maximum penalty $75,000 per year ($25,000 for small businesses, defined later)
- $30 per Form W-2 if you correctly file more than 30 days after the due date but by August 1; maximum penalty $150,000 per year ($50,000 for small businesses)
- $50 per Form W-2 if you file after August 1 or you do not file required Forms W-2; maximum penalty $250,000 per year ($100,000 for small businesses)

Fringe Benefits

Include all taxable fringe benefits in box 1 of Form W-2 as wages, tips, and other compensation and, if applicable, in boxes 3 and 5 as social security and Medicare wages. However, fringe benefits can potentially be included in the amount reported in boxes 1, 3, 5, 10, 11, 12, 13, and 14 on the Form W-2. The following excerpts from the Form W-2 instructions describe the fringe benefit reporting in those boxes:

Box 1—Wages, Tips, Other Compensation. Show the total wages, tips, and other compensation—before any payroll deductions—that you paid your employee during the year. Do not include elective deferrals, except I.R.C. §501(c)(18) contributions. Include the following:

1. Total wages, prizes, and awards paid to employees during the year
2. Total non-cash payments, including certain fringe benefits
3. Total **tips** reported by the employee to the employer (not allocated tips)
4. Certain employee business expense reimbursements
5. The cost of **accident and health insurance** premiums for 2% or more shareholder-employees paid by an S corporation
6. Taxable benefits from an I.R.C. §125 **(cafeteria) plan** (i.e., employee chooses cash)
7. Employee contributions to an **MSA**
8. Employer contributions to an **MSA** if includable in the income of the employee
9. Employer contributions for **qualified long-term care services** to the extent that such coverage is provided through a flexible spending or similar arrangement
10. Group-term life insurance in excess of $50,000
11. Unless excludable under an **educational assistance program,** payments for non–job-related education expenses or payments under a nonaccountable plan
12. The amount includable as wages because you paid your employee's share of taxes.
13. All other compensation, including certain scholarship and fellowship grants. Other compensation is amounts you pay your employee from which federal income tax is not withheld. You may show other compensation on a separate Form W-2

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

14. **Distributions** to an employee or former employee from a nonqualified deferred compensation plan (including a rabbi trust) or an I.R.C. §457 plan
15. Payments to statutory employees that are subject to social security and Medicare taxes but not subject to federal income tax withholding must be shown in box 1 as other compensation

Box 3—Social Security Wages. Show the total wages paid (before payroll deductions) subject to employee social security tax but **not** including **social security tips** and **allocated tips.** Generally, non-cash payments are considered wages. Include employee business expense reimbursements reported in box 1. The total of boxes 3 and 7 cannot exceed $80,400 (2001 maximum social security wage base).

Also, include elective deferrals to certain qualified cash or **deferred compensation** arrangements and to retirement arrangements described in box 12, in codes **D, E, F, G,** and **S,** even though the deferrals are not includable in box 1. Amounts deferred under a **nonqualified or I.R.C. §457** plan must be included in boxes 3 and/or 5 as social security and/or Medicare wages as of the later of when the services giving rise to the deferral are performed or when there is no substantial forfeiture risk of the rights to the deferred amount. Include elective and nonelective deferrals for purposes of I.R.C. §457 plans.

Also Include in Box 3

- Cost of group-term life insurance over $50,000 included in box 1
- Cost of accident and health insurance premiums for 2% or more shareholder-employees paid by an S corporation, but only if not excludable under I.R.C. §3121(a)(2)(B)
- Employee and nonexcludable employer contributions to an MSA
- Employee contributions to a SIMPLE retirement account
- Adoption benefits

Box 5—Medicare Wages and Tips. The wages and tips subject to Medicare tax are the same as those subject to social security tax (boxes 3 and 7), except that there is no wage base limit for Medicare tax. Enter the total Medicare wages and tips in box 5. Be sure to enter tips the employee reported even if you did not have enough employee funds to collect the Medicare tax for those tips.

Box 10—Dependent Care Benefits. Show the total dependent care benefits under a dependent care assistance program (I.R.C. §129) paid or incurred by you for your employee. Include the fair market value (FMV) of employer-provided or employer-sponsored day-care facilities and amounts paid or incurred in an I.R.C. §125 (cafeteria) plan. Report all amounts paid or incurred, including those in excess of the $5,000 exclusion. This may include (a) the FMV of benefits provided in kind by the employer; (b) an amount paid directly to a day-care facility by the employer or reimbursed to the employee to subsidize the benefit; or (c) benefits from the pre-tax contributions made by the employee to an I.R.C. §125 dependent care flexible spending account. Include any amounts over $5,000 in boxes 1, 3, and 5. For more information, see Pubs. 15-A and 15-B.

Box 11—Nonqualified Plans. Show **distributions** to an employee from a nonqualified plan or an I.R.C. §457 plan. Also report the distributions in box 1. **Make only one entry in this box. If you did not make distributions this year, show deferrals (plus earnings) under a nonqualified or I.R.C. §457 plan that became taxable for social security and Medicare taxes during the year (but were for prior year services)** because the deferred amounts were no longer subject to a substantial risk of forfeiture. **Do not report in box 11 deferrals that are included in boxes 3 and/or 5 and that are for current year services.**

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Practitioner Caution. If you made distributions and are also reporting deferrals in box 3 and/or 5, do not complete box 11. See Publication 957, Reporting Back Pay and Special Wage Payments to the Social Security Administration, and Form SSA-131, Employer Report of Special Wage Payments, for instructions on reporting these and other kinds of compensation earned in prior years. However, do not file Form SSA-131 if contributions and distributions occur in the same year and the employee will not be age 62 or older by the end of that year.

The purpose of box 11 is for the SSA to determine if any part of the amount reported in box 1 or boxes 3 and/or 5 was earned in a prior year. The SSA uses this information to verify that they have properly applied the social security earnings test and paid the correct amount of benefits.

Unlike qualified plans, nonqualified deferred compensation plans do not meet the qualification requirements for tax-favored status. Nonqualified plans include those arrangements traditionally viewed as deferring the receipt of current compensation. Accordingly, welfare benefit plans, stock option plans, and plans providing dismissal pay, termination pay, or early retirement pay are **not** nonqualified plans.

State and local agencies must separately identify **I.R.C. §457 distributions** in this box by entering code G followed by a space, and then the dollar amount. However, if you are reporting a distribution from both a nonqualified plan and an I.R.C. §457 plan, report it as a single amount in this box; do not enter code G.

Report distributions from nonqualified or I.R.C. §457 plans to **beneficiaries** of deceased employees on **Form 1099-R,** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., not on Form W-2.

Military employers must report military retirement payments on Form 1099-R.

Box 12—Codes. Complete and code this box for all items described below. Do not report in box 12 any items that are not listed as codes **A–V.** Also, do not report in box 12 I.R.C. §414(h)(2) contributions (relating to certain state or local government plans). Instead, use box 14 for these items and any other information you wish to give your employee. For example, union dues and uniform payments may be reported in box 14.

Practitioner Note. On Copy A (Form W-2), do not enter more than four items in box 12. If more than four items need to be reported in box 12, use a separate Form W-2 to report the additional items (but enter no more than four items on each Copy A (Form W-2)). On **all other copies** of Form W-2 (Copies B, C, etc.), you may enter more than four items in box 12.

Use the IRS code designated below for the item you are entering followed by the dollar amount for that item. Even if only one item is entered, you must use the IRS code designated for that item. Enter the code using a capital letter. Leave at least one space blank after the code, and enter the dollar amount on the same line. Use decimal points but not dollar signs or commas. For example, if you are reporting $5,300.00 in elective deferrals to an I.R.C. §401(k) plan, the entry would be **D 5300.00** (not A 5300.00, even though it is the first or only entry in this box). Report the IRS code to the left of the vertical line in boxes 12a-d and money amount to the right of the vertical line.

Code A—Uncollected Social Security or RRTA Tax on Tips. Show the employee social security or Railroad Retirement Tax Act (RRTA) tax on all the employee's tips that you could not collect because the employee did not have enough funds from which to deduct it. Do not include this amount in box 4.

Code B—Uncollected Medicare Tax on Tips. Show the employee Medicare tax or RRTA Medicare tax on tips that you could not collect because the employee did not have enough funds from which to deduct it. Do not include this amount in box 6.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Code C—Cost of Group-Term Life Insurance over $50,000. Show the taxable cost of group-term life insurance coverage over $50,000 provided to your employee (including a former employee). Also include it in boxes 1, 3 (up to the social security wage base), and 5.

Codes D through H and S. Use these codes to show deferrals made to the plans listed. Do not report amounts for other types of plans. See below for an example of reporting elective deferrals to an I.R.C. §401(k) plan.

The amount reported as elective deferrals is only the part of the employee's salary (or other compensation) that he or she did not receive because of the deferrals. Only elective deferrals should be reported in box 12 for all coded plans, except, when using code G for I.R.C. §457(b) plans, include both elective and non-elective deferrals.

The following are not elective deferrals and may be reported in box 14, but not in box 12:

- Non-elective employer contributions made on behalf of an employee.
- After-tax contributions, such as voluntary contributions to a pension plan that are deducted from an employee's pay.
- Required employee contributions.
- Employer matching contributions.

Practitioner Note. If any elective deferrals, salary reduction amounts, or non-elective contributions to an I.R.C. §457(b) plan during the year are makeup amounts under the **Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)** for a prior year, you must enter the prior year contributions separately. Beginning with the earliest year, enter the code, the year, and the amount. For example, elective deferrals under USERRA to an I.R.C. §401(k) plan are reported in box 12 as follows:

- D 99 2250.00, D 00 1250.00. The 2001 contribution does not require a year designation; Enter it as D 7000.00.
- Report the code (and year for prior year USERRA contributions) to the left of the vertical line in boxes 12a-d.

Code D—Elective Deferrals to an I.R.C. §401(k) Cash or Deferred Arrangement. Also show deferrals under a SIMPLE retirement account that is part of an I.R.C. §401(k) arrangement.

Code E—Elective Deferrals Under an I.R.C. §403(b) Salary Reduction Agreement.

Code F—Elective Deferrals Under an I.R.C. §408(k)(6) Salary Reduction SEP.

Code G—Elective Deferrals and Employer Contributions (Including Non-Elective Deferrals) to an §457(b) Deferred Compensation Plan for Employees of State and Local Governments or Tax-Exempt Organizations.

Do not report I.R.C. §457(f) amounts or amounts deferred under I.R.C. §457(b) that are subject to a substantial risk of forfeiture.

Practitioner Caution. The I.R.C. §457 dollar limit should be reduced by deferrals to certain other deferred compensation plans [I.R.C. §457(c)(2)].

Code H—Elective Deferrals to an I.R.C. §501(c)(18)(D) Tax-Exempt Organization Plan. Be sure to include this amount in box 1 as wages. The employee will deduct the amount on his or her Form 1040.

Example 4. Reporting elective deferrals to an I.R.C. §401(k) plan. For 2001, Employee A elected to defer $11,300 to an I.R.C. §401(k) plan and made a voluntary after-tax contribution of $600. In addi-

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

tion, the employer, on A's behalf, made a qualified non-elective contribution of $1,000 to the plan and a non-elective profit-sharing employer contribution of $2,000.

The total elective deferral of $11,300 is reported in box 12 with code **D** (D 11300.00). Even though the 2001 limit for elective deferrals is $10,500, the employer must report the total amount of $11,300 in box 12. The excess is not reported in box 1.

The $600 voluntary after-tax contribution may be reported in box 14 (this is optional) but not in box 12. The $1,000 nonelective contribution and the $2,000 nonelective profit-sharing employer contribution are not required to be reported on Form W-2, but may be reported in box 14. Mark the "Retirement plan" checkbox in box 13.

Code J—Nontaxable Sick Pay. Show any sick pay **not** includable in income (and **not** shown in boxes 1, 3, and 5) because the employee contributed to the sick pay plan.

Code K—20% Excise Tax on Excess Golden Parachute Payments. If you made excess "golden parachute" payments to certain key corporate employees, report the 20% excise tax on these payments. If the excess payments are considered wages, also report the 20% excise tax as income tax withheld in box 2.

Code L—Substantiated Employee Business Expense Reimbursements. Use this code **only** if you reimbursed your employee for employee business expenses using a per diem or mileage allowance and the amount you reimbursed exceeds the amount treated as substantiated under IRS rules. **Report only the amount treated as substantiated, i.e., the nontaxable part.** In box 1, include the part of the reimbursement that is more than the amount treated as substantiated.

Code M—Uncollected Social Security or RRTA Tax on Cost of Group-Term Life Insurance over $50,000 (for Former Employees). If you provided your former employees (including retirees) more than $50,000 of group-term life insurance coverage for periods during which an employment relationship no longer exists, enter the amount of uncollected social security or RRTA tax on the coverage in box 12.

Code N—Uncollected Medicare Tax on Cost of Group-Term Life Insurance over $50,000 (for Former Employees). If you provided your former employees (including retirees) more than $50,000 of group-term life insurance coverage for periods during which an employment relationship no longer existed, enter the amount of uncollected Medicare tax or RRTA Medicare tax on the coverage in box 12.

Code P—Excludable Moving Expense Reimbursements Paid Directly to Employee. Show the total moving expense reimbursements you paid directly to your employee for qualified (deductible) moving expenses.

Code Q—Military Employee Basic Housing, Subsistence, and Combat Zone Compensation. If you are a military employer and provide your employee with basic housing, subsistence allowances, or combat zone compensation, report it in box 12.

Code R—Employer Contributions to a Medical Savings Account (MSA). Show any employer contributions to an MSA.

Code S—Employee Salary Reduction Contributions Under an I.R.C. §408(p) SIMPLE. Show deferrals under an I.R.C. §408(p) salary reduction SIMPLE retirement account. However, if the SIMPLE is part of an I.R.C. §401(k) arrangement, use code **D.** If you are reporting prior year contributions under USERRA, see the **TIP** above **Code D** on previous page.

Code T—Adoption Benefits. Show the total you paid or reimbursed for qualified adoption expenses furnished to your employee under an adoption assistance program. Also include adoption benefits paid or reimbursed from the pre-tax contributions made by the employee to an I.R.C. §125 (cafeteria) plan.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

However, do not include adoption benefits forfeited from an I.R.C. §125 (cafeteria) plan. Report all amounts including those in excess of the $5,000 or $6,000 exclusion.

Code V—Income from the Exercise of Nonstatutory Stock Option(s). Show the spread (i.e., fair market value of stock over the exercise price of option(s) granted to your employee with respect to that stock) from your employee's (or former employee's) exercise of nonstatutory stock options. Include this amount in boxes 1, 3 (up to the social security wage base), and 5. (Use of this code is optional for 2001.)

Box 13—Checkboxes. Mark all checkboxes that apply.

Statutory Employee. Mark this checkbox for statutory employees whose earnings are subject to social security and Medicare taxes but **not subject to Federal income tax withholding.** Do not mark this checkbox for common-law employees. There are workers who are independent contractors under the common-law rules but are treated by statute as employees. They are called statutory employees.

1. A driver who distributes beverages (other than milk), or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4. A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity.

Retirement Plan. Mark this checkbox if the employee was an active participant (for any part of the year) in any of the following:

1. A qualified pension, profit-sharing, or stock bonus plan described in an I.R.C. §401(a) (including an I.R.C. §401(k) plan).
2. An annuity plan described in I.R.C. §403(a).
3. An annuity contract or custodial account described in I.R.C. §403(b).
4. A simplified employee pension (SEP) plan described in I.R.C. §408(k).
5. A SIMPLE retirement account described in I.R.C. §408(p).
6. A trust described in I.R.C. §501(c)(18).
7. A plan for Federal, state, or local government employees or by an agency or instrumentality thereof (other than an I.R.C. §457 plan).

For information on the active participant rules, see Notice 87-16, 1987-1 C.B. 446, Notice 98-49, 1998-2 C.B. 365, I.R.C. §219(g)(5), and **Pub. 590,** Individual Retirement Arrangements (IRAs).

Do not mark this checkbox for contributions made to a nonqualified or I.R.C. §457 plan.

- **Third-Party Sick Pay.** Mark this checkbox **only** if you are a third-party sick pay payer filing a Form W-2 for an insured employee.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Box 14—Other. The lease value of a vehicle provided to your employee and reported in box 1 **must** be reported here or in a separate statement to your employee. You may also use this box for any other information you want to give your employee. **Please label each item.** Examples include state disability insurance taxes withheld, union dues, uniform payments, health insurance premiums deducted, nontaxable income, educational assistance payments, or a member of the clergy's parsonage allowance and utilities. In addition, you may enter the following contributions to a pension plan:

1. Non-elective employer contributions made on behalf of an employee
2. Voluntary after-tax contributions that are deducted from an employee's pay
3. Required employee contributions
4. Employer matching contributions

Example 5. James Henderson works for Investco Industries, Inc. and receives a salary of $100,000 per year. Investco reimburses his meal and lodging expenses for travel away from home by paying him a per diem rate that is equal to 120% of the federal per diem rate for the localities to which he travels. In 2001, James substantiated six days of travel away from home: two days in a locality in which the federal per diem rate is $100 and four days in a locality in which the per diem rate is $125. Investco reimbursed James $840 for the six days of travel away from home [2 × (120% × $100) + 4 × (120% × $125)], and it did not require James to return the excess payment of $140 [2 days × $20($120 – $100) + 4 days × $25($150 – $125)].

In 2001, James adopted a child. Investco's adoption assistance program paid $5,000 of qualified adoption expenses. The $5,000 adoption expenses paid by Investco are not subject to income tax withholding and are not reportable in box 1. However, these amounts are subject to social security, Medicare, and railroad retirement taxes and must be reported in boxes 3 and 5. Also, the total amount must be reported in box 12 with code T.

Investco provides a SIMPLE (savings incentive match plan for employees) retirement plan for its employees. James elected to contribute the maximum $6,500. An employee's salary reduction contributions to a SIMPLE retirement account are not subject to income tax withholding but are subject to social security, Medicare, and railroad retirement taxes. Investco should not include James's contribution in box 1, but must include it in boxes 3 and 5. James' total contribution also must be included in box 12 with code **D** or **S.**

Investco also reimbursed James for $6,000 of dependent care expenses and for $150 of meals that James ate at meetings for which he was not traveling away from home.

Investco must report the above fringe benefits as shown on the following Form W-2.

In box 1, Investco reports the sum of James's $100,000 salary, the $140 excess per diem payment, the $1,000 of child care benefits in excess of the $5,000 exclusion, and the $150 of meal reimbursement for meals that do not qualify as travel away from home: $100,000 + $140 + $1,000 + $150 = $101,290.

In box 2, Investco reports the $25,445 of federal income tax that was withheld. In boxes 3 and 4, Investco reports the maximum social security wages and the social security tax that was withheld because James's salary exceeds the $80,400 base for 2001.

In box 5, Investco reports the $112,790 of wages and fringe benefits that are treated as Medicare wages. The $112,790 × 1.45% = $1,635.46 of Medicare tax that was withheld is reported in box 6. The total includes:

Box 1 amount	$101,290
Adoption expenses	5,000
Simple contribution	6,500
Total	$112,790

In box 10, Investco reports the full $6,000 of dependent care assistance provided to James.

In box 12, using **Code D,** Investco reports the $6,500 simple contribution.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

In box 12, using **Code L,** Investco reports the $700 of per diem payments that are treated as substantiated and are not included in James's income.

In box 12, using **Code T,** Investco reports the $5,000 qualified adoption expenses.

In box 14, Investco is not required to but can report the $150 of meal reimbursements and the $140 of excess per diem payment that were included in his income in box 1.

Field	Value
a Control number	22222
Void	☐
For Official Use Only ▶ OMB No. 1545-0008	
b Employer identification number	47-1234567
c Employer's name, address, and ZIP code	Investco, Inc. 1000 Investment Way Central, NY 12345
d Employee's social security number	128-68-4391
e Employee's first name and initial	James P.
Last name	Henderson
f Employee's address and ZIP code	101356 Henderson Road Getawayfromitall, NY 12345
1 Wages, tips, other compensation	$ 101290.00
2 Federal income tax withheld	$ 25445.00
3 Social security wages	$ 80400.00
4 Social security tax withheld	$ 4984.80
5 Medicare wages and tips	$ 112790.00
6 Medicare tax withheld	$ 1635.46
7 Social security tips	$
8 Allocated tips	$
9 Advance EIC payment	$
10 Dependent care benefits	$ 6000.00
11 Nonqualified plans	$
12a See instructions for box 12	Code D $ 6500.00
12b	Code L $ 700.00
12c	Code T $ 5000.00
12d	Code $
13 Statutory employee / Retirement plan / Third-party sick pay	☐ / ☒ / ☐
14 Other	
15 State / Employer's state ID number	
16 State wages, tips, etc.	$
17 State income tax	$
18 Local wages, tips, etc.	$
19 Local income tax	$
20 Locality name	

Form **W-2** Wage and Tax Statement **2001**

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

Cat. No. 10134D

ACCOUNTABLE PLANS

An employer may pay employees in advance or reimburse them for some benefits. These reimbursements or advances are excluded from taxable income and are exempt from FITW, FICA, and FUTA if they are made under an "accountable plan."

To be accountable, an employer's reimbursement or allowance plan must provide for the following rules:

- Expenses must be directly connected to the employer's trade or business.
- Employees must adequately account for expenses within a reasonable period of time (generally within 60 days after they are incurred).
- Employees must return any excess advancement or allowance within a reasonable period of time (generally within 120 days after the expense is paid or incurred).
- The employer must not pay out an advance too long before the employee is expected to incur the qualifying expenses (generally not more than 30 days).

NONDISCRIMINATION RULES

Many employer-provided benefits, such as health and retirement benefits, are excluded from taxation to encourage employers to provide them to low- and middle-income employees. To ensure that these benefits are not given disproportionately to highly compensated or key employees, detailed nondiscrimination rules are applied. **These detailed rules are not discussed in this chapter.**

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

TYPES OF FRINGE BENEFITS

Employers may offer employees several types of benefits, the value of which may be excluded from the employees' income as fringe benefits under I.R.C. §132. These benefits must be made available to all employees on a nondiscriminatory basis and include:

No-Additional-Cost Services. Gross income does not include the value of any service provided by an employer to an employee for the employee's personal use if [I.R.C. §132(b)]:

- Services or products that the employer offered for sale to customers in the line of business in which the employees work are provided as a no-additional-cost fringe benefit.
- The employer does not incur any substantial additional cost, nor suffer any loss of revenue in providing it to the employee.
- The services are provided by the employer to the employee for use by the employee, spouse, or a dependent.

Example 6. Andrew works for an airline that allows employees to fly on its regularly scheduled flights at no charge on a stand-by basis. Andrew can exclude the value of flights he takes under this program from his income.

Example 7. Joyce works for an airline that allows its employees to take personal flights at no charge and receive reserved seating. Because her employer forgoes potential revenue by permitting the employees to reserve seats, Joyce must include the value of the flight in her income.

The service can be provided **directly, at a reduced price, or through a cash rebate** [Treas. Reg. §1.132-2(a)(3)]. **Services provided by another employer** are treated as if they were provided by the taxpayer's employer if:

- The employers have a written agreement to provide such services
- The services are within the line of business of both employers
- The services are provided at no (substantial) additional cost to either employer [I.R.C. §132(g); Treas. Reg. §1.132-2(b)]

Qualified Employee Discounts. As a benefit to employees, an employer may allow them to purchase, at a discount, qualified property or services generally offered for sale to customers. The value of these discounts will not be includable in income [I.R.C. §132(c)] if:

- The discount does **not** exceed the gross profit percentage of the price at which the property is sold to customers (gross profit divided by aggregate sales price)
- The discount on services does not exceed 20% of the cost to customers. These discounts are only excludable by employees who perform substantial services in the line of business in which the benefits are offered for sale to customers

Example 8. Saveco is a retailer that had $1,000,000 in sales during 2001, and its cost of goods sold was $750,000. Its gross profit percentage is therefore $250,000 profit divided by the $1,000,000 in sales, which is 25%. That 25% is the limit on the excludable discount Saveco can provide to its employees.

Working-Condition Fringes. For a benefit to qualify as a working-condition fringe benefit, it must be a benefit that would **normally be deductible** on an **employee's personal income tax return** had the employee purchased the benefit on his or her own as a necessary and ordinary business expense as defined under I.R.C. §162. Reimbursements of these benefits must be made by employers under an accountable plan. Under such a plan, employees must keep adequate records and substantiate business

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

use of these "fringes." Working-condition fringes may be offered in a discriminatory way by employers without losing their tax-favored status. Working-condition fringes include:

- Company cars used for business purposes
- Product-testing goods
- Job-related educational expenses
- Employer-provided parking
- Uniform expenses
- Equipment allowances
- Security services such as a bodyguard or chauffeur

Example 9. James paid $1,000 for subscriptions that qualify as a deduction under I.R.C. §162 but are subject to the 2% of adjusted gross income floor. James's AGI is $40,000, and his deduction is therefore limited to $200. If James's employer had paid the $1,000, the full $1,000 would be excluded under I.R.C. §132(d).

For purposes of this exclusion, the term "employee" includes the following [Treas. Reg. §1.132l(b)(2)]:

- Any partner who performs services for the partnership
- Any director of the employer (but directors cannot exclude the value of goods provided in a product-testing program)
- Any independent contractor who performs services for the employer (but independent contractors cannot exclude the value of parking or the value of goods provided in a product-testing program)

Example 10. Appraisalco buys a subscription to a professional journal for its employees, who need the journal to perform their job. The value of the subscription is excluded from the employees' incomes.

A cash payment made by an employer to an employee will not qualify as a working condition fringe unless the employer requires the employee to:

a. Use the payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under I.R.C. §§162 or 167
b. Verify that the payment is actually used for such expenses
c. Return to the employer any part of the payment not so used

Items not entitled to exclusion as working-condition fringes include

- Benefits purchased through a flexible spending account
- Physical examinations for employees, even if required by the employer

De Minimis Fringe Benefits. Some benefits provided by employers are offered so infrequently and have a fair-market value (FMV) so small that it is impractical and unreasonable to account for them. In these cases, employers may offer these benefits to employees as tax-free de minimis fringes.

Any benefit that qualifies as a de minimis fringe is excludable from an employee's gross income, and neither the employee nor the employer is required to report or pay any federal taxes on the amounts.

De minimis fringe benefits include [Treas. Reg. §1.132-6(e)]:

- Occasional supper money or cab fare
- Occasional personal use of a copy machine (cannot be more than 15% of the total usage of the machine)

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

- Occasional typing of a letter
- Discounted meals at an employer-operated eating facility
- Occasional company parties or picnics, and holiday gifts (turkeys, hams)

Example 11. If an employer provides a free meal to one employee on a daily basis, but not to any other employee, the value of the meal is not de minimis with respect to that employee, even though the employer is infrequently providing meals to its entire workforce.

Example 12. If an employer exercises sufficient control and imposes significant restrictions on the personal use of a company copying machine so that at least 85% of the use of the machine is for business purposes, any personal use of the copying machine by a particular employee is considered to be a de minimis fringe benefit.

Example 13. The provision of cash to an employee for a theater ticket that would itself be excludable as a de minimis fringe is not excludable as a de minimis fringe since it is not administratively impractical to account for the cash.

Items not considered de minimis include:

- Personal use of membership at country clubs or certain athletic facilities
- Season tickets to sporting or entertainment events
- Use of an employer-owned boat, plane, or lodge

ACCIDENT AND HEALTH BENEFITS

Most employer-provided health and accident benefits are excluded from the employee's income. Both the employer's contribution to an accident or health plan [I.R.C. §106] and the benefits received from an accident or health plan [I.R.C. §105(a)] are excluded from income. Benefits paid directly by an employer to an employee are also excluded from the employee's income [I.R.C. §105(a)] unless the employee is a highly compensated employee and the employer's plan discriminates in favor of highly compensated employees [I.R.C. §105(h)]. Similarly, amounts received as worker's compensation are excluded from income [I.R.C. §104(a)(I)]. In addition to income taxes, this exclusion is effective for FICA I.R.C. §3121(a)(2), FUTA I.R.C. §3306(b)(4), and withholding I.R.C. §3401(a)(20).

This exclusion applies to employer contributions to an accident or health plan for an employee, including the following:

- Contributions to the cost of accident or health insurance
- Contributions to a separate trust or fund that provides accident or health benefits directly or through insurance
- Contributions to medical savings accounts

This exclusion also applies to employer payments made (directly or indirectly) to an employee under an accident or health plan for employees that is either of the following:

- Payments or reimbursements of medical expenses
- Payments for specific injuries or illnesses (such as the loss of the use of an arm or leg). The payments must be figured without regard to any period of absence from work

Accident or Health Plan. An arrangement that provides benefits for your employees, their spouses, and their dependents in the event of personal injury or sickness. The plan may be insured or noninsured and does not need to be in writing.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Employee. For this exclusion, treat the following individuals as employees:

- A current common-law employee
- A full-time life insurance agent who is a current statutory employee
- A retired employee
- A widow or widower of an individual who died while an employee
- A widow or widower of a retired employee
- For the exclusion of contributions to an accident or health plan, a leased employee who has provided services to you on a substantially full-time basis for at least a year if the services are performed under your primary direction or control

Example 14. Yung Chow's employer pays $200 per month for Yung's health insurance. In 2001, Yung received $900 in benefits from the insurance. The premiums paid for the insurance as well as the benefits from the insurance are excluded from Yung's income. Yung's employer can deduct the $200 per month it contributes to purchase the insurance.

Example 15. If Yung Chow's employer provided insurance that included Yung's spouse and children, the premium paid by the employer and the benefits received by Yung would be excluded from income.

Example 16. Bonny Bright's employer reimburses its employees for the first $1,500 of medical expenses each year. All employees receive the same benefits. In 2001, Bonny received $900 of reimbursements. The $900 is excluded from Bonny's income and her employer can deduct the $900 as a business expense. The exclusion also covers health and accident plans for members of the employee's family.

Exception for S Corporation Shareholders. Do not treat a 2% shareholder of an S corporation as an employee of the corporation. A 2% shareholder is someone who directly or indirectly owns (at any time during the year) more than 2% of the Corporation's stock, or stock with more than 2% of the voting power.

Exclusion from Wages. Generally the value of accident or health benefits provided to an employee are excluded from the employee's wages.

Exception for Certain Long-Term Care Benefits

Contributions to the cost of long-term care insurance cannot be excluded from an employee's wages subject to federal income tax withholding if the coverage is provided through a flexible spending or similar arrangement. This is a benefit program that reimburses specified expenses up to a maximum amount that is reasonably available to the employee and is less than 5 times the total cost of the insurance. However, these contributions can be excluded from the employee's wages subject to social security, Medicare, and federal unemployment taxes.

ATHLETIC FACILITIES

The value of an employee's use of an on-premises gym or other athletic facility operated by the employer can be excluded from the employee's wages if substantially all use of the facility during the calendar year is by employees, their spouses, and their dependent children. For this purpose, an employee's dependent child is a child or stepchild who is the employee's dependent or who, if both parents are deceased, is age 24 or younger.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

On-Premises Facility. The athletic facility must be located on premises the employer owns or leases. It does not have to be located on the business premises. However, the exclusion does not apply to an athletic facility for residential use, such as athletic facilities that are part of a resort.

Employee. For this exclusion, treat the following individuals as employees:

1. A current employee
2. A former employee who retired or left on disability
3. A widow or widower of an individual who died while an employee
4. A widow or widower of a former employee who retired or left on disability
5. A leased employee who has provided services on a substantially full-time basis for at least a year if the services are performed under the employer's primary direction or control
6. A partner who performs services for a partnership

EMPLOYER PROVIDED VEHICLES

One of the most valuable tax-free benefits an employer may provide to its employees is an employer-owned vehicle to use for business purposes. The employee, however, must be taxed on any personal use of the vehicle. This amount must be included in gross income, is subject to FITW, FICA, and FUTA, and must be reported on the employee's Form W-2.

Generally, if an employer provides a vehicle to an employee, who then uses it for personal purposes, the value of such use must be considered income to the employee for the year in which the personal benefit was received. Even an employee who uses an employer-provided vehicle solely for business purposes may have a commuting valuation added to his or her gross income. For example, if an employee takes an employer-provided vehicle home at night, rather than leaving it on the employer's premises (e.g., because of a bad neighborhood or no overnight parking facility), the drive to the employee's home from work and back again is personal use of the vehicle. An employer must compute this taxable benefit and add it to the employee's income.

Example 17. John is a repair technician for Repairco. Because repair parts were disappearing from John's truck when it was parked at Repairco, John's employer asked him to park his truck at home. Repairco can use the commuting valuation rule and include $3 per day in John's income for the commuting use of the truck.

An employee's use of an employer-provided vehicle will not result in taxable income in the following circumstances:

- If an employee could deduct his or her business use of the employer's vehicle under I.R.C. §162 as an ordinary and necessary business expense, it is considered a working-condition fringe benefit and is not taxable.
- If personal use is so minimal—such as stopping to pick up dry cleaning between business appointments—that accounting for it would be unreasonable or administratively impractical, it may be excluded as a de minimis fringe benefit.
- If the personal use of a demonstration vehicle by a full-time salesperson in the dealer's sales area is substantially restricted (i.e., no one else can use the vehicle, and it may not be used for vacation), it may be excluded from an employee's gross income.
- If a vehicle's size, design, or markings make it difficult to use for personal purposes, such as clearly marked police and fire vehicles, ambulances, hearses, cranes and derricks, school buses, forklifts, and various types of trucks and vans, personal use may be excludable.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

CAFETERIA PLANS

A cafeteria plan is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits for which the law provides an exclusion from wages. If an employee chooses to receive a qualified benefit under the plan, the fact that the employee could have received cash or a taxable benefit instead will not make the qualified benefit taxable.

Generally, a cafeteria plan does not include any plan that offers a benefit that defers pay. However, a cafeteria plan can include a qualified I.R.C. 401(k) plan as a benefit. Also, certain life insurance plans maintained by educational institutions can be offered as a benefit even though they defer pay.

Example 18. Debbie's employer has a cafeteria plan that allows Debbie to choose:

- Cash
- Qualified medical reimbursements
- Qualified dependent care reimbursements

In 2001, Debbie chose to put $500 into the medical reimbursement plan and $2,000 into the dependent care reimbursement plan. She receives the remainder of her $30,000 total salary in cash. The $2,500 Debbie put into the two reimbursement accounts is excluded from her taxable income. The remaining $27,500 of her salary is included in her taxable income.

A cafeteria plan **cannot** include the following benefits:

- Athletic facilities
- De minimis (minimal) benefits
- Educational assistance
- Employee discounts
- Lodging on your business premises
- Moving expense reimbursements
- No-additional-cost services
- Transportation (commuting) benefits
- Tuition reduction
- Working condition benefits
- Scholarships or fellowships

Qualified Benefits. Qualified benefits include the following:

- Accident and health benefits (but not medical savings accounts or long-term care insurance)
- Adoption assistance
- Dependent care assistance
- Group-term life insurance coverage (including costs that cannot be excluded from wages)

Employee. For these plans, treat the following individuals as employees:

1. A current common-law employee
2. A full-time life insurance agent who is a current statutory employee
3. A leased employee who has provided services to you on a substantially full-time basis for at least a year if the services are performed under your primary direction or control

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

2001 Workbook

Exception for S Corporation Shareholders. Do not treat a 2% shareholder of an S corporation as an employee of the corporation. A 2% shareholder is someone who directly or indirectly owns (at any time during the year) more than 2% of the corporation's stock, or stock with more than 2% of the voting power.

Highly Compensated Employees. If a plan favors highly compensated employees as to eligibility to participate, contributions, or benefits, it must include in their wages the value of taxable benefits they could have selected. A plan maintained under a collective bargaining agreement does not favor highly compensated employees.

SCHOLARSHIPS AND FELLOWSHIPS

Amounts received as scholarships or fellowship grants by degree candidates for qualified tuition and related expenses are excludable from gross income and are not subject to FITW, FICA, and FUTA. However, this exclusion does not apply to any amount received as payment for teaching, research, or other services rendered to the school and required as a condition of receiving the scholarship.

Qualified tuition and related expenses are defined as amounts paid or allowed to a student to aid in the pursuit of studies at a qualified educational institution. They include fees, books, supplies, and equipment required for courses of instruction. Additional amounts such as room and board, travel, research, clerical help, and equipment are not qualified expenses.

Example 19. Lotta Labor received a scholarship to State University for $8,000. As a condition of receiving the scholarship, she must serve as a half-time teaching assistant. Of the total $8,000 scholarship, $5,000 represents payment for teaching. State should issue to Lotta a Form W-2 showing $5,000 as taxable income.

Assume that Lotta uses all the money for tuition and course-related material, and that all other requirements are met. The $3,000 is tax-free.

ISSUE 13: UNIFORM CAPITALIZATION

I.R.C. §263A provides that both direct costs and an allocable portion of most indirect costs incurred during the tax year due to either production or resale activities must be capitalized. The effect is a timing issue and a deferral of the otherwise allowable deduction, as certain overhead expenses need to be included in the cost of the property manufactured, which becomes a part of the year-end inventory for the taxpayer. These capitalized costs are not lost but later recovered when the inventory is sold or the property becomes subject to depreciation.

I.R.C. §263A must be used by a taxpayer who:

1. Produces real property or tangible personal property for use in a trade or business, or an activity engaged in for profit
2. Produces real property or tangible personal property for sale to customers, or
3. Acquires property for resale (but note exemption below)

However, the uniform capitalization rules under I.R.C. §263A exempt certain types of property which include:

1. Property produced that is not for use in taxpayer's trade or business, or activity conducted for profit
2. Cost paid or incurred by an individual (other than in the capacity of an employee) or a qualified employee-owner of a corporation who is a writer, photographer, or artist

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

3. Property produced under a long-term contract
4. Research and development expenses allowable as a deduction under I.R.C. §174, and
5. Costs for personal property acquired for resale if the individual's (or predecessor's) average annual gross receipts do not exceed $10 million

Practitioner Note. I.R.C. §263A is the IRS foray into cost accounting and a favorite adjustment by IRS agents. These uniform capitalization rules apply not only to large corporate manufacturers but also to the self-employed home builder with just one house in inventory at year end. I.R.C. §263A is not an option with taxpayers as "unicap rules" are required to be used if applicable.

COSTS SUBJECT TO THE UNIFORM CAPITALIZATION RULES

Direct Costs

Whether the taxpayer is a manufacturer or producer, all direct costs of labor and material go into the cost of the finished product, and become part of inventory if not sold by year-end. Resellers include not only direct costs of inventory purchases but also total costs for acquiring such inventory as freight-in and other necessary charges.

The following indirect costs are required to be capitalized in part under I.R.C. §263A. For a taxpayer NOT required to use I.R.C. §263A, these costs are treated as "period" costs and are fully deductible as overhead.

1. Officers' compensation
2. Indirect labor costs
3. Pension costs
4. Indirect material costs
5. Handling costs
6. Rent
7. Taxes
8. Depletion
9. Depreciation expenses
10. Storage costs
11. Handling costs
12. Purchasing costs
13. Utilities
14. Insurance
15. Engineering/design costs
16. Repairs and maintenance
17. Quality control costs
18. Spoilage
19. Interest expense
20. License/franchise costs
21. Bidding costs
22. Certain service costs

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Indirect Costs NOT Subject to the Uniform Capitalization Rules

1. Selling and distribution costs
2. Research and development costs
3. Additional first year depreciation under I.R.C. §179
4. Casualty losses under I.R.C. §165
5. Depreciation on idle equipment/facilities
6. Income taxes
7. Strike expenses
8. Warranty and product liability costs
9. On-site storage costs
10. Unsuccessful bid expenses
11. Certain service costs

Example 1. Your first year S corporation client, Hawkeye Homebuilders, Inc., engages you to prepare its tax return for the year 2001. Woody "Hawk" Boatmiller, the president of the company, is proud of his initial year in business and points to his computerized prepared income statement (noted below) that reflects a $28,000 profit even after Mr. Boatmiller paid himself a $58,000 salary. He noted that he completed and sold 16 homes during the year with 4 homes in process at the end of year. And he smartly observes to you, "I know how you tax guys think, so I have included all my direct labor, material, land, and subcontractor costs in my ending inventory representing those four homes not yet sold." After your initial review of his income statement you report back that you can increase his tax profit even more by using the magic of I.R.C. §263A.

HAWKEYE HOMEBUILDERS, INC
Statement of Income and Expenses
For the Period Ending December 31, 2001

Gross sales		$2,240,000
Cost of sales:		
Materials	984,000	
Labor	966,000	
Subcontractors	490,000	
Sub-total	2,440,000	
Less: ending inventory	(440,000)	
Total cost of sales		$2,000,000
Gross profit		$ 240,000
Selling and administrative expenses:		
Officers salary	58,000	
Office salaries	16,000	
Rent	19,400	
Advertising	14,600	
Payroll taxes	6,200	
State income tax	1,000	
Depreciation	7,600	
Employee benefits	27,800	
Utilities	4,500	
Telephone	4,600	
Legal and accounting	5,700	
Repairs	11,000	
Transportation costs	23,300	
Insurance	12,300	
Total selling and administrative expenses		$212,000
Net operating profit		$ 28,000

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Mr. Boatmiller, anticipating to pay tax on a flow-through 1120-S profit of $28,000, becomes defensive at your suggestion that his financial statement profit will be increased. You then proceed to explain to him the requirements of I.R.C. §263A—the Uniform Capitalization Rules—and how it is mandated that he comply. The tax practitioner should clearly stress that it is better for the taxpayer to get in step now than to have the IRS adjust on a later examination. Plus, the fact that you start with the process of pulling overhead costs into inventory will mean you generally have only the initial tax hit in the first year of compliance with I.R.C. §263A.

DETERMINING THE AMOUNT OF I.R.C. §263A COSTS

Step 1

Use a "reasonable allocation" method, such as taking the percentage of inventory to total direct costs. In the Hawkeye Homebuilders, Inc., situation, total direct costs were $2,440,000 for the year, and this included the ending inventory of $440,000.

$$\frac{\$440,000}{\$2,440,000} \text{ equals } 18\%$$

This result indicates that 18% of the direct costs for the year are still in inventory and a true application of I.R.C. §263A would then require 18% of those allocable indirect costs to also be a part of inventory.

Step 2

Determine the allocable indirect costs subject to the Uniform Capitalization rules and apply the percentage (18%) against those costs. In this contractor's situation, all indirect costs except advertising and state income taxes have to be reduced by the 18% going into ending inventory for the year. Period Costs represent those costs currently deductible in the year 2001.

	Indirect Cost		I.R.C. §263A	Period Cost
Officer's salary	$58,000	× 18%	$10,440	$47,560
Office salaries	16,000	× 18%	2,880	13,120
Rent	19,400	× 18%	3,492	15,908
Payroll taxes	6,200	× 18%	1,116	5,084
Depreciation	7,600	× 18%	1,368	6,232
Employee benefits	27,800	× 18%	5,004	22,796
Utilities	4,500	× 18%	810	3,690
Telephone	4,600	× 18%	828	3,772
Legal and accounting	5,700	× 18%	1,026	4,674
Repairs	11,000	× 18%	1,980	9,020
Transportation costs	23,300	× 18%	4,194	19,106
Insurance	12,300	× 18%	2,214	10,086
Totals	$196,400		$35,352	$161,048

The completed Schedule A (Form 1120S) illustrates the presentation of the I.R.C. §263A costs in the cost of goods sold section of the income statement. As these costs are added in on line 4, these same costs become a part of ending inventory. The taxpayer's gross profit does not change. However, the $35,352 in indirect costs reduces his general and administration expenses and thereby increases profit by the same amount. The net taxable profit of the corporation now becomes $63,352–the initial $28,000 plus the deferral of $35,352 in indirect costs.

The completed Form 1120S reflects the adjustment for I.R.C. §263A costs. Note that full indirect costs are entered in the applicable line items of the tax return, with the I.R.C. §263A adjustment reflected in Line 19 by reducing overall costs by $35,352 and making reference to the schedule as prepared in Step 2.

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Schedule A — Cost of Goods Sold (see page 16 of the instructions)

		Line	Amount
1	Inventory at beginning of year	1	
2	Purchases	2	984,000 00
3	Cost of labor	3	966,000 00
4	Additional section 263A costs *(attach schedule)*	4	35,352 00
5	Other costs *(attach schedule)*	5	490,000 00
6	**Total.** Add lines 1 through 5	6	2,475,352 00
7	Inventory at end of year	7	475,352 00
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	2,000,000 00

9a Check all methods used for valuing closing inventory:
- (i) ☒ Cost as described in Regulations section 1.471-3
- (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
- (iii) ☐ Other (specify method used and attach explanation) ▶

b Check if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO | 9d |

e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☒ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☒ No
If "Yes," attach explanation.

Schedule B — Other Information

		Yes	No
1	Check method of accounting: **(a)** ☐ Cash **(b)** ☐ Accrual **(c)** ☐ Other (specify) ▶		
2	Refer to the list on pages 29 through 31 of the instructions and state the corporation's principal: **(a)** Business activity ▶ CONTRACTOR **(b)** Product or service ▶ Product		
3	Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: **(a)** name, address, and employer identification number and **(b)** percentage owned.		X
4	Was the corporation a member of a controlled group subject to the provisions of section 1561?		X
5	Check this box if the corporation has filed or is required to file **Form 8264,** Application for Registration of a Tax Shelter ▶ ☐		
6	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
7	If the corporation: **(a)** filed its election to be an S corporation after 1986, **(b)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and **(c)** has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see page 17 of the instructions) ▶ $		
8	Check this box if the corporation had accumulated earnings and profits at the close of the tax year (see page 18 of the instructions) ▶ ☐		

Note: *If the corporation had assets or operated a business in a foreign country or U.S. possession, it may be required to attach Schedule N (Form 1120), Foreign Operations of U.S. Corporations, to this return. See Schedule N for details.*

Schedule K — Shareholders' Shares of Income, Credits, Deductions, etc.

Income (Loss)

	(a) Pro rata share items			(b) Total amount
1	Ordinary income (loss) from trade or business activities (page 1, line 21)		1	63,352 00
2	Net income (loss) from rental real estate activities *(attach Form 8825)*		2	
3a	Gross income from other rental activities	3a		
b	Expenses from other rental activities *(attach schedule)*	3b		
c	Net income (loss) from other rental activities. Subtract line 3b from line 3a		3c	
4	Portfolio income (loss):			
a	Interest income		4a	
b	Ordinary dividends		4b	
c	Royalty income		4c	
d	Net short-term capital gain (loss) *(attach Schedule D (Form 1120S))*		4d	
e	Net long-term capital gain (loss) *(attach Schedule D (Form 1120S))*:			
	(1) 28% rate gain (loss) ▶ **(2)** Total for year ▶		4e(2)	
f	Other portfolio income (loss) *(attach schedule)*		4f	
5	Net section 1231 gain (loss) (other than due to casualty or theft) *(attach Form 4797)*		5	
6	Other income (loss) *(attach schedule)*		6	

Form **1120S** (2000)

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Form **1120S** — Department of the Treasury, Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation.
▶ See separate instructions.

OMB No. 1545-0130 — 2000

For calendar year 2000, or tax year beginning *1/1*, 2000, and ending *12/31*, 20*01*

A Effective date of election as an S corporation	Name: *HAWKEYE CONTRUCTION CO*	C Employer identification number: *58-1651321*
B Business code no. (see pages 29–31)	Number, street, and room or suite no. (If a P.O. box, see page 11 of the instructions.): *1471 EAST RUTHERFORD*	D Date incorporated: *01/01/2001*
Use IRS label. Otherwise, print or type.	City or town, state, and ZIP code: *DECATUR, GA 35202*	E Total assets (see page 11): $ *475,352 00*

F Check applicable boxes: (1) ☒ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

G Enter number of shareholders in the corporation at end of the tax year ▶

Caution: *Include **only** trade or business income and expenses on lines 1a through 21. See page 11 of the instructions for more information.*

	Line	Description		Amount
Income	1a	Gross receipts or sales *2,240,000 00* b Less returns and allowances c Bal ▶	1c	*2,240,000 00*
	2	Cost of goods sold (Schedule A, line 8)	2	*2,000,000 00*
	3	Gross profit. Subtract line 2 from line 1c	3	*240,000 00*
	4	Net gain (loss) from Form 4797, Part II, line 18 *(attach Form 4797)*	4	
	5	Other income (loss) *(attach schedule)*	5	
	6	**Total income (loss).** Combine lines 3 through 5 ▶	6	*240,000 00*
Deductions (see page 12 of the instructions for limitations)	7	Compensation of officers	7	*58,000 00*
	8	Salaries and wages (less employment credits)	8	*16,000 00*
	9	Repairs and maintenance	9	*11,000 00*
	10	Bad debts	10	
	11	Rents	11	*19,400 00*
	12	Taxes and licenses	12	*7,200 00*
	13	Interest	13	
	14a	Depreciation *(if required, attach Form 4562)* 14a		
	b	Depreciation claimed on Schedule A and elsewhere on return 14b		
	c	Subtract line 14b from line 14a	14c	*7,600 00*
	15	Depletion **(Do not deduct oil and gas depletion.)**	15	
	16	Advertising	16	*14,600 00*
	17	Pension, profit-sharing, etc., plans	17	
	18	Employee benefit programs	18	*27,800 00*
	19	Other deductions *(attach schedule)*	19	*15,048 00*
	20	**Total deductions.** Add the amounts shown in the far right column for lines 7 through 19 ▶	20	*176,648 00*
	21	Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6	21	*63,352 00*

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.

Supplemental Schedules - 2000 Page: 1
COMPANY: HAWKEYE CONSTRUCTION CO EIN: 58-1651321

Form 1120S - Deductions, Line 19
Other Deductions

Description	Amount
UTILITIES	4,500
TELEPHONE	4,600
LEGAL AND ACCOUNTING	5,700
TRANSPORTATION	23,300
INSURANCE	12,300
LESS; SECTION 263A COSTS	
SCHEDULE ATTACHED	-35,352
TOTAL	15,048

Copyrighted by the Board of Trustees of the University of Illinois.
This information was correct when originally published. It has not been updated for any subsequent law changes.