

# 2001 Workbook

## INDIVIDUAL TAXPAYER ISSUES

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### ISSUE 1: HOME REFINANCING ISSUES

With the decline in interest rates in 2001, many homeowners will refinance their existing home mortgages. The advent of **no closing cost** loans has made refinancing more attractive to some homeowners. From a planning standpoint, no closing cost refinancing loans usually carry a slightly higher interest rate of about ½ of a percentage point. One of the key factors for those who are considering refinancing is the estimated time they will reside in their homes. Those who expect to remain in their homes for 10 years or more might be wise to choose a lower rate loan with points over a no closing cost loan with a higher rate. No closing cost loans are not available from traditional lenders in many parts of the country. However, many fixed-rate refinancing loans charge no points, but do charge closing costs such as appraisal and “document” fees.

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## TAX RULES FOR HOME REFINANCING MORTGAGES THAT CHARGE POINTS

1. Refinancing points are **not** deductible in the year paid even if the new mortgage is secured by the principal residence.
2. An **exception** applies if a **portion** of the refinanced mortgage proceeds is used to **improve** a principal residence. Points attributable to improvement costs may be deducted in the year paid.
3. Points that are not currently deductible must be prorated and deducted over the life of the refinanced loan.
4. Deductible points that are not reported on Form 1098 are entered on line 12, Schedule A.
5. Deductible points that are reported on Form 1098 are entered on line 10, Schedule A.
6. If a refinanced mortgage is paid off early, the remaining points are deducted in the year the mortgage is paid off.
7. Amounts charged by the lender for specific services connected to the loan are not deductible, assuming the home is used only for personal use. **Examples:** Appraisal fees, attorney fees, recording fees.

**Example 1.** Terry and Barb bought their principal residence in 1995 for \$125,000. They financed the purchase with a 30-year fixed-rate mortgage with a 9% interest rate. They refinanced the old mortgage in 2001. Following are the facts regarding the refinanced mortgage:

■ Date of refinancing	May 2001
■ Type of mortgage	30-year fixed
■ Interest rate	7%
■ Points paid (2% of \$115,000)	\$2,300
■ Amount of loan proceeds used to improve home	None
■ Date of first payment on the mortgage	June 1, 2001
■ Amount of points reported on the 2001 Form 1098	None

**Question 1.** Can Terry and Barb deduct any of the \$2,300 points they paid on the 2001 Schedule A?

**Answer 1.** Yes. The prorated deduction is \$38.34, computed as follows:

$$\begin{aligned} \$2,300 \text{ points} \div 360 \text{ monthly payments} &= \$6.39 / \text{month} \\ \$6.39 \times 6 \text{ payments in 2001} &= \$38.34 \end{aligned}$$

**Example 2.** Assume the same facts as in Example 1 except that the refinanced mortgage was \$145,000 rather than \$115,000. \$30,000 was used to add a swimming pool and deck to their home. The remaining \$115,000 was used to repay the original mortgage balance.

Points paid (2% of \$145,000)	\$ 2,900
Amount of loan proceeds used to improve home	\$30,000
Amount of points reported on the 2001 Form 1098 (2% of \$30,000)	\$ 600

**Question 2.** What amount of points is deductible on their 2001 Schedule A?

**Answer 2.** \$638.34 (\$600 reported on Form 1098 and \$38.34 not reported on Form 1098).

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SCHEDULES A&B  
(Form 1040)

## Schedule A-Itemized Deductions

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **07**

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

Name(s) shown on Form 1040

**Terry and Barb**

Your social security number

<b>Interest You Paid</b> (See page A-3.)	<b>10</b>	Home mortgage interest and points reported to you on Form 1098	<b>10</b>			
	<b>11</b>	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶				
<b>Note.</b> Personal interest is not deductible.	<b>12</b>	Points not reported to you on Form 1098. See page A-3 for special rules . . . . .	<b>12</b>	<b>38</b>	<b>34</b>	
	<b>13</b>	Investment interest. Attach Form 4952 if required. (See page A-3.) . . . . .	<b>13</b>			
	<b>14</b>	Add lines 10 through 13 . . . . .	<b>14</b>			

**Example 3.** Assume the same facts as in Example 2 with these additional facts:

- Barb inherited \$500,000 from her uncle in 2002 and they paid off the entire refinanced mortgage in 2002.
- The interest reported on the 2002 Form 1098 was \$5,750.

**Question 3.** What is the total deduction for points and interest on their 2002 Schedule A?

**Answer 3.** \$8,011.66 (computation shown below).

Interest reported on the 2002 Form 1098	\$5,750.00
Balance of points not deducted in 2001 (\$2,900 – \$638.34 deducted in 2001)	+ 2,261.66
	<b>\$8,011.66</b>

SCHEDULES A&B  
(Form 1040)

## Schedule A- Itemized Deductions

OMB No. 1545-0074

**2002**

Attachment  
Sequence No. **07**

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

Name(s) shown on Form 1040

**Terry and Barb**

Your social security number

<b>Interest You Paid</b> (See page A-3.)	<b>10</b>	Home mortgage interest and points reported to you on Form 1098	<b>10</b>	<b>5,750</b>	<b>00</b>	
	<b>11</b>	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶				
<b>Note.</b> Personal interest is not deductible.	<b>12</b>	Points not reported to you on Form 1098. See page A-3 for special rules . . . . .	<b>12</b>	<b>2,261</b>	<b>66</b>	
	<b>13</b>	Investment interest. Attach Form 4952 if required. (See page A-3.) . . . . .	<b>13</b>			
	<b>14</b>	Add lines 10 through 13 . . . . .	<b>14</b>			

### ISSUE 2: CIVIL SERVICE ANNUITY

Retired federal employees receive an annuity paid under one of the following retirement plans:

- Civil Service Retirement System (CSRS)
- Federal Employees Retirement System (FERS)

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Part of each annuity payment is a tax-free recovery of the retiree's contributions to the CSRS or FERS. The rest is taxable. If the annuity starting date is **after November 18, 1996**, the Simplified Method must be used to compute the taxable and tax-free parts. A completed Simplified Method Worksheet is shown in the example.

Retired federal employees receive Form CSA 1099R from the Office of Personnel Management (OPM). This form reports the "Gross annuity amount" but does not report the "Taxable annuity" figure. A 2000 Form CSA 1099-R is shown in the example that follows.

**Practitioner Caution.** The OPM issued to annuitants an original 2000 Form CSA 1099-R which was incorrect. The original form reported an amount in the "Taxable annuity" box equal to the amount reported in the "Gross annuity amount" box. The OPM issued "Corrected Copy" 2000 1099-R forms to annuitants in March 2001. **If you filed a 2000 return for a federal employee who retired after July 1, 1986, and you reported 100% of the "Gross annuity amount" as the taxable amount (on line 16b, Form 1040), an amended return should be filed.**

**Example 1.** Milo retired from his job at the IRS on May 31, 2000. He began to draw his Civil Service Retirement System pension on June 1, 2000. Milo is married and elected to receive a 50% joint and survivor annuity. This allows his wife, Martha, to receive half of his monthly pension if he dies first. Milo received the following "**Corrected Copy**" 2000 Form CSA 1099R and an accompanying notice from the OPM.

<p><b>PAID BY</b> OFFICE OF PERSONNEL MANAGEMENT RETIREMENT PROGRAMS P.O. BOX 45 BOYERS, PA 16017-0045</p>	<p><b>STATEMENT OF ANNUITY PAID</b> Copy B - File with Federal tax return</p>	<p><b>2000</b></p>
<p><b>CORRECTED COPY</b></p>		
<p>Annuitant's Social Security No. <b>888-88-8888</b></p>	<p>11. Federal Income Tax withheld <b>2364.00</b></p>	<p>Gross annuity amount <b>22176.00</b></p>
<p>Health Insurance Premiums <b>1726.62</b></p>	<p><b>PAID TO</b> <b>MILO</b></p>	
<p>Retirement Claim No. <b>CS A8073921</b></p>		
<p>Distribution Code <b>7-NONDISABILITY</b></p>		
<p>State 1 State income tax withheld <b>NONE</b></p>	<p>State 2 State income tax withheld <b>NONE</b></p>	
		<p>Original contributions <b>30143.00</b></p>
		<p>Taxable annuity</p>
		<p>PAYER'S Federal Identification Number <b>52-6083699</b></p>
		<p>CU0629772-10010630148</p>

Form CSA 1099R (Rev. 1/2001)  
This information is being furnished to the Department of Treasury - Internal Revenue Service

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## IMPORTANT TAX INFORMATION CSA 1099R, STATEMENT OF ANNUITY PAID

**General.** The 2000 tax year includes only the 12 monthly annuity payments dated January 3 through December 1, 2000, as well as any adjustments made through December. It does not include the payment you received in January 2001.

**Filing Instructions.** For a detailed explanation of how to determine the taxable portion of your annuity, request Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits*, from the IRS. The retirement system does not provide tax advice and does not supply IRS publications.

**Question 1.** How is the taxable part of Milo's CSRS pension computed?

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**Answer 1.** Since Milo's annuity starting date is **after November 18, 1996**, the **simplified method** must be used. A worksheet for this computation can be found in IRS Publication 721.

Table 1. **Simplified Method Worksheet** (Keep For Your Records)

See the instructions for the worksheet in Part II under *Simplified Method*.

1. Enter the total annuity received this year. Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a . . . . .	\$ <u>22,176</u>
2. Enter your cost in the plan at the annuity starting date, plus any death benefit exclusion	<u>30,143</u>
<b>NOTE:</b> If your annuity starting date was <b>before this year</b> and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below. Otherwise, go to line 3.	
3. Enter the appropriate number from Table 1 below. <b>But</b> if your annuity starting date was <b>after 1997 and</b> the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below . . . . .	<u>310</u>
4. Divide line 2 by line 3 . . . . .	<u>97</u>
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise go to line 6 . . . . .	<u>679</u>
6. Enter any amounts previously recovered tax free in years after 1986 . . . . .	<u>0</u>
7. Subtract line 6 from line 2 . . . . .	<u>30,143</u>
8. Enter the smaller of line 5 or line 7 . . . . .	<u>679</u>
9. <b>Taxable annuity for year.</b> Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 12b. If your Form CSA 1099R or Form CSF 1099R shows a larger amount, use the amount on this line instead . . . . .	\$ <u>21,497</u>
10. Add lines 6 and 8 . . . . .	<u>679</u>
11. <b>Balance of cost to be recovered.</b> Subtract line 10 from line 2 . . . . .	\$ <u>29,464</u>



**Table 1 for Line 3 Above**

IF the age at annuity starting date was . . .	AND your annuity starting date was—	
	before November 19, 1996, enter on line 3. . .	after November 18, 1996, enter on line 3. . .
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

**Table 2 for Line 3 Above**

IF the combined ages at annuity starting date were . . .	THEN enter on line 3. . .
110 and under	410
111–120	360
121–130	310
131–140	260
141 or older	210

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Notes regarding the completed worksheet shown above:

1. Table 2 is used for line 3 on the worksheet, since Milo elected a joint and survivor annuity with his spouse, Martha.
2. Milo was age 63 and Martha was 61 on June 1, 2000, the annuity starting date.

Form	1040	Department of the Treasury—Internal Revenue Service <b>U.S. Individual Income Tax Return</b>	2000	(99) IRS Use Only—Do not write or staple in this space.
		For the year Jan. 1–Dec. 31, 2000, or other tax year beginning	, 2000, ending	, 20 OMB No. 1545-0074
<b>Label</b> (See instructions on page 19.)  <b>Use the IRS label.</b> Otherwise, please print or type.  <b>Presidential Election Campaign</b> (See page 19.)	L A B E L  H E R E	Your first name and initial <b>Milo</b> Last name If a joint return, spouse's first name and initial <b>Martha</b> Last name Home address (number and street). If you have a P.O. box, see page 19. Apt. no. City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.	Your social security number <b>888 : 88 : 8888</b> Spouse's social security number	<b>▲ Important! ▲</b> You must enter your SSN(s) above.
		Note. Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund?	You                      Spouse <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
<b>Filing Status</b>  Check only one box.	1 <input type="checkbox"/> Single 2 <input checked="" type="checkbox"/> Married filing joint return (even if only one had income) 3 <input type="checkbox"/> Married filing separate return. Enter spouse's social security no. above and full name here. ▶ _____ 4 <input type="checkbox"/> Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ _____ 5 <input type="checkbox"/> Qualifying widow(er) with dependent child (year spouse died ▶ _____). (See page 19.)			
<b>Income</b>  Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.  If you did not get a W-2, see page 21.  Enclose, but do not attach, any payment. Also, please use Form 1040-V.	7 Wages, salaries, tips, etc. Attach Form(s) W-2 . . . . . 8a Taxable interest. Attach Schedule B if required . . . . . b Tax-exempt interest. Do not include on line 8a . . . . . 8b 9 Ordinary dividends. Attach Schedule B if required . . . . . 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 22) . . . . . 11 Alimony received . . . . . 12 Business income or (loss). Attach Schedule C or C-EZ . . . . . 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/> 14 Other gains or (losses). Attach Form 4797 . . . . . 15a Total IRA distributions . 15a                      b Taxable amount (see page 23) 16a Total pensions and annuities . 16a <b>22,176</b> b Taxable amount (see page 23) <b>21,497</b> 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E . . . . . 18 Farm income or (loss). Attach Schedule F . . . . . 19 Unemployment compensation . . . . . 20a Social security benefits . 20a                      b Taxable amount (see page 25) 21 Other income. List type and amount (see page 25) . . . . . 22 Add the amounts in the far right column for lines 7 through 21. This is your <b>total income</b> ▶	7 8a 9 10 11 12 13 14 15b 16b <b>21,497</b> 17 18 19 20b 21 22		

**Practitioner Caution.** Milo's tax-free monthly amount is \$97, as shown on line 4 of the worksheet. **If he lives to collect more than 310 monthly payments, he will have to include in his gross income the full amount of subsequent annuity payments.**

If Milo does **not** live to collect 310 monthly payments and Martha begins to receive payments, she will also **exclude** \$97 from **each** monthly payment until 310 payments (Milo's and hers) have been collected. If she dies **before** 310 payments have been made, **a miscellaneous itemized deduction (not subject to the 2% of AGI limit) will be allowed for the unrecovered cost on her final income tax return.**

# 2001 Workbook

## ISSUE 3: RENTAL REAL ESTATE ISSUES

### TOPIC 1: UNRECAPTURED I.R.C. §1250 GAIN

#### General Information

1. Any gain on the sale of I.R.C. §1250 property (real property) **held long term** attributable to depreciation **not** subject to the ordinary income recapture rules is **unrecaptured §1250 gain**.
2. A 17-line worksheet on page D-7 of the 2001 Form 1040 Instructions can be used to calculate this gain.
3. When §1250 property is sold, Form 4797 must be prepared before the worksheet can be completed.
4. Line 17 of the worksheet is carried to line 19, Schedule D (Part IV—Tax Computation Using Maximum Capital Gains Rates).
5. Line 19 on the 2001 Schedule D states: “Enter your unrecaptured §1250 gain, if any, from line 17 of the worksheet on page D-7.”
6. For taxpayers whose top tax bracket exceeds 15%, the unrecaptured §1250 gain will be taxed at 25%, rather than the normal 20% capital gain rate.
7. Unrecaptured §1250 gain **cannot** exceed net §1231 gain for the tax year. The worksheet factors in this rule.
8. There are special rules for §1250 property sold on the **installment method** and reported on Form 6252. If gain from the installment sale includes unrecaptured §1250 gain, the unrecaptured §1250 gain must be **reported first** (before the remaining gain that is subject to the 20%, 10%, or 8% maximum capital gain rate). The worksheet factors in these special rules for installment sales.

**Example 1.** Sydney, who is single, bought an apartment building in 1986 and sold it in 2001. Her top tax bracket in 2001 is 35.5%. Following are the facts and figures regarding this rental real estate property.

Date purchased	July 1, 1986
Purchase price	\$145,000
Amount allocated to land	(20,000)
Depreciable cost of building	\$125,000
Depreciation method used	ACRS (19-year life)
Date sold	July 1, 2001
Sales price	\$245,000
Expense of sale	15,000
Total ACRS deductions (1986–2001)	100,000
Additional depreciation (ACRS-SL)	5,000 (included in the \$100,000 total)
Gain on sale (computed below)	185,000

#### COMPUTATION OF GAIN

Sales price	\$245,000
Less: Purchase price	(145,000)
Plus: ACRS deductions	100,000
Less: Expense of Sale	(15,000)
<b>Total Gain on sale in July 2001</b>	<b>\$185,000</b>



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**Notes on Gain.**

1. The \$5,000 gain in excess of straight-line depreciation is \$1250 ordinary income under the depreciation recapture rules. It will be taxed at the same rates as the taxpayer's wages and interest income.
2. The \$95,000 gain equal to straight-line depreciation is unrecaptured \$1250 gain. It will be taxed at a 25% maximum rate (computed on the worksheet on page D-9 of the Form 1040 Instructions).
3. The remaining gain of \$85,000 is \$1231 gain. It will be taxed at a 20% rate (computed on the worksheet on page D-9 of the Form 1040 Instructions).

**Other facts:**

1. Sydney's **taxable income** on her 2001 Form 1040 (not shown) is \$237,100.
2. She also had \$7,000 of capital gain distributions from mutual funds and a \$14,000 long-term stock sale gain in 2001.

See the completed 2001 forms and schedules that follow:

- Form 4797
- Unrecaptured \$1250 Worksheet from the 1040 Instructions
- Schedule D

**Practitioner Note.** Page 2 of Sydney's 2001 Schedule D is shown on page 311. The computation for the \$51,503 figure on line 40 (tax on all taxable income using the favorable capital gains rates) is computed on a worksheet on page D-9 of the Form 1040 Instructions. The worksheet is not shown, but the computations from it are shown below.

a. \$1231 gain on apt. bldg.	\$ 85,000	
Long-term gain on Coca-Cola stock	14,000	
Capital gain distributions	7,000	
<b>Total income taxed at a 20% rate</b>	<u>\$106,000</u>	
<b>\$106,000 × 20%</b> .....		<b>\$21,200</b>
b. The \$95,000 unrecaptured \$1250 gain is taxed at a maximum 25% rate.		
<b>\$95,000 × 25%</b> .....		<b>\$23,750</b>
c. The remaining \$36,100 of taxable income (\$237,100 total taxable income – \$106,000 – \$95,000 = \$36,000) is taxed at the ordinary income tax rates using the Tax Table figure.		
<b>Tax table tax on \$36,100</b> .....		<u><b>\$ 6,553</b></u>
<b>Tax figure on line 40, page 2 of Schedule D</b> .....		<b>\$51,503</b>



# 2001 Workbook

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  
**2001**  
 Attachment  
 Sequence No. 27

Name(s) shown on return **Sydney** 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)
<b>2</b>						

<b>3</b> Gain, if any, from Form 4684, line 39 . . . . .	<b>3</b>	
<b>4</b> Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . .	<b>4</b>	
<b>5</b> Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . .	<b>5</b>	
<b>6</b> Gain, if any, from line 32, from other than casualty or theft . . . . .	<b>6</b>	<b>180,000</b>

<b>7</b> Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: . . . . .	<b>7</b>	<b>180,000</b>
<b>Partnerships (except electing large partnerships).</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.		
<b>S corporations.</b> 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.		
<b>All others.</b> 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.		

<b>8</b> Nonrecaptured net section 1231 losses from prior years (see instructions) . . . . .	<b>8</b>	<b>0</b>
----------------------------------------------------------------------------------------------	----------	----------

<b>9</b> Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):	<b>9</b>	<b>180,000</b>
<b>S corporations.</b> Enter any gain from line 9 on Schedule D (Form 1120S), line 15, and skip lines 11 and 12 below.		
<b>All others.</b> 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):


<b>11</b> Loss, if any, from line 7 . . . . .	<b>11</b>	
<b>12</b> Gain, if any, from line 7 or amount from line 8, if applicable . . . . .	<b>12</b>	
<b>13</b> Gain, if any, from line 31 . . . . .	<b>13</b>	<b>5,000</b>
<b>14</b> Net gain or (loss) from Form 4684, lines 31 and 38a . . . . .	<b>14</b>	
<b>15</b> Ordinary gain from installment sales from Form 6252, line 25 or 36 . . . . .	<b>15</b>	
<b>16</b> Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . . . .	<b>16</b>	
<b>17</b> Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions) . . . . .	<b>17</b>	
<b>18</b> Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows: . . . . .	<b>18</b>	<b>5,000</b>

**a** For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.

**b** For individual returns:

(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions . . . . .	<b>18b(1)</b>	
(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14 . . . . .	<b>18b(2)</b>	<b>5,000</b>

For Paperwork Reduction Act Notice, see page 7 of the instructions. Cat. No. 13086I Form **4797** (2001)



# 2001 Workbook

## 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.)
<b>A Apartment building</b>	<b>7-1-86</b>	<b>7-1-01</b>
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.) . . . . .	<b>245,000</b>			
21	Cost or other basis plus expense of sale . . . . .	<b>160,000</b>			
22	Depreciation (or depletion) allowed or allowable . . . . .	<b>100,000</b>			
23	Adjusted basis. Subtract line 22 from line 21 . . . . .	<b>60,000</b>			
24	Total gain. Subtract line 23 from line 20 . . . . .	<b>185,000</b>			
<b>25 If section 1245 property:</b>					
a	Depreciation allowed or allowable from line 22 . . . . .	25a			
b	Enter the smaller of line 24 or 25a . . . . .	25b			
<b>26 If section 1250 property:</b> 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>5,000</b>		
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions) . . . . .	26b	<b>5,000</b>		
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	<b>180,000</b>		
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	<b>5,000</b>		
<b>27 If section 1252 property:</b> 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			
<b>28 If section 1254 property:</b>					
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			
<b>29 If section 1255 property:</b>					
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	<b>185,000</b>
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13 . . . . .	31	<b>5,000</b>
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	<b>180,000</b>

## 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** (2001)

# 2001 Workbook

**Note:** If you are **not** reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.

<p><b>1.</b> Did you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252)?</p> <p><input type="checkbox"/> <b>No.</b> Leave lines 1 through 3 blank. Go to line 4.</p> <p><input checked="" type="checkbox"/> <b>Yes.</b> Enter the <b>smaller</b> of line 22 or line 24 of Form 4797 for that property. If you had more than one such property, see instructions . . . . .</p> <p><b>2.</b> Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1</p> <p><b>3.</b> Subtract line 2 from line 1 . . . . .</p> <p><b>4.</b> Do you have any unrecaptured section 1250 gain from an installment sale of trade or business property held more than 1 year that you are reporting on Form 6252?</p> <p><input type="checkbox"/> <b>No.</b> Leave line 4 blank. Go to line 5.</p> <p><input type="checkbox"/> <b>Yes.</b> Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year (see instructions) . . .</p> <p><b>5.</b> Was any amount reported to you on a Schedule K-1 from a partnership or an S corporation as “unrecaptured section 1250 gain”?</p> <p><input type="checkbox"/> <b>No.</b> Leave line 5 blank. Go to line 6.</p> <p><input type="checkbox"/> <b>Yes.</b> Enter the total amount of that unrecaptured section 1250 gain . . . . .</p> <p><b>6.</b> Add lines 3 through 5 . . . . .</p> <p><b>7.</b> Enter the <b>smaller</b> of line 6 or the gain from Form 4797, line 7 . . . . . <b>7.</b> <u>95,000</u></p> <p><b>8.</b> Enter the amount, if any, from Form 4797, line 8 . . . . . <b>8.</b> <u>0</u></p> <p><b>9.</b> Subtract line 8 from line 7. If zero or less, enter -0- . . . . .</p> <p><b>10.</b> Do you have any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain?</p> <p><input type="checkbox"/> <b>No.</b> Leave line 10 blank. Go to line 11.</p> <p><input type="checkbox"/> <b>Yes.</b> Enter the total amount of that unrecaptured section 1250 gain (see instructions) . . . . .</p> <p><b>11.</b> Was any amount reported to you on a Schedule K-1, Form 1099-DIV, or Form 2439 as “unrecaptured section 1250 gain” from an estate, trust, real estate investment trust, or mutual fund (or other regulated investment company)?</p> <p><input type="checkbox"/> <b>No.</b> Leave line 11 blank. Go to line 12.</p> <p><input type="checkbox"/> <b>Yes.</b> Enter the total amount of that unrecaptured section 1250 gain . . . . .</p> <p><b>12.</b> Do you have any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you did not make an entry in Part I of Form 4797 for the year of sale (see instructions)?</p> <p><input type="checkbox"/> <b>No.</b> Leave line 12 blank. Go to line 13.</p> <p><input type="checkbox"/> <b>Yes.</b> Enter the total amount of that unrecaptured section 1250 gain . . . . .</p> <p><b>13.</b> Add lines 9 through 12 . . . . .</p> <p><b>14.</b> Enter the gain or (loss) from Schedule D, line 15 . . . . . <b>14.</b> <u>0</u></p> <p><b>15.</b> Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0- . . . . . <b>15.</b> <u>0</u></p> <p><b>16.</b> Combine lines 14 and 15. If the result is zero or a gain, enter -0-. If the result is a (loss), enter it as a positive amount . . . . . <b>16.</b> <u>0</u></p> <p><b>17.</b> Subtract line 16 from line 13. If zero or less, enter -0-. Enter the result here and on Schedule D, line 19 . . . . . <b>17.</b> <u>95,000</u></p>	<p><b>1.</b> <u>100,000</u></p> <p><b>2.</b> <u>5,000</u></p> <p><b>3.</b> <u>95,000</u></p> <p><b>4.</b> _____</p> <p><b>5.</b> _____</p> <p><b>6.</b> <u>95,000</u></p> <p><b>7.</b> <u>95,000</u></p> <p><b>8.</b> _____</p> <p><b>9.</b> <u>95,000</u></p> <p><b>10.</b> _____</p> <p><b>11.</b> _____</p> <p><b>12.</b> _____</p> <p><b>13.</b> <u>95,000</u></p> <p><b>14.</b> _____</p> <p><b>15.</b> _____</p> <p><b>16.</b> <u>0</u></p> <p><b>17.</b> <u>95,000</u></p>
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# 2001 Workbook

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)  
Name(s) shown on Form 1040

## Capital Gains and Losses

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

OMB No. 1545-0074

2001

Attachment  
Sequence No. **12**

**Sidney**

Your social security number

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	
<b>1</b>						
2 Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .			<b>2</b>			
3 <b>Total short-term sales price amounts.</b> Add lines 1 and 2 in column (d) . . . . .			<b>3</b>			
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					<b>4</b>	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					<b>5</b>	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 2000 Capital Loss Carryover Worksheet . . . . .					<b>6</b> (      )	
7 <b>Net short-term capital gain or (loss).</b> Combine lines 1 through 6 in column (f).					<b>7</b>	

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
<b>8</b> <b>500 sh. Coca-Cola</b>	<b>3-1-81</b>	<b>4-14-01</b>	<b>23,000</b>	<b>9,000</b>	<b>14,000</b>	
9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .			<b>9</b>			
10 <b>Total long-term sales price amounts.</b> Add lines 8 and 9 in column (d) . . . . .			<b>10</b>			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					<b>11</b> <b>180,000</b>	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					<b>12</b>	
13 Capital gain distributions. See page D-1 of the instructions . . . . .					<b>13</b> <b>7,000</b>	
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 Capital Loss Carryover Worksheet . . . . .					<b>14</b> (      ) (      )	
15 Combine lines 8 through 14 in column (g) . . . . .					<b>15</b>	
16 <b>Net long-term capital gain or (loss).</b> Combine lines 8 through 14 in column (f) <b>Next:</b> Go to Part III on the back.					<b>16</b> <b>201,000</b>	

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

# 2001 Workbook

**Part III Taxable Gain or Deductible Loss**

17	Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39 . . . . .	17	<b>201,000</b>
<p><b>Next:</b></p> <ul style="list-style-type: none"> <li>• If both lines 16 and 17 are gains <b>and</b> Form 1040, line 39, is more than zero, complete Part IV below.</li> <li>• Otherwise, skip the rest of Schedule D and complete Form 1040.</li> </ul>			
18	If line 17 is a loss, enter the <b>smaller</b> of that loss or (\$3,000) (or, if married filing separately, (\$1,500)) here and on Form 1040, line 13. Then complete Form 1040 through line 37 . . . . .	18	( )
<p><b>Next:</b></p> <ul style="list-style-type: none"> <li>• If the loss on line 17 is more than the loss on line 18 <b>or</b> if Form 1040, line 37, is less than zero, skip <b>Part IV</b> below and complete the <b>Capital Loss Carryover Worksheet</b> on page D-6 of the instructions before completing the rest of Form 1040.</li> <li>• Otherwise, skip <b>Part IV</b> below and complete the rest of Form 1040.</li> </ul>			

**Part IV Tax Computation Using Maximum Capital Gains Rates**

19	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions . . . . .	19	<b>95,000</b>
<p><b>*If line 15 or line 19 is more than zero, see the instructions for line 40 on page D-8 of the instructions. Otherwise, go to line 20.</b></p>			
20	Enter your taxable income from Form 1040, line 39 . . . . .	20	<b>237,100</b>
21	Enter the <b>smaller</b> of line 16 or line 17 . . . . .	21	
22	If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0- . . . . .	22	
23	Subtract line 22 from line 21. If zero or less, enter -0- . . . . .	23	
24	Subtract line 23 from line 20. If zero or less, enter -0- . . . . .	24	
25	Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .	25	
26	Enter the <b>smaller</b> of: <ul style="list-style-type: none"> <li>• The amount on line 20 <b>or</b></li> <li>• \$45,200 if married filing jointly or qualifying widow(er);                        \$27,050 if single;                        \$36,250 if head of household; or                        \$22,600 if married filing separately</li> </ul>	26	
<p><b>If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.</b></p>			
27	Enter the amount from line 24 . . . . .	27	
28	Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34 . . . . .	28	
29	Enter your qualified 5-year gain, if any, from line 5 of the worksheet on page D-8 . . . . .	29	
30	Enter the <b>smaller</b> of line 28 or line 29 . . . . .	30	
31	Multiply line 30 by 8% (.08) . . . . .	31	
32	Subtract line 30 from line 28 . . . . .	32	
33	Multiply line 32 by 10% (.10) . . . . .	33	
<p><b>If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.</b></p>			
34	Enter the <b>smaller</b> of line 20 or line 23 . . . . .	34	
35	Enter the amount from line 28 (if line 28 is blank, enter -0-) . . . . .	35	
36	Subtract line 35 from line 34 . . . . .	36	
37	Multiply line 36 by 20% (.20) . . . . .	37	
38	Add lines 25, 31, 33, and 37 . . . . .	38	
39	Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .	39	<b>71,985</b>
40	<b>Tax on all taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 38 or line 39 here and on Form 1040, line 40 . . . . .	*	<b>51,503</b>
40		40	<b>51,503</b>

\*The worksheet from page D-9 of the Form 1040 Instructions is not shown. See the note on page 306 for details on the computation of the line 40 tax figure of \$51,503.



# 2001 Workbook

## TOPIC 2: THE SELF-RENTAL RULE UNDER TREAS. REG. §1.469-2(f)(6)

### General Information

The self-rental regulation poses a considerable risk to preparers who ignore it when completing Form 8582, Passive Activity Loss Limitations. In an IRS exam, the examiner probably will raise the issue and propose adjustments to claimed passive losses. **All five court cases, shown in the Conclusion of this section, have been decided in favor of the IRS.** The issue in the court cases is whether the regulation is valid. The courts have consistently ruled that it is.

In the IRS's Market Segment Specialization Program (MSSP) guidance to IRS examiners for Passive Activity Losses, the self-rental rule is emphasized. IRS examiners are encouraged by the MSSP to raise the self-rental issue when conducting exams involving reported passive activity losses.

This issue is most likely to occur when professionals such as dentists or attorneys incorporate and lease personally owned buildings to their corporations. In four of the five court cases, the taxpayers involved were dentists or attorneys.

### Treas. Reg. §1.469-2(f)(6) (The Self-Rental Rule)

The regulation states: An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as **not from a passive activity** if the property:

- a. Is rented for use in a trade or business activity in which the taxpayer **materially participates** for the taxable year, and
- b. Is not described in I.R.C. §1.469-2T(f)(5).

**In essence, this regulation provides that when a taxpayer rents property to his or her own business, the rental profit is not treated as passive activity income.**

**Practitioner Note.** The following example uses facts similar to the *Krukowski* Tax Court case discussed on pages 653–654 of the *2000 Farm Income Tax School Workbook*. [ *Krukowski v. Commissioner*, 114 T.C. 366 (2000). ]

**Example 1.** Tom Kaye is the president and sole shareholder of two C corporations. One operates a health club and the other is Tom's law firm. He owns and rents a building to each corporation. On the joint 2001 return for Tom and his wife, Susan, Schedule E (Form 1040) shows the following:

Property	Rents Rec'd	Expenses	Rental Profit (Loss)
Health club building	\$ 36,000	\$105,000	\$ (69,000)—Loss
Law firm building	\$300,000	\$125,000	\$175,000—Profit
Net rental income on the 2001 Schedule E			<u>\$ 106,000—Profit</u>

For passive activity loss purposes, Tom **materially participated** in the activities of his law firm as an employee/shareholder. However, he did **not** meet the material participation test for his health club.

**Question 1.** If the preparer **ignores** the self-rental regulation, what will be the tax result for 2001 for Tom and his wife?

**Answer 1.** The two rental activities will be treated as passive activities and will be entered on Tom and Susan's Form 8582 as shown. The tax result is that the \$69,000 rental loss on the health club building will be allowed to partially offset the \$175,000 rental profit on the law firm building. Thus, the \$106,000 net rental income figure shown on the 2001 Schedule E will be reported on line 17 of Form 1040.



# 2001 Workbook

Form **8582**

## Passive Activity Loss Limitations

OMB No. 1545-1008

Department of the Treasury  
Internal Revenue Service

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

**2001**  
Attachment  
Sequence No. **88**

Name(s) shown on return

**Tom and Susan Kaye**

Identifying number

### Part I 2000 Passive Activity Loss

Caution: See the instructions for Worksheets 1 and 2 on page 8 before completing Part I.

**Rental Real Estate Activities With Active Participation** (For the definition of active participation see **Active Participation in a Rental Real Estate Activity** on page 4 of the instructions.)

1a Activities with net income (enter the amount from Worksheet 1, column (a)). . . . .	1a	<b>175,000</b>		
1b Activities with net loss (enter the amount from Worksheet 1, column (b)). . . . .	1b (	<b>69,000</b>	)	
1c Prior years unallowed losses (enter the amount from Worksheet 1, column (c)). . . . .	1c (		)	
1d Combine lines 1a, 1b, and 1c . . . . .	1d			<b>106,000</b>

### All Other Passive Activities

2a Activities with net income (enter the amount from Worksheet 2, column (a)). . . . .	2a			
2b Activities with net loss (enter the amount from Worksheet 2, column (b)). . . . .	2b (		)	
2c Prior years unallowed losses (enter the amount from Worksheet 2, column (c)). . . . .	2c (		)	
2d Combine lines 2a, 2b, and 2c . . . . .	2d			

3 Combine lines 1d and 2d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c or 2c. <b>Do not</b> complete Form 8582. Report the losses on the forms and schedules normally used. If this line and line 1d are losses, go to Part II. Otherwise, enter -0- on line 9 and go to line 10 . . . . .	3			<b>106,000</b>
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### Part II Special Allowance for Rental Real Estate With Active Participation

Note: Enter all numbers in Part II as positive amounts. See page 8 for examples.

Note: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II. Instead, enter -0- on line 9 and go to line 10.

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

### Part III Total Losses Allowed

10 Add the income, if any, on lines 1a and 2a and enter the total . . . . .	10			<b>175,000</b>
11 <b>Total losses allowed from all passive activities for 2000.</b> Add lines 9 and 10. See page 11 to find out how to report the losses on your tax return . . . . .	11			<b>175,000</b>

For Paperwork Reduction Act Notice, see page 12 of the instructions.

Cat. No. 63704F

Form **8582** (2000)

7



# 2001 Workbook

**Question 2.** If the preparer follows the self-rental regulation, what will be the tax result?

**Answer 2.** The \$69,000 rental loss on the health club building will be treated as a **passive** activity and will be entered on Tom and Susan's Form 8582 as shown. However, the \$175,000 rental profit on the law firm building is considered **nonpassive** income and is omitted from Form 8582.

The tax result is that the \$69,000 rental loss on the health club building is a **suspended** passive loss for 2001. It is **not** deductible on their 2001 Form 1040. Tom and Susan have no other passive activity income in 2001 to absorb and allow the deduction of the \$69,000 rental loss.

## Conclusion

There is no adequate authority for preparers to ignore the self-rental regulation. However, if it is ignored, preparers must attach Form 8275-R, Regulation Disclosure Statement, to protect the client from potential exam penalties.

## Listing of Court Cases That Hold the Self-Rental Regulation To Be Valid.

1. *Krukowski v. Commissioner*, 114 T.C. 366 (2000) (see pp. 653-654 of the *2000 Farm Income Tax School Workbook*)
2. *Sidell v. Commissioner*, 225 F. 3d 103 (1st Cir. 2000)
3. *Fransen v. United States*, 191 F. 3d 599 (5th Cir. 1999)
4. *Connor v. Commissioner*, 218 F. 3d 733 (7th Cir. 2000)
5. *Schwalbach v. Commissioner*, 111 T.C. 215 (1998)

## TOPIC 3: MISCELLANEOUS INFORMATION REGARDING RENTAL REAL ESTATE

1. In August 1999, the IRS announced that furniture, carpeting, and appliances (including stoves and refrigerators) used in residential rental property qualified as **5-year** MACRS property. Prior to this change, this property was 7-year MACRS property [Announcement 99-82].
2. Office furniture and equipment such as desks and filing cabinets are **7-year** MACRS property.
3. See Table 3 from IRS Publication 527, *Residential Rental Property*, shown below.
4. The §179 deduction cannot be claimed on property held for the production of income, including investment property and rental property. There is an exception if rental property is the taxpayer's trade or business.  
**Example.** Fred and Jan are high school teachers. They own three single-family rental houses. They report their rental activity on Schedule E and do not pay self-employment tax on the net rental profit. They are not entitled to claim an §179 deduction on any property they purchase for the rental houses since it is not acquired **for use in the active conduct of a trade or business**.
5. The §179 deduction cannot be claimed on property used predominantly to furnish lodging or in connection with the furnishing of lodging. I.R.C. §179(d)(1) excludes property described in I.R.C. §50(b).

**Practitioner Note.** For a good discussion of this issue, see page 175 in the *2000 Farm Income Tax School Workbook* and page 14 of the IRS Publication 946, *How to Depreciate Property* (for use in preparing 2000 returns).

# 2001 Workbook

Table 3. **MACRS Recovery Periods for Property Used in Rental Activities**

Type of Property	MACRS Recovery Period To Use	
	General Depreciation System	Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as:		
Typewriters		
Calculators		
Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as:		
Stoves		
Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as:		
Desks		
Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	40 years
Improvements and additions, such as a new roof	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the improvement or addition.	

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## ISSUE 4: TAX PLANNING FOR HIGH-INCOME TAXPAYERS

### TOPIC 1: PLANNING SUGGESTIONS TO MINIMIZE TAXATION OF SOCIAL SECURITY BENEFITS

Social Security recipients may be startled when they receive unexpected or unplanned income. The unpleasant result is that the extra income often subjects more of their social security benefits to taxation. The goal of this planning issue is to offer some suggestions to prevent this situation. The following example explains the problem.

**Example 1.** Sam and Kathy, a married couple, will both be 72 in 2001. They visit your office on November 15, 2001 to discuss year-end tax planning. Their social security benefits for 2001 will be \$22,000. You discover that their other projected 2001 income will be as follows:

Type of Income	Amount of Income
Ordinary dividends on individual stocks	\$ 4,000
Interest income on bonds and CDs	15,000
Taxable pensions (2)	10,000
Capital gain dividends received as of 11-15-01	4,000
<b>Projected 2001 income excluding social security benefits</b>	<b>\$33,000</b>
Add: Projected taxable portion of \$22,000 social security benefits (worksheet not shown)	6,000

# 2001 Workbook

Projected 2001 AGI as of 11-15-01	\$39,000
Less: Standard deduction (both are over 65)	(9,400)
Less: Exemptions ( $\$2,900 \times 2$ )	(5,800)
	<hr/>
Projected 2001 taxable income as of 11-15-01	\$23,800
Projected total 2001 tax as of 11-15-01 from Part IV, Sch. D (not shown)	\$ 3,374

**Practitioner Note.** They are in the 15% tax bracket. You anticipate that **none** of the \$4,000 capital gain distribution from the mutual fund will be designated as qualified 5-year gain in the new Box 2c of the 2001 Form 1099-DIV. Therefore, the \$4,000 is taxed at a 10% rate ( $\$4,000 \times 10\% = \$400$ ). The remaining \$19,800 of taxable income is taxed at a 15% rate using the Tax Table figure of \$2,974.  $\$400 + \$2,974 = \$3,374$  total projected tax as of November 15, 2001.

You discover that they own a second mutual fund that will pay them a \$16,000 capital gain distribution on December 15, 2001, based on the number of shares they currently own. The mutual fund has indicated that **none** of the \$16,000 distribution will qualify as 5-year gain. If they sold all the shares in the fund before the record date of November 25, they would have a negligible long-term capital loss of under \$10, as of November 15, 2001.

**Question 1.** What advice should you give them to prevent a significant increase in their projected total 2001 tax liability?

**Answer 1.** At a minimum, you should show them how the extra \$16,000 capital gain distribution will affect your previous tax projections. Then let them decide if they want to sell the mutual fund shares before the record date and forfeit their \$16,000 distribution.

**Practitioner Note.** The distribution will not increase their wealth since the amount of the distribution lowers the NAV (net asset value) of the mutual fund. However, the distribution will definitely increase their tax liability whether they take it in cash or reinvest it.

If they don't sell the mutual fund shares, the previous projections will change as follows:

Type of Income	Amount of Income
Ordinary dividends on individual stocks	\$ 4,000
Interest income on bonds and CDs	15,000
Sam's taxable state pension	10,000
Capital gain distributions (4,000 + 16,000)	20,000
	<hr/>
<b>Projected 2001 income excluding social security benefits</b>	<b>\$49,000</b>
Add: Projected taxable portion of \$22,000 social security benefits (worksheet shown below)	18,700
	<hr/>
<b>Projected 2001 AGI</b>	<b>\$67,700</b>
Less: Standard deduction (both are over 65)	(9,400)
Less: Exemptions ( $\$2,900 \times 2$ )	(5,800)
	<hr/>
<b>Projected 2001 taxable income</b>	<b>\$52,500</b>
<b>Projected 2001 tax from Part IV, Schedule D (not shown)</b>	<b>\$ 7,609</b>

# 2001 Workbook

**Practitioner Note.** Their taxable income of \$52,500 puts them in the 27.5% tax bracket. Part of the \$20,000 capital gain distributions is taxed at the 10% rate and part is taxed at the 20% rate. Since none of the \$20,000 qualifies as 5-year gain, the lower 8% tax rate does not apply.

## Tax results of the extra \$16,000 capital gain distribution:

■ Additional tax (\$7,609 – \$3,374)	\$4,235
■ Effective tax rate on the \$16,000	26.5%
■ Increase in taxable portion of social security (\$18,700 – \$6,000)	\$12,700

**Conclusion.** After explaining the numbers to Sam and Kathy, they may well decide to liquidate the mutual fund before the record date for the payment of the capital gain distribution. They could sell their shares, gift them to a relative, or make a charitable contribution.

**Practitioner Note.** The completed worksheet that follows is from the 2001 Publication 915.

## Other Tax Planning Suggestions to Minimize Taxation of Social Security Benefits

1. If your client has acquired shares in a mutual fund via multiple purchases, including reinvestment of dividends, consider the following strategy if a **partial** sale of the mutual fund shares is contemplated:

Suggest to your clients, **before** a partial sale of mutual fund shares, that they consider the **specific share identification method** to establish the cost basis of the shares sold. In doing so, they can select the **high cost shares** to be sold that will either decrease the gain or increase the loss on the sale. Or, in some situations, clients can generate **either** a gain or a loss on the sale depending on their tax needs.

**Practitioner Note.** See page 404 in the 2000 *Farm Income Tax School Workbook* for details on this method of establishing cost basis for partial mutual fund sales.

2. If your client has already recognized capital gains during the year, or intends to do so before year-end, consider the sale of other assets at a loss to offset the gains.
3. If the client needs to raise cash, a loan may make more tax sense than selling highly appreciated securities. Then the loan can be paid off by selling the stock over a period of years.
4. Making gifts to family members can reduce invested funds that earn interest. Reducing interest income could potentially lower the amount of social security benefits subject to taxation.

**Practitioner Note.** This gifting strategy also applies to reducing funds invested in municipal bonds and tax-exempt bond funds. Tax-exempt interest from line 8b of Form 1040 is a factor in the computation of the taxable portion of social security benefits.

# 2001 Workbook

## Publication 915

Forms 1040, 1040A

Use this worksheet to figure taxable social security benefits if Form 2555, 2555-EZ, 4563, or 8815 is filed, or if employer-provided adoption benefits or income from sources within Puerto Rico is excluded.



### Worksheet 1. Figuring Your Taxable Benefits

**Before you start:** Is your filing status *Married filing separately*?

**No.** Go to line 1 below.

**Yes.** Did you live apart from your spouse all year?

**No.** Go to line 1 below.

**Yes.** Do the following if you file:

**Form 1040:** Enter "D" to the left of line 20a, then go to line 1 below.

**Form 1040A:** Enter "D" to the right of the word "benefits" on line 14a, then go to line 1 below.

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099 . . . . .	1.	<u>22,000</u>
<b>Note:</b> If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.		
2. Enter one-half of line 1 . . . . .	2.	<u>11,000</u>
3. Enter the total of the amounts from:		
<b>Form 1040:</b> Lines 7, 8a, 8b, 9-14, 15b, 16b, 17-19, and 21.		
<b>Form 1040A:</b> Lines 7, 8a, 8b, 9, 10, 11b, 12b, and 13 . . . . .		
4. <b>Form 1040A filers:</b> Enter the total of any exclusions for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 26)	3.	<u>49,000</u>
<b>Form 1040 filers:</b> Enter the total of any exclusions/adjustments for:		
• Qualified U.S. savings bond interest (Form 8815, line 14)		
• Adoption benefits (Form 8839, line 26)		
• Foreign earned income or housing (Form 2555, lines 43 and 48, or Form 2555-EZ, line 18), and		
• Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico		
5. Add lines 2, 3, and 4 . . . . .	4.	<u>0</u>
6. <b>Form 1040A filers:</b> Enter the amount from Form 1040A, line 16. <b>Form 1040 filers:</b> Enter the amount from Form 1040, line 32, minus any amount on Form 1040, line 24 . . . . .	5.	<u>60,000</u>
7. Subtract line 6 from line 5 . . . . .	6.	<u>0</u>
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 2001). . . . .	7.	<u>60,000</u>
9. Subtract line 8 from line 7. If zero or less, enter -0- . . . . .	8.	<u>32,000</u>
<b>Note:</b> If line 9 is zero or less, stop here; none of your benefits are taxable. (Do not enter any amounts on Form 1040, line 20a or 20b, or on Form 1040A, line 14a or line 14b. But if you are married filing separately and you lived apart from your spouse for all of 2001, enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b.) Otherwise, go on to line 10.		
10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and you lived with your spouse at any time during 2001). . . . .	9.	<u>28,000</u>
11. Subtract line 10 from line 9. If zero or less, enter -0- . . . . .	10.	<u>12,000</u>
12. Enter the <b>smaller</b> of line 9 or line 10 . . . . .	11.	<u>16,000</u>
13. Enter one-half of line 12 . . . . .	12.	<u>12,000</u>
14. Enter the <b>smaller</b> of line 2 or line 13 . . . . .	13.	<u>6,000</u>
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- . . . . .	14.	<u>6,000</u>
16. Add lines 14 and 15 . . . . .	15.	<u>13,600</u>
17. Multiply line 1 by 85% (.85) . . . . .	16.	<u>19,600</u>
18. <b>Taxable benefits.</b> Enter the <b>smaller</b> of line 16 or line 17 . . . . .	17.	<u>18,700</u>
	18.	<u>18,700</u>

• Enter the amount from line 1 above on Form 1040, line 20a, or on Form 1040A, line 14a.

• Enter the amount from line 18 above on Form 1040, line 20b, or on Form 1040A, line 14b.

**Note:** If you received a lump-sum payment in this year that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 to see whether you can report a lower taxable benefit.

# 2001 Workbook

## TOPIC 2: VACATION HOME TAX PLANNING SUGGESTIONS

Tax planning for vacation homes under I.R.C. §280A depends on several factors, two of which are discussed below.

### Factor 1

Is the personal use of the home during the year more than the greater of:

- 14 days, or
- 10% of the total days rented to others at fair rental value?

If so, it qualifies as a residence.

**Discussion of Factor 1.** Most taxpayers want to ensure that their vacation home qualifies as a residence. For most taxpayers, that qualification can be met by using the home for personal purposes a **minimum of 15 days** during the year.

### Tax advantages when the home qualifies as a residence:

1. Real estate taxes and mortgage interest on the personal use portion can be deducted on Schedule A (Form 1040). This assumes the vacation home qualifies as a second residence. These deductions are usually significant and most taxpayers who own vacation homes do itemize deductions. Therefore, this tax advantage can save a considerable amount of taxes.
2. If the home is rented at a fair rental price for **less than 15 days** during the year, any rental income received is **excludable**. Similarly, any rental expenses incurred during the period of the temporary rental are not deductible [I.R.C. §280A(g)].

**Practitioner Note.** Legislation to close this loophole has been proposed several times in the past. To date, these proposals have not been enacted.

The following two examples explain the tax advantages when a vacation home **qualifies as a residence**.

**Example 1.** Ed is single and has 2001 wages of \$125,000. He owns a personal residence in Iowa and a condo in Arizona. He did not rent the condo in 2001. He spent a total of 20 days in the condo in 2001. He paid \$5,700 of real estate taxes and \$12,600 of mortgage interest in 2001 on the condo.

### Example 1 Tax Result

Expense	Amount Paid	Where Deductible
Real estate taxes	\$ 5,700	Schedule A, line 6
Mortgage interest	12,600	Schedule A, line 10
<b>Total</b>	<b>\$18,300</b>	

# 2001 Workbook

**Example 2.** Same facts as in Example 1, except that Ed rented the condo for 10 days in 2001 at a fair rental rate to a co-worker. Ed's rental income was \$2,000.

## Example 2 Tax Result

Ed can **exclude** the \$2,000 rental income from his 2001 tax return. Since the home qualifies as a residence, his property taxes and mortgage interest are still **fully deductible** on Schedule A. However, no rental expenses (utilities, condo association fees, depreciation, etc.) are deductible.

## Factor 2

If the vacation home does **not qualify as a residence** due to insufficient personal use days (generally 14 days or less), is the taxpayer's modified AGI \$150,000 or more? If the answer is yes and the home has been rented, any rental loss will **not qualify for the \$25,000 special allowance** (for rental real estate with active participation) on Form 8582 (Passive Activity Loss Limitations).

**Example 3.** Sally, an employed physician, owns a main home in Texas and a vacation home in Utah. Her 2001 wages are \$300,000. She was so busy at work that she used her Utah home for personal purposes only during one three-day weekend in 2001. She rented out the home for 50 days during the ski season. **Under the rules of I.R.C. §280A, the home is treated as rental property.** Her rental loss for the year is (\$10,000). She meets the active participation test for passive loss purposes.

## Example 3 Tax Result

Since the Utah home is considered rental property, Sally's rental activity is covered by the passive loss rules. If Sally has no other passive activity income in 2001, the \$10,000 rental loss will **not** be deductible on her 2001 Form 1040. Rather, it will be a **nondeductible suspended** passive loss.

**Conclusion for Factor 2.** In Sally's case, the following recommendation can be made for the 2002 tax year: Suggest that she spend the **greater** of 15 days or 10% of the total rental days in the vacation home. If she is too busy to meet that goal in 2002, suggest that she let family member(s) stay in the home to meet the **used as a residence** test. If that is done, she will be entitled to deduct the personal use portion of taxes and interest on her 2002 Schedule A.

**Practitioner Note.** Sally also could satisfy the personal use test by donating use of the Utah home to a charitable fund-raiser. The donation would not qualify for a charitable contribution but the use would count as personal use by her (Rev. Rul. 89-51).

## Explanation of Personal-Use Days under I.R.C. §280A(d)(3)

Personal-use days include days that the dwelling unit is used by a spouse, child, grandchild, mother, father, grandparent, brother, sister, half-brother, or half-sister.

**Example 4.** Sally allows her grandfather to use her Utah home for 16 days in January 2002, and charges him no rent. His main home is in Wisconsin. The home is rented for 50 days at fair rental to others in 2002.

## Example 4 Tax Result

Sally will count the 16 days as her personal-use days. Therefore, the home will qualify as her second residence in 2002. She must allocate the taxes and interest paid on the home in 2002 between her 2002 Schedule A and Schedule E.



# 2001 Workbook

Several courts have accepted an allocation treating days when the property was not rented at fair rental as personal use days. If this rationale is followed, Sally can deduct 315/365 of the taxes and interest on her 2002 Schedule A. Assume that Sally's property taxes are \$5,700 and her mortgage interest is \$12,600 for the 2002 tax year. Sally would allocate the expenses to her 2002 Schedule A and Schedule E as follows:

Expenses	Amount Paid	Deductible on Schedule A	Deductible on Schedule E
Taxes	\$ 5,700	\$ 4,919 (315/365)	\$ 781
Interest	12,600	10,874 (315/365)	1,726
<b>Total</b>	<b>\$18,300</b>	<b>\$15,793</b>	<b>\$2,507</b>

Sally could also deduct utilities, repairs, depreciation, and other allocable rental expenses to absorb any remaining rental income on her 2002 Schedule E. Any excess expenses would carry forward to 2003.

**Practitioner Note.** The deductible amount of Schedule A taxes and interest shown in **Example 4 Tax Result** above is sanctioned by the Tax Court and the 9th and 10th Circuit Courts of Appeal. The deductible percentage is equal to the ratio of **nonrental days during the year divided by 365** (or 315/365 in Example 4).

The IRS uses a different formula to allocate expenses between **personal use** and **rental use** amounts if the home qualifies as a residence. The formula is

$$\frac{\text{number of days rented at a fair rental price}}{\text{total number of days rented plus personal use days}}$$

**Example 5.** Identical facts as for Example 4, except Sally's grandfather pays her a fair rental price for the 16 days.

## Example 5 Tax Result

The tax result is the same as in Example 4. Sally can count the 16 days as her **personal use days** because the Utah home is not her grandfather's main home.

**Practitioner Note.** See pages 92–97 in the 1997 *Farm Income Tax School Workbook* for a thorough analysis of the complex rules governing vacation homes. These rules have not changed.

## TOPIC 3: SPECIAL TAX DEDUCTION FOR PURCHASE OF "CLEAN-FUEL" VEHICLES

A tax deduction of up to \$2,000 is allowed on line 32, Form 1040 on the purchase of a new "clean-fuel" auto. "Clean-fuel" vehicles are those that use the following fuels:

- Natural gas
- Liquefied natural gas
- Liquefied petroleum gas
- Hydrogen
- Electricity
- Any other fuel that is at least 85% alcohol or ether

# 2001 Workbook

It appears that some portion of the cost of **hybrid electric vehicles (HEVs)** is eligible for the \$2,000 deduction on 2001 tax returns. The authority is the 2000 Form 8834 (Qualified Electric Vehicle Credit) Instructions and IRS Publication 535, *Business Expenses*.

**Excerpt from the 2000 Form 8834 Instructions:**

**“Caution.** Gasoline/electric hybrid vehicles that are not powered primarily by an electric motor are not qualified electric vehicles. However, part of the cost of these vehicles (up to \$2,000 for a vehicle with a gross vehicle weight rating that does not exceed 10,000 pounds) may qualify for the deduction for clean-fuel vehicles, even if you do not use the vehicle for business purposes.”

**Excerpt from Publication 535, Business Expenses (for use in preparing 2000 returns):**

“For vehicles that may be propelled by both a clean-burning fuel and any other fuel, your deduction is generally the additional cost of permitting the use of the clean-burning fuel.”

At present, only two manufacturers sell production model HEVs (Toyota Prius and Honda Insight). Other companies, including Ford, General Motors, Daimler-Chrysler, Mitsubishi, Nissan, Fiat, Renault, and Subaru are planning to introduce their own HEVs in the near future.

**Example 1.** Christy bought a new Honda Insight in August 2001 for \$21,500 (including sales tax). She used it entirely for personal purposes. She may claim a deduction on line 32 on her 2001 Form 1040 for the “additional cost of permitting the use of the clean-burning fuel” (electricity). If this “additional cost” is \$1,000, she will deduct the \$1,000 as shown below.

<b>Adjusted Gross Income</b>	23	IRA deduction (see page 27) . . . . .	23	<b>2,000</b>		
	24	Student loan interest deduction (see page 27) . . . . .	24			
	25	Archer MSA deduction. Attach Form 8853 . . . . .	25			
	26	Moving expenses. Attach Form 3903 . . . . .	26			
	27	One-half of self-employment tax. Attach Schedule SE . . . . .	27			
	28	Self-employed health insurance deduction (see page 29) . . . . .	28			
	29	Self-employed SEP, SIMPLE, and qualified plans . . . . .	29			
	30	Penalty on early withdrawal of savings . . . . .	30			
	31a	Alimony paid b Recipient's SSN ▶ . . . . .	31a			
	32	Add lines 23 through 31a . . . . . <b>\$1,000 Clean-Fuel</b> . . . . .	32	<b>3,000</b>		
	33	Subtract line 32 from line 22. This is your <b>adjusted gross income</b> . . . . . ▶	33			

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 56. Cat. No. 11320B Form **1040** (2001)

**ISSUE 5: MINOR CHILD WITH INVESTMENT INCOME (KIDDIE TAX)**

**GENERAL INFORMATION**

The “kiddie tax” was enacted as part of the Tax Reform Act of 1986. It is designed to discourage intrafamily transfers of income-generating assets to reduce tax. The rules are complex and involve complicated tax preparation of children’s returns. **The preparation of the child’s return can be time-consuming, especially if the child has capital gain income in addition to interest and dividends.** This situation is likely to occur when the minor child has invested in mutual funds that pay capital gain distributions. Hopefully, a preparer’s tax preparation software will handle the difficult computations required.

# 2001 Workbook

## THE BASICS

Part of a child's 2001 investment income may be taxed at the parents' highest marginal tax rate if a child:

- Was under age 14 on January 1, 2002
- Had investment income in excess of \$1,500
- Is required to file a 2001 return
- Had either parent alive on December 31, 2001

Investment income of the child includes all taxable income other than earned income (wages, tips, and other payments for personal services). **Form 8615** is used to compute the child's tax on 2001 investment income in excess of \$1,500 and is attached to the child's Form 1040.

An **election** can be made on **Form 8814** to report the child's investment income on the parents' 2001 tax return. A separate Form 8814 must be filed for each child under age 14 whose income the parents choose to report. The election(s) can be made if the child:

- Was under age 14 on January 1, 2002
- Is required to file a 2001 return
- Had **only** 2001 interest and dividend income of **more** than \$750 and **less** than \$7,500
- Made no estimated tax payments for 2001 in the child's name (including any overpayment of tax from the child's 2000 return applied to 2001 estimated tax)
- Had no federal income tax withholding, including backup withholding

Many tax advisors warn against making the election to use Form 8814 to report the child's investment income on the parents' return. If this election is made, the parents' AGI will be higher. This could result in a detrimental tax effect to the parents.

If an election is not made by the parents on Form 8814, the child's tax liability is computed on Form 8615. The tax is calculated in three stages on Form 8615:

1. Compute the child's net investment income in Part I.
2. Compute a tentative tax on the net investment income based on the parents' tax rate in Part II.
3. Compute the child's tax in Part III.

**The complexity in preparing Form 8615 occurs when the child has capital gains.** Worksheets found in IRS Publication 929, *Tax Rules for Children and Dependents*, are used to compute the child's tax liability. Many tax preparation software programs provide these worksheets as dropdown windows when preparing Form 8615.

# 2001 Workbook

Form **8615**  
 Department of the Treasury  
 Internal Revenue Service (99)

## Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400

▶ Attach only to the child's Form 1040, Form 1040A, or Form 1040NR.  
 ▶ See separate instructions.

OMB No. 1545-0998  
**2000**  
 Attachment  
 Sequence No. **33**

Child's name shown on return	Child's social security number : : :
------------------------------	-----------------------------------------------

**Before you begin:** If the child, the parent, or any of the parent's other children under age 14 received capital gains (including capital gain distributions) or farm income, see **Pub. 929**, Tax Rules for Children and Dependents. It explains how to figure the child's tax using the **Capital Gain Tax Worksheet** in the Form 1040 or Form 1040A instructions or **Schedule D or J** (Form 1040).

<b>A</b> Parent's name (first, initial, and last). <b>Caution:</b> See instructions before completing.	<b>B</b> Parent's social security number : : :
<b>C</b> Parent's filing status (check one): <input type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately <input type="checkbox"/> Head of household <input type="checkbox"/> Qualifying widow(er)	

**Part I Child's Net Investment Income**

1 Enter the child's investment income, such as taxable interest, ordinary dividends, and capital gain distributions. See instructions. If this amount is \$1,400 or less, <b>stop</b> ; do not file this form.	1		
2 If the child <b>did not</b> itemize deductions on <b>Schedule A</b> (Form 1040 or Form 1040NR), enter \$1,400. If the child <b>did</b> itemize deductions, see instructions . . . . .	2		
3 Subtract line 2 from line 1. If the result is zero or less, <b>stop</b> ; do not complete the rest of this form but <b>do</b> attach it to the child's return . . . . .	3		
4 Enter the child's <b>taxable income</b> from Form 1040, line 39; Form 1040A, line 25; or Form 1040NR, line 38 . . . . .	4		
5 Enter the <b>smaller</b> of line 3 or line 4 . . . . .	5		

**Part II Tentative Tax Based on the Tax Rate of the Parent Listed on Line A**

6 Enter the parent's <b>taxable income</b> from Form 1040, line 39; Form 1040A, line 25; Form 1040EZ, line 6; TeleFile Tax Record, line K; Form 1040NR, line 38; or Form 1040NR-EZ, line 14. If less than zero, enter -0- . . . . . <b>Note:</b> If the total of lines 4 and 6 above is not more than \$43,850, lines 7 through 16 may not have to be completed. For details, see the instructions for line 6.	6		
7 Enter the total net investment income, if any, from Forms 8615, line 5, of <b>all other</b> children of the parent identified above. <b>Do not</b> include the amount from line 5 above . . . . .	7		
8 Add lines 5, 6, and 7 . . . . .	8		
9 Enter the tax on line 8 based on the <b>parent's</b> filing status. See instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D or J</b> (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	9		
10 Enter the parent's tax from Form 1040, line 40; Form 1040A, line 26, minus any alternative minimum tax; Form 1040EZ, line 10; TeleFile Tax Record, line K; Form 1040NR, line 39; or Form 1040NR-EZ, line 15. If any tax is from <b>Form 4972</b> or <b>8814</b> , see instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D or J</b> (Form 1040) was used to figure the tax, . . . . . check here ▶ <input type="checkbox"/>	10		
11 Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to <b>Part III</b> . . . . .	11		
12a Add lines 5 and 7 . . . . . <span style="float: right;">12a</span>	12a		
b Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places) . . . . .	12b	×	
13 Multiply line 11 by line 12b . . . . .	13		

**Part III Child's Tax**—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14 Subtract line 5 from line 4 . . . . . <span style="float: right;">14</span>	14		
15 Enter the tax on line 14 based on the <b>child's</b> filing status. See instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D or J</b> (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	15		
16 Add lines 13 and 15 . . . . .	16		
17 Enter the tax on line 4 based on the <b>child's</b> filing status. See instructions. If the <b>Capital Gain Tax Worksheet</b> or <b>Schedule D or J</b> (Form 1040) is used to figure the tax, check here ▶ <input type="checkbox"/>	17		
18 Enter the <b>larger</b> of line 16 or line 17 here and on Form 1040, line 40; Form 1040A, line 26; or Form 1040NR, line 39 . . . . .	18		

For Paperwork Reduction Act Notice, see page 2 of the instructions. Cat. No. 64113U Form **8615** (2000)

### Information Regarding Completion of the 2001 Form 8615 for the Child

- Part 1** is not complex. Generally, **line 1** is the total of the child's interest income, ordinary dividends, and capital gains including capital gain distributions from mutual funds. For many children, the only capital gains will be capital gain distributions. The worksheet below, can be used to compute the figure to enter on line 1. It is from the 2000 Instructions for Form 8615.

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Child's Investment Income Worksheet—Line 1 (keep for your records)	
1. Enter the amount from the child's Form 1040, line 22; Form 1040A, line 15; or Form 1040NR, line 23, whichever applies . . . . .	1. _____
2. Enter the child's <b>earned income</b> (defined on page 1) plus any deduction the child claims on Form 1040, line 30, or Form 1040NR, line 30, whichever applies . . . . .	2. _____
3. Subtract line 2 from line 1. Enter the result here and on Form 8615, line 1 . . . . .	3. _____

The parents' 2001 return must be prepared before **Part II** of Form 8615 can be completed.

- Line 7** must be completed if brothers or sisters under age 14 have net investment income on line 5 of their 2001 Form(s) 8615.
- Line 9** can be time-consuming if there is any net capital gain included on line 8. If there is net capital gain on line 5, 6, or 7, then there is also net capital gain on line 8. One of three worksheets from IRS Publication 929 must be used in computing the figure to enter on line 9.
- Line 10** is taken directly from the parents' 2001 return. It is usually the total tax shown on line 40, Form 1040 on the parents' return. If the parents filed Form 4972 (Tax on Lump-Sum Distributions), do *not* include any tax from that form on line 10.
- Line 11** is the tax on the portion of the child's income that is taxed at the parents' rate.
- Line 14** shows the **balance** of the child's taxable income (line 4 on the child's Form 8615) less the amount that has been taxed at the parents' rate (line 5 on the child's Form 8615).
- Line 18** is the child's total tax and is entered on line 40 of the child's 2001 Form 1040.

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**Conclusion.** Hopefully, your tax preparation software will make these time-consuming calculations for you and will print a completed Form 8615 for the child. If not, see pages 351–366 in the *1999 Farm Income Tax School Workbook* for detailed instructions with completed worksheets for guidance.

## ISSUE 6: CONTINGENT ATTORNEY FEES

### GENERAL INFORMATION

With the continuing flood of age discrimination, sexual harassment, racial discrimination and other similar lawsuits, tax preparers may encounter clients who receive significant court awarded judgments. Since the 1995 Supreme Court decision in *Commissioner v. Schleier*, 515 U.S. 323 (1995), these types of judgments awarded are generally **not** excludable from gross income.

**I.R.C. §104(a)(2), as amended in 1996, states:** Gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

The tax result is that judgments received after August 20, 1996, for **nonphysical personal injury or sickness** are includible in gross income. Examples of these (not all inclusive) are:

- Employment discrimination (age, racial, gender)
- Wrongful termination of employment
- Defamation of character (libel/slander)

# 2001 Workbook

- Alienation of affections
- Wrongful prosecution
- Breach of contract (including business disputes)

## CONTINGENT ATTORNEY FEES PAID BY CLIENTS

### General Information

The tax issue is whether contingent attorney fees are includible in the client's gross income. The courts are split on this issue. Following is a combined judicial/IRS "scoreboard" of the decisions/positions as of May 2001 (see the introduction to the Rulings and Cases chapter for the jurisdictions of the various courts).

Includable in Gross Income	Excludable from Gross Income
Internal Revenue Service	5th Circuit Ct. of Appeals
Tax Court	6th Circuit Ct. of Appeals
Federal Circuit Ct. of Appeals	11th Circuit Ct. of Appeals
9th Circuit Ct. of Appeals	
1st Circuit Ct. of Appeals	
4th Circuit Ct. of Appeals	
7th Circuit Ct. of Appeals	

Two lines of reasoning in the conflicting court decisions are:

1. The **assignment-of-income doctrine** results in the inclusion of income to the client. This doctrine, established by the Supreme Court in 1930, holds that taxpayers can't assign income, to which they are legally entitled, to a third party without first paying tax on it. The Tax Court applied this doctrine to contingent attorneys fees in *Kenseth v. Commissioner*, 114 T.C. 399 (2000). See pages 630–31 in the *2000 Farm Income Tax School Workbook* for an analysis of this important decision. The 7th Circuit Court of Appeals affirmed the Tax Court's decision in 2001.

**Practitioner Caution.** The nine majority Tax Court judges in the *Kenseth* decision held that state lien statutes are irrelevant. The "shotgun" approach of I.R.C. §61 controls and the assignment-of-income doctrine must be applied. Gross income means all income from whatever source derived [I.R.C. §61(a)].

2. **State law** must be examined to determine if attorneys have a superior lien or ownership right in judgments of their clients. If **not**, the contingent fee must be **included** in the client's gross income. See *Coady v. Commissioner*, 213 F. 3d 1187 (9th Cir. 2000) discussed on pages 629–30 in the *2000 Farm Income Tax School Workbook*. In the *Coady* case, Alaskan state law did **not** grant a superior lien. Thus the contingent fee was **includable** in gross income of the taxpayer/client.

**Practitioner Caution.** From an analysis of the numerous court cases in this highly litigated area, it appears that the courts have decided that **only** the statutes of the following states **do grant attorneys a superior lien or ownership right in judgments** awarded to clients (based on cases decided as of August 2001):

Texas  
Michigan  
Alabama



# 2001 Workbook

## Tax Complications Caused by Inclusion in Gross Income of Contingent Attorney Fees Paid by Clients

1. These legal fees are a miscellaneous itemized deduction, subject to the 2% of AGI floor.
2. The legal fees also are subject to the 3% of AGI reduction rules for itemized deductions claimed by high-income taxpayers. In most cases, successful litigants are high-income taxpayers in the year the judgment is paid.
3. Miscellaneous itemized deductions are not deductible for alternative minimum (AMT) purposes. This can cause a significant AMT liability for the taxpayer/client in the year the judgment is received and the legal fee is paid.

**Example from facts in the *Kenseth* case (amounts listed are after the IRS exam results as affirmed by the Tax Court):**

■ Total judgment received by taxpayer in 1993	\$229,000	
■ Contingent fee paid directly to taxpayers' attorney (40%) by the defendant/employer	<u>(92,000)</u>	
■ Net amount retained by taxpayer		\$137,000
■ Amount of contingent fee deductible on Schedule A after the 2% of AGI floor and the 3% of AGI reduction for high-income taxpayers	82,000	
■ AMT liability created by the \$82,000 Schedule A deduction (not deductible for AMT purposes)	17,000	
■ Additional regular tax owed to IRS	<u>38,000</u>	
■ Total additional tax owed on the 1993 Form 1040		\$55,000
■ After-tax settlement retained by taxpayer		\$82,000
■ Legal fees paid by taxpayer in disputing the IRS exam result in Appeals and in Tax Court	?	
■ Interest paid to IRS on the \$55,000 deficiency	?	

**Summary for Example.** All of the facts and numbers aren't shown, but it is clear that the taxpayers kept less than \$82,000 of the court awarded judgment in the age discrimination suit against the husband's former employer.

**Conclusion.** This is a difficult issue for preparers. Since IRS is entering a more vigorous enforcement mode, this area is a logical one for selected IRS exam projects. Both the IRS and the Tax Court agree on the **inclusion** of contingent fees in gross income of clients. Taxpayers who reside in the Fifth, Sixth, and Eleventh Circuits can assert "substantial authority" for **exclusion** of contingent fees. It is expected that the Supreme Court will eventually resolve the conflict that now exists among the various appellate courts.

## ISSUE 7: FINAL MATURITY OF HH BONDS

### GENERAL INFORMATION

Many taxpayers own U.S. savings bonds (Series E, EE, H, HH or I). In many instances, taxpayers inherit these bonds. The tendency is to put them in a safe deposit box and forget them. The danger is that the bonds eventually reach a **final maturity date**, after which interest no longer accrues. Action must be taken before the final maturity date to either redeem or exchange the bonds.



# 2001 Workbook

## FINAL MATURITY CHART FOR U.S. SAVINGS BONDS

Type of Bond	Issue Date	Final Maturity Date
E Bonds	May 1941–November 1965	40 years from issue date
E Bonds	December 1965–June 1980	30 years from issue date
EE Bonds	January 1980 and later	30 years from issue date
H Bonds	February 1957–December 1979	30 years from issue date
HH Bonds	January 1980 and later	20 years from issue date
I Bonds	September 1998 and later	30 years from issue date

**Facts for Example.** Renee Lomax inherited two \$10,000 HH bonds from her father's estate in 1994. Renee has received 6% interest on the bonds semi-annually on June and December first. Her father, Myron Lomax, had acquired the HH bonds on June 1, 1981 via an exchange of Series E bonds that he had purchased during World War II. Myron had deferred reporting the interest on the E bonds. Consequently, when he exchanged them for HH bonds on June 1, 1981, the deferred interest on each E bond was \$7,079.60. Renee's HH bonds, which reached final maturity on June 1, 2001, are shown below.



# 2001 Workbook

Schedule B from the estate tax return (Form 706) of Myron Lomax is shown next. His date of death was August 9, 1994. The HH bonds he owned at death are Item Number 2 on Schedule B. Myron had three heirs, Renee and her two brothers, Kurt and Chad Lomax. The HH bonds owned by Myron (father) were reissued in the heirs' (children's) names as shown in the following:

Name of Heir	Description of HH Bonds Received
Renee Lomax	two \$10,000 bonds
Kurt Lomax	two \$10,000 bonds
Chad Lomax	one \$10,000 bond, one \$5,000 bond and two \$1,000 bonds

**Practitioner Note.** HH bonds are issued only in \$500, \$1,000, \$5,000 and \$10,000 denominations. The HH bonds owned by the decedent, Myron Lomax, were not reissued equally in the names of his three heirs following his death. Each of the three heirs could have received \$19,000 of reissued HH bonds, but the executor did not choose that option.

Form 706 (Rev. 8-93)

Estate of: **Myron C. Lomax**

## SCHEDULE B—Stocks and Bonds

*(For jointly owned property that must be disclosed on Schedule E, see the instructions for Schedule E.)*

Item number	Description including face amount of bonds or number of shares and par value where needed for identification. Give 9-digit CUSIP number.	Unit value	Alternate valuation date	Alternate value	Value at date of death
1	<b>Alliance Grain, Company</b> <b>122 shares</b>	<b>25.00</b>			<b>3,050.00</b>
2	<b>HH bonds with interest</b>				<b>57,152.58</b>
3	<b>McLean County Service Company</b> <b>42 shares</b>	<b>25.00</b>			<b>1,050.00</b>
Total from continuation schedules (or additional sheets) attached to this schedule . . .					
<b>TOTAL.</b> (Also enter on Part 5, Recapitulation, page 3, at item 2.) . . . . .					<b>61,252.58</b>

(If more space is needed, attach the continuation schedule from the end of this package or additional sheets of the same size.)  
(The instructions to Schedule B are in the separate instructions.)

Schedule B—Page 12

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**Question 1.** What are Renee's options concerning the HH bonds?

**Answer 1.** She has **two** options:

1. **Reinvest** the \$20,000 from the matured HH bonds in newly-issued HH bonds of the same denomination that will pay interest at an annual rate of 4%.
2. **Redeem** the HH bonds and receive \$20,000 from the U.S. Treasury (Bureau of the Public Debt) soon after June 1, 2001.

**Question 2.** Will she get a final 6% interest check on June 1, 2001?

**Answer 2.** Yes. Her final semi-annual interest amount will be \$600 ( $\$20,000 \times 6\% \div 2$ ). However, she should have submitted the matured HH bonds to a Federal Reserve Bank for either reinvestment or redemption in May 2001.

**Question 3.** What are the tax consequences to Renee in 2001 if she redeems the HH bonds?

**Answer 3.** Renee will receive a 2001 Form 1099-INT from the U.S. Treasury for \$14,759.20, which consists of

Deferred interest from HH bond X724916HH	\$ 7,079.60
Deferred interest from HH bond X724915HH	7,079.60
Final semi-annual 6% interest payment on June 1	600.00
<b>Amount of interest reported on Renee's 2001 Form 1099-INT from U.S. Treasury</b>	<b>\$14,759.20</b>

**Question 4.** What are the tax consequences if she reinvests the \$20,000 of matured HH bonds in newly-issued HH bonds that pay 4% interest?

**Answer 4.** Renee will receive a 2001 Form 1099-INT from the U.S. Treasury for \$15,159.20, that consists of

Total interest shown in <b>Answer 3</b> above	\$14,759.20
Initial semi-annual 4% interest payment on December 1, 2001	400.00
<b>Amount of interest reported on Renee's 2001 Form 1099-INT from U.S. Treasury</b>	<b>\$15,159.20</b>

**Practitioner Note.** The deferred interest from Myron's E bonds that was deferred into the HH bonds acquired on June 1, 1981 is shown on Renee's HH bonds. On the final maturity date of June 1, 2001, the deferred interest of \$14,159.20 ( $\$7,079.20 \times 2$ ) is taxable to Renee regardless of what she does with her HH bonds in 2001.

**Question 5.** Are there any other tax consequences to Renee in 2001?

**Answer 5.** Possibly, since the \$14,159.20 of deferred interest is **income in respect of a decedent**. If Myron's estate tax return reported estate tax attributable to the \$14,159.20, Renee will be entitled to an itemized deduction on line 27, Schedule A (other miscellaneous deductions). Her deduction will equal the estate tax paid on the \$14,159.20. She should contact the executor of her father's estate for information regarding this potential Schedule A (Form 1040) deduction. This deduction is not subject to the 2% AGI limitation.

**Conclusion.** This issue can result in significant tax liability. If the amount of taxable deferred interest is material, tax planning is advised to reduce the impact of the additional interest income. Possible strategies include:

# 2001 Workbook

- Delaying current year income
- Accelerating current year deductions
- Shifting invested funds to tax-exempt securities

**Practitioner Note.** See pages 157 through 166 in the Investment Reporting chapter (chapter 5) for a general discussion of the tax rules pertaining to various U.S. savings bonds.

## ISSUE 8: COMMON AMT TRAPS

As the regular income tax rates have decreased over the years and the AMT rate has increased slightly, more and more taxpayers are subject to AMT. According to the IRS, nearly one million filers paid AMT in 1999 and it is projected that this number will increase to over one million for 2000 returns. The increase in the AMT exemption amount for tax years 2001–2004 (due to the 2001 Tax Act) will temporarily reduce AMT problems for many taxpayers. However, AMT will continue to be a significant problem as regular tax rates decline and inflation adjustments are made to regular tax brackets.

### HIGH STATE AND LOCAL TAXES

High state and local taxes can cause taxpayers to owe AMT.

**Example 1.** Dunn Bluit is single and has \$150,000 of income each year. He takes advantage of the standard deduction by doubling his payment of real property taxes and state income taxes in one year and paying none in the next. He claims the standard deduction on his federal income tax return in the year he pays no state and local taxes.

Dunn also doubles up on charitable contributions in alternate years. For **2001** he had the following income, deductions, and regular income tax.

#### FORM 1040 TAX LIABILITY COMPUTATION

	Itemized Deductions	Income
Ordinary income		\$150,000
Long-term capital gain		–0–
Adjusted gross income		\$150,000
Less itemized deductions		
Real property taxes	\$18,000	
State income taxes	12,000	
Charitable contributions	8,000	
Total itemized deductions	\$38,000	
Less phase-out due to excess AGI ( $\$150,000 - \$132,950 \times 3\%$ )	(512)	
Balance		(37,488)
line 37, Form 1040		\$112,512
Less exemption deduction (\$2,900 reduced by phase-out)		(2,494)
Taxable income		\$ 10,018
<b>Regular tax liability</b> (using Tax Rate Schedule)		<b>\$ 28,208</b>

# 2001 Workbook

Dunn owes \$1,334 of AMT, as shown in the following calculation.

COMPUTATION—AMT LIABILITY	
Taxable income before exemptions (line 37, Form 1040)	\$112,512
Plus adjustments and preferences	
Taxes — Schedule A	30,000
Less itemized deductions limitation — Schedule A	(512)
Alternative minimum taxable income	\$142,000
Less AMT Exemption (\$35,750 reduced by partial phase-out)	(28,375)
Alternative minimum tax base	\$113,625
Tentative minimum tax (\$113,625 × 26%)	29,542
Less regular income tax liability	(28,208)
<b>Alternative minimum tax</b>	<b>\$ 1,334</b>

## EMPLOYEE BUSINESS EXPENSES

Employee business expenses that are reported as miscellaneous itemized deductions on Schedule A (Form 1040) cannot be deducted for AMT purposes. Therefore, for AMT purposes, the taxpayer must report the salary and wage income, but is not allowed to deduct the employee business expenses.

**Example 2.** In 2001, Will Endeavor, a single taxpayer, had \$95,000 of salary income from his employer and incurred \$30,000 of employee business expenses. The \$95,000 salary included \$28,000 of expense allowance paid under a nonaccountable plan. For regular tax purposes, Will is allowed a \$26,100 deduction for his employee business expenses after the 2% of AGI floor is subtracted. He cannot claim any of the employee business expenses for AMT purposes, which creates a \$1,186 AMT liability for Will in 2001.

Will's income, deductions and regular tax liability for 2001 are as follows:

FORM 1040 REGULAR TAX LIABILITY COMPUTATION			
		Itemized Deductions	Income
W-2 income			\$ 95,000
Adjusted gross income			95,000
Less itemized deductions:			
Miscellaneous deductions (employee business expenses)	\$30,000		
Less 2% AGI	(1,900)	\$28,100	(28,100)
Line 37, Form 1040			\$66,900
Less exemption deduction			(2,900)
Taxable Income			64,000
<b>Regular tax liability</b> (using Tax Table)			<b>\$ 14,226</b>

# 2001 Workbook

Will's AMT liability is calculated as follows:

COMPUTATION—AMT LIABILITY	
Taxable income before exemptions (line 37, Form 1040)	\$ 66,900
Plus adjustments and preferences	
Miscellaneous itemized deductions — Schedule A	28,100
Less itemized deductions limitation — Schedule A	-0-
Alternative minimum taxable income	\$ 95,000
Less AMT exemption (no phase-out)	(35,750)
Alternative minimum tax base	\$ 59,250
Tentative minimum tax ( $\$59,250 \times 26\%$ )	15,405
Less regular income tax liability	(14,226)
<b>Alternative minimum tax</b>	<b>\$ 1,179</b>

## LONG-TERM CAPITAL GAINS AND PRE-PAYMENT OF STATE INCOME TAXES

I.R.C. §55(b) (3), which was added by the Taxpayer Relief Act of 1997, applies the capital gains rates used for regular tax purposes to the calculation of the tentative minimum tax. Therefore, on the face of the code language, capital gain appears **not** to cause a taxpayer to owe AMT. **However, taxpayers who have high income and very high capital gains are subject to the AMT.**

**In addition, prepaying state income tax in a year with very large capital gains may produce little tax benefit.** While the prepayment of state income tax will reduce the regular tax liability, the state income tax deduction is not allowed for AMT purposes. This can greatly diminish the tax savings of prepaying state income tax.

**Example 3.** Hy and Lois Roller report \$350,000 of AGI in 2001. The income consists of \$100,000 of ordinary income and \$250,000 of long-term capital gain from the sale of property held for investment. Hy and Lois prepay an additional \$10,000 of state income tax in December 2001, in addition to their 2001 regular estimated state income tax payments of \$5,000. They also make charitable contributions of \$5,000 during 2001.

Hi and Lois calculate their **2001** regular tax liability as follows:

FORM 1040 REGULAR TAX LIABILITY COMPUTATION		
	Itemized Deductions	Income
Ordinary income		\$100,000
Long-term capital gain		250,000
Adjusted gross income		\$350,000
Less itemized deductions:		
State income taxes	\$15,500	
Charitable contributions	5,000	
Total itemized deductions	\$20,500	
Less phase-out ( $\$350,000 - \$132,950 \times 3\%$ )	(6,512)	(13,988)
line 37 Form 1040		\$336,012
Less exemptions (\$5,800 eliminated by phase-out)		(-0-)
Taxable income		\$336,012
<b>Regular tax liability</b> (using Part IV of Schedule D)		<b>\$ 68,007</b>

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# 2001 Workbook

Hy and Lois next calculated their AMT liability as follows:

## COMPUTATION—AMT LIABILITY

	Adjustments	Income
Taxable income before exemptions (line 37, Form 1040)		\$336,012
Plus adjustments and preferences		
Taxes—Schedule A	\$15,500	
Total adjustments and preferences		15,500
Less itemized deductions limitation—Schedule A		(6,512)
Alternative minimum taxable income		\$345,000
Less AMT exemption (\$49,000 reduced by partial phase-out)		(250)
Alternative minimum tax base		\$344,750
Tentative minimum tax (using capital gains rates)		74,635
Less regular income tax liability		(68,007)
<b>Alternative minimum tax</b>		<b>\$ 6,628</b>

**Example 4.** Hy and Lois, from Example 3, observe from the above calculation of AMT liability, that they were not allowed to deduct the state income taxes they paid in 2001. They want to know what, if any, tax benefit they received by prepaying \$10,000 on state income tax in December, 2001.

They recalculate their regular tax liability **without** deducting the \$10,000 of state income taxes paid in December, 2001.

## FORM 1040 REGULAR TAX LIABILITY COMPUTATION

	Itemized Deductions	Income
Ordinary income		\$100,000
Long-term capital gains		250,000
Adjusted gross income		\$350,000
Less itemized deductions:		
State income taxes	\$ 5,500	
Charitable contributions	5,000	
Total itemized deductions	\$10,500	
Less phase-out ( $\$350,000 - \$132,950 \times 3$ percent)	(6,512)	
Less Standard Deduction (greater)		(7,600)
Line 37, Form 1040		\$342,400
Less exemptions (\$5,800 eliminated by phase-out)		(–0–)
Taxable Income		\$342,400
<b>Regular tax liability</b> (using Part IV of Schedule D)		<b>\$ 69,767</b>



# 2001 Workbook

Hy and Lois recalculate their AMT liability as follows:

## COMPUTATION—AMT LIABILITY

	Adjustments	Income
Taxable income before exemptions (line 37, Form 1040)		\$342,400
Plus adjustments and preferences		
Standard deduction	\$7,600	7,600
Alternative minimum taxable income		350,000
Less AMT exemption (\$49,000 eliminated by phase-out)		(–0–)
Alternative minimum tax base		350,000
Tentative minimum tax (using capital gain rates)		76,000
Less regular income tax liability		(69,767)
Alternative minimum tax		\$ 6,233

Therefore, by **prepaying** \$10,000 of state income tax in December, 2001, Hy and Lois reduced their federal tax liability by \$1,365 (\$76,000 – \$74,635). This translates into a 13.65% tax savings rate from the \$10,000 deduction. By paying an extra \$1,365 in federal tax for 2001 and **deferring** the state income tax payment to 2002, Hy and Lois could realize a \$2,700 tax savings in 2002 (if they are in the 27% tax bracket.) The net tax savings by **deferring** the state income tax payment in this scenario would be \$1,335 (\$2,700 in 2002 tax savings less \$1,365 in 2001 tax increase).

**Observation.** If it were possible for Hy and Lois to allocate one-half of the capital gain to 2001 and one-half of the capital gain to 2002 by using an **installment sale**, they could reduce the potential AMT liability to less than \$1,000. This would produce an overall tax savings in excess of \$5,600. However, the economic risk of the installment sale may outweigh the tax detriment associated with including all sales proceeds in 2001.

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## AMT AND FILING STATUS

In some cases it may be advantageous for married couples with AMT liability to compare the aggregate tax liability of married filing jointly status, with the aggregate tax liability of married filing separately status. A 10% rate on capital gains in an unused 15% bracket if filing separately could produce tax savings compared to a 20% rate on a joint return.

**Example 5.** Miles and Spring Aparte have the following income and deductions in 2001:

	Miles	Spring	Total
Salary	\$ 46,000	\$ 20,000	\$ 66,000
Other ordinary income	28,000	6,000	34,000
Long-term capital gain	75,000	75,000	150,000
<b>Total income</b>	<b>\$149,000</b>	<b>\$101,000</b>	<b>\$250,000</b>
Taxes	\$ 11,000	\$ 10,000	\$ 21,000
Contributions	1,200	1,200	2,400
Miscellaneous (after 2% of AGI floor)	2,400	3,400	5,800
<b>Total itemized deductions</b>	<b>\$ 14,600</b>	<b>\$ 4,600</b>	<b>\$ 29,200</b>

# 2001 Workbook

Miles and Spring first calculate their **regular tax liability** by using **married filing jointly rates**:

## FORM 1040 REGULAR TAX LIABILITY COMPUTATION (JOINT)

	Itemized Deductions	Income
W-2 Income		\$ 66,000
Other ordinary income		34,000
Long-term capital gains		150,000
Adjusted gross income		\$ 250,000
Less itemized deductions:		
State and local taxes	\$ 21,000	
Charitable contributions	2,400	
Miscellaneous deductions	\$10,800	
Less 2% AGI	(5,000)	
Total itemized deductions	\$29,200	
Less phase-out ( $\$250,000 - \$132,950 \times 3\%$ )		(3,512)
		(25,688)
Line 37, Form 1040		\$224,312
Less exemptions (\$5,800 reduced by phase-out)		(3,364)
Taxable income		\$220,948
<b>Regular tax liability</b> (using Part IV of Schedule D)		\$ 43,854

Miles and Spring next calculate their **AMT liability** on the **joint return**.

## COMPUTATION—AMT LIABILITY (JOINT)

	Adjustments	Income
Taxable income before exemptions (line 37, Form 1040)		\$224,312
Plus adjustments and preferences		
Taxes—Schedule A	\$21,000	
Miscellaneous itemized deductions—Schedule A	5,800	26,800
Less itemized deductions limitation—Schedule A		(3,512)
Alternative minimum taxable income		\$ 247,600
Less AMT exemption ( $\$49,000$ reduced by partial phase-out)		(24,600)
Alternative minimum tax base		\$223,000
Tentative minimum tax (using capital gain rates)		48,980
Less regular income tax liability		(43,854)
<b>Alternative minimum tax</b>		\$ 5,126

Miles and Spring then calculate their tax liability on separate returns to determine which filing status (MFJ or MFS) is most advantageous.

# 2001 Workbook

**Miles** calculates his separate regular tax liability as follows:

## FORM 1040 REGULAR TAX LIABILITY COMPUTATION (SEPARATE—Miles)

	Itemized Deductions	Income
W-2 income		\$ 46,000
Other ordinary income		28,000
Long-term capital gains		75,000
Adjusted gross income		\$ 149,000
Less itemized deductions:		
State and local taxes	\$ 11,000	
Charitable contributions	1,200	
Miscellaneous deductions	\$5,380	
Less 2% AGI	(2,980)	
Total itemized deductions	\$ 14,600	
Less phase-out ( $\$149,000 - \$66,475 \times 3\%$ )	(2,476)	(12,124)
Line 37, Form 1040		\$ 136,876
Less exemption (\$2,900 reduced by phase-out)		(580)
Taxable income		\$ 136,296
<b>Regular tax liability</b> (using Part IV of Schedule D)		<b>\$ 29,225</b>

**Miles** calculates his separate AMT liability as follows:

## COMPUTATION—AMT LIABILITY (SEPARATE—Miles)

	Adjustments	Income
Taxable income before exemptions (line 37, Form 1040)		\$ 136,876
Plus adjustments and preferences		
Taxes—Schedule A	\$ 11,000	
Miscellaneous itemized deductions—Schedule A	2,400	13,400
Less itemized deductions limitation—Schedule A		(2,476)
Alternative minimum taxable income		\$ 147,800
Less AMT exemption ( $\$24,500$ reduced by partial phase-out)		6,300
Alternative minimum tax base		\$ 141,500
Tentative minimum tax (using capital gain rates)		32,290
Less regular income tax liability		(29,225)
<b>Alternative minimum tax</b>		<b>\$ 3,065</b>

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**Spring** calculates her separate regular tax liability as follows:

FORM 1040 REGULAR TAX LIABILITY COMPUTATION (SEPARATE—Spring)			
		Itemized Deductions	Income
W-2 income			\$ 20,000
Other ordinary income			6,000
Long-term capital gains (none is qualified 5-year gain)			75,000
Adjusted gross income			\$101,000
Less itemized deductions:			
state and local taxes		\$ 10,000	
charitable contributions		1,200	
miscellaneous deductions	\$5,420		
Less 2% AGI	(2,020)	3,400	
Total itemized deductions		\$ 14,600	
Less phase-out (\$101,000 – \$66,475 × 3%)		(1,036)	(13,564)
Line 37, Form 1040			\$ 87,436
Less exemption (\$2,900 reduced by phase-out)			(2,784)
Taxable income			\$ 84,652
<b>Regular tax liability</b> (using Part IV of Schedule D)			<b>\$ 15,156</b>

**Spring** then calculates her separate AMT liability as follows:

COMPUTATION—AMT LIABILITY (SEPARATE—Spring)		
	Adjustments	Income
Taxable income before exemptions (line 37, form 1040)		\$ 87,436
Plus adjustments and preferences		
Taxes—Schedule A	\$10,000	
Miscellaneous itemized deductions—Schedule A	3,400	13,400
Less itemized deductions limitation—Schedule A		(1,036)
Alternative minimum taxable income		\$ 99,800
Less ATM exemption (\$24,500 reduced by partial phase-out)		(18,300)
Alternative minimum tax base		\$ 81,500
Tentative minimum tax (using capital gain rates)		15,395
Less regular income tax liability		(15,156)
<b>Alternative minimum tax</b>		<b>\$ 239</b>

After all calculations are completed, Miles and Spring compare their total liability using MFJ rates versus using MFS rates.

	MFS-Miles	MFS-Spring	Total MFS	MFJ
Regular Tax	\$29,225	\$15,156	\$44,381	\$43,854
AMT	\$ 3,065	\$ 239	\$ 3,304	\$ 5,126
<b>Total Tax</b>	<b>\$32,290</b>	<b>\$15,395</b>	<b>\$47,685</b>	<b>\$48,980</b>

**Conclusion for Example 5. Miles and Spring realize \$1,295 in tax savings by filing separately.** Even though the regular tax liability is greater by filing separately, the reduction in AMT liability more than offsets the regular tax increase.

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## SUMMARY

Careful tax planning is advised when taxpayers are potentially exposed to an AMT liability. Using the following tax planning techniques may reduce potential AMT liability:

- Employee business expenses should be reimbursed by employers who establish accountable plans.
- Large long-term capital gains could be spread over several years.
- Analyze selecting married separate as opposed to married filing jointly if long-term capital gains are realized.

## ISSUE 9: REVERSE EXCHANGES

Prior to Rev. Proc. 2000-37, exchangers and qualified intermediaries were concerned about “reverse” exchanges, where the closing date for the purchase of the replacement property occurred prior to the closing date for the sale of the relinquished property. **Rev. Proc. 2000-37 provides “safe harbors”, that, if followed, will allow the acquisition of the replacement property prior to the sale of the relinquished property.**

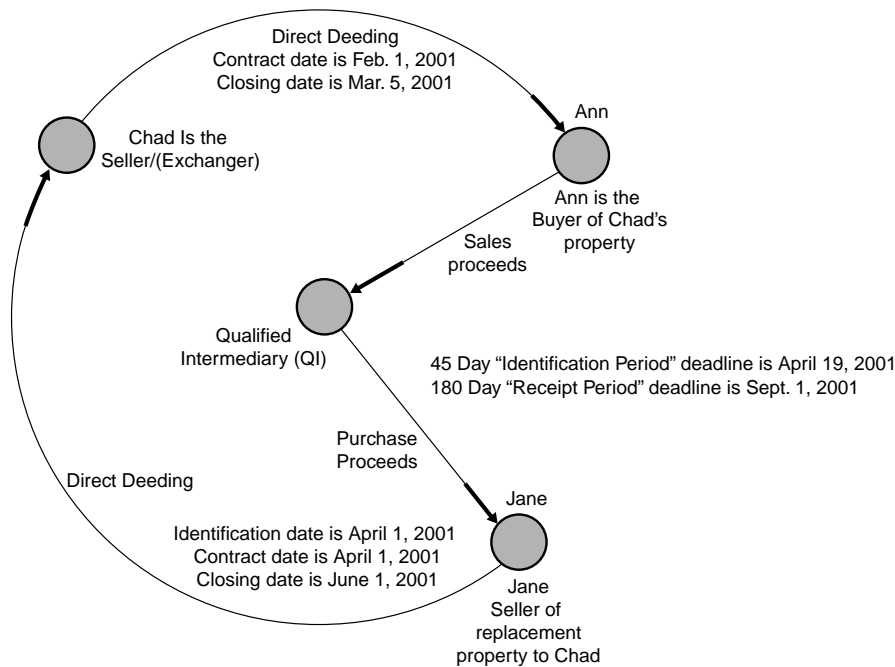
Rev. Proc. 2000-37 is effective for acquisitions of property **on or after September 15, 2000.**

Terminology Changes	Regular Exchange	Reverse Exchange
A	Qualified intermediary (QI)	Exchange accommodation titleholder (EAT)
B	Exchange agreement	Qualified exchange accommodation arrangement (QEAA)

In order to better understand a reverse exchange, a review of a **regular exchange** is shown in Chart 1 below. The closing date of the relinquished property triggers the 45-day identification period and the 180 day exchange period for the replacement property. **The 45-day and 180-day periods start the day *after* the closing date for the sale of the relinquished property.**

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## CHART 1—REGULAR EXCHANGE



**Practitioner Note.** See pages 543–45 in the *2000 Farm Income Tax School Workbook* for more details on the 45-day and 180-day rules specified by I.R.C. §1031.

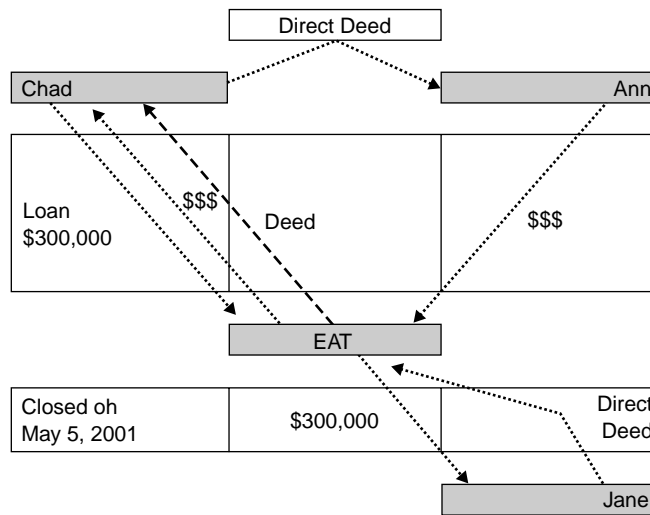
The fact that a contract has been negotiated for the purchase of the replacement property prior to the sale of the relinquished property will not preclude a tax-deferred exchange result. A seller who has entered into a contract to sell the relinquished property may still enter into an exchange of that property, if **an exchange agreement is entered into prior to closing**. On the other side of the exchange, the seller of the relinquished property may enter into a contract to purchase the replacement property prior to closing on the sale of the relinquished property.

Chart 2 (below) illustrates the timing sequence, parties, and logistical issues of a **reverse exchange**. A reverse exchange is more complex than a regular exchange and is more difficult to complete.

## CHART 2—REVERSE EXCHANGE

- The identification date for the property to be sold by Chad is April 1, 2001.
- The 45-day "Identification Period" deadline is April 19, 2001 (midnight).
- The closing date of the sale of Chad's relinquished property to Ann is June 1, 2001.
- The 180-day "Receipt Period" deadline is September 1, 2001 (midnight).

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The most significant difference between a regular and reverse exchange is that in the latter, the Exchange Accommodation Titleholder (EAT) **must** take title to the replacement property.

Revenue Procedure 2000-37 defines the exchange accommodation titleholder (EAT) as:

“a person who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90% percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax.”

1. Chad, the seller, lends funds to the exchange accommodation titleholder (EAT) for the purpose of the acquisition of the replacement property. In many cases, unrelated LLCs are being used as the EAT. In others, title companies or other facilitators are serving as the EAT.
2. The EAT then enters into a contract purchase, and subsequently closes, on the purchase of Jane’s property. The EAT now owns the replacement property.
3. Rev. Proc. 2000-37 provides that no later than 5 business days after the title to the **replacement property** has passed to the EAT, Chad, the seller, and the EAT must enter into a “qualified exchange accommodation arrangement” (QEAA). Assuming a March 5, 2001, closing date for the purchase of Jane’s property, the QEAA must be entered into by midnight, March 12, 2001.
4. Rev. Proc. 2000-37 provides that no later than 45 days after the title to the replacement property has passed to the EAT, the **property to be relinquished** must be identified. Therefore Chad has until midnight April 19, 2001, to identify the property he intends to sell.

**Practitioner Note.** The 5 business day and the 45-day identification requirements run concurrently.

In this example, Chad, by written notice to his EAT, identified the property to be sold on April 1, 2001, well within the 45-day period, which ended on April 19.

Rev. Proc. 2000-37 provides that no later than 180 days after the title to the replacement property has passed to the EAT, the property to be relinquished is transferred to a person (in this case, Ann) who is not the taxpayer (Chad) or a disqualified person. In this example, the closing date for the sale of Chad’s relinquished property to Ann occurred on June 01, 2001, well within the 180-day period. The 180-day period would have expired at midnight on September 1.



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In the example, Chad, through the EAT, closed on the sale of his relinquished property with Ann. At closing, the EAT directly deeded title to Chad's relinquished property to Ann. In return, the EAT received Ann's purchase proceeds into escrow for the eventual benefit of Chad.

**Practitioner Note.** The combined time period that the relinquished property and the replacement property can be held in a qualified exchange arrangement (QEAA) by the EAT cannot exceed 180 days.

As of the closing date for the sale of Chad's relinquished property to Ann, the EAT has possession of:

1. Title to the replacement property (acquired from Jane)
2. The escrowed net sales proceeds of the relinquished property (acquired from Ann)
3. A note payable to Chad evidencing the original \$300,000 loan Chad lent to the EAT

**The final leg of the reverse exchange is the transfer by the EAT of the three items above to Chad.** As indicated previously, the transfer of the replacement property by the EAT to Chad and the transfer of the relinquished property to Ann must occur by midnight September 1, in order to satisfy the 180-day requirement.

## CONCLUSION

**Regular exchanges continue to be the norm, with reverse exchanges being utilized in exceptional situations.** Due to financing issues, EAT's are not usually willing to take on the costs or liability issues of borrowing large amounts of money in order to acquire the replacement property for the exchange. **As a result, reverse exchanges are more likely to occur when the exchanger is a high income, high net worth individual who actually loans the needed acquisition funds to the EAT.** Reverse exchanges allow a property owner, who owns highly appreciated real estate, to acquire the replacement property first, something that was previously not possible under the regular exchange rules.

**Practitioner Note.** Rev. Proc. 2000-37 specifically states that no inference is intended with respect to the federal income tax treatment of arrangements similar to those described in the Rev. Proc. that were entered into **prior** to the effective date September 15, 2000. The Rev. Proc. also indicates that certain transactions can still be accomplished outside the "safe harbors," and presumably still qualify for reverse exchange treatment. Therefore, it is possible that reverse exchanges that occurred **prior** to September 15, 2000, that do not specifically follow the "safe harbor" guidelines **might** still be accepted by the IRS in exam situations.